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August 2008

Expatriation Pursuant to the Heroes Act

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Introduction

On May 20, 2008 and May 22, 2008, the House of Representatives and the Senate, respectively, unanimously approved H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008" (the "**Heroes Act**"). On June 17, 2008, the President signed into law the Heroes Act. Section 301 of the Heroes Act added new Section 877A to the Internal Revenue Code of 1986, as amended (the "**Code**"), which effectively replaces and broadens current Code Section 877. Code Section 877A changes the taxation rules for certain US citizens that relinquish their US citizenship and certain long-term US residents who terminate their US residency after June 17, 2008 (collectively, "**Covered Expatriates**," and the activity of relinquishing citizenship or terminating residency, "**Expatriating**"). In general, Code Section 877A provides a new mark-to-market deemed sale regime for all of the assets owned by Covered Expatriates upon Expatriation.

Pre-Heroes Act Law – Section 877

Code Section 877 ("**Pre-Heroes Act Law**") continues to apply to Covered Expatriates that expatriated prior to June 17, 2008. In general, the Pre-Heroes Act Law subjected a Covered Expatriate to an alternative income tax regime. Under Pre-Heroes Act Law, a Covered Expatriate included US citizens that relinquished their citizenship and certain long-term US residents. A long-term US resident

would have been a Covered Expatriate if he was a lawful permanent resident of the US ("**Green Card Holder**") for eight of the last 15 taxable years (the "**Timing Requirement**") prior to (i) ceasing to being a Green Card Holder or (ii) commencing to be treated as a resident of a foreign country under the provisions of a tax treaty between the US and a foreign country and who does not waive the benefits of such treaty applicable to residents of the foreign country.¹ However, with certain exceptions, the alternative tax regime did not apply to any individual who was physically present in the US for more than 30 days in such taxable year.² In such case, the individual was treated as a citizen or resident of the US, as the case may have been, for such taxable year.³

In addition, in order for a Covered Expatriate to have been subject to the alternative income tax regime under the Pre-Heroes Act Law, he must have been an individual who: (1) had an average annual net income tax liability for the period of five taxable years prior to Expatriation of greater than \$139,000 (this amount was adjusted for inflation annually) ("**Income Tax Liability Test**"); (2) had a net worth of \$2 million or more on the date of expatriation ("**Net Worth Test**"); or (3) failed to certify under penalties of perjury that he complied with all US Federal tax obligations for the preceding five years or failed to submit such evidence of compliance as the IRS may require ("**Compliance Test**").⁴

There were a few exceptions that applied to US citizens and Green Card Holders. An US citizen would not have been deemed to satisfy the Income Tax Liability Test or the Net Worth Test if he was a dual citizen (the "**Dual Citizen Exception**") or a minor (the "**Minor Exception**").⁵ In order to qualify under the Dual Citizen Exception, a person must (i) have become a citizen of the US and a citizen of another country at birth and continued to have been a citizen of the other country and (ii) not have had substantial contacts with the US.⁶ A person was not considered to have substantial contacts with the US if he (a) was never a tax resident of the US (i.e., in general, never met the substantial presence test⁷); (b) never held a US passport; and (c) was not present in the US for more than 30 days during any of the 10 calendar years prior to Expatriation.⁸

An individual qualified for the Minor Exception if (i) the individual became a US citizen at birth; (ii) neither parent of such individual was a US citizen at his birth; (iii) the individual lost his US citizenship before attaining age 18.5; and (iv) the individual was not present in the US for more than 30 days during any of the 10 calendar years prior to Expatriation.⁹ In addition, for purposes of determining whether a Green Card Holder satisfied the Timing Requirement, the time period that such Green Card Holder was treated as a resident of a foreign country for the taxable year under the provisions of a tax treaty between the US and the foreign country and did not waive the benefits of such treaty applicable to residents of the foreign country was not taken into consideration.¹⁰

As mentioned above, if a Covered Expatriate Expatriated from the US, then he would have been subject to an alternative tax regime if the tax imposed by such regime was greater than the tax imposed generally to nonresident aliens. Generally, a Covered Expatriate is subject to US income tax pursuant to the graduated rates on his US sourced income.¹¹ However, for purposes of the alternative tax

regime, US sourced income had a broader scope than its meaning for general taxation of nonresidents.¹²

Heroes Act – Section 877A

The Heroes Act not only changed the method that a Covered Expatriate is taxed but also the determination as to who is a covered expatriate. A Covered Expatriate is still required to be a US citizen or a Green Card Holder that satisfies the Timing Requirement.¹³ Further, under the Heroes Act, the Dual Citizen Exception and the Minor Exception are still applicable, with minor changes.¹⁴

Most significantly, if a person is a Covered Expatriate and such person Expatriates, all of the person's property is treated as sold on the day before the Expatriation for its fair market value¹⁵ ("**Mark to Market Sale**").¹⁶ The Covered Expatriate must take into account any gain or loss under such deemed sale in the taxable year of the Expatriation.¹⁷ However, losses are allowed only to the extent that they are otherwise allowed under the general principles of tax law.¹⁸

