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## The Exit Tax's Inconsistent Treatment of Trusts

By Robert E. Ward, J.D., LL.M.\*  
WardChisholm, LLP

Vancouver, British Columbia and Bethesda, Maryland

The Heroes Earnings Assistance and Relief Tax Act of 2008<sup>1</sup> (the “HEART Act”) reformed the income, gift, and estate tax treatment of United States citizens who relinquish their citizenship and long-term U.S. residents who cease to be lawful permanent residents within the meaning of §7701(b)(6) (“expatriates”). In broad terms, the exit tax regime enacted in 2008 marks to market the assets of expatriates determined to be “covered expatriates.” Assets of covered expatriates are deemed to have been sold for fair market value on the day before expatriation.<sup>2</sup> Compared with most international tax provisions, the statutes and resulting rules regarding the exit tax are mercifully brief and considerably easier to comprehend. Regulations interpreting and applying §877A have never been

written in either proposed or temporary form. Instead, the only guidance the Internal Revenue Service has provided is Notice 2009-85.<sup>3</sup> That Notice explains who is a “covered expatriate” subject to the exit tax and the computation of the covered expatriate’s exit tax liability. In doing so, the Notice draws distinctions between settlors of different types of trusts to determine who is a covered expatriate, provides inconsistent guidance regarding the effect of beneficial interests in trusts in the computation of the exit tax, and creates extra-statutory distinctions in the treatment of different types of trusts in closely related but nonetheless different circumstances. Traps for the unwary abound, along with potential planning opportunities.

### WHO IS SUBJECT TO THE EXIT TAX?

The exit tax applies only to covered expatriates. Covered expatriates are defined as expatriates

- (1) whose average net income tax liability for the five taxable years ending prior to the date of expatriation is greater than \$124,000 (inflation adjusted to \$171,000 in 2020),<sup>4</sup>
- (2) whose net worth is \$2,000,000 or more, or
- (3) who fail to certify under penalties of perjury that they have satisfied all income tax compliance obligations imposed on individual taxpayers by Title 26 of the U.S. Code for each of the five taxable years preceding the year of expatriation.<sup>5</sup>

What if the covered expatriate settled a trust prior to expatriation? How do the income and assets of the trust affect the expatriate’s average annual income tax liability and net worth? What if instead of settling the trust, the expatriate is a beneficiary of a trust settled by someone else? The answers to these questions are not found in the Code provisions enacted as part of

\* Robert E. Ward, J.D., LL.M. is a fellow of the American College of Tax Counsel who advises businesses and individuals on U.S. international and domestic tax matters from his firm’s offices in Vancouver, British Columbia and Bethesda, Maryland.

<sup>1</sup> Pub. L. No. 110-245 (June 17, 2008).

<sup>2</sup> In the case of a U.S. citizen, the expatriation date is the date the individual relinquishes U.S. citizenship (usually before a diplomatic counselor or officer pursuant to Section 349(a)(5) of the Immigration and Nationality Act (8 U.S.C. 1481(a)(5)). See §877A(g)(4). In the case of a long-term U.S. resident, the expatriation date is the date on which the individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty without waiving the benefits of such treaty and notifies the Secretary of the Treasury of commencement of such treatment, usually by filing a Form 8854 or 8833. See §7701(b)(6) (flush); Notice 2009-85, §2A.

All section references are to the Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury regulations thereunder, unless otherwise indicated.

<sup>3</sup> I.R.B. 2009-45 (Nov. 9, 2009).

<sup>4</sup> Rev. Proc. 2019-44, §3.37.

<sup>5</sup> §877(a)(2).

the HEART Act nor are those answers found in Notice 2009-85. Instead, both §877A and Notice 2009-85 refer to prior law.<sup>6</sup> To determine who is a covered expatriate, Notice 97-19 distinguishes grantor trusts from non-grantor trusts.<sup>7</sup> With regard to the first prong of the test for covered expatriate status under §877(a)(2) (the “Tax Liability Test”), Notice 97-19 measures an expatriate’s tax liability as determined under §38(c)(1). An expatriate treated as the owner of trust income or corpus under the Grantor Trust Rules also bears the burden of the income tax on that portion of the trust the expatriate/grantor is deemed to own. The result is that trust income is automatically included to determine whether the expatriate is caught by the Tax Liability Test.<sup>8</sup>

In contrast, the distinction between grantor and non-grantor trusts is irrelevant for purposes of the second prong of the test for covered expatriate status (the “Net Worth Test”). Instead, the Net Worth Test distinguishes between trusts in which the expatriate does or does not own a beneficial interest. The Net Worth Test only takes into account interests in property which would be taxable as a gift if transferred immediately prior to expatriation. The provisions of Chapter 12 of Subtitle B of the Code are applied to determine whether the property interest would be a taxable gift without regard to §2503(b) through (g) (annual and other exclusions from taxable gifts), §2513 (gift splitting), §2522 (gift tax charitable deduction), §2523 (gift tax marital deduction), and §2524 (limitation on the extent of gift tax deductions).<sup>9</sup>

Resorting to gift tax principles to determine which assets are counted to determine an expatriate’s net worth requires valuation of the expatriate’s property interests. Notice 97-19 provides special rules to determine the value of beneficial interests in trusts. Many settlors who are characterized as grantors under the Grantor Trust Rules have no beneficial interest in trusts they have settled. This produces the somewhat anomalous result that the income and gains of a grantor trust contribute to the tax which may satisfy the Tax Liability Test, but the assets producing that income may not be counted for purposes of the Net Worth Test.

<sup>6</sup> See §877A(g)(1)(A) (cross-referencing §877(a)(2)); Notice 2009-85, §2B (cross-referencing Notice 97-19, 1997-1 C.B. 394, §III).

<sup>7</sup> A grantor trust is a trust with respect to which the settlor or a beneficiary is treated as the owner of trust income and/or corpus for U.S. income tax purposes, as determined by subpart E of subchapter J, chapter 1 of subtitle A (§671-§679) (the “Grantor Trust Rules”). A non-grantor trust is any trust which is not a grantor trust.

<sup>8</sup> In the case of an individual who inadvisably files a joint income tax return, all of the tax resulting from income counted on the return is reported for purposes of the Tax Liability Test.

<sup>9</sup> Notice 97-19, §III.

In the context of 2020 estate planning, the distinction which excludes the assets of a grantor trust in which the expatriate is not a beneficiary (despite being treated as the owner by the Grantor Trust rules) from the asset base to which the Net Worth Test is applied is important. Concerns regarding possible acceleration of the sunset of the temporary increase in the gift and estate tax exemption have motivated many individuals to establish trusts designed to take advantage of the exemption without a meaningful loss of the income produced by the assets with which the trusts are funded.<sup>10</sup> Any trust whose income may be distributed or accumulated for distribution to the settlor’s spouse without the consent of an adverse party is regarded as a grantor trust.<sup>11</sup> However, the assets of such a trust would not be counted for purposes of the Net Worth Test if the expatriating settlor retained no beneficial interest. In fact, the assets of any trust settled by an expatriate in which the expatriate did not retain a beneficial interest would not be counted for purposes of the Net Worth Test. Thus, someone wishing to avoid covered expatriate status can transfer significant amounts of wealth prior to expatriation (up to \$ 11.58 million in 2020) to a trust for the benefit of the settlor’s spouse or other close family members. The trust assets will be ignored for purposes of the Net Worth Test as long as the settlor retains no beneficial interest in the trust.

Notice 97-19 provides useful guidance to determine the value of an expatriate’s beneficial interest in a trust. “First, all interests in property held by the trust must be allocated to beneficiaries (or potential beneficiaries) of the trust based on all relevant facts and circumstances, including the terms of the trust instrument, letter of wishes (and any similar document), historical patterns of trust distributions, and any functions performed by a trust protector or similar advisor.”<sup>12</sup> If these indicia prove inadequate (as might be the case with a purely discretionary trust from which no or very limited distributions have been made), the assets of the trust will be allocated among the beneficiaries as if the settlor had continued to own the assets but had died intestate. Instead of referring to the local law of the settlor’s domicile to determine which rules of intestate succession apply, the rules of intes-

<sup>10</sup> In these arrangements, spouses usually establish trusts for the benefit of one another (often referred to as “Spousal Lifetime Access Trusts” or “SLATs”). See generally Ward, *Hard Times in the Land of Plenty: Depressed Asset Values Create Opportunities for Wealth Transfers for U.S. Persons (Part 2)*, 49 Tax Mgmt. Int’l J. 437 (Sept. 11, 2020).

<sup>11</sup> See §677(a).

<sup>12</sup> Notice 97-19 §III.

tacy under the Uniform Probate Code control.<sup>13</sup> Depending upon the way in which the beneficiaries are related to the settlor, the laws of intestacy may produce dramatically different beneficial interests than the relevant facts and circumstances.

The second step in determining the extent of the expatriate's beneficial interest in a trust is to assign a value to the expatriate's beneficial interest by resorting to the principles of §2512 and the regulations thereunder "without regard to any prohibitions or restrictions on such interest."<sup>14</sup> When the beneficial interests in the trust are fixed (for example, the expatriate holds either an income or vested remainder interest) actuarial tables are available to determine the value of the expatriate's interest.<sup>15</sup> However, in the case of a truly discretionary trust with multiple beneficiaries, the valuation exercise may be more daunting, especially in the case of a trust without an established pattern of distributions among the beneficiaries.

### HOW IS THE EXIT TAX COMPUTED?

The distinction between grantor and non-grantor trusts is also important in computing the amount of the exit tax. As explained above, the assets of a grantor trust settled by an expatriate who retained no beneficial interest in the trust are not counted for purposes of the Net Worth Test to determine whether the expatriate will be a covered expatriate. However, those assets would be treated as owned by a covered expatriate for purposes of computing the exit tax. Assets held by the grantor trust and all other assets owned by the covered expatriate are marked to market and deemed to have been sold on the day before the expatriation date for fair market value.<sup>16</sup>

The general rule which governs computation of the exit tax is that all assets which the covered expatriate owns are deemed to have been sold on the day before the expatriation date for fair market value.<sup>17</sup> Three categories of assets are excepted:

- (1) deferred compensation items as defined in §877A(d)(4),
- (2) specified tax deferred accounts as defined in §877A(e)(2), and
- (3) interests in non-grantor trusts.

By implication, assets of a trust with respect to which the covered expatriate is regarded as the owner of trust income or corpus under the Grantor Trust Rules are included among the assets marked to market for purposes of computation of the exit tax. As ob-

served above, many settlors regarded as grantors under the Grantor Trust Rules have no beneficial interest in their grantor trusts. Notice 2009-85 ignores this nuance and simply provides that all of the assets with respect to which the covered expatriate is regarded as the owner of income or corpus will be marked to market in the computation of the exit tax to which the covered expatriate will be subject.<sup>18</sup>

While interests in non-grantor trusts, deferred compensation items, and certain tax deferred accounts are excluded from the mark-to-market computation of the exit tax by §877A(c), they are not ignored. Further, while the statute has very clear instructions regarding how non-grantor trusts affect the exit tax of the covered expatriate, the instructions of Notice 2009-85 are not clear. In fact, the guidance in Notice 2009-85 is directly and inherently contradictory. Section 3 of the Notice (captioned "Mark-to-Market Regime"), under subsection A (captioned "Identification of Covered Expatriate's Property and Determination of Fair Market Value") provides that the assets counted under the mark-to-market regime are any property that would be taxable as part of the covered expatriate's gross estate for federal estate tax purposes under Chapter 11 of Subtitle B of the Code as if the covered expatriate had died on the day before the expatriation date as a citizen or resident of the United States. "In addition, for this purpose, a covered expatriate is also deemed to own his or her beneficial interest(s) in each trust (or portion of a trust) that would not constitute part of his gross estate. . . ."<sup>19</sup> The Notice then directs the reader to the special rules set forth in Section III of Notice 97-19 which were discussed above. Notice 2009-85's overbroad statement extends the mark-to-market regime to trust assets which by the Notice's own guidance as well as the language of §877A and the legislative history are not intended to be included in the mark-to-market regime. The overview of §877A which appears in Section 1 of Notice 2009-85 takes cognizance of the statutory exception of §877A(c) for interests in non-grantor trusts. Section 7 of Notice 2009-85 is exclusively devoted to the treatment of non-grantor trusts under §877A(f). One might conclude then that the language regarding extension of the mark-to-market regime to include the covered expatriate's beneficial interest in trusts that would not constitute part of the covered expatriate's gross estate must, by default, refer to grantor trusts in which the covered expatriate retained a beneficial interest. However, this generous reading of the language quoted above from Notice 2009-85 remains overbroad. This is because §877A(h)(3), as well as Section 4 of Notice 2009-85, specifically address §684 and provide that it pre-empts application of §877A.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> See, e.g., Reg. §25.2512-5.

<sup>16</sup> Notice 2009-85, §1.

<sup>17</sup> §877A(a)(1).

<sup>18</sup> See Notice 2009-85, §1.

<sup>19</sup> Notice 2009-85, §3A.

Section 684 requires a U.S. person to recognize gain on transfer of property to a foreign trust in an amount equal to the difference between the fair market value of the property and its basis. The same rule applies to the assets of a domestic trust which becomes a foreign trust. However, §684(b) creates an exception if the transferor of property to the foreign trust is regarded as the grantor under the Grantor Trust Rules. Expatriation may cause a domestic trust to become a foreign trust under the rules of §7701(a)(31)(B) and Reg. §301.7701-7. The Grantor Trust Rules are applied in a significantly more limited fashion in the case of a nonresident alien who settles a foreign trust.<sup>20</sup> Consequently, a trust settled by covered expatriate may no longer be regarded as a grantor trust after the covered expatriate's expatriation date. Notice 2009-85 provides that gains subject to tax under the rules of §684 will not also be subject to tax under the mark-to-market regime of §877A.<sup>21</sup> If the assertion in Notice 2009-85 — that a covered expatriate is deemed to own a beneficial interest in each trust that would not be part of the covered expatriate's gross estate — is to have any meaning whatsoever after contradiction by both the statute and other parts of that same Notice, its application would be limited to grantor trusts (not included in the covered expatriate's gross estate) with respect to which the covered expatriate remains the grantor under the rules of §672(f) and did not retain a beneficial interest. Such a generous reading that reduces such a broad statement to such a small universe of trusts stretches credulity.<sup>22</sup>

#### NON-GRANTOR TRUSTS

A covered expatriate's beneficial interest in a nongrantor trust receives special treatment under both the statute and Notice 2009-85.<sup>23</sup> The covered expatriate is deemed to own a beneficial interest in any nongrantor trust with respect to which she

- is entitled or permitted to receive direct or indirect distributions of trust income or corpus (including distributions which would discharge an obligation of the covered expatriate),
- holds the power to apply trust income or corpus for the benefit of the covered expatriate, or

<sup>20</sup> §672(f).

<sup>21</sup> Notice 2009-85, §4.

<sup>22</sup> Informal conversations with one of the drafters of Notice 2009-85 have confirmed that the statement in §3A, requiring inclusion of the covered expatriate's beneficial interests in trust which would not constitute part of the covered expatriate's gross estate, is simply wrong.

<sup>23</sup> For purposes of §877A and this article a nongrantor trust is each trust with respect to which the settlor is not considered the owner under Grantor Trust Rules. Thus, a trust with respect to which someone other than the expatriate is considered the owner under the Grantor Trust Rules would nonetheless be considered a nongrantor trust for purposes of §877A.

- could receive income or corpus if the trust terminated.<sup>24</sup>

The covered expatriate's beneficial interest in a nongrantor trust is not subject to the mark-to-market regime but, instead, becomes subject to tax as distributions are made from the trust. Inasmuch as the covered expatriate is no longer a citizen or resident of the United States at the time trust distributions are received post-expatriation, the distributions are subject to withholding under subchapter B of chapter 3 of Subtitle A.<sup>25</sup> Distributions are subject to 30% withholding (on the taxable portion of the distribution). In the case of distributions in kind, the trust will recognize gain to the extent the fair market value of the distributed property exceeds the trust's adjusted basis in that property.<sup>26</sup> Further, any treaty provisions which would reduce the rate of withholding are made inapplicable. To the extent the income tax liability of the covered expatriate with respect to trust distributions is less than the tax due under §871, the covered expatriate must continue to file U.S. income tax returns for the taxable year in which the distribution is received.<sup>27</sup> A trustee who fails to withhold becomes liable for the tax under §1461. Finally, the covered expatriate must provide notification of such status by submitting Form W-8CE to the trustee within 30 days after the expatriation date or the day before the first post-expatriation distribution, if sooner. For covered expatriates who wish to avoid withholding on trust distributions, Notice 2009-85 provides a procedure to elect on Form 8854 to be treated as having received the value of his interest in the trust on the day before the expatriation date. Such election would have the effect of including the covered expatriate's beneficial interest in the trust in the computation of the exit tax under the mark-to-market regime.<sup>28</sup>

#### PLANNING

The most important strategy in exit tax planning is to avoid covered expatriate status. Not only will the covered expatriate's assets (including assets held in grantor trusts settled by the covered expatriate) be subject to the exit tax imposed by §877A, but those same assets when given to or inherited by a U.S. person will also be subject to a gift or estate tax uniquely imposed on the recipient under §2801. Most significant gifts are made using trusts to take advantage of the asset protection and estate tax benefit trusts provide. Selecting trust structures which avoid grantor trust status and provide no beneficial interest for the

<sup>24</sup> Notice 2009-85, §7.

<sup>25</sup> §877A(f)(4)(A), §877A(d)(6)(A).

<sup>26</sup> §877A(f)(1).

<sup>27</sup> Notice 2009-85, §7C.

<sup>28</sup> Filing and reporting requirements are further elaborated in Notice 2009-85, §8.

expatriating settlor prevents trust assets from being counted as part of the expatriating settlor's net worth and prevents trust income from increasing the expatriating settlor's net tax liability. For those familiar with wealth transfer planning, these considerations eliminate an expatriate's use of charitable remainder trusts, charitable lead trusts, grantor retained annuity or unitrusts, and qualified personal residence trusts to avoid covered expatriate status.

Clearly the design of a trust settled by someone contemplating expatriation as well as a trust intended to benefit the prospective expatriate require careful consideration of both §877A and Notice 2009-85. An individual contemplating expatriation may have no control over trusts for her benefit but will have complete control over trusts she settles. Many individuals contemplating expatriation are compelled to make significant gifts prior to their expatriation date in order to avoid being caught by the Net Worth Test.<sup>29</sup> Asset protection and estate tax concerns (for the recipients) motivate the use of trusts to make the gifts.

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<sup>29</sup> It should be remembered that the instructions to Form 8854 require disclosure of any "significant changes" in the expatriate's assets and liabilities during the five-year period preceding expatriation.

The current \$11.58 million gift tax exemption facilitates such transfers on a tax-free basis. The trusts to which gifts are made should not be designed as grantor trusts if the tax on the income of the assets held therein will cause the expatriate to be caught by the Net Tax Liability Test. However, where the Net Tax Liability Test is not a concern, the trust's character as a grantor trust will not cause its assets to be counted in determining whether the expatriate is caught by the Net Worth Test.

If the expatriate cannot avoid covered expatriate status, the grantor trust status of any trust settled by the covered expatriate is problematic. Unless the trust does not become a foreign trust or, if it does, unless the covered expatriate remains the owner under the rules of §672(f), the assets of the trust are subject to gain recognition under §684. Any remaining unrealized gain will be included in the mark-to-market computation of the exit tax. Given a choice between gain recognition under §684 or §877A, §684 is to be avoided. The \$600,000 exemption provided by §877A(a)(3)(A) (indexed to \$737,000 in 2020) shelters gain that would otherwise be recognized under the mark-to-market regime.