

# **EXPATRIATE GAMES - New Sections 877A and 2801**

ABA Section of Taxation  
Committee on U.S. Activities of  
Foreigners and Tax Treaties

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# Panel

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# Introduction

- The United States, uniquely, fully taxes its citizens on their worldwide income and estates irrespective of residence or domicile
- Because nonresident aliens pay U.S. tax only on U.S. related income and assets, expatriation (loss of citizenship and residence) generally results in lower tax burden
- Legislation concerning individual expatriation first enacted in 1966 (FITA)
- Basic approach: 10-year expanded U.S. income and estate tax base for nonresident aliens whose loss of U.S. citizenship had principal purpose of tax avoidance

# 12 Years of Changes

- In 1995, Congress, prompted by President Clinton, became concerned that FITA regime ineffective
- From 1996 to 2008, Congress enacted three major revisions to taxation of expatriates
  - ◆ 1996 (HIPAA) – Added presumption of tax avoidance if 5-year average net income tax exceeds \$100,000 or net worth is \$500,000 or more; extended rules to former “long-term residents”; tightened compliance and reporting
  - ◆ 2004 (AJCA) – Eliminated tax avoidance test; increased tax and net worth thresholds to \$124,000 and \$2,000,000; added short-term residence rule for aliens spending more than 30 days in U.S. in any of 10 years following expatriation
  - ◆ 2008 (HEART) – Replaced existing regime with “mark-to-market” tax; added succession tax on gifts/bequests to U.S. persons, directly or via trusts

# Forthcoming Guidance

- IRS working on extensive Notice on section 877A – Bill Yates is principal drafter
  - ◆ Guidance is expected imminently
  - ◆ Expect significant redraft of IRS Form 8854
- Separate Notice on section 2801 – Kathy Mellody is principal drafter
  - ◆ Guidance also expected soon, possibly concurrently with section 877A Notice
  - ◆ Expect new IRS form for section 2801 succession tax

# Mark-to-Market Rules – Section 877A

- Exit Tax -
  - ◆ Applicable to expatriations occurring on or after June 17, 2008
  - ◆ Under section 877A, mark-to-market regime replaces prior 10-year “alternative tax” on U.S. source income under section 877
  - ◆ A “covered expatriate” is deemed to sell all worldwide property for FMV on day before expatriation date and is taxed on gains >\$600,000 (indexed post-2008)
  - ◆ Section 877A does not address character. Unclear how \$600,000 exclusion to be allocated among different classes of assets, gain on which may be subject to varying tax rates (e.g., capital gain vs. collectibles gain)
    - Presumably, allocation will be pro rata across income classes

# “Covered Expatriate” Defined

- “Covered Expatriate”
  - ◆ Same income tax liability/net worth standards apply
    - Average annual net income tax of > \$145,000 (for 2009) for the five tax years preceding expatriation. Rev. Proc. 2008-66
    - Net worth \$2 million or more at date of expatriation (not indexed for inflation)
  - ◆ 5-year tax compliance certification still required
  - ◆ Exceptions for certain dual citizens at birth who have not met “substantial presence” test more than 10 of 15 prior years and who continue to be citizens of and taxed by other country, and persons under 18½ who relinquish U.S. citizenship and have not met “substantial presence” test for more than 10 years before date of relinquishment
    - No similar exception for children who were long-term resident green card holders.

# Adjustments Under Section 877A

- “Proper adjustment” made for any gain or loss subsequently realized on property deemed sold to account for gain or loss on deemed sale (determined w/o regard to the \$600,000 exclusion)
  - ◆ Will this be basis adjustment? Property specific?
  - ◆ Adjustment generally of limited value to expatriates with respect to most property, as such persons will be nonresidents not subject to U.S. tax on subsequent sales
  - ◆ But, e.g., USRPI adjustments continue to be valuable
- Limited basis step-up for property owned by person when first becoming U.S. resident under section 7701(b) (including residency based on substantial presence though section 877A applies only to green card holders)
  - ◆ Solely for purposes of exit tax, basis stepped-up to FMV on residency starting date
  - ◆ Expatriate can irrevocably elect out of basis adjustment



# Valuation Issues Under Mark-to-Market Regime

## ■ Determining Value

- ◆ Are qualified appraisals required? (they were not under prior rules but valuation then was significant only for purposes of net worth test)
- ◆ Are discounts available?
- ◆ Joint ownership interests and community property
  - 50/50 (or other pro rata allocation) where unilaterally severable, or pursuant to state law for community property
  - Actuarial computations required where not unilaterally severable (i.e., TBE properties). This issue significant where one spouse is covered expatriate but other is not
  - Can expatriating spouse transfer interest to non-expatriating spouse and thereby avoid the mark-to-market regime as to transferred assets?

