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ADVISING US CITIZENS AND LONG-TERM RESIDENTS ON EXPATRIATING

WHAT TO ASK AND WHY IT MATTERS: CRITICAL QUESTIONS TO PROVIDE GOOD ADVICE

ROBERT E WARD

Notice 2009-85 issued by the Internal Revenue Service (IRS) on 9 November 2009 provides helpful guidance to practitioners advising clients who wish to give up their US citizenship. By relinquishing citizenship, clients avoid further US tax compliance, as well as US taxation on worldwide income. The Notice answers many questions left open by the statute adopted as part of the *Heroes Earnings Assistance and Relief Tax Act of 2008*[1]. That Act added new s877A and s2801 to the US *Internal Revenue Code* (Code), effective for individuals relinquishing US citizenship or ceasing to be lawful permanent residents of the US on or after 17 June 2008. For those individuals, Code s877A creates an exit tax regime. This article sets forth the questions practitioners should ask their clients who have an interest in expatriating. These questions will allow the practitioner to elicit information necessary to advise clients properly regarding their exposure to the US exit tax.

ARE YOU A CITIZEN OR LAWFUL PERMANENT RESIDENT OF THE US?

The exit tax of Code s877A is potentially applicable not only to US citizens, but also individuals who have resided in the US for at least eight out of 15 taxable years (long-term resident). The 15-year period ends with the year in which the individual ceases to be a lawful permanent resident of the US or becomes a resident of a non-US jurisdiction under the provisions of a tax treaty between the US and the other country[2].

WHAT IS YOUR NET WORTH? WHAT IS YOUR ANNUAL US INCOME TAX LIABILITY?

These questions provide an initial screen to determine which clients are subject to the exit tax imposed by Code s887A. Unless the taxpayer's net worth exceeds USD2 million (the net worth test) or the taxpayer's average annual net income tax liability for the five preceding taxable years prior to the year of expatriation exceeds the USD124,000 amount set forth in Code s887(a)(2)(A), as adjusted for inflation (USD147,000 for individuals expatriating in 2011[3]) (the tax liability test) the exit tax imposed by the statute does not apply. Any US citizen or long-term resident who satisfies the net worth test or the tax liability test is characterised as a 'covered expatriate' and subject to the exit tax. However, the converse is not necessarily true. That is, a taxpayer who does not satisfy either of these tests is not necessarily exempt from the exit tax.

HAVE YOU FILED ALL REQUIRED US TAX RETURNS FOR THE LAST FIVE YEARS?

To avoid the exit tax, the taxpayer who is expatriating must also be US tax-compliant: that is, all US tax returns

(including income, employment, gift tax, and information returns) must have been filed by the individual for each of the five taxable years preceding the taxable year in which expatriation occurs and all relevant tax liabilities, interest, and penalties must have been paid[4].

Notice 2009-85 clarifies that US tax-compliance includes filing all information returns. This includes Form TDF 90-22.1 Report of Foreign Bank and Financial Accounts, as well as all other information returns required by US persons owning foreign accounts, entities, and other assets.

Whether or not a taxpayer who intends to expatriate is a covered expatriate, the taxpayer must file Form 8854 to confirm US compliance obligations have been satisfied for the prior five years[5]. Failure to file Form 8854 or to sign the return under penalties of perjury not only subjects the person who is expatriating to a USD10,000 penalty, it also will cause an individual who does not satisfy either the net worth test or the tax liability test to nonetheless be treated as a covered expatriate and subject to the exit tax[6].

HOW DID YOU BECOME A US CITIZEN?

There are a variety of ways in which someone may acquire US citizenship, but the most common are either to be born in the US or to have a parent who is a US citizen. Code s877A(g)(1)(B) creates a loophole for individuals who become dual citizens at birth.

HAVE YOU EVER LIVED IN THE US?

Even if an individual meets the tax liability test or the net worth test, the individual may still avoid the exit tax if the expatriate became a US citizen and a citizen of another country at birth and has continued to be a citizen and taxed as a resident of that other country.

Example: Mr Smythe's mother was a US citizen residing in Canada at the time Mr Smythe was born. As a result, Mr Smythe has dual Canadian-US citizenship. Although his net worth is in excess of USD2 million, if Mr Smythe has been a US resident for ten or fewer years during the 15-year period ending with the taxable year during which expatriation occurs, he can avoid the exit tax[7].

HOW OLD ARE YOU? HOW LONG DID YOU LIVE IN THE US?

A further exception to the exit tax exists for individuals with a net worth in excess of USD2 million or average annual tax liabilities in excess of USD147,000 if US citizenship is renounced before age 18 and a half[8]. In this case, the taxpayer must not have been resident in the US for more than ten taxable years before relinquishing citizenship[9].

HOW DO YOU PLAN TO RELINQUISH US CITIZENSHIP?

