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## **Tax Planning Issues for U.S. Expatriation: Minimizing the IRC 877A Exit Tax**

Determining Covered Expatriates, Navigating the Mark-to-Market Tax on Unrealized Gains,  
Reporting Elections

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WEDNESDAY, NOVEMBER 18, 2020

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Today's faculty features:

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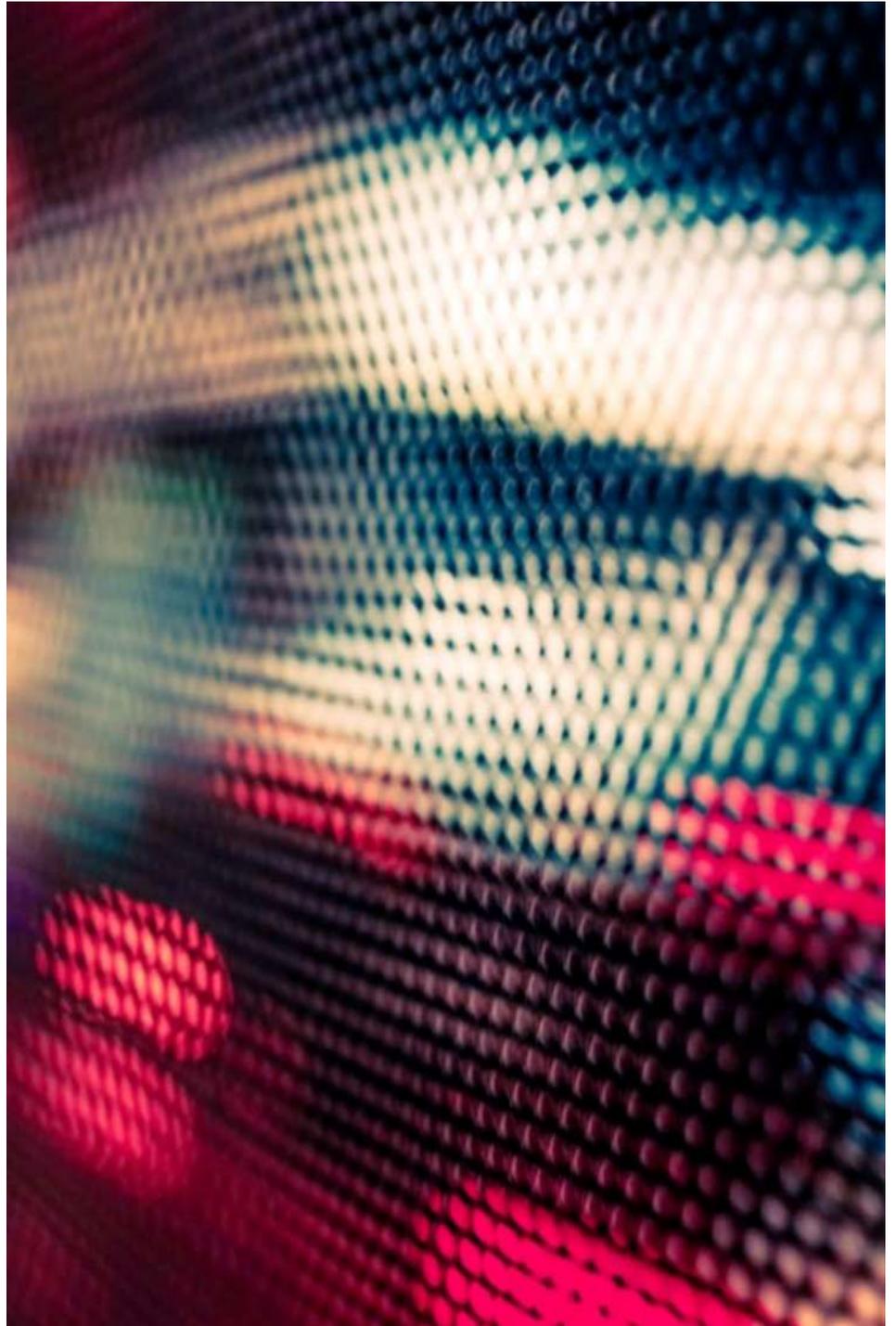


