Bloomberg Tax

Daily Tax Report®

Expatriation

INSIGHT: EXIT TAX: Through the Maze of Expatriation—Part 1

In Part 1 of a two-part article, Ragini Subramanian of Marcum LLP analyzes factors to consider when contemplating expatriation, including whether the taxpayer is a U.S. citizen or a U.S. resident when he or she expatriates, and whether that person becomes a ''covered expatriate'' or a ''non-covered expatriate'' upon the date of expatriation and why it matters.

BY RAGINI SUBRAMANIAN

The Treasury Department regularly publishes the names of the individuals who renounce their U.S. citizenship or terminate their long-term U.S. residency (expatriated). (See 82 Federal Register 21877, 36188, 50960 and 5830 in 2017). With well over 1300 names in the first quarter, 1700 names in the second quarter, and almost 1400 names in the third quarter (with some decline in the fourth quarter), 2017 is one of the noteworthy periods in the history of U.S. expatriation that prompts the writing of this article.

One may think that with so many choosing to expatriate, the process must be far from onerous. Not quite! Relinquishing U.S. citizenship or U.S. residency is not easy, as a myriad of complex U.S. tax laws must be complied with before and sometimes even after expatriation. A thoughtful consideration of the kinds, value, and location of assets held before and after expatriation, how will they be taxed in the U.S. as well as in the country that will be home after expatriation, and many other factors need to be reviewed before undertaking expatriation.

Ragini Subramanian is a Tax & Business Services manager in Marcum LLP's Greenwich, Conn., office. She is New York attorney and enrolled agent with an LL.M. in Taxation from Boston University. She can be reached at ragini.subramanian@marcumllp.com.

Marcum LLP is a national accounting and advisory services firm with offices in major business markets throughout the U.S., as well as Grand Cayman, China, and Ireland.

This article reviews pre- and post-compliance requirements under the U.S. tax laws for individuals who are thinking about expatriating, that is giving up their U.S. citizenship or long-term U.S. residency. It also touches upon planning and other considerations, before and after actual expatriation, as they relate to the U.S. tax laws.

The primary tax code sections that govern individuals who wish to relinquish, renounce, or give up their U.S. citizenship, or long-term U.S. resident status include, tax code Sections 877, 877A, 6039G, and Treasury Regulations thereunder. Section 877 primarily applies to expatriation before June 17, 2008; Section 877A applies to expatriation after June 17, 2008; and Section 6039G largely deals with the reporting requirements of expatriating individuals. As of the date of the writing of this article no regulations under Sections 877, or 877A, or 6039G have been issued. Notice 2009-85 provides guidance in the meantime for Sections 877A and 6039G. Notice 97-19 (as modified by Notice 98-34 and Notice 2005-19), provides guidance for Sections 877 and 6039G.

In this article I will discuss the expatriation provisions of Section 877A, Section 6038G, and guidance un-

 ISSN 0092-6884

der Notice 2009-85 (and not the expatriation under Section 877). For the purposes of this article, these tax code sections and Notice 2009-85 are collectively referred to as ''U.S. expatriation provisions'' or ''expatriation provisions.'' To the extent Notice 2009-85 applies certain provisions of Notice 97-19 to Section 877A, the term ''expatriation provision'' or ''U.S. expatriation provision'' will also include the provisions of Notice 97-19. Let us begin.

Here is a list of some things to think about before expatriating:

I. Are you a U.S. citizen or a U.S. resident?

II. Are you a ''covered expatriate'' or a ''non-covered expatriate''?

III. Why does it matter whether you are a ''covered'' or a ''non-covered'' expatriate?

IV. What is the value, type, and location of the assets owned by you on the day before expatriation?

V. Are you compliant with all U.S. tax obligations?

VI. What is your date of expatriation?

VII. Are you subject to tax under the U.S. expatriation provisions and when is this tax payable?

VIII. What needs to be done before expatriating?

I. Are you a U.S. citizen or a U.S. resident?

The U.S. expatriation provisions apply to U.S. citizens and to long-term residents of the U.S. Note that the expatriation provisions use the term ''long-term residents of the U.S.'' and not ''U.S. resident'' or ''lawful permanent resident of the U.S.'' Not all lawful permanent residents of the U.S. or U.S. residents are long-term residents of the U.S., but all long-term residents of the U.S. are lawful permanent residents of the U.S. or U.S. residents.