Section 1481 of title 8 of the *United States Code* (USC) describes seven ways in which a US citizen can lose their nationality, including committing an act of treason. However, treason and most of the other acts described in s1481 are insufficient to enable an individual who is a US citizen or long-term resident to expatriate effectively for US income tax purposes. The one act within the scope of s1481 which is effective is 'making a formal renunciation of nationality before a diplomatic or counselor officer of the United States in a foreign state in such a form as may be prescribed by the Secretary of State'[10]. The author understands it is the practice in most US embassies to insist upon submission of Form DS-4079, 'Questionnaire: Information for Determining Possible Loss of US Citizenship' and a 'Statement of Understanding Concerning the Consequences and Ramifications of Relinquishment or Renunciation of US Citizenship', along with a copy of the individual's passports (both from the US and from the second country of the individual's nationality).

Code s877A(g)(4) provides that citizenship will be lost on the earliest of:

(1) the date the taxpayer renounces their US nationality before a diplomatic or counsellor officer in a foreign embassy

(2) the date the taxpayer furnishes the US Department of State with a signed statement of voluntary relinquishment of US nationality confirming either:
- (a) naturalisation in non-US jurisdiction
- (b) taking an oath or making an affirmation or other formal declaration of allegiance to a non-US jurisdiction
- (c) serving in the armed forces of a non-US jurisdiction, or
- (d) accepting employment by the government of a non-US jurisdiction

(3) the date the US Department of State issues a certificate of loss of nationality to the taxpayer, or

(4) the date a court of the US cancels a naturalised citizen's certificate of naturalisation.

While Code s877A(g)(4) recognises four ways in which citizenship may be relinquished, in most cases the taxpayer will submit two forms to the US embassy or consulate in the country where the individual resides: a 'Statement of Understanding Concerning the Consequences and Ramifications of Relinquishment or Renunciation of US Citizenship' and Form DS-4079 'Questionnaire: Information for Determining Possible Loss of US Citizenship', along with copies of the taxpayer's US and foreign passports.

WHAT ASSETS DO YOU OWN?

The vast majority of individuals who have dual citizenship with the US and another country will not be subject to the exit tax of Code s877A. Many of these taxpayers will not satisfy the tax liability test or the net worth test. Others will not be treated as covered expatriates because their citizenship arises as an accident of birth and the time the individual was present in the US was less than five out of the last 15 years. However, for individuals who fail to satisfy these requirements or others summarised above, which allow expatriation on a tax-free basis, the exit tax under Code s877A must be computed to determine the tax liability the individual will incur on expatriation.

Generally, the exit tax on expatriation is a tax on the unrealised income inherent in the covered expatriate's assets. Thus, assets the individual owns are deemed to have been sold on the day before the date of expatriation. Retirement plan assets and other deferred compensation items are deemed to have been paid to the covered expatriate on the day before the date of expatriation.

To determine the extent and value of the covered expatriate's assets, US estate tax principles apply[11]. The same revenue laws that determine the extent of a taxpayer's gross estate for US estate tax purposes under Code s2033 to s2046 will apply to determine the assets included in the covered expatriate's net worth. The same principles appearing in *US Treasury Regulations* issued under Code s2031 and s2512 apply to measure the value of the assets the covered expatriate owns or is deemed to own. (In this regard, the alternate valuation date election under Code s2032 and special use valuation under Code s2032A are not available[12].) Contractual arrangements, such as options or other transactions involving family members, will generally be ignored if these arrangements have the effect of depressing the value of an asset[13].

HAVE YOU EVER TRANSFERRED ASSETS TO A TRUST?

In certain cases a covered expatriate will also be deemed to own assets that would not be subject to US estate taxation at the covered expatriate's death. Although not explicit in the statute, the technical explanation to the *Heroes Earnings Assistance and Relief Tax Act of 2008* confirms that the assets with respect to which the covered expatriate is treated as the owner under the grantor trust rules of Code s671 to s679 will be included in the tax base on which the exit tax is assessed[14]. Thus, if the covered expatriate is treated as the owner of the trust for US income tax purposes, the assets of the trust will be treated as owned by the covered expatriate for purposes of computing the exit tax.

If expatriation causes the grantor trust to be converted from a US to a non-US trust as a result of relinquishment of citizenship and application of the rules of Code s7701(a)(31)(b) and *US Treasury Regulations* s301.7701-7, *Notice 2009-85* makes it clear that Code s684 may apply[15]. This Code provision treats the transfer of appreciated property to a foreign trust as a gain recognition event[16] unless the transferor is treated as the owner of the trust for US income tax purposes under Code s671 to s679. Thus, if (a) expatriation causes the *situs* of the trust to change from domestic to foreign, and (b) expatriation causes the covered expatriate to no longer be treated as grantor of the trust, *Notice 2009-85* confirms that the assets of the trust will be deemed to have been sold. With regard to these circumstances, the Notice is explicit that the provisions of Code s684 apply before the provisions of Code s877A[17]. As a result, it would appear that the USD600,000 exclusion of gain under Code s877A(a)(3)(A) (adjusted to USD636,000 for individuals expatriating in 2011[18]) would not be available to reduce or offset gain recognition under Code s684.

