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IRS Expatriation Guidance Is Helpful, But Also Overreaches

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The Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 substantially modified the treatment, under the Internal Revenue Code (the "Code"), of persons who expatriate from the United States on or after June 17, 2008. New §§877A and 2801,[1] along with modifications to existing sections, implemented a novel regime of deemed-sale treatment and post-expatriation income and transfer taxes. Guidance implementing the statutory provisions was needed, and the Internal Revenue Service issued Notice 2009-85 (the "Notice")[2] on October 15, 2009, to provide interim guidance pending the issuance of Treasury regulations.

The Notice provides welcome and detailed guidance on the income tax issues at hand. Guidance as to transfer tax issues is postponed. The guidance is generally in line with the new and revised Code provisions, and fleshes out the statutes in a reasonable manner. However, there are some areas where the IRS provided rules that exceed statutory authority. This article is not intended as a comprehensive overview of the combined statutory provisions and the Notice guidance. Instead, it focuses on the areas where the guidance adds to (or differs from) the Code provisions.

INDIVIDUALS COVERED

The expatriation provisions apply only to "covered expatriates." Covered expatriates are individuals who exceed the five-year annual net income thresholds or net worth threshold of §877(a)(2) *or* who cannot certify, under penalties of perjury, compliance with all U.S. federal tax obligations for the five taxable years preceding the taxable year that includes the expatriation date.[3]

The Notice provides that taxpayers who are not covered expatriates under the net income or net worth tests will still be considered covered expatriates *unless* they make the required certification of federal tax compliance on a timely filed Form 8854 for their taxable year that includes the day before the expatriation date.[4] This filing requirement can be a trap for the unwary low-income/low-net-worth expatriate who may believe he or she has no Form 8854 filing requirement. The Notice also clarifies that the testing date under the net income and net worth tests is the "expatriation date." [5]

MARK-TO-MARKET REGIME

Property Covered

Covered expatriates are treated as having sold all of their property for fair market value on the day before the expatriation date (subject to some statutory exclusions).[6] The statute does not define what property is considered property of the expatriate for this purpose. The Notice fills the gap.

It does so first by subjecting to the deemed-sale treatment "any interest in property" of the covered expatriate — a subtle difference from the mere use of the term "property" in §877A(a)(1).[7] It then borrows from the federal estate tax rules to define an "interest in property" as that which would be taxable as part of the expatriate's gross estate for federal estate tax purposes if the expatriate had died on the day before the expatriation date while a citizen or resident of the United States.[8] Such gross estate inclusion cannot be

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[1] All section ("§") references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[2] 2009-45 I.R.B.

[3] §877A(g).

[4] Notice 2009-85, §2.A.

[5] *Id.* This is the date of relinquishment of U.S. citizenship or, in the case of a long-term U.S. resident who is subject to the expatriation rules, the date on which he or she ceases to be a lawful permanent resident of the United States under §7701(b)(6).

[6] §877A(a)(1), subject to the exclusions of (a)(3).

[7] Notice 2009-85, §3.A.

[8] *Id.* Presumably the Notice for this purpose intends to apply

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reduced by credits that are allowable for federal estate taxes under §§2010–2016.[9]

In principle, determining ownership of property using the estate tax rules is a useful mechanism for providing greater certainty, because the issue of what is a decedent's "property" has far more official guidance and judicial precedent in the estate tax arena than in the income tax arena. Nonetheless, the Notice engages in some overreaching.

Chapter 11 of the Code (the federal estate tax provisions) brings into a decedent's gross estate numerous assets that are not actually owned by the decedent, for the purpose of protecting the transfer tax base. For example, §2036 will include in a decedent's gross estate property that was gifted away but for which the decedent retained the right to designate the person who will enjoy or possess the property or its income. If the transferee of that property sold that property before the transferor expatriated, the expatriate, if living at the time, would not have been subject to income tax on any resulting gain or loss in many instances. By drawing in assets under the "string" provisions of the estate tax rules (among others), the Notice will subject to income tax many gains that never would have been taxable to the expatriate if the expatriate had remained in the United States.