Section 877A defines a long-term resident of the U.S. as an individual who is a lawful permanent resident of the U.S. (but not a citizen of the U.S.), as defined in Section 7701(b)(6), in at least eight out of 15 taxable years ending with the taxable year in which such individual ceases to be a lawful permanent resident of the U.S. Sections 877A(g)(5), 877(e)(2), 7701(b)6).

Section 7701(b)(6) defines a lawful permanent resident of the U.S. as an individual:

(a) who has been granted such status under the U.S. immigration laws, and (b) such status has not been revoked and has not been administratively or judicially determined to have been abandoned. If in any taxable year the individual is treated under an applicable treaty as a resident of a foreign country, does not waive the benefit of such treaty, and notifies the Secretary of the Treasury of the commencement of such treatment, he is not treated as a lawful permanent resident of the U.S. for such tax year. Sections 877(e)(2), Section 7701(b)(6). *See also* Section 877A(g)(2) for the definition of the term ''Expatriate.''

In summary, the first thing to consider, before one forges ahead to comply with the expatriation provisions is to review whether one is a U.S. citizen, or a lawful permanent resident of the U.S. If a U.S. citizen, read on and see what you need to do before expatriating. If a lawful permanent resident of the U.S., the next two questions to investigate are: (i) for how long, and (ii) are you considered a resident of another country during that period because you applied to be treated as such under the existing treaty? If the final answers to these questions yield eight out of 15 years and a NO, read on and see what you may need to do before expatriating.

II. Are you a 'covered' expatriate or a 'non-covered' expatriate?

The next item to consider is whether an individual is a ''covered'' expatriate or a ''non-covered'' expatriate. This determination is made as of the date of expatriation (Notice 2009-85, Section 2) (See *VI—What is your date of expatriation?* later in this article).

Neither Section 877A nor Notice 2009-85 define the term ''non-covered'' expatriate. It is safe to say however that a ''non-covered'' expatriate is an individual who is not a ''covered'' expatriate.

A ''covered'' expatriate is any U.S. citizen who relinquishes his citizenship, or any long-term resident of the U.S. who ceases to be a lawful permanent resident of the U.S. under Section 7701(b)(6), and with respect to whom either of the following statements are true (Sections 877A(g)(1)(A), (2) and 877(a)(2)):

A. Such individual's annual net income tax for the five preceding years ending before the year of expatriation exceeds $162,000 for 2017 (adjusted for inflation each year—$165,000 for 2018) (For 2012—$151,000; for 2013—155,000; for 2014—$157,000; for 2015—$160,000; for 2016—$161,000) (''tax liability'' test);

B. Such individual's net worth is $2 million or more as of the expatriation date (''net worth'' test); or

C. Such individual fails to certify, under penalty of perjury, his compliance with all U.S. federal tax obligations for the five years preceding the tax year that includes the expatriation date (''certification'' test).

An individual ceases to be a permanent resident of the U.S. within the meaning of Section 7701(b)(6): (1) at the time when such status is revoked and has been administratively or judicially determined to have been abandoned; or (2) if the individual commences to be treated as a resident of the foreign country under the provisions of a tax treaty between the U.S. and the foreign country, does not waive the benefits of such treaty applicable to the residents of the foreign country, and notifies the Secretary of the Treasury of the commencement of such treatment.

Note that an individual who otherwise does not meet the parameters of the ''tax liability'' test or the ''net worth'' test, can be a ''covered'' expatriate if she fails to certify her compliance with all U.S. federal tax obligations on Form 8854 (See *V. Are you compliant with all U.S. tax obligations?* later in this article for more on ''certification'' test).

There are two exceptions to the ''tax liability'' and the ''net worth'' test for certain U.S. citizens (but not for long-term residents of the U.S.). These two exceptions do not apply to the ''certification'' test. Under these two exceptions, certain U.S. citizens—even though they otherwise meet the ''net worth'' or the ''tax liability'' tests—are considered as not meeting those tests and consequently not considered ''covered'' expatriates. These U.S. citizens are:

(i) *Dual citizens*: Citizens of the U.S. and another country by birth and who are subject to tax of such other country and who are not the residents of the U.S. for more than 10 out of the 15-year period ending with the tax year during which expatriation occurs, or

  DTR ISSN 0092-6884

(ii) *Minors*: Minors with respect to whom the relinquishment of the U.S. citizenship occurs before such individuals attain age 18 ½ and the individuals are not residents of the U.S. for more than 10 years before the date of relinquishment of the U.S. citizenship (Section 877A(g)(1)).