Other arrangements that frequently (but not necessarily) involve the use of trusts will also increase a covered expatriate's net worth – for purposes of the exit tax. As observed above, US estate tax principles determine the extent and value of the covered expatriate's assets[19]. For example, Code s2035 to s2038 treat a decedent as owning assets previously transferred prior to death if the decedent retained control over the transferred property or the income therefrom, unless the retained control or income was relinquished more than three years prior to expatriation[20]. Where control or income was retained through a trust, the assets held in trust will be subject to the exit tax computed as if the previously transferred assets had been sold for an amount equal to their fair market value on the day before the date of expatriation. No relief is provided for US gift taxes paid in connection with the initial transfer to the trust. In contrast, gift tax paid in connection with the transfer of property subject to inclusion in the gross estate of a decedent for US estate tax purposes under Code s2035 to s2038 is credited in the computation of the transferor's estate tax liability[21].

ARE YOU A BENEFICIARY OF A TRUST?

Section 3A of the Notice is confusing in stating 'a covered expatriate is deemed to own his or her beneficial interest(s) in each trust (or portion of a trust) that would not constitute part of his or her gross estate...' This blanket statement

'The vast majority of individuals who have dual citizenship with the US and another country will not be subject to the exit tax'

appearing in s3A of the Notice is contradicted by both the statute and s7A of the Notice. Code s877A(c)(3) expressly excludes application of the mark-to-market rules of Code s877A(a)(2) to 'any interest in a non-grantor trust (as defined in subsection (f)(3))'. A non-grantor trust is defined by Code s877A(f)(3) as any portion of a trust with respect to which the settlor is not considered to be the owner under Code s671 to s679. This determination is made immediately before expatriation[22].

The relief from the exit tax provided by Code s877A(c)(3) and s7A of the Notice to a covered expatriate's beneficial interest in a non-grantor trust may prove to be ephemeral. The unrealised gain inherent in the assets held by a non-grantor trust will be recognised if the non-grantor trust subsequently becomes a grantor trust after the covered expatriate's expatriation[23]. The Notice provides the assets held by the trust with respect to which the covered expatriate is treated as the owner will be deemed to have been distributed under Code s877A(f)(1) to the covered expatriate.

Although the covered expatriate's beneficial interest in a non-grantor trust is not included in the tax base on which the exit tax is assessed, the covered expatriate will be subject to 30 per cent withholding[24] on distributions from the trust[25]. Generally, treaty relief is not available to reduce or eliminate such withholding. If the distribution takes the form of appreciated property, the trust will recognise gain as if the distributed property had been sold to the expatriate at fair market value. The covered expatriate must file Form W-8CE with the trustee of the non-grantor trust annually to notify the trustee of the covered expatriate's status and that the covered expatriate has waived any applicable tax treaty benefits[26]. The covered expatriate must also file Form 8854 each year to report either the receipt or absence of distributions from the trust[27].

DO YOU OWN ANY LIFE INSURANCE OR ANNUITY CONTRACTS?

Assets such as annuities and life insurance policies are also included in applying the net worth test and in computing the exit tax if the taxpayer who relinquished US citizenship is determined to be a covered expatriate. Annuities and life insurance policies are generally valued at their replacement cost[28].

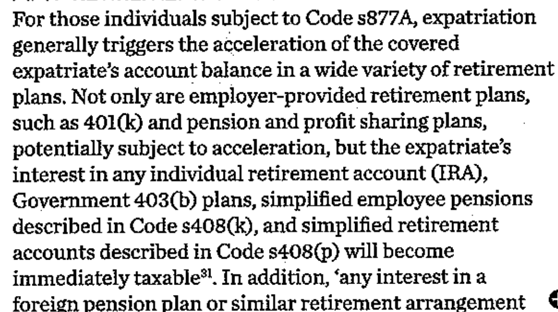
HAVE YOU EVER TRANSFERRED ASSETS TO A NON-US CORPORATION?

Generally, gain is required to be recognised on contribution of appreciated property to a non-US corporation. However, the gain realised may be deferred by entering into a gain recognition agreement satisfying the requirements of *US Treasury Regulations* issued under Code s367(a). These regulations also provide that if an individual US transferor loses US citizenship or ceases to be a lawful permanent resident of the US, the individual will be treated as having disposed of all of the stock of the foreign corporation to which the appreciated property was transferred[29]. As a result, the gain that was deferred as a result of the gain recognition agreement will be accelerated and recognised on the date of expatriation.

Again, the Notice is explicit: the gain that was deferred by the gain recognition agreement is recognised and taxed before application of Code s877A[30]. The result of the ordering rule of the Notice is to make the USD600,000 exclusion under Code s877A(a)(3)(A) unavailable to reduce or offset gain recognition under Code s367(a).

DO YOU OWN ANY INDIVIDUAL RETIREMENT ACCOUNTS, DO YOU PARTICIPATE IN EMPLOYER PROVIDED RETIREMENT PLANS, OR ARE YOU ELIGIBLE FOR ANY OTHER FORM OF DEFERRED COMPENSATION BENEFIT?

Computation of the exit tax under Code s877A begins with analysis of the assets the covered expatriate owns or is deemed to own. Once these assets are identified, special rules apply to determine the income required to be recognised under Code s877A. In the case of personal and investment assets owned directly by the expatriate, these assets are marked to market as if they had been sold for fair market value on the date of expatriation. In the case of other assets such as deferred compensation items, income will be realised as if the deferred compensation were received. In each case, the practitioner should ask questions necessary to identify the types of property s877A seeks to tax.