This is not authorized by the statute, and is not appropriate. Section 877A is an income tax provision, after all, and is partly an attempt to protect the income tax base of the United States by taxing the expatriate on appreciated assets via a deemed sale. There is no policy justification for extending this deemed-sale treatment to assets on which the expatriate never would have been taxable if he or she had remained in the United States.

There is a possible remedy for this policy lapse when the Treasury Department incorporates the Notice into Treasury regulations. That remedy would be to limit the use of the Chapter 11 principles in defining property to include only such property as is in a decedent's gross estate under §2031, and/or only property that would otherwise be subject to income taxation to the expatriate if it had been disposed of in a gain/loss recognition transaction on the day before the expatriation date.

The overreaching continues in the Notice where it provides that a covered expatriate also is deemed to own for purposes of the deemed-sale rules "his or her beneficial interest(s) in each trust. . .that would *not* constitute part of his or her gross estate" under the preceding rules.[10] By this rule, the covered expatriate's beneficial interests in nongrantor trusts that are excluded from his or her gross estate are included in the deemed sale. This contradicts §877A(c)(3). It may be that the intent is to subject these non-gross-estate trust interests only in the case of trusts that are not otherwise nongrantor trusts under §§877A(c)(3) and (f)(3), and the Notice includes some language that suggests such a reading. Therefore, the IRS should revisit this provision of the Notice and expressly limit it to the particular situation it has in mind, clarify that the provision does not apply to nongrantor trusts subject to §877A(f)(3), and/or otherwise restrict it, because presently its scope is at best not clear and at worst substantially beyond the statutory scope.

Fair Market Value

The Notice also defers to estate tax principles in determining "fair market valuation."[11] This again makes good policy sense. The Notice does not allow the tax that will be imposed on the deemed sale to be taken into account in determining fair market value, and excludes §§2032 and 2032A from affecting value, as well as the deductions allowed in computing estate taxes under §§2055, 2056, 2056A and 2057. Again, this is not objectionable. What is objectionable is that the Notice will apply the special valuation rules of §2701 through 2704 as if there were transfers being made to family members. First, most of those provisions have no application to income taxes, and there is no authority for bringing them in here. It is one thing to use a general definition of fair market value under the estate tax rules for a deemed income tax sale; such correlation of fair market value between the income tax rules and the transfer tax rules has been otherwise established.[12] It is another to use provisions that were intended to protect the transfer tax base to modify definitions of value in an income tax scenario. Second, the IRS is engaging in cherry picking — excluding estate tax Code provisions that can reduce fair market value, while including those that increase fair

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the estate tax definition of "residency" (which is based on U.S. *domicile*) and not the income tax definition based on green card possession or the substantial presence test of §7701(b). Otherwise, those expatriates who were resident aliens for income tax purposes under §7701(b) would nonetheless be subject to the gross estate inclusion of only U.S. situs assets under the estate tax rules if they were otherwise not domiciled in the United States prior to expatriation. It is unlikely that the Notice intends to subject only the U.S. situs assets of such expatriates to the deemed-sale rules.

[9] *Id.*

[10] Notice 2009-85, §3.A (emphasis added).

[11] *Id.*

[12] Both the income tax rules and the transfer tax rules use the same "willing buyer — willing seller" standard for fair market value. Regs. §20.2031-1(b); Regs. §25.2501-1; *U.S. v. Campbell*, 897 F.2d 1317 (5th Cir. 1990); *Peck v. Comr.*, 752 F.2d 469 (9th Cir. 1985); *Andrews v. Comr.*, 135 F.2d 314 (2d Cir.), *cert. denied*, 320 U.S. 748 (1943); *Charter Co. v. U.S.*, 90-2 USTC ¶50,424 (M.D. Fla. 1990); *Drybrough v. Comr.*, 45 TC 424 (1966); *C.G. Meaker Co. v. Comr.*, 16 T.C. 1348 (1951); *Beltzhoover v. Comr.*, T.C. Memo 1991-493; *White v. Comr.*, T.C. Memo 1976-382.

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market value. Lastly, it applies these rules based on an assumption of a transfer of interests to applicable family members. What basis or authority does that come from?[13] What if the expatriate has no applicable family members?