For purposes of the ''tax liability'' test, an individual's net U.S. income tax is determined under Section 38(c)(1). Notice 2009-85, Section 2.B; Notice 97-19, Section III. The term ''net income tax'' means the sum of the regular tax liability and the alternative minimum tax imposed by Section 55, reduced by the allowable credits, and the term ''net regular tax liability'' means the regular tax liability reduced by the sum of the allowable credits. Section 38(c)(1). That is the credits allowable under Subparts A and B of Part IV of the tax code. These include child tax credit, dependent care credit, foreign tax credit, adoption expenses, credit for elderly, education credits, etc. An individual who files a joint income tax return must take into account the net income tax that is reflected on the joint income tax return for purposes of the ''tax liability'' test. Notice 97-19 Section III.

For purposes of the ''net worth'' test, the individual is considered to own an interest in property that would be taxable as a gift under Chapter 12 (Gift tax) Schedule B (Transfers) of the tax code if the individual were a citizen or resident of the U.S. who transferred the interest immediately prior to expatriation. Notice 97-19, Section III. Detailed valuation rules apply to various types of property interests for purposes of the net worth test, which are not discussed in this article. These valuation rules are laid out in Notice 97-19. Note that Notice 2009-85 directs to Notice 97-19 for the parameters related to the Section 877A ''net worth'' test.

The classification of a ''covered'' or a ''non-covered'' expatriate is important as we will see in the sections that follow. If you are a ''covered'' expatriate, read every single section of this article. If you are a ''non-covered'' expatriate, because you do not meet the requirements of ''net worth'' or ''tax liability'' tests, read on to make sure that you are not a ''covered'' expatriate.

III. Why does it matter whether one is a 'covered' or a 'non-covered' expatriate?

It matters due to the difference in the tax treatment afforded to a ''covered'' and a ''non-covered'' expatriate. More complex tax rules apply to a ''covered'' expatriate than to a ''non-covered'' expatriate. A ''non-covered'' expatriate can leave the country upon filing all the necessary tax returns and Form 8854 for the tax year in which she expatriates. For the year of expatriation, she is subject to tax liability on the income and gain in accordance with normal tax rules applicable to a U.S. tax resident, or a U.S. citizen, up to the period of her residency in the U.S., and as a non-resident after the expatriation date. More on this in *Part VIII – what needs to be done before expatriating*.

A ''covered'' expatriate on the other hand is subject to the mark-to-market or an alternative tax regime, depending on the type of assets held by her as of the expatriation date. For example, the deferred compensation items, the specified tax deferred accounts, and an interest in a non-grantor trust are subject to an alternative tax regime whereas all other assets including interest in a grantor trust are subject to the mark-to-market regime. A careful analysis of types, location, and value of assets held by a ''covered'' expatriate on the day before expatriation is necessary to know the individual's U.S. tax liability before and after expatriation, elections that may be made, or steps that may be taken to maximize her U.S. tax position, and compliance requirements before and after expatriation under mark-to-market and/or alternative tax regimes as applicable. Let us look at each of these two expatriation tax regimes applicable to ''covered'' expatriates.

III.A. Assets Subject to Mark-to-Market Tax Regime

The mark-to-market regime is fraught with complexity. For ease of understanding one can break it down in three components:

(i) Deemed sale of the property held by the expatriating individual and application of the exclusion amount to determine taxable gain;

(ii) In-bound step-up to basis rules applicable to long term residents of the United State to determine taxable gain; and

(iii) Determination of what property is considered held by the expatriating individual to which the deemed sale, exclusion amount, and basis rules should be applied?

i. Deemed sale and application of the exclusion amount:

Under the mark-to-market tax regime, a ''covered'' expatriate is deemed to have sold, on the day before the expatriation date, all the property she held on such date, at its fair market value. Section 877A(a)(1). The unrealized gain upon this deemed sale on such date, reduced by an exclusion amount, is subject to tax in the year of expatriation, without regard to any other provision of the tax code. Section 877A(a)(2)(A), (3). Any available gain deferral or tax deferral will cease on the day before expatriation. Section 877A(h)(1)(A), (B). For example, property acquired under Section 1031 deferred exchange rules will be subject to tax as if it is sold on the day before the expatriation date.