When calculating the gain from a Mark to Market Sale, a Covered Expatriate is deemed to have a basis in property owned by such person on the day he first (i) becomes a US citizen, (ii) becomes a Green Card Holder or (iii) satisfies the Substantial Presence Test in an amount equal to the fair market value¹⁹ of such property on such date.²⁰ However, a Covered Expatriate can irrevocably elect to not have the basis determined as described in the preceding sentence and instead have the normal basis rules apply.²¹ Note that the first \$600,000 of gain that the Covered Expatriate realizes as a result of the Mark to Market Sale is excluded from taxable income.²²

The Heroes Act imposes special rules that are different from those described above in connection with the taxation of certain assets owned by a Covered Expatriate upon Expatriation. The assets covered by the special

taxation rules include an Expatriate's deferred compensation items, specified tax-deferred accounts and interests in nongrantor trusts.²³

A Covered Expatriate may irrevocably elect to defer the tax owed with respect to some types of property²⁴ pursuant to a Mark to Market Sale until the Covered Expatriate disposes of such property (the "**Deferral Election**").²⁵ The Deferral Election can only be made if the Covered Expatriate agrees to irrevocably waive any tax treaty of the US which would prevent assessment of collection under Code Section 877A.²⁶ The amount of deferred tax attributable to a particular property is an amount that bears the same ratio to the total tax pursuant to the Mark to Market Sale as the gain taken into account from the Mark to Market Sale for such property bears to the total gain from the Mark to Market Sale.²⁷ In addition to any tax liability, in order to eliminate the time value of money benefit the Covered Expatriate also owes interest at the rate for underpayments from the date of Expatriation until such liability is paid.²⁸

In general, in order for a Covered Expatriate to make a Deferral Election, he must provide adequate security with respect to such property.²⁹ Adequate security is (i) a bond which is furnished to, and accepted by, the

IRS, which is conditioned on the payment of tax (and interest thereon) and (ii) any other form of security for such payment (including letters of credit) that meets such requirements as the Secretary deems satisfactory.³⁰

The Heroes Act changes the Dual Citizen Exception by requiring that a dual citizen, as of the Expatriation date, be taxed as a resident of the other country.³¹ In addition, the Heroes Act changes the requirements relating to residency in the US in connection with the Dual Citizen Exception. Code Section 877A(g)(1)(B)(i)(II) provides that a person satisfies the residency requirement so long as he does not meet the Substantial Presence Test³² in more than 10 taxable years during the 15-taxable year period ending with the taxable year during which the person Expatriates.

The Heroes Act also changed the Minor Exception. Under current law, a minor must still Expatriate prior to attaining age 18.5. However, a minor must also not satisfy the Substantial Presence Test for more than 10 taxable years before the date of Expatriation to qualify for the Minor Exception.³³ For the Minor Exception, it no longer matters whether the minor was a US citizen at birth or the citizenship of the minor's parents.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ IRC § 877(e)

² IRC § 877(g)(1).

³ Id.

⁴ IRC § 877(a)(2).

⁵ IRC § 877(c).

⁶ IRC § 877(c)(2)(A)(ii).

⁷ See IRC § 7701(b)(3). A person meets the substantial presence test if: (i) such individual was present in the US at least 31 days during the calendar year and (ii) the sum of the number of days on which the individual was present in the US during the current year and the two preceding years (multiplied by the applicable multiplier determined below) equals or exceeds 183 days.

Current year - multiplier is "1"

1st preceding year - multiplier is "1/3"

2nd preceding year - multiplier is "1/6"

Certain days may not count if certain factors are present. These factors include, among other things, medical conditions that cause an individual to be present or if the individual is a teacher, student or professional athlete.

⁸ IRC § 877(c)(2).

⁹ IRC § 877(c)(3).

¹⁰ IRC § 877(e)(2).

¹¹ IRC § 877(b).

¹² See IRC § 877(d).

¹³ IRC § 877A(g)(2).

¹⁴ IRC § 877A(g)(1)(B).

¹⁵ Neither the Code nor the Treasury Regulations provide a definition or explanation of how the fair market value of the assets is determined.

¹⁶ IRC § 877A(a)(1).

¹⁷ IRC § 877A(a)(2)(A).

¹⁸ IRC § 877A(a)(2)(B). However, the disallowance of a loss deduction from a wash sale of stock or securities in Code Section 1091 does not apply.

¹⁹ See footnote 15 regarding the term "fair market value."

²⁰ IRC § 877(h)(2).

²¹ IRC § 877(e)(3)(B) and BNA Portfolio 560(E)(6).

²² IRC § 877A(3)(A). This amount is adjusted for inflation for any taxable year beginning in a calendar year after 2008.

²³ See IRC § 877A(d) – (f).

²⁴ IRC § 877A(b)(6).

²⁵ IRC § 877A(b)(1). However, if the property is disposed of in a nonrecognition transaction, then the gain shall be recognized on such date as prescribed by the Secretary. Id. However, in no event shall the tax be postponed later than the due date of the tax return for the taxable year of the Covered Expatriate which includes the date of death of the Covered Expatriate or if the security fails to meet the requirements in Code Section 877A(b)(4). IRC § 877A(b)(3).

²⁶ IRC § 877A(5).

²⁷ IRC § 877A(b)(2).

²⁸ IRC § 877A(b)(7).

²⁹ IRC § 877A(b)(4)(1).

³⁰ IRC § 877A(b)(4)(B).

³¹ IRC § 877A(g)(1)(B)(i)(I).

³² See footnote 6 *supra*.

³³ IRC § 877A(g)(1)(B)(ii).