# Election to Defer Tax

- Covered expatriate can irrevocably elect to defer payment on specified assets until actual sale or exchange, failure of security, or death
  - ◆ Must provide “adequate security”
  - ◆ Must irrevocably waive U.S. tax treaty benefits
  - ◆ Interest accrues on unpaid tax at underpayment rate (currently 6%)
- How will IRS track subsequent sales/exchanges? Via expanded annual Form 8854 for electing expatriates?
- If covered expatriate dies before paying all deferred tax, unpaid tax due with expatriate’s final income tax return

## “Adequate Security” to Defer Payment of Tax

- A bond furnished to, and accepted by, IRS, conditioned on payment of tax and interest, and meeting requirements applicable to bonds posted under section 6325 to release tax liens
- IRS is authorized to prescribe other forms of adequate security, including letters of credit
- If security ceases to be “adequate” and covered expatriate does not correct this error within time specified by Secretary, remaining tax becomes immediately payable
- What is “adequate”? Are adjustments required where property declines in value? How will IRS monitor?
- What other forms of security will be acceptable to IRS?
- How will this help those most in need of deferral – owners of significant illiquid assets?

# Exceptions to Mark-to-Market Regime

## ■ “Deferred compensation items”

- ◆ Includes interests in qualified and non-qualified U.S. and foreign retirement and deferred compensation plans, other deferred compensation, and interests in property for performance of services to extent not previously included under section 83
- ◆ Exception for deferred compensation for non-U.S. services while covered expatriate not U.S. citizen or resident
- ◆ Tax on “**eligible deferred compensation**” deferred until includible in gross income under U.S. rules; collected by means of 30% withholding tax
  - Deferred compensation is “eligible” if paid by U.S. payor or foreign payor electing, under terms acceptable to IRS, to be treated as U.S. payor
  - Covered expatriate must waive applicable tax treaty benefits and notify payor of status
  - Risk of double taxation, although tax credits may be available

## Exceptions to Mark-to-Market Regime (cont'd)

- **Non-eligible deferred compensation** is present valued and treated as received day before expatriation
  - ◆ “restricted property” under section 83 treated as transferable and no longer subject to substantial risk of forfeiture
  - ◆ Risk of double taxation; likely no tax credit in foreign country
- **“Specified tax deferred account”** treated as received day before expatriation
  - ◆ Includes, e.g., IRA’s, qualified tuition plan, Coverdell education savings account, health savings account and Archer MSA plans; doesn’t include SEP’s and simplified retirement accounts (treated as deferred compensation and not specified tax deferred accounts)
- In foregoing cases, adjustments will be made on subsequent distributions and no early distribution penalties

## Exceptions to Mark-to-Market Regime (cont'd)

### ■ **Interests in nongrantor trusts**

- ◆ Taxable portion of direct or indirect distributions to covered expatriate subject to 30% withholding tax
- ◆ Applicable whether U.S. or foreign trust
  - How will IRS collect? No statutory election for foreign fiduciaries to be treated as U.S. fiduciaries
- ◆ Recipient must be beneficiary *prior to* expatriation date; will be treated as having waived applicable tax treaty benefits
- ◆ If trust distributes appreciated property, treated as sale of property to recipient
- ◆ No exception for grantor trusts – assets are treated as belonging to expatriate grantor and are marked to market
  - If nongrantor trust becomes grantor trust of covered expatriate, treated as distribution to covered expatriate

## Section 2801: New Succession Tax

- Gifts and bequests to U.S. persons from covered expatriate under section 877A taxed to recipient at highest gift or estate tax rate
  - ◆ Exceptions for gifts within annual exclusion (currently \$13,000) or entitled to charitable or marital deduction
    - Must bequests to resident alien spouse go into QDOT?
  - ◆ Exceptions also for property shown on timely filed gift tax return of covered expatriate or included in gross estate of covered expatriate and shown on timely filed estate tax return
  - ◆ Credit for foreign gift or estate/inheritance taxes

## Section 2801: New Succession Tax (cont'd)

- Special rule for transfers in trust:
  - ◆ If domestic trust, tax paid by trust
  - ◆ If foreign trust, tax paid by U.S. recipient on distribution portion attributable to covered expatriate's prior transfer in trust
  - ◆ U.S. recipient can deduct section 2801 tax attributable to income in computing income tax liability on distribution
  - ◆ Foreign trust can elect to be treated as domestic trust
- How will IRS monitor transfers by covered expatriate long after expatriation?
  - ◆ Presumably reporting will be cross-referenced to U.S. person's obligation to report receipt of large (> \$100,000 non-indexed) foreign gifts/bequests from individuals under section 6039F
  - ◆ What about smaller gifts (>\$13,000 but less than \$100,000)?



