

US Exit Tax Guidance

Notice 2009-85 (2009-45 IRB 598), October 15, 2009, contains long-awaited guidance on the new exit tax rules in Code section 877A (enacted by section 301 of the Heroes Earnings Assistance and Relief Tax Act of 2008 to replace Code section 877's 10-year alternative tax regime on certain US-source income of covered expatriates). The exit tax may apply to a US citizen who relinquishes citizenship and to a long-term US resident (who has held a green card for at least 8 of 15 years) who ceases to be a lawful permanent resident. A "covered expatriate" generally includes an individual who meets an income tax liability test or a net worth test and may include an individual who has not filed US tax returns. The notice may be of particular interest to a US citizen living in Canada who may be considering the renunciation of his or her US citizenship.

Code section 877A(a) imposes a mark-to-market regime on a covered expatriate: generally, all of his or her property is deemed to have been sold at FMV on the day before expatriation. Regardless of other Code rules, the deemed gain is included in that taxable year's gross income and reduced—but not below zero—by \$600,000, adjusted for inflation (\$626,000 in 2009); but any loss from the deemed sale is taken into account only if allowed by another Code section. Payment of the resulting tax may be deferred until the due date of the return for the taxable year of actual disposal.

The mark-to-market regime does not apply to specified tax-deferred accounts, interests in certain non-grantor trusts, or deferred compensation items; alternative tax regimes apply to some deferred compensation items under Code section 877A(d). A payer of eligible deferred compensation items must deduct and withhold 30 percent of taxable payments made to a covered expatriate; a covered expatriate recipient of ineligible deferred compensation items is treated as having received the present value of the accrued benefit on the day before expatriation. A covered expatriate who holds an interest in a specified tax-deferred account is treated as having received a distribution of all the account's interest on the day before expatriation. Special rules also apply to property distributions by a non-grantor trust to a covered expatriate beneficiary.

The notice provides helpful and specific definitions of terms such as "expatriate" and "covered expatriate" and offers rules and examples addressing the mark-to-market regime's application, such as (1) identification of a covered expatriate's property and FMV determination, (2) allocation of the exclusion amount, (3) adjustment of the basis of property subject to the mark-to-market regime, (4) an inbound basis step-up for non-resident aliens becoming resident, and (5) deferral of the tax.

The notice describes the interaction of section 877A and other Code provisions such as sections 367(a) (gain recognition agreements), 684 (recognition of gain on transfers to certain foreign trusts, estates, and non-resident aliens), and 897 (dispositions of investments in US real property). The notice provides special rules and definitions regarding deferred compensation items, including taxability and withholding. The notice also illuminates section 877A's effect on distributions from certain non-grantor trusts, such as gain recognition, withholding, and treaty interaction.

Until regulations incorporating the notice's guidance are issued, an individual expatriating after October 14, 2009 may rely on the notice. An individual who expatriates after June 16, 2008 and before October 15, 2009 may rely on the notice even after the regulations' issuance.

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