INTERNATIONAL ESTATE PLANNING

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1. INTRODUCTION

When the two original authors of this article began practice, it was common to divide international tax practice between inbound and outbound. Inbound referred to the U.S. tax rules applicable to non-U.S. persons whose contact with the United States was the result of investment or business activities here. Outbound referred to U.S. tax rules applicable to U.S. persons who ventured abroad to invest or engage in business; it also referred to the rules applicable to non-resident citizens, because of the United States' unique insistence on taxing its citizens regardless of residence.

Today, the lines between inbound and outbound have blurred, for many reasons. Perhaps the most important is the greatly increased mobility of capital, people and information. Individual clients may begin as inbound investors with U.S. activities and then become U.S. residents and later citizens who retain activities, assets and family, social and business connections abroad. Individual and corporate clients may begin as U.S. residents who invest and do business abroad and, in some cases, seek to escape the burdens of worldwide taxation by expatriating.

These clients face overwhelmingly complex laws, the foundations of which were laid in another era and which have seen engrafted on to them a variegated set of increasingly burdensome requirements, both substantive and procedural, many of which appear to proceed from an outdated assumption by legislators and regulators, fanned by populist outrage at some well-publicized cases of abuse, that all taxpayers engaged in cross-border activities are suspect.

These laws are not limited to the field of taxation. They encompass laws relating to immigration, trade, finance and, most noticeably in recent years, laws designed to interrupt the use of the world's economic infrastructure by tax evaders, criminals (organized or not), terrorists, and. increasingly, the corrupt rulers of some countries and their supporters and enablers. As a result, rather like going through security at the airport to get to the plane, a simple activity like opening a bank account has become an immense bureaucracy-encrusted task that, in many cases, has limited deterrent effect on the real targets while inconveniencing and delaying legitimate commercial activity.

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If this all begins to sound like the introduction to a treatise, it is not. On the contrary, it is intended to serve as our excuse for the innumerable lacunae in this article. We have chosen to focus our attention on some of the important tax and related compliance issues faced by individuals and families investing, working and living across international borders, to the exclusion of many others. We do so from the perspective of U.S. tax and estate planners and while we allude to issues arising in other countries and the interactions between U.S. and foreign, the widest gap in this presentation as a resource for the practitioners to whom it is addressed concerns the development and resolution by other countries of the issues we describe below. A U.S. tax or estate planner operating in the international sphere needs not only a profound understanding of U.S. rules and practice but also an excellent network of similarly qualified colleagues in other countries.

We begin in Part 2 with estate planning issues that affect nonresident aliens. In Part 3, we consider in greater detail the rules defining residence and domicile for tax purposes. Part 4 describes pre-immigration planning for aliens who may become residents and or domiciliaries of the United States. Part 5 describes the law governing U.S. citizens and aliens who cease to be residents and domiciliaries of the United States. In Part 6 we offer some concluding thoughts.

2. ESTATE PLANNING FOR NONRESIDENT ALIENS

The United States remains a magnet for foreign investment, volatile times notwithstanding. Whether the dollar is weak and assets appear cheap or the dollar is strong because of the flight to safety, foreign investor dollars continue to pour into the United States.

Current U.S. tax laws act paradoxically both as a tremendous incentive for foreigners to invest their wealth in the United States and as a tremendous disincentive for such individuals to immigrate. We may therefore expect large amounts of foreign private wealth to continue to come to the United States unaccompanied by its owners or accompanied by owners who have no intention of remaining here indefinitely. We also will continue to see wealthy multinational families, with some family members in the United States and others living abroad. In the modern era of increased mobility, U.S. nationality laws, under which anyone born in the United States or to one or two U.S. citizen parents is U.S. citizen, will continue to result in the proliferation of

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U.S. citizens with diminished personal but undiminished fiscal ties to the United States. The family migration patterns of the modern era present a variety of challenges and opportunities for estate planners.

2.1 Citizenship. The starting point in any estate planning involving an individual from abroad is determining whether or not the individual or any member of the family is a U.S. citizen.

The 14th Amendment to the U.S. Constitution provides that "All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside".

Birth in United States includes not only birth in one of the fifty states or the District of Columbia but also birth in the U.S. territories of Puerto Rico, Guam U.S. Virgin Islands and Northern Marianas).[2] An individual must be subject to the jurisdiction of the United States, which excludes the children of certain foreign diplomats.[3]

Naturalization in the United States refers to acquisition of citizenship by foreign national under the naturalization laws.[4]

An individual born outside the United States may also become a citizen at birth, or later, based on having one or two U.S. citizen parents. These rules, a discussion of which is outside the scope of this article. are the source of confusion and the creation of a not insubstantial number of citizens who may not be aware of their status and, therefore, their tax filing obligations. In any case of doubt, specialist immigration counsel should be consulted.[5]

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[2] However, U.S. nationals born in American Samoa and Swains Island are not U.S. citizens. See 8 USC sections 1408 and 1101(a)(29).

[3] For a full discussion of the rules, under which only some diplomats are subject to this exception (the more senior diplomats listed on the State Department's "Blue List"), see 8 CFR 101.3 available at https://www.ecfr.gov/current/title-8/chapter-I/subchapter-B/part-101/section-101.3 (viewed Mar. 21, 2022). It is not clear what happens if the child has one parent who is a foreign diplomat and another who is a U.S. citizen parent (or indeed if the foreign diplomat is a U.S. citizen, since service as a foreign diplomat does not automatically constitute an expatriating act).

[4] 8 USC section 1401.

[5] See U.S. State Department, "Acquisition of U.S. Citizenship at Birth by a Child Born Abroad", available at https://travel.state.gov/content/travel/en/legal/travel-legal-considerations/us-citizenship/Acquisition-US-Citizenship-Child-Born-Abroad.html (viewed March 21, 2022).

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2.2 Domicile. Once the citizenship status of an individual has been determined to be foreign, the next step in any estate planning is determining whether the individual is resident or nonresident for purposes of income and transfer taxes. We discuss the rules relating to residence and domicile in greater detail below. For purposes of this Part, we note only that the relatively objective tests contained in the definition of "resident alien" in section 7701(b) apply for all purposes of the Internal Revenue Code except for purposes of the U.S. estate and gift taxes.[6] Rather, for purposes of the estate and gift tax purposes an alien is considered to be a U.S. resident if he or she is domiciled in the United States at the time of his or death or at the time of a gift. If an alien enters the United States for even a brief period of time, with no definite present intention of later leaving the United States, he or she is deemed to be domiciled in the United States and, therefore, is considered a U.S. resident for estate and gift tax purposes.[7] Since the rules for income tax purposes are quite different, an alien may be considered a nonresident for estate tax purposes and a U.S. resident for income tax purposes, or vice versa.[8]

The U.S. definition of domicile is not shared by every country. The U.S. definition causes domicile to be relatively easily acquired and easily lost. By contrast, the United Kingdom's definition of domicile, which is derived primarily from case law with some statutory add-ons, is extremely adhesive.[9] Individuals have a domicile of origin acquired at birth that is hard to lose. Although the domicile of origin can be replaced by a domicile of choice, the domicile of origin can readily revive when a domicile of choice is lost without being immediately replaced – we have even heard the argument that an individual with a U.K. domicile of origin who moves from one U.S. state to another might find his U.K. domicile revived if he does not rapidly and definitively acquire a domicile of choice in the new state. The takeaway is that home country domicile must be carefully considered in conjunction with U.S. domicile planning.

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6 All unprefixed statutory references are to sections of the Internal Revenue Code of 1986, as amended, Title 26 U.S. Code (the "Code"); references to "Treas. Reg." are to regulations promulgated by the United States Treasury Department under the Code.
7 Treas. Reg. §§ 20.0-1(b) and 25.2501-1(b).
8 Section 7701(b)(1)(A).
9 See footnote 120 below.

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2.3 Assets Subject to U.S. Estate and Gift Tax. Generally, nonresident aliens are subject to Federal estate tax only on "U.S.-situs" property, with no credit for foreign death taxes paid.[10] (The foreign country may allow a credit against its death taxes for Federal estate tax paid.[11]) Nonresident aliens are also subject to Federal gift tax on lifetime gifts of U.S.-situs property, but not on gifts of U.S.-situs intangible property, with exceptions if the individual is a former U.S. citizen or long-term resident.[12]

U.S.-situs property includes the following: (i) Real property located in the United States;[13] (ii) tangible personal property located in the United States[14] (including cash,[15] short-term U.S. Treasury Bills,[16] cars, furniture, jewelry, artwork,[17] etc.); (iii) shares of stock issued by a U.S. corporation;[18] (iv) subject to certain exceptions (set forth below), any debt obligation, the primary obligor of which is a U.S. person or the United States, a state or any political subdivision of the United States, or the District of Columbia, or any agency or instrumentality of any such government;[19] and (v) the cash value of life insurance on another individual issued by a U.S. insurer and owned by the nonresident alien.

U.S.-situs property also includes property that is gratuitously transferred by a nonresident alien decedent while he or she is alive, by trust or otherwise, if (1) the nonresident alien decedent retained for his or her life (or for a period that cannot be ascertained without reference to his or

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[10] Sections 2101, 2103, and 2106.

[11] *See, e.g.,* Article 784 A of the Code Général des Impôts (France); Section 21 Erbschaftsteuer- und Schenkungsteuergesetz (Germany); Inheritance Tax Act 1984 (United Kingdom), sections 158 (treaty relief) and 159 (unilateral relief) (if unilateral relief is more favorable than treaty relief, the taxpayer chooses the former).

[12] Sections 2501(a)(1) and (2) and 2511(a).

[13] Treas. Reg. §20.2104-1(a)(1).

[14] Treas. Reg. § 20.2104-1(a)(2).

[15] *See* Treas. Reg. §§ 20.2104-1(a)(7)(ii) and 25.2511-3(b)(4)(iv), which provide that currency is not a debt obligation of the United States, implying that it is tangible personal property. *See also* Rev. Rul. 55-143, 1955-1 C.B. 465, where the decedent died with funds which he had placed in a safe-deposit box, and the IRS held that "[s]ince the funds in the safe-deposit box on the date of decedent's death [did] not represent moneys deposited with a person carrying on the banking business within the meaning of section 863(b) of the Code, they [were] includible, for Federal estate tax purposes, in the decedent's gross estate situated in the United States." *See Blodgett v. Silberman,* 277 U.S. 1 (1928), where the Supreme Court held "… that money, so definitely fixed and separated in its actual situs from the person of the owner…is tangible property…" *See* also PLR 8138103 and PLR 7737063 (cash is tangible property).

[16] *See* PLR 8138103, PLR 9422001 and section 871(g)(1)(B).

[17] *See* footnote 28 below.

[18] Section 2104(a) and Treas. Reg. § 20.2104-1(a)(5).

[19] Treas. Reg. § 20.2104-1(a)(7).

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her death) some type of possession, control, or enjoyment of said property or its income or the right to designate who will possess or enjoy the property, (2) possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest in the property that exceeds 5% of the value of the property at the time of the decedent's death, (3) the property was, on the date of the nonresident alien decedent's death, subject to his or her right to alter or revoke the transfer (or if such a power was relinquished by the NRA decedent within three years of the date of his or death), or (4) the decedent transferred within the three-year period prior to his or her death an interest in property that would have been included in his or her estate under any of the foregoing rules, and the property so transferred was situated in the United States at the time of the transfer or at the time of the decedent's death.[20]

Examples of assets that are deemed to be situated outside of the United States are: (i) shares of stock issued by a foreign corporation;[21] (ii) deposits with persons carrying on the banking business, deposits or withdrawable accounts with a federal or state chartered savings institution (if the interest on such accounts is withdrawable on demand subject only to customary notice requirements), and amounts held by an insurance company under an agreement to pay interest thereon, as long as, in each case, the interest on such deposits or amounts is not effectively connected with the conduct of a trade or business in the United States by the recipient thereof;[22] (iii) deposits with a foreign branch of a domestic corporation or partnership engaged in the commercial banking business;[23] (iv) obligations the interest on which would be treated as exempt from tax under section 871 as portfolio interest, as long as the decedent was a nonresident alien for income tax purposes (a portfolio debt obligation will be considered U.S.-situs property if the decedent was a resident for income tax purposes, even if he or she was a nonresident alien for estate tax purposes);[24] (v) interest on short-term (183 days or less) obligations carrying original

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[20] Section 2104(b).

[21] Section 2104(a) and Treas. Reg. §20.2105-1(f).

[22] Section 2105(b)(1) and Treas. Reg. § 20.21051(h).

[23] Section 2105(b)(2) and Treas. Reg. § 20.2105-1(j).

[24] Section 2105(b)(3). Portfolio interest is interest on bonds, debentures, notes or other forms of debt which meets specific formal requirements of section 871(h). Most U.S. corporate bonds and Treasury obligations having a term greater than 183 days meet these requirements; many private obligations can readily meet the requirements although, in the authors' experience, private issuers and their advisors are often unaware of the requirements. The principal exceptions to the exemption in the case of debt that otherwise meets the formal requirements relate to interest effectively with the conduct of a U.S. trade or business; interest paid to controlled foreign corporations by U.S.

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issue discount, so long as the original issue discount would not be treated as effectively connected with a trade or business;[25] (vi) proceeds from a life insurance policy on the nonresident alien decedent's life owned by the decedent, whether insured by a U.S. or non-U.S. insurer;[26] and (vii) works of art which are in the United States if they were imported solely for exhibition, were loaned to a nonprofit public gallery or museum and were on exhibition or *en route* to or from exhibition at death.[27]

Although nonresident aliens are also subject to gift tax on gifts of U.S.-situs property, gifts of U.S.-situs intangible property by a nonresident alien are generally exempt from the gift tax.[28] Property which is not considered intangible property, and is therefore subject to federal gift tax when given away by a nonresident alien, includes; (i) real property situated within the United States;[29] (ii) tangible personal property situated within the United States at the time of the gift;[30] and (iii) U.S. or foreign currency or cash situated within the United States at the time of the gift.[31]

Property which is considered intangible personal property and is therefore not subject to federal gift tax when given by a nonresident alien includes: (i) shares of stock issued by a U.S. or foreign corporation;[32] and (ii) debt obligations, including a bank deposit, the primary obligor of which is a U.S. person, the United States, a State, or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government.[33]

One area in which there is substantial uncertainty, in part because of the IRS' incomprehensible unwillingness to provide any guidance, relates to interests in domestic and foreign partnerships.

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affiliates; interest paid to "10-percent shareholders" and "10-percent partners"; and interest described as contingent interest in section 871(h)(4). Where an obligation carries both non-contingent interest and contingent interest, an "appropriate portion" of the obligation, determined in a manner prescribed by the IRS, is to be treated as U.S.-situs property. The IRS has not in fact prescribed how the determination is to be made.

[25] Section 2105(b)(4).

[26] Section 2105(a).

[27] Section 2105(c); Treas. Reg. § 20.2105-2(b).

[28] *See* sections 2501(a)(1) and (2) and 2511(a).

[29] Treas. Reg. § 25.2511-3(a)(1) and (b)(1).

[30] Treas. Reg. § 25.2511-3(a)(1) and (b).

[31] Treas. Reg. § 25.2511-3(b)(4)(iv)(provides that currency is not a debt obligation for purposes of applying the gift tax to the transfer of property owned by a nonresident alien; Treas. Reg. §§ 25.2511-3(b)(2) and (4) provide that debt obligations are intangibles).

[32] Section 2511(b)(1) and Treas. Reg. § 25.2511-3(b)(3).

[33] Section 2511(b)(2) and Treas. Reg. § 25.2511-3(b)(4).

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The principal uncertainties concern, first, whether it is the partnership interest or its assets that are subject to gift or estate tax (entity v. aggregate) and, second, if the partnership is treated as an entity, how the situs of the partnership interest is to be determined. [34] The authors have concluded that a gift or bequest of a partnership interest is a gift or bequest of an intangible asset rather than of its underlying property but that there is simply no reliable answer to the question of situs. Under the estate tax regulations, the situs of an intangible asset (other than a bearer instrument) is in the United States if it is enforceable against a resident of the United States. So, when is a partnership resident in the United States? Unfortunately, a 2004 change to the entity classification regulations under section 7701 removed the only regulatory guidance on what constituted a resident partnership.[35] Before the change, the regulations provided that a partnership was resident in the United States if it was engaged in a U.S trade or business. But in 2004, the IRS removed the regulation and adopted a temporary regulation with the same number. The regulation, finalized in 2006, addressed the completely unrelated question of whether a business entity is domestic or foreign, primarily where the entity was organized both in the United States and under the laws of a foreign country. As a result, no regulation defines what is a resident partnership.[36] An ancient IRS ruling states that an interest in a partnership is located where the partnership does business, but the ruling relates to a domestic partnership which conducted all of its business in the United States and is not very reliable authority on the treatment of a partnership that is foreign or, whether foreign or domestic, conducts only part, perhaps only a small part, of its business in

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[34] For a review of the issues, see Karlin, Cassell, McCaffrey and Streng, "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests", 99 Tax Notes 1683 (June 16, 2003). See *Blodgett v. Silberman,* 277 U.S. 1, 11 (1928); *Sanchez v. Bowers,* 70 F.2d 715 (2d Cir 1934); GCM 18718, 1937-2 C.B. 476); Rev. Rul. 55-701, 1955-2C.B. 836, PLR 7737063 (6/17/1977); 2 Rhoades and Langer, U.S. International Taxation and Tax Treaties, § 33.01[2][iii] (gift tax) and 33.02[2][a][vi]; "Disposition of U.S. Partnership Interests by Nonresident Aliens", 8 Journal of Partnership Taxation 133 (1991); Rev. Rul. 91-32, 1991-1 C.B. 107; Glod, "United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues", 51Tax Law. 110 (1997); Robert F. Hudson, Jr., "The Tax Effects of Choice of Entities for Foreign Investment in U.S. Real Estate and U.S. Businesses", Business Entities, March/April 2002. The IRS will not even rule on whether a partnership interest is an intangible asset for estate tax purposes. Rev. Proc. 2022-7, 2022-1 I.R.B. 297, §4.01(28).

[35] Treas. Reg. § 301.7701-5, adopted in temporary form by T.D. 9153 (2004) and, with minor modifications, in final form by T.D. 9246 (2006).

[36] *But see* Treas. Reg. § 1.861-2(a)(2), which treats a partnership as resident in the United States if it is domestic or, if foreign, it is engaged in a trade or business within the United States. This regulation interprets section 861(a)(1), under which interest has a U.S. source if paid by a "noncorporate resident" of the United States, a phrase found nowhere else in the Code. *See, also,* section 865(g), which defines a "United States resident" for purposes of the sourcing rules on sales of property without referring to partnerships at all.

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the United States.[37] The authorities we cite are all over the map – a partnership interest is located where the partnership does business, where the partnership is organized, where the owner is domiciled (*mobilia sequuntur personam*).