# **Tax Planning Issues for U.S. Expatriation: Minimizing the IRC 877A Exit Tax**

K. Eli Akhavan  
Norton Rose Fulbright US LLP

November 18, 2020

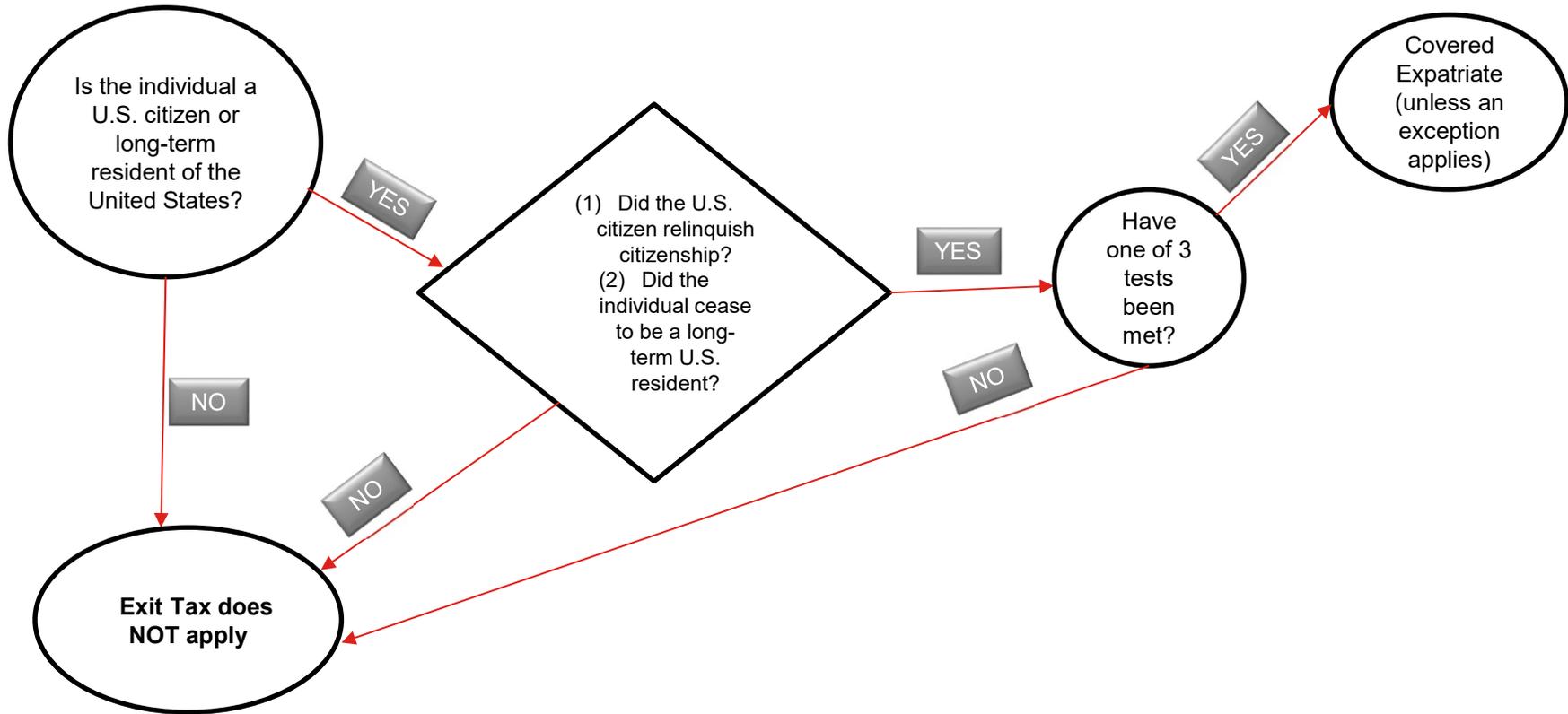
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# Agenda