EXCEPTIONS AND ADJUSTMENTS

Excludible Income

Section 877A(a)(3) excludes from the income arising from the deemed sale an amount equal to $600,000 (adjusted for inflation). The Code does not provide for how to allocate the exclusion amount among deemed sale gains. The Notice allocates the exclusion amount among the gain assets, in proportion of the gain incurred by each to the total gain incurred by all.[14] This is relevant for purposes of determining the character of each gain. For example, an expatriate will not be able to allocate the gain exclusion primarily or exclusively among ordinary income assets (so as to maximize capital gains that are taxed at lower rates).

If an expatriate subsequently becomes a U.S. citizen, or U.S. resident alien, and then expatriates *again*, the exclusion available the second (or subsequent) time is limited to the unused exclusion from the first expatriation.[15] While this may cut down on tax manipulation transactions (i.e., becoming a U.S. resident alien and then expatriating to reduce gain subject to U.S. tax through applying multiple exclusion amounts), the statute is silent and probably is more supportive of a *per expatriation* exclusion rather than one lifetime total exclusion.

Losses

The examples in the Notice confirm that any losses arising from the deemed sale can offset other gains or be deducted against other income for the taxable year ending on the day before the expatriation date to the extent normally allowed under the Code (but excluding the application of §1091 wash sale rules).[16]

Adjustments to Basis as a Result of Deemed Sale

Section 877A(a) indicates that a "proper adjustment" shall be made for property subject to the mark-to-market rules (for purposes of later gain or loss computations involving that property and other tax purposes). The Notice implements this by providing that the basis of the property deemed sold will be adjusted up or down in accordance with the amount of gain or loss incurred on the deemed sale.[17] According to the Code, the upward adjustment will be equal to the full amount of the built-in gain of an asset, even though some of the gain may be excluded from gross income by allocation of the $600,000 exclusion amount (as adjusted for inflation).[18] As a practical matter, these adjustments to basis will only have relevance to assets that are taxable upon disposition in the hands of a nonresident alien expatriate and to assets subject to depreciation deductions in the United States, such as U.S. real property interests and U.S. trade or business assets.[19]

Adjustments to Basis for Nonresident Aliens Becoming Resident Aliens

When nonresident aliens become U.S. resident aliens for income tax purposes, generally there is no adjustment to the basis of assets owned by them at that time. However, §877A(h)(2) provides that, solely for purposes of determining tax under §877A(a), property held by an individual on the date that individual first became a U.S. resident (within the meaning of §7701(b)) is treated as having a tax basis of not less than its fair market value on that date, absent an irrevocable election to the contrary. The Notice favorably allows the cost-basis election to be made on an asset-by-asset basis.[20]

The Notice further provides that the election is made on a Form 8854 filed with the covered expatriate's federal income tax return for the taxable year that includes the day before the expatriation date. This is favorable to taxpayers, as it requires the election to be made after expatriation and not at the time the taxpayer became a U.S. resident alien.

The Notice excludes from such basis step-up any U.S. real property interests and U.S. trade or business property owned by the nonresident alien at the time he or she became a U.S. resident alien.[21] Clearly, the purpose of this exclusion is to avoid the ultimate exclu-

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[13] The Notice also overreaches when it applies gift tax valuation rules to interests in nongrantor trusts that are subject to the deemed sale rules, "without regard to any prohibitions or restrictions on such interest." Again, on what basis can the IRS exclude prohibitions or restrictions that would otherwise impact valuation — especially for those that are allowable in determining value for gift tax purposes?

[14] Notice 2009-85, §3.B.

[15] *Id.*

[16] *Id., Ex. 1.*

[17] *Id.*, §3.C.

[18] *Id.*

[19] Such basis adjustments may also be relevant if the expatriate becomes a U.S. citizen or resident alien in the future, or transfers the asset in a carryover basis scenario to a U.S. taxpayer.

[20] Notice 2009-85, §3.D.