The exclusion amount for the tax year 2017 is $699,000 ($713,000 for 2018) and is adjusted for inflation each year. Section 877A(a)(3). The exclusion amount reduces proportionately, but not below zero, the unrealized gain from all the assets deemed sold on the day before expatriation. Section 877A(a)(3)(B); Notice 2009-85, Section 3B. Loss upon deemed sale cannot offset the unrealized gain to which the exclusion amount is applied. The loss is allowed to the extent permitted by the tax code, except that the wash sale rule of Section 1091 does not apply. Thus, for example, a capital loss deduction is limited to $3,000 per year for a married couple filing a joint return. Section 877A(a)(2)(B); Notice 2009-85, Section 3B; *see also* Section 1211(b) for rules on limitation on losses. When the property is eventually sold the amount of any gain or loss actually realized is adjusted for gain and loss taken into account under the mark-to-market tax regime, but without regard to the exclusion amount. Section 877A(a)(2).

Let's see an example of how this works.

Example 1: Assume that Taxpayer A is a ''covered'' expatriate who owns properties X, Y, and Z located in the U.S., each of which are subject to the mark-to-

market regime. Assume further that none of these properties are a U.S. real property interest, nor are they held by the taxpayer in a trade or business in the U.S.

	Fair Market Value on the day Before Expatriation	Basis	Recognizable Gain/Loss	Application of Exclusion Amount	Gain/Lost Subject to Tax in the Year of Expatriation
	A	B	C=B-A	D**	E=D-C
X	$ 3,725,000.00	$ 3,700,000.00	$ 25,000.00	$ 25,000.00	$ -
Y	$ 4,500,000.00	$ 4,000,000.00	$ 500,000.00	$ 500,000.00	$ -
Z	$ 200,000.00	$ 300,000.00	$ (100,000.00)	Not Applied	$ (100,000.00)

** Total Gain = $525,000 ($25,000 + $500,000)
Application of Exclusion Amount
Property X - $699,000 x ($25,000/$525,000) = $25,000
Property Y - $699,000 x ($500,000/$525,000) = $500,000

Note that the exclusion amount cannot be more than the gain to be excluded.

In the year of expatriation, the gain to be included on Form 1040 for Property X = $0, for Property Y = $0. The loss of $100,000 or applicable portion thereof should be reported on appropriate schedule or forms (e.g., Sched. D, Sched. E, Form 4797) associated with Form 1040 in the year of expatriation.

Example 2: Same facts but different fair market values and basis for each of the properties.

	Fair Market Value on the day Before Expatriation	Basis	Recognizable Gain/Loss	Application of Exclusion Amount	Gain/Lost Subject to Tax in the Year of Expatriation
	A	B	C=B-A	D**	E=D-C
X	$ 3,725,000.00	$ 3,500,000.00	$ 225,000.00	$ 216,931.03	$ 8,068.97
Y	$ 4,500,000.00	$ 4,000,000.00	$ 500,000.00	$ 482,068.97	$ 17,931.03
Z	$ 200,000.00	$ 300,000.00	$ (100,000.00)	Not Applied	$ (100,000.00)

** Total Gain = $725,000 ($225,000 + $500,000)
Application of Exclusion Amount
Property X - $699,000 x ($225,000/$725,000) = $216,931
Property Y - $699,000 x ($500,000/$725,000) = $ 482,068.9

In the year of expatriation, the gain to be included on Form 1040 for Property X = $8,068; for Property Y = $17,931. The loss of $100,000 or applicable portion thereof should be reported on appropriate schedule or forms (e.g., Sched. D, Sched. E, Form 4797) associated with Form 1040 in the year of expatriation.

Let's say that two years after expatriation, the taxpayer sells Property X for $4,000,000. The basis of the property for the purposes of gain calculation upon actual sale is $3,950,000 ($3,725,000 fair market value on the day before expatriation plus $225,000 gain in Column D from the above table upon deemed sale on the date of expatriation), gain upon subsequent sale of this property will not be subject to U.S. tax but subject to tax laws of the new home country of the expatriated individual. This will most likely be the original basis of the property less the fair market value upon sale. In the case of Example 2 above, it will most likely be $500,000 ($4,000,000 less $3,500,000). The rule of not taking into account the exclusion amount in calculating gain upon subsequent sale of the property is irrelevant to this sale.

ii. In-bound step-up to basis rules applicable to long term residents of the United State to determine taxable gain:

Normal rules of basis determination for the purposes of computing gain as above apply to the U.S. citizens. However, a special in-bound step-up in basis rule applies to the long-term residents of the U.S. If this individual owned the property (which is now subject to the mark-to-market tax regime applicable to a ''covered'' expatriate) prior to becoming a U.S. resident, the basis of such property is not the original purchase price, but it is not less than the fair market value on the day the individual became the U.S. resident. Section

  DTR ISSN 0092-6884

877A(h)(2); Notice 2009-85, Section 3.D. Let's look at the example of this as laid out in Notice 2009-85.