- 1. Definition of “Covered Expatriate”**
- 2. Exceptions to the Definition**
- 3. The “Exit Tax” Applicable to a Covered Expatriate**
- 4. Estate and Gift Taxation**
- 5. Mechanics of Expatriation**
- 6. Planning strategies**

# Expatriation and Exit Tax Flow Chart



# Forms Required for Expatriates

- All expatriates must file a final income tax return and IRS Form 8854
- Covered Expatriates may be required to file Form W-8CE (depending on assets)

# Definition of Covered Expatriate

- 877A(g)(2)(A) and 877A(g)(2)(B) – An expatriate is any U.S. citizen who relinquishes U.S. citizenship, or any long-term U.S. resident who ceases to be a lawful permanent resident of the U.S.
- A Covered Expatriate is a individual who meets ONE of THREE tests:
  - Average annual net income tax liability for the period of the 5 taxable years ending before the date of the loss of the United States citizenship is greater than \$124,000 (indexed for inflation – currently \$171,000)
  - Net worth of individual is \$2MM or more
  - The individual fails to certify that he or she has complied with all US federal tax obligations for 5 years preceding expatriation

# United States Citizen

- Matter of immigration law

# Long-term resident

- Lawful permanent resident (means someone with permanent resident status; see IRC §7701(b)(6)).
- In at least 8 years in the 15-year period ending with the expatriation year.

# Long-term resident status: tax treaty complexity

- In computing your “8 years in the last 15 years” **do not count years** if:
  - you are not yet a long-term resident, **and**
  - you make a treaty election to be taxed as a nonresident alien for the entire calendar year.
- IRC §§877(e)(2), 877A(g)(5).

# Citizens: six ways to expatriate

- U.S. citizens have U.S. nationality.
- An “expatriate” is a **U.S. citizen** who **relinquishes U.S. nationality**. IRC §877A(g)(2)(A).
- “Relinquish” means doing one of six **voluntary acts** with the **intention** of relinquishing U.S. nationality. 8 U.S.C. §1481(a).
- Most common: **renunciation**. 8 U.S.C. §1481(a)(5).

# Expatriation date: renunciation

- “The date an individual relinquishes citizenship”. IRC §877A(g)(3)(A).
- Expatriation date for **relinquishment by renunciation** is the **earlier** of:
  - The date of renunciation. IRC §877A(g)(4)(A).
  - The date the State Department issues a Certificate of Loss of Nationality. IRC §877A(g)(4)(C).
  - Generally date of renunciation

# Expatriation date: other relinquishment methods

- IRS: (IRC §877A(g)(4)(C)) -- the earlier of:
  - The date the individual furnishes a signed statement of voluntary relinquishment of United States nationality under 8 U.S.C. §1481(a)(1)-(4).  
IRC §877A(g)(4)(B).
  - The date the State Department issues a Certificate of Loss of Nationality.
- State Department: the date of the expatriating act.
- Generally will be before State Department issuance of certificate

# IRS Tax Rules have Priority

- Department of State – Foreign Affairs Manual (7 FAM 1228.3)
- The individual should be referred to the IRS for all taxation questions, as the IRS may determine a different, and subsequent, date of loss of nationality for federal taxation purposes

# Long-term resident: visa termination

- **Abandoned:** the individual voluntarily gives up permanent resident status. Files Form I-407.
- **Revoked:** the government terminates permanent resident status by administrative or judicial proceedings.
- Green card expiration – not abandoned nor revoked - still a U.S. taxpayer and subject to US taxation on worldwide income.

# Long-term resident: visa termination date

- Abandon: the day of Form I-407 submission in person, or the date you mail it in (certified mail or its equivalent in the foreign country).
- Revoke: the final administrative ruling date. If you take it to court after the administrative ruling against you, the effective date is the date of the judicial ruling against you.
- Regs. §301.7701(b)-1(b)(3).

# Cease lawful permanent resident status

- The term “expatriate” means . . . any long-term resident of the United States who **ceases to be a lawful permanent resident** of the United States (within the meaning of section 7701(b)(6)).

## Mechanics with a tax treaty

- “An individual shall **cease to be treated as a lawful permanent resident** of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment.”

