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Shameful Double Taxation of Individual Expatriates

By: Michael J. Miller

Pursuant to section 877A, special tax rules apply to "covered expatriates."[1] A covered expatriate is generally any U.S. citizen who relinquishes citizenship or any long-term resident who gives up his green card, if such individual: (1) has an average annual net income tax liability for the five years immediately preceding the deemed expatriation that exceeds $147,000 ("the net income tax liability requirement");[2] (2) has a net worth of $2 million or more on the date of expatriation ("the net worth requirement"); or (3) fails to certify under penalties of perjury that he or she has complied with all US federal tax obligations for the preceding five years or to provide such other evidence as the Secretary of the Treasury may require.[3]

Section 877A(a)(1) generally deems the covered expatriate to have sold all of his assets for fair market value on the day preceding the expatriation date.[4] Such "mark-to-market" treatment can be extremely burdensome. The covered expatriate may not have liquid assets sufficient to pay the tax and, if foreign taxes are imposed upon the actual sale in a later year, double tax relief may not be available. For example, foreign taxes paid (or, if a certain election has been made, accrued) in the year of sale may only be carried back one year.[5]

Section 877A(b)(1) theoretically permits a taxpayer to avoid the cash-flow problem with respect to a particular item of property by electing to defer payment of the tax due with respect to such property until the due date of the return for the year of sale. Pursuant to section 877A(b)(4)(A), however, such election may be made only if "adequate security" is provided. Section 877A(b)(4)(B) provides, not so helpfully, that adequate security includes: (1) a bond satisfying certain requirements set forth in section 6325, and (2) some other form of security, including letters of credit, satisfying such requirements as the IRS may prescribe.[6] In reality, the election seems of little practical utility, since a taxpayer who is able to provide the bond or letter of credit is probably able to pay the tax. Moreover, the election would do nothing to solve the double-tax problem, because it would only defer payment: it would not change the year in which the income from the deemed sale is considered to arise.

Where feasible, a covered expatriate may wish to employ a little "self help" by selling appreciated assets prior to expatriation. In addition to providing cash flow, the sale may solve the double tax problem by eliminating the timing mismatch (since both the U.S. and the relevant foreign country would presumably view the gain as arising in the same year).[7] Of course, this solution may be impractical for a variety of reasons.

The mark-to-market rules described above apply somewhat differently to deferred compensation items. Pursuant to section 877A(d)(2) a covered expatriate is generally taxed, as of the day preceding the expatriation date, on the present value of any deferred compensation item. This can be burdensome for the same reasons discussed above, i.e., cash flow and risk of double taxation if the services were performed in a foreign country.

A measure of relief is available for "eligible deferred compensation items." Pursuant to section 877A(d)(3), eligible deferred compensation means any deferred compensation item with respect to which—

> **"(A)** the payor of such item is—
>
> > **(i)** a United States person, or
> >
> > **(ii)** a person who is not a United States person but who elects to be treated as a United States person for purposes of paragraph (1) and meets such requirements as the Secretary may provide to ensure that the payor will meet the requirements of paragraph (1), and
>
> **(B)** the covered expatriate—
>
> > **(i)** notifies the payor of his status as a covered expatriate, and
> >
> > **(ii)** makes an irrevocable waiver of any right to claim any reduction under any treaty with the United States in withholding on such item."

Notice 2009-85 elaborates on the notification and waiver requirements of subparagraph (B) by requiring a covered expatriate to provide the payor with IRS Form W-8CE by the earlier of (1) a date prior to the first distribution on or after the expatriation date and (2) 30 days after the expatriation date.[8] The reason for the 30-day requirement is not apparent. Providing the form some reasonable number of days prior to the first distribution should be adequate to protect the Government's interests by ensuring that the payor will have sufficient time to withhold under the rules discussed below. Notice 2009-85 also provides that the covered expatriate must timely file Form 8854 for the taxable year that includes the day before the expatriation date.

Pursuant to section 877A(d)(1)(A), an eligible deferred compensation item is subject to a 30% withholding tax when paid, to the extent such item constitutes a "taxable payment."[9] At first blush, the rules for deferred compensation may therefore *appear* to solve both the cash flow and double tax problems referenced above.

Unfortunately, appearances can be deceiving. Consider the following example.