Assume that Taxpayer A, a non-resident of the U.S. became a lawful permanent resident of the U.S. on April 1, 1995. She is a long-term resident of the U.S. She decides to expatriate, and her date of expatriation is July 1, 2010. She is subject to the mark-to-market tax regime applicable to ''covered'' expatriates. The value of the two assets she owns is as follows:

- Asset S with a basis of $400X, fair market value on April 1, 1995, of $700X, and fair market value of on July 1, 2010, of $1300X.

- Asset T with a basis of $500X, fair market value on April 1, 1995, of $300X, and fair market value of on July 1, 2010, of $800X.

Neither of these assets are a U.S. real property interest, or effectively connected with a U.S. trade or business. In accordance with the in-bound step-up in basis rule, the default result for taxable gain in the year of expatriation (2010) would be:

- Gain on Asset S = $600X ($1,300X less $700X)

- Gain on Asset T = $300X ($800X less $500X)

A long-term resident of the U.S. can however, elect to not apply this in-bound step-up in basis rule. Section 877A(h)(2). If Taxpayer A elects to not apply this in-bound step-up in basis rules, her gain with respect to Asset S would be $1,300X less $400X = $900X. Notice 2009-85, Section 3.D. The election is made on a property-by-property basis on Form 8854, which is filed in the year of expatriation. *See* Notice 2009-85, Section 3.D. Generally speaking, such election cannot be made with respect to the U.S. real property interest and property used or held for use in connection with the conduct of a trade or business in the U.S. *See* Section 897(c) for what is a U.S. real property interest. Essentially, if the expatriating individual can establish fair market value on the date she became a U.S. resident, the in-bound step-up in basis can help reduce the gain subject to the mark-to-market tax regime.

iii. Property considered owned by the expatriating individual:

While all of the above may seem quite complicated, the determination of what is the property in the hands of a ''covered'' expatriate, on a day before expatriation date, is equally daunting—especially for individuals with millions of dollars in different types of assets. The rule in this respect is described in Notice 2009-85. Notice 2009-85 Section 3.A. It states that for purposes of computing the tax liability under the mark-to-market regime, a ''covered'' expatriate is considered to own any interest in property that would be taxable as part of his gross estate for federal estate tax purposes under Chapter 11 of Subtitle B of the tax code as if he dies on the day before the expatriation date as a citizen or resident of the U.S. Whether property would constitute part of the gross estate is determined without regard to credit under Sections 2010 through 2016.

A ''covered'' expatriate is also deemed to own his beneficial interest(s) in each trust (or portion of a trust), that would not constitute part of his gross estate. The covered expatriate's beneficial interest in such a trust shall be determined under the special rules set forth in Section II of Notice 97-19. This article will not go into what is considered includible in one's estate, as it is a topic by itself. Suffice it to say that determining what is and what is not included in the gross estate of an ultra-high net worth individual and therefore subject or not subject to the mark-to-market tax regime is not an easy task. And if you are thinking of gifting your assets, think carefully because if not correctly structured, the gifted asset may still be included in the estate of an expatriating individual and therefore subject to the mark-to-market tax regime. With that said let's review the alternative tax regime applicable to a ''covered'' expatriate.

III.B. Assets Subject to Alternative Tax Regime As stated earlier not all assets are subject to the mark-to-market tax regime. The following assets are not subject to the mark-to-market tax regime but are subject to an alternative tax regime:

III.B (i) Deferred compensation item,

III.B (ii) Specified tax deferred account, and

III.B (iii) Interest in non-grantor trust.

The timing of tax and the value of the asset subject to tax depends on the type of asset and the elections made by the expatriating individual. A failure to fully analyze these assets can result in missed pre-expatriation planning opportunities discussed later. Let us look at each of these and taxation of each.

III.B(i). Deferred compensation items under Section 877A(d)(4). **Notice 2009-85 Section 5B provide definition of deferred compensation items. These include:**

(*a) Any interest in a plan or arrangement described in Section 219(g)(5), that is:*

1. a plan described in Section 401(a) which includes a trust exempt from tax under Section 501(a);

2. an annuity plan described in Section 403(a);

3. a plan established for its employees by the U.S., by a state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing (but not an eligible deferred compensation plan under Section 457(b);

4. an annuity contract described in Section 403(b);

5. a simplified employee pension (within the meaning of Section 408(k));

6. a simplified retirement account (within the meaning of Section 408(p)); or

7. any contribution to a trust described in Section 501(c)(18), which is a trust created before June 25, 1959, forming part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees, etc.