DO YOU PARTICIPATE IN ANY RETIREMENT PLANS?

For those individuals subject to Code s877A, expatriation generally triggers the acceleration of the covered expatriate's account balance in a wide variety of retirement plans. Not only are employer-provided retirement plans, such as 401(k) and pension and profit sharing plans, potentially subject to acceleration, but the expatriate's interest in any individual retirement account (IRA), Government 403(b) plans, simplified employee pensions described in Code s408(k), and simplified retirement accounts described in Code s408(p) will become immediately taxable[31]. In addition, 'any interest in a foreign pension plan or similar retirement arrangement

or program' is included within the definition of a 'deferred compensation item' for purposes of Code s877A(g)(4). Further, amounts payable under non-qualified deferred compensation arrangements, such as trusts or other arrangements in which the 'covered expatriate has a legally binding right as of the expatriation date to such compensation... not... actually or constructively received on or before the expatriation date...' will be deemed to have been paid[32].

Finally, deferred compensation items also include *'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*[33]*.'* This includes statutory and non-statutory stock options, stock appreciation rights, restricted stock units with respect to which income recognition has been deferred because the property is either subject to a substantial risk of forfeiture or non-transferable. However, if the property has been the subject of an election under Code s83(b) resulting in its fair market value having been taken into income by the covered expatriate, it will not be treated as a deferred compensation item for purposes of Code s877A[34].

DO YOU HAVE ANY REGISTERED RETIREMENT SAVINGS PLANS (RRSPs), REGISTERED RETIREMENT INCOME FUNDS (RRIFs), OR SIMILAR RETIREMENT SAVINGS ARRANGEMENTS?

Guidance is needed regarding the proper characterisation of RRSPs, RRIFs, and other retirement savings arrangements common in Canada. In certain respects, these savings arrangements would seem to not be properly characterised as deferred compensation items inasmuch as they do not seem to fit easily under the rubric 'foreign pension plan or similar retirement arrangement or program' because the RRSP or RRIF is linked to a particular employee not to a particular employer. In this respect, the RRSP would seem to be more analogous to an individual retirement account, which is characterised by Code s877A(e)(2) as a 'specified tax deferred account' instead of a deferred compensation item. However, unlike an IRA, there are no penalties for early withdrawals of amounts from RRSPs and the tax deferral (for US income tax purposes) is limited to the accrual of funds held in the plan or fund, not the contributions. Deferral of accruals is provided by para 7 of Article XVIII of the *Convention between the US of America and Canada with Respect to Taxes on Income and on Capital* (US-Canada Tax Treaty). The relief provided by Article XVIII of the US-Canada Tax Treaty extends to accruals under 'a trust, company, organisation or other arrangement... operated exclusively to provide pension, retirement or employee benefits...' *Revenue Procedure* 2002-23 explicitly recognises RRSPs and RRIFs as within the scope of arrangements covered by para 7 of Article XVIII of the US-Canada Tax Treaty, but did not characterise these savings arrangements as 'pension plans'[35]. Finally, *Notice 2003-25* and *2003-57* characterised RRSPs and RRIFs as trusts subject to the reporting requirements of Code s6048[36].

If RRSPs and RRIFs and other similar retirement savings arrangements are regarded as trusts, they are clearly grantor trusts because of the access and control the covered expatriate has over the assets of the plan or fund. As explained above, the assets of a grantor trust are treated as owned by the covered expatriate and marked to market. As such, the difference between the contributions made by the covered expatriate to the plan or fund and the fair market value of the assets in which those contributions were invested as of the day before the date of expatriation will be recognised and subject to the exit tax to the extent not sheltered by the exclusion of Code s877A(a)(3)(A). In contrast, Code s877A(d)(2)(A)(i) treats deferred compensation item as having been 'received' by the covered expatriate and Code s877A(e)(1)(A) treats the covered expatriate 'as receiving the entire interest in such account'. Characterisation of the RRSP, RRIF or similar retirement savings arrangement as a deferred compensation item requires the custodian to 'deduct and withhold from any taxable payment to a covered expatriate with respect to such item a tax equal to 30 per cent thereof[37].' As such, the Notice requires the untaxed income of the plan or fund to be included in the final return of the covered expatriate or – if the item of deferred compensation qualifies as 'eligible deferred compensation – subject to 30 per cent withholding when paid[38].' Because the market-to-market regime does not apply to either items of deferred compensation or tax deferred accounts, the USD600,000 exclusion of Code s877A(a)(3)(A) does not apply[39].

WERE ANY OF THE SERVICES GIVING RISE TO THE DEFERRED COMPENSATION ITEM PERFORMED OUTSIDE OF THE US?