[21] *Id.* The Notice would allow the step-up in basis in the case of a U.S. resident who had beforehand been a resident of a U.S. treaty country as to property such individual used or held for use in connection with the conduct of a U.S. trade or business that was

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sion of built-in gain that would be eventually taxable to the taxpayer, even if he or she had never become a U.S. resident. The Notice provides that the IRS is providing this exception in exercise of its regulatory authority. As §877(h)(2) provides for no such exception from basis step-up, it is questionable whether the IRS has the authority to make such exceptions under the grant of regulatory authority provided under §877A(i).

Election to Defer Tax

Section 877A(b) allows a covered expatriate to defer U.S. taxes on the deemed sale until the subject property is disposed of. This deferral is subject to the imposition of interest, the provision of adequate security, and the waiver of applicable treaty benefits. The Notice provides detailed implementation rules on how a taxpayer can obtain deferral.[22]

The election is made on an asset-by-asset basis. The taxpayer can pay the deferred tax and interest at any time.[23] Interest is computed at the §6621 underpayment rate, compounded daily, from the initial due date of the return (without extensions) for the taxable year that includes the day before the expatriation date.[24] The taxpayer must enter into a tax deferral agreement with the IRS, and a template of an agreement is provided in the Notice.[25] The taxpayer must also enter into an agreement with a U.S. agent for the agent to accept on behalf of the taxpayer IRS communications relating to the tax deferral agreement.

A taxpayer elects to defer tax by filing a deferral request with the IRS at the address provided in the Notice by the due date of the return for the taxable year that includes the day before the expatriation date. The application must include: (1) two signed copies of the template agreement; (2) a description of the elected assets; (3) a calculation of the tax relating to such assets; (4) documentation regarding the security to be offered; (5) a copy of the agreement with a U.S. agent; and (6) a copy of the tax return for the taxable year that includes the day before the expatriation date. The taxpayer also attaches a copy of the request with the tax return for the taxable year that includes the day before the expatriation date. If the IRS accepts the security, it will sign the agreement.

The deferred tax is computed at marginal rates. To determine the amount of the deferred tax, the taxpayer first computes his or her tax liability for the year that includes the deemed sale with and without the gain attributable to all assets that are marked-to-market (including the assets for which deferral is sought). This aggregate tax difference is then allocated to assets for which an election is sought based on the ratio of the gain on such assets to the total gain on all assets that are marked-to-market.

The agreement provides for periodic renewal. If the IRS subsequently determines that the security is inadequate, the expatriate will have to pay the deferred tax and interest immediately, subject to a 30-day period to provide additional security after IRS notice.[26]

Coordination with Various Code Provisions

Section 877A(h)(1)(A) provides for the termination of any period for acquiring property that would reduce the amount of the taxpayer's gain recognition with respect to the property. This period terminates on the day before the expatriation date. The Notice explains that this includes transactions such as deferred like-kind exchanges and involuntary conversions.[27]

Section 877A(h)(1)(B) provides for the termination of any extension of time to pay tax as of the day before the expatriation date. The Notice confirms the application of this rule to gain recognition agreements under §367(a).[28]

Deferred Compensation Items

Section 877A(d) has special provisions relating to the taxation of deferred compensation items under the mark-to-market rules. These rules impose a 30% withholding tax on distributions subsequently made on or out of "eligible deferred compensation items," and treat most other deferred compensation items as having paid out the present value of the expatriate's accrued benefit on the day before the expatriation date.

The Notice provides useful guidance with respect to these statutory rules. The guidance includes: (1) clarification of how the rules apply to §83 items;[29] (2) identification of the items of deferred compensation that are covered by the rules;[30] and (3) definitions of "property," "stock appreciation rights," "restricted stock units," and "substantially vested."[31]

The Notice indicates that separate guidance will be issued under §877A(d)(3)(A) for a non-U.S. payor

not carried on through a U.S. permanent establishment under that treaty.

[22] Notice 2009-85, §3.E.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*, §4.

[28] *Id.*

[29] *Id.*, §5.B.(1).

[30] *Id.*, §5.B.(4).

[31] *Id.*, §5.B.(5)–(7).