(b) Any interest in a foreign pension plan or similar retirement arrangement or program.

(c) Any property, or right to property, which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under Section 83 or in accordance with Section 83 (Section 877A(c)(1), (d)(4)(A) to (D)).

In this context, statutory or non-statutory stock options (under Sections 421-424), stock-settled stock appreciation rights, and stock-settled restricted stock units, constitute property or a right to property. Notice 2009-85, Section 5B. Note that as compared to the stock-settled stock appreciation rights or stock-settled restricted stock units, the cash-settled stock appreciation rights and cash-settled restricted stock units are considered an item of deferred compensation under Section 877A(d)(4)(c) as discussed in (d) below. Whether or not such property or right to property is considered previously taken into account would depend on whether such property is transferred to the indi-

vidual on or before the date of expatriation, and whether or not before the expatriation date it is vested and taxes related to such vesting have been paid (and tax returns filed), or having made a Section 83(b) election, the individual has paid taxes related to such election (Notice 2009-85) (and tax return filed). In this case, if the tax return is due after the expatriation date, the item is considered previously taken into account if the transferred property is subject to appropriate tax withholding.

(d) Any item of deferred compensation. This means any amount of compensation if, under the terms of the plan, contract, or other arrangement providing for such compensation or compensation arrangement), the ''covered'' expatriate has a legally binding right as of the expatriation date to such compensation, the compensation has not been actually or constructively received on or before the expatriation date, and pursuant to the compensation arrangement the compensation is payable to (or on behalf of) the ''covered'' expatriate on or after the expatriation date. Such term however does not include any deferred compensation item that is described in (a), (b), and (c) here.

An item of deferred compensation generally includes an amount whether or not substantially vested, that constitutes nonqualified deferred compensation for purposes of Section 404(a)(5) (determined without regard to Treas. Reg. Section 1.404(b)-1T, Q&A-2, including a cash-settled stock appreciation right, a phantom stock arrangement, a cash-settled restricted stock unit, an unfunded and unsecured promise to pay money or other compensation in the future (other than such a promise to transfer property in the future), and in a trust described in Section 402(b)(1) or (4) (commonly referred to as a secular trust. Notice 2009-85, Section 5.B(4). Note that as opposed to cash-settled stock appreciation rights or cash-settled restricted stock units, the stock-settled stock appreciation rights and stock-settled restricted stock units are not an item of deferred compensation but will be governed by Section 877A(d)(4)(D) as property or right to property under Section 83, as discussed in (c) above.

Simply put a deferred compensation item includes U.S. or foreign pension or retirement plans, payments under deferred compensation arrangements, stock or cash settled stock appreciation rights, stock purchases, stock options, and restricted stock plans. However, in determining the taxable component, the deferred compensation item that is attributable to services performed outside of the U.S. while the ''covered'' expatriate was not a citizen or a resident of the U.S. is excluded. Section 877A(d)(5).

Taxation of Deferred compensation item

The timing of taxation of an asset that is a deferred compensation item depends on whether it is an eligible deferred compensation item or an ineligible deferred compensation item.

Generally speaking, the eligible deferred compensation item is taxed when payable to the expatriating individual and the taxable component of such deferred compensation item is subject to withholding by the payor at 30 percent. Section 877A(d)(1) (A), (B). The expatriating individual is subject to tax on this item even if on the date of the payment such individual is not a U.S. resident or citizen, that is she has already expatriated. An eligible deferred compensation item is any deferred compensation item:

1. With respect to which the payor is the U.S. person or the payor is the one who elects to be treated as a U.S. person(Section 877A(d)(3)(A)), and

2. The ''covered'' expatriate has notified the payor of such item, of his status as a ''covered'' expatriate and elected irrevocably to waive any right to claim any reduction under any treaty with the U.S. in withholding on such items (Section 877A(d)(3)(B)).

