OBSERVATIONS
ON
AMERICA'S NEW EXPATRIATION RULES

BY

WAYNE R. JOHNSON

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Section 301 of the Heroes Earnings Assistance and Relief Act of 2008 made sweeping changes in the way the United States taxes persons who relinquish their U.S. citizenship or cease to be lawful permanent residents of the United States on or after June 17, 2008 (with exception, these persons are referred to as "covered expatriates"). The Act achieved this sweeping change by adding new Sections 877A and 2801 to the Internal Revenue Code.

Under Code Section 877A, a covered expatriate is treated as though he sold all of his world wide property on the day before he expatriates. If the deemed sale results in gain in excess of the exclusion amount provided under Section 877A(a) (for 2009, the gain exclusion amount is $626,000), the covered expatriate must pay tax on the deemed gain. Section 877A also provides elaborate rules for the taxation of certain deferred income arrangements (including grants of restricted property that remain subject to taxation under Code Section 83).

In addition to the income tax aspects of the new expatriation rules, the Heart Act also introduces a new estate tax regime applicable to future gifts or bequests made, directly or indirectly, by covered expatriates. Interestingly, Code Section 2801 imposes tax on the recipient of such gifts, not the covered expatriate. Thus, Code Section 2801 is unique in that it introduces an inheritance tax for the first time.

Because the tax regimes established by Code Sections 877A and 2801 are both recent and unique, one should expect to encounter a good deal of controversy and confusion in the taxation of covered expatriates until the new law is further developed through litigation or IRS guidance. Until then, some issues practitioners can expect to encounter might include the following:

1. OLD EXPATRIATION TAX REGIME REMAINS VIABLE, FOR NOW –

Because Code Sections 877A and 2801 only apply to persons who relinquish their U.S. citizenship or cease to be lawful permanent residents of the United States on or after June 17, 2008, it necessarily follows that the provisions of Code Section 877 will remain applicable to those who relinquished U.S. citizenship or lawful permanent residency prior to that date. Consequently, one can not simply ignore the expatriation rules that existed under prior law. Because of the lengthy tax tail that applied to expatriates under prior law (i.e., 10 years), one should expect the old rules to remain viable until 2018.

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2. VALUATION PRINCIPLES ARE UNCERTAIN UNDER THE NEW EXPATRIATION REGIME –

As noted above, Section 877A treats covered expatriates as if they sold their worldwide assets at fair market value on the day before the expatriation date. Just what constitutes fair market value for this purpose is unclear. In Notice 2009-85, 2009-45 I.R.B. 598, IRS announced that, in general, "the valuation principles applicable for purposes of the Federal estate tax" should be used when determining fair market value under Code Section 877A. In particular, the Service announced that fair market value should be determined under Code Section 2031 and the regulations promulgated thereunder.

The immediate question presented by IRS' announcement is whether formal appraisals are required. One is also left to wonder about the extent to which valuation discounts apply for expatriation purposes.

Under prior expatriation tax law, IRS neither required formal asset appraisals (a good faith estimate of asset value was considered sufficient) nor accepted valuation discounts claimed. *See* Notice 97-19, 1997-1 C.B. 394. When it announced that estate tax valuation rules applied under Code Section 877A, however, the Service did not carry forward the valuation pronouncements made in Notice 97-19. Instead, the Service simply stated that the estate tax valuation rules would apply. IRS' statement suggests that all aspects of valuation (including discounting) will apply when determining fair market value under the new expatriation regime. Moreover, until further guidance is issued, one would be wise to use formal appraisals for valuation purposes.

Given the great deal of controversy that surrounds valuation under estate and gift tax laws, should we expect this same level of controversy to extend over to expatriation? Will valuation audits become the rage under the new expatriation regime? If so, the expatriation process might prove much more lengthy than any imagined.

3. TOO MANY PEOPLE AT THE EXPAT'S TABLE? –

Under Code Section 877A, there is a great deal of effort that must be made to ensure (a) the proper amount of tax is paid at the time of expatriation, (b) tax is withheld from benefits paid to the expatriate from certain deferred compensation arrangements, and (c) tax is withheld on distributions made to the expatriate from nongrantor trusts or ineligible deferred compensation items. This effort will require timely notices to payors of compensation and trustees of nongrantor trusts. It will also require that payors and trustees determine asset values for reporting under Section 877A. The amount of time and energy required in this regard may become overwhelming. Unless someone is able and willing to coordinate this effort (over a long period of time, no doubt), confusion will reign supreme.