Once development worth noting in this area is the case of *Grecian Magnesite v. Commissioner*.[38] *Grecian Magnesite* is an income tax point, but what makes it interesting is that the Tax Court agreed with the taxpayer that the gain derived from the sale of the partnership interest could not be treated as a sale of the underlying assets. In other words, the Tax Court adopted the entity approach at least for purposes of determining what it was that the taxpayer had sold. We should also note the case of *Suzanne J. Pierre v. Commissioner*,[39] in which the Tax Court ruled that for purpose of application of the Federal gift tax, the transfers of an interest in an LLC that was a disregarded entity under the "check-the-box" regulations were to be valued as the transfer of an interest in the LLC, and the LLC was not disregarded under the entity classification regulations so as to treat the transfers as transfers of a proportionate share of assets owned by LLC. While this holding relates to the valuation of a gift, it may provide some support for the argument that the IRS may not look through the interest in a partnership or disregarded entity for purposes of determining that a gift or bequest is taxed based on the nature and location of the underlying assets. The authors would not plan on this basis, but might use the argument in defense of an assessment.

2.4 Estate and Gift Tax Credits and Deductions. The estate of a nonresident alien receives a credit of only $13,000 against the federal estate tax (the equivalent of a $60,000 exemption), an exemption level that has stayed unchanged since 1988.[40] There is no credit for gifts made during the lifetime of a nonresident alien. Nonresident aliens do, however, receive the benefit of the so-called annual exclusion from gifts ($16,000 per donee for 2022)[41] and unlimited gifts to pay tuition and medical expenses.

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[37] Rev. Rul. 55-701, 1955-2C.B. 836.
[38] Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner, 149 T.C. No. 3 (2017), *affirmed* 926 F.3d 819 (DC Cir. 2019).
[39] *Suzanne J. Pierre v. Commissioner*, 133 T.C. No. 2 (2009).
[40] Section 2102(b)(1), as amended by Pub. L. 100-647, § 5032(b)(1)(A) (1988).
[41] Sections 2503(b)(1) and 2503(e). Rev. Proc. 2021-45; 2021-48 IRB 764 § 3.43(1).

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The estate of a nonresident alien may deduct from the gross estate the value of property passing to the decedent's surviving spouse, to the same extent as the estate of a resident alien or U.S. citizen.[42] Consequently, if the nonresident alien decedent's spouse is a U.S. citizen, a marital deduction will be permitted if all of the requirements of section 2056 (covering bequests to surviving spouse) are satisfied.[43] If the surviving spouse is not a U.S. citizen (regardless of whether he or she resides in the United States), as with the estate of a resident alien or U.S. citizen, in order for the estate of the nonresident alien to take advantage of the marital deduction, the provisions of section 2056(d) must be satisfied (which provides that a bequest to a surviving spouse will not qualify for the marital deduction unless the property is held in a qualified domestic trust, as provided in section 2056A, or unless the surviving spouse becomes a U.S. citizen within a specified period of time are decedent's death).[44] In addition, the gift tax marital deduction is generally not allowed for property passing to a spouse who is not a U.S. citizen, except that a donor can give his or her non-U.S. citizen spouse up to $100,000 per year (indexed for inflation to $164,000 for 2022) without the imposition of any gift tax.[45]

As to other deductions, estates of nonresident aliens are entitled to deduct a portion of the expenses, losses, indebtedness, and taxes set forth in sections 2053 and 2054, which include funeral and administration expenses, claims against the estate, mortgages on, and indebtedness with respect to, property included in gross estate, and uninsured casualty losses suffered by the estate.[46] The portion of these expenses which the nonresident alien's estate may deduct is determined by multiplying the expenses by a fraction, the numerator of which is the value of gross estate situated in the United States, and the denominator of which is the value of all property, wherever situated, included in the gross estate.[47] Whether the amounts that are to be deducted were incurred in the United States is irrelevant for purposes of the deduction.

Consequently, a recourse note secured by a mortgage on U.S.-situs property is only partially deductible, notwithstanding the fact that the mortgaged property is includible in full. If, however,

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[42] Section 2106(a)(3).
[43] Treas. Reg. § 20.2106-1(a)(3).
[44] *Id*.
[45] Section 2523(i). 2021-45; 2021-48 IRB 764, § 3.43(2).
[46] *See* Section 2106.
[47] Section 2106 and Treas. Reg. § 20.2106-2(a)(2).

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the property is subject to a mortgage as to which the mortgagor has no personal liability (non-recourse debt), only the value of the property less the mortgage or indebtedness is included in the gross estate, thus, in effect, giving a 100% deduction of the mortgage.[48]

2.5 Assets Subject to U.S. Estate and Gift Tax under Treaties. The United States is party to treaties dealing with the estate tax with Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland and the United Kingdom. A limited number of these treaties also deal with gift tax: Austria, Denmark, France, Germany, Japan and the United Kingdom. In the case of Australia, there is a separate treaty dealing with gifts.[49] Our agreement with Canada relating to the estate tax is contained in the income tax treaty, as Canada does not have an estate tax but does impose tax on capital gains at death.

The United States has not updated any of these treaties since the early 1980s, with the exception of Canada, France and Germany. The treaties with France and Germany were updated by protocols in 1998 and 2004, respectively, and are the only gift and estate tax treaties with a savings clause that refers to former long-term residents.

In part, this rather small number of treaties reflects the fact that many countries with which we have an income tax treaty do not impose taxes on gifts and bequests. In fact, the United States has terminated treaties with some countries that have repealed such taxes, most recently our estate and gift tax treaty with Sweden, terminated effective at the beginning of 2008.[50] Nevertheless,

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[48] Treas. Reg. § 20.2053-7. See *Estate of Hon Hing Fung et al. v. Commissioner*, 117 T.C. 247 (2001) in which the court held that although California law (California Code of Civil Procedure (CCP) section 580d) does not permit a deficiency judgment where the creditor exercises a power of sale under a mortgage or deed of trust, the loan was nevertheless a recourse loan because the creditor could choose to enforce through a judicial sale, thereby preserving the right to sue for a deficiency. The court did accept an argument that the existence of the right of judicial foreclosure should be disregarded because it is almost never pursued in California (this is because the debtor retains a right of redemption the existence of which will, as a practical matter, significantly reduce the price that can be obtained in a judicial sale and because judicial sales take much longer). The result would presumably be different where a statute did not permit any deficiency (for example, California law does not permit a deficiency on a purchase money mortgage or on a loan securing the purchase of a dwelling – see CCP section 580b).

[49] A helpful table of our estate and gift tax treaties may be found on the IRS website at https://www.irs.gov/businesses/small-businesses-self-employed/estate-gift-tax-treaties-international (viewed March 21, 2022).

[50] *Cf.* Australia, which abolished its estate tax in 1979, but whose estate and gift tax treaty with the United States is still in force.

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our remaining treaties are with countries with which we have significant flows of individuals and investment.

U.S. treaties dealing with transfer taxes generally fall into two broad types:

- Older treaties, which do not explicitly limit the right of either party to impose taxes but have two principal operative provisions: The first, a set of rules that determine the situs of property; the second, provisions confirming that each country will provide tax credits to its domiciliaries for taxes paid to the other country. In some cases, the treaty also requires the situs country to allow to non-domiciliaries (or their estates) an exemption from situs country tax comparable to the one allowed for domiciliaries of the situs country, but usually based on the proportion of the non-domiciliary's assets in the situs country to worldwide assets.
- Newer treaties, which generally explicitly limit situs country taxation of gifts and estates of non-domiciliaries to real property located in the situs country and property attributable to a permanent establishment of the non-domiciliary in the situs country.

These newer domicile-based treaties afford their residents estate planning opportunities not available to residents of countries with which the United States does not have transfer tax treaties or with which the United States has older, situs-based treaties. Under the domicile-based treaties, however, certain property may be taxed by the country in which it is situated. Even the domicile-based treaties as issue can differ in this regard, which may afford even greater planning opportunities for residents of one of these countries over another.

Some of the clear benefits to alien residents of countries with which the United States has a domicile-based treaty are that they can own a U.S. business or real property through a corporation formed in a U.S. jurisdiction and, generally speaking, shelter that property from U.S. estate tax.

Since shares of stock in a U.S. corporation owned by a nonresident alien are generally subject to the U.S. estate tax, [51] residents of countries with which the United States does not have domicile based treaties can achieve such estate tax protection by only owning shares of stock in a foreign corporation that owns shares of stock in a U.S. corporation, which ultimately owns the U.S.-situs

[51] Section 2104(a).

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real property or business. The downside to the use of this structure is that the entity may be considered a "personal holding company" ("PHC"). The PHC rules are generally intended to prevent the avoidance of shareholder level taxes by the accumulation of certain types of earnings by certain closely-held corporations (this is beyond the scope of this article). The rules impose a penalty tax at the corporate level on the "undistributed personal holding company income" of a PHC.[52] Even if the PHC rules are inapplicable, this structure results in double taxation of income, because the United States will also impose income tax at 30% (or lower treaty rate) on dividends paid by the PHC to its nonresident alien shareholder.

Nevertheless, even for an alien who is a resident of a country with which the United States has a domicile-based treaty, owning a business in the United States or U.S.-situs real property through a U.S. corporation is not an ideal solution. Since such a corporation would not be able to make an election to be treated as a so-called "S corporation" under section 1362(a) of the Code (because a corporation may not make such an election if any of its shareholders are nonresident aliens),[53] which election generally avoids taxation at the corporate level,[54] the earnings of the corporation would be taxed at both the corporate level and the individual level when dividends are paid.[55] In addition, the corporation would not receive preferential capital gains tax treatment, otherwise available to an individual.[56]

Another solution might be to hold the U.S.-situs real property or business through a partnership or limited liability company that is taxed as a partnership.[57] Gifts of such interests should be sheltered from the gift tax, assuming that a partnership interest qualifies as an intangible asset. Without treaty protection, however, an interest in a partnership may or may not be subject to the

[52] Section 540.
[53] Section 1361(b)(1)(C). However, Pub. L. 115-97 (the "2017 Act") amended the rules relating to "electing small business trusts" to allow a trust to have a nonresident alien beneficiary, provided certain conditions are met. See D'Avico and Decker, "Nonresident alien as an indirect S corp. shareholder, The Tax Adviser (April 1, 2019), available at https://www.thetaxadviser.com/issues/2019/apr/nonresident-alien-indirect-s-corp-shareholder.html (qviewed June 4, 2022).
[54] Section 1363(a).
[55] Section 11 and 301(c)(1).
[56] Section 2101(a).
[57] *See* Treas. Reg. § 301.7701-3.

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U.S. estate tax, depending on the outcome of the uncertainties concerning partnership interests discussed above.[58]

2.6 Generation-Skipping Transfer Tax. If a U.S. citizen or resident alien creates a generation-skipping trust, the generation-skipping transfer tax ("GST") will be payable on a taxable termination or distribution with respect to trust assets located anywhere in the world even though the trustees, income beneficiaries and remaindermen are all nonresident aliens. Treasury regulations provide that nonresident aliens are entitled to claim a $1 million GST exemption against lifetime generation skipping transfers and the same GST exemption on death as U.S. citizens and residents and are subject to the automatic allocation of exemption to generation skipping transfers.[59] However, the regulations referring to a $1 million exemption for lifetime generation-skipping transfers were issued in 1995 before the GST exemption was uncreased and indexed for inflation. That reference in the regulations should be interpreted as allowing to a nonresident alien the same lifetime GST exemption as a U.S. citizen or resident, which is currently $10 million indexed for inflation since 2018.[60] The regulations establish two rules for the applicability of Chapter 13 of the Code, which contains the GST rules, to transfers by nonresident aliens. Chapter 13 is applicable to transfers at death by nonresident aliens to the extent that the transferred property is situated in the United States for purposes of the estate tax laws. Chapter 13 also applies to lifetime transfers to the extent that the transferred property is situated in the United States for purposes of the gift tax laws and is subject to tax under Code section 2501(a). Subsequent taxable distributions and taxable terminations with respect to property held in trust are subject to Chapter 13 if the original transfer by the nonresident alien of the property to the trust was subject to Chapter 13.[61] An "anti-abuse" rule makes Chapter 13 applicable without regard to any transaction or other activity if the effect of such transaction or activity is to transfer U.S.-situs property from the transferor to the transferee.

The estate and gift tax treaties presently in effect either expressly refer to the GST or provide that they will cover subsequently enacted taxes which are of a substantially similar character to the

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58 *See* discussion at footnotes 34-37 and accompanying text.
59 Treas. Reg. § 26.2663-2, effective for transfers made on or after December 24, 1992.
60 See Harrington, 850-2nd T.M., Generation-Skipping Transfer Tax at page A-105.
61 Treas. Reg. § 26.2663-2(b).

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taxes expressly covered by treaty. For these purposes, the GST should be "substantially similar" to the estate tax. However, the general situs rules which serve to exempt many types of U.S. property from estate taxation under the various treaties may not shield such property if it is owned by a generation-skipping trust.

2.7 Strategies to Reduce or Eliminate U.S. Transfer Taxes. Nonresidents can use many strategies to avoid or minimize U.S. transfer taxes.

(a) Gift tax strategies. It is generally easier for nonresident aliens, especially those not protected by treaties, to avoid gift tax than estate tax. Among the most common strategies to avoid U.S. gift tax are:

(i) making gifts of U.S.-situs intangible assets;

(ii) transferring U.S. real property to a corporation, partnership or a limited liability company to convert the holding to an intangible and, after a period of time (generally at least a year), making gifts of interests in the entity, outright or in trust, to children who are U.S. transfer tax residents;

(iii) setting up offshore grantor trusts for the benefit of children who are U.S. transfer tax residents;

(iv) making gifts of U.S.-situs assets within gift tax annual exclusion amounts;[62]

(v) making gifts of U.S.-situs assets for tuition and medical expenses;[63] and

(vi) making gifts of U.S.-situs property to a spouse, subject to the $100,000 adjusted for cost of living annual cap if the spouse is not a U.S. citizen.

(b) Estate tax strategies. Among the most common strategies for minimizing or avoiding U.S. estate tax are:

(i) not holding at death any assets that have a U.S. situs for estate tax purposes;

(ii) releasing all general powers of appointment granted under U.S. trusts; and

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[62] Section 2503(b).
[63] Section 2503(e).

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(iii) holding any U.S. real property through a U.S. corporation, partnership or limited liability company that is, in turn, owned by an offshore corporation.

2.8 Basis Planning. As is the case in the domestic planning arena, one significant difference between property passing by gift and property passing on death is the different treatment of basis. Property received by gift generally has a basis equal to the lower of fair market value and the donor's basis; inherited property generally has a basis equal to fair market value at the date of death.

Despite the common application of these rules whether the donor or decedent is a U.S. person or a nonresident alien, they plainly will affect planning somewhat differently. A gift by a U.S. citizen or resident alien triggers gift tax or at least the need to use the lifetime exemption, whereas gifts by nonresident aliens can usually be structured to avoid gift tax. In the case of nonresident alien donors, gift tax free gifts of appreciated property may get made without attention to the fact that the donee will inherit the donor's basis, whereas waiting to receive the property by inheritance might have resulted in a stepped up basis (assuming, as at least seems likely at the time of writing, that carryover basis on death does not get re-introduced).

Further, steps intended to shield assets from the U.S. estate tax, such as the interposition of blocker corporations, can result in the inability to step up the basis of the assets, even if the shares of the blocker are stepped up.

Additional complexities arise in drafting trusts, because property held in trust may not be entitled to a step-up on death of a grantor unless the property was held in trust to pay the income to or at the direction of the grantor for life with power to revoke or the property was includible in the U.S. gross estate of the grantor, i.e., was potentially subject to U.S. estate tax.

It follows that planning for gifts and bequests from nonresident aliens needs to consider not only the potential transfer taxes but the tax basis of the donee, heir, or trust beneficiary. So much will depend on the location and nature of the assets and whether or not one or more of the donees, heirs, or trust beneficiaries are U.S. persons. In this article, we can only point out these issues without offering comprehensive solutions.

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2.9 Impact of Other Countries' Laws. Estate and gift tax treaties will often affect such planning, so any applicable gift and/or estate tax treaty must be thoroughly reviewed. In gift tax planning for nonresident aliens, confer with counsel in the client's home jurisdiction to be sure that a transfer will not cause liability for foreign gift taxes or give rise to adverse income tax results under the laws of the home jurisdiction.

3. RESIDENCE AND DOMICILE[64]

The United States chooses to exercise comprehensive taxing jurisdiction over its citizens and residents, subjecting them to taxation on their income wherever it may arise in the world and on their gifts and bequests of property, wherever situated in the world. (The United States is almost unique in imposing the full weight of its income and transfer taxes on its nonresident citizens.) While nothing in our Constitution prohibits imposing tax on the same basis upon nonresident noncitizens ("nonresident aliens"), the United States out of comity generally limits its taxing jurisdiction to nonresident aliens who derive income from U.S. economic activity or make gifts or bequests of property located in the United States.[65] The determination of an individual's status is therefore of primary importance in defining his or her fiscal responsibilities in the United States and this section of the presentation reviews the rules.

One first and critical point: Residence is defined differently for the purposes of the Federal income tax, the Federal estate and gift tax purposes, State taxes on income and other taxes, and U.S. immigration law, not to mention the tax laws of other countries. While in many cases, the

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[64] This section of our presentation draws in part on an article by Michael Karlin, "Coming to America" which appeared in the Journal of International Taxation in 2002.

[65] For an example of a remarkable claim to extraterritorial enforcement of its tax laws, the United States technically requires employers worldwide to withhold U.S. income tax at source from wages paid to U.S. citizens and residents, with limited exceptions, even where the employment is entirely exercised entirely overseas. See Bissell, International Aspects of U.S. Income Tax Withholding on Wages and Service Fees, Tax Management Portfolio 6820-1st (Bureau of National Affairs), Part VI.A.8.d ("Even if the U.S. citizen's employer is a foreign company that is entirely owned by foreign persons, the same U.S. wage withholding obligations apply to the employer. If . . . the foreign employer is not engaged in a U.S. trade or business, it is still technically required to withhold U.S. wage withholding tax from the U.S. citizen's remuneration if no exemption is available under §3401. As if to stress this point, Reg. §31.3401(a)-1(b)(7) states expressly that the term 'wages' includes remuneration for services performed by a 'citizen or resident' as an employee of a foreign person 'whether or not such [foreign person] is engaged in trade or business within the United States.'")

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residence of an individual may be easy to determine for all such purposes, we encounter numerous clients whose status is changing or difficult to determine.

3.1 Federal Income Tax

The starting point for determining whether an alien individual is a resident for income tax purposes is section 7701(b). Section 7701(b) came into effect on January 1, 1985, which is long enough ago that we will not spend any time on prior law – still contained in Treas. Reg. § 1.871-2, which gives no warning at all that it does not apply for calendar years 1985 and later.[66]

Section 7701(b) provides two tests. Whether the tests are satisfied is a matter of fact on which the IRS generally will not rule privately.[67] If either is satisfied, an alien will be a resident.

