Service Issues Guidance on Section 877A Exit Tax

By Michael A. Spielman*

In June 2008, a new expatriation provision, section 877A, was enacted by the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART"). Section 877A applies to certain individuals who, on or after June 17, 2008, relinquish their U.S. citizenship or cease to be a lawful permanent resident of the United States. In addition to a brief background on section 877A, this article provides highlights of the 65 pages of written guidance on section 877A in Notice 2009-85, 2009-45 I.R.B. 598.

In addition to section 877A, HEART also introduced a new succession tax under section 2801 that imposes a tax on U.S. persons who receive a gift or bequest from an expatriate who was subject to the rules of section 877A. Generally, the rules under section 2801 require the recipient of the gift or bequest to pay tax on the fair market value of the property received at the highest gift or estate tax in effect on the date of receipt. Gifts or bequests to a qualified charity or U.S. spouse are exempt from the tax if made in a form that would be eligible for a deduction under the relevant estate or gift tax Code section. Although Notice 2009-85 does not provide guidance on section 2801, it indicates that future guidance on section 2801 will be issued separately.

Prior to the enactment of HEART, covered expatriates were subject to a 10-year alternative tax regime (1) on their U. S. source income and gain under section 877 and (2) a modified estate and gift tax regime under sections 2107 and 2501. In its most recent incarnation, as modified by the American Jobs Creation Act of 2004 ("AJCA"), section 877 became applicable solely on the basis of objective tests that measured an expatriating individual's net worth and net income tax liability, without regard to whether the individual had a tax avoidance purpose for expatriating. AJCA also added a third test, which caused expatriating individuals to become subject to the 10-year alternative tax regime if they failed to certify compliance with all U.S. federal tax obligations for the five preceding taxable years. In addition, AJCA added section 877(g), which caused covered expatriates to be treated as U.S. citizens for all federal tax purposes for any year during the 10-year period in which they spent 30 days or more in the U.S. This 30-day rule was not carried over to new section 877A.

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Section 877A

Under new section 877A, Tax Responsibilities of Expatriation, covered expatriates (generally, U.S. citizens or long-term residents with a five-year average income tax liability exceeding $124,000 as indexed for inflation ($145,000 in 2009 and 2010) ("tax liability test") or net worth of $2 million or more ("net worth test"), are immediately taxed on the net unrealized gain in their property exceeding $600,000 ($626,000 in 2009 and $627,000 in 2010) as if they sold the property for fair market value the day before relinquishing U.S. citizenship or terminating their U.S. residency ("expatriating"). This mark-to-market tax regime applies to all property of the covered expatriate, other than deferred compensation items, specified tax deferred accounts, and interests in a nongrantor trust of which the covered expatriate was a beneficiary on the day before the expatriation date. Separate provisions apply with respect to these items.

Notice 2009-85

Individuals Covered. Notice 2009-85 clarifies that for purposes of determining whether a person is a covered expatriate under the tax liability and net worth tests, the guidance provided in Notice 97-19, 1997-1 C.B. 394, is applicable. Thus, for purposes of the tax liability test, joint filers must take into account the net income tax that is reflected on the joint income tax return. For purposes of the net worth test, an individual is considered to own any interest in property that would be taxable as a gift under Chapter 12 of Subtitle B of the Code if the individual were a citizen or resident of the United States who transferred the interest immediately prior to expatriation. The determination of whether a transfer by gift would be taxable is made without regard to sections 2503(b)-(g), 2513, 2522, 2523, and 2524.

Identification of a Covered Expatriate's Property. For purposes of applying the mark-to-market tax under section 877A(a), Notice 2009-85 treats a covered expatriate as owning any property interest that would be taxable as part of his or her gross estate for federal estate tax purposes if he or she had died on the day before the expatriation date as a citizen or resident of the United States. A covered expatriate is also deemed to own his her beneficial interest in each trust that would not be a part of the gross estate. A covered expatriate's beneficial interest in such a trust is to be determined by applying the rules set forth in Section III of Notice 97-19. For this purpose, the value of the beneficial interest is determined using a two-step process. First, all interests in property held by the trust are allocated to beneficiaries (or potential beneficiaries) based on all relevant facts and circumstances. Interests in property held by the trust that cannot be allocated based on the factors described in the previous sentence are allocated to the beneficiaries