Persons practicing in this area may be able to make themselves invaluable for expatriation reporting purposes by taking on the coordinator role. Proper compliance

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with applicable reporting and withholding principles will be key to successful expatriation.

4. EXPATRIATION WILL NOT LIKELY BE THE MAGIC BULLET NON-REPORTING FOREIGN ACCOUNT HOLDERS ARE LOOKING FOR –

Although the Heart Act repeals Code Section 7701(n), the reporting requirements of Code Section 6039G remain in tact. Thus, the expatriate must still notify IRS of his expatriation, although the giving of such notice will not impact the time at which expatriation is effective. Use of Form 8854 satisfies the reporting obligations of Code Section 6039G. Part A of the current Form 8854 applies to persons who expatriated before June 17, 2008. Part B of current Form 8854 applies to persons who expatriated after June 16, 2008.

On line 6 of Part B, Section 1, the expatriate is asked whether he certifies under penalty of perjury that he complied with all U.S. tax obligations for the 5 years preceding expatriation. Failure to give this certification will cause the taxpayer to be treated as a covered expatriate. Taxpayers continuing to have unreported foreign bank accounts will find it difficult to answer the question presented on line 6. If the taxpayer certifies that he has complied with U.S. laws when he knows he has not, he commits perjury and exposes himself to possible criminal sanction. On the other hand, refusing to give the requested certification will announce to IRS that the taxpayer has not complied with U.S. tax laws at some time during the preceding 5 year period – an answer that will no doubt give IRS pause to consider whether audit is appropriate.

The certification requirement thus presents the non-compliant taxpayer with a conundrum: do I falsely certify compliance and risk criminal sanction, or do I refuse to give the certification and risk exposure through audit? Neither of these choices is a good one for the non-compliant taxpayer. For this reason, expatriation will not likely be the magic bullet many taxpayers might hope it to be.

5. SECTION 2801: THE AMERICAN INHERITANCE TAX –

New Code Section 2801 imposes an inheritance tax on U.S. persons who, directly or indirectly, receive gifts or bequests from covered expatriates. The tax is imposed at the highest gift or estate tax rate then in effect (45% in 2009). Just how this tax will work in practice is unclear. IRS has promised to issue guidance, but has not yet done so.

What do we know for now? The tax imposed by Code Section 2801 applies to all gifts or bequests, other than: (a) gifts protected from taxation under Code Section 2503(b) (annual exclusion gifts); (b) gifts that are deductible under Code Sections 2522 (charitable gifts) and 2523 (gifts to a U.S. citizen spouse); and (c) gifts or bequests that

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are reported by the covered expatriate on a timely filed U.S. gift or estate tax return. The gift tax exclusion permitted by Code Section 2503(e) is not available.

Section 2801 will reach asset appreciation that occurs post-expatriation. Thus, if the natural objects of a covered expatriate's bounty remain in the United States following expatriation, serious consideration must be given to the impact of Section 2801 before the decision to expatriate is made. One is left to wonder how IRS will monitor these gifts. Will a Form 3520 be required upon receipt of such gifts?

There are also special rules that apply for gifts made in trust. If the trust is a U.S. domestic trust, it will be treated as the gift recipient and required to pay tax on the gift or bequest received. If the trust is a foreign trust, the tax will be collected on distribution to beneficiaries. Imagine the enforcement issues to be faced in this regard! If the reporting obligations become too burdensome for the foreign trustee, the foreign trust can elect to be treated as a domestic trust under Code Section 2801.

One should expect that compliance with Code Section 2801 will present significant administrative issues for persons advising in this area or administering trusts or estate plans subject to Code Section 2801. Thus, a new estate planning wrinkle is born.

CONCLUSION –

The issues presented above are only a small taste of those to come. With the introduction of Code Sections 877A and 2801, tax practitioners must now become familiar with two expatriation regimes and a new inheritance tax. Further, given the broad scope of the new regimes, planning opportunities remain limited. While the guidance provided in Notice 2009-85 is helpful, it leaves many questions unanswered.

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