(a) The lawful permanent resident test. Under this test, an individual is a resident for income tax purposes if he is a lawful permanent resident of the United States under the immigration laws.[68]

This test is often referred to as the "green card" test. However, under the test, the alien becomes a resident for tax purposes on the first day he or she is physically present in the United States as a lawful permanent resident for immigration law purposes. There is a misconception that receipt of the actual green card, which is formally known as an Alien Registration Receipt Card (U.S. Citizenship and Immigration Services Form I-551) and is not actually green, is the date that status changes.[69] This is not necessarily the case; in fact, lawful permanent residence almost always begins before receipt of the card. Another misconception is caused by the fact that green cards must be renewed every ten years.[70] Failure to obtain replacement card does not cause a loss of

[66] For completeness, we note that section 876 treats an alien who is a bona fide resident of Puerto Rico as a resident alien with the right to exclude from income all Puerto Rico source income.
[67] Rev. Proc. 2009-7, 2009-1 I.R.B. 226, §3.01(6) (which states that the IRS will not rule on this area).
[68] Sections 7701(b)(1)(A)(i) and (6).
[69] U.S. Citizenship and Immigration Services (USCIS), formed in March 2003, is an agency within the Department of Homeland Security. It was formerly known as the Immigration and Naturalization Service, or INS, at which time it was part of the Department of Justice.
[70] For a full list of the situations in which green cards mut be replaced, see U.S. Citizen and Immigration Services, "Replace Your Green Card", available at https://www.uscis.gov/green-card/after-we-grant-your-green-card/replace-your-green-card (viewed April 25, 2022).

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lawful permanent resident status although it may make the expired card unusable when trying to gain entry to the United States.

There are two ways to become a lawful permanent resident for immigration law purposes: The first is to have status as a nonresident adjusted while already in the United States. In that case, it is quite likely status will change on the day the adjustment is made, even though the alien may receive notification of the adjustment only a little while later and may not receive the actual green card for a period of time while the card is being physically produced. The second is that, upon approval of a petition to be admitted as a legal permanent resident, the alien is given a visa to enter the United States as a permanent resident, typically evidenced by a passport stamp that serves as temporary evidence of the right to reside permanently in the United States. The alien then becomes a lawful permanent resident for immigration law purposes when granted entry into the United States, at which time he or she may not yet have actually received the green card and is continuing to rely on the passport stamp.[71]

The key is that residence for tax purposes begins on the first day of physical presence in the United States upon adjustment of status or on the day of entry into the United States under the status of a lawful permanent resident. In either case, the timing of the issuance or receipt of the green card is not determinative. An alien who receives the right to lawful permanent residence through adjustment of status will have less ability to control timing of tax residence than if the visa is received outside the United States and the alien then chooses when to enter the United States.

(b) The substantial presence test. This test, sometimes referred to as the day counting test, is applied in each calendar year.[72] The individual counts the number of days in which he was physically present in the United States. Days of arrival and days of departure are counted as full days. Days are not counted if an alien is in transit between two foreign points and spends less than 24 hours in the United States, so long as the alien does not conduct any business in the United

[71] Our thanks to Mark Ivener, Esq., of Mark A. Ivener Law Corporation, Los Angeles, for confirming this description of the relevant immigration law procedures.
[72] Sections 7701(b)(1)(A)(ii) and (3).

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States during the layover.[73] There are a variety of exceptions relating to such aliens as commuters from Canada and Mexico, employees of foreign governments and international organizations and their families, student visas, persons prevented from leaving because of medical conditions that arose while the individual was in the United States and professional athletes present to compete in a charitable sports event (the so-called "PGA exception").[74] These exceptions are rarely relevant to cross-border estate planning, but if they come into play, there are various technical rules that have to be carefully considered as they can affect eligibility and timing.

After having counted the days in the current calendar year:

- If the number of days is less than 31, the individual is not a resident.
- If the number of days is 183 or more, the individual is a resident, subject to the effects of an income tax treaty (discussed below).
- If the number of days is 31 or more but not more than 182, the individual must count the number of days of U.S. presence in the two preceding years and calculate the result of the following formula:

$$CY + 1/3\ PY_1 + 1/6\ PY_2$$

where CY = the number of days of presence in the current calendar year

PY_1 = the number of days of presence in the preceding calendar year

PY_2 = the number of days of presence in the second preceding calendar year

If the result of the formula is 183 or more (fractions are not rounded), the individual is a resident. However, unlike the case where CY by itself is 183 or more, the individual may escape being a resident under the "foreign tax home/closer connection" test. Under this test, the individual can show (by timely filing a tax return and including the requisite statement) that he is not a resident by establishing that he has *a tax home outside the United States* AND that he has *a closer*

[73] Section 7701(b)(7)(C); Reg. section 201.7701(b)-3(d).

[74] Section 7701(b)(5). There is substantial uncertainty concerning whether the medical condition exception applies only to the person suffering from the medical condition or can also extend to individuals, such as caregivers or dependents, who are prevented from leaving because of another individual's medical condition. See "Working Group Seeks Answers on 'Medical Condition' Exception", Tax Notes (May 15, 2020).

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connection to the foreign country in which the tax home is located than to the United States.[75] It is clear that the tax home and the country to which the individual has the closer connection must be the same country. The exception does not apply if at any time during the year in question the individual has taken steps to be admitted as a permanent resident of the United States or the alien has an application pending for adjustment of status to that of a permanent resident.

The Internal Revenue Service (IRS) treats an individual's tax home as:

> "his regular or principal (if more than one regular) place of business, or if the individual has no regular or principal place of business because of the nature of his business, then at his regular place of abode in a real and substantial sense."[76]

A closer connection to a foreign country is demonstrated by facts and circumstances relating to personal life, such as the location of (1) home, (2) family, (3) belongings, (4) social, business and religious organizations, (5) personal bank accounts, (6) driver's license, (7) the country of residence listed on forms and documents, (8) the types of forms and documents filed, and (9) where the individual votes.[77]

(c) Tax treaty exception. What if an individual is resident in more than one country under the respective laws of each? Tax treaties may provide the answer in many cases. Most U.S. tax treaties contain a provision fairly similar to Article 4(3) of the U.S. model income tax treaty (2006) reproduced below.[78] Fairly similar means there is no substitute for reading the specific treaty potentially applicable to any particular individual, but the model is more than sufficient for purposes of a general discussion.

> 3. Where, by reason of the provisions of paragraph 1 [which in substance provides that domestic law of each country is applied to determine the question], an individual is a resident of both Contracting States, then his status shall be determined as follows:

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[75] Section 7701(b)(3)(B).
[76] Treas. Reg. § 301.7701(b)-2(c)(1).
[77] Treas. Reg. § 301.7701(b)-2(d).
[78] The United States Treasury issued a revised model income tax treaty in 2016 but the model makes no substantive change to the 2006 model in relation to the residence of individuals and, as of the time of writing, no U.S. treaty currently in effect or even awaiting ratification is actually based on the 2016 model.

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a) he shall be deemed to be a resident only of the Contracting State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be only a resident of the State with which his personal and economic relations are closer (center of vital interests);

b) if the Contracting State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either Contracting State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

c) if he has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident only of the Contracting State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall endeavor to settle the question by mutual agreement.

The principal variant in our treaties is that not all of them use nationality as a tiebreaker.

To claim to be a nonresident under a treaty, an alien must file a U.S. tax return and include a form, IRS Form 8833 (Treaty-Based Return Position Disclosure Under section 6114 or 7701(b)), claiming that he or she is not a U.S. resident because of the treaty.[79]

(d) Differences between statutory and tax treaty residence. It is useful to compare the effects of nonresidence under the statutory test and nonresidence under a treaty.

An individual who is nonresident under the statutory test is nonresident for virtually all purposes of the income tax.

By contrast, the regulations provide that an individual who is nonresident under a treaty is nonresident for the purposes of computing tax liability and the imposition of withholding under

[79] Treas. Reg. § 301.6114-1. The regulations do not specifically state that a claim to be a nonresident alien based on application of a treaty is a treaty-based return position but this is the clear implication of Treas. Reg. § 301.6114-1(c)(iii), which waives reporting for positions taken by taxpayers for returns relating to taxable years for which the due date for filing (without extensions) is on or before December 15, 1997 that residency is determined under a treaty.

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Chapter 3 of the Internal Revenue Code (withholding on payments to foreign persons); for all other purposes of the Code, the individual will be resident.[80] For example, an individual will be a resident for determining whether a foreign corporation is a controlled foreign corporation. This does not mean that the alien will be taxable on Subpart F income or global intangible low-taxed income ("GILTI"); but it can have an effect on other U.S. shareholders, to their potential surprise, if the corporation becomes a CFC only because the treaty nonresident's stock is counted as held by a U.S. shareholder.[81] We discuss below one substantial uncertainty created by the regulations in relation to the filing of international tax information forms as well as foreign bank account reports (FBARs).

Imagine a couple moving to the United States. Assume they jointly own 100% of the stock of a foreign corporation. Assume that one spouse moves here outright but the other continues for a year or two to travel back and forth because of continuing commitments in the home country. As a result, perhaps that spouse will be resident under the statutory test but will escape under a treaty. Under the IRS view, the foreign corporation would be a CFC because *all* the shares, rather than just 50%, would be treated as owned by U.S. shareholders. Subpart F income or GILTI would therefore be includible in the income of the resident spouse, but not in the income of the treaty nonresident. This might encourage a planner to try to find a way for the treaty nonresident to escape the statutory test, including by not applying for a green card and claiming protection of the foreign tax home/closer connection test.

We may also note the differences between the closer connection/foreign tax home test and the center of vital interests test under the tax treaty dual residence provisions. An alien resident in a treaty country may be entitled to establish non-residence under either or both of these provisions. Leaving aside the CFC issue noted above, should the alien care? We shall see.

Assume first that the permanent home test would not resolve the matter under a treaty because, as in many cases, the alien has a home in each country or, more rarely, neither. The treaty will provide that, where an individual is a dual resident, residence will be in the country where the individual's personal and economic relations (center of vital interests) are closer. The statutory

[80] Treas. Reg. § 301.7701(b)-7(a).
[81] For a discussion of Subpart F and GILTI, see Part 4.8(c) below.

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exception says that the individual must have a foreign tax home and a closer connection to a foreign country than to the United States.

The center of vital interests provision of the treaty sounds similar to the foreign tax home (principal place of business)/closer connection (location of personal connections) test. Not quite. For one thing, the statute requires separate examination of the foreign tax home (regular or principal place of business) and the closer connection. The treaty looks at this on an overall basis and it may be possible to claim not to be U.S. resident under a treaty without having to deal with some of the technical requirements of the statutory test. Moreover, one cannot precisely equate the location of a place of business with the location of economic ties, which would seem to be a much broader concept. But if this seems a little too subtle, and there are indications the IRS regards the practical application of the two tests as virtually identical, there are other significant differences.

Most importantly, a treaty can apply regardless of how many days the individual spent in the United States and regardless of the individual's immigration status. Certainly U.S. Citizen and Immigration Services (USCIS) in most cases might be expected to take a dim view of a green card holder who claimed that he was not a resident for tax purposes under a treaty. The USCIS might argue that the green card holder had abandoned U.S. residence or never intended to take it up, although this is not an argument likely to be made against new immigrants who claim residence of their home country under a tax treaty for one or perhaps two years following their obtaining lawful permanent resident status in the United States.[82] But for tax treaty purposes, the holding of a green card would be relevant only as one of a number of balancing factors to be weighed if the matter were being determined based on an evaluation of the center of vital interests, and would not be very persuasive at that, since in most such cases, the alien will also be a citizen or have residence privileges in the other country.

[82] In 1996, an internal memorandum from the Office of General Counsel to the Assistant Commissioner of what was then known as the Immigration and Naturalization Service (INS) accepted that "it may that the [INS] could not base a claim of abandonment of lawful permanent residence solely on the alien's having filed a nonresident income tax return". The memorandum pointed out, however, that a tax treaty claim might support a claim of abandonment along with other facts.

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Another crucial difference between the statutory and treaty exceptions to U.S. residence is timing. The treaty will address overlapping periods of residence. The day the balance tips from one country to another, residence will shift. This can presumably occur at any time during the year. By contrast, if the foreign tax home/closer connection test is satisfied, the alien escapes residence for an entire calendar year. Indeed, if the alien then becomes a resident in the following year, he or she will have a residency starting date which could be later than January 1.

One final procedural point: To claim not to be resident under the closer connection exception, the alien's claim must be made on a timely filed IRS Form 8840 (Closer Connection Exception Statement for Aliens). Timely means by the due date for filing a tax return, including based on a timely filed extension request. The regulations provide that failure to file the form timely makes the alien ineligible to for the exception.[83] An exception is made if the individual can show by clear and convincing evidence that he or she took reasonable actions to become aware of the filing requirements and significant affirmative steps to comply with those requirements.[84] Our experience has been that the IRS is somewhat flexible in applying the exception.

In the case of a claim to be nonresident under a treaty, the taxpayer must file a tax return and include a statement on Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)). The return must be made timely. However, unlike the regulations relating to the closer connection exemption, the regulations do not provide that the penalty for untimely filing is to make the alien ineligible for treaty benefits.[85] In fact, failure to file Form 8833 does come with a $1,000 penalty and one may therefore infer that this is all that the IRS can do if an alien taxpayer makes an untimely treaty claim.

One procedural problem with both these exceptions to U.S. residence, but particularly the treaty exception, relates to taxpayers who previously filed joint returns with their spouses. Only where both members of a couple are U.S. residents[86] or where the couple has made an election under section 6013(g) are eligible to file a joint return. On the other hand, once a joint return has been

[83] Reg. section 301.7701-8(d)(1).
[84] Reg. section 301.7701-8(d)(2).
[85] Reg. section 301.7701-7.
[86] Section 6013(a)(1).

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filed, regulations provide that the couple may not change their filing status.[87] But what if one of the taxpayers was not, or claims not to have been, a resident as a result of the application of the closer connection exception or a treaty? One would think it obvious that the spouses should file amended returns. Since the rule preventing changing status is regulatory (it is not required by statute), and the rule that limits joint returns to resident couples is statutory, the latter should prevail. However, as a practical matter, it may be difficult or impossible to get the IRS to process the amended returns.

(e) When does residence begin and end? The residence rules require residence to be tested for each calendar year and individuals who satisfy either test are treated as resident for the whole year.[88] For individuals who have been continuously resident for a period of years, no great amount of analysis is required.

However, the law provides special rules for newly resident individuals who were not resident *at any time* in the preceding calendar year or are not resident *at any time* during the next calendar year. These individuals are treated as resident only for the portion of the year which begins on the residency starting date or, as the case may be, the portion of the year that ends on the last day of residence, as explained below.

(i) Substantial presence test. In the case of the substantial presence test, the residency starting date is the first day of presence in the calendar year in which the test is satisfied. The last day of residence is the last day of presence during the final year, provided that the individual had a closer connection to a foreign country during the period after the last day of presence. Just for this limited purpose (*i.e.*, not for purposes of the day counting formula), the individual is not treated as present during any period for which he or she can establish a closer connection to another country than to the United States – no need to prove the existence of a foreign tax home. However, no more than 10 days of presence may be excluded in this way. The regulations make clear that this rule may refer to more than one period, so that an individual who was here for two or even more stays where the total for all such stays was 10 days or less would

[87] Reg. section 1.6013-1(a)(1).

[88] This is stated explicitly in section 7701(b)(1)(A)(i) for the green card test and it is the necessary consequence of sections 7701(b)(1)(A) and (b)(2)(A)(i) so far as the day counting test is concerned.

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be able to exclude each such period. The regulations also make clear that taking advantage of the 10 days is optional, as the taxpayer must affirmatively establish the closer connection to a foreign country.

There is a regulatory trap here: The individual may not exclude any day that is part of a period where not all of the days in the period can be excluded. For example, suppose N stays in the United States for from February 1 through 11 and then returns on July 1 for the rest of the year. Suppose during those 11 days, he had a closer connection to his home country. Residence would begin on February 1, not February 11. Similarly, if an alien stayed from March 1 to March 4 and from April 10 to April 17, residence would begin on April 10. The four days in March could be excluded, but because not all the days in April could be excluded, none of them may be excluded.[89]

(ii) Lawful permanent residence test. In the case of an individual who satisfies the substantial presence test, immigration status is irrelevant. Taking steps to obtain lawful permanent residence will disqualify an individual from escaping residence based on the foreign tax home/closer connection test. [90]

Under the lawful permanent residence test, residence for an alien who was not previously resident under the substantial presence test begins on the first day of presence in the United States under the status. (If he was already resident under the substantial presence test, then this substantial presence test rule will apply.) Similarly, residence ends when the individual "is no longer described in section 7701(b)(1)(A)(i)", meaning the individual is no longer a lawful permanent resident. For this purpose, lawful permanent resident status must have been revoked or administratively or judicially determined to have been abandoned.[91] There are numerous green card holders who believe that by returning to the United States every two years, they can maintain their immigration status but are no longer tax residents. But this is not the case. To terminate tax

[89] Treas. Reg. § 301.7701(b)-4(c).
[90] Section 7701(b)(3)(C); see Treas. Reg. § 301.7701(b)-2(f) for a (non-exclusive) list of affirmative steps that would disqualify the alien from making use of the foreign tax home/closer connection test.
[91] Section 7701(b)(6)(B).

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residence based on the lawful permanent immigrant test, an alien has to take steps to relinquish his or her status or the status has to be revoked by the U.S. government.

The United States has enacted a series of special rules applicable to "covered expatriates", namely U.S. citizens who cease to be citizens and "long-term residents", a misleading phrase that applies to aliens who have been lawful permanent residents in eight of the preceding 15 years. This phrasing means that an individual who became a lawful permanent resident for income tax purposes at any time in 2022 will become a long-term resident on January 1, 2029, which could be as little as six years and two days later. (This does not seem very "long-term" to us.) We discuss these rules elsewhere in greater detail in Part 5 below but, for present purposes, we note that such an individual will cease to be treated as a resident:

- On the date he voluntarily abandoned his lawful permanent resident status by filing Homeland Security Form I-407 with a U.S. consular or immigration officer, and the Department of Homeland Security determines that he has, in fact, abandoned such status; or
- On the date he became subject to a final administrative order for removal from the United States under the Immigration and Nationality Act and he actually left the United States as a result of that order; or
- On the date he commenced to be treated as a resident of a treaty country under the provisions of an income tax treaty (see below).[92]

(iii) Tax treaty dual residence provisions. If a taxpayer intends to rely on the dual residence provision of a treaty to avoid being treated as a resident, the taxpayer may never become a U.S. resident, at least for treaty purposes. But there may come a point when the individual becomes a U.S. resident, notwithstanding the treaty. This may occur in one of two ways. First, the taxpayer may cease to be a resident of the other country entitled to rely on the treaty. Second, the taxpayer's factual circumstances may change in such a way that the treaty balance tips in favor of U.S. residence.

[92] Section 7701(b)(6); Treas. Reg. §§ 301.7701(b)-1(b)(2) and (3).