under the principles of intestate succession (determined by reference to the settlor's intestacy) as contained in the Uniform Probate Code, as amended. Second, interests in property held by a trust that are allocated to the expatriate are valued under the principles of section 2512 and the regulations thereunder without regard to any prohibitions or restrictions on such interests. Because section 877A(f)(3) includes special rules that apply to interests in nongrantor trusts in lieu of the general mark-to-market rules of section 877A(a), the rules of Notice 97-19 for interests in certain trusts should be limited to trusts that are not subject to section 877A(f)(3). Thus, the Notice 97-19 rules would apply when a trust is a grantor trust with respect to the covered expatriate for U.S. income tax purposes, but the assets of the trust are not includible in the covered expatriate's estate for U.S. estate tax purposes.

Determination of Fair Market Value. Notice 2009-85 provides helpful guidance on the determination of fair market value. In general, the notice applies estate tax valuation principles. It provides that the fair market value of each interest in property will be determined under section 2031 and the regulations, without regard to the alternate valuation provisions of sections 2032 and 2032A, as if the covered expatriate had died as a U.S. citizen or resident on the day before the expatriation. For property subject to the special valuation rules of sections 2701 through 2704 (Chapter 14), the notice provides that the provisions of Chapter 14 are to be applied as if the covered expatriate's interests were being transferred to family members. The notice also provides that in defining and valuing the gross estate under the estate tax valuation regime, the following may not be taken into account: (1) a covered expatriate's tax liability as a result of section 877A or another Code section and (2) amounts that would be subject to the charitable, marital, or family-owned business deductions under sections 2055 through 2057.

Calculation of Gain on Property Subject to Section 877A(a). For purposes of determining the mark-to-market tax, section 877A(a)(2) requires the calculation of net unrealized gain and loss to be individually determined for each item of property deemed owned by the covered expatriate on the day before the expatriation date, taking into account his or her worldwide holdings. The section 877A(a)(3) gain exclusion amount is then allocated among each item of built-in gain property. Net gains must be recognized to the extent that they exceed the $600,000 (increased by a cost-of-living adjustment factor for years after 2008 as noted above) gain exclusion provided in section 877A(a)(3). Recognized gains may be offset by recognized losses under the general provisions of Subtitle A of the Code.

As clarified by the notice, for each item of property subject to section 877A(a), basis is adjusted by the amount of gain or loss taken into account for each item of property under sections 877A(a)(2)(A) and (B), respectively, without regard to the exclusion amount provided in section 877A(a)(3). Thus, basis adjustments are available for the amount of built-in gain deemed realized with respect to an asset, even if such gain is not recognized due to the exclusion amount.

Under section 877A(h)(2), solely for purposes of determining the tax under section 877A(a), property held by a nonresident alien on the day that individual became a resident of the United States will be treated as having a basis of not less than the fair market value on such date. Notice 2009-85 indicates that the Service and Treasury intend to exercise their regulatory authority to exclude the basis step-up for U.S. real property interests or property used or held in conjunction with a U.S. trade or business.

Deferred Compensation. Deferred compensation items are not subject to the mark-to-market regime of section 877A(a). Instead, section 877A(d) applies a separate set of rules to these items: either a deemed distribution occurs or a special withholding regime is applied. Notice 2009-85 provides extensive guidance on the definition and treatment of eligible and ineligible deferred compensation items, and suggests that additional guidance may be issued. However, several important interpretative questions remain unanswered by the notice, including the relationship and application of section 871 to section 877A.

Interests in Nongrantor Trusts. Direct or indirect distributions of property to a covered expatriate who was a beneficiary on the day before the expatriation date are subject to withholding equal to 30% of the taxable portion of the distribution. Notice 2009-85 defines the term "beneficiary" and provides guidance on: (1) trust distributions of built-in-gain property; (2) conversions of nongrantor trusts into grantor trusts; and (3) the application of section 877A(f), which subjects a covered expatriate's nongrantor trust distributions to tax that is imposed under section 871, and section 877A(f)(1)(A), which subjects the payment to withholding. The notice also distinguishes between a trustee's obligation to deduct and withhold on distribution and a covered expatriate's obligation to inform the trustee of his covered status and report on his income tax return any tax not withheld. Under section 877A(f)(4)(B), covered expatriates who were nongrantor trust beneficiaries before expatriating waive their right to reduced withholding on those distributions under U.S. tax treaties unless they follow certain procedures. Until further guidance is issued, Notice 2009-85 outlines the procedures that covered expatriates must follow to preserve their treaty rights.

