downturn, a new investor instructs a broker-dealer to offer to buy the Company X debt instruments for twenty cents on the dollar. The broker then phones other brokers with a 200 bid on the Company X notes. Eventually a seller is found, but only a few of the notes are sold at the 200 price. The trade is reported on TRACE. Later in 2008, Company X seeks to exchange new notes with a four-year term and an interest rate and stated redemption price at maturity identical to those of its 2006 notes for all of its outstanding 2006 notes. Because the notes for which the 2008 notes are being exchanged appear on a quotation medium, the 2008 notes will be issued in exchange for publicly traded property. Accordingly, the issue price of the 2008 notes would seem to be 200, the price of the most recent trade on the TRACE system.

For the issuer, the best case scenario is that the holders of its outstanding notes are tax-indifferent parties and are not deterred from participating in the exchange by the OID that they will need to take into income over the term of the new debt instrument as a result of the disparity between the issue price and the stated redemption price at maturity. Even in this best case scenario, the issuer could have a substantial inclusion of cancellation of debt ("COD") income in the year of the exchange. That sting of the COD income in the year of the exchange will be mitigated by deductions for OID over the term of the newly issued debt instrument, but for an issuer that does not have a net operating loss carryforward to offset the COD income, this result may be a bitter pill to swallow. But if the majority of the holders are taxable entities, a far worse fate likely awaits the issuer, *i.e.*, a failed exchange offer.

The Proposed Regulations

In January of this year, the Service issued proposed changes to these regulations. The proposed regulations reorganize the concepts in the current regulations and, by most accounts, will create much clearer rules as to what debt instruments will be considered publicly traded. Specifically, the proposed regulations will require that, in order for an instrument to qualify as "publicly traded" mere listing on TRACE or similar services will not be sufficient; there will need to be actual sales prices or price quotations (either firm or indicative) for the security in question. Moreover, if the only information is an indicative price quote, under the proposed regulations, if the taxpayer determines that the quote materially misrepresents the fair market value of the property, the taxpayer can use any method that provides a reasonable basis to determine the fair market value of the property.

Another notable proposed change is that the proposed regulations will include a presumption that the fair market value of a debt instrument will equal the trading price, listing price or quoted price under the new rules. But perhaps the most important change proposed is a new de minimis trading rule. Under the new de minimis rule, a debt instrument will not be treated as traded on an established market if (A) each trade of such debt instrument during the 31-day period ending 15 days after the issue date is for quantities of one million dollars or less; and (B) the aggregate amount of all such trades does not exceed five million dollars. *See* Prop. Treas. Reg. § 1.1273-2(f)(7)(ii). If such a de minimis rule were in effect in the example discussed above, as a result of the low trading volume, the newly issued notes would not be treated as traded on an established securities market and the issue price likely would be significantly higher. As a result there likely would have been less OID for the holders, less COD income for the issuer and a greater likelihood of a successful exchange offer.

For all of the positive changes that the proposed regulations will make, the Service still insists on designating these concepts as "[t]raded on an established market (publicly traded)," though even under the proposed regulations actual trades made by investors on a public market are not required for a debt instrument to be considered publicly traded. But if the worst thing that can be said about the new regulations is the fact that one of its headings is a double misnomer, then the Service has done an admirable job revising regulations that, for many years, have had much more serious shortcomings. ■

Is Your Client Planning to Expatriate? Why the HEART Act May Cause a Change of Heart

By Vlad Frants*

On its surface, legislation known as the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act") provides a number of pay and employee benefits to military personnel. Pub. L. No. 110-245, 122 Stat. 1624. But at its core, the HEART Act significantly changes the tax system applicable to U.S. citizens and lawful permanent residents who expatriate by relinquishing, respectively, their citizenship or permanent resident status. This Article discusses the tax consequences of U.S. citizens who relinquish their citizenship and long term residents of the U.S. who cease to be lawful permanent residents within the meaning of section 7701(b)(6).

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The United States' imposing and far reaching taxation rules are widely considered to be a motivation for wealthy citizens and lawful permanent residents to expatriate. Under the U.S. income tax system, a citizen or permanent resident is subject to income tax on his or her worldwide income, regardless of where the income is earned or where the taxpayer is at the time the income is earned. In contrast, nonresident aliens are generally subject to U.S. income tax at a flat rate of 30% on U.S.-source income that is not effectively connected with a U.S. trade or business (I.R.C. § 871(a)(1)), and at graduated rates on income that is effectively connected with a U.S. trade or business (I.R.C. § 871(b)). As tax minimization planning can be more readily accomplished if the individual is deemed a nonresident alien, it makes sense that some U.S. citizens and U.S. permanent residents may want to expatriate.