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In the former case, U.S. residence will begin the minute treaty protection ceases. In the latter case, U.S. residence will begin when the balance tips. Either way, residence will begin on the date that treaty protection is no longer available. Treaty dual residence provisions do not appear to apply on a calendar year basis but rather on a day by day basis, although as a practical matter, the question will be analyzed with respect to the facts over a period of time. In many cases, a well-advised taxpayer will have some control over the process of becoming a U.S. resident through the way the facts are presented to the IRS.

For departing residents, Congress added a clarification effective June 17, 2008: An individual ceases to be treated as a lawful permanent resident of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the IRS of the commencement of such treatment. The notification will be required to be made on IRS Form 8854.[93]

(iv) Accelerating residence by election. There are several elections available to taxpayers who actively wish to become U.S. residents at an earlier date than might otherwise be the case. Why would they want this? One reason would be to permit the filing of a joint return, which requires the spouses to be resident for the entire year; another would be if the alien had U.S. source income taxed at a flat rate of 30% and would be subject to a lower effective rate if such income were taxable at regular graduated rates. However, the type of case where the most dollars would be at stake is where the alien had sustained losses or incurred deductions before what would otherwise be the residency starting date and the losses would not be deductible unless the alien were a resident. An example would be an alien whose property was expropriated and who later came to the United States as a refugee. (The timing of losses in an expropriation is a whole other topic.)

Section 7701(b)(4) allows an alien to make an election to be treated as resident during a year (the "election year") if he or she meets several requirements. The alien must not otherwise be resident in the United States within the election year or the immediately preceding calendar year. The

[93] See section 877A(g) and flush language to section 7701(b)(6).

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alien must meet the substantial presence test for the calendar year following the election year. The alien must spend at least 31 consecutive days in the United States during the election year and must be present for 75% of the days in a "testing period" that begins with the first day of the 31 consecutive days and ending on December 31 of the election year. For this purpose, the alien is required to treat up to five days of absence from the United States during the testing period as days of presence. The election must be made on a tax return, but cannot be made until the substantial presence test has been met in the year after the election year.

Where the election is made, residence begins on the first day of the earliest testing period during the election year. In those cases where an alien is contemplating whether to take advantage of the election but wants to time the starting date, understanding these mechanical rules is essential.

Section 6013(g) allows a nonresident alien to elect to be treated as a resident for the whole of the taxable year (for most, but not all, couples, the taxable year will be the calendar year) if he or she was married to a U.S. citizen or resident on the last day of the year. The election remains in effect until revoked by either of the taxpayers, divorce, legal separation or termination by the IRS if the couple fails to maintain proper records. A couple may make the election once only.

Section 6013(h) allows an individual to elect to be treated as a resident for the whole taxable year if he or she was a nonresident alien at the beginning of the taxable year but a resident at the end of the year *and* the other spouse is a citizen or resident at the close of the year. A couple may make only one such election, even if they cease to be residents and resume residence in a later year.

In both cases, both members of the couple must make the election. There is nothing in either provision that explicitly states that the couple must file a joint return. Nevertheless, the elections are both placed within section 6013, which is the section that deals with joint returns and it would be a brave taxpayer that would file these elections as part of a separate return.

Sections 6013(g) and (h) apply only for purposes of Chapters 1 (income tax) and 24 (in relation to wage withholding). They do not apply, notably, for purposes of Chapter 3 (withholding on payments to foreign persons), as to which see below.

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Last and probably least, a few treaties allow students or trainees to elect to be treated as U.S. residents.

(f) Reporting requirements for residents. The United States imposes numerous reporting requirements for U.S. persons in relation to foreign assets and income. Many of these requirements are backed up by significant penalties. Even a limited discussion of these requirements is beyond the scope of this article, but new residents need to be aware of them. Although the regulations do not state that a treaty nonresident is subject to reporting requirements as if they were U.S. residents, that is a possible way of interpreting the regulations. The uncertainty has resulted in many treaty nonresidents filing international information forms and foreign bank account reports even though the information is self-evidently useless to the government.[94]

(g) Loss of citizenship. A citizen who relinquishes or loses U.S. citizenship is subject to special timing rules discussed in Part 5 below. A former citizen does not, however, automatically become a nonresident alien. Voluntary relinquishment is usually done abroad and former citizens do not usually return to the United States for long periods of time. But it is theoretically possible for the former citizen to continue to be treated as a resident alien under the substantial presence test.

(h) When is a resident not a resident? There are circumstances in which an individual who is resident for most purposes of the income tax laws is not resident for all such purposes. These circumstances are most likely to arise round about the time residence begins.

(i) Withholding. The United States has an extensive set of requirements for the withholding of tax on income of nonresident aliens. How is a nonresident alien defined for this purpose? Section 7701(b) applies for purposes of withholding but its operation is not entirely obvious in the case of an alien who is not a green card holder or in a year in which a treaty could override the result of section 7701(b). The substantial presence test may require residence to be

[94] `For a fuller discussion, see Menzie and Karlin, "Requesting Guidance For Treaty Nonresidents", 148 Tax Notes 1115 (2015), available at https://karlinpeebles.com/wp-content/uploads/Requesting_Guidance_for_Treaty_NonResidents_Tax_Notes-092015.pdf.

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determined based on facts that will not be known until the end of the year or even later. Determination of residence or nonresidence may be affected by a treaty claim or a first year election made in a tax return filed many months after the close of a taxable year. In the meantime, it seems reasonable to require that the individual be treated as nonresident for withholding tax purposes but the results can be decidedly odd.

This may not be a significant issue for withholding agents. They are allowed to rely on the form filed by an individual – either IRS Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding) for foreign persons claiming treaty benefits or nonresident status, subject to Chapter 3 withholding but not to back-up withholding; or IRS Form W-9 (Request for Taxpayer Identification Number and Certification) for persons claiming to be U.S. residents, who are not subject to Chapter 3 withholding and will be subject to back-up withholding in limited circumstances (failure to provide a valid taxpayer identification number, IRS notice to payor, etc.).[95]

But what about the taxpayer? For example, an individual may begin the year as a nonresident but, by staying here for 183 days, can become a resident retroactive to the residency starting date. The residency starting date is the beginning of his stay in the year he became a resident, but the duration of the stay cannot be guaranteed at the outset of the stay. Can the alien file a Form W-8BEN to (a) claim a treaty rate reduction or (b) claim to be a nonresident, knowing perhaps that he or she was going to become a resident? And if not, can the alien file a Form W-9 and claim to be a resident not subject to chapter 24 withholding (back-up withholding)?

The regulations ignore these tantalizing questions. Instead, they simply state that a nonresident alien individual means a person described in section 7701(b)(1)(B), which in turn says that a nonresident is someone to whom the green card test, the substantial presence test and the first-year election do not apply. But advisers to intending immigrants should give some thought to how to avoid unnecessary withholding. One way to narrow down the problems is as follows: If the taxpayer has a high degree of confidence as to what his or her status will be, the taxpayer can file a form (W-8BEN or W-9) or make a claim based on that status. It would be pretty awkward for

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[95] Treas. Reg. §1.1441-1(b)(2)(i).

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the IRS to attack a taxpayer who claimed a status based on events that had not yet occurred if the events did in fact occur and the taxpayer has control over whether they did occur. But what about taxpayers who are not certain how long they are going to stay? This question may not be so readily answered. What is clear is that if a taxpayer certifies a status to a withholding agent and that status definitively changes, the taxpayer must promptly (within 30 days) advise the withholding agent by submitting a corrected form.

We have already considered two other examples of the phenomenon of discontinuity between residence for substantive income tax purposes and for withholding purposes, namely the elections under section 6013(g) and (h). Under these elections, an individual is resident for purposes of Chapters 1 and 24, but not for purposes of withholding. It is easy to think of the two sections in the same way, but they actually operate quite differently. A section 6013(h) election will be made just once, most typically by a newly immigrated couple or a couple who were married during the year, one of whom was not a resident at the beginning of the year. It will be made well after the end of the year and will not be made again because the statute allows it to be made only once, and in most cases the couple wouldn't need to make the election a second time even if it were possible because they will be resident for the full year without needing an election. So, in the year covered by the election, it seems reasonable to treat the electing nonresident alien(s) as nonresident for purposes of withholding in the year covered by the election. A section 6013(g) election, on the other hand, is made with respect to an individual who is otherwise a nonresident at the end of the year. The election will then apply indefinitely in future years. While it would seem reasonable to treat the electing alien as nonresident in the first year of the election, one might reasonably ask why withholding status should not be based on the election after it has been made. The statute and the regulations do not permit this, however, so that an alien who is not resident under section 7701(b) but is resident under section 6013(g) will be subject to withholding as a foreign person.

There is one last sting in the tail here: Despite the fact that the individual is treated as a nonresident alien for withholding purposes, the regulations under section 6013(g) and (h) require the election to include a treaty benefit waiver and the waiver appears to cover all treaty benefits, including limitations on withholding.[96] At least the maker of an unrevoked section 6013(g)

[96] Treas. Reg. § 1.6013-6(a)(2)(v), cross-referenced in § 1.6013-7(a)(2).

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election can file a Form W-8BEN to avoid back-up withholding and information reporting, at least until he or she becomes a resident without regard to the election.

(ii) Source of Income Rules. It is sometimes necessary to determine the source of income based on residence of a payor or the taxpayer. Residence in these circumstances requires a look at more than section 7701(b). For example, under section 861(a), interest has a U.S. source if paid by a domestic corporation or a "noncorporate resident". Section 7701(b) seems to apply for this purpose where the borrower is an alien; but interest paid by a U.S. citizen resident abroad also has a foreign source and the regulations under section 861(a) do not explain how to determine residence of a U.S. citizen. There are analogous concepts in other parts of the Code that might be used for this purpose (the substantial presence test; the bona fide foreign residence for purposes of the foreign earned income exclusion of section 911).

Section 865(a) applies for determining the source of gains from sales of some classes of personal property. Gain is sourced according to the residence of the payor; but a resident is defined by section 865(g) to be a U.S. citizen or resident alien who does not have a tax home in a foreign country or a nonresident alien who does have a tax home in the United States.[97] In these cases, we would assume that the tax home must be determined at the time of the sale, which means that once again the timing of an individual is acquiring or giving up the tax home is important.

3.2 Gift, Estate and Generation Skipping Transfer Taxes.

(a) Regulatory definition. Section 7701(b) does not apply for the purposes of Subtitle B, which deals with the gift, estate and generation skipping taxes. In short, residence is determined based on the domicile of the donor or decedent.[98] The regulations provide that a person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain

[97] The definition of tax home is by cross-reference to section 911(d)(3), which defines tax home as the individual's home for purposes of section 162(a)(2) (relating to traveling expenses while away from home). See Treas. Reg. § 1.911-2(b).
[98] Treas. Reg. §§ 20.0-1(b)(1) (as amended in 1980), 25.2501-1(b) (as amended in 1983).

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indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.[99]

This determination is a factual issue that focuses on many factors, none of which is determinative. As in the case of residence for income tax purposes, it is understood that the IRS will not rule privately on the domicile of an individual.[100] Some of the factors on which the IRS and courts focus[101] are:

(i) the length of time spent in the United States and abroad and the amount of travel to and from the United States and between other countries;[102]

(ii) the value, size, and locations of the donor's or decedent's homes and whether he or she owned or rented them;[103]

(iii) whether the alien spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.;[104]

(iv) the situs of valuable or meaningful tangible personal property;[105]

(v) where the alien's close friends and family are situated;[106]

(vi) the locales in which the alien has religious and social affiliations or in which he or she partakes in civic affairs;[107]

(vii) the locales in which the alien's business interests are situated;[108]

(viii) visa status (see discussion below);

[99] Rev. Rul. 58-70, 1958-1 CB 341 (alien intended to take up U.S. domicile but died before accomplishing objective).
[100] For some reason, this is not specifically stated in Rev. Proc. 2009-9, *supra* footnote 67. But as a general matter, the IRS will not rule on any matter in which the determination requested is primarily one of fact. *See* Rev. Rul. Rev. Proc. 2009-3, 2009-1 I.R.B. 107, §4.02(1).
[101] Heimos, *Non-Citizens – Estate, Gift and Generation-Skipping Taxation,* Tax Management Portfolio 837-2nd (Bureau of National Affairs), Part III.C.4 for a more expansive list.
[102] In *Estate of Edouard H. Paquette v. Commissioner,* T.C. Memo, 1983-571, the decedent was a Canadian "snowbird", who purchased a home in Florida in which he resided during the winter months of each year. The decedent in that case was found to have retained his Canadian domicile.
[103] *See Estate of Anthony H. G. Fokker v. Commissioner,* 10 T.C. 1225 (1948) and *Estate of Jan Willem Nienhuys Est. v. Commissioner,* 17 T.C. 1149 (1952).
[104] *Id.*
[105] *See Farmers' Loan & Trust Co. v. United States.,* 60 F.2d 618 (S.D.N.Y. 1932).
[106] *See Estate of Nienhuys, supra* note103.
[107] *See Farmers' Loan, supra* note 105 and *Estate of Nienhuys, supra* note 103.
[108] *See Fokker.*

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(ix) the places where the alien states that he or she resides in legal documents;[109]

(x) the jurisdiction where the alien is registered to vote;

(xi) the jurisdiction that issued the alien's driver's license; and

(xii) the alien's income tax filing status.

An alien's status under the U.S. immigration laws is a relevant consideration in determining the alien's domicile but it is not conclusive. The IRS has ruled that an alien who entered the country illegally and remained for 19 years, purchasing a house and participating actively in community affairs was domiciled in the United States. The IRS ruled that it would reach the same result on similar facts in the case of an alien who entered the country legally but remained after expiration of the stay allowed by the terms on which he was allowed to enter the United States.[110]

This conclusion is, paradoxically, more easily reached in the case of an undocumented alien than in the case of an alien who is legally present under limited duration status and who complies with the terms of that status. Many, if not most, undocumented aliens intend to stay indefinitely and their lives generally reflect this. (It is also true that undocumented aliens rarely have the wealth that brings transfer taxes into play.) A legal alien, by complying with the requirements of his or her status, may well be manifesting an intent to leave once the status expires.

There are, it is true, immigration statuses that have terms of several years and can be renewed, thereby allowing the alien to spend lengthy periods of time in the United States. In a non-tax case, the Supreme Court has held that a nonimmigrant alien holding G-4 status has the legal capacity to establish domicile within the United States.[111] The Court concluded that when federal law, such as the statute that governs the granting of G-4 status, did not impose restrictions on intent or duration of stay, Congress intended that, while permanent immigration would normally occur through immigrant channels, non-restricted nonimmigrant aliens could adopt the United

[109] *See Fokker* and *Farmers' Loan.*

[110] Rev. Rul. 80-209, 1980-2 C.B. 248. Although it is common to refer to an alien holding one or other kind of visa, this is, according to our immigration colleagues, a misnomer. An alien has a status under the immigration and nationality laws; the visa is just a document permitting the alien to enter the United States and confirming that the alien's status that allows for such entry. In many cases, no visa is required, as a result of the Visa Waiver Program which allows aliens from certain countries to enter the United States for up to 90 days for tourism or business. See https://travel.state.gov/content/travel/en/us-visas/tourism-visit/visa-waiver-program.html (viewed March 8, 2022).

[111] *Elkins v. Moreno*, 435 U.S. 647 (1978).

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States as their domicile under certain circumstances. The IRS cited the case to rule that the holder of G-4 was a domiciliary because (based on facts not explained in the ruling, other than the alien's stay of 13 years under the G-4 status) he had formed the intent to remain indefinitely in the United States.[112]

At least in some cases, an alien holding non-immigrant status may well not become domiciled in the United States right away and in some cases may never become domiciled at all, even though he or she early on become resident for income tax purposes under the substantial presence test. Ultimately, as the Court of Claims has ruled in such circumstances, domicile is a question of fact based on the alien's intent, and while immigrant status may be relevant, it is not by itself a conclusive factor.[113]

The same conclusion can even be reached with green card holders, although with much greater difficulty and, we can assume, with much greater likelihood of IRS resistance.[114] A claim of nonresidence for a green card holder will likely have most chance of success either very early in an alien's presence in the United States, perhaps after the green card has been issued but before the alien has severed ties with the prior domiciliary jurisdiction, or if the alien has left the United States without giving up his green card.[115]

There does not seem to have been any consideration of an alien's status under the citizenship or immigration laws of other countries. It may be noted that in Europe (as a result of Brexit, the

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[112] Rev. Rul. 80-36, 1980-2 C.B. 249, *revoking* Rev. Rul. 74-364, 1974-2 C.B. 321.

[113] *Estate of Robert A. Jack v. United States*, 54 Fed. Cl. 590 (2002) (granting government's summary judgment motion that it should be allowed to show that the decedent intended to stay in the United States in violation of his visa status).

[114] In *Estate of Nienhuys, supra* note 103, a Dutch individual came to the United States during World War II and was prevented by the war from returning to the Netherlands. He was able to replace his visitor status with a status allowing him entry as a "Netherlands quota immigrant", a form of lawful permanent residence. He remained in the United States until his death in early 1946, although he had tried to return to the Netherlands soon after the war ended but did not, discouraged at first by Netherlands government policy and then prevented by illness that turned out to be cancer. The Tax Court found that he had not relinquished his Dutch domicile, even though on some documents he had declared himself to be a permanent resident of the United States.

[115] But see *Estate of Barkat A. Khan v. Commissioner*, T.C. Memo. 1998-22, where it was the decedent's estate that was arguing for U.S. domicile for the decedent, who was an elderly Pakistani citizen who had returned to Pakistan after obtaining a re-entry permit. The decedent fell ill and did not renew the permit; he died in Pakistan while still owning U.S. property and little else. The Tax Court ruled in favor of the estate, citing *Samuel W. Weis v Commissioner*, 30 B.T.A. 478 (1934); for the proposition that "A domicile is not changed even by long continued absence if there is any intention of returning, even though intention be doubtful."

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United Kingdom is now a notable exception), citizenship in most European countries confers the right to reside in any of the others and immigration status therefore may not shed much light on domicile.

(b) Impact of treaties. Dual residents may find relief under treaties, but the United States has entered into many fewer estate and gift treaties than it has income tax treaties. Only the newer treaties contain a treaty tiebreaker of the kind found in our income tax treaties. Where the treaties contain such a tiebreaker, the provision is generally similar but not identical to those in our income tax treaties.

(c) Covered expatriates. There is a form of transfer tax – section 2801, enacted in 2008 – which applies to gifts, bequests and trust distributions to U.S. citizens and resident aliens (as defined for income tax purposes) by "covered expatriates", meaning former citizens and long-term residents as defined in section 877, which is an income tax provision.[116] Section 2801 is described in greater detail in Part 5**Error! Unknown switch argument.** below. For present purposes, we note only that the domicile of the covered expatriate is generally irrelevant – what matters is whether the expatriate met the definition in section 877 relating to net worth, average annual income tax liability or tax filing requirements. Domicile may however be relevant depending on the interaction between section 2801 and our estate and gift tax treaties, an issue also discussed in Part 5 below.