An exception is provided by Code s877A(d)(5) for deferred compensation items attributable to services performed outside the US while the covered expatriate was not a citizen or resident of the US. These items fall outside the scope of the exit tax imposed by Code s877A[40]. This would most commonly arise in the case of an individual who is

'To determine intelligently whether the exit tax should be deferred, it is necessary first to compute the covered expatriate's tax exposure'

not a US citizen but became subject to Code s877A as a result of satisfying the definition of a long-term resident. *Notice 2009-85* provides that taxpayers may use 'any reasonable method' to determine what portion of a deferred compensation item is attributable to services performed outside the US while the covered expatriate was not a citizen or resident, as distinguished from that portion attributable to services performed while the covered expatriate was a resident of the US[41].

WHEN DID YOU BECOME A US RESIDENT?

A special exception is available to those individuals who become subject to the exit tax of Code s877A as a result of characterisation as a long-term resident (that is, a lawful permanent resident of the US for at least eight taxable years during the 15-year period ending with the taxable year in which residency ceases). Gain inherent in the assets owned by the covered expatriate at the time the individual first became a resident of the US will be ignored[42]. Residency for these purposes is determined on the basis of the tests found in Code s7701(b). Thus, residency could commence on the date the individual first:

(1) became a lawful permanent resident of the US (that is, a 'green card' holder)
(2) satisfied the substantial presence test of Code s7701(b)(3), or
(3) elected to be treated as a US resident pursuant to Code s7701(b)(4).

Property owned by the covered expatriate on the residency starting date is deemed to have a basis for purposes of computing gain or loss under Code s877A equal to the fair market value of the property on that date[43]. This basis adjustment is automatic unless the covered expatriate elects out of these rules. Such an election may be appropriate in the case of a covered expatriate whose gain recognition is sufficiently limited so as to be sheltered by the USD600,000 exclusion provided by Code s877A(a)(3)(A) or who owns a US real property interest with respect to which the individual prefers to recognise gain otherwise excluded as a result of Code s877A(h)(2), perhaps because of lower capital gain rates applicable to the year of expatriation[44]. *Notice 2009-85* provides that the basis step-up allowed by Code s877A(h)(2) will not be available in the case of a US real property interest held in connection with the conduct of a US trade or business on the date the covered expatriate first became a resident of the US unless the US trade or business was not carried on through a permanent establishment in the US as a result of a tax treaty between the US and the country in which the covered expatriate resided prior to US residency[45].

ARE YOU WILLING TO GIVE AWAY ASSETS?

The obvious planning opportunity to avoid status as a covered expatriate is to give assets away prior to expatriation so as to avoid the net worth test. If the asset transfers reduce the taxpayer's net worth below the USD2 million threshold, the exit tax may be avoided. (The taxpayer will also have to fail to satisfy the tax liability test to avoid status as a covered expatriate.) Gifts prior to expatriation will qualify for the gift tax exemption of Code s2505[46].

To be effective to reduce the net worth of the taxpayer who is contemplating expatriation below the USD2 million threshold of the net worth test, conveyances do not need to take the form of direct gifts. Transfers in trust will qualify so long as the conveyance is a completed gift prior to the date of expatriation. Such trusts will have to run the gauntlet of the rules discussed above regarding the circumstances in which assets held in trust will be considered to comprise part of the asset base to which the net worth test is applied: generally a non-grantor trust with respect to which the taxpayer has no beneficial interest. The taxpayer could nonetheless act as trustee of such a trust as long as the trustee's discretion to make distributions was limited by an ascertainable standard[47] or the beneficial interests in the trust were administered as separate shares[48].

DO YOU WISH TO INCUR THE EXIT TAX IN THE YEAR OF EXPATRIATION OR TAKE ADVANTAGE OF OPPORTUNITIES FOR ITS DEFERRAL?

Computation of the exit tax

To determine intelligently whether the exit tax should be deferred, it is necessary first to compute the covered expatriate's tax exposure under Code s877A. Unless the taxpayer's expatriation date is 1 January, the covered expatriate will file a 'dual status return' for the year in which expatriation occurs[49]. The dual status return requires preparation of both Form 1040NR and Form 1040[50] attached as a schedule. With the dual status return, the covered expatriate must provide a statement that includes the information required by Code s6039G: generally, the covered expatriate's income, assets, and liabilities. This information will be used to compute the gain realised as a result of the deemed sale of the covered expatriate's assets and the income realised as a result the deemed payment of the covered expatriate's deferred compensation items. *Notice 2009-85* provides examples illustrating how the USD600,000 exclusion provided by Code s877A(a)(3)(A) will be allocated among the assets with respect to which gain is realised. The Notice resolves two unanswered questions or ambiguities present in the language of the statute. First,

loss realised as a result of marking-to-market the covered expatriate's assets will be applied to offset gains. Second, the resulting basis adjustment will take into account gain sheltered as a result of the USD600,000 exclusion.

Example: Mr Smythe owns one asset with a basis of USD200,000 and a fair market value of USD2 million. As a result of his expatriation in 2011, the asset is marked to market and deemed to be sold for USD2 million. Of the USD1.8 million of deemed realised gain, USD636,000 is sheltered as a result of the exclusion provided by Code s877A(a)(3)(A). Mr Smythe will pay a tax on the remaining USD1.2 million of unsheltered gain. *Notice 2009-85* makes clear that the basis which Mr Smythe takes in his US real property interest is USD2 million, despite the USD636,000 exclusion[51].