# Tax treaty election: effective date

- Effective date is the date taxpayer commenced be treated as a resident of the other country.
- May not be January 1.
- Confirm that “resident for tax purposes” is assured in the other country and know the date (in their law) that this status began.

# How to calculate net income tax liability

- Average income tax liability for prior 5 years is equal or greater than \$171,000 (2020 expatriations – annual adjustments for inflation). IRC §§877A(g)(1)(A), 877(a)(2)(A); Rev. Proc. 2019-44.
- Use the rules in IRC §38(c)(1) to compute “tax liability” (Notice 2009-85)
- NIIT and SE taxes do not count
- For married couples filing jointly, cannot divide liability.

# Net worth test

- Net worth greater or equal to \$2,000,000 on the date of expatriation – NOT indexed for. IRC §§877(a)(2)(B), 877A(g)(1)(A).
- Assets included - if giving it away would be a taxable gift if you were a U.S. citizen, include it.
- Also include the value of beneficial interests in trusts.
- Subtract liabilities to get net worth.
- Look at Notice 2009-85



## Dual citizen: the law

- “. . . **became at birth** a citizen of the United States and a citizen of another country and, as of the expatriation date, **continues to be a citizen** of, and is **taxed as a resident** of, such other country.” IRC §877A(g)(1)(B)(i)(I).

# Dual citizen: citizenship, tax residence

- “**Became a citizen at birth . . . .**” probably (!) means citizenship was automatically possible due to the fact of birth in the right circumstances, even if it took a while to do the paperwork.
- “. . . **continues to be a citizen . . .**” probably (!) means citizenship status has been uninterrupted since birth.
- “. . . **taxed as a resident. . . of such other country**” is confusing. What if the country has no income tax? Is it impossible to qualify for the dual citizen exception?

# U.S. residence

- “. . . has been a resident of the United States (as defined in section 7701(b)(1)(A)(ii)) for not more than 10 taxable years during the 15- taxable year period ending with the taxable year during which the expatriation date occurs[.]” IRC §877A(g)(1)(B)(i)(II).
- IRC §7701(b)(1)(A)(ii) is the substantial presence test.

## Under age 18 1/2 exception

“ . . . the individual’s relinquishment of United States citizenship occurs before such individual attains **age 18½** . . .” IRC §877A(g)(1)(B)(ii)(I).

and

“ . . . the individual has been a **resident of the United States** (as so defined) for not more than 10 taxable years before the date of relinquishment. . .”  
IRC §877A(g)(1)(B)(ii)(II).

# Certification test

- “[S]uch individual fails to certify under penalty of perjury that he has met the requirements **of this title** for the 5 preceding taxable years or fails to submit such evidence of such compliance as the Secretary may require.”  
IRC §877(a)(2)(C).
- “This title” = Title 26, United States Code (aka the Internal Revenue Code)

# Accuracy of tax returns

- Substantial versus non-substantial compliance
- The IRS program for remedial expatriation filing suggest that minor failures will not be an issue

# Income tax effect of IRC §877A

- Specified tax deferred accounts - (IRAs, for example). Deemed distribution (no early distribution penalty). IRC §877A(e).
- Deferred compensation - “ineligible” taxed as a deemed present value lump sum distribution; “eligible” has 30% withheld from distributions. IRC §877A(d).
- Trust distributions - 30% withheld from the taxable portion of the trust distributions when paid. IRC §877A(f).
- Everything else - deemed sale with gain/loss recognized. IRC §877A(a)(1).
  - The first \$737,000 of capital gain recognized on the deemed sale is exempted from taxation (for 2020 expatriations). IRC §877A(a)(3), Rev. Proc. 2019-44, §3.38. This amount is indexed for inflation.

# Specified tax deferred accounts and taxation

- IRC §877A(e), Notice 2009-85, Section 6.
- IRA, Roth IRA, HSA, Coverdell Education Savings Account, Medical Savings Account. IRC §877A(e)(2).
- Not: SEP, Simplified Retirement Account (these are deferred compensation items).
- Deemed distribution on the day before expatriation. IRC §877A(e)(1)(A).
- No early distribution penalty. IRC §877A(e)(1)(B).
- The gain exclusion for mark-to-market deemed sales does not apply, because this is not a mark-to-market disposition.
- Adjustment “basis” in the IRA, so the amount taxed isn’t taxed again. IRC §72, Notice 2009-85, Section 6.