3.3 Other Taxes

(a) State taxes. Section 7701(b) does not apply for state tax purposes either. Immigration status and days of presence in the United States are not really helpful concepts in trying to determine residence in a state; and U.S. treaties generally do not apply for state tax purposes.

[116] Although this section was enacted in 2008, it has not yet been enforced as of March 2022. Announcement 2009-57, 2009-29 I.R.B. 158, and Notice 2009-85, 2009-45 I.R.B. 598, section 9, delayed the due date for reporting and paying this tax until final regulations are issued. The IRS issued proposed regulations in 2015. As of April 2022, these regulations have not yet been finalized.

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Instead, residence in a state is determined based on a patchwork of state rules, mostly subjective rules with the occasional rebuttable presumption in the case of presence in the state in excess of a minimum period of time.

Almost all states will treat an individual as resident for state income tax purposes if that individual is domiciled in the state. California law, for example, provides that a "resident" includes: (1) Every individual who is in California for other than a temporary or transitory purpose and (2) every individual domiciled in California who is outside the state for a temporary or transitory purpose. There is a rebuttable presumption that an individual present in the state for nine months within a taxable year is a resident.[117] Massachusetts says that a "resident" or "inhabitant" is (1) any Massachusetts domiciliary, or (2) any non-domiciliary who maintains a permanent place of abode in Massachusetts who spends in the aggregate more than 183 whole or partial days of the taxable year there.[118] In New York, a resident individual means (1) a New York domiciliary, unless he maintains no permanent place of abode in New York, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than 30 days of the taxable year in this state, or (2) a non-domiciliary who maintains a permanent place of abode in New York and spends there in the aggregate more than 183 days of the taxable year.[119] Several states, including California and New York, have special rules for prolonged absences related to employment and/or service in the armed forces.

(b) Foreign taxes. All countries and their political subdivisions have their own rules for determining residence for tax purposes. In those countries that impose an income tax, residence is usually based on physical presence within the jurisdiction and, like the United States, residence will be found within a single fiscal year if the number of days of presence is not less than some arbitrary number, frequently 183, and it will also be found if an individual spends an average of an arbitrary number of days, typically 90 or 120 days, over a three or four-year period. While few countries' rules rival the density and detail of the U.S. rules, the basic approach is structurally similar.

[117] Cal. Rev. & Tax. Code §§ 17614-6.
[118] Mass. Ann. Laws ch. 62, § 1.
[119] NY CLS Tax § 605 (2001)

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In those countries that impose a tax on gifts and inheritances, the domicile of the donor (or donee where the tax is a succession tax imposed on the recipient) typically determines the scope of the tax. However, the concept of domicile is often not specifically defined for tax purposes but is based on law developed for purposes of determining the rights of the heirs of a decedent. Such law may differ substantially in practical effect from the U.S. concept of domicile.[120]

A survey of this area is well beyond the scope of this paper. It cannot be emphasized too strongly how critical it is to coordinate U.S. planning with advice from competent tax advisors in the countries involved.

4. PRE-IMMIGRATION PLANNING

4.1 Pre-Residence Planning. The key to planning for the prospective resident is to determine exactly when he or she will become a resident and to carry out any tax planning steps that can best be undertaken before residence begins.

The principal pre-residence steps can be summarized as follows:

- Accurately time the beginning of U.S. tax residence for both income tax and transfer tax purposes
- Consider very carefully what immigration status is appropriate, given the punitive rules applicable to immigrants who become green card holders and become "covered expatriates" if they later leave the United States

[120] A brief survey of the position in England will illustrate this: Under English common law, an individual's domicile is initially the "domicile of origin", usually meaning the domicile of the individual's father (or the domicile of the mother in the case of illegitimate children) at the date of the individual's birth. An individual under the age of 16 will have a "domicile of dependency" based on a change in the domicile of the relevant parent. An individual can acquire a "domicile of choice" by moving to another jurisdiction and establishing an intent to remain there permanently. If the individual abandons the domicile of choice, the domicile of origin will revive until and unless the individual acquires another domicile of choice. If a couple was married prior to January 1st 1974, the wife was treated as having acquired the same domicile as her husband on that date; as a result of the Domicile and Matrimonial Proceedings Act 1973, this rule does not apply to women married on or after that date and women married before that date can acquire a domicile of choice after that date. U.K. inheritance tax laws apply these rules but can change the result in the case of an individual resident for U.K. income tax purposes for 17 of the preceding 20 years; such an individual will be deemed domiciled in the United Kingdom. See Inheritance Tax Act 1984 (United Kingdom) section 267(1)(b), as amended. Before 2017, it was 17 out of 20 years.

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- Accelerate collection of non-U.S. income
- Accelerate realization of gains not subject to U.S. tax
- Defer realization of losses
- Deal with holdings in foreign corporations, especially corporations that might become controlled foreign corporations or passive foreign investment companies following the beginning of residence
- Deal with trusts that are already in existence, whether formed by the prospective resident or by the new immigrant's family members
- To the extent necessary and possible, deal with income and gains held in deferred compensation plans and other foreign pension and savings accounts
- Make gifts and create trusts for spouse and children and otherwise take steps to keep assets from falling into the U.S. estate and gift tax net

4.2 Timing of Residence. We previously noted that residence is determined based on two tests. For a majority of new residents, the first day of residence will be determined based on the substantial presence test. In our experience, many aliens, even those who eventually obtain green cards, first become residents by virtue of spending 183 days or more in the United States in a calendar year. For example, many aliens are able to obtain H-1B, E, L or O status, which, with available renewals, may allow them and their dependents to spend sustained periods of time in the United States.[121]

[121] Status is designated based on subdivisions of 8 U.S.C. §1101(a)(15) (Aliens and Nationality), which defines the various classes of nonimmigrant aliens:
H-1B – an alien coming temporarily to the United States to perform services in a specialty occupation, defined as an occupation that requires (A) theoretical and practical application of a body of highly specialized knowledge, and (B) attainment of a bachelor's or higher degree in the specific specialty (or its equivalent) as a minimum for entry into the occupation in the United States. H-1B visas are also the ones used by fashion models.
E – an alien entitled to enter the United States under a treaty of commerce and navigation with a country of which he is a national. There are two categories: a so-called treaty trader who will carry on a substantial trade between the United States and his country of nationality; and a treaty investor, who will develop and direct a U.S. business in which he is investing a substantial amount of capital. The United States has a number of such treaties, mostly with developed countries.
L – an intercompany transferee who will be in the United States for his employer or a subsidiary or affiliate in a managerial or executive capacity or in a capacity that involves specialized knowledge
O – aliens of extraordinary ability in the sciences, arts, education, business or athletics.

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Where the alien has not spent much time in the United States in the year before moving here, it may make sense to arrive in the second part of the year. The substantial presence test requires an alien who has not been in the United States in the preceding two years to be in the United States for at least 183 days during the calendar year of arrival. By definition, such an alien arriving for the first time on or after July 3 cannot satisfy the test.[122]

If the alien has spent time in the United States in the two preceding years, those days must be taken into account according to the formula set out above. For example, an alien who spent six weeks in the United States in 2020 and another 30 days in 2021 would start with 17 days (42/6 + 30/3) and should therefore delay arriving in the United States until July 20 at the earliest.[123] Alternatively, the alien who needs to arrive earlier also needs to leave the United States for a period of time before the end of the year of arrival.

An alien who can avoid being a resident under any leg of the substantial presence test may nevertheless be able to escape tax residence in his or her country of origin for part of the year and undertake pre-immigration tax planning while a resident of nowhere. (This is not possible under the dual residence provision of a treaty, where an honest alien will always be contending with the tax laws of one of the treaty partners.) A resident of nowhere may be in a position to sell or give away assets without being subject to taxes on capital gains or transfer taxes in any country.

An alien coming to a state that imposes an income tax, particularly a state with high rates such as California or New York (or, sadly, Hawaii), has to be concerned with the residence rules of that state. In many states, it is possible to arrive later in the year and be treated as a part-year resident from the date of arrival. A survey of the rules in this area is another area beyond the scope of this article, but plainly, an individual might fail the Federal substantial presence test could become a resident of a state for state income tax purposes. Any planning that involves realization of gains or acceleration of income is therefore best accomplished prior to arrival for anything beyond a minimal stay.

[122] Bear in mind that there are 184 days in the second six months of the year.
[123] Any alien choosing to cut it this fine should carefully take into account the rule that partial days (both days of arrival and days of departure) both count as full days.

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Because the tests of residence are different, an alien who becomes a resident of the United States for income tax purposes may not immediately become a resident for estate and gift tax purposes under the U.S. version of the domicile test (and indeed may not immediately cease to be domiciled in his home country; conversely, in some cases, domicile may precede income tax residence. This needs to be taken into account in planning. While we generally counsel aliens who become green card holders to make any pre-immigration gifts before they obtain their green card, it is not inevitably the case that being accorded lawful permanent resident status means that the alien has become a U.S. domiciliary. And it is possible that aliens who spend several years in the United States under a renewable status that allows them to remain for a long time may not become domiciled for some years or may never become domiciled in the United States.

4.3 Choice of Taxable Year. A newly resident alien must adopt a taxable year, if he has not already done so in the context of prior contacts with the United States. But unlike an individual who has always been a U.S. citizen or resident, the individual may adopt a taxable year that does not end on December 31, so long as it ends on the last day of the month.[124] To do this, he needs never to have filed a U.S. return on any other basis and he must be able to demonstrate that this is the basis on which he has kept his books and records in the past. Otherwise, the calendar year will be required.[125]

For some aliens, choosing a taxable year that is coincident with their home country taxable year may make sense and it should be part of pre-residence planning or, at least, planning soon after arrival. Even if the alien is entitled to choose a taxable year other than the calendar year, however, the determination of residence under section 7701(b) will still be made on the basis of days of presence in the calendar year.

4.4 Consider Whether to Apply for Lawful Permanent Immigrant Status. The decision whether to obtain a green card will be driven by a variety of considerations, taxation being only one. But no alien with significant means or expectations should now attempt to become a lawful

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[124] This usually means that residents newly arrived from the United Kingdom must adopt a calendar year, because their taxable year ends on April 5. This is not inevitable, because a U.K. individual may, in theory, have kept books and records based on a month-end fiscal year. But the authors at least have never encountered this in practice.

[125] See section 441 and regulations thereunder.

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permanent immigrant without being made aware of the expatriation rules previously mentioned and further described below in Part 5.

For an alien who is certain that he will spend the rest of his life in the United States as an immigrant and eventually as a citizen, the decision is relatively straightforward. But for any alien who wishes to remain flexible about his long-term plans, the decision has now been complicated by the enactment of 2008 rules relating to the treatment of covered expatriates. On the one hand, a green card has a number of significant advantages over nonimmigrant status, and not just because green card holders generally do not have to endure visits to U.S. consulates as well as the longer lines and occasionally intrusive or even insulting questioning by immigration officers at U.S. borders and airports. A green card holder's minor children can obtain green cards and they can retain them after they become adults, whereas the accompanying children under nonimmigrant status lose their status when they become adults. Similarly, the green card holder's spouse can obtain a green card and, following divorce and so long as the marriage was not a sham, can retain the green card; a divorced spouse of a nonimmigrant visa holder cannot retain dependent status. Green card holders generally have few limits placed on the pursuit of legitimate activities in the United States, including employment or establishing a business. Nonimmigrants generally cannot take up employment or engage in business other than one authorized under the terms of the status.

On the other hand, the expatriation rules now provide a very strong incentive not to obtain a green card and to find a way to remain in the United States under some form of nonimmigrant status. Even for an alien with long term plans to remain in the United States, it is worth considering if it is possible and if so desirable to postpone a green card application until a relatively high level of certainty has been reached about these plans. In our practice, we have found that we are repeatedly advising high net worth individuals to defer or reconsider applying for green cards. It is no exaggeration to say that sections 877A and 2801 read as if they had been designed by the U.S. Congress to warn off wealthy immigrants.

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4.5 Accelerate Collection of Non-U.S. Income. The United States taxes most individuals based on income when received, whether in the form of cash or property.[126] It follows that an individual about to become a U.S. resident should accelerate the receipt of income which may already have been earned but not yet been paid over.

How income should be accelerated depends on the type of income. Compensation for services, both from employment and for work as an independent contractor, should be collected promptly. Where possible, the prospective resident should seek pre-payment of rents and royalties.

In theory, the same advice applies to pension plans and other forms of deferred compensation. But this is easier said than done, because of the terms of the plan and possible penalties, forfeitures and home country tax disadvantages from early distributions.

If possible, partnerships should be terminated prior to the residency starting date – a change of residence of a partner does not terminate the partnership – otherwise there is a risk that a new resident may be required to include his distributive share of the partnership's income if the partnership's taxable year ends after the residency starting date.[127]

We discuss below in greater detail how to deal with income related to foreign corporations.

4.6 Accelerate Realization of Gains Not Subject to U.S. Tax. Unlike Canada, the United States does not provide new residents with a landed basis, meaning a basis for assets not previously subject to U.S. tax jurisdiction adjusted to fair market value as of the residency starting date.[128] Therefore, if an asset is sold after the owner has become a U.S. resident, the entire amount of gain, even with respect to appreciation that arose before the residency starting date, will be recognized in full.

A prospective resident should therefore try to realize all unrealized gains before residence begins. In determining whether an asset has an unrealized gain, the basis of an asset purchased in a foreign currency must be computed by translating the foreign currency purchase price at the historical

[126] See sections 446 (general rule for methods of accounting) and 451(general rule for taxable year of inclusion).
[127] *See* Treas. Reg. § 1.706-1.
[128] For an 11-country survey of the rules in this area, see Karlin (ed.) "We'll Be Landing Soon: Income and Gains of Individuals Who Change Residence", Journal of International Taxation (March – May 2017).

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exchange rate.[129] It should also be remembered that the United States treats foreign currency transactions as realization events and that includes the exchange of the currency for another currency, including the dollar, as well as the use of the currency to purchase an asset. Therefore, a prospective resident should exchange foreign currency that has appreciated in value compared to when the currency was first acquired. For example, an individual with a bank account denominated in euros held before the euro's rise against the dollar should consider converting the euros (or spending them) before the residency starting date.

In the case of marketable assets that have appreciated in value, assets can be sold into the market. The question sometimes arises how quickly they can be repurchased. The wash sale rules of section 1091 do not apply – those rules are designed to prevent the artificial realization of losses on assets repurchased within 31 days of the sale, not to prevent the accelerated realization of gains. Nevertheless, prudence suggests a delay in repurchasing the exact same securities; repurchase of securities that are similar but not "substantially identical" would be safer.

Less liquid assets can present greater challenges, especially those which the taxpayer wants to retain over the longer term. The taxpayer should be wary of sales to related parties or accommodators, since these are vulnerable to challenges based on a lack of substance.

An installment sale that passes the test of substance is generally effective to cause gain to be realized, notwithstanding the normal rule that gain from installment sales is recognized as the installments are received. The IRS generally treats a newly resident taxpayer as if he had elected out of installment sale treatment in the case of pre-residence sales, so that the principal element of installment payments received after the taxpayer becomes a resident will not be includible.[130]

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[129] The IRS does not prescribe the use of a particular database of historical exchange rates. We recommend use of the free data available on www.oanda.com, which covers historical rates for numerous foreign currencies.

[130] Section 453(d). In Ltr. Rul. 9412008 (Dec. 20, 1993), a Canadian resident sold Canadian real property in 1986 for price payable by installments; she became a U.S. resident in 1993 while installments were still due, before which she had never been required to file a U.S. tax return. The IRS ruled that consequences of the installment sale should be determined as if the individual had elected under section 453(d) not to report the sale on the installment method. The IRS based its ruling on the legislative history for the Installment Sales Revision Act of 1980, which states that "It is anticipated that the regulations will prescribe election rules relating to the treatment of gains from deferred payment sales of property by a nonresident alien. Under the installment method rules of present law, these gains do not become taxable as payment are received after the seller becomes a resident or citizen subject to U.S. income tax for a taxable year subsequent to the year in which the sale was made. It is intended that the election regulations will continue this treatment in appropriate cases."

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The IRS apparently does not require an actual election, which might be difficult to make in the case of sales made in years in which the taxpayer may have no connection with the United States. However, we generally counsel that an election be made with respect to any sale made during the year residence begins. The new resident will need to recognize any interest income related to the installments and interest can be imputed to a pre-residence sale and taxed if earned after the residency starting date.[131]

In some cases, incoming residents actually sell their businesses on an earn-out basis and then come to the United States. Such sales typically qualify as installment sales and the treatment described in the preceding paragraph will apply. However, the earn-out component adds a layer of complication. An election out of installment sale treatment requires recognition of gain as of a sale date that will precede the beginning of U.S. residence. In the case of an earn-out, that requires valuing the earn-out payments as of the sale date. That value will be fixed and if the amounts received in the earn-out after the beginning of U.S. residence exceed the valuation, there will be gain that is taxable by the United States. Valuing the earn-out payments using U.S. valuation principles may therefore be desirable, the incentive being the highest sustainable value.

It may not be necessary to sell an appreciated family home before moving. A new resident is entitled to the exemption for up to $250,000 ($500,000 for a newly resident couple) on the sale of a principal residence, including a home located outside the United States, so long as the general requirements of section 121 are met. As a practical matter, this means that the new resident has to have lived in the home as his principal residence for at least two years before the move to the United States and then needs to complete the sale of the house within three years of moving out of the home.

There is, however, a trap in the case of foreign homes that were financed with a loan, if the U.S. dollar has appreciated against the currency in which the debt was incurred. If the property is sold after the individual has acquired U.S. residence, the gain may be smaller than the gain from simply translating the net gain at the rate on the date of sale. There may even be a loss. This is because the basis in the house will be the dollar equivalent of the cost translated at the time of purchase.

[131] Section 1274. Note that there are several exceptions to the imputed interest requirement for sales, especially sales involving proceeds of less than $250,000.

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So far, so good. But equally, there will be a gain resulting from repaying the loan because the amount borrowed in dollar terms will be higher than the amount repaid. That gain will be taxable and it cannot be offset by any loss on the sale of the house, since that loss will be personal. One way to deal with this problem is to repay or refinance the loan before residence begins. Another would be to lease the house out and turn it into an investment property before the loan is repaid.

Sometimes, the prospective resident may consider more exotic approaches, such as contribution of the assets to a corporation in a transaction deliberately designed to fail the requirements for tax-free incorporation under section 351, possibly using non-qualified preferred stock as described in section 351(g). These transactions may be subject to heightened scrutiny by the IRS but it is also doubtful that the IRS would be motivated to seek to recharacterize properly designed redeemable preferred stock as qualified preferred stock.

4.7 Defer Realization of Losses. Just as income and gains should be accelerated into the pre-residence period, so losses should (if possible) be deferred until residence begins. The entire loss on a high basis-low value asset sold after residence begins is allowable.

Sometimes, if significant losses have been realized shortly before what would otherwise be the residency starting date, it may be desirable to accelerate residence as described in Part 3.1(e)(iv) above. We have encountered this fact pattern from time to time where new residents have suffered expropriation losses in their home countries.