Deferral of income recognition from deemed sales

There are two opportunities to defer the exit tax. First, in the case of any asset subject to the mark-to-market regime a deferral election is available under Code s877A(b). Elective deferral is available on an asset-by-asset basis[52]. As a result of the deferral election, the exit tax will be deferred until the asset is sold. In the interim, interest will accrue on the deferred tax liability at the underpayment rate established under Code s6621 from the due date of the covered expatriate's US income tax return determined without extensions for the taxable year that includes the day before the expatriation date[53]. That is, 15 April of the year after the year in which the expatriation date occurs, unless the expatriation date occurs on 1 January, in which case interest will accrue starting on 15 April of the year in which the expatriation date occurs[54].

To qualify for the deferral election, the covered expatriate must:

(1) waive any treaty benefits which would preclude assessment or collection of the exit tax by filing Form 8854 with the covered expatriate's US income tax return for the taxable year that includes the day before the expatriation date

(2) provide adequate security, described by the Notice as either:

(a) a bond meeting the requirements of Code s6325, or

(b) another form of security acceptable to the US Secretary of the Treasury, such as a letter of credit

(3) enter into a tax deferral agreement with the IRS conforming to the template provided as appendix A to *Notice 2009-85*, and

(4) appoint a US person to act as the covered expatriate's agent for purposes of receiving correspondence from the IRS relating to the tax deferral agreement by entering into a binding agreement substantially similar to the form of the agreement provided as appendix B to *Notice 2009-85*.

The deferral request the covered expatriate is required to provide to elect to defer the exit tax must include:

(1) two signed copies of the tax deferral agreement

(2) a description of the assets with respect to which elective deferral applies

(3) an attachment showing the calculation of the tax attributable to each of the assets computed in the manner required by *Notice 2009-85*

(4) documentation of the security offered by the covered expatriate for deferral of the tax

(5) a copy of the agreement with the US agent, and

(6) a copy of the covered expatriate's US income tax return for the taxable year that includes the day before the expatriation date.

In addition, the covered expatriate must include a copy of the deferral request with their tax return for the taxable year that includes the day before the expatriation date. The Notice makes clear that the covered expatriate may file[55] the deferral request simultaneously with this tax return.

Deferral of income recognition from deemed payment of deferred compensation items. Deferral is also available with respect to deferred compensation items that satisfy the definition of an eligible deferred compensation item under Code s877A(g)(3). Despite expatriation, eligible deferred compensation items are not subject to US taxation until actually paid to the covered expatriate. To satisfy the requirements of the statute, the deferred compensation must be payable by a US person or a person who elects to be treated as a US person for purposes of the statute. The covered expatriate must notify the payer of the taxpayer's status as a covered expatriate and waive reduced withholding provided by any applicable tax treaty[56]. The Notice requirement is satisfied by filing form W-8CE with the payer within 30 days of the expatriation date or prior to the first distribution on or after the expatriation date if fewer than 30 days[57]. As a result of the treaty waiver, payment of the deferred compensation to the covered expatriate will be subject to 30 per cent withholding under Code s877A(d)(1). Until the eligible deferred compensation items are paid, the covered expatriate must also file Form 8854 annually to avoid imposition of a USD10,000 penalty for failure to file.

Anything that is not an eligible deferred compensation item is characterised by the Notice as an 'ineligible deferred compensation item[58].' These items will be fully taxable in the taxable year of the covered expatriate, which includes the day before the expatriation date. The Notice requires the covered expatriate to provide Form W-8CE to the payer of the deferred compensation item. Within 60 days of receipt

'Despite expatriation, eligible deferred compensation items are not subject to US taxation until actually paid to the covered expatriate'

of Form W-8CE 'the payer must 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[59]'. Generally in the case of ineligible deferred compensation items, the amount included in income is the covered expatriate's account balance on the day before the expatriation date[60]. However, in the case of a defined benefit plan, the present value of the covered expatriate's accrued benefit will be determined using the methodology set forth in s4.02 of *Revenue Procedure* 2004-37, 2004-1C.B.1099. Early distribution taxes and penalties will not apply in computing the tax liability for ineligible deferred compensation items subject to the exit tax[61]. In the case of ineligible deferred compensation items, which represent interests in foreign pension plans or similar retirement arrangements or items of deferred compensation payable by a non-US employer (such as non-qualified deferred compensation), the present value of the covered expatriate's accrued benefit will be determined by applying the principles set forth in *Proposed Treasury Reg.* s1.409A-4. In the case of an ineligible deferred compensation item that takes the form of property subject to Code s83, the fair market value of the property interest will be determined as of the day before the expatriation date without regard to any risk of forfeiture as if the item were fully transferrable by the covered expatriate (reduced by the amount, if any, paid by the covered expatriate for the property)[62]. With respect to stock appreciation rights or restricted stock units, the Notice provides that these interests will be treated as substantially vested as of the day before the expatriation date and valued by reference to the 'cash equivalency doctrine[63].'