> Abe and his wife, who are both covered expatriates, relinquish their U.S. citizenship on December 1, 2011. As of that date, Abe is entitled to

> deferred compensation with a present value of $10,000,000, payable on May 1, 2014, for services performed entirely within a foreign country ("FC"). Abe's tax lawyer tells him that, if he pays U.S. tax with his 2011 return and FC tax in 2014 (or 2015), the FC tax will ***not*** be creditable, and advises him how to defer the U.S. tax by satisfying the requirements for eligible deferred compensation. Abe acts timely to notify his former employer, a U.S. corporation, of his status as a covered expatriate (by providing IRS Form W-8CE within 30 days) and to satisfy the other reporting requirements of section 877A and Notice 89-85. On May 1, 2014, Abe receives $11,000,000, which is subject to a 30% U.S. withholding tax of $3,300,000 and 30% FC tax of $3,300,000, for a total of $6,600,000. Abe is not physically present in the United States at any time during 2014.

Unfortunately, even though Abe has successfully avoided mark-to-market treatment, he still has a ***huge*** double tax problem. When Abe receives his deferred payout in 2014, he is a nonresident. Under section 906, a nonresident alien is entitled to foreign tax credits ***only*** for foreign taxes imposed on foreign-source income that is effectively connected with the conduct of a trade or business in the United States ("effective connected income"). Abe's deferred compensation is not effectively connected income,[10] so his FC taxes would be noncreditable under a straightforward reading of section 906.[11] Sorry, Abe.

So, now let's consider Ben. His facts are the same as Abe's, but with two key differences. First, his wife retains her U.S. citizenship indefinitely. Second, his former employer ("FE") is a *foreign* corporation.

Fortunately for Ben, he can avoid the section 906 problem by filing a joint return for 2014 with his wife. Section 6013(g) permits a nonresident alien who is married to a U.S. citizen to file a joint resident return with such citizen spouse, if they both elect to do so. What a stroke of luck!

But, wait. Ben escapes mark-to-market treatment in 2011 *only* if his deferred compensation is "eligible" under the rules of section 877A(d)(3) set forth above. Pursuant to section 877A(d)(3)(A), this will be the case *only* if FE elects to be treated as a U.S. person for purposes of section 877A(d)(1). Well, that's unfortunate. Chances are that FE has no desire for any avoidable interaction with the U.S. tax authorities. But let's suppose that Ben is on excellent terms with the company and that, when he calls screaming incoherently about a double tax problem, the executives at FE agree to accommodate him. Stroke of luck number two!

Unfortunately, there are no regulations or other guidance prescribing a procedure for foreign companies, such as FE, to make the election contemplated under section 877A(d)(3)(A). This provision was enacted in 2008, so it's fair to say that the IRS and Treasury have dropped the ball. Nevertheless, one would certainly think that a foreign company, such as FE, can still elect if it reasonably apprises the IRS of its intention to do so.

Well, here comes the interesting part. In the context of a client matter (discussed below), an IRS representative who works extensively with section 877A maintained that it is *impossible* (!) for a foreign payor to elect under section 877A(d)(3)(A), because no procedure for making such election has been prescribed. Of course, such a proposition is indefensible, to say the least.

Two lines of cases strongly contradict the IRS's position. First, the courts have held that a lack of guidance about how to elect does not excuse the taxpayer from the *obligation* to elect.

In *Kosonen v. Commissioner*, T.C. Memo 2000-107, a taxpayer with real estate rental activities failed to elect, under section 469(c)(7), to treat seven real estate rental activities as a single activity for passive activity loss purposes on his 1994 and 1995 returns. Final regulations prescribing guidance on how to make the election were not issued until December 21, 1995, after the taxpayer's 1994 return was filed, so the taxpayer argued that he should be deemed to have made the election. The Tax Court rejected this argument, holding that "[t]he lack of guidance does not eliminate the statutory requirement to elect."[12] Since one cannot be required to do something that he cannot do, the Tax Court evidently concluded that the lack of administrative guidance did not bar Mr. Kosonen from making the section 469(c)(7) election.[13]

In *Marandola v. United States*, 99 AFTR.2d (Apr. 4, 2007), a trader in securities failed to elect mark-to-market treatment under section 475(f) on his original returns for 1997, 1998, and 1999, and tried unsuccessfully to make the election on amended returns.[14] One issue addressed by the court was whether the taxpayer's failure to elect on his original 1997 return should be excused, because Treasury and the IRS had not issued guidance on how to make the election when that return was filed on October 17, 1998.[15]

The Government could have argued, if it dared, that no election was possible for 1997, but it did nothing of the kind. Rather, the Government *conceded* that the taxpayer was eligible to make the election for 1997 (as well as the subsequent years at issue).[16] Moreover, the court cited *Kosonen* for the proposition that, even in the absence of guidance, a taxpayer that wishes to make an election must notify the Commissioner of his intent to do so.

Also instructive is a line of cases addressing the question of what happens when the Code clearly contemplates some taxpayer-favorable treatment under regulations, but Treasury fails to issue those regulations. Under these cases, the courts have repeatedly held that Treasury cannot thwart the will of Congress simply by declining to issue regulations.

In *Maddox v. Commissioner*, 93 T.C. 228 (1989), the Tax Court addressed the application of §2032A(g), which instructed the Treasury Department to prescribe regulations applying certain favorable estate-tax rules of §2032A governing the valuation of family farms to circumstances where the family farm is held through an entity. Notwithstanding the absence of implementing regulations, the Tax Court applied §2032A(g) an incorporated family farm, holding that "the Secretary cannot deprive a taxpayer of rights which the Congress plainly intended to confer simply by failing to promulgate the required regulations."

In *Hillman v. Commissioner*, 114 T.C. 103 (2000), the Tax Court addressed the application of Section 469(l)(2), which instructed the Treasury Department to prescribe taxpayer-favorable

regulations under the passive activity loss rules to prevent "self-charged" items from creating an unfavorable mismatch of passive deductions and nonpassive income. Holding for the taxpayer, the Tax Court held that "[t]he failure to issue regulations … should not be a reason to preclude taxpayer from congressionally intended and appropriate relief."[17]

Given these authorities, the IRS's position seems, to use a technical term, way out there. Luckily for Ben, the IRS's cooperation is not needed. If FE timely files an appropriate document apprising the IRS of its intention to elect to be treated as a U.S. person for purposes of the section 877A(d)(1) withholding rules, and actually withholds, the possibility of a successful challenge by the IRS seems remote.

Unfortunately, the client matter referenced above arose in a context in which the IRS's help was desperately needed. The circumstances of the taxpayer, whom we can call Carl, were much like Ben's, but with two key differences. First, Carl failed to provide FE with Form W-8CE within the 30 days of expatriation, as required by Notice 2009-85. Second, FE advised that it was willing in principle to elect under section 877A(d)(3)(A), but was concerned that Carl's failure to provide Form W-8CE in a timely fashion rendered Carl's compensation ineligible. FE was extremely skittish about participating in anything that could even remotely be viewed as an effort by Carl to improperly evade the mark-to-market rules. FE therefore advised Carl that, because of his failure to satisfy the 30-day rule, it was unwilling to elect under section 877A(d)(3)(A).

In an effort to address FE's concern, Carl's tax advisor spoke with the above-referenced IRS representative who works extensively with section 877A to request an extension of time to file Form W-8CE. Had the IRS been willing to grant such relief, FE presumably would have been willing to make the desired election, and Carl could have been spared a substantial amount of double tax.[18]

Unfortunately, the IRS representative advised that the IRS would not grant Carl's request. Even if it were demonstrated that Carl acted in good faith, and the Government's interests would not be harmed, the IRS representative stated that the relief would be meaningless because a section 877A(d)(3)(A) election is impossible in the absence of guidance about how to elect, and thus the deferred compensation could not in any circumstance be made eligible to avoid mark-to-market treatment.

After a few moments of disbelief, Carl's tax advisor proposed that the IRS should grant the relief anyway, and could certainly protect its interests by including an appropriate caveat in the ruling. Surely, he said, the IRS must at least acknowledge *some* uncertainty regarding its position, and should therefore allow Carl to have his day in court. The IRS representative disagreed, however, stating that the inability to elect was absolutely clear. Ultimately, Carl gave up and resigned himself to double tax.

The team effort that was required to achieve this horrific result was truly extraordinary and is worthy of closer examination.

Obviously, a great deal of blame must go to Congress, for drafting a statute rife with prospects for double taxation. As discussed above, ineligible deferred compensation may be double taxed,

due to the inability to carry back excess foreign taxes for more than one year; and eligible deferred compensation may be double taxed, due to the apparent inability of nonresident aliens to claim foreign tax credits for non-effectively connected income.

Rather than trying to do what it can to alleviate these problems, Treasury and the IRS have exacerbated them. First, the IRS decided for no apparent reason to adopt a 30-day requirement that serves no rational purpose.[19] Second, the IRS and Treasury dropped the ball by failing to issue implementing guidance for the election permitted to foreign payors under section 877A(d)(3)(A). Third, and most egregious, the IRS has taken the indefensible position that it can negate taxpayer-favorable provisions of the Internal Revenue Code by refusing to issue implementing guidance. The fact that the IRS relied on its own failure to do its job as an excuse for refusing to grant relief from a purposeless administrative deadline that never should have been imposed seems particularly disgraceful.

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[1] Except as may otherwise be indicated, all "section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code"). The rules in §877A apply to any covered expatriate whose "expatriation date" is on or after June 17, 2008.

[2] The figure set forth above applies to expatriations in 2011, Rev. Proc. 2010-40, 2010-46 IRB 663 (10/28/2010), §3.17, and is indexed for inflation.

[3] §§877A(g)(1)(A) & 877(a)(2). Certain narrow exceptions are set forth in §877A(g)(1)(B) & (C).

[4] Note also that §2801 imposes a transfer tax on any U.S. citizen or resident who receives a "covered gift or bequest" from a covered expatriate.

[5] §904(c).

[6] Notice 2009-85, 2009-45 IRB 598 (10/15/2009), provides some guidance, including a standard form of deferral agreement, but it is not clear whether any form of security other than a bond or letter of credit may suffice.

[7] If the asset cannot be sold to a third party, and cash flow is not an issue, it might be desirable to trigger gain, for both U.S. and foreign tax purposes, by selling to a controlled entity. Care would need to be taken to ensure that such controlled sale is a fully taxable transaction.

[8] A special transition rule applies if the covered expatriate expatriated prior to the publication of such form.

[9] The taxable payment is the portion that would have been includible in gross income if the covered expatriate had continued to be subject to U.S. federal income tax as a U.S. citizen or resident. §877A(d)(1)(B). Pursuant to section 877A(d)(6)(B), such item is deemed to be "subject to tax under section 871."

[10] Pursuant to §862(a)(3), compensation for labor or personal services performed outside the United States has a foreign source. With limited exceptions not applicable here, §864(c) provides that foreign-source income is not effectively connected.

[11] The IRS could save the day by deeming such deferred compensation to be effectively connected income for foreign tax credit purposes; but to date the IRS has provided taxpayers with no comfort that it will do so.

[12] Citations omitted.

[13] Furthermore, it seems unlikely that the IRS argued otherwise, since the Tax Court presumably would have addressed that argument in its opinion (unless it considered the argument too frivolous to merit discussion).

[14] The Government ultimately won the case, because the Court of Federal Claims held that the taxpayer had not made the election on his original returns and could not unilaterally change his method of accounting on amended returns.

[15] The IRS issued a notice of proposed rulemaking on January 28, 1999, and Revenue Procedure 99-17, 1999-7 IRB 52, on February 16, 1999.

[16] "The government concedes that Mr. Marandola was a trader in securities who, for tax years 1997, 1998, and 1998, was eligible to elect, pursuant to I.R.C. §475(f), to use the mark-to-market method of accounting set forth in I.R.C. §475(f)."

[17] *See also Francisco v. Commissioner*, 119 T.C. 317 (2002) ("We have frequently held that the Secretary may not prevent implementation of a tax benefit provision simply by failing to issue regulations."); *International Multifoods Corp. v. Commissioner*, 108 T.C. 579, 584 (1997) ("It is well established that the absence of regulations is not an acceptable basis for refusing to apply the substantive provisions of a section of the Internal Revenue Code.").

[18] It is, of course, impossible to know for certain whether FE would have followed through once its stated concern was addressed.

[19] As noted above, Notice 2009-85 requires an expatriate to provide Form W-8CE within 30 days of expatriation.