4.8 Deal with Holdings in Foreign Corporations. A prospective resident needs to plan for his interests in foreign corporations.

(a) Preliminary issue: entity classification. Before any planning can be undertaken, a foreign entity in which the prospective resident holds an interest must be classified for federal tax purposes. A foreign entity that is on an IRS list of about 85 companies (no more than one per country) is automatically treated as a corporation.[132] Note however that no type of company or

[132] Treas. Reg. § 301.7701-2(b)(8).

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entity formed in any offshore jurisdiction such as Bermuda, the British Virgin Islands or the Cayman Islands is on the list.[133]

A foreign entity not on the list is treated, by default, as a corporation if all shareholders or members have limited liability for the company's recourse debts. It is treated by default as a partnership if any shareholder or member has unlimited liability.[134] However, the entity, with its owners' consent, can elect to be treated as a partnership. This election, which we will refer to again below, is known as a "check-the-box" election. The election is a powerful planning tool for prospective residents.

The treatment of a business entity for U.S. tax purposes is controlling for state tax purposes but it is not controlling for non-tax purposes and it is not controlling for purposes of foreign tax law. For example, a foreign company may be treated as a partnership for U.S. tax purposes but as a separate entity subject to the foreign country's tax. This sort of inconsistent treatment is very common in international tax planning and compliance.

In the balance of this portion of this chapter, any reference to a foreign corporation is to an entity classified as a corporation for federal income tax purposes.

(b) Taxation of foreign corporations held by U.S. persons. In general, the United States does not tax foreign corporations on foreign income or on certain kinds of U.S.-related income. This means that there is a potential for U.S. persons to defer tax on foreign and even some types of U.S. income by having it earned through a foreign corporation, so that tax is payable only when the income is distributed to the U.S. shareholder or the U.S. shareholder sells the shares of the foreign corporation. This is sometimes referred to as the "deferral benefit".

Over many decades, the United States enacted anti-avoidance measures designed to counteract the deferral benefit. The American Jobs Creation Act of 2004 in October 2004 contracted these

[133] The one exception for traditional tax haven jurisdictions is Panama – a Panamanian *sociedad anonima* is automatically classified as a corporation.
[134] If an entity would be treated as a partnership but only has one owner, the entity is instead disregarded as an entity separate from the owner. Where the owner is an individual, it is convenient to refer to the entity as a sole proprietorship of the owner; where the owner is itself a corporation or other entity, it is convenient to think of the disregarded entity as a branch of the owner.

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measures into two regimes, namely the controlled foreign corporation (CFC rules), directed at closely held foreign corporations, and the passive foreign investment company (PFIC) rules, directed at offshore funds.

(c) CFCs.

(i) Overview. CFCs are foreign corporations majority-controlled by "United States shareholders" – a United States shareholder being defined as a person resident in the United States who owns, directly, indirectly or by attribution at least 10% of the shares of the foreign corporation.[135] So far as a new resident is concerned, a foreign corporation may already be a CFC because of the existing composition of the shareholder body; if the new resident is a 10% shareholder, he will become subject to the CFC rules. Alternatively, the foreign corporation may become a CFC as a result of the individual becoming a U.S. resident – either because the individual was the majority shareholder or because his shareholding causes the percentages of voting power or value held by U.S. shareholders to exceed 50%.

The principal consequence for a United States shareholder of owning shares in a CFC is that certain kinds of the CFC's income, known as Subpart F income and "global intangible low-tax income" (GILTI), are treated as distributed to the shareholder each year and taxed at ordinary rates. Subpart F income refers to passive income and to certain income generated outside the CFC's country of incorporation from related party business transactions. GILTI refers to all other income of the CFC (less allocable deductions) reduced by 10% of the adjusted tax basis of the CFC's depreciable tangible assets (generally, plant and equipment, but not land).[136] CFC status therefore can eliminate the deferral benefit by accelerating the tax on the U.S. shareholder.

[135] More specifically, a "United States shareholder" is a holder of 10% or more of the voting stock or (since 2018) 10% or more of the total value of the corporation; the shareholder's holding includes shares held directly or indirectly and also shares held by attribution from family members and others under a modified version of section 318(a). A CFC is defined as a foreign corporation where United States shareholders own more than 50% of the voting power or more than 50% of the value of the corporation. See IRC sections 957 and 958.

[136] The GILTI regime was put in place by the 2017 Act (P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act), as a base protection measure to deter taxpayers from shifting highly mobile income from intangible property to low-tax jurisdictions. Due to the administrative difficulty in identifying income attributable to intangible assets, rather than explicitly identifying intangible income, the GILTI provisions approximate the intangible income of a CFC by assuming a 10% rate of return on the tangible assets of the CFC, and any income in excess of that "normal return" on assets is effectively treated as intangible income. See section 951A.

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In addition, U.S. shareholders will pay tax on their share of non-Subpart F, non-GILTI income when it is actually distributed by the CFC to the shareholders or, in certain circumstances, deemed to be distributed. One situation where non-Subpart F income, non-GILTI is deemed to be distributed is where the CFC acquires U.S. assets.[137] Another is where the shareholder sells stock of a CFC, in which case gain will be treated as a dividend to the extent of the U.S. shareholder's share of undistributed non-Subpart F, non-GILTI earnings and profits; the amount taxable as a capital gain will be reduced accordingly.[138]

(ii) Pre-residence planning. A prospective resident who will become a United States shareholder of an existing or newly minted CFC needs to be advised on how to mitigate the impact of the Subpart F and GILTI rules. Because of the wide variety of possible fact patterns, this is a topic of such broad scope that it cannot be addressed here. We note only that the corporate structure and activities of the foreign corporation need to be analyzed and a determination made as to whether to employ a number of possible strategies, including:

- Make distributions of accumulated earnings and profits to the prospective resident
- Have the foreign corporation sell or otherwise realize gain on assets and distribute the proceeds
- Have the foreign corporation distribute assets to the prospective resident
- Make a check-the-box election with respect to the foreign corporation and/or its subsidiaries
- Restructure the foreign corporate group

The check-the-box election can be useful in undertaking restructurings because it has no effect for foreign tax purposes. It is also a powerful tool because it is treated as a liquidation of the corporation that results in a step up in basis for U.S. tax purposes of all the underlying assets and an immediate deemed distribution of all earnings and profits, none of which should be taxed to

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[137] Section 956. A deemed distribution can also occur under section 956 if the CFC lends money or property to the U.S. shareholder or when the CFC invests money or property in the United States; it can also occur in certain circumstances when the U.S. shareholder pledges shares of the foreign corporation to secure a loan.
[138] Section 1248.

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the prospective resident if the election is made effective before the residency starting date.[139] Furthermore, the newly resident shareholder will then be taxed on the income of the corporation as if it were a partnership and allowed to claim a foreign tax credit for tax on future earnings. Unlike U.S. corporations that own at least 10% of the shares of a foreign corporation, individuals are generally not allowed a credit for foreign tax paid by the corporation.[140] But if the corporation is classified as a partnership, the individual shareholder can now claim a pass-through of the credits.

(Almost) needless to say, the election requires the cooperation of the foreign corporation both in the making of the election and in subsequent provision of information which the new resident will have in turn to report to the IRS. That cooperation does not technically require the consent of other shareholders (with an exception too arcane to discuss here) but we can imagine that if the corporation already has U.S. persons as shareholders, whether holding more or less than 10%, those shareholders will want their interests taken into account before the election is made.

Once the individual has become a U.S. resident, section 962 provides a special rule which allows a U.S. individual shareholder to elect to be taxed as a corporation on amounts included in gross income under sections 951(a) and 951A to get the benefit of section 960 foreign tax credits with respect to such income. In the absence of a Section 962 election, this foreign tax credit is disallowed. However, a disadvantage of the election is that when the corporate profits are distributed, the dividends will be taxed again at to the individual, which may result in a higher overall effective tax rate than if no section 962 election were made. Therefore, it is important to consider all the facts and circumstances and to model out the tax impacts of the election against other planning options.

(d) PFICs.

[139] Clearing out the earnings and profits has another important benefit, which is that it will avoid the future need to reconstruct the earnings and profits of the corporation U.S. tax purposes, which could be particularly difficult for a long-established foreign corporation which had never had any connection to the United States before the shareholder became a U.S. resident.

[140] There is an exception for withholding taxes on dividends. Even though the tax is collected by the foreign corporation, it is deemed to be imposed on the shareholder and is therefore creditable at the shareholder level.

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(i) Overview. A foreign corporation is a PFIC with respect to a U.S. person if (i) it is not a CFC or, if it is, the U.S. person in question is not a United States shareholder; and (ii) it meets one or other of certain tests concerning the percentage of its income that is passive income and the percentage of its assets that generate passive income. If a corporation is a PFIC, then unlike in the case of the CFC, there is no minimum percentage shareholding requirement for PFIC treatment to apply.[141]

The PFIC rules are extraordinarily complex and PFIC status is highly disadvantageous. The rules were designed to counteract the otherwise advantageous treatment of offshore investment funds compared to U.S. mutual funds prior to enactment of the PFIC rules in 1986. However, the reach of the rules goes beyond investment funds and the rules go beyond the counteracting of the advantages available under prior law.

The question of whether a person owns PFIC stock requires extensive analysis. In recent years, the IRS has issued some regulations clarifying the attribution rules for ownership of PFIC stock. For instance, proposed regulations in 2022 provide that a person is treated as actually owning his proportionate share of stock owned by an entity directly held by the person for further attribution.[142] For example, if a U.S. resident holds an interest in a U.S. partnership that holds PFIC stock, the U.S. resident is treated as holding his proportionate amount of stock in that PFIC. Further, any information reporting requirements with respect to the PFIC stock do not apply to the U.S. partnership; they apply to the U.S. resident.[143]

The principal consequence for a U.S. person of owning shares in a PFIC is that when the PFIC distributes income to a U.S. shareholder in excess of an annual average level of distributions,[144] the tax on the so-called excess distribution is increased by an interest charge which operates in an extremely punitive manner. Moreover, any capital gain on the sale of a share in a PFIC is taxed at ordinary income tax rates and the gain is treated in its entirety as an excess distribution.

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[141] Sections 1297 and 1298.
[142] Proposed Treasury Reg. §§ 1.1291-1(b)(7), 1.1295-1(j)(3), 1.1296-1(a)(4).
[143] Proposed Treasury Reg. § 1.1298-1(b)(1).
[144] Section 1291. Specifically, a distribution is known as an "excess distribution" with respect to a share in a PFIC if it exceeds 125% of the average of the distributions made with respect to such share over the three preceding taxable years.

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A U.S. shareholder can elect out of these rules by making what is known as a "qualified electing fund" election with respect to a holding in a PFIC but only if the PFIC cooperates with in providing information – often not the case with offshore funds. In part this is because many such funds do not wish to have U.S. investors and those that do organize themselves into two parallel funds, one organized offshore that is available only to non-U.S. investors and one organized in the United States that is available only to U.S. investors. At all events, the effect of a QEF election is that the U.S. shareholder is required to include in his income for the taxable year his share of the "ordinary" earnings and profits of the QEF for the QEF's taxable year ending in the shareholder's taxable year and also his share of the QEF's net capital gain. As a result, the U.S. shareholder gives up deferral but gets capital gains treatment.[145]

Another alternative, in the case of publicly traded stock, is to make an annual mark-to-market election under section 1296.

(ii) Pre-residence planning. Prospective residents need to analyze their entire portfolio of non-U.S. equity securities and determine if any of the securities would be PFICs following the residency starting date.

For securities in foreign corporations that would not be PFICs, a transaction to step up basis should be considered. Otherwise, the taxation of income derived from such securities, especially from shares of corporations resident in treaty countries, is virtually identical to the taxation of income derived from U.S. shares.

If, however, the corporations would be PFICs, then what to do depends on a variety of factors, some of them not tax factors. Some possibilities:

- Sell offshore funds, especially those with respect to which a QEF election would not be possible because the fund will not provide the necessary information to U.S. holders of interests in the fund.
- Retain the funds but make a QEF election. Bear in mind that a QEF election may be difficult or ineffective in the case of funds that are organized as "fund of funds", where the prospective

[145] Section 1293.

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resident has to be concerned not only with the status of the funds as a PFIC but also the status of the underlying funds.

- Exchange the funds for their U.S. equivalents. Many funds have a parallel structure for U.S. and non-U.S. investors and will permit (or even require) a fund holder moving to the United States to exchange into the U.S. version.
- In the case of foreign corporations that are not funds, but would be PFICs because of their assets or income, consider having the corporation make a check-the-box election. This technique is most likely to make sense where the prospective resident is the minority shareholder of a corporation controlled by foreign family members, although foreign family members can sometimes be reluctant to accede to a request for the election to be made, however earnestly they are assured that the election will not affect them or the corporation. As in the case of an election with respect to a corporation that would otherwise become a CFC, the election causes a step up in basis for U.S. tax purposes of all the underlying assets and an immediate deemed distribution of all earnings and profits, none of which should be taxed to the prospective resident if the election is made effective before the residency starting date.
- The prospective resident should be particularly wary of the treatment of PFICs held by foreign trusts. The IRS considers that a U.S. beneficiary of a trust is treated as the owner of PFIC securities owned by a trust, based on the U.S. beneficiary's interest in the trust. Although the U.S. beneficiary's interest may be difficult to ascertain, especially if the trust is discretionary and there are both foreign and U.S. beneficiaries, the IRS will look at actuarial interests, distribution patterns, letters of wishes and, if all else fails, it will require a determination of which beneficiaries would receive the trust's assets upon a termination of the trust.[146]

[146] For a partial discussion of these issues, see TAM 200733024 (Oct. 26, 2006; released Aug. 17, 2007). The PFIC rules were first enacted in 1986 and are in great need of clarification and implementation by regulations. The IRS has issued piecemeal regulations on a limited number of issues. As of February 2022, the Treasury regulations indicate that a United States person that is considered to own an interest in a PFIC because it is the beneficiary of an estate or a trust that owns stock of a PFIC, is not required under section 1298(f) to file Form 8621 with respect to the stock of the PFIC if the beneficiary is not treated as receiving an excess distribution or as recognizing gain that is treated as an excess distribution with respect to the stock. The 2022 proposed regulations indicate that more comprehensive PFIC guidance is being worked on. The authors' view is that no one should hold their breath waiting for this guidance.

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4.9 Foreign Trusts. The taxation of foreign trusts in which a U.S. individual is an actual or potential beneficiary is a vast topic with critical unresolved issues. This paper can do no more than skim the surface.

(a) Trust classifications. All trusts need to be classified as grantor or nongrantor trusts, domestic or foreign and simple or complex.

(i) Grantor trust or nongrantor (or ordinary) trust. Every trust must be classified either as a grantor trust or an ordinary trust. A grantor trust is one where the grantor (essentially the settlor and others who add assets to the trust) retains certain rights or powers, some obvious ones such as the right to receive income, some less obvious such as the right of the grantor to control the disposition of trust assets or income or certain administrative powers.[147] A common misconception is that the grantor and settlor of a trust are necessarily the same person. As far as U.S. tax law is concerned, while a settlor of a trust may be treated as the grantor, the true grantor is the person who made the gratuitous transfers with which the trust was funded.[148]

Where the grantor is foreign, however, the grantor trust rules apply only if and to the extent they result in income of the trust being taken into account by a U.S. person.[149] There are two exceptions: The first is where the trust contains a power to re-vest absolutely in the grantor title to trust property is exercisable solely by the grantor either without the approval or consent of any other person or only with the consent of a related or subordinate party who is subservient to the grantor. (A trust containing such a power is commonly referred to as revocable trust.) The second is where the only amounts distributable during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

Grantor trust status lasts only as long as the grantor is alive. A trust may be subject to equivalent treatment if following the grantor's lifetime powers to re-vest the income or capital belong to someone else.[150] But this rule does not apply if the holder of the power is foreign.

[147] Sections 671 – 679.
[148] See Treas. Reg. §1.671-2(e).
[149] Section 672(f).
[150] Section 678.

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Prospective residents should be aware of a special U.S. rule concerning foreign trusts. A trust will be a grantor trust if it is established by a U.S. person and, at any time in the year, has a U.S. beneficiary, including a beneficiary who may not be entitled to current distributions of income but to whom income or capital may be distributed at some future point.[151] In 1997, this rule was extended to a trust established by a nonresident alien if the alien becomes a U.S. resident within five years following the date of the transfer of assets to the trust.[152]

(ii) Foreign trust or domestic trust. For U.S tax purposes, all trusts are either foreign or domestic. A foreign trust is one that is not domestic. A domestic trust is one that satisfies both prongs of a two-prong test: (i) the trust's administration must be subject to the jurisdiction of a U.S. court ("Court Test") and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust ("Control Test").[153]

A foreign trust is treated for tax purposes as a nonresident alien individual and only taxable to the extent a nonresident alien would be taxable under U.S. law.

(iii) Simple or complex trust. A simple trust is one that is obligated to distribute all of its income to its beneficiaries on a current basis. A complex trust is a trust where the trust does not have to make such distributions. A foreign trust that looks like a simple trust will nevertheless be a complex trust if it is not obligated to distribute its capital gains on a current basis. This would not make it a complex trust if it were a domestic trust; but special rules apply to a foreign trust that does not have to distribute capital gains on a current basis.

(b) Substantive U.S. tax consequences.

(i) Grantor trust. The grantor of a grantor trust, including a foreign trust that meets the requirements of section 672(f), is the sole taxpayer with respect to the income and gains of

[151] Section 679.
[152] Section 670(a)(4). It is theoretically possible for a trust to be a grantor trust with respect to the part of the trust attributable to transfers made within the five-year period and not with respect to the part of the trust attributable to earlier transfers.
[153] Sections 7701(a)(30)(E) and (31).

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the trust. The trust is not subject to income tax nor are the beneficiaries, even U.S. beneficiaries.[154]

(ii) Nongrantor trust. A foreign nongrantor trust has, in summary, the following U.S. tax consequences:

Grantor. Where a trust is a nongrantor trust, the grantor is not taxed on income of the trust. This can result in potential double taxation for trustees and beneficiaries where the settlor is subject to tax under non-U.S. analogues of the grantor trust rules. This is because the United States will not give a foreign tax credit to the trust or the beneficiaries for tax paid by the grantor on the same income. Also, the United States generally will not give an increased basis for assets which the grantor may be deemed under foreign law to have sold but did not actually sell.

Trust. A foreign ordinary trust is treated as a nonresident alien. The United States taxes nonresident aliens on investment income from U.S. sources and on income that is effectively connected with a U.S. trade or business.[155] Assuming that the trustees do not engage in any U.S. activity that would be taxable to a nonresident alien, a foreign trust will not be subject to U.S. tax. It is relatively rare to encounter a foreign trust (with a beneficiary who is a prospective U.S. resident) that is engaged in a U.S. business.[156] However, such trusts commonly own U.S. securities. Dividend income from such securities will generally be taxable at a rate of 30% or a lower treaty rate; interest income is usually exempt either under the portfolio interest or bank interest exemptions.[157] Capital gains will not be subject to tax, unless the securities are U.S. real property interests.[158]

Beneficiaries. The treatment of U.S. beneficiaries of a foreign trust is quite a bit more complicated than the treatment of U.S. beneficiaries of a domestic trust.