DO YOU OWN ANY INTEREST IN AN IRA, 529 PLAN, COVERDELL SAVING ACCOUNT, HEALTH SAVINGS ACCOUNT, OR ARCHER MEDICAL SAVINGS ACCOUNT?

Although not explicitly stated in *Notice 2009-85*, accounts of the covered expatriate that fall within the definition of 'specified tax deferred accounts' under Code s877A(e)(2) are not eligible for deferral. Although no early distribution penalties or taxes will apply to the account balance in the specified tax deferred account, the entire account balance on the day before the expatriation date will be treated as distributed to the covered expatriate[64]. Specified tax deferred accounts are defined by the statute to include any individual retirement plan as defined by Code s7701(a)(37) (that is, individual retirement accounts and individual retirement annuities, other than simplified employee pension plans described in Code s408(k) and simple retirement accounts described in Code s408(p), qualified tuition programmes described in Code s529, Coverdell education savings accounts described in Code s530, health savings accounts described in Code s223, and Archer medical savings accounts described in Code s220).

DO YOU OWN ANY US REAL PROPERTY INTERESTS, STOCK OF ANY US CORPORATION, OR ASSETS USED IN A US TRADE OR BUSINESS?

US real property interests, stock of US corporations, or assets used in US trade or business are examples of US *situs* property. Non-resident aliens are subject to US estate taxation on US *situs* assets[65]. Further, these assets will also be subject to US gift taxation if transferred prior to the death of the non-resident alien. Unlike a non-resident alien, a US citizen or resident has the benefit of a significant US gift tax exemption. For transfers made after 31 December 2010 and before 1 January 2013, a US citizen or resident may transfer up to USD5 million in assets without incurring a US gift tax liability[66]. Because of the adverse gift and estate tax treatment imposed on US *situs* assets transferred by a non-resident alien while alive or at death, these assets should be transferred prior to expatriation. (Non-resident alien decedents receive the benefit of only a USD60,000 US estate tax exemption[67].)

DO YOU HAVE ANY FAMILY MEMBERS TO WHOM YOU INTEND TO MAKE GIFTS DURING YOUR LIFETIME OR BEQUESTS AT YOUR DEATH WHO ARE US CITIZENS AND MAY RESIDE IN THE US?

Code s2801 imposes a US transfer (gift or estate) tax on any gift or bequest made by a covered expatriate to a US citizen or resident. The tax imposed by Code s2801 falls not on the covered expatriate[68] but rather the US citizen or resident receiving the gift or bequest from the covered expatriate. The gift will be reported on a Form 708, which has yet to be issued by the IRS. 'The due date for reporting, and for paying any tax imposed on, the receipt of such gifts or bequests has not yet been determined[69].'

The tax imposed by Code s2801 is calculated at the maximum gift or estate tax rate in effect under Code s2001(c)[70]. The tax is applied to the fair market value of the assets that are the subject of the gift or bequest[71]. Value is determined on the date the transfer occurs. Although Code s2801(d) provides for a tax credit for 'any gift or estate tax paid to a foreign country', it is not clear that an income tax on dispositions of capital assets (such as the tax imposed by s69.1 to s70.5 of the Canadian *Income Tax Act* on transfers while alive and deemed dispositions at death) will satisfy

the requirements of the statute. In this regard, *Notice 2009-85* provides that '[s]atisfaction of the reporting and tax obligations for covered gifts or bequests received will be deferred, pending the issuance of guidance'[72].

HAVE YOU PREVIOUSLY EXPATRIATED?

Each covered expatriate is allowed one exclusion under Code s877A(a)(3)(A)[73]. If an individual expatriates more than once, any unused portion of the covered expatriate's exclusion will be available on subsequent exits[74].

CONCLUSION

While guidance remains pending on certain matters (particularly as related to the operation of Code s2801), *Notice 2009-85* fills in many of the gaps left by Code s877A and provides essential guidance regarding compliance procedures for paying the exit tax and taking advantage of the deferral opportunities provided by the statute. Perhaps the most essential unanswered question for advisers to clients residing in Canada is whether para 7 of Article XIII of the *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital 1980-* (the Tax Treaty) may be relied upon by a covered expatriate. This provision of the Tax Treaty appears to offer an opportunity to coordinate the recognition of gain under the revenue systems of both countries so as to make the US exit tax creditable against the Canadian tax liability of a covered expatriate residing in Canada. Presumably, if para 7 of Article XIII of the Tax Treaty applies to allow gain to be recognised and taxed by Canada in the same year the exit tax under Code s877A is imposed by the US, there would be a corresponding basis adjustment for Canadian tax purposes for the gain recognised[75]. Competent authority relief may ultimately be necessary to determine whether relief from double taxation is available on imposition of the exit tax under Code s877A, as well as the transfer tax imposed by Code s2801.