Prior Law Affecting Expatriates

The U.S. income tax law applicable to expatriates has evolved over the years. At one time, an expatriate was taxed on income realized over the succeeding ten-year period only if one of the principal purposes for expatriating was to avoid tax. A former citizen was presumed to have expatriated with a principal purpose of avoiding tax if either the person's average annual U.S. income for the five taxable years before expatriating was greater than $100,000, or the individual's net worth on the date of expatriation was $500,000 or more. I.R.C. § 877(a)(2)(A)&(B), before amendment by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 804(a)(1). It was very difficult to determine whether expatriation was tax-motivated and, while it was automatically presumed that a high-net-worth individual's expatriation was tax-motivated, the expatriating individual could overcome the presumption by submitting a ruling request demonstrating the absence of a principal tax avoidance purpose for expatriating.

Substantial changes to the tax system governing expatriates were made by section 804 of the American Jobs Creation Act of 2004. In particular, the subjective tax-motivation standard discussed above was eliminated, specific rules for determining the date of expatriation were added, the scope of U.S. taxation for certain expatriates maintaining significant contacts with the U.S. was expanded, and new reporting requirements were added to the already existing annual information return filing requirement. *See* Steven J. Arsenault, *Surviving a HEART Attack: Expatriation and the Tax Policy Implications of the New Exit Tax*, 24 AKRON TAX J. 37, 48–50 (2009). On June 17, 2008, President Bush's signing of the HEART Act into law created a new system of taxation applicable to expatriates.

HEART Act Rules

With two exceptions, the new expatriate rules under the HEART Act apply to a citizen who relinquishes citizenship or a permanent resident who terminates U.S. residency if he or she either (1) has an average annual net income tax liability for the five preceding years ending before the date of the loss of U.S. citizenship or residency that exceeds $124,000, (2) has a net worth of $2 million or more on the date of expatriation, or (3) fails to certify under penalties of perjury that he or she has complied with all U.S. federal tax obligations for the preceding five years. I.R.C. § 877A(g)(1)(A), which refers to I.R.C. § 877(a)(2). The first exception applies to certain persons with dual citizenship. The second exception involves U.S. citizens who relinquish their citizenship before reaching the age of 18½. I.R.C. § 877A(g)(1)(B)(i)-(ii).

An individual will be deemed to have relinquished U.S. citizenship on the earliest of four possible dates: (1) the date the individual renounces U.S. nationality before a U.S. diplomatic or consular officer; (2) the date that the individual furnishes a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act to the State Department; (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization. I.R.C. § 877A(g)(4)(A)-(D).

The HEART Act enacts a deemed sale, "mark-to-market" exit income tax approach for expatriates, replacing the Code's former expatriation approach with new section 877A. The tax applies to the net unrealized gain in the expatriate's property as if the property had been sold at market value on the day before the expatriation date. I.R.C. § 877A(a)(1). If there is any net gain from these deemed sales, then the gain must be recognized to the extent that it exceeds $600,000; this amount is indexed for inflation in future years. I.R.C. § 877A(a)(2)–(3). Net losses are also recognized. I.R.C. § 877A(a)(2)(B). The gain or loss recognized will be taken into account as an adjustment to any gain or loss subsequently recognized on the same assets. I.R.C. § 877A(a)(2).

Expatriates may elect to defer the tax due if "adequate security" is provided to the Service, *e.g.*, the furnishing of a bond, a letter of credit, or other acceptable form of security for payment. The expatriate would also have to consent to a waiver of any treaty rights that would preclude assessment or collection of the tax. The election to defer payment of tax under section 877A is irrevocable and must specify the property to which it applies. The deferred tax will be subject to accrual of interest at the underpayments of taxation rate and will be due when the return is due for the taxable year in which the property is disposed of. I.R.C. § 877A(b)(1)–(7).

While the deemed sale rules of section 877A apply to most types of property interests held by expatriates, there are exceptions which subject the property to different tax treatment. Items subject to exceptions and special rules include deferred compensation items, certain tax deferred accounts (including IRAs, qualified tuition plans, Coverdell education savings accounts, health savings accounts, and Archer MSAs), and interests in trusts. The tax treatment of these types of property is beyond the scope of this Article. Also beyond the scope of this Article is a discussion of the new estate and gift tax rules for expatriates. *See generally Surviving a HEART Attack, supra.* ■