# What are deferred compensation items?

- IRC §877A(d), Notice 2009-85, §5.
- Step 1: “Is this a deferred compensation item?” Notice 2009-85, §5(B)(1).
- Step 2: “Is this an eligible or ineligible deferred compensation item?” Notice 2009-85, §5(B)(2), (3).
- Step 3: “How is this (eligible or ineligible) deferred compensation item taxed and what are the withholding rules?”

# Eligible or ineligible?

- “Eligible” has two requirements:
  - The payor is a U.S. person (or a foreign person who elects to be treated as a U.S. person for this purpose). Notice 2009-85, §5.B(2).
  - AND . . . the covered expatriate gives the payor Form W-8CE within 30 days of the expatriation date. Notice 2009-85, §§5.B(2), 8.
- “Ineligible” if you fail one or both of those requirements. Notice 2009-85, §5.B(3).

# Taxation: ineligible deferred compensation

- Deemed lump sum distribution of the present value of accrued benefits, deemed received on the day before expatriation. Notice 2009-85, §5.D.
- Present value computation methods are found in Notice 2009-85, §5.D.

# Taxation: eligible deferred compensation

- The covered expatriate is a nonresident alien after expatriation.
- Normal tax rules for nonresident aliens apply. Use IRC §871 to determine U.S. tax liability. IRC §877A(d)(6)(B).
- Treaties can be used to change taxation of eligible deferred compensation items. (You aren't forced to waive the right to treaty benefits).

# Withholding

- Eligible deferred compensation:
  - 30% of the taxable payment. IRC §877A(d)(1)(A), Notice 2009-85, Withholding cannot be reduced by making a treaty claim.

# Withholding rules

- Withholding must be 30%. The covered expatriate must waive the right to reduce withholding rates by treaty in order to get the “pay as you go” treatment for eligible deferred compensation items. IRC §877A(d)(3)(B)(ii).
- Tax liability can be 0%. A covered expatriate doesn’t waive the right to use a treaty to reduce tax liability.
- Result: a covered expatriate needs to file Form 1040-NR to get withheld tax refunded.

# Nongrantor trust distributions: withholding

- IRC §877A(f), Notice 2009-85
- Applies to distributions from both foreign and domestic nongrantor trusts - IRC §877A(f)(3).
- Withholding: 30% of the taxable portion of the trust distributions, as made. IRC §877A(f)(1)(A).

# Nongrantor trust distributions: taxation

- The covered expatriate is a nonresident alien. Compute tax liability on the trust distribution using IRC §871.
- If the trust distribution contains U.S. source income, the beneficiary is taxed using the principles of IRC §871. If the trust distribution is foreign source income, the beneficiary has no tax liability under IRC §871.
- Result: Form 1040-NR is needed to claim tax refunds.

# Mark-to-market for everything else

- IRC §877A(a), Notice 2009-85, §3.
- Elements:
  - Deemed disposition; gain/loss recognition
  - Special basis rule for green card holders
  - Exemption amount and allocation among assets
  - Tax payment deferral

# Mark-to-market: assets it applies to

- Everything. IRC §877A(a)(1).
- Except assets with special rules. IRC §877A(c).
  - Specified tax deferred accounts
  - Deferred compensation items
  - Beneficial interests in nongrantor trusts

# Mark-to-market: what is “everything”?

- Assets includable in gross estate taxpayer died on the day before expatriating (Notice 2009-85)
- Value of beneficial interests in trusts that are not includable in gross estate (Notice 2009-85)

# Mark-to-market: what's the sale price?

- Deemed sold at fair market value.
- Use estate tax principles to determine fair market value.
- Except: beneficial interests in trusts are valued using gift tax principles of IRC §2512. Notice 2009-85.
- Except: value life insurance policies using gift tax rules; apply Reg. §25.2512-6. Notice 2009-85.