Deferral of Payment of Tax Under the Mark-to-Market Regime. Section 877A(b) allows a covered expatriate to make an irrevocable election for any property deemed sold by reason of section 877A(a)

to defer the payment of additional tax attributable to the property. The election is made on an asset-by-asset basis. To make the election, the covered expatriate must provide adequate security and must irrevocably waive on Form 8854 any right under any U.S. treaty that would preclude assessment or collection of tax imposed by section 877A.

The ability of a covered expatriate to make a deferral election is subject to the Service's acceptance of a tax deferral agreement, including evaluation of the adequacy of the security to be provided. The notice provides that the deferred tax and interest will be due immediately if the Service determines that the security provided no longer qualifies as adequate security unless the covered expatriate corrects the failure within 30 days after the Service mails the notification of the failure. Because the Service's approval of a tax deferral agreement is discretionary and would not be made until after the expatriation, this procedure is unlikely to prove helpful to covered expatriates who are less affluent or have liquidity constraints.

Filing and Reporting Requirements. Notice 2009-85 imposes rules that covered expatriates must follow to report information until regulations are issued under section 877A. Most notably, the rules require covered expatriates to file Form 1040NR with Form 1040 attached for the year of expatriation and, in certain cases, Form 1040NR for subsequent years. Importantly, the notice clarifies that all U.S. citizens who relinquish their U.S. citizenship and all long-term residents who cease to be lawful permanent residents of the U.S. are required to file Form 8854 in order to certify that they have been in compliance with all federal tax laws during the five years preceding the year of expatriation. Individuals who fail to make such certification will be treated as covered expatriates within the meaning of section 877A(g), whether or not they also meet the tax liability test or the net worth test.

Conclusion

In comparison to the ten-year alternative tax regime under prior law, the section 877A exit tax regime has a far greater potential for adverse consequences. These consequences include higher net tax cost due to the imposition of the mark-to-market tax, the potential for U.S. taxation in perpetuity on distributions from nongrantor trusts and certain deferred compensation items, ongoing and onerous U.S. tax reporting requirements, and risks of double taxation. Thus, it should not be surprising that the new exit tax regime has caused many global executives, entrepreneurs, and other individuals with ties to other countries to rethink the benefits of acquiring or retaining U.S. citizenship or green cards. In addition, the prospect of increased tax rates, the increased emphasis on individual compliance and transparency and its implications for individuals with non-U.S. assets, and the current environment of depressed asset values across all markets are stimulating further interest in expatriation. ■

Employee Benefit Plans: Recent Developments

By David Pratt*

Retirement Plans

Temporary Waiver of Required Minimum Distribution Rules. Under the Worker, Retiree, and Employer Recovery Act of 2008 no required minimum distribution (RMD) was required *for calendar year 2009* from IRAs and employer-sponsored defined contribution plans, including governmental 457(b) plans. Act § 201(a); I.R.C. § 401(a)(9)(H). The next RMD would be for calendar year 2010.

In Notice 2009-82, 2009-41 I.R.B. 491, the Service issued guidance regarding the waiver. Individuals who receive a 2009 RMD have until the later of November 30, 2009, or 60 days after the date the distribution was received, to roll it over. The Notice provides sample plan amendments that plan sponsors may adopt or use in drafting individualized amendments. A plan amendment is generally required by the last day of the 2011 plan year (2012 for a governmental plan). The Notice also includes additional guidance for plan sponsors.

Amendments to Comply with the Pension Protection Act of 2006. In general, section 1107 of the PPA requires plans to be amended by the last day of the first plan year beginning on or after January 1, 2009, to effectuate the changes made by the Act. Governmental plans have until 2011. In some cases there is a delayed compliance date for collectively bargained plans. Defined benefit plans must be amended to provide for limitations on benefit payments and benefit accruals under section 436.

Announcement 2009-82, 2009-48 I.R.B. 720, gives sponsors of cash balance and other hybrid plans until the end of the 2010 plan year to comply with the PPA requirement that the plan's interest-crediting rate not exceed a "market rate of interest." The Service has also extended by one year the deadline for amending plans to comply with other requirements of PPA. The new deadline is the last day

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