# Other Section 2801 Issues

## ■ Scope

- ◆ Applies to gifts of wealth created long after expatriation
- ◆ Applies to gifts to recipients who may have become U.S. persons long after death of covered expatriate and who may not even have been born at time of expatriation

## ■ Compliance

- ◆ U.S. recipient may be unaware of covered expatriation
- ◆ Indirect covered gifts

## ■ Impact on prospective immigrants –

- ◆ Will wealthy individuals stop applying for green cards or even moving to the United States? If already here, will they leave before 8<sup>th</sup> year? Might such decisions entirely consume estimated revenues?

# Additional Issues with Exit Tax

- Tax on items excepted from mark-to-market rules violates fundamental exit tax principle
  - ◆ Tax should be limited to income and wealth arising/accrued or accumulated while covered expatriate was U.S. person
  - ◆ Withholding tax on deferred compensation and distributions from nongrantor trusts, and section 2801 succession tax, can be imposed on income/wealth arising long after U.S. tax status legitimately relinquished
  - ◆ Prior exit tax proposals created maximum tax amount or allowed election to remain U.S. taxpayer in respect of assets held at expatriation date
- Guidance needed on certain transition issues, e.g.:
  - ◆ When is “lawful permanent residence” relinquished?
    - Date when tie-breaker claim made or effective?
  - ◆ What if expatriate continues to hold valid green card?

# Treaty Interactions – Section 877

- U.S. income tax treaties generally preserve U.S. right to tax former citizens and, in some cases, former long-term residents for 10 years following expatriation
- But most treaties require tax avoidance purpose
  - ◆ Pre-1996 section 877, required there be a principal purpose of tax avoidance
  - ◆ 1996 Act deemed individuals to have a principal purpose of tax avoidance if one of two objective tests (5-year average annual income tax liability or minimum net worth) were met
  - ◆ 2004 Act abolished principal purpose test.
    - Treasury view was that objective tests were substitute method of determining tax avoidance intent
    - 2003 JCT report calls the objective tests a “proxy” and states: “[u]nlike present law, no subsequent inquiry into the taxpayer’s intent would be required or permitted”

# Treaty Interactions – Section 877

- Conference report on HIPAA states that 1996 changes will override treaties for 10 years
  - ◆ Congress anticipated treaties would be renegotiated during this period
  - ◆ After 10<sup>th</sup> anniversary (8/21/2006), treaties were to prevail
  - ◆ All treaties renegotiated after 1996 Act now address former citizens and long-term residents, but pre-2004 ones still refer to tax avoidance purpose
  - ◆ Many treaties have not been renegotiated and incentive to do so will fade as time passes

# Treaty Interactions – Section 877A

- Mark-to-market tax under section 877A imposed on U.S. persons – or, more precisely, imposed on gains deemed recognized while covered expatriate was U.S. person
- Therefore, tax is covered by typical treaty saving clause as tax imposed on U.S. citizens and residents
- Section 877A will cause double taxation unless other countries allow exemption for exit tax gain
  - ◆ 5<sup>th</sup> Protocol to Canada treaty (2007): pre-departure gain taxed for alienation of property immediately before individual's emigration exempt from taxation in the destination country (Canada has its own departure tax)
  - ◆ How will first \$600,000 of gain be treated in Canada?

# Treaty Interactions – Section 2801

- Section 2801 tax appears to be a covered tax
  - ◆ It appears to be a form of gift or estate tax
  - ◆ But in any event it is a tax of “substantially similar character”
- Tax is imposed on U.S. persons
  - ◆ However, estate and gift tax exemptions typically apply based on domicile of donor, whether tax imposed on donor (U.S. estate tax/U.K. inheritance tax) or donee (typical European succession tax)
  - ◆ This is clearly the case for newer treaties, which limit scope of tax on gifts and bequests to business property and real estate
  - ◆ Less clear in the case of older treaties, which do not explicitly limit right to tax but establish situs rules and confirm the availability of tax credits
- Does HIPAA treaty override still apply?

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