# Mark-to-market: what's your basis?

- Basis under standard tax principles
- Except for green card holders, who can elect basis to be the fair market value of assets they owned on the first day the individual became a resident alien IRC §877A(h)(2).
- But green card holders can't elect basis on first day of resident alien status for U.S. real property interests, which the IRS intends to say is out of bounds for basis step-up. Except maybe you can get a basis step-up if a treaty allows it. Notice 2009-85, §3.D.

# Mark-to-market: losses and carryforwards

- Losses are recognized.
- The wash sale rules don't apply.
- No guidance exists, but I take the position that a sale is a sale (even "deemed" transactions) and this unlocks suspended passive activity losses.
- Use your NOLs.

# Mark-to-market: gains and exemption

- Gain/loss is recognized because of IRC §877A(a).
- The character of the gain/loss is determined by the regular rules of the Internal Revenue Code.
- The first \$737,000 of gain is tax-free (expatriations in 2020).

# Mark-to-market: tax payment deferral

- IRC §877A(b), Notice 2009-85
- Paperwork.
- Post “bond”
- Interest accrues on the unpaid tax liability.
- Deferral is allowed on mark-to-market tax liability only, not on tax liability triggered by specified tax deferred accounts, deferred compensation, or trust distributions

# The IRC §2801 equation

“Covered Expatriate” + “U.S. Recipient” + “Covered Gift or Bequest”

= Section 2801 Tax Liability

## “Covered expatriate” for IRC §2801

- Same definition as used for income tax purposes from IRC §877A(g)(1). IRC §2801(f).
- Except . . . not if the covered expatriate became a U.S. resident or citizen again. Prop. Reg. §28.2801-2(h).
- Use the estate/gift tax definition of “resident”. Prop. Reg. §28.2801-2(b).



# What is U.S. domicile?

- Reg. §20.0-1(b)(1):

A “resident” decedent is a decedent who, at the time of his death, had his domicile in the United States. \* \* \* \* A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom.

# Anything from a covered expatriate

- It must be a gift in order to be a covered gift. The usual definition of “gift” applies. Prop. Reg. §28.2801-3(a).
- Covered gifts and bequests mean any transfers coming from a covered expatriate, directly or indirectly . . . to ANYONE.
- 2801 tax only applies when there is a US recipient

# Exceptions that don't work

- You can't use some exceptions to claim that a gift is not a gift and therefore it can't be a covered gift. If you make these transfers, they will be covered gifts. See Prop. Reg. §28.2801-3(a).
  - Transfers of intangibles by nonresidents.
  - Payments of school and medical expenses.

# Exceptions that work

- Fair market value transactions. They're not gifts.
- Annual small gift exclusion - IRC §2503(b). An amount smaller than the threshold is a "covered gift" but the tax does not apply to amounts below the IRC §2503(b) threshold. IRC §2801(c).
- Gifts that are otherwise subject to the gift tax, and are reported on a timely gift tax return. IRC §2801(e)(2).
- Gifts made while the covered expatriate is a U.S. resident.
- Marital deduction transfers to U.S. citizen spouses. IRC §2801(e)(3).
- QDOTs for bequests to noncitizen spouses. Prop. Reg. §28.2801-3(c)(4).
- Gifts to noncitizen spouses under the IRC §2523(i)(2) large annual gift exclusion. Prop. Reg. §28.2801-3(f), Example 1. (Hint: green card holder spouse living abroad).
- Charitable transfers. IRC §2801(e)(3).

# Form 708 and tax payment

- Form 708 has not yet been published; it will be published when the Proposed Regulations are final.
- No filing requirement until the Final Regulations are published. Announcement 2009-57.
- No payment of tax is required until the Final Regulations are published. Announcement 2009-57.

# Tax liability calculations

- FMV of covered gift or bequest received, minus the annual exclusion amount. Multiply that by the highest estate/gift tax rate in effect when the covered gift or bequest was received. IRC §2801(a), (c).
- Take a credit for foreign gift or estate taxes paid on the covered gift or bequest. IRC §2801(c).

# Noncitizens: don't be a long-term resident

- Use a visa category to live and work in the United States.
- If you must get a green card, prevent long-term resident status:
  - Abandon green card status before triggering the 8th year.
  - Use treaty elections to be a nonresident in tax years before the 8th year.

# Net worth test - Gifts to spouse

- Make gifts to spouse that is not expatriating
- The marital deduction is not permitted for gifts to noncitizen spouses. IRC §2523(i). Plan on using the unified credit if you are making gifts to a noncitizen spouse.
- Gifts in one calendar year and expatriate in the next.
- Non-gift transfers to nonresident alien spouses will be treated as a gain recognition event. IRC §1041(d).
- Possible solution is having the nonresident alien spouse elect under IRC §6013(g) to be a U.S. resident for income tax purposes in the year of transfer.

# Tax liability test - reduction

- Married filing separately
- Make gifts so that income isn't attributed to the average in past 5 years

# Gifts: green card holder abroad

- Gift tax rules apply to U.S. citizens and residents. “Resident” means domiciled in the United States. Reg. §25.2501-1(b).
- A green card holder domiciled abroad is only subject to gift tax on U.S. real estate transfers and gifts of U.S.-situs tangible personal property. IRC §2501(a)(1), (2).
- Foreign assets and worldwide intangible personal property can be given away without concern for gift taxation by or reporting to the U.S.

## Reduce exit tax

- Minimize mark-to-market gain by gift transfers. E.g., give away low basis/high capital gain assets, keep cash and high-basis assets.
- Where exit tax is unavoidable, ensure foreign tax credit availability in the expatriate's home country. Do this by triggering a gain recognition event in the foreign country.

# Relief Procedures for Certain Former Citizens

- Not for green card holders; citizens only.
- You never filed a U.S. resident tax return (erroneously filing Form 1040- NR is OK).
- Net worth under \$2,000,000 on expatriation date and when you file under the relief procedures.
- \$25,000 or less Federal tax liability for the year of expatriation and five prior years.
- Nonwillful failure to file must be asserted

# Takeaways

- It's relatively easy to avoid the net worth test for most people (make gifts using the unified credit, then expatriate).
- It's relatively easy to avoid the certification test It's not easy to avoid the net income tax liability test.
- File all appropriate forms – IRS Form 8854, Final Income Tax Return, Form I-407 (green card holders)

# Thank you



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Eli Akhavan is Senior Counsel in the New York office, focusing on tax and estate planning for high net-worth US and non-US clients. Eli advises international individuals and families with respect to tax and estate planning for their US assets and beneficiaries as well as other international estate matters, including foreign trusts, pre-immigration and expatriation planning, and on planning for the purchase of US residential and investment property. Eli has considerable knowledge of the reporting requirements applicable with respect to foreign financial accounts and assets and with respect to FATCA and its global equivalent, the Common Reporting Standards (CRS). Eli's practice includes advising clients on the formation of private trust companies for purposes of wealth management and privacy.

Additionally, Eli counsels US and non-US individuals and families on implementing domestic and foreign asset protection structures involving trusts and other vehicles to protect clients from creditors. Eli advises clients on domestic asset protection trusts in the US in jurisdictions such as Nevada, Delaware and Wyoming, and on foreign asset protection trusts in jurisdictions such as the Cook Islands and Nevis. Eli also integrates innovative private placement life insurance planning into his clients' plans as an estate and asset protection tool.

With respect to ultra-affluent US clients, Eli employs sophisticated wills and trusts, as well as closely-held entities, to enable his clients to transfer their wealth at a minimum tax cost. Eli also advises US clients on Puerto Rico's Acts 20 and 22 which allow clients to achieve income tax savings by relocating to Puerto Rico.

Eli has served as professor of International Taxation at St. John's University Law School. He is a recognized authority on tax and estate planning matters having been quoted by the Wall Street Journal, Fox Business and Bloomberg News. Most recently, he has lectured in the Caribbean and the Middle East on asset protection and cross-border planning matters. Eli has written numerous articles that appear in legal publications in the US and abroad.



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