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electing to be treated as a U.S. person so that a deferred compensation item can qualify as an "eligible deferred compensation item." [32]

In regard to ineligible deferred compensation items, the payor is required to provide to the expatriate a statement of what is the present value of his or her accrued benefit within 60 days of receipt of a Form W-8CE.[33] The Notice also provides special rules for calculating the present value in regard to various types of deferred compensation items, such as defined contribution plans, defined benefit plans, and other items.[34]

Section 877A(d)(2)(B) provides that no early distribution tax applies to the deemed distribution that occurs on ineligible deferred compensation items. The Notice clarifies that such taxes include taxes that would be imposed on early distributions under §72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), or 530(d)(4).[35] The Notice also provides that a taxpayer will be able to avoid double tax on such deemed distributions by increasing his or her investment in the contract for §72 purposes or by making other appropriate adjustments.[36]

Section 877A(d)(5) provides that these rules will not apply to any deferred compensation item to the extent it is attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States. The Notice provides that, until further guidance is issued, taxpayers may use any reasonable method of making this determination, consistent with existing guidance, that is based on a reasonable and good faith interpretation of these rules.[37]

In regard to the required 30% withholding on distributions from or of eligible deferred compensation items, if the payor does not withhold, the expatriate must report the distributions on a U.S. tax return and pay the tax.[38]

The Notice provides that, pending further guidance, employers and plans need not withhold income taxes with respect to the deemed distribution of an expatriate's accrued benefit. Instead, the expatriate is to report the deemed distribution on his or her tax return for the taxable year that includes the day before the expatriation date.[39] Also, until further guidance is issued, FICA and FUTA taxation of deferred compensation items is to be determined without regard to §877A.

Specified Tax Deferred Accounts

Certain specified tax deferred accounts are not subject to the mark-to-market rules.[40] Instead, the expatriate is taxed as if he or she received the entire balance of the account on the day before the expatriation date.[41] So that the expatriate can determine the tax consequences, the Notice requires that the custodian of the account advise the expatriate of the amount of the expatriate's entire interest in the account within 60 days of receiving a Form W-8CE from the expatriate.[42]

Section 877A(e)(1)(C) provides that an appropriate adjustment must be made to subsequent distributions to account for the early distribution treatment. The Notice provides an example: In the case of distributions taxable under the §72 annuity rules, the amount the expatriate includes in gross income on the deemed distribution is treated as an additional investment in the contract under §72.[43]

Nongrantor Trust Interests

Section 877A(c)(3) exempts covered expatriate interests in nongrantor trusts from the mark-to-market rules. The Code further provides that nongrantor trust status is determined on the day before the expatriation date, that the trustee must withhold 30% of the taxable portion of subsequent distributions to the expatriate, and the trust must recognize gain on the distribution of appreciated property to the expatriate.

The Notice provides a definition of beneficiary for this purpose. An expatriate is considered a beneficiary if the expatriate: (1) is entitled to receive (directly or indirectly) a distribution of trust income or corpus (including a distribution in discharge of that person's obligations); (2) has the power to apply trust income or corpus for the expatriate's own benefit; or (3) would receive trust income or corpus if the current interests in the trust were then terminated.[44]

Creating a rule not found in the statute, the Notice provides that if a nongrantor trust later becomes a grantor trust of which the covered expatriate is treated

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[32] *Id.*, §5.B.(2).

[33] *Id.*, §5.D.

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Id.* Such existing guidance includes Regs. §1.861-4(b)(2); Rev. Rul. 79-388, 1979-2 C.B. 270; and Rev. Proc. 2004-37, 2004-26 I.R.B. 1099.

[38] Notice 2009-85, §5.F.

[39] *Id.*

[40] §877A(c)(2).

[41] §877A(e)(1)(A).

[42] Notice 2009-85, §6.

[43] *Id.*

[44] Notice 2009-85, §7.A.

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as the owner, then the conversion is treated as a taxable distribution under these rules.[45]

The Notice points out that if a foreign trust incurs a capital gain under these rules relating to the distribution of appreciated property to an expatriate, and that capital gain is included in distributable net income (DNI) and carries through to the expatriate, the 30% withholding tax still applies. This is because the tax is imposed not on whether the expatriate is subject to tax on the distributed gain under Subchapter J, but rather on whether the expatriate *would have been* taxed on the distribution if he or she had been a U.S. citizen or resident alien at the time of distribution.[46]

The Notice provides that any tax imposed under these rules that is not collected by the trustee must be reported and paid by the expatriate. It further provides that a covered expatriate must notify the trustee of his or her covered expatriate status by delivering a Form W-8CE to the trustee on the earlier of: (1) the day before the first distribution on or after the expatriation date; or (2) 30 days after the expatriation date.[47]

Section 877A(f)(4)(B) treats the expatriate as waiving any treaty rights to reduced withholding on distributions from the nongrantor trust, unless the expatriate agrees to such other treatment as the Secretary provides. In exercise of this discretion, the Notice allows an expatriate to opt out of the waiver of treaty benefits by electing on Form 8854 to be treated as having received the value of his or her interest in the trust on the day before the expatriation date.[48] To use this procedure, the taxpayer must obtain a letter ruling from the IRS as to the value of his or her interest in the trust at that time. If a value cannot be determined, then this procedure is not available.

FILING AND REPORTING REQUIREMENTS

Income Tax Returns

The Notice requires the covered expatriate to file a dual-status return for the year of expatriation, unless the expatriation date is January 1.[49] This obligates the expatriate to file a Form 1040NR (covering the period the taxpayer is taxable as a nonresident alien) with a Form 1040 attached as a schedule (covering the period the taxpayer was a U.S. person for income tax purposes).

In subsequent years, the Notice obligates the covered expatriate to file a Form 1040NR when required by Regs. §1.6012-1(b). Under those regulations, if the covered expatriate is fully withheld upon at source for a particular taxable year and has no effectively connected income in that year, then no Form 1040NR is required.[50]

Form 8854

A covered expatriate must file a Form 8854 with his or her Form 1040 or 1040NR for the expatriate's taxable year that includes the day before the expatriation date.[51] It will be timely filed if it is filed by the due date (with extensions) for the applicable Form 1040 or 1040NR.

As noted above, expatriates who are not covered expatriates because they do not meet the income or net worth thresholds for covered expatriate status must still file a Form 8854 to certify their compliance with all federal tax laws during the preceding five years.[52] Failure to make that certification results in the taxpayer being treated as a covered expatriate.

The Form 8854 also covers various waivers and elections, including the initial waiver of treaty benefits for eligible deferred compensation items and annual reporting requirements, to certify no distributions or to report distributions from nongrantor trusts, to make an election to preserve treaty benefits with regard to nongrantor trusts, to elect not to apply the inbound step-up-in-basis rule, and to elect to defer tax on the deemed sale of property. Some of these items require additional Form 8854 filings in subsequent years.

Form W-8CE

A covered expatriate with a deferred compensation item, a specified tax deferred account, or an interest in a nongrantor trust is required by the Notice to deliver a Form W-8CE to the relevant payor.[53] The Form must be delivered by the earlier of: (1) the day before the first distribution on or after the expatriation date; or (2) 30 days after the expatriation date (with an extension for expatriation dates before the publication date of Form W-8CE).

GIFTS OR BEQUESTS TO U.S. PERSONS

Section 2801 imposes federal transfer taxes on gifts and bequests to U.S. persons by a covered expatriate.

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[45] *Id.*

[46] Notice 2009-85, §7.B.

[47] Notice 2009-85, §7.C.

[48] *Id.*, §7.D.

[49] *Id.*, §8.B.

[50] *Id.*

[51] *Id.*, §8.C.

[52] *Id.*

[53] *Id.*, §8.D.

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The Notice provides that the deadline for reporting, and for satisfying tax obligations related to, covered gifts or bequests received will be deferred, pending the issuance of guidance.[54] This deferral of *tax* is quite unusual. Presumably, when guidance is issued, interest on deferred tax will be applicable.

[54] *Id.*, §9.

CONCLUSION

The Notice provides welcome guidance to covered expatriates and their advisors. While in most instances the Notice acts within the scope of the Code's expatriation provisions, at times it includes rules that appear beyond that scope. Hopefully, the IRS will give due consideration to these areas when revising the Notice or writing the regulations.

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