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[154] Rev. Rul. 69-70, 1969-1 C.B. 182.
[155] Sections 871(a) and (b).
[156] Occasionally, we encounter trusts that are members of entities classified as partnerships for U.S. purposes. If such entity is engaged in a U.S. trade or business, the trust (and any other foreign member) would be treated as engaged in such trade or business. Section 875.
[157] Section 871.
[158] Section 897.

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The starting point is the same as for domestic trusts: The beneficiary is taxed each year on any distribution required to be made by the trust and also on any distribution actually made, not to exceed the amount of distributable net income (DNI) of the trust. DNI is essentially defined as the taxable income of the trust; in the case of a foreign trust, DNI is computed as if the trust were a U.S. person.[159] However, unlike in the case of a domestic trust, the DNI of a foreign trust includes all of the capital gains of the trust, whether or not distributed.[160] Distributions are taxed in the year made; however, an election may be made to treat a distribution made not later than 65 days after the close of the taxable year of the trust as being made in that taxable year.[161]

In the case of domestic trusts, since 1997 a distribution exceeding DNI of the trust has not been taxable to beneficiaries, the undistributed income of the trust having already been taxed to the trust. As a result, the distinction between ordinary and complex trusts has become less significant, although it is still necessary to determine which beneficiaries are required to include income that is required to be distributed.

But in the case of a distribution by a foreign trust, such a distribution will still be taxable to the extent it is an "accumulation distribution" made out of the undistributed net income (UNI) of the trust from prior taxable years. Any capital gains included in the UNI will not preserve their character in the hands of the U.S. beneficiary, meaning that the entire distribution will be taxed at ordinary income rates. Moreover, the U.S. beneficiary of a foreign trust will be subject to an interest charge on tax attributable to UNI. Although distributions are generally treated for tax purposes as being made from the UNI attributable to the earliest years in which such UNI was accumulated, the interest charge is computed based on a weighted average of UNI spread over the years in which income was accumulated.[162] The United States does allow a foreign tax credit for foreign taxes paid by the trust (but not by some other person, such as a grantor, even if under local law the tax was paid by the grantor with reference to the trust income).[163]

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[159] Other adjustments disallow the deduction of trust distributions and personal exemptions and require the inclusion of certain tax-exempt interest. Special treatment may apply to extraordinary dividends and taxable stock dividends.
[160] Section 643(a); and especially section 643(a)(6), which contains the adjustments applicable to foreign trusts.
[161] Section 663(b).
[162] Sections 665 to 668.
[163] Section 665(d)(2).

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(c) Pre-residence planning. Prospective residents should consider how to deal with the foreign trusts of which they are grantors and/or beneficiaries. As in all of the cases discussed above, it is much easier to implement planning before the individual has become a resident. But this is particularly true for foreign trusts because there are, unfortunately, some surprising gaps in the applicable rules.

(i) Grantor trusts. Where the grantor of the trust is and will remain a foreign person, that is, the prospective resident is not the grantor, the trust's status will not be affected by the change of residence of the beneficiary. Therefore, trust income and gains will be treated as belonging to the grantor and will be taxable only if they fall within the limited classes of income that are subject to U.S. tax in the hands of a nonresident alien. This treatment is favorable to the beneficiary and need not be disturbed. The newly resident beneficiary is required to report distributions from the trust. While there is no substantive income tax imposed on the distribution, there is a 35% penalty for failing to report.[164]

If the prospective resident is the grantor of a grantor trust, the trust will remain a grantor trust following the residency starting date. The grantor will be subject to reporting requirements if the trust remains foreign and the same severe penalty will apply to failures to report.[165] The trust will otherwise be subject to normal grantor trust treatment, in which the new resident is required to include all of the income and gains of the trust in his income.

Some unusual problems arise where the foreign trust was not a grantor trust before the grantor became a U.S. resident but becomes a grantor trust as a result of the change of residence. There appears to be no authority for what happens to the income of the trust accumulated before the change of residence.

(ii) Nongrantor trusts. A more complex set of choices confronts the prospective U.S. resident beneficiary of a foreign trust. The discussion below assumes that the trustees and any trust protector will cooperate with the beneficiary and that the interests of other beneficiaries will

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[164] Section 6048. IRS Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts). The 35% penalty applicable to failure to file Forms 3520 and 3520-A (see footnote 165 below) are provided by section 6677.

[165] IRS Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner).

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not interfere with any planning. But these assumptions should not be taken for granted. Also, it is not uncommon to encounter foreign trusts which specifically exclude a beneficiary from taking any benefit under the trust while the beneficiary is a U.S. citizen or resident. The trust should be examined to ensure it does not contain such a provision or consideration should be given to having the trust varied.

As a starting point, the prospective resident should assess with the trustees the amount of undistributed net income held by the trust. This can be a challenge, because the typical foreign trust will rarely have kept books and records that will allow for a straightforward computation of UNI under U.S. principles. Trust accounting in typical jurisdictions based on English law, where many of these trusts will be found, is very different in substance and presentation from U.S. trust accounting.

The even more delicate question is how to deal with the UNI, assuming some reasonable estimate can be made. As a practical matter, if the new resident will never receive distributions that will exceed DNI, the need to take any action is reduced. For this purpose, a distribution by a foreign trust includes not only direct distributions but also indirect distributions having a tax avoidance intent and loans that do not meet a narrow set of criteria for "qualified obligations".[166]

The first question that arises is therefore whether the new resident will be taxed on accumulation distributions that are attributable to UNI earned by the trust in years before the residence began. It is at least clear that no interest can be imposed on a distribution with respect to a year when the beneficiary was not a U.S. resident.[167] But otherwise it is not at all clear whether the distribution itself is taxable. We understand that the IRS position is that it is; but cogent arguments can be (and have been) made that such a distribution is not taxable.[168]

If accumulation distributions can be taxed only to the extent they relate to income accumulated after the date of residence, a secondary question is whether distributions in excess of DNI are to be attributed first to UNI accumulated after the residency starting date or should be attributed to

[166] Sections 643(h) and (i); see also IRS Notice 97-34, 1997-1 C.B. 422, especially Part V and Treas. Reg. §1.643(h) (Distributions by certain foreign trusts through intermediaries.)
[167] Section 668(a)(4).
[168] See Nuñez and Mirabito, "Just Off the Boat, Trust Fund in Hand", Trusts and Estates (Dec. 2005).

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pre-residence UNI on a first in-first out basis. Another way of stating this question is to ask whether the pre-residence UNI is exempt or simply not UNI at all.

Depending on, among many other factors, the prospective resident's appetite for U.S. tax risk of a highly technical nature, the better alternative may be to find a way to clear out UNI from the trust. This can be done before or after the residency starting date, so long as the distribution is made to a nonresident. In other words, the UNI can be cleared out by distribution to the prospective resident before the residency starting date, but thereafter can only be cleared out by distribution to one or more beneficiaries who have not become U.S. persons.

One obvious disadvantage to the prospective resident receiving a large distribution before becoming a U.S. resident will be that the distribution will become part of his estate for U.S. tax purposes once he becomes resident for purposes of the estate tax (it will be remembered from our earlier discussion that residence is defined differently for income and estate tax purposes). Consideration may therefore be given to domesticating the trust or re-settling all or a part of it, a process sometimes referred to as "decanting".[169] But decanting offers its own challenges: It has to be effective to clear out DNI and UNI without causing the prospective beneficiary to be treated as the grantor of the trust for income tax purposes and without bringing into play the retained interest provisions of the estate tax laws.[170]

Perhaps we should leave this subject at this point. As promised, we have skimmed the surface of a mighty and complex problem. Switching metaphors, any prospective resident and his advisors should have plenty of food for thought.

4.10 Foreign Deferred Compensation Plans, Pensions and Savings Accounts. New residents often come to the United States as members of deferred compensation plans established by their companies. Few of these plans are qualified, unless the new resident worked for a U.S. company or for a foreign multinational that regularly employs Americans.

[169] Decanting is a word that has no technical definition and is used by practitioners to refer to several kinds of transactions involving the distribution of trust capital and/or the conversion or domestication of a trust.
[170] Section 2036.

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Section 409A potentially presents particular difficulties for new residents because it potentially applies in all its variegated severity from the residency starting date. However, there are a number of exceptions that may be helpful to U.S. members of foreign plans otherwise within the cross-hairs of section, including:[171]

- the short-term deferral exemption for plans that require payment within 2½ months of the end of the first year the compensation first becomes vested;
- the grandfathered plan exemption, for amounts that were earned and vested under a plan prior to January 1, 2005, provided that the plan is not materially modified after October 3, 2004;
- a regulatory exemption for foreign "broad-based" unfunded retirement plans if:[172]

  (1) the plan (alone or in combination with other comparable plans) covers a wide range of employees substantially all of whom are nonresident aliens, including rank and file employees;
  (2) the plan provides significant benefits to a substantial majority of such covered employees;
  (3) the benefits actually provided under the plan are nondiscriminatory; and
  (4) the plan has in-service withdrawal restrictions to discourage employees from using plan benefits for non-retirement purposes, with some limited exceptions.

If the individual is a U.S. citizen or lawful permanent resident, then the individual must not be eligible to participate in a "U.S. qualified plan," regardless of whether the individual actually participates and the exemption is subject to additional limitations. An individual who is resident only under the substantial presence test may continue to accrue benefits under the foreign plan without these restrictions.

Section 409A does not apply to plans that are fully funded. If amounts contributed to such a plan vest fully before the individual becomes a U.S. resident, those amounts are exempt from U.S. income tax to the extent they relate to services performed outside the United States.[173]

[171] We are indebted to Sandra Cohen for her helpful discussion of the application of section 409A in the international context. Cohen, "Addressing Foreign Plan Issues Under §409A", 37 TM International Journal 584 (2008).
[172] Treas. Reg. §1.409A-1(a)(3)(v).
[173] Treas. Reg. § 1.409A-1(b)(8)(ii).

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Distributions from the plan while the individual is a U.S. resident will be taxable in the normal way. Employer contributions to the plan while the individual is a U.S. resident will generally be taxed to the individual unless steps are taken to qualify the plan.

Pension plans and savings accounts present a number of difficulties. These plans will generally not have been designed to meet U.S. requirements. As a result, once an individual becomes a U.S. resident, he or she may become taxable on income earned by the plan or account even though the terms of the plan do not permit withdrawal of funds or would condition withdrawal on significant fees or penalties. Even if the design of the plan or account is such that the individual would not be taxable on this income, he or she will become taxable once the plan pays out benefits at any time after income tax residence has begun, at least to the extent the benefits are attributable to income earned by the plan.

One key consideration relates to the ownership of any plan or account. Where the individual is the beneficial owner of the plan or account, the individual will be taxable in the United States on the income as it arises. There are treaty exceptions in the case of Canadian registered retirement savings plans (RRSPs) and some other foreign plans – this is one of the relatively rare cases where a U.S. citizen or resident is allowed to rely on a treaty for U.S. tax purposes. Foreign equivalents of IRAs, such as the U.K. individual savings account (ISA), are generally treated as foreign grantor trusts, with Form 3520 and 3520-A reporting requirements. The treatment of Australian superannuation funds, which are individually owned funds to which Australian residents must contribute 9.5% of their annual income (12% between 2021 and 2025), is uncertain.[174]

The United States treats plans in which an employee only has a contractual right to a pension or other benefit differently. In such a case, the employer or the plan administrators are treated as the owner of the plan assets and income. Accordingly, the employee (or former employee) will be taxable only when distributions are received.

[174] At least one author believes they should be treated as "are covered under Paragraph 2 of Article 18 of the tax treaty with Australia as privatized individual social security accounts that are exclusively taxable in the country of source, Australia." Castro, U.S. Tax Treatment of Australian Superannuation, 2 Nev. L.J. Forum 91 (2018), available at https://scholars.law.unlv.edu/cgi/viewcontent.cgi?article=1010&context=nljforum (viewed March 21, 2022). But this is not a universally shared view.

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Whichever type of plan it is, the simple advice is to have the plan distribute its assets to the individual before he becomes a U.S. resident. But this advice may not be practical. Any pre-residence planning for foreign deferred compensation plans, as well as pension plans and savings accounts is generally limited by the terms and limitations set by the plan or the foreign legislation under which the plan was established. The prospective resident should contact the plan administrators or trustees to determine if it is possible to receive a lump sum distribution prior to the move to the United States. He or she should also determine the local tax consequences of such a distribution. Where the incoming resident is the beneficiary of a foreign plan that was funded by employer or employee contributions, section 72(w) comes into play. This provision was introduced by the American Jobs Creation Act of 2004. It provides that the "investment in the contract" (the portion of a pension account that is to be returned taxfree to the account holder through a series of distributions) does not include amounts that were contributed by an employer or employee with respect to foreign services performed by the employee that were not taxed by the foreign country but would have been taxable in the foreign country had they been paid as compensation. In other words, when the incoming resident eventually receives pension payments, the taxable portion of those payments will include the return of contributions on which tax was not paid in the foreign country when contributed by the employer or were deductible by the employee for foreign tax purposes when contributed by the employee.

Section 72(w) is somewhat curmudgeonly but its scope is limited to contributions to foreign plans that related to the performance of services. At least by its terms, it does not appear to apply to contributions to savings plans that were unrelated to employment, such as a Canadian RRSP.

4.11 Social Security Coverage and Benefits. A new resident may need to give consideration to social security issues. New immigrants generally become subject to the U.S. social security system immediately. However, the United States may not recognize contributions made to the previous country of residence and, in some cases, both countries may claim that the individual is subject to contribution requirements.

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To alleviate these problems, the United States has entered into social security agreements with 31 countries, 30 of which are in effect.[175] The agreements cover two principal subjects, coverage and benefits. Coverage refers to the country to which contributions should be made; benefits refers to the entitlement to benefits under the respective social security systems of the United States and its treaty partner. Of particular relevance to workers, employed or self-employed, moving to the United States are the coverage provisions, which typically allow a temporary immigrant to remain within his or her home country system until it becomes clear that the immigrant's stay will exceed five years. The agreements also require each country to recognize contributions made to the other country in determining benefits.

4.12 Gifts and Trusts for Spouse and Children. Given the heavy burden of U.S. gift and estate taxation, a prospective resident needs to consider what pre-residence gifts can be made and whether to structure the gifts outright or in trust. As noted earlier, residence for income tax purposes and gift and estate tax purposes are defined differently and therefore it is possible to become a resident for the purposes of one before the other. For example, an individual who takes advantage of the income tax planning suggested above by arriving in the second half of the year may nevertheless become a U.S. domiciliary immediately. Conversely, an individual may become a resident without immediately or, in some cases, ever becoming a U.S. domiciliary.

This article is primarily concerned with income tax planning and the gift and estate tax planning aspects of outright gifts, as gifts in trust are a vast topic worthy of more attention than we can provide here. Some highlights:

(a) Gifts to Spouses. Couples moving to the United States should consider equalizing their estates before they arrive, especially if both spouses (or the less wealthy spouse) are not U.S. citizens. While the United States allows an unlimited marital deduction for gifts and bequests to spouses, the deduction is available in the case of bequests to non-citizen spouses only if the

[175] Australia, Austria, Belgium, Brazil, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (South), Luxembourg, Netherlands, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, United Kingdom, and Uruguay. An agreement with Mexico signed in 2004 still awaits ratification. These agreements, together with plain English explanations, can be found on the very helpful international pages of the Social Security Administration at http://www.ssa.gov/international/.

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property is tied up in a qualified domestic trust and, in the case of gifts, an annual exclusion of $100,000 is allowed.[176]

Given these limitations, it plainly makes sense to make gifts before any of these restrictions take effect. In practice, however, non-tax considerations may predominate. A wealthy couple (or the wealthier half) may not wish to change the balance of wealth or to disturb existing pre-marital agreements.[177] But where such considerations do not obstruct tax planning, pre-residence gifts can be considered to equalize the spouse's estates or even to transfer wealth from an older spouse to a younger one.

(b) Gifts to Children. Gifts to children and younger generations should also be considered before arrival. The structure of the gift may depend on the age of the child and also whether the child becomes a U.S. resident.

In many cases, the gift will be made in trust. One consideration will be whether the trust will be a grantor trust (that is, the donor will want to be responsible for income taxes on the trust's income) even though the gift is complete and therefore the property is out of the donor's estate. If the prospective resident does not mind the trust being a grantor trust, the trust can be established as a foreign trust; otherwise, it must be established as a domestic trust unless it is established more than five years before the residency starting date.[178]

If the children will not become U.S. residents, the trust can be a foreign trust without being automatically treated as a grantor trust under section 679. The trust cannot have any U.S. beneficiaries and therefore any trust for non-U.S. beneficiaries should be kept separate from trusts

[176] Sections 2056(d), 2056A and 2523(i). This $100,000 limit is subject to cost of living adjustments and the maximum annual gift to a noncitizen spouse is $164,000 for 2022.

[177] A word of caution on a non-tax point: It should not be assumed that pre- or post-marital agreements entered into outside the United States will necessarily be enforceable in the United States. This will be a matter of state law. See, in general, "Family Law Disputes Between International Couples in U.S. Courts", 43 Family Advocate No. 2 (November 1, 2020), available at https://www.americanbar.org/groups/family_law/publications/family-advocate/2020/fall/family-law-disputes-between-international-couples-us-courts/. For a look at this issue under California law, see Walzer, "Foreign Affairs", 31 Los Angeles Lawyer 18 (December 2008).

[178] Section 679(a)(4).

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which have U.S. beneficiaries. Alternatively, the trust could be drafted to exclude benefit to any beneficiary who become U.S. residents or citizens.

For prospective residents with grandchildren, pre-residence gifts, both outright and in trust, will be effective to avoid application of the tax on generation-skipping transfers. The tax applies to gifts and bequests by nonresident aliens to the extent that the transferred property was situated in the United States for purposes of the gift tax or estate tax, as applicable.[179] Consequently, if the initial transfer does not consist of property subject to the relevant tax, subsequent transfers will be exempt from the tax, even if the original property has been reinvested in property located in the United States.

4.13 Tax Compliance. As noted earlier, if the newly resident alien had previously submitted one or more Forms W-8BEN to U.S. payors of income, the alien must submit to the payor a Form W-9 to notify the payor of the change of status. This is required to be done within 30 days of the change. As also noted, the change of status may be retroactive to the first day of physical presence during the taxable year. Residence under a section 6013(g) or (h) election does not apply for purpose of Chapter 3 withholding, but if the Form W-8BEN included a treaty claim of withholding at zero or at a reduced rate, it must be resubmitted without the claim, because the election requires a waiver of treaty benefits.[180]

The new resident will become subject to taxation on worldwide income. Therefore, the new resident generally must file an income tax return for the taxable year in which residence begins (unless the alien does not meet the minimum thresholds for filing). The return must be filed on Form 1040. Unless a joint return for the whole year is filed under section 6013(g) or (h), discussed above, a separate schedule is required to be attached to show the income tax computation for the part of the taxable year during which the alien was neither a citizen nor resident of the United States. A Form 1040NR, clearly marked "Statement" across the top,

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[179] Treas. Reg. § 26.2663-2. Note that the scope of the estate tax and gift tax as applied to nonresident aliens is different: Generally, the gift tax applies only to transfers of U.S. real property and tangible property physically located in the United States (including cash) and it therefore does not apply to gifts of U.S. securities. The estate tax applies to all kinds of property located in the United States, including U.S. equity securities and most intangibles, other than non-business U.S. bank accounts and most corporate bonds. Cf. section 2104 and 2105 with sections 2501(a) and 2511.

[180] See discussion in Part 3.1(h) above.

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may be used as such a separate schedule. The schedule is not required if the alien would not otherwise have been required to file a Form 1040NR because, for example, the alien had no U.S. income or all U.S. income tax was satisfied by Chapter 3 withholding.[181] In the absence of one or other of the elections, a joint return may not be filed for a split year of nonresidence and residence.

While new residents are treated no differently from other individual citizens and residents, they should be aware of a number of U.S. tax compliance requirements that are more likely to affect them than most other U.S. taxpayers. These include:

- Including IRS Forms 5471, 8865 and 8858 in their income tax returns in relation to foreign corporations, partnerships and disregarded entities.
- Reporting foreign gifts and interests in foreign trusts on IRS Forms 3520 and 3520-A.
- Withholding tax on payments of various items of income to foreign persons, paying over the tax and reporting it under a host of IRS forms.
- Annual report of foreign bank accounts and foreign financial accounts over which the new resident has control or in which he has a beneficial interest. The form, currently known as FinCen 114, was formally known as T.D. 90-22.1 and was and is popularly known as the FBAR. These reports are submitted online. [182] They are due on April 15 each year for the preceding calendar year; the deadline is automatically extended to October 15 for reports not filed by April 15.[183]

The penalties for failing to file these returns and reports, quite aside from the penalties for failing to pay tax, are very severe. And we emphasize that these are highlights and are not intended as a comprehensive list of compliance requirements. One other point of emphasis: The government seems to do little with properly filed forms. But it deals harshly with those who do not file timely or at all, if it becomes aware of compliance failures, especially in the case of Forms 3520 and 3520-A. The IRS has a practice, that appears to be institutionally designed, to ignore, by which

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[181] Treas. Reg. § 1.6012-2(b)(2)(i) (return not required when tax is fully paid at source) and (ii)(b) and (c)(Return of individual for taxable year of change of U.S. citizenship or residence).
[182] See https://bsaefiling.fincen.treas.gov/NoRegFBARFiler.html.
[183] Notice, "New Due Date for FBARs", available at https://www.fincen.gov/sites/default/files/shared/FBAR_Due_Date_20190306.pdf (accessed January 21, 2022).

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we mean not to even read, claims that a failure was not willful or due to reasonable cause, at least until the matter is litigated.[184] Despite an IRS program designed to encourage voluntary late submission of international tax forms, the program actually offers no incentive at all and in fact almost guarantees the imposition of maximum penalties, which can be impossible or very expensive to have abated or removed.[185]

4.14 Foreign Taxes. It may be self-evident, but anyone becoming a U.S. resident is also someone who is leaving another country. If that country imposes any form of taxation of individuals' income or wealth, consideration must be given to those taxes, both in relation to the steps recommended here from a U.S. perspective and to their continuing application to the individual after residence has changed. Many countries, including Australia, Canada, Germany and the Netherlands (not a complete list), impose exit taxes on their departing residents. This can create difficulties if the United States does not treat deemed sales for foreign tax purposes as sales for U.S purposes, because, as noted above, the United States does not provide a landed basis, not even if the foreign country has imposed tax on a deemed sale.[186] Indeed, consideration must be given to the timing rules in the home country concerning loss of residence and loss of domicile, and also to the possible application of tax treaties – income, estate and gift and social security – not only in the United States but in the individual's home country and third countries. As planning proceeds for moving to the United States, it must be coordinated with home country advice.

[184] For a description of current IRS practice, see Ruchelman and Lee, "The Price is Right: Former I.R.S. Attorney Discusses Information Return and F.B.A.R. Penalties", 9 Insights No. 2 (March 30, 2022), available at http://www.ruchelaw.com/publications/the-price-is-right-former-irs-attorney-discusses-information-return-and-fbar-penalties (viewed March 31, 2022).

[185] See IRS Delinquent International Information Return Submission Procedures, last updated as of September 21, 2021 ("Taxpayers may attach a reasonable cause statement to each delinquent information return filed for which reasonable cause is being asserted. *During processing of the delinquent information return, penalties may be assessed without considering the attached reasonable cause statement.* It may be necessary for taxpayers to respond to specific correspondence and submit or resubmit reasonable cause information." (emphasis added)) The procedures are available at https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures (viewed April 3, 2022).

[186] See text accompanying footnote 128 above.

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5. EXPATRIATION

Just as it makes sense to plan carefully for the beginning of residence, so it makes sense to plan ahead of departure.

For individuals, complete departure takes two forms: A U.S. citizen moves to a foreign country and gives up his citizenship, almost always in that order, since renunciation of citizenship while in the United States generally causes the freshly minted alien to become immediately subject to deportation. A resident alien can simply become resident in a foreign country and no longer be resident under either the lawful permanent resident test or the substantial presence test. Residence may terminate either because the resident alien no longer satisfies either test or because of the application of a tax treaty tiebreaker.

Planning in this area is dominated by the potential application of the expatriation rules, which were subject to a radical change of Congressional direction in 2008. We then briefly discuss some rules that apply individuals who cease to be citizens and residents irrespective of whether they are subject to the rules introduced in 2008.

5.1 U.S. Treatment of Expatriates

(a) Overview. U.S. citizens and residents are taxed on their worldwide income and on gifts and bequests of property wherever located. Nonresident aliens are taxed on a more limited basis. Therefore, there is potentially a significant tax benefit to becoming a nonresident alien.

(i) Pre-1996 law. The United States first enacted legislation in 1966 to counteract the benefit to U.S. citizens of emigrating from the United States and relinquishing citizenship.[187] An individual who relinquished his U.S. citizenship with a principal purpose of avoiding U.S. income or gift or estate taxes was subject to tax on U.S. source income at the rates applicable to U.S. citizens, rather than the rates applicable to other nonresident aliens, for 10 years after expatriation. In addition, the definition of U.S. source income for this purpose was broadened to include gains on the sale of personal property located in the United States and gains on the sale

[187] Section 877 was originally enacted as part of the Foreign Investors Tax Act of 1966, P.L. 89-809.

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or exchange of stock or securities issued by U.S. persons. This alternative method of income taxation applied only if it resulted in a higher U.S. tax liability.

Analogous gift and estate tax rules expanded the categories of property subject to those taxes where a U.S. citizen relinquished citizenship with a principal purpose of avoiding U.S. taxes within the 10-year period ending on the date of the transfer.

(ii) 1996 and 2004 changes. The legislation applied only to individuals with a principal purpose of tax avoidance. The IRS in practice had significant difficulty locating former citizens and then making the case that tax avoidance was a principal purpose for the loss of citizenship. In 1996, Congress sought to put teeth into the expatriation rules. It introduced a rebuttable presumption of tax avoidance when certain if the expatriate's 5-year average of income tax exceeded $100,000[188] or net worth was $500,000 or more; significantly tightened compliance and reporting; and, critically, extended the rules to "former long-term residents". Congress rejected a Senate proposal to impose what has come to be known as a "mark-to-market" tax on expatriates, including former citizens and long-term residents, on the net unrealized gain in their property as if such property were sold for fair market value on the expatriation date.[189]

In addition, HIPAA required that the Department of State furnish copies of the Certificate of Loss of Nationality of expatriating citizens to the IRS and that names of such persons be published quarterly in the Federal Register. The immigration authorities (then the Immigration and Naturalization Service; now USCIS) were also required to furnish the names of all persons whose green cards were revoked or considered to have been administratively abandoned.[190]

In 2004, prompted by a 550-page report by the Joint Committee on Taxation in 2003 (the "Joint Committee Report")[191], Congress returned to the expatriation regime. It once again rejected a mark-to-market tax and opted for further reinforcement of the existing regime. It eliminated the

[188] In the case of married couples who filed joint returns, each spouse was treated as responsible for the entire amount of the tax. Notice 97-19, 1997-1 C.B. 394, Section III. The IRS considers that this rule remains in effect.
[189] Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191 ("HIPAA"). The use of the phrase "mark-to-market tax" rather than the "exit tax" is explained on page 87 below.
[190] Section 6039G(d).
[191] JCS-2-03 (Feb 12, 2003), reproduced at https://www.govinfo.gov/content/pkg/GPO-CPRT-JCS-2-03/pdf/GPO-CPRT-JCS-2-03.pdf (viewed February 26, 2022).

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tax avoidance purpose requirement and eliminated the availability of rulings to avoid application of the regime; increased the thresholds for average income tax liability to $124,000 and net worth to $2,000,000; and added an alternative regime where an alien who spent 30 or 60 days or more in the United States in any year in the 10-year period following expatriation would be treated as a resident during such year.[192]

(iii) 2008 changes. In 2008, Congress returned one more time to the scene of the crime.[193] It decided to institute a completely new regime. It would be fair to say that the new regime did not represent a reasoned response to perceived inadequacies in the existing regime, which, as modified in 2004, had essentially been given no time to work. Rather, the changes were prompted by the need to pay for tax relief for veterans and spurred by estimates of increased revenue which we believe have never materialized. In the process, the new law includes one new provision, section 2801, which we consider will lose revenue by deterring immigration by wealthy individuals, and another, the mark-to-market tax that had been rejected in 1996 and again in 2004 in favor of changes that were never given a chance to work. The IRS issued proposed regulations for section 2801 in 2015, which have not yet been finalized.

(iv) Immigration law consequence of expatriation. The Reed Amendment made inadmissible "any alien who is a former citizen of the United States who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation." The amendment applied only to individuals who renounced U.S. citizenship on or after September 30, 1996.[194]

A 2015 Report to Congress by the Department of Homeland Security indicates that between 2002 and 2015, the number of individuals who admitted to having renounced their citizenships for tax avoidance purposes and were found to be inadmissible under the Reed Amendment was two.[195]

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[192] American Jobs Creation Act of 2004, P.L. 108-357.

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

[194] The Reed amendment was by section 352(a) of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996, Pub. L. No. 104-208, and is codified at 8 USC section 1182(a)(10)(E).

[195] Department of Homeland Security, Inadmissibility of Tax-Based Citizenship Renunciants, November 30, 2015, available at https://www.dhs.gov/sites/default/files/publications/Departmental%20Management%20and%20Operations%20%28DMO%29%20-%20Policy%20-%20Inadmissibility%20of%20Tax-Based%20Citizenship%20Renunciants_0.pdf (accessed February 27, 2022).

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It describes "legal, operational, and policy challenges" to implementing the Reed Amendment, but concludes that "the Department of Homeland Security and the Department of State remain committed to continuing to . . . ensure that both Departments are aware when a renunciant admits that he or she renounced U.S. citizenship for the purpose of U.S. tax avoidance." It is difficult to take this statement seriously, if we are to judge by results.

(b) Targets: Covered expatriates.

(i) Basic definition. The rules apply to "covered expatriates". An expatriate is any U.S. citizen who relinquishes his citizenship, and any long-term resident of the United States who ceases to be a resident under the lawful permanent residence test.[196] A covered expatriate is an expatriate who meets one of three statutory tests:

- the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of United States citizenship is greater than $124,000, adjusted for inflation since 2003. In 2022, this amount is $178,000.[197]
- the net worth of the individual as of such date is $2,000,000 or more – there is no inflation adjustment.
- the individual fails to certify under penalty of perjury that he or she has complied with all tax obligations for the five preceding taxable years or fails to submit evidence of compliance. The certification requirement is generally met by filing IRS Form 8854 (Initial and Annual Expatriation Information Statement).

The last of these three requirements creates a trap for former citizens and especially former long-term residents who would not otherwise be subject to the new regime. And, since this article is addressed to tax professionals, we should caution that it also offers the opportunity for some spectacular malpractice claims.

(ii) Exceptions. There are two exceptions to the definition of a covered expatriate. The first is that an individual who was born with citizenship both in the United States and in

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[196] Section 877A(g)(2).
[197] Section 877(a)(2). See Rev. Proc. 2021-45 ¶3.37.

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another country will not be a covered expatriate, 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 for not more than 10 taxable years during the 15-year taxable year period ending with the taxable year of expatriation.[198]

For some reason, no comparable relief is offered to naturalized U.S. citizens or to long-term residents who return to the country of their citizenship at birth. We wonder if this failure to provide relief to citizens of treaty countries might violate the nondiscrimination provisions of our tax treaties or our friendship, commerce and navigation treaties. The current U.S. Model Income Tax Convention provides, in language that has not changed since it appeared in the 1977 Model, that "Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances . . .".[199] It would seem clear that the exception differentiates between citizens of our treaty partners according to whether they were U.S. citizens or not, with the former being eligible for a benefit that does not apply to the latter, even though there seems to be no other difference between the situation of such expatriates.

The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18-1/2, provided that the individual was a resident of the United States under the substantial presence test for no more than 10 taxable years before such relinquishment.[200]

Neither exception applies to aliens who fail to provide the required certification of compliance under penalty of perjury on Form 8854.

[198] Section 877A(g)(1)(B)((i). By the way, note the difference in terminology. The definition of a long-term resident in section 877(g) is an individual who was a long-term resident "in" 8 of the 15 years ending with the year in which expatriation occurred. But the exception for individuals returning to their country of citizenship at birth applies if the individual has not been a resident of the United States "for" not more than 10 taxable years in the 15-year taxable period. We have to assume that this difference means that the individual must not have been a resident for 10 full taxable years – otherwise, why use a different preposition?
[199] United States Model Income Tax Convention of 2016, art. 24. Virtually identical language appears in art. 24 of the 1977, 1981, 1996 and 2016 models.
[200] Section 877A(g)(1)(B)((ii).

Section 877 provides that, for all tax purposes, a U.S. citizen continues to be treated as a U.S. citizen for tax purposes until that individual's citizenship is treated as relinquished under the following rules. An individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces 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); (2) 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); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.[201] Notwithstanding the two immediately preceding sentences, relinquishment may occur earlier under Treasury regulations with respect to an individual who became at birth a citizen of the United States and of another country.

In the case of a long-term resident, the date that long-term residency is terminated is the "expatriation date." In the case of a citizen, the date that the individual relinquishes citizenship is the "expatriation date."

The foregoing rules replace the prior rules[202] that provide that an individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes until the individual gives notice of an expatriating act or termination of residency.

(c) Section 877A – the mark-to-market tax.

(i) Basic rule. Effective June 17, 2008, section 877A provides that covered expatriates are subject to income tax on the net unrealized gain in their property as if the property had been sold for its fair market value on the day before the expatriation ("mark-to-market tax"). Gain from the deemed sale is "taken into account" at that time without regard to other Code

[201] Notice 2009-85, 2009-45 I.R.B. 598, Section 2.
[202] Section 7701(n), repealed effective for individuals with an expatriation date on or after June 17, 2008. The rules remain in effect for prior expatriations.

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provisions – it is not clear whether Code provisions that would exclude gain from gross income, such as section 121, will apply, although the AICPA thinks that it will not.[203] (It follows that any principal residence should actually be sold before the date of expatriation.) Losses are taken into account to the extent otherwise allowable and without regard to the wash sale rules of section 1091. Net gain on the deemed sale is recognized to the extent it exceeds $600,000. The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2008; for 2022, the equivalent amount is $767,000.[204]

Any gains or losses subsequently realized are to be properly adjusted for gains and losses taken into account under the deemed sale rules, without regard to the $600,000 exemption. This means that assets will be stepped up (or down) in basis – which will be relevant if the assets remain within or return to U.S. taxing jurisdiction. For example, a covered expatriate will remain liable to tax on gains recognized on the sale of U.S. real property interests and the gain on such property will be appropriately adjusted based on the deemed sale gain or loss. What is less clear is whether the basis of the asset is adjusted for purposes of computing depreciation.[205]

Certain exceptions apply in the case of deferred compensation items, interests in nongrantor trusts, and specified tax deferred accounts, all of which are subject to special rules.

(ii) Deferral of payment of tax. The covered expatriate may elect to defer payment of the mark-to-market tax until the property is disposed of or the due date of the return for the taxable year of the expatriate's death. Interest will then be payable for the period the tax is deferred at the rate normally applicable to underpayments by noncorporate taxpayers. The election is irrevocable. The election may be made property by property, and the tax deferred with respect to any property is a proportion of the entire mark-to-market tax based on the proportion borne by the gain on the property to the gain on all property deemed sold.

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[203] See the 2008 AICPA report more fully cited in footnote 218 below.

[204] Rev, Proc, 2021-45 ¶3.38.

[205] Congress failed to address the AICPA's comment that "We assume that this 'proper adjustment' refers to an adjustment to the basis of assets for which a gain or loss is recognized. However, this should be clarified in the statutory language."

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The electing individual is required to furnish to the government a bond or other acceptable security mechanisms, to be spelled out in regulations, and waive any treaty rights that would preclude the assessment or collection of the tax.

It will be interesting to see if the conditions set out by the government will make the election useful in practice. The deferral arrangements seem unlikely to help the taxpayers most in need of deferral, namely those with illiquid assets which may prove difficult to sell sufficiently quickly either to pay the tax or provide the necessary security. It is not hard to imagine, for example, an alien owning an interest in a valuable closely held family business and returning home to manage it. The business may be entirely illiquid and the alien's share may be tied up by shareholder agreements that would prevent a sale or even a hypothecation of the shares. Such an alien might truly be trapped in the United States by section 877A.

(iii) Deferred compensation. The provision contains special rules for interests in deferred compensation items.[206]

Special treatment is accorded to "eligible deferred compensation items". To be an eligible deferred compensation items, the payor of must be a U.S. person or a person who elects to be treated as a U.S. person for this purpose and meets additional requirements to be prescribed. In addition, the covered expatriate must notify the payor of his status as a covered expatriate and waive any treaty reduction in withholding.

Any taxable payment with respect to an eligible deferred compensation item will be subject to tax at 30% under section 871 and the payor must deduct and withhold a 30% tax from the payment under this rule rather than under any other withholding requirement (such as wage withholding

[206] Section 877A(d)(4) provides that a "deferred compensation item" means any interest in a plan or arrangement described in section 219(g)(5), 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 section 83 or in accordance with section 83. Section 219(g)(5) covers the following (i) a plan described in section 401(a), which includes a trust exempt from tax under section 501(a); (ii) an annuity plan described in section 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 section 457(b)); (iv) an annuity contract described in section 403(b); (v) a simplified employee pension (within the meaning of section 408(k)); (vi) a simplified retirement account (within the meaning of section 408(p)); and (vