JERALD DAVID AUGUST is a partner in Fox Rothschild LLP, Philadelphia, PA.

Acquisitions, Dispositions & Structuring Techniques Corner

The U.S. Expatriates Are Coming? Fear of Increased U.S. Taxation May Drive More Citizens and Long-Term Residents to Become Tax Refugees and Subject Themselves to the Mark-to-Market Exit Tax

By Jerald David August

There is an increasing number of U.S. taxpayers who expatriate each year. Some former U.S. citizens or long-term residents want to permanently reside in another country to avoid the high taxes on income during life and wealth taxes during life and at death.[1] In many cases, U.S. expatriates are U.S. citizens or long-term residents who have lived abroad for several years and have decided that they do not intend to live in the United States again, do not believe U.S. citizenship or a green card confers any special benefits to them, and have in good faith completed all U.S. income and informational tax return reporting, while also complying with the tax laws of the country where they reside. Often, the tax benefit of expatriating has little or nothing to do with reducing the individual's U.S. tax liability or overall amount of tax paid. Instead, it is driven by a desire to reduce the cost of compliance and prevent the assessment of potential penalties related not to the underpayment of tax but to inadvertent omissions of some information reporting. Consider, for example, a U.S. citizen living in France who owns a greater than 50% interest in 20 CFCs under Code Sec. 951 and now with respect to Code Sec. 951A pertaining to the accelerated "GILTI" income. Such individual also owns several foreign grantor trusts which he established for his children. He files his tax return in France as well in the United States reporting both on a worldwide basis. To meet his U.S. filing obligations, he annually files a U.S. federal income tax return reporting his worldwide income taxable in the United States and his U.S. tax liability, an amount typically offset by foreign tax credits and other allowable deductions, exemptions, and credits. Consequently, he pays no incremental U.S. tax; however, to meet his U.S. filing obligations,

he incurs significant professional service fees every year. There would be significant penalties for this gentleman, if he did not file Forms 5471 for each CFC ($10,000 per year for each CFC with possible additional penalties) and Forms 3520 and 3520A for foreign trusts.

With the divide among our Congressional leadership and calls for much higher income and wealth taxes on the wealthy by members of the House of Representatives from the Democrat party, there is renewed concern about the direction that the United States is taking and that high net worth individuals may find their tax situation must be improved by relinquishing their U.S. citizenship and moving abroad or make their already obtained residence in a foreign country permanent. The same motivation to exit and return back to a prior country will continue to be under consideration by a long-term resident in returning to his country of citizenship or perhaps to permanently reside in a third country.[2]

The Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act") made profound changes in the tax law with respect to the expatriation of U.S. citizens but also with respect to the departure of a long-term resident alien from the United States.[3] The HEART Act, which applies to individuals who renounce their U.S. citizenship or relinquish their "long-term resident" status in the United States after June 16, 2018 (at times collectively referred to herein as a "covered expatriate"). There are two core provisions that are at the center of the HEART Act. First, Code Sec. 877A, which imposes, in general, an income tax on the worldwide assets of the "covered expatriate" as of the day prior to the date of expatriation. There are certain special rules permitting deferral of the special "mark-to-market" tax under Code Sec. 877A subject to an election to accelerate and report the tax in the current year. There are also important compliance issues involved in expatriation and that concern is sourced from the five-year certification standard whereby the covered expatriate, as part of the departure filings, must certify that he or she has been tax compliant in the United States for the preceding five-year period ending on the last day of the taxable year preceding the year of the expatriation and continuing through the departure year as well. There is an added or third consequence, *i.e.*, a substantial inheritance tax on U.S. donees of donative transfers received from U.S. expatriates under Code Sec. 2801.

Income Taxation of U.S. Citizens and Residents

A U.S. citizen, in general, is subject to U.S. individual income tax on his or her worldwide income subject to the allowance of applicable foreign tax credits and other deductions, exclusions from gross income and other allowances.[4] Every person born or naturalized in the United States and subject to its jurisdiction is a citizen. A foreigner who has filed his declaration of intention of becoming a citizen but who has not yet been admitted to citizenship by a final order of a naturalization court is still treated as an alien.[5] The determination of who is a U.S. citizen and when such citizenship has been abandoned is determined by the Immigration and Nationality Act, 8 USC §1401, *et seq*.[6]

The taxable income of a U.S. citizen or resident is determined by computing the individual's gross income, less applicable exclusions, exemptions, and deductions. The appropriate tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. This liability can be reduced by available tax credits, including foreign tax credits under Code Sec. 901 as subject to certain limitations.[7] For dispositions of property made by an individual, gain or loss is determined by reference to the taxpayer's cost basis in the property, regardless of whether the property was acquired during the period in which the taxpayer was a citizen or resident of the United States. Where a U.S. citizen or resident has foreign source income which is subject to foreign income tax, Code Secs. 901–907 generally permit such individual to claim, subject to certain limitations, a foreign tax credit ("FTC") (or, alternatively, as a deduction in computing taxable income under Code Sec. 164(a)(3)), against his or her U.S. income tax liability. If a U.S. citizen or resident earns income from sources outside the United States, and that income is subject to foreign income taxes, the individual generally is permitted a foreign tax credit against his or her U.S. income tax liability to the extent of foreign income taxes paid on that income.

Foreign Earned Income Exclusion and Qualified Housing Costs

Under Code Sec. 911, where a U.S. citizen lives and works in a foreign country and meets certain requirements, such as either the *bona fide* foreign residence test or the foreign physical presence test, such qualified individual is generally permitted to elect to exclude up to $70,000 (as increased in subsequent years and now at $105,000) of annual (annualized) compensation, *i.e.*, "foreign earned income" per Code Sec. 911(b)(1)(A) from being subject to U.S. income taxes, and is permitted, per Code Sec. 911(b)(2)(A), an exclusion or deduction for certain housing expenses. In order to qualify for the benefits provided under Code Sec. 911, a U.S.

individual must establish that her tax home is in a foreign country by meeting one of two requirements. First, a U.S. citizen may establish that she has been a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year. Alternatively, a U.S. citizen or resident is a qualified individual if she, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period.[8] Qualification under either test means an individual may claim the Code Sec. 911 foreign service income exclusion and the attendant housing cost amount "for such taxable year or for any taxable year which contains part of such period." Therefore, for example, a taxpayer returning to the United States in the middle of a tax year is still eligible to claim a partial exclusion (Reg. §1.911-3(d)). The exclusion is elective. The term "foreign country" is defined as any territory under the sovereignty of a government other than that of the United States. A foreign country includes the air space over such territories, its territorial waters, and the adjacent seabed for which the foreign country has exclusive exploitation rights.[9]

Amount of Exclusion/Housing Cost Limitation

In addition to the foreign earned income exclusion, a qualified individual may make a separate election to exclude from her gross income an amount equal to her housing cost amount per Code Sec. 911(a)(2). The term "housing cost amount" is the qualified individual's housing expenses for the taxable year to the extent such expenses exceed a specified base amount but do not exceed a specified limitation amount in Code Sec. 911(c)(1). The base amount is 16% of the maximum foreign earned income exclusion amount for the year (calculated on a daily basis) multiplied by the number of days in the year on which the taxpayer is a qualified individual as defined in Code Secs. 911(d)(1)(A) or 911(d)(1)(B). The limitation amount is 30% of the maximum foreign earned income exclusion amount for the year (calculated on a daily basis) multiplied by the number of days in the year on which the taxpayer is a qualified individual.[10] In no event may the sum of the foreign housing cost amount exclusion, the foreign earned income exclusion, and the foreign housing cost amount deduction exceed the individual's foreign earned income for the tax year. If a married couple are each qualified individuals, the determination of the foreign housing cost amount exclusion or deduction is more involved. Where the Code Sec. 911 election is made, the U.S. individual cannot claim a foreign tax credit or deduction for foreign taxes paid on any amounts excluded from gross income under Code Sec. 911.[11]

Special Look-Through Regimes Applicable to U.S. Citizens and Residents with Respect to Foreign Corporations or Entities Taxed as Associations

Anti-Income Deferral Tax Regimes: In General

U.S. citizens and residents are subject to special income taxation regimes which look through corporate structures that have certain species or classes of foreign source taxable income where certain ownership requirements are met. These rules are the controlled foreign corporation provisions, the passive foreign investment company ("PFIC") rules and domestic international sales corporations ("CFC") rules or "interest-charged DISCs." Other special rules (Code Secs. 671–679) apply to certain trusts deemed to be owned by the grantor or other person by the retention of certain rights or powers with respect to such trust held by the grantor and/or a "non-adverse" party (a "grantor trust"). In that case, the deemed owner must include in income the items of income and deduction (and credits against tax) of the portion of such trust deemed to be owned by such person. Except to the extent a trust is a grantor trust, a transfer of property by a U.S. person to a foreign estate or trust is treated (under Code Sec. 684) by the transferor as if the property had been sold to such estate or trust. Code Sec. 684(a) generally treats the transfer as a sale or exchange with recognition of gain measured by the excess of fair market value over the transferor's adjusted basis as determined for gain purposes (*see* former Code Secs. 1451, 1057). Where gain is recognized under Code Sec. 684(a) to the U.S. settlor, the trust will acquire a fair market value basis in the subject property. The same result applies where a domestic trust becomes a foreign trust.[12]

Controlled Foreign Corporation Provisions

Under the CFC rules set forth Code Secs. 951 through 964, a controlled foreign corporation is a foreign corporation (including an unincorporated entity which makes a check-the-box election to be treated as an association or is a "per se" foreign corporation) in which U.S. shareholders,

who each own at least 10% of the CFC's stock (by vote or value), together own more than 50% of the CFC's stock (by vote or value). Each U.S. shareholder (per Code Sec. 951(b)) of the C and who owns (within the meaning of Code Sec. 958(a)) stock in such corporation on the last day in such year on which such corporation is a CFC must include in gross income, for her taxable year in which or with which such taxable year of the corporation, her proportionate share of the CFC's (undistributed) subpart F income.[13] In other words, a U.S. shareholder of a CFC is currently required to include in gross income such individual's proportionate share of the undistributed earnings of the CFC's subpart F income. The purpose of the CFC rules was to prevent U.S. shareholders from using foreign corporations to defer U.S. taxes from certain types of "tax haven" operations. Where a CFC earns income in a U.S. business subject to U.S. taxation at regular rates with the result that no U.S. taxes are being deferred, there is no policy reason to tax the U.S. shareholders on deemed income.

A CFC's earnings and profits directly impact the Code Sec. 951(a)(1) income inclusion. As a starting point, under Code Sec. 952(c)(1)(A), subpart F income of a CFC for any taxable year may not exceed the earnings and profits of such corporation for such year.[14] Certain prior year deficits in earnings and profits from a "qualified deficit" are permitted to be taken into account in making this computation. Pursuant to Code Sec. 951(a)(1)(A)(i) and Reg. §1.951-1, a U.S. shareholder of such CFC must include her *pro rata* share of such subpart F income in gross income for her taxable year in which or with which such taxable year of the foreign corporation ends.[15]

Subpart F Income

Subpart F is comprised of several categories or species of income with which Congress was particularly concerned that are generated by U.S. controlled corporations to inappropriately defer current taxation, which planning would also include the use of lower tax jurisdictions or tax havens. The use of a C corporation to warehouse foreign source income without paying dividends on a current basis did pose the opportunity for tax deferral until repatriation or deemed repatriation of the earnings of the C corporation "blocker." Subpart F income includes passive forms of investment income, income from goods purchased from or sold to related persons, service income for services performed for or on behalf of a related person, certain insurance income from insuring risks outside of the CFC's country of incorporation, foreign shipping income and income from processing, transporting or distributing oil and gas and certain illegal bribes or kickbacks as well as participation in an international boycott (Code Sec. 952(a)). There are various important concepts and terms to be applied in determining what is subpart F income and making the necessary computations. One important area is the "chain deficit rules." Under this rule, a CFC is allowed to reduce its subpart F income by an earnings and profits deficit of another CFC provided: (i) the other CFC is a "qualified chain member"; (ii) the deficit was incurred in a taxable year ending with or within the current taxable year of the CFC; (iii) the income and deficit arise from the same type of activity; (iv) the income is not "disqualified" income; and (v) the taxpayer CFC elects to apply the rule (*see* Code Sec. 952(c)(1)(C)(i)). A CFC is a qualified chain member if it is organized under the laws of the same foreign country as the taxpayer CFC and the taxpayer CFC owns all the stock of the other CFC or the other CFC owns all of the taxpayer CFC's stock. In either case, directors' qualifying shares are ignored, and the shares can be held directly or indirectly through other corporations (but not through the common parent). When the chain deficit rule applies, each CFC first reduces its subpart F income by its deficits from prior years under the offset rule, and a deficit of a qualified chain member may be applied only against any subpart F income remaining after the CFC's prior deficits have been fully used. When a CFC's deficit is used to reduce current subpart F income of another CFC, the deficit may not be carried forward to offset the CFC's subpart F income for a subsequent year (Code Sec. 952(c)(1)(C)(iii)).

Where stock of a U.S. person in a CFC is sold or disposed of in a taxable transaction, gain recognized is treated as a dividend taxable as ordinary income to the extent of the shareholder's share of the accumulated earnings and profits of the CFC attributable to the period of time that the U.S. shareholder held the stock.[16] Note that the "same country exception" for dividends paid from a foreign subsidiary to a foreign parent (both subject to the CFC rules), which would be non-taxable, are still taxable with respect to gain recognized on the sale of the parent foreign corporation's stock per Code Sec. 964(e)(2).[17] Under the TCJA, for tax years beginning after 2017, if any amount is treated as a dividend under Code Sec. 964(e)(1) by reason of a sale or exchange by the CFC of stock in another corporation held for one year or more, then notwithstanding any other provision in the Code: (i) the foreign source portion of the deemed dividend is treated as subpart F income of the selling CFC shareholder under Code Sec. 951(a)(1)(A); a U.S. shareholder with respect to the selling CFC includes in gross income with or within which the tax year of the CFC ends an amount equal to the shareholder's *pro rata* share (per Code Sec. 951(a)(2)) of the amount treated as subpart F income; and the

participation exemption dividends received deduction under Code Sec. 245A is allowable to the U.S. shareholder with respect to the deemed dividend under Code Sec. 1248 where the shareholder is a U.S. domestic corporation (*see* also Code Sec. 961(d)).

Global Intangible Low Taxed Income: New Code Sec. 951A

While the Tax Cuts and Jobs Act of 2017 enacted welcome reforms to the international tax rules affecting U.S. corporations doing business overseas thru the participation exemption provision allowing a U.S. corporation a 100% dividends received deduction under Code Sec. 245A as well as a low rate repatriation tax under Code Sec. 965 on the deemed repatriation of post-1986 accumulated (untaxed) foreign earnings and profit for which the associated tax could be deferred over an eight year period under Code Sec. 965(c), and the allowance of an eight year spread on the payment of associated U.S. tax as set forth in Code Sec. 965, another reform substantially reduced the income deferral opportunities associated with the active conduct of foreign business operations through a foreign corporation. Prior to the TCJA, active business income of a U.S. shareholder owning 10% or more of the stock of a foreign corporation could be deferred for U.S. income tax purposes until actual or deemed dividends were received. Such active business income would have to fall outside of the scope of subpart F income under the CFC rules. Under the TCJA, new Code Sec. 951A requires a U.S. shareholder, including both corporate and non-corporate taxpayers, to currently include in gross income, its *pro rata* share of global intangible low-taxed income (GILTI). U.S. shareholders that are domestic corporations, however, can mitigate the income tax rate on GILTI under Code Sec. 250 by receiving a 50% deduction reducing the effective U.S. income tax rate to 10.5% and subject to further reduction for allocable foreign tax credits. Individual U.S. shareholders subject to GILTI should consider making an election under Code Sec. 962 permits the U.S. shareholder to be treated as a domestic corporation with respect to subpart F and GILTI inclusions thereby benefitting from Code Sec. 250 but only reducing the resulting maximum federal income tax rate to 18.5% (50% of 37%).[18]

State and Local Tax Impacts of Code Sec. 951A

There are state and local tax considerations to take into account under GILTI. For example, New York expressly excludes Subpart F income from a corporation's taxable income under the New York corporate franchise tax and New York City corporate income tax where the corporate shareholder and the CFC are part of a unitary business.[19] Conversely, some states, such as Pennsylvania, allow individuals to defer taxation on their Subpart F income until actual distribution. California law provides that federal AGI is reduced by the Code Sec. 951(a) inclusions in determining California AGI. In the year the CFC's accumulated earnings are actually distributed to the U.S. shareholder, any amounts excluded from federal AGI as previously taxed income (PTI) under Code Sec. 959 are added back in computing California AGI.

Presence of Previously Taxed Income

The new anti-deferral rule sought to protect the domestic income tax base with respect to mobile, foreign-source income from intangible property—including goodwill—whether or not reflective of purchased goodwill on the CFC's balance sheet, by subjecting current year foreign-source business income to U.S. income tax. The new GILTI regime has as its primary beneficiary U.S. domestic corporations that are U.S. shareholders in a foreign corporation.

Meet the FDII Provision as Well

The benefits extended to domestic C corporations under the TCJA include the new GILTI rule as well as a U.S. corporation's direct realization of income from its FDII, *i.e.*, qualified foreign-source services or manufacturing income, as a result of new Code Sec. 250. Under new Code Sec. 250(a)(1), a domestic corporation is allowed a deduction equal to the sum of: (i) 37.5% of its net income from FDII for the tax year; plus (ii) 50% of its GILTI, which is included in gross income under Code Sec. 951A for the tax year, plus the Code Sec. 78 gross-up amount attributable to the GILTI inclusion. For allocations or associated dividends received from the CFC after 2017 and before 2026, Code Sec. 250 allows the recipient domestic corporation a deduction equal to the sum of 37.5% of the corporation's FDII for the tax year plus 50% of its GILTI (if any), and the Code Sec. 78 gross-up attributable to the GILTI inclusion. For tax years beginning after 2025, the deduction is reduced to 21.875% of the FDII and 37.5% of the GILTI included in gross income under Code Sec. 951A.

Limitation on Code Sec. 250 Deduction for GILTI/FDII

The deduction allowed under Code Sec. 250 is limited by Code Sec. 250(a)(2) to a domestic corporation's taxable

income for the tax year. In instances where the sum of a domestic corporation's FDII and GILTI amounts exceeds its taxable income (determined without taking into account the deduction allowed under Code Sec. 250), then the FDII and GILTI amounts used in computing the deduction must be reduced. The Code Sec. 250(a) deduction effectively reduces the U.S. corporate income tax rate to 13.125% with respect to FDII and to 10.5% with respect to GILTI; those rates are subject to further adjustment for the corresponding percentage of foreign taxes directly or indirectly paid or accrued with respect to that income. The aggregate GILTI and FDII deductions cannot exceed a taxpayer's taxable income and any excess deduction is eliminated and may not be carried forward or backward. The rates of U.S. tax on GILTI or FDII income are further reduced from 21% to 13.5% to 10.5%, respectively, plus any FTC allowance. However, the GILTI and FDII deductions are only extended to regular or C corporations (*see* Code Sec. 250(a)(2) (any excess deduction is permanently disallowed)).[20]

Extracting CFC Income from the GILTI Inclusion

In order to compute the GILTI inclusion amount, a U.S. shareholder, regardless of whether the shareholder is a U.S. corporation, must weave through a statutorily-prescribed maze of interrelated computations driven by several formulae. The two sets of recently issued proposed regulations reinforce the perception that this presents a tax reporting and compliance challenge worthy of the cost of a well-designed software program. Removed from the GILTI are categories of Subpart F income and related deductions, with the resulting amount—assuming the amount is positive on an aggregate basis—includible in gross income under Code Sec. 951A and available for the 50% deduction in Code Sec. 250(a)(1)(B). The U.S. shareholder must include in gross income its GILTI in a manner similar to the reporting of a Subpart F income inclusion under Code Sec. 951(a). A foreign tax credit is permitted for taxes properly attributable to tested income taken into account by a domestic corporation under Code Sec. 951A per Code Sec. 960(d). Under Code Sec. 904(d)(1)(A), any amount included in gross income in Code Sec. 951(A) (other than passive category income) is treated as a separate category income for Code Sec. 904 purposes.

GILTI Formula

GILTI means, with respect to any U.S. shareholder (per Code Sec. 951(b)) for the shareholder's tax year, the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return ("DTIR"). The shareholder's net DTIR is equal to 10% of the aggregate amount of the shareholder's *pro rata* share of the qualified business asset investment ("QBAI") of each CFC in which it is a U.S. shareholder.

The formula for GILTI, which is calculated at the U.S. shareholder level, is:

GILTI = Net CFC Tested Income – [(10% × QBAI) – Interest Expense].

Net CFC tested income, as defined in Code Sec. 951A(c), is the excess of the aggregate of the U.S. shareholder's *pro rata* share of the tested income of each shareholder's CFC(s) over the aggregate of its *pro rata* share of the tested loss of each CFC in which it is a U.S. shareholder. *Pro rata* shares are determined under the rules of Code Sec. 951(a)(2).

Pro Rata Share of GILTI

The TCJA's Conference Report added that, in determining a U.S. shareholder's *pro rata* shares of GILTI for one or more CFCs, a person is treated as a U.S. shareholder of a CFC for any tax year of that person only if the person owns (per Code Sec. 958(a)) stock in the foreign corporation on the last day in the tax year of the foreign corporation on which the foreign corporation is a CFC.

Net CFC Tested Income

The formula for net CFC tested income, which is also required to be determined at the U.S. shareholder level, is:

Net CFC Tested Income = Sum of CFC Tested Income – Sum of CFC Tested Loss

The tested income of a CFC, as provided in Code Sec. 951A(c)(2)(A), means the excess (if any) of the gross income of the corporation—determined without regard to certain exceptions to tested income—over deductions (including taxes) properly allocable to such gross income. The exceptions to tested income are: (1) the corporation's effectively connected income ("ECI") under Code Sec. 952(b); (2) gross income taken into account in determining the corporation's Subpart F income, including the high-tax kick out exception; (3) gross income excluded from foreign base company income or insurance income due to Code Sec. 954(b)(4)'s high-tax exception; (4) dividends received from a related person (per Code Sec. 954(d)(3)); and (5) foreign oil and gas extraction income (per Code Sec. 907(c)(1)).

The tested loss of a CFC is the excess, if any, of the deductions, including taxes, properly allocable to the

corporation's gross income without taking into account the tested income exceptions as set forth above, over the gross income. As to a CFC's tested loss, special rules apply under Code Sec. 951A(c)(2)(B)(ii) to deny a taxpayer basis from which to claim "double" deductions.

Tested income is based on the CFC's gross income for its entire tax year, which a U.S. shareholder takes into account where last day of the CFC tax year is included in the U.S. shareholder's tax year. The CFC's gross income is calculated as if it were a domestic corporation. The next step, of course, is to remove the CFC's net income, *i.e.*, gross income less allocable deductions, from each class or species of its Subpart F income, as well as less obvious exclusions such as foreign high-taxed income kicked out of Subpart F, dividends from certain related foreign corporations, and oil and gas income. The Subpart F income does not necessarily have to be included in each U.S. shareholder's gross income under Code Sec. 951. This will occur, for example, when an exemption to a Subpart F inclusion applies, such as the "same country" limitation.

However, investment in U.S. property inclusions under Code Sec. 956 is not removed or eliminated. Accordingly, a U.S. shareholder may have a Code Sec. 956 inclusion based on its CFC income from a current or prior CFC tax year without affecting its GILTI inclusion. Moreover, income of a CFC that is effectively connected with the conduct of a U.S. trade or business is not included in the CFC's gross income and so is outside of the GILTI inclusion rule in Code Sec. 951A. Accordingly, ECI of a U.S. branch of a CFC is eliminated from the GILTI gross income calculation.

High-Tax "Kick Out" Exception

The high-tax "kick out" exception will also play an active role in this area because many foreign countries have a corporate income tax rate of 18.9% or more on a CFC's foreign-source income. The controlling shareholder makes the election to apply the high-tax "kick out" rule for the entire CFC, which would presumably exclude that income from both the Subpart F and GILTI tax base. Is this what Congress intended?

Dividend Income

Dividend income from a corporation which is related to a CFC under Code Sec. 954(d)(3) is also eliminated from the GILTI base. Also, although oil and gas income is disregarded, other forms of foreign-source mineral or energy-producing income presumably cannot be excluded.

Further Calculations

After gross income from GILTI-eligible sources is determined, in determining a U.S. shareholder's *pro rata* share of a CFC's tested loss, the amount distributed is the tested loss, rather than the CFC's current E&P, and the tested loss is distributed solely with respect to the CFC's common stock, except in certain cases involving dividend arrearages on preferred stock and common stock with no liquidation value. Any tested loss that would be distributed in the hypothetical distribution to a class of common stock that has no liquidation value is deemed distributed to the most junior class of equity having a positive liquidation value. In subsequent years, tested income is allocated to any class of stock to the extent the tested loss was allocated to the class in prior years. A shareholder's *pro rata* share of tested loss is reduced based on the number of days that the U.S. shareholder owned stock in the CFC for Code Sec. 958(a) purposes.

Code Sec. 962 Election

A U.S. shareholder who is an individual may elect to be taxed on the Code Sec. 951(a)(1) inclusion for CFC income and presumably as well for GILTI income under Code Sec. 951A(a)(1) as though he or she were a corporation. The purpose of the election is to make sure that an individual taxed under Code Sec. 951(a)(1) is not required to pay more tax than "would have [been due if he had] invested in an American corporation doing business abroad." If the individual is a U.S. shareholder of more than one CFC, an election applies to Code Sec. 951(a)(1) inclusions from all of them. Consideration should further be given to the interplay between Code Sec. 965(c) and Code Sec. 962 to an electing individual.

Passive Foreign Investment Company

In the Tax Reform Act of 1986, Congress enacted the PFIC rules to apply to tax U.S. investors under a special tax regime which offers the investor several options in reporting income. Code Sec. 1296(a) defines a PFIC as any FC which: (i) derives 75% or more of gross income from "passive income," defined in Code Sec. 1296(b)(1), or (ii) 50% of the value of its assets are passive assets. No percentage of ownership requirement is imposed as in the CFC rules. Where the PFIC rules overlap with the CFC provisions, the Taxpayer Relief Act of 1997 provided that the CFC rules control.[21]

Interest Toll Charge on Deferred Income

Under Code Sec. 1291, a U.S. shareholder of a PFIC is subject to an interest toll charge on the deferred income realized upon the disposition of the PFIC stock. This method of reporting PFIC income results in a deferral of reporting income until the stock is disposed in a taxable transaction. The interest charge technically is calculated

based on the amounts received and is not limited to dividend income. A U.S. shareholder of a PFIC may permanently elect to be taxed under Code Sec. 1295 under the qualified elective fund ("QEF") approach, which requires that the U.S. shareholder be taxed currently on its *pro rata* share the current year's undistributed earnings of the PFIC. The U.S. shareholder is permitted to defer payment of the tax on undistributed earnings by election under section Losses, however, do not pass through to shareholders. Failure to elect QEF treatment denies a step up in stock basis at death under Code Sec. 1291(e) and Code Sec. 1014.

Mark-to-Market Election

A third method for a U.S. shareholder's reporting under the PFIC rules allows a U.S. shareholder to elect a "mark-to-market" reporting for stock held in a publicly traded PFIC. Where a mark-to-market election is made, annual year-end gains are taxed as ordinary income. Year-end losses, to the extent of previously included gains, are permitted and characterized as ordinary losses. Stock basis is adjusted for the amount of gains and losses reported. Source is determined under the usual sale of personal property rules (*i.e.*, residence of seller), and the election is a binding one.

U.S. Income Taxation of Nonresident Aliens

In General

Non-U.S. citizens who do not meet the definition of "resident aliens" are treated as nonresident aliens for U.S. income tax purposes. Nonresident aliens are subject to U.S. income taxation only to the extent their income is from U.S. sources, generally passive in nature, or is effectively connected income or ECI with a U.S. trade or business. Withholding rules apply.[22] Such rules are subject to modification to the extent a particular tax treaty is involved. A nonresident alien is taxed at regular rates on net profits from ECI or gains from U.S. real property under Code Sec. 897.

Fixed or Determinable Periodic Income

In accordance with Code Sec. 871(a), nonresident aliens also are taxed at a flat rate of 30% on certain types of passive income derived from U.S. sources, "fixed or determinable annual periodic" income or "FDAP," although a lower rate may be provided by treaty. FDAP includes passive income categories such as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income. There is no U.S. tax imposed, however, on interest earned by nonresident aliens with respect to deposits with U.S. banks and certain types of portfolio debt investments described in Code Sec. 871(h). Gains on the sale of stocks or securities issued by U.S. persons generally are not taxable to a nonresident alien because they are considered to be foreign source income. Foreign corporations are not subject to U.S. income tax on gains from the sale of U.S. stock or securities unless such gains are ECI with a U.S. trade or business.

Foreign Investment in Real Property Tax Act "FIRPTA"

Code Sec. 897(a) provides that nonresident aliens are subject to U.S. income taxation on gains recognized with respect to the disposition of an interest in U.S. real property ("USRPI"), per Code Sec. 897(c)(1), including gain recognized with respect to a U.S. real property holding corporation ("USRPHC") defined in Code Sec. 897(c)(2). Gains from dispositions of USRPIs and USRPHCs are treated as ECI with a U.S. trade or business.[23] More particularly, a USRPI is any interest (than solely as a creditor) in a domestic corporation unless the taxpayer can establish that the corporation was not a USRPHC at any time during the five-year period ending on the date of disposition.[24] A USRPHC is any corporation, the fair market value of U.S. real property interests of which equals or exceeds 50% of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (Code Sec. 897(c)(2)). Where a USRPI is acquired from a foreign person, the purchaser, either a domestic or foreign person, is required, in general, to withhold and remit to the IRS 10% of the gross sales price. As an exception, either party may file a statement with the IRS as to the transferor's maximum tax liability in connection with the disposition and receive, assuming all requirements are met, a certificate from the IRS setting forth a reduced amount of withholding.[25]

Treatment of Gain or Loss of Foreign Person from Sale or Exchange of Partnership Interests[26]

In Rev. Rul. 91-32,[27] a long-standing ruling issued by the Service, gain or loss of a foreign partner from a disposition of an interest in a partnership that conducts a

trade or business through a fixed place of business or has a permanent establishment in the United States is gain effectively connected with such trade or business (or loss allocable to such gain). However, the Tax Court, in *Grecian Magnesite Mining, Industrial & Shipping Co.*,[28] rejected the IRS position and held that a foreign corporation's gain on the sale of an interest in a partnership that engaged in a U.S. trade or business wasn't U.S. source income and wasn't effectively connected with a U.S. trade or business.[29] The Tax Cuts and Jobs Act provides that notwithstanding any tax rules, if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership that is engaged in any trade or business in the United States, gain or loss on the sale or exchange of all (or any portion of) the interest is treated as effectively connected with the conduct of the trade or business to the extent the gain or loss does not exceed the amount described below. This revision to Code Sec. 864(c)(8)(A) overrides the Tax Court's decision in *Grecian Magnesite Mining*, *supra*, and validates the IRS's long-standing position in Rev. Rul. 91-32, *supra*.

Determination of U.S. Residence Under U.S. Domestic Law

A non-U.S. citizen is resident in the United States where such individual falls within one of two categories, to-wit: (i) where such person has entered the United States as a lawful permanent resident, *e.g.*, the "green card" test; or (ii) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time, *i.e.*, 183 or more days over a weighted three-year period, *e.g.*, the "substantial presence test").[30] This weighted average formula, stated in different terms, results in U.S. residence where the individual is present for 122 or more days over the weighted (average) three-year period. In addition, where an individual is present in the United States for fewer than 183 days during a calendar year, and can further establish that she has a "closer connection" with a specific foreign country and maintains a "tax home" in that country for the year, such individual generally is not treated as a U.S. resident under the "substantial presence test." Where an individual is present for 183 or more days during a calendar year, then the "closer connection," "tax home" exception is inapplicable.

Where an alien has an application pending to change her status to permanent resident or has taken other steps to apply for status as a lawful permanent resident, such person is also ineligible for the closer connection-tax home exception. In applying the substantial presence test, days where an individual is present as an "exempt individual" are not counted. "Exempt individuals" include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events. In addition, the substantial presence test does not count days of presence of an individual who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States, if the individual can establish to the satisfaction of the Secretary of the Treasury that he or she qualifies for this special medical exception.

Determination of U.S. Residence Under Tax Treaty Tie-Breaker Provision

In certain instances, a foreign person will meet the definition of a U.S. resident while, at the same time, such person is classified as a "resident" of the domestic tax law of another country. This can pose a substantial problem, particularly for the individual whose country of nationality does not maintain an income tax treaty with the United States. However, where such foreign individual is from a country that maintains an income tax treaty with the United States, most income tax treaties maintain a set of "tie-breaker" rules which resolve the individual's country of residence for income tax purposes in an effort to avoid double taxation.

In general, a dual resident is deemed to be a resident of the country in which such person has a permanent home. If the individual has a permanent home available in both countries, the individual's residence is deemed to be the country with which her personal and economic relations are closer, *i.e.*, the "center of vital interests." If the country in which such individual has her center or vital interests cannot be determined, or if such individual does not have a permanent home available in either country, she is deemed to be a resident of the country in which she has a habitual abode. If the individual has a habitual abode in both countries or in neither country, she is deemed to be a resident of the country of which she is a citizen. If each country considers the person to be its citizen or if she is a citizen of neither country, the competent authorities of the countries are to settle the question of residence by mutual agreement, *i.e.*, by resolution of competent authorities. The terms "citizen" and "resident" as applied to an individual are quite important. Establishing tax residency in a contracting state to a bilateral income tax convention entitles, in general, the resident to treaty benefits. Thus, it is possible that a citizen of non-contracting state, *i.e.*, a U.S. citizen, is able to claim relief under a U.S. income

tax treaty for example, where such individual qualifies as a resident of one of the Contracting States. A few U.S. tax treaties have incorporated a definition of "resident" that is substantially similar to that of the U.S. Model treaties. Under those treaties, treaty benefits generally are available to individuals who are citizens of a Contracting State, even though these individuals are not residents of either Contracting State.

An individual's country of citizenship, *per se*, does not qualify an individual for treaty benefits, other than under the non-discrimination article of the relevant treaty.[31] However, the U.S. Model Treaties include "citizenship" as one of the bases upon which an individual may qualify as a "resident" of a Contracting State.[32] Despite the residence tie-breaker provisions in our tax treaties, the United States insists upon the adoption of a savings clause in its bilateral tax treaties to preserve the right to tax its own citizens under its domestic laws.[33] For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss. Thus, it nullifies application of the treaty to U.S. citizens as their tax treatment is determined under the Internal Revenue Code and not under the treaty. Where a U.S. citizen is deemed to reside in another country, even a country with a bilateral income tax convention with the United States, double taxation can result.[34] In such event, the taxpayer, provided such individual resides in a tax treaty jurisdiction, should apply under the competent authority of the treaty to have the double taxation impact mitigation. Some tax treaties provide for cross-crediting with respect to income taxable under special sourcing rules by one of the contracting states.

U.S. Transfer Tax Rules Applicable to U.S. Citizens and Domiciliaries (non-U.S. citizens)

U.S. citizens and resident aliens, the latter term being determined by reference to an individual's domicile being in the United States, are subject to U.S. transfer tax, including gift, estate and generation skipping transfer taxes ("GST") (assuming such laws are in effect), on transfers of property wherever such property is situated. For non-domiciled, non-citizen, individuals, U.S. transfer taxes apply only with respect to transfers of property which are actually or treated by statute or case law as located within the United States.

The U.S. estate tax is imposed on the taxable estate of a decedent. This tax is imposed on worldwide assets owned at death or rights with respect to certain interests in property as set forth in Code Secs. 2033 through 2044. All such property interests, wherever situated, must be included in the gross estate of a U.S. citizen or domiciled resident, even if he or she lived and died abroad.[35] The U.S. gift tax applies with respect to transfers by gift of interests in property, regardless of where the property is located or the individual making the gift may "temporarily" reside, or in all cases as to a U.S. citizen (including naturalized U.S. citizen).[36] Under the GST tax, under Reg. §26.2663-2, the GST tax is imposed on a non-resident's transfer of property situs in the United States provided that the property transferred would be subject to estate and gift tax provision. For example, a non-resident (non-U.S. citizen) would not be taxable on a direct skip by lifetime gift if the gift itself was not subject to gift tax in the United States under the various situs rules and exemptions. As to the GST inclusion ratio, as defined in Reg. §26.2642-1, in many instances the GST ratio for a non-resident alien will be zero. The regulations provide that every nonresident noncitizen is allowed a GST exemption based on the amount available under current law.

General Rules U.S. Estate Taxation of Foreign Estates (see Code Secs. 2101–2108)

Under Code Sec. 2103, the gross estate of a non-resident (non-citizen) consists of the value of property sitused within the United States.[37] Transfers described within the "string" provisions of Code Secs. 2035–2038 made by a non-resident in trust are includible in the gross estate where the property transferred into the trust was sitused within the United States when transferred or at the time of death.[38]

Ownership of U.S. real property by a non-resident is includible in the gross estate of the individual and is also subject to U.S. gift tax if transferred during life.[39] An interest in real property includes land and improvements. This presumably includes units in a condominium as well as time-share units, again on the basis that such interests are generally treated under local law as interests in real property.[40] On the other hand, a cooperative apartment may be treated under local law as an interest in intangible personal property, *i.e.*, an interest in a corporation and a proprietary interest in a proprietary lease.[41] Mortgages may be treated as interests in real property even though the underlying note is an interest in intangible personal property. Some states treat mortgages as merely security for a debt obligation (lien theory) while others follow the rule that a mortgage is an interest in real property (title theory).

For personal property located in the United States, Reg. §20.2104-1(a)(2) provides such property is U.S.

situs property except for certain works of art on loan for exhibition.[42] Domestic and foreign currency is treated as personal property and sitused where located at death.[43] Intangible personal property will have a U.S. situs where: (i) it is intangible personal property under local law; (ii) the written evidence of the property is not treated as being the property interest; and (iii) the interest, *e.g.*, obligation, stock, is issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit.[44] Accordingly, shares of stock issued by a U.S. corporation are situated within the United States, even if the shares are physically located outside of the country at the date of death.[45]

Debt obligations of a "US person" including a citizen or resident of the United States also are U.S. sitused. This includes obligations of the United States, any state or political subdivision or the District of Columbia.[46] Where there is more than one primary obligor, the debt is apportioned among the obligors in accordance with the regulations.[47] While deposits with domestic financial institutions are subject to a special exception and are not includible in a non-resident's gross estate, for decedents dying after 1969, deposits with a domestic branch of a foreign commercial bank are debt obligations and are deemed property within the United States.[48]

As to ownership of partnership interests in domestic partnerships or foreign partnerships doing business or owning real property in the United States, there is some uncertainty as to whether such ownership interests are U.S. property inasmuch as there are no clear rules set forth in the Code or the regulations.[49] Where a partnership interest is owned by a non-domiciled individual at death, there is authority that the foreign estate should include the value of the decedent's proportionate share of the partnership's assets which have a U.S. situs.[50] The same look-through approach should be applied to the ownership of a membership interest in a domestic or foreign LLC to the extent of the value of its U.S.-sitused assets. In some instances, there is a risk that the entire value of the ownership interest may be includible in the U.S. gross estate. Relevant principles to be applied in resolving the issue of whether the interest is includible in a decedent's gross estate include: (i) location of the partnership's trade or business; (ii) domicile of the holder of the partnership interest; (iii) location of the partnership's assets; or (iv) situs of the partnership interest included whether the interest is held in a foreign or domestic trust.[51]

Beneficial Interests in a U.S. Situs Trust

Where trust funds are held through participating units, the IRS ruled in Rev. Rul. 55-163,[52] based on the facts, that the participating units held by a resident and national of Great Britain are sitused within the United States for Federal estate tax purposes. In general, the situs of an equitable interest in a conventional trust is determined by reference to the underlying assets.[53] The IRS noted that, in this situation, the participating units in the U.S. trust are includible in the gross estate based on the location of the underlying assets of the trust. Such units are also evidence of the rights of the trust against the trustee of the common trust fund. While the participating units are not a "debt" per Article II (2)(c) of the U.S.–U.K. estate tax convention, the units are still in the nature of proprietary units … therefore the situs of the participating units is in the United States for U.S. estate tax purposes.

The situs of a beneficial interest in a trust is based on a look-through approach by examining the value of the underlying assets. The same look-through approach would apply with respect to the decedent (non-resident's) holding of a general power of appointment of a trust created by another person.[54] The same approach would apply to the potential inclusion of a trust's assets in applying the "string provisions" under Code Secs. 2036–2038.

Under Code Sec. 2106, a foreign estate may deduct a ratable share of its worldwide expenses, losses, debts, and taxes that would otherwise be deductible under Code Secs. 2053 and 2054, in the proportion that the U.S. gross estate bears to the entire gross estate.[55] As to the marital deduction, where the estate of a non-resident alien is survived by U.S. citizen spouse, the martial deduction is unlimited.[56] A marital deduction for property passing to a surviving spouse who is a non-resident can qualify for the marital deduction if it meets the requirements of qualified domestic trust ("QDOT"). Once funded, distributions of principal from the QDOT to the non-citizen spouse are subject to federal estate tax and a withholding-type regime. There are certain requirements for a QDOT.[57] There are limitations on who can serve as a QDOT trustee and security requirements are imposed to ensure that the federal estate tax will be paid on distributions of principal from a QDOT.[58] There are exceptions to the security requirements for certain small QDOTs, and for QDOTs holding the personal residence of the non-citizen spouse. However, under Code Sec. 2056(d)(4), the marital deduction is also allowed if the surviving spouse becomes a U.S. citizen before the estate tax return is filed and the spouse was a U.S. resident at all times after the decedent's death and before becoming a U.S. citizen. Otherwise, there is no marital deduction

available for property passing from the estate of a non-resident alien to a surviving spouse who is a non-U.S. citizen or resident. Only the estate tax exclusion for non-resident aliens of $60,000 is available, unless an estate tax treaty provides greater relief. The estate tax rates over the exemption amount are the same rates as imposed on U.S. citizens.

The estate of a non-citizen, non-resident is also allowed to deduct the value of certain bequests, including transfer by disclaimer and through the exercise of a general power of appointment over trust property: (i) to or for the use of the U.S. or governmental entity; or (ii) to a trust or a fraternal society, order, or association operating under the lodge system if the contribution will be used exclusively for charitable purposes within the United States as set forth in the Code.[59] Treaties may expand the allowable charitable deduction.

For U.S. gift tax purposes, U.S. citizens with non-U.S. citizen spouses do not have an unlimited marital deduction under Code Sec. 2523. Under Code Sec. 2523(i), the annual present interest exclusion is increased to $100,000 indexed for inflation (per Rev. Proc. 2018-57). In 2019 the amounts were indexed at $15,000 and $155,000 (other than gifts of future interests) (*see* Code Sec. 2523(i)(2)).

The gift tax on non-resident alien donors is imposed under the unified rate schedule of Code Sec. 2001(c), which also applies to citizens and residents. However, the unified credit is not allowed to a non-resident alien, and thus relatively small taxable gifts can, therefore, generate surprisingly high taxes. However, for non-resident aliens, the gift tax is qualified by two exceptions: (i) Code Sec. 2501(a)(2), stating that the tax shall not apply to transfers of intangible property by a nonresident alien, and (ii) Code Sec. 2511(a), stating that the tax applies to transfers by nonresident aliens only if the property is "situated within the United States." Non-resident aliens, therefore, are subject to gift tax only on transfers of real or tangible personal property situated in the United States at the time of the transfer.

Under Code Sec. 2010(b), the estate of a non-U.S. person is subject to the same tax rates imposed on domestic estates as provided under Code Sec. 2001(c). The tax base is determined by combining the decedent's "adjusted taxable gifts" (post-1976 taxable gifts for U.S. situs property), but not including gifts includible in the gross estate, to the value of assets includible in the gross estate at death under Code Sec. 2033 and Code Secs. 2035 through 2042. This yields a tax on the combined base less a credit for gift taxes paid.

No Unified Credit or Applicable Exclusion Amount Under Code Sec. 2010

Foreign estates are entitled to only a $13,000 credit against their U.S. estate tax liability, which shelters from tax only the first $60,000 of value of the U.S. taxable estate. The estates of domiciliaries of U.S. possessions receive a credit of the greater of $13,000, or $46,800 multiplied by the percentage of the decedent's gross estate located within the United States.[60]

Determination of Domicile of a Non-U.S. Citizen

The determination of a non-U.S. citizen's resident for U.S. gift, estate and GST tax is based on review of all facts and circumstances as that specific place where an individual intends to be her permanent residence at the applicable valuation date either by presently residing in such locale or by evidencing intent to return to her permanent residence.[61] Still, evidence goes to the subjective intent of the individual based on objective criteria including: (i) the statements, declarations, admissions of the decedent; (ii) immigration status including visa, work permit, passport; (iii) the location of business and economic interests; (iv) a comparison of residences based on size and value; (v) location of family members and citizenships; (v) the period of time spent in the United States; (vii) the center of personal life, social and recreational affiliations; (viii) church affiliations, *etc.*; (ix) voting registration; and (x) other factors.

The U.S. Approach to the Expatriation of a U.S. Citizen and Then Long-Term Resident Prior to the Heroes Act in 2008

Before the enactment of the Foreign Investors Tax Act of 1966, when an individual renounced her U.S. citizenship or green card status and to become a nonresident, no realization event was imposed as is the case under Code Sec. 877A. In addition, the U.S. expatriate would no longer be subject to tax on her worldwide income, only income sourced within the United States.

By 1960, Congress became concerned that the state of the law at that time encouraged expatriation since it allowed the expatriate to avoid the graduated income tax rates on her U.S. investment income, *e.g.*, FDAP and U.S. gift and estate tax on worldwide holdings. The response was the enactment of the Foreign Investors Tax

Act ("FITA") of 1966.[62] Under new Code Sec. 877 under FITA, a U.S. citizen who renounced her U.S. citizenship would remain subject to U.S. income tax on such individual's ECI and any other U.S. source income at regular income tax rates for a period of 10 years from the taxable year in question (and after March 8, 1965) provided that one of the principal purposes of the expatriation was the avoidance of U.S. income, estate, or gift taxes, and further provided such rule did not result in a lower income tax impact than would otherwise follow.[63] If the individual expatriate passed away within the 10-year period, a special estate tax rule applied.

Under FITA, an alternative income tax rule applied under Code Sec. 877(b) should the alternative regime produce a greater amount of tax. Code Sec. 877(b) included as U.S. source income, gains from the sale or exchange or property (other than stock or debt obligations) located in the United States, and gains on the sale or exchange of stock of a domestic corporation or debt obligations of U.S. persons or of the United States, a State or political subdivision, or the District of Columbia, regardless of where the sale or exchange occurs or title is transferred. Deductions were allowed only to the extent properly allocable to the gross income of the expatriate, determined under the above-described provisions (except that the capital loss carryover provision is not to apply).

For federal transfer tax purposes, under Code Sec. 2017, in the event a U.S. expatriate died within 10 years following expatriation, such individual's U.S. taxable estate would include, in addition to U.S. situs property otherwise subject to estate tax in the case of a nonresident (non-domiciled) individual, shares of stock held at the date of death reflecting ownership, whether direct or indirect, of 10% or more of a foreign corporation treated as owned more than 50% by the decedent. Constructive ownership rules under Code Sec. 958 were applied. Under Code Sec. 2501(a)(3), also amended by FITA, the general gift tax exclusion for transfers by gift of intangible property made by a nonresident (nondomiciled) alien was not applicable for transfers by gift made within 10 years after expatriation by a U.S. citizen. Accordingly, an expatriate was subject to gift tax on transfers of U.S. situs intangible property during the 10-year post-expatriation period. It should be noted that under FITA, "a" principal purpose test was applied separately for income tax purposes versus U.S. transfer tax purposes.

Twenty years later, in The Health Insurance Portability and Accountability Act of 1996 ("HIPAA"),[64] Congress expanded the expatriation rules for long-term residents who relinquish their green cards.[65] HIPAA revised the "a principal purpose" of tax avoidance prerequisite by setting forth a statutory presumption that such purpose was present where an expatriate individual satisfied an average tax liability and net worth tests. Where the statutory presumption test was met, the expatriate in many cases would need to request a favorable private letter ruling from the IRS within the one-year period beginning on the date of the loss of United States citizenship that a principal purpose was not avoidance of taxes. Other changes were made, including special anti-avoidance sourcing rules with respect to: (i) gains from the sale of property other than stock or debt; (ii) gains from the sale of stock issued by a U.S. corporation; (iii) gains on debt obligations of a U.S. person or government; and (iv) gains from a CFC where the expatriate owned 10% or more of the voting power and at least 50% of the total value of that corporation's stock.

In The American Jobs Protection Act of 2004 ("AJCA"),[66] Congress decided it was time to abandon the "a principal purpose" test in trying to determine the subjective intent of the taxpayer. While the presumptions based on average income tax liability or net worth thresholds reflected objective facts, the presumptions were still rebuttable. Moreover, the subject test still applied to expatriates who did not meet either statutory presumption test. Congress noted that the level of reporting by individuals after an expatriation was spotty and undesirable. Many in Congress wanted the tax benefits of citizenship relinquishment or residency termination denied until an individual provides information necessary for the IRS to properly administer the alternative tax regime.

ACJA enacted major reforms to the expatriation provisions. First, it repealed the subjective intent test and provided objective standards for applying the alternative tax regime for the requisite 10-year period. In order to avoid being subject to the alternative tax provisions, the former U.S. citizen or green card holder would need to: (i) establish that her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) (now $168,000 in 2019); (ii) establishes her net worth does not exceed $2 million (without inflation adjustment), or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (ii) certifies under penalties of perjury that she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

ACJA also announced a notification of the expatriate's renunciation of citizenship or green card status had to be noticed with the Office of Homeland Security and until such notice is provided, such individual is still treated as a U.S. citizen or permanent resident for U.S. federal tax

purposes until such individual provides such notice and files a statement required under Code Sec. 6039G.

Another AJCA reform was that the expatriate remains subject to full U.S. taxation on her worldwide income where such expatriating individual is present in the United States for more than 30 days in the calendar year ending in such taxable year within the 10-year window. Should the expatriate die within a taxable year in which she is present in the United States for more than 30 days, she is treated as domiciled in the United States and subject to U.S. estate tax on her worldwide gross estate less applicable deductions. Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer by gift of assets regardless of sections 2104 or 2105 of the Code. This rule is referred to as some commentators as the anti-gaming the system rule.

The Current Expatriation Rules: The Heroes Earnings Assistance and Relief Tax Act of 2008 ("Heroes Act")[67]—Introduction of Mark-to-Market Regime

Wide-sweeping changes were again made to the expatriation provisions, both for income and transfer tax rules under the Heroes Act. The goal of Congress' acting once more in this area was clear. It was to make the tax impact attendant to expatriation more costly to those leaving. One scenario that Congress wanted to address was where talented individuals realize financial success in their endeavors and have much unrealized appreciation in their business assets generated while living in the United States that somehow escape U.S. taxation indefinitely or somehow are eliminated from U.S. income tax and/or U.S. transfer tax on the wealth that was generated. Two rules addressed this concern, to-wit: (i) the mark-to-market income tax under Code Sec. 877A; and (ii) the U.S. donee inheritance tax under Code Sec. 2801 on transfers of property from a covered expatriate to a U.S. donee.

The mark-to-market tax applies to individuals who terminated their citizenship or long-term residency after June 16, 2008, and meet certain tests. Where the requirements for the tax are met, the individual is treated as having sold all her assets or interests in property in a taxable disposition for fair market value on the day prior to the actual date of expatriation.[68] Unlike the 10-year phase out rule under former Code Sec. 877, expatriation status of a covered expatriate individual is permanent. The United States broadening the impact of expatriation spurred the enactment of expatriation tax provisions in a number of other countries, including France, Germany and the Netherlands.

A covered expatriate, as such term is defined, is generally entitled to have to report only gain in excess of the exclusion amount (as adjusted for inflation), which is $725,000 for 2019. The exclusion amount is allocated among all built-in gain property that is subject to the mark-to-market regime, *pro-rata*, based on the relative amount of unrealized gain for each built-in gain asset.[69] The characterization of gain or loss under Code Sec. 877A is based on the nature of the asset held. Each individual is allowed only one lifetime exclusion amount, with the result that an exclusion amount is no longer available upon a later expatriation to the extent that it has been used up in an earlier expatriation. The tax-free exchange rules or income exclusion provisions are ignored.

Covered Expatriate

Under Code Sec. 877A(g)(1)(A), a covered expatriate is defined based on the requirements contained in Code Sec. 877(a)(2)(A)–(C), with exceptions set forth in Code Sec. 877A(g)(1)(B). Thus, the ACJA amendments defining an expatriate remain in place with respect to the: (i) average annual net income tax liability (as adjusted for inflation, which is $168,000 for 2019) for the prior five taxable years; or (ii) the $2,000,000 net worth test, which is not adjusted for inflation; or (iii) the individual fails to certify under penalty of perjury that she has met the requirements of the Code for the preceding five taxable years or fails to submit such evidence of such compliance in the manner required.

The Code Sec. 877A test is met when an individual "ceases to be a lawful permanent resident of the United States" (*i.e.*, loses his or her green card status through revocation or has been administratively or judicially determined to have abandoned such status). The HEART Act amended Code Sec. 7701(b)(6) to provide that an ex-green card holder will no longer be treated as a permanent resident for tax purposes if: (i) he begins to be treated as a taxable resident of another country "under a tax treaty between the United States and such foreign country"; (ii) chooses not to waive the benefits for which he would otherwise qualify as resident of the foreign country under the treaty; and (iii) notifies the Secretary of the Internal Revenue Service "of the commencement of such treatment." These "requirements" include filing all required

income tax, employment tax, gift tax, and information returns and paying all tax liabilities, interest, and penalties. A taxpayer must make this certification on Form 8854, which must be filed by the due date of the taxpayer's income tax return for the taxable year that includes the day before the expatriation date.[70]

Exception to Covered Expatriate Classification

There are two exceptions to the definition of a covered expatriate. The first is the "dual citizen" returning home rule. It applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual has been a resident of the United States (under the substantial presence test of Code Sec. 7701(b)(1)(A)(ii)) for not more than 10 taxable years during the 15-year taxable year period ending with the taxable year of expatriation.[71] The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 ½, provided that the individual was a resident of the United States (under the substantial presence test of Code Sec. 7701(b)(1)(A)(ii)) for no more than 10 taxable years before such relinquishment (Code Sec. 877A(g)(1)(B)(ii)).

The Expatriating Long-Term U.S. Resident

The term "long-term resident" means any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least eight taxable years during the period of 15 taxable years ending with the tax year of expatriation.[72] Cessation of residence occurs where: (i) the individual's status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with immigration laws has been revoked or has been administratively or judicially determined to have been abandoned, or if (ii) the 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 the treaty applicable to residents of the foreign country, and notifies the IRS of such treatment on Forms 8833 and 8854.[73]

Any long-term resident who ceases to be a lawful permanent U.S. resident under the rules described above is treated for the purposes of Code Sec. 877 as if the resident were a U.S. citizen who lost her U.S. citizenship on the date of the cessation or commencement.[74] This includes a long-term resident who loses his green card status or gains benefits of a tax treaty as a foreign resident.[75]

In the case of a long-term resident, the date that long-term residency is terminated is the "expatriation date" (Code Sec. 877A(g)(3)(B)). In the case of a citizen, the date that the individual relinquishes citizenship is the "expatriation date" (Code Sec. 877A(g)(3)(A)). The deemed sale date is the day prior to the expatriation date.

As for the relinquishment of U.S. citizen status, such is deemed to occur on the earliest of four possible dates: (i) the date that the individual renounces her U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (ii) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (iii) the date that the State Department issues a certificate of loss of nationality; or (iv) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.[76]

Where an individual who is a covered expatriate becomes subject to tax as a citizen or resident of the United States for any period beginning after the expatriation date, the individual is not treated as a covered expatriate during that period for purposes of applying the withholding rules relating to deferred compensation items, the rules relating to interests in non-grantor trusts, and the rules relating to gifts and bequests from covered expatriates. Where the individual again relinquishes citizenship or terminates long-term residency (after meeting anew the requirements to become a long-term resident), the mark-to-market tax and other provisions are re-triggered with the new expatriation date.

Computing Gain Realized Under Code Sec. 877A(a)(1)

In determining the asset basis for property subject to Code Sec. 877A, a long-term resident is permitted to claim an initial adjusted basis with respect to the property based on the date the individual first becomes a U.S. resident but not for an amount less than the fair market value of the property on such date in accordance with Code Sec. 877A(h)(2). A taxpayer may make an irrevocable election for this basis rule not to apply. The IRS has announced that the step-up-in-basis rule will not apply to U.S. real property interests under Code Sec. 897(c) and with respect to property used or held for use in connection with the conduct of a trade or business within the United States.[77] However, if prior to becoming a U.S. resident, the nonresident alien was a resident of a country with which the

United States had an income tax treaty, and the nonresident alien held property used or held for use in connection with the conduct of a U.S. trade or business that was not carried on through a permanent establishment in the United States under the income tax treaty, the property is eligible for a step-up in basis to fair market value.

Election to Defer

Under Code Sec. 877A(b)(1), an expatriate individual may elect to defer payment of the mark-to-market tax imposed on the deemed sale of property. This election may be made to delay payment of the exit tax on one or more assets until the tax due-date of the year after those assets are actually sold (Code Sec. 877A(b)(1)). To take advantage of those deferrals, she must provide "adequate security" and "irrevocably waive the benefit of any U.S. tax treaty that would preclude assessment of the tax." Where deferral of gain is properly elected, interest is charged for the period the tax is deferred at the rate normally applicable to individual underpayments.[78] The election is irrevocable and is made on a property-by-property basis.[79] Under the election, the deferred tax attributable to a particular property is due when the return is due for the taxable year in which the property is disposed (or, if the property is disposed of in a transaction in which gain is not recognized in whole or in part, at such other time as the Secretary may prescribe).[80] The deferral of the mark-to-market tax may not be extended beyond the due date of the return for the taxable year which includes the individual's death. The election is made by entering into a deferral agreement with the IRS and appointing a limited agent in the United States as directed by Notice 2009-85, *supra*, and related guidance.