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[1]PL 110-245
[2]Code s877A(g)(5), referring to Code s877(e). *Notice 2009-85* clarifies that the exit tax of Code s877A will apply in cases in which loss of tax status as a US resident is a result of treaty tie-breaker provisions. *Notice 2009-85*, 2009-45 IRB 598
[3]Rev. Proc. 2010-40; 2010-46 IRB 663
[4]Code s877A(g)(1)(A) cross-referencing Code s877(a)(2)(c)
[5]*Notice 2009-85*, s8C
[6]*Notice 2009-85*, s8C, example 22
[7]*Notice 2009-85*, s2A
[8]Code s877A(g)(1)(B)(ii)
[9]Id
[10]*USC* s1481(a)(5)
[11]*Notice 2009-85*, s3A
[12]Id
[13]Id
[14]Technical Explanation of HR 6081 – the *Heroes Earnings Assistance and Relief Tax Act of 2008*, as Scheduled for Consideration by the House of Representatives on 20 May 2008, Prepared by the Staff of the Joint Committee on Taxation, p43
[15]*Notice 2009-85*, s4
[16]Code s684(a)
[17]*Notice 2009-85*, s4
[18]Rev. Proc. 2010-40; 2010-46 I.R.B. 663
[19]*Notice 2009-85*, s3A
[20]*Notice 2009-85*, s3A. '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 or her gross estate for Federal estate tax purposes under Chapter 11 of Subtitle B of the Code as if he or she had died on the day before the expatriation date as a citizen or resident of the United States.' While the literal language of the Notice supports the conclusion set forth in the text. This conclusion may be more than the drafters of the Notice intended.
[21]Code s2001(b)(2)
[22]Code s877A(f)(3)
[23]Code s877A(f)(1)(B); *Notice 2009-85*, s7A
[24]Code s877A(f)(1)(A)
[25]Code s877A(f)(4)(B)
[26]*Notice 2009-85*, s8D
[27]*Notice 2009-85*, s8C
[28]*Notice 2009-85*, s3A, referring to *US Treasury Reg.* s25.2512-6
[29]*Temp. Reg.* s1.367(a) 8T(d)(6)
[30]*Notice 2009-85*, s4
[31]Code s877A(g)(4)(A) brings within the scope of Code s877A 'any interest in a plan or arrangement described in s219(g)(5)'
[32]*Notice 2009-85*, s5B(4)
[33]Code s877A(g)(4)(D)
[34]*Notice 2009-85*, s5B(1)(d)
[35]Rev. Proc. 2002-23, 2002-1 CB 744, s3
[36]*Notice 2003-25*, 2003-18 IRB 855, *Notice 2003-57*, 2003-34 IRB 397
[37]Code s877(A)(d)(1)(A)
[38]Code s877A(d)(1)(A), 877A(d)(2)
[39]Code s877A(c)
[40]*Notice 2009-85*, s5E
[41]Id
[42]Code s877A(h)(2)
[43]Code s877A(h)(2)
[44]In this regard, the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* extended the 15 per cent rate on capital gains for two years. Absent further Congressional action the capital gains reverts to 20 per cent for sales and exchanges after 31 December 2012. Pub L No 111-132, s102
[45]*Notice 2009-85*, s3D
[46]Code s877A(d)(1)(A), 877A(d)(2)
[47]Code s877A(c)
[48]Code s674(b)(5)(B). Some commentators have also suggested that it may be possible to design a trust with respect to which the settlor retains a beneficial interest. *Campbell and Stegman*, 'Confronting the new expatriation tax: advice for the US Green Card holder' 35 *ACTEC Journal*, 266, 270 (Winter, 2009)
[49]*Notice 2009-85*, s8B
[50]The Notice refers taxpayers to US *Treasury Reg* s1.6012-1(b)(2)(ii)(b), *US Treasury Reg* s1.871-13, and chapter 6 of IRS Publication 519 for the requirements for filing a dual status return
[51]*Notice 2009-85*, s3C
[52]*Notice 2009-85*, s3E
[53]*Notice 2009-85*, s3E
[54]The underpayment rate for the first quarter of 2011 is 30 per cent. Rev Rul 2010-31; 2010-52 IRB 898
[55]*Notice 2009-85*, s8C
[56]*Notice 2009-85*, s5B(2)
[57]*Notice 2009-85*, s8D, referring to defined contribution plans within the scope of Code s401(a)
[58]*Notice 2009-85*, s5B(3)
[59]*Notice 2009-85*, s8D
[60]*Notice 2009-85*, s5D
[61]Code s877A(d)(2)(B)
[62]*Notice 2009-85*, s5D
[63]Id, referring to *Cowden v Commissioner*, 289 F.2d 20 (5th Cir 1961)
[64]*Notice 2009-85*, s6
[65]Code s2101, 2104(a)
[66]Code s2505; Pub L No 111-132, s302
[67]Code s2102(b)(1) and s2001(c). Canadian residents may take advantage of a larger exemption to shelter US *situs* assets from US estate taxation at the death of the non-resident alien available under Article XXIXB of the *Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital 1980-*.
[68]Code s2801(b)
[69]*Notice 2009-85*, s9
[70]Code s2801(a)(1)
[71]Code s2801(a)(2)
[72]Announcement 2009-57, 2009-29 IRB 158
[73]*Notice 2009-85*, s3B
[74]Id
[75]Whether any basis adjustment is available for the USD600,000 exclusion provided by Code s877A(a)(3)(A) appears doubtful