This election is made on Form 8854 for each deferred compensation item. Notice 2009-85, Section 8.C. The covered expatriate must provide Form W-8CE to the payor on the earlier of (1) the day before the first distribution after the expatriation date, or (2) 30-days after the expatriation date. The purpose of this form is to provide payor with a notice that the individual is a ''covered'' expatriate who has waived treaty benefit and that payments to such individual is subject to 30 percent withholding. While the responsibility to pay the 30 percent withholding tax is on the payor, the ''covered'' expatriate must annually file Form 8854 to certify that no distributions of the eligible deferred compensation item has been received or to report the amount of distribution received. Notice 2009-85, Section 8.D.

The tax code does not define the term ''ineligible deferred compensation item.'' Notice 2009-85 however states that a deferred compensation item that is not an eligible deferred compensation item is an ineligible deferred compensation item. Essentially, if the required election discussed above is not made, a deferred compensation item is an ineligible deferred compensation item.

As to the taxation of an ineligible deferred compensation item, generally speaking, the present value of the ''covered'' expatriate's accrued benefit is treated as received by the expatriating individual on the day before the expatriation date as if there is a distribution. Section 87A(d)(2)(A). An early distribution tax is not applied, and appropriate adjustment is made to subsequent distributions from the plan to reflect such treatment. Section 877A(d)(2)(B), (C).

If the deferred compensation item is the one described in III.B(i)(c) above (that is the property subject to Section 83), it is taxable on the date before the expatriation as if the property is not subject to substantial risk of forfeiture on the date before the expatriation.

In the case of an ineligible deferred compensation item, the ''covered'' expatriate is also required to provide Form W-8CE to the payor on the earlier of (1) the day before the first distribution after the expatriation date, or (2) 30-days after the expatriation date. However, the purpose of this form is to provide notice to the payor that the individual is a ''covered'' expatriate who is treated as receiving an amount equal to the present value of his or her accrued benefit on the day before the expatriation date and with respect to which appropriate adjustments must be made to subsequent distributions to reflect the tax imposed by reason of such treatment. Notice 2009-85, Section 8.D. Within 60 days of receipt of Form W-8CE, the payor is required to provide a written statement to the ''covered'' expatriate setting forth the present value of the ''covered'' expatriate's accrued benefit on the day before the expatriation date. As one may observe, W-8CE is one way to get a written confirmation of the present value of the accrued benefit that is reported on the tax return of the expatriate in the year of expatriation.

  DTR ISSN 0092-6884

In summary, a deferred compensation item is taxed either on the day before expatriation or any time in the future when it is actually paid (even if the expatriating individual is no longer a U.S. resident or a U.S. citizen), and this timing depends upon whether the item is an eligible deferred compensation item or an ineligible deferred compensation item. In the case of an eligible deferred compensation item the ''covered'' expatriate may remain subject to future compliance, for example, the need to file Form 8854 annually even after expatriation is otherwise complete. The eligible deferred compensation item when distributed is subject to 30 percent withholding rate, but not an ineligible deferred compensation item. Whether or not to elect to treat a deferred compensation item as an eligible or ineligible is a matter of pre-expatriation tax planning and personal choice. Some considerations in making this choice include: tax rate under a treaty between U.S. and new home country of the expatriate, desire to annually think about the need to file Form 8854, expatriate's tax rate in the U.S. in the year of expatriation and future tax rate in the new home country, need to file a nonresident tax return in the U.S. upon receipt of distribution, etc.

III.B(ii). Specified tax deferred account. **A specified tax deferred account is (Section 877A(c)(2)):**

1. An individual retirement plan (as defined in Section 7701(a)(37) that is,

a. An individual retirement account described in Section 408(a), or

b. An individual retirement annuity described in Section 408(b),

But not an arrangement described in subsection (k) or (p) of Section 408 (note that these arrangements are considered deferred compensation items under Section 877A(d)(4));

2. A qualified tuition program (as defined in Section 529);

3. A qualified ABLE program (as defined in Section 529A);

4. A Coverdell education savings account (as defined in Section 530);

5. A health savings account (as defined in Section 223); and

6. An Archer MSA (as defined in Section 220) (Section 877A(e)(2)).

The specified tax deferred accounts are taxable in the year of expatriation. On the day before the expatriation date, the expatriating individual is deemed to have received a distribution of her entire interest in the specified deferred account. Section 877A(d)(5). No early distribution tax applies to such deemed distribution and subsequent adjustment is permitted in the event of subsequent distribution from the plan. Section 877A(3)(1)(B), (C).

The covered expatriate must provide Form W-8CE to the payor on the earlier of (1) the day before the first distribution after the expatriation date, or (2) 30-days after the expatriation date. The purpose of this form is to provide payor with a notice that the individual is a ''covered'' expatriate who is treated as receiving a distribution of his entire interest in the specified deferred account on the day before the expatriation date and with respect to which appropriate adjustments must be made to subsequent distributions to reflect the tax imposed by reason of such treatment. Notice 2009-85, Section 8.D. Within 60 days of receipt of Form W-8CE, the payor must provide a written statement to the ''covered'' expatriate setting forth amount of the ''covered'' expatriate's entire interest in his or her account on the day before his or her expatriation date. Notice 2009-85, Section 8.D and Section 6. As one may observe, W-8CE is one way to get a written confirmation of the value of the interest in the plan on the day before expatriation to be reported on the tax return of the expatriate in the year of expatriation.

III.B(iii). Interest in a non-grantor trust(Section 877A(c)(3)). **Section 877A defines a non-grantor trust as any trust or any portion of a trust, which the individual is not considered the owner of, immediately before the expatriation date. Section 877A(f)(3). While a non-grantor trust is subject to an alternative tax regime, a grantor trust is subject to the mark-to-market tax regime.**

Generally speaking, the distributions from a non-grantor trust are taxable when made. The taxable portion is the amount that would have been includible in the income of the ''covered'' expatriate had he been a U.S. resident or U.S. citizen. Section 877A(f)(2). This taxable portion is subject to withholding at 30 percent by the trustee of the trust. The covered expatriate however is required to inform the trustee of a non-grantor trust of his ''covered'' expatriate status by giving to the trustee a Form W-8CE on the earlier of (1) the day prior to the first distribution on or after the expatriation date, or (2) 30 days after the expatriation date. Section 877A(f)(2). The trustee of the trust is required to withhold a 30 percent tax on such taxable portion (Section 877A(f)(1)(A)) and is liable for non-withholding under Section 1461. Notice 2009-85, Section 7.C. It the trustee fails to withhold the 30 percent tax, the ''covered'' expatriate is required to file a tax return for that year. In certain specific instances, e.g., when appreciated property is distributed to a covered expatriate, the trust may be subject to tax on the gain. Notice 2009-95, Section 7.

The 30 percent tax cannot be reduced under an applicable treaty with the U.S. unless the ''covered'' expatriate:

1. Obtains a letter ruling from the Internal Revenue Service as to the value, if ascertainable, of his or her interest in the trust as of the day before the expatriation date (Revenue Procedure 2009-4);

2. Supplies a copy of the ruling and a certification signed under penalties of perjury that the tax due on the value of the interest in the trust has been paid to the IRS; and

3. Elects on Form 8854 that he has received the value of his interest in the trust on the day before the expatriation date and pays tax on such valuation on his timely filed tax return for the year of expatriation (Notice 2009-85, Section 7.C.).

Once this procedure is completed, the ''covered'' expatriate can request reduced withholding under an applicable treaty. The ''covered'' expatriate may not make the election if the IRS determines that his or her interest in the trust does not have an ascertainable value as of the day before the expatriation date.

In summary, the alternative tax regime is no less burdensome when compared to the mark-to-market regime. The final objective of each of the tax regimes (mark-to-market and alternative) is the same, impose tax on assets in the hands of expatriating individual on the day before the expatriation, and if the tax is not collected (e.g. in the case of eligible deferred compensa-

tion item, or taxable portion of income from nongrantor trust) before expatriation, collect the same at a flat rate (30 percent) irrespective of what the tax bracket of the individual is at a later date.

A closing note to this section III—unlike the mark-to-market tax regime, the alternative tax regime does not refer to the federal gross estate in determining what property is in the hands of an expatriating individual. It would seem therefore that one may gift these assets before expatriation to keep them out of the calculation of the net worth test. This however should be done only after a thorough review of the applicable federal gift and estate tax regulations, and applicable penalties if any for early withdrawal.

Given the complexity associated with the mark-to-market and alternative tax regimes applicable to a ''covered'' expatriate, it would make sense to review possible strategies where the individual is not considered a ''covered'' expatriate. These strategies should however take into account immediate versus future tax and compliance burdens.

Part 2 of this article will discuss (IV) determining the value, type, and location of assets on the day before expatriation; (V) compliance with U.S. tax obligations; (VI) determining the date of expatriation; (VII) whether the taxpayer is subject to tax under the U.S. expatriation provisions and when that tax is payable; and (VIII) what needs to be done before expatriating.

  DTR ISSN 0092-6884