Under the security or bond requirement in order to elect deferral of the mark-to-market tax, the individual is required to furnish a bond to the Secretary.[81] The bond must be conditioned upon payment of the amount of tax due, plus interest thereon, and must be in accordance with such requirements relating to terms, conditions, form of the bond, and sureties, as may be specified by regulations and approved by the Secretary.[82] Other security mechanisms, including letters of credit, are permitted provided that they meet such requirements as the Secretary may prescribe. Where the security provided with respect to a particular property subsequently fails to meet the requirements of these rules and the individual fails to correct such failure, the deferred tax and the interest with respect to such property will become due.[83]As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the assessment or collection of the tax.[84]

Application of the Transfers of Appreciated Property to a Foreign Trust

The act of expatriating will convert many U.S. grantor trusts into foreign grantor trusts. This implicates the realization rule in Code Sec. 684 for such former U.S. grantors. More specifically, where a U.S. person transfers property to a non-grantor, foreign trust, Code Sec. 684 treats the transfer as a sale or exchange of the property for a price equal to its fair market value. Loss is not permitted on the transfer or deemed transfer of loss property. Because a nonresident alien generally may not be considered owner of a trust under the grantor trust rules, an individual's expatriation can terminate his or her ownership of a grantor trust, thereby causing Code Sec. 684 to apply.[85] Code Sec. 684 takes priority over Code Sec. 877A.

Withholding Requirement of Non-Grantor Trusts

The Heroes Act imposes a tax withholding requirement on all non-grantor trusts, foreign or domestic, that make taxable distributions to a covered expatriate. The mark-to-market tax, in general, does not apply with respect to any portion of a trust that is not treated as owned (under the grantor trust rules) by the covered expatriate immediately before the expatriation date. Special rules apply to any non-grantor trust with respect to which the covered expatriate is a beneficiary on the day before the expatriation date. Under Code Sec. 877A(f)(3), where there is a subsequent direct or indirect distribution of any property from a non-grantor trust to a covered expatriate, the trustee must deduct and withhold from the distribution an amount equal to 30% of the portion of the distribution which would be includible in the gross income of the covered expatriate if the covered expatriate continued to be subject to tax as a citizen or resident of the United States. Such portion of such distribution that is subject to the 30% withholding requirement is subject to tax under Code Sec. 871. The covered expatriate is treated as having waived any right to claim any reduction in withholding under any treaty with the United States on any distribution to which Code Sec. 877A(f)(1)(A) applies, unless the covered expatriate agrees to "such other treatment as the Secretary determines appropriate." If the non-grantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at its fair market value.

Succession Tax: New Code Sec. 2801—Pertains to Gifts or Bequests from Covered Expatriate Donors to U.S. Donees

The new "succession tax" covers any "direct or indirect gift or bequest," and imposes a tax rate that is equivalent to "the highest applicable gift or estate tax rates." The expatriation succession tax under Code Sec. 2801 is imposed on the donee rather than the expatriate donor. The expatriate donor may, however, be subject to federal gift or estate tax with respect to transfers of U.S. situs property, in which event the application of the succession tax under Code Sec. 2801 is "turned-off" should the recipient of the gift or bequest be a U.S. donee.

Exceptions to Mark-to-Market Tax Under Code Sec. 877A

The mark-to-market tax applies to most types of property interests held by the individual on the date of relinquishment of citizenship or termination of residency, with certain exceptions. Deferred compensation items, interests in non-grantor trusts, and specified tax-deferred accounts are excepted from the mark-to-market tax but are subject to the special rules described below.[86]

Deferred Compensation in General

Special rules are contained in Code Sec. 877A(d) for interests in non-grantor trusts, specified tax-deferral accounts, and deferred compensation items. For purposes of the provision, a "deferred compensation item" means any interest in a qualified plan or arrangement described in Code Sec. 219(g)(5), any interest in a foreign pension plan or similar retirement arrangement or program, any interest in a foreign pension plan or similar retirement arrangement or program, any item of deferred compensation, and any property, or right to property, which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under Code Sec. 83 or in accordance with Code Sec. 83 (a Code section that requires the inclusion of the fair market value of property received for the performance of services, less any amount paid for such property, to be included in gross income of the service provider in the first taxable year in which such property is transferable or not subject to substantial risk of forfeiture). A special deferral rule, an "inclusion deferral election," is provided in the TCJA for postponing income tax on the spread associated with exercising non-qualified stock options for example for a period of up to five years. Under Code Sec. 83(i), a qualified employee may elect to defer the inclusion in income of the amount of income attributable to qualified stock received by the employee. While presently uncertain, presumably Code Sec. 83(i) may result in the applicable period of deferral of income to a covered expatriate.

Under Code Sec. 877A(d), alternative tax regimes apply with respect to "eligible deferred compensation items" and to other or "ineligible deferred compensation items." For eligible deferred compensation items, Code Sec. 877A(d)(1)(A) provides, in general, that the payor must deduct and withhold from any taxable payments to a covered expatriate as to such items a tax equal to 30% of the amount of such taxable payments. For "ineligible deferred compensation items," Code Sec. 877(d)(2)(A) provides that a covered expatriate generally is treated as having received an amount equal to the present value of the covered expatriate's accrued benefit on the day prior to the expatriation date.

Code Sec. 877A(e)(1)(A) provides that if a covered expatriate holds any interest in a specified tax-deferred account on the day before the expatriation date, such covered expatriate is treated as having received a distribution of the covered expatriate's entire interest in such account on the day before the expatriation date. The special covered plans and arrangements described in Code Sec. 219(g)(5) are (i) a plan described in Code Sec. 401(a), which includes a trust exempt from tax under Code Sec. 501(a); (ii) an annuity plan described in Code Sec. 403(a); (iii) a plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, but excluding an eligible deferred compensation plan (within the meaning of Code Sec. 457(b)); (iv) an annuity contract described in Code Sec. 403(b); (v) a simplified employee pension (within the meaning of Code Sec. 408(k)); (vi) a simplified retirement account (within the meaning of Code Sec. 408(p)); and (vii) a trust described in Code Sec. 501(c)(18).

Where a deferred compensation item is an eligible deferred compensation item, the payor must deduct and withhold from a "taxable payment" to the covered expatriate a tax equal to 30% of such taxable payment.[87] This withholding requirement is *in lieu* of any withholding requirement under present law. A taxable payment is subject to withholding to the extent it would be included in gross income of the covered expatriate, if such person were subject to tax as a citizen or resident of the United States. A deferred compensation item is taken into account as a payment when such item would be so includible.

An "eligible deferred compensation item" means any deferred compensation item with respect to which (i) the

payor is either a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of withholding and who meet the requirements prescribed by the Secretary to ensure compliance with the withholding requirements, and (ii) the covered expatriate notifies the payor of his status as a covered expatriate and irrevocably waives any claim of withholding reduction under any treaty with the United States. The foregoing taxing rules regarding eligible deferred compensation items and items that are not eligible deferred compensation items do not apply to deferred compensation items to the extent attributable to services performed outside the United States while the covered expatriate was not a citizen or resident of the United States.[88]

Special rules apply for interests in "specified tax-deferred accounts." If a covered expatriate holds any interest in a specified tax-deferred account on the day before the expatriation date, such covered expatriate is treated as receiving a distribution of his entire interest in such account on the day before the expatriation date. Appropriate adjustments are made for subsequent distributions to take into account this treatment. As with deferred compensation items, these deemed distributions are not subject to early distribution tax.[89] A "specified tax-deferred account" means an individual retirement plan (as defined in Code Sec. 7701(a)(37)), a qualified tuition plan (as defined in Code Sec. 529), a Coverdell education savings account (as defined in Code Sec. 530), a health savings account (as defined in Code Sec. 223), and an Archer MSA (as defined in Code Sec. 220). However, simplified employee pensions (within the meaning of Code Sec. 408(k)) and simplified retirement accounts (within the meaning of Code Sec. 408(p)) of a covered expatriate are treated as deferred compensation items and not as specified tax-deferred accounts.

Where an item of deferred compensation is not an "eligible deferred compensation" item (and is not subject to Code Sec. 83), an amount equal to the present value of the covered expatriate's deferred compensation item is treated as having been received on the day before the expatriation date. In the case of a deferred compensation item that is subject to Code Sec. 83, the item is treated as becoming transferable and no longer subject to a substantial risk of forfeiture on the day before the expatriation date. Appropriate adjustments are made to subsequent distributions to take into account the foregoing treatment. In addition, these deemed distributions are not subject to early distribution tax.[90]

Interests in Trusts

Grantor trusts. In the case of the portion of any trust for which the covered expatriate is treated as the owner under the grantor trust provisions of the Code, as determined immediately before the expatriation date, the assets held by that portion of the trust are subject to the mark-to-market tax. If a trust that is a grantor trust immediately before the expatriation date subsequently becomes a non-grantor trust, such trust remains a grantor trust for purposes of the provision.

Non-Grantor Trusts: 30% Withholding on Distributions to Expatriate. Special rules apply to trusts with respect to which the covered expatriate is a beneficiary on the day before the expatriation date. The mark-to-market tax does not apply with respect to the portion of any such trust not treated (under the grantor trust provisions of the Code) as owned by a covered expatriate immediately before the expatriation date. Under Code Sec. 877A(f), in the case of any direct or indirect distribution from such a portion of a trust ("non-grantor trust") to a covered expatriate, the trustee must deduct and withhold from the distribution an amount equal to 30% of the portion of the distribution which would be includible in the gross income of the covered expatriate, if the covered expatriate continued to be subject to tax as a citizen or resident of the United States. Such portion of such distribution (that is subject to the 30% withholding requirement) is subject to tax under Code Sec. 871. If the fair market value of the property distributed to a beneficiary exceeds its adjusted basis in the hands of the trust, gain shall be recognized to the trust as if the property had been sold by the trust and the proceeds distributed to the covered expatriate. It should again be noted that a covered expatriate, including a beneficiary of an accumulation or simple trust subject to the expatriation rules, is treated as having waived any right to claim any reduction in withholding under any treaty with the United States.[91] As previously mentioned, where a non-grantor trust distributes appreciated property to a covered expatriate, the trust must recognize gain as if the property were sold to the covered expatriate at its fair market value.

Grantor Trust Conversion. If a trust that is a non-grantor trust immediately before the expatriation date subsequently becomes a grantor trust of which a covered expatriate is treated as the owner, directly or indirectly, such conversion is treated under the provision as a distribution to such covered expatriate to the extent of the portion of the trust of which the covered expatriate is treated as the owner (Code Sec. 877A(f)). In other words, domestic donee trusts would have to file and pay the succession tax as if it were the ultimate donee.[92] Foreign donee trusts would either have to "elect to be treated as a domestic trust solely for purposes of" Code Sec. 2801 and pay the succession tax (Code Sec. 2801(e)(4)-(B)(iii)),

or pass the succession tax burden to the U.S. donee of "any distribution attributable to such gift or bequest from such trust (whether from income or corpus) … as if such distribution were a covered gift or bequest."[93] The donee can deduct, under Code Sec. 164, the amount of tax imposed under Code Sec. 2801 that is attributable to gross income of the recipient but not to the capital portion of the distribution.

Transfer Tax and Succession Tax Implications of Expatriation

Prior Law

Americans who give up U.S. citizenship and establish foreign domiciles become nonresident aliens for purposes of the U.S. gift and estate taxes, as do alien individuals who abandon their U.S. domiciles. Because the estate and gift taxes apply to the worldwide estates and gifts of U.S. citizens and residents, while nonresident (non-domiciled) aliens and their estates are taxed only on transfers of property located in the United States under specific statutory provision or controlling case law authority, provisions of the Code have, in certain instances, limited the estate and gift tax savings flowing from a loss of U.S. citizenship or residence. For individuals expatriating before June 17, 2008, these provisions expand the taxable estates and gifts of expatriated donors and decedents to include some, but far from all, transfers that are normally not taxable when made by nonresident donors and decedents. The expansion generally applies for taxable years ending within 10 years after the loss of citizenship or residence.

Expatriation Prior to June 17, 2008

The usual rules for nonresident alien donors and decedents are modified for many former citizens and residents who lost U.S. citizenship or residence before June 17, 2008.[94] The modifications are most significant under the gift tax. For a period of 10 years, an affected expatriate loses the benefit of the usual exemption of gifts of intangible property. The principal estate tax modification is that the gross estate includes all or part of the value of stock of a foreign corporation that owns U.S. property.

Alien Donors and Decedents Affected by Modifications

The modifications apply to the estate of a nonresident alien decedent who lost U.S. citizenship or relinquished U.S. residence after June 3, 2004, and before June 17, 2008, if the decedent was "subject to the tax under section 877(b)" for the taxable year during which he or she died (Code Sec. 2107(a)). Code Sec. 877 only applies to former citizens and residents who expatriated before June 17, 2008 (Code Sec. 877(h)).

Code Sec. 877(b) applies only if the tax under that provision exceeds the U.S. tax that would be imposed on the individual for the year in the absence of Code Sec. 877 (Code Sec. 877(a)(1)). If the requirements described in the text are met, a decedent is probably "subject to the tax under section 877(b)," even if, for the taxable year ending with the decedent's death, the Code Sec. 877(b) tax is less than the tax determined apart from Code Sec. 877. Congress likely did not intend that the application of Code Sec. 2107(a) should turn on the relative amounts, for a single year, of the Code Sec. 877(b) tax and the tax without Code Sec. 877(b). The modifications apply to gifts made by a nonresident alien donor who lost citizenship or relinquished residence during the period June 4, 2004, through June 16, 2008, if Code Sec. 877(b) "applies for the taxable year which includes the date of the transfer" (Code Sec. 2501(a)(3)(A)). It is not clear whether Code Sec. 877(b) "applies" for a year for which tax under Code Sec. 877(b) is less than the tax determined apart from Code Sec. 877(b). A former citizen who lost citizenship during this period is subject to Code Sec. 877(b) for taxable years ending within 10 years after the loss of citizenship if his or her average annual net income tax for the five taxable years ending most recently before the loss exceeded $124,000 (adjusted for inflation), his or her net worth was at least $2 million when citizenship was lost, or he or she "fails to certify under penalty of perjury" that he or she met "the requirements of" the Internal Revenue Code for the five preceding taxable years (Code Sec. 877(a)(2)). An alien individual who relinquished residence during this period is subject to Code Sec. 877(b) for taxable years ending within 10 years after he or she ceased being a U.S. resident or became a resident of a country with which the United States has an income tax treaty if he or she satisfies one of the criteria described in the preceding sentence and was a lawful permanent resident of the United States for at least eight of the preceding 15 taxable years. Code Sec. 877(b) also applies to a former alien resident if he or she was a resident during at least three consecutive calendar years and resumes residence before completing at least three calendar years of non-residence.

Expatriation Prior to June 4, 2004

For a nonresident alien donor or decedent who lost U.S. citizenship before June 4, 2004, the modifications apply

if the individual lost U.S. citizenship during the 10 years preceding the gift or the date of death and avoidance of federal income, gift, estate, or generation-skipping taxes was a principal purpose for the loss of citizenship (Code Secs. 2107(a), 2501(a)(3)(A) (before amendment in 2004)). If the IRS "establishes that it is reasonable to believe that an individual's loss of" citizenship would "result in a substantial reduction" in U.S. taxes, the individual has the burden of proving that tax avoidance was not a principal purpose for the loss of citizenship (Code Secs. 2107(d), 2501(a)(4) (before amendment in 2004)). A former citizen is also treated as having a principal purpose to avoid U.S. taxes, regardless of actual motivation for loss of citizenship, if (1) his or her average annual net income tax exceeded $100,000 (adjusted for inflation) over the five taxable years ending before the loss of citizenship or (2) the person's net worth was at least $500,000 when citizenship is lost (Code Secs. 877(a)(2), 2107(a)(2), 2501(a)(3)(B) (applicable to persons losing citizenship after February 5, 1996, and before June 4, 2004)). A person may be exempted from the rule described in the preceding sentence if he or she:

a. Was, at birth, a citizen of both the United States and another country,
b. Became, within a reasonable time after losing U.S. citizenship, a citizen of the country of birth of the taxpayer, the taxpayer's spouse, or either of the taxpayer's parents,
c. Was not present in the United States for more than 30 days during any year within the 10 years preceding the loss of citizenship, or
d. Lost citizenship before reaching the age of 18 ½ (Code Sec. 877(c) (before amendment in 2004)). Under a similar rule of prior law, a loss of citizenship before February 6, 1996, is irrefutably presumed not to be tax-motivated if it occurred under specified provisions of the Immigration and Nationality Act, including the provision relating to renunciation of U.S. citizenship by a person who acquired dual citizenship at birth (Code Sec. 2107(d) (before amendment in 1996), Code Sec. 2501(a)(3)(A) (before amendment in 1996)).

Obtaining Benefit Prior to June 4, 2004

To obtain the benefit of this exemption, an individual, not later than one year after the loss of citizenship, had to request a ruling that avoidance of federal taxes was not a principal purpose of the loss of citizenship and receive a favorable response from the IRS. The modifying rules apply to a nonresident alien donor or decedent who relinquished U.S. residence before June 4, 2004, if (1) the rules would have applied had the donor or decedent lost citizenship when U.S. residence was relinquished and (2) the donor or decedent was a lawful permanent resident of the United States for at least eight of the 15 years ending with the year in which residence was relinquished (Code Sec. 877(e) (applicable to aliens who, after February 5, 1996, cease being U.S. residents or acquire residence in a treaty country)). An alien ceases being a lawful permanent resident of the United States only if the right of permanent residence is revoked or is administratively or judicially determined to be abandoned (Code Secs. 877(e)(1), 7701(b)(6)(B)). An individual who remains a lawful permanent resident is deemed for this purpose to relinquish residence on becoming a resident of a country having an income tax treaty with the United States if he or she does not waive treaty benefits allowable to residents of that country and was a lawful permanent resident for at least eight years during the 15-year period ending with the year during which residence in the treaty country begins. Whether avoiding U.S. taxes was a principal purpose of a relinquishment or constructive relinquishment of residence is determined by the same rules that apply to losses of citizenship. For example, if an alien giving up lawful permanent residence then had a net worth of at least $500,000, the relinquishment of residence is deemed tax motivated, regardless of actual purpose (Code Sec. 877(a)(2)). A former citizen may be exempted from this irrefutable presumption if, for example, he or she was born a dual citizen (Code Sec. 877(c), discussed *supra*). This exemption is not available to lawful permanent resident aliens or former lawful permanent residents (Code Sec. 877(e)(3)(A)).

Gift Tax Modifications

A donor to whom the modifications apply is denied the benefit of the rule that normally exempts nonresident alien donors' gifts of intangible property from gift tax (Code Sec. 2501(a)(3)(A)). However, whether the property is tangible or intangible, taxable gifts are, with one exception noted in the next paragraph, restricted to property situated in the United States (Code Sec. 2511(a)). The situs of property is determined under rules resembling those used in applying the estate tax to nonresident aliens (Code Sec. 2511(b); Reg. §25.2511-3(b)). Stock of a domestic corporation, as well as real and tangible personal property located in the United States, is considered situated in the United States and is therefore subject to gift tax if transferred during the tainted 10-year period. Also, debt instruments issued by U.S. obligors (including deposits in U.S. banks) have a U.S. situs for this purpose, even though they are not usually considered situated in the United States when held by other nonresident aliens (Code Sec. 2511(b)(2); Reg. §25.2511-3(b)(4)).

Immediately before the transfer, the donor owned stock of the foreign corporation carrying at least 10% of the total combined voting power of all classes of stock entitled to vote, and (a) Code Sec. 877(b) applies to the donor for the taxable year that includes the date of transfer.

Foreign Stock Transfer

Stock and obligations issued by foreign corporations are not situated in the United States. However, an otherwise includable transfer of stock in a foreign corporation is included in taxable gifts, even though the stock is considered situated outside the United States, if all of the following are true: The donor then owned, directly, indirectly, or constructively, stock of the foreign corporation representing more than 50% of either the total combined voting power of all classes of stock entitled to vote or the total value of all of the corporation's stock (Code Sec. 2501(a)(5) (effective for donors who expatriated after June 3, 2004)).

Foreign Stock Value

The gift tax value of such stock is its fair market value when transferred, multiplied by a fraction the numerator of which is the fair market value at that time of the assets owned by the foreign corporation that are situated in the United States and the denominator of which is the aggregate fair market value of all of the corporation's assets. Congress adopted this rule in 2004 because it was "concerned that [prior law did] not adequately address opportunities for the avoidance of tax on the value of assets held by a foreign corporation whose stock the individual transfers."[95] The rule applies "regardless of how such stock was acquired (e.g., whether issued originally to the donor, purchased, or received as a gift or bequest)."[96]

Property Situs

Because an expatriate is not taxed on gifts of property situated outside the United States, apart from the rule described in the preceding paragraph, an expatriate may avoid gift taxes, even on gifts made during the ensuing 10 years, so long as he or she takes care to shift the situs of property outside the United States before giving it away (*e.g.*, by selling U.S. securities, depositing the proceeds in an account in a foreign bank, and writing a check to the donee from this account). However, a sale of U.S. property within 10 years of expatriation may subject an expatriate to U.S. income tax on gain realized on the sale (Code Sec. 877). Thus, a donor making a gift within the tainted 10-year period can easily avoid the gift tax or the income tax, but usually not both. With respect to tangible personal property located in the United States at the time of the expatriation, it is apparently possible to avoid both taxes by removing the property from the United States before making the gift. However, the Treasury may, by regulations, treat the removal as a taxable sale for income tax purposes (Code Sec. 877(d)(2)(E)). The gift tax resulting from the expatriation rules may be offset by a credit for foreign gift taxes on the same gift (Code Sec. 2501(a)(3)(B) (effective for persons losing citizenship after June 3, 2004), Code Sec. 2501(a)(3)(D) (effective for persons losing citizenship after February 5, 1996, and before June 4, 2004)).

Estate Tax Modifications

When the modifications apply, estate tax is imposed only on property situated in the United States, just as for estates of other nonresident aliens, but with one modification (Code Sec. 2107(a)(1) (before amendment in 2004)): A decedent's shareholdings in a foreign corporation are included in the U.S. gross estate, in whole or in part, if the decedent (1) owned at least 10% of the voting corporation's stock, directly or indirectly through other foreign corporations, and (2) owned more than 50% (by vote or value) of the stock directly, indirectly, or constructively through family members and related entities (Code Sec. 2107(b)). The amount included in the gross estate is the value of the stock owned directly or indirectly, multiplied by a fraction the numerator of which is the value of the corporation's assets situated in the United States and the denominator is the value of the corporation's worldwide assets. For purposes of this rule, a decedent is deemed to own at death any stock included in the gross estate under Code Secs. 2035 through 2038.

For Example

Assume D, a nonresident alien decedent, was the sole shareholder of X Corp., a foreign corporation the only assets of which are a portfolio of publicly traded stocks of domestic corporations. Because stock issued by a foreign corporation is generally considered not situated in the United States, regardless of the location of the corporation's business or assets, the X stock is not included in the U.S. gross estate unless the rules for tax-motivated expatriations apply. However, if D is subject to Code Sec. 877(b) for the taxable year ending with her death, the X stock is included in the gross estate because the decedent satisfied the 10% and 50% ownership tests and the corporation's assets consist solely of property situated in the United States (stock of domestic corporations). Assume, in contrast, that X's assets consist of stock and bonds of domestic corporations. Portfolio debt instruments of domestic corporations are deemed not situated in the United States. Because only part of X's assets have a U.S. situs, only part of the X stock is included in D's gross estate under the rules for expatriates.

Estate Tax Computation

The tax computation for the estate of an expatriate is generally the same as for other nonresident aliens. Tax is determined under the unified rate schedule of Code Sec. 2001(c) (Code Sec. 2107(a)). A unified credit of $13,000 is allowed, and other credits are allowed subject to the same restrictions that apply to nonresident aliens' estates generally (Code Sec. 2107(c)). A credit is allowed for foreign death taxes on property that is included in the gross estate solely because of the rules for expatriates (Code Sec. 2107(c)(2)). The credit for taxes paid to a particular foreign country may not exceed the lesser of (1) the foreign death tax ratably allocable to property included in the gross estate solely because of the expatriate rules or (2) that property's proportionate share of the increase in U.S. estate tax resulting from the expatriate rules.

Physical Presence in United States Causing Alien to Be Treated as U.S. Citizen or Resident

If a nonresident alien to whom Code Sec. 877 would otherwise apply for a taxable year is physically present in the United States on more than 30 days during the year, he or she is treated as a U.S. citizen or resident for the year for all U.S. tax purposes (Code Sec. 877(g)(1) (applicable to persons expatriating after June 3, 2004)). If an expatriate's taxable year is not the calendar year, this rule applies for a taxable year if he or she is present in the United States for more than 30 days during the calendar year ending within the taxable year. If the individual makes gifts or dies during a year to which this rule applies, the gift and estate taxes apply as though he or she were a U.S. citizen or resident.[97] Note that in recommending adoption of this provision in 2004, the House Ways and Means Committee indicated that individuals who relinquish citizenship or terminate residency for tax reasons often do not want to fully sever their ties with the United States; they hope to retain some of the benefits of citizenship or residency without being subject to the U.S. tax system as a U.S. citizen or resident. These individuals generally (could, under prior law) continue to spend significant amounts of time in the United States following citizenship relinquishment or residency termination—approximately four months every year—without being treated as a U.S. resident. The Committee believes that provisions in the bill that impose full U.S. taxation if the individual is present in the United States for more than 30 days in a calendar year will substantially reduce the incentives to relinquish citizenship or terminate residency for individuals who desire to maintain significant ties to the United States.[98]

Presence

Considered for purposes of this rule, a person is considered present for a day if he or she is physically within the United States at any time during the day. A day of physical presence may, however, be ignored if the person is "performing services in the United States on such day for an employer" that is not "related" to him or her (Code Sec. 877(g)(2)(A)). Relatedness is determined under Code Secs. 267(b) and 707(b). The Treasury may, by regulations, prescribe additional conditions "to prevent the avoidance of the purposes of this paragraph." This exclusion applies only if at least one of the following is true:

1. Within "a reasonable period after loss of United States citizenship or termination of residency," he or she (1) became a citizen or resident of the country in which the individual, his or her spouse, or either of his or her parents were born and (2) became "fully liable for income tax in such country" (Code Sec. 877(g)(2)(B));
2. He or she was not present in the United States for as many as 30 days during any year within the 10-year period ending when the person lost U.S. citizenship or terminated U.S. residency (Code Sec. 877(g)(2)(C)). A day of presence is disregarded for this purpose, if the individual was "unable to leave the United States on such day because of a medical condition which arose while such individual was present in the United States" (Code Sec. 7701(b)(3)(D)(ii));
3. Even if a person satisfies one of these tests, however, not more than 30 days may be disregarded for any calendar year (Code Sec. 877(g)(2)(A)).

HEART/Heroes Act

Under the new provision, a special transfer tax is imposed in any calendar year during which a U.S. citizen or resident receives a "covered gift or bequest" (Code Secs. 2801(a), 2801(b)). Congress, in 2008, adopted an entirely new approach to this concept. Under this approach, which applies to gifts by and the estates of persons who expatriate after June 16, 2008, the expatriate is taxed under the normal rules for nonresident alien decedents and donors, but a special tax, in the nature of an inheritance tax, applies to a U.S. citizen or resident who receives a gift or bequest from a "covered expatriate" (Code Sec. 2801). This tax applies regardless of the length of time between the expatriation and the gift or bequest. Thus, if a U.S. citizen or resident emigrates together with all objects of his or her bounty, the U.S. estate and gift taxes have no application to subsequent transfers of his or her property, except as they are caught by the rules for nonresident alien donors and decedents, but if an emigrating citizen or resident later transfers property

to donees or heirs who remain in the United States, the donees and heirs are subject to this special tax, which may exceed the gift or estate tax that the expatriate or his or her estate would have paid, absent expatriation. According to the House Ways and Means Committee, in recommending enactment of these rules, "where U.S. estate or gift taxes are avoided with respect to a transfer of property to a U.S. person by reason of the expatriation of the donor, it is appropriate for the recipient to be subject to a transfer tax similar to the avoided transfer taxes."[99]

Covered Gift or Bequest

A covered gift or bequest is any property acquired (i) by gift directly or indirectly from an individual who is a covered expatriate at the time of such acquisition, or (ii) directly or indirectly by reason of the death of an individual who was a covered expatriate immediately before death (Code Sec. 2801(e)(1)). A covered gift or bequest, however, does not include (i) any property shown as a taxable gift on a timely filed gift tax return by the covered expatriate, (ii) any property included in the gross estate of the covered expatriate for estate tax purposes and shown on a timely filed estate tax return of the estate of the covered expatriate, and (iii) any property with respect to which a deduction would be allowed under Code Secs. 2055, 2056, 2522 or 2523, whichever is appropriate (these sections allow deductions for transfers for charitable purposes or to spouses, for purposes of determining estate and gift taxes) (Code Secs. 2801(e)(2) and 2801(e)(3)).

Rate of Tax Under Code Sec. 2801

The amount of the Code Sec. 2801 tax is determined by multiplying the value of the covered gift or bequest by the greater of (i) the highest estate tax rate listed in the Code Sec. 2001(c) rate table in effect on the date the transferee receives the covered gift or bequest, or (ii) the highest gift tax rate listed in the Code Sec. 2502(a) rate table in effect on that date (Code Sec. 2801(a)):

Net Gift

For gift tax purposes, the donor is the person primarily liable for paying the tax. The donor may make the gift conditional on the donee paying the tax out of the transferred property, *i.e.*, a "net gift." The value of a net gift is the fair market value of the property passing from the donor, minus the amount of gift tax to be paid by the donee.

Covered Gift

A covered gift is similar to a net gift in that the recipient of a covered gift is liable for the Code Sec. 2801 tax on the gift. However, neither Code Sec. 2801 nor the legislative history contains any statement that the value of a covered gift is computed in the same way as the value of a net gift. In the absence of such a statement, it would appear that Congress intended that the full value of a covered gift, without reduction for the Code Sec. 2801 tax payable by the donee, is subject to the Code Sec. 2801 tax.

Some former U.S. citizens or long-term residents want to permanently reside in another country to avoid the high taxes on income during life and wealth taxes during life and at death.

Exception for Certain Gifts

The tax applies to a recipient of a covered gift or bequest only to the extent that the total value of covered gifts and bequests received by such recipient during a calendar year exceeds the amount in effect under Code Sec. 2503(b) for that calendar year (Rev. Proc. 2007-66[100]). The tax on covered gifts and bequests is reduced by the amount of any gift or estate tax paid to a foreign country with respect to such covered gift or bequest (Code Sec. 2801(d)).

Transfers in Trust

Special rules apply to the tax on covered gifts or bequests made to domestic or foreign trusts.

Domestic Trust

In the case of a covered gift or bequest made to a domestic trust, the tax applies as if the trust is a U.S. citizen, and the trust is required to pay the tax. In the case of a covered gift or bequest made to a foreign trust, the tax applies to any distribution from such trust (whether from income or corpus) attributable to such covered gift or bequest to a recipient that is a U.S. citizen or resident, in the same manner as if such distribution were a covered gift or bequest. Such a recipient is entitled to deduct the amount of such tax for income tax purposes to the extent such tax is imposed on the portion of such distribution that is included in the gross income of the recipient (Code Sec. 2801(e)(4)(A)).

Foreign Trust

For purposes of these rules, a foreign trust may elect to be treated as a domestic trust. The election may not

be revoked without the Secretary's consent (Code Sec. 2801(e)(4)(B)).

Planning for Expatriation (Before the Expatriation Date)

There are essentially three areas that need to be addressed, other than focusing on the compliance burdens and obligations of reporting under the expatriation rules to the IRS and such include: (i) valuation of assets; (ii) planning to minimize the impact of the toll charge on the mark-to-market tax under Code Sec. 877A; and (iii) planning to minimize the impact of other U.S. taxation, including transfer taxes, after the act of expatriation occurs.

Asset Valuation

Determination is made on the deemed sale which occurs on the day prior to the day of expatriation:

1. Need for Contemporaneous Appraisals.
   a. Hard to value assets, such as assets which are not sold or traded on an established market. This would include intangible assets in connection with ownership in a trade or business. A list of such assets may include those set out in Code Sec. 197, *e.g.*, trademarks, tradenames, customer lists, *etc*.
   b. Copyrights and patents.
   c. Contract rights.
   d. Judgments, causes of action.
2. Selection of Proper Method for Valuation of Assets.

Planning to Minimize the Impact of the Mark-to-Market Toll Charge

1. Sell preferential gain assets before the deemed sale date. The idea here is to allow ordinary income gains to fall within the $725,000 (2019) exemption from Code Sec. 877A.
2. Consider making charitable contributions. Consider making charitable contributions in year of expatriation, including possibly for estate tax purposes as well.
3. Transfer Tax. On the transfer tax side, consider maxing out the applicable gift and possibly GST exemptions.
4. Retain high basis assets. Retain high basis assets for the deemed sale event.
5. Consider transfer of assets to non-grantor trust prior to the expatriation date. Interests in a non-grantor trust are generally excluded from those assets that are subject to the exit charge.
6. Evaluate state income tax impacts. Only some states follow Code Sec. 877A. Should the client move to a more favorable state prior to expatriation?

Taxation After the Expatriation Date

1. Impact of Status as a Non-Resident.
2. Taxed on U.S. sourced income. Only taxed on U.S. source income including income which is effectively connected with a U.S. trade or business, and application of Code Sec. 897 (FIRPTA).
3. Applicable withholding rules.
4. Compliance obligations. Elimination of Miscellaneous Filings Including FBARs. A Person's Interests in Foreign Corps or Other Entities that are Disregarded. (Forms 5471, 8858) entities that are disregarded for U.S. tax purposes but are business associations regarded under non-U.S. tax rules; reporting on Form 8865 information related to a U.S. person's interests in controlled foreign partnerships; and reporting on Form T.D. F 90-22.1 a U.S. person's financial interest in or signatory authority over a foreign financial account. For a U.S. citizen who has lived overseas for an extended period, the elimination of those burdensome U.S. filing obligations often provides more benefit and greater peace of mind than avoiding the future payment of U.S. tax.
5. Exposure or potential for double taxation.
6. Deferral Election. Attractive if expatriate is relocating to low or tax haven jurisdiction.
7. Impact on Limitation of Benefits Under Tax Treaties.
8. Spousal Gifts Prior to Expatriation Date. Perhaps one spouse should defer expatriation until the other spouse expatriates so as to foster greater gift-giving to family members.
9. Succession tax rules (U.S. inheritance tax). Before the HEART Act, U.S. law provided for an estate tax not an inheritance tax which HEART imposes.
10. Preserving rights to visit the United States. A rule of U.S. immigration law provides that a U.S. former citizen "who officially renounces United States citizenship" and has done so for the purpose of evading U.S. tax will be barred from entering the United States (8 USC §1182(a)(10)(E) (emphasis added)). The statute uses the term "renounce," which is interesting and highly relevant, because renouncing one's citizenship is one way to relinquish it under Code Sec. 877A. For example, a taxpayer who completes a formal naturalization process in another country and provides the State

Department with a signed statement of voluntary relinquishment of U.S. nationality confirming her acts of expatriation has relinquished her U.S. citizenship and expatriated for purposes of Code Sec. 877A. But she will not have renounced her U.S. citizenship as long as she is not required under the naturalization rules in her new home country to formally "renounce" her citizenship (some countries require an oath formally renouncing allegiance to any other countries).25 In other words, how a person expatriates may be just as important as when.

Covered expatriates who have become nonresident aliens must also keep in mind that they are subject to the rules applicable to aliens; notably, they must manage the amount of time spent in the United States so that they are not treated again as U.S. residents under the so-called substantial presence test.

Moreover, a covered expatriate who becomes a U.S. person within three years of expatriating may be subject to a modified U.S. tax for the intervening years during which he was not a U.S. person, as if he had retained U.S. tax resident status (Code Sec. 7701(b)(10)).

Code Sec. 877A. Code Sec. 877A provides that a nongrantor trust shall deduct and withhold 30% of the amount of any distribution to a covered expatriate. That withholding is imposed on the portion of a distribution that would have been taxable to the covered expatriate if he had been a U.S. person on the date of distribution. Where the trust distributes appreciated property to a covered expatriate, the distributing trust will be subject to U.S. tax on the gain. The covered expatriate will be prohibited from claiming benefits under any treaty to reduce the amount of withholding. An individual considering expatriation may attempt to receive as much cash and property as possible through distributions from the trust before the expatriation date.

Jerald David August is a partner in Fox Rothschild LLP, Philadelphia, PA. Mr. August is Chair of the firm's International Taxation and Wealth Planning Practice Group. Jerry is a nationally recognized tax lawyer who advises clients on income tax matters, including foreign taxation of U.S. businesses and U.S. taxation of foreign businesses and investors. He frequently advises high net worth individuals, both U.S. and non-U.S. citizens and residents, on estate planning and taxation issues. Mr. August represents clients before the Internal Revenue Service, including trials before the U.S. Tax Court, the Court of Federal Claims, federal district courts and the Eleventh Circuit Court of Appeals, on a various business and wealth tax matters as well as complex and serious tax compliance issues. He has also represented taxpayers in both income and estate tax cases at the state level. Jerry represented the Tax Section of the Florida Bar in filing an *amicus curiae* brief before the U.S. Supreme Court in a landmark tax case, *O.C. Hubert Est.*, SCt, 97-1 USTC ¶60,261, 520 US 93, 117 SCt 1124. Mr. August is a Life Sustaining Member of the prestigious American Law Institute (ALI) and regularly serves as program chair and speaker for ALI-CLE federal tax webcasts and seminars on various topics involving federal taxation and is chair of the Advisory Board of the ALI's long-standing tax law journal, The Practical Tax Lawyer. For more than 30 years, he has served on the Board of Advisors of the New York University Federal Institute of Taxation. August has been a guest lecturer at the University of Pennsylvania Law School and the University of Pittsburgh School of Law, and a visiting professor on corporate income taxation at the Graduate Tax Program of the University of Florida School of Law. He has published more than 200 articles on partnership, corporate and international taxation published by national professional journals, including the Florida Law Review, Corporate Taxation, Business Entities, Journal of Passthrough Entities and Tax Notes. He is a member of American College of Tax Counsel, the American College of Trust and Estate Counsel and the American Tax Policy Institute. He is admitted to practice in Pennsylvania, New York and Florida.

ENDNOTES

[1] The IRS, pursuant to Code Sec. 6039G, of the Health Insurance Portability and Accountability Act (HIPPA) of 1996, as amended, quarterly publishes in the Federal Register the list of each individual losing U.S. citizenship, including long-term residents as defined in Code Sec. 877(e)(2). The FBI also maintains a list of "renounced US citizenship" category in its National Instant Criminal Background Check System ("NICS").

[2] The factors requiring consideration in determining whether or not to expatriate include: (i) a personal preference for becoming a permanent resident of another country while relinquishing or forfeiting rights afforded to

a U.S. citizen under the U.S. Constitution and Bill of Rights; (ii) to reduce the burden of tax compliance costs, particularly where a U.S. citizen is a dual resident, and to avoid being subject to worldwide income tax in her country of residence; (iii) avoiding the annual cost and reporting obligations under the Code and finCEN regulations, *i.e.*, FBAR returns, gifts from non-residents disclosures, interests in foreign financial assets and businesses, the controlled foreign corporation filings, the annual reporting attributable to passive foreign investment income, *etc.*; (iv) consideration of making a "voluntary disclosure" to the IRS for prior years' non-compliance in light of the expatriation provision's certification statement requirement; (v) compliance with the reporting requirements imposed on foreign financial institutions and foreign private business enterprises under Foreign Account Tax Compliance Act ("FACTA"), which has led some foreign financial institutions to stop taking new U.S. clients or close out accounts; there are also a host of recent tax information exchange agreements ("TIEAs") entered into by the United States and most tax haven jurisdictions and other countries which mandates information sharing even if there is no underlying tax treaty; (vi) selecting a new tax home, with regard to whether such jurisdiction either imposes no income tax or does not tax a resident's income not sourced from within the country of residence; and (vii) selecting a new tax home where the country of preferred residence does not impose gift and/or estate or inheritance taxes on its residents.

[3] Heroes Earnings Assistance and Relief Tax Act of 2008, P.L. 110-245.

[4] *See* Code Secs. 1, 55, 62, 67, 68, 162, (former) 212, 465, 469, 871, 904(a), 911, 951, 951A–959, *etc*. All references to sections (§§) are with respect to the Internal Revenue Code of 1986, as amended, and the regulations promulgated by the Treasury and its delegate, the Internal Revenue Service.

[5] *See* Code Sec. 7701(a)(30) ("U.S. Person, includes, per §7701(a)(30)(A), a U.S. citizen or resident").

[6] *See* Reg. §1.1-1(c).

[7] *See* Code Secs. 901, 904(d), 909, 78. *See also* Reg. §1.901-2(a); Code Sec. 901(j) (denial of FTC with respect to certain countries).

[8] *See* Code Secs. 911(d)(1)(A), 911(d)(1)(B). *See also* Rev. Rul. 73-181, 1973-1 CB 347 (U.S. citizen employed on fishing trawler operating over the continental shelf adjacent to foreign country's territorial waters over which that country exercises taxing authority does not meet the presence requirement under Code Sec. 911(a)(2)).

[9] *See* Reg. §1.911-2(b).

[10] Code Sec. 911(c)(2)(A).

[11] Code Sec. 911(d)(6).

[12] *See* examples in Reg. §1.684-1(d).

[13] Code Sec. 951(a). Prior to the Tax Cuts and Jobs Act of 2017, for taxable years commencing prior to January 1, 2018, a U.S. shareholder of a FC was only required to include in gross income a deemed dividend under Code Sec. 951(a) where the FC was a CFC for an uninterrupted period of 30 days or more during its taxable year (and the U.S. shareholder was a shareholder on the last day of the taxable year). Former Code Sec. 951(a)(1). While a foreign corporation was a CFC during this period (*i.e.*, it meets the ownership tests), the subpart F income derived during the taxable year in which the 30-day rule was not met was not included in the U.S. shareholders' gross income, nor would Code Sec. 956 amounts be includible in the U.S. shareholders' gross income because the foreign corporation was not a CFC, rendering Code Sec. 951(a)(1) inoperative.

[14] *See* Reg. §1.952-1(c)(1).

[15] *See, e.g.*, Notice 2009-7, 2009-3 IRB 312, Dec. 29, 2008 (Service identified transaction and substantially similar ones as "transactions of interest" under Reg. §1.6011-4(b)(6), and for the material advisor and list maintenance rules under Code Secs. 6111 and 6112 where U.S. taxpayer, which owns CFCs that hold stock of lower-tier CFC through domestic partnership, takes position that subpart F income of lower-tier CFC or amount determined under Code Sec. 956(a) related to U.S. property held by lower-tier CFC doesn't result in Code Sec. 951(a) income inclusions for U.S. taxpayer. *See also* Notice 2010-41, 2010-22 IRB 715. Jackel, *IRS Notice Wrongly Treats Domestic Partnerships as Foreign*, 127 Tax Notes 1021 (May 31, 2010); and Cummings, *The Subpart F Blocker and Manifest Incompatibility*, Daily Tax Rep. (BNA) No. 106, at J-1 (June 4, 2010).

[16] Code Sec. 1248. *See also* Code Secs. 964(e)(1), 964(e)(3).

[17] *See* Code Sec. 904(d)(2)(E)(i) (Code Sec. 902 dividend gross-up rule), Code Sec. 960, Code Sec. 962.

[18] *See* August, *The Proposed GILTI Regulations Under Section 951A*, J. Corp. Tax'n (Mar/Apr. 2019).

[19] *See* N.Y. Tax Law 208.6-a(b); *see also* Feingold and Berg, *Tax Relief for New York Individuals with Shares in Foreign Corps*, Tax Notes (Apr. 2, 2018).

[20] An Overview of GILTI Mechanics. *See, e.g.*, Cummings, Jr., *GILTI Puts Territoriality in Doubt*, Tax Notes (Apr. 9, 2018).

[21] *See* Code Sec. 1297(e). P.L. 105-34, 105th Cong., 1st Sess., §1121.

[22] *See* Code Secs. 1441, 1442, 1445, 1446.

[23] *See* Code Sec. 897(a)(2)(A).

[24] *See* Code Sec. 897(c)(1)(A)(ii).

[25] *See* Code Secs. 897, 1445, 6039C and 6652(f). *See also* August & Antaramian, *Foreign Investment in Real Property Tax Act Revisited*, Business Entities (Sept./Oct. 2011).

[26] *See* TCJA of 2017 amending Code Secs. 864(c)(8) and 1445(f). The Service recently issued proposed regulations under Code Sec. 1445(f).

[27] Rev. Rul. 91-32, 1991-1 CB 107.

[28] *Grecian Magnesite Mining, Industrial & Shipping Co.*, 149 TC 63, *aff'd*, 926 F3d 819 (DC Cir. June 11, 2019).

[29] *See* August, *Tax Court Rejects Rev. Rul. 91-32, Holds Foreign Partner's Gain from Redemption Not ECI*, J. Corp. Tax'n (WG&L) (Nov./Dec. 2017).

[30] *See* Code Sec. 7701(b) (definition of resident and non-resident aliens).

[31] *M.H. Siddiqi*, 70 TC 553, Dec. 35,269 (1978) (citizen of Pakistan could not claim benefit under U.S.-Pakistan treaty because he was resident of United States and hence not of Pakistan); *A. Budhwani*, 70 TC 287, Dec. 35,161 (1978) (same); Rev. Rul. 75-489, 1975-2 CB 511 (U.S. Social Security payments under French treaty).

[32] *See, e.g.*, the 1996 U.S. Model Treaty, Article 4(1); 1981 U.S. Model Treaty, Article (4)(1).

[33] *See, e.g.*, Article 1(a) of the U.S.-Germany Income Tax Treaty ("Thus, notwithstanding any provision of the Convention or this Protocol except subparagraph (b), the United States may tax its residents (as determined under Article 4 (Residence)) and its citizens as if the Convention had not come into effect).

[34] *See, e.g.*, *A. Ready*, TC Summ. Op. 2012-12 (Feb. 1, 2012) (Tax Court held a flight attendant of a U.S. carrier who was a dual U.S.-U.K. citizen and a resident of France was not permitted to exclude from income her wages attributable to services performed in the United States and over international airspace under the Code Sec. 911 foreign income exclusion or the 1994 U.S.-France income tax treaty).

[35] *See* Regs. §§20.0-1(b)(1), 20.2033-1.

[36] Code Sec. 2501; Reg. §25.2501-1.

[37] *See H. Johnstone Est.*, 19 TC 44, Dec. 19,246 (1952), *acq.*, 1953-1 CB (estate inclusion of U.S. real property limited to value of net equity); *J.W. Nienhuys Est.*, 17 TC 1149, Dec. 18,734 (1952), *acq.* 1952-1 CB 3 (domestic corporation stock included in gross estate despite certificates being held in Netherlands). *See also* Code Sec. 2104(b) (inclusion of string provision transfers where funded with U.S. situs property or holding U.S. situs property at death). *See* CCA 210102009 (payment of gift tax by non-resident within three years of death is not a transfer within Code Secs. 2035–2038 and is therefore not property situated in the United States under Code Sec. 2104(b). *See* Code Sec. 2105 (life insurance on the life of a non-resident (non-citizen) bank accounts in U.S. banks if the interest would be treated as foreign source income under Code Sec. 871(i)(3), deposits with the foreign branch of a U.S. bank, certain debt obligations, and works of art on loan for exhibition in the United States, are excluded from the gross estate of a foreign decedent. *See also* Rev. Rul. 82-193, 1982-2 CB 219 (reversionary interest in trust under facts not U.S. property).

[38] Code Sec. 2104(b). Reg. §20.2104-1(b).

[39] Reg. §20.2104-1(a)(1).

[40] *See* Rev. Rul. 77-423, 1977-2 CB 352 (time share unit as "real property").

[41] *See* Code Sec. 2104(a) (estate tax inclusion of co-op under the domestic stock situs rule for non-resident decedents).

[42] Code Sec. 2105(c); Regs. §§20.2105-1(b), 20.2104-1(a)(2); *De Perigny Est.*, 9 TC 782, Dec. 16,100 (1947) (as to leased personal property), *nonacq.*, 1948-2 CB 5.

[43] *See* Rev. Rul. 55-143, 1955-1 CB 465.

[44] Code Sec. 2104(a); Reg. §20.2104-1(a)(5). *N. Charania Est.*, 133 TC 122, Dec. 57,929 (2009), *aff'd in part, rev'd in part*, CA-1, 2010-1 USTC ¶60,595, 603 F3d 67. *See* also Code Sec. 2105(d) (stock in a RIC; special provision enacted in AJCA, P.L. 108-357 (2004)). *See* Reg. §20.2104-1(a)(4). In certain instances, the corporate inversion rules under Code Sec. 7874(b) may cause shares of stock in a foreign holding company to be treated as shares of a U.S. corporation for all purposes of the Code, notwithstanding Code Sec. 7701(a)(4). Code Sec. 7874(b) applies to a corporate inversion (*i.e.*, the expatriation of a U.S. corporation) if: (i) the U.S. corporation (former parent corporation) becomes a subsidiary of a foreign corporation or transfers substantially all of its assets to a foreign corporation; (ii) the former shareholders of the U.S. parent corporation own at least 80% of the foreign corporation's stock (by vote or value) after the transaction; and (iii) the foreign corporation does not have substantial business activities (as compared with its "group's" worldwide business activities) in the foreign country in which it is incorporated.

[45] [Reserved].

[46] Code Secs. 7701(b), 7701(a)(4), (30).

[47] Reg. §20.2104-1(a)(7). *See* Code Secs. 2104(b), 2105(b).

[48] *See* Code Secs. 2104(c), 2105(b)(2).

[49] *See* Sanna, *Calling for Clarity on NRA's Partnership Situs*, TR. & EST. (Nov. 2009); Martin, *Why Section 2104 Must Address When Partnership Interests Owned by Foreign Investors Are (And Are Not) Subject to United States Estate Tax*, TAX NOTES TODAY 94-127 (May 15, 2003); Cassell, Karlin, McCaffrey & Streng, *U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests*, TAX NOTES (June 16, 2003); and Hudson, *Current Techniques for Foreign Investment in U.S. Real Estate—Income and Estate Tax Considerations*, 22 TAX NOTES INT'L 3027 (June 11, 2001).

[50] *See Sanchez v. Bowers*, CA-2, 70 F2d 715 (1934). *See also* OECD Model Estate and Gift Tax Treaty, Article 8.

[51] *See* Rev. Rul. 55-701, 1966-2 CB 836 (application of U.S.-U.K. Estate Tax Treaty to partnership interest; facts involved a partner's share in a co-partnership is situated where the partnership business is carried on, in this case the United States. At the time of death, the decedent was domiciled in the United Kingdom and a partner in a co-partnership organized in and doing business in the State of New York. The Service noted three potential outcomes: (i) the interest is a "debt" and under Article III(2)(c) of the U.S.-U.K. tax treaty is situated at the place of decedent's domicile; (ii) that the situs of his interest is where the individual items of the partnership assets are located; or (3) that the situs of a partner's interest is where the business is carried on. After reviewing the potential arguments, certain cases in the United States for state inheritance tax purposes, and a review of pertinent sections of the tax treaty, the Service ruled that it is held that in the application of the U.S.-U.K. Estate Tax Convention the situs of a partnership interest is where the business is carried on.

[52] Rev. Rul. 55-163, 1955-1 CB 674.

[53] *D.B. Nevius*, 76 Fed. (2d) 109, Ct. D. 1049, C. B. XIV-2, 350 (1935).

[54] *D.B. Nevius*, CA-2, 35-1 USTC ¶9227, 76 F2d 109, *cert. den*. *See also Swan Est.*, CA-2, 57-2 USTC ¶11,714, 247 F2d 144. Code Secs. 2103, 2104(a).

[55] Code Sec. 2016(a)(1). Reg. §20.2106-2.

[56] *Id*.

[57] *See* Code Sec. 2056(d). Reg. §20.2056A-1(a). *See* LTR 199917045 (May 3, 1999).

[58] Reg. §20.2056A-2.

[59] Code Sec. 2106(a)(2)(A), Code Sec. 2106(a)(2)(B). *See McAllister Est.*, 54 TC 1407, Dec. 30,209 (1970), *acq.*, 1971-2 CB 3 (deduction allowed for bequest in trust by nonresident non-citizen to Canadian foundation since funds were used exclusively for assisting needy students at U.S. colleges).

[60] *See* Code Sec. 2012(b)(2) (for estates of decedents dying after 2004). A foreign estate is allowed credits for gift taxes on pre-1977 transfers (Code Sec. 2012) and for estate taxes on prior transfers (Code Sec. 2013). Certain treaties allow 2010 unified credit amount to a foreign estate. *See C.H. Burghardt Est.*, 80 TC 705, Dec. 40,025 (1983), *aff'd*, CA-3, 734 F2d 3 (1984) (Italy); *L.M. Mudry*, ClsCt, 86-2 USTC ¶13,706, 11 CtCls 207 (Switzerland). *Cf. J.S.A Arnaud Est.*, 90 TC 649, Dec. 44,682 (1988), *aff'd* CA-9, 895 F2d 624 (1990) (unified credit not allowable under U.S. France estate tax treaty). *See also* Code Sec. 2102(c)(3) (effective for decedents dying after 2004) to the effect that if foreign estate is entitled to full unified credit under U.S. law by treaty provision or interpretation, estate will receive portion of credit equal to the percentage of property located in the United States only. In Rev. Rul. 90-101, 1990-2 CB 315, the Service held that the estate tax conventions between the United States and Australia, Finland, Greece, Italy, Norway, Japan and Switzerland permit residents of such countries to the unified credit per Code Sec. 2102(b)(3). Prior to an amendment in 1988 in P.L. 100-647 (TAMRA), Rev. Rul. 81-303, 1981-2 CB 255 held that residents of treaty countries were entitled to only the smaller exemption under Code Sec. 2102(b)(1) (formerly Code Sec. 2102(b)(1). Dual citizens are treated as U.S. citizens for transfer tax purposes, subject to treaty override by tie-breaker rule, and as may be further subject to a particular savings clause provision. *W.L. Matheson*, CA-2, 76-1 USTC ¶9304, 532 F2d 809, *cert. denied*, SCt, 429 US 823 (1976); *E.D. Vriniotis Est.*, 79 TC 298, Dec. 39,272 (1982). A foreigner who has filed his or her declaration of intention of becoming a U.S. citizen but who has not yet been admitted to U.S. citizenship by a final order of a naturalization court should presumably not be treated as a U.S. citizen. *See* Reg. §1.1-1(c). *See* for further background, United States: Treasury Technical Explanation, Nov. 20, 1980 (1980 Estate & Gift tax treaty).

[61] *See* Rev. Rul. 80-363, 1980-2 CB 249; Rev. Rul. 80-209, 1980-2 CB 248. *See, e.g.*, *Nienhuys Est.*, 17 TC 1149, Dec. 18,734 (1952); *Jack Est. ex rel Blair*, FedCl, 54 FedCl 590 (2002); *Carlson v. Reed*, CA-9, 249 F3d 876 (2001); *E.H. Paquette Est.*, 46 TCM 1400, Dec. 40,460(M), TC Memo. 1983-571; *J. Bloch-Sulzberger Est.*, 6 TCM 1201, Dec. 16,129(M) (1947). Change in Domicile by Non-Citizen. The taxpayer bears the burden of proving that his (subjective) intent to permanently remain resident in the United States has changed, and this also goes to the factors listed above as to the change in "presence." *See, e.g.*, *B.A. Khan Est.*, 75 TCM 1597, Dec. 52,525(M), TC Memo. 1998-22.

[62] Foreign Investors Tax Act ("FITA") of 1966, P.L. 89-809 (Nov. 13, 1966).

[63] The FITA provisions to combat expatriation driven by tax motivation purposes were set out in Code Secs. 877, 2107 (estate tax) and 2501(a)(3) (gift tax).

[64] The Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), P.L. 104-191, secs. 511–513.

[65] *See* Code Sec. 877(e).

[66] The American Jobs Protection Act of 2004 ("AJCA"), P.L. 108-357.

[67] The Heroes Earnings Assistance and Relief Tax Act of 2008 ("Heroes Act"), P.L. 110-245, §301 (2008).

[68] The covered expatriate is deemed to have sold any interest in property that would be included in his gross estate (with modifications) for fair market value, determined as of the expatriate date. Notice 2009-85, Sec. 3, 2009-45 IRB 598 (the IRS issued guidance in Notice 2009-85, 2009-45 IRB 598, which taxpayers can apply in their entirety and which will be incorporated in regulations that would be effective for individuals whose expatriation date is after October 14, 2009). Gain from the deemed sale is taken into account at the time of the expatriation date, notwithstanding any other Code provision. *See* Code Sec. 877A(a)(2)(A). Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code, except that the wash sale rules of Code Sec. 1091 do not apply. Code Sec. 877A(a)(2)(B).

[69] Notice 2009-85, Sec. 3, 2009-45 IRB 598.

[70] Notice 2009-85, 2009-45 IRB 598, §§2.A, 8.C. *See also* Code Sec. 6039C.

[71] Code Sec. 877A(g)(1)(B)(i)(II).

[72] Code Secs. 877A(g)(5), 877(e)(2).

[73] *See* Code Sec. 7701(b)(6).

[74] Code Sec. 877(e)(1).

[75] Joint Comm Staff, Tech Expln of the Heroes Earnings Assistance and Relief Tax Act of 2008 (JCX-44-08), May 20, 2008, at 40.

[76] Code Sec. 877A(g)(4).

[77] Notice 2009-85, Sec. 3, 2009-45 IRB 598.

[78] Code Sec. 877A(b)(7).

[79] Code Sec. 877A(b)(6).

[80] Code Sec. 877A(b)(1).

[81] Code Sec. 877A(b)(4)(A).

[82] Code Sec. 877A(b)(4)(B).

[83] Code Sec. 877A(b)(3).
[84] Code Sec. 877A(b)(5).
[85] Code Sec. 684(c).
[86] Code Sec. 877A(c).
[87] Code Sec. 877A(d).
[88] Code Sec. 877A(d)(4).
[89] Code Sec. 877A(e).
[90] For this purpose, "early distribution tax" means any increase in tax imposed under Code Secs. 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), or 530(d)(4). Code Sec. 877A(d).
[91] Code Sec. 877A(f).
[92] Code Sec. 2801(e)(4)(A).
[93] Code Sec. 2801(e)(4)(B)(i).
[94] Code Secs. 2107, 2501(a)(3). *See* Notice 97-19, 1997-10 IRB 40 (guidance on 1996 amendments to Code Secs. 2107 and 2501(a)(3).
[95] HR Rep. No. 548, 108th Cong., 2d Sess. 254 (2004).
[96] HR Rep. No. 548, 108th Cong., 2d Sess. 256 (2004).
[97] HR Rep. No. 548, 108th Cong., 2d Sess. 255 (2004).
[98] HR Rep. No. 548, 108th Cong., 2d Sess. 253–254 (2004).
[99] HR Rep. No. 431, 110th Cong., 1st Sess. 114 (2008).
[100] Rev. Proc. 2007-66, sec. 3.32(1), 2007-45 IRB 970. Code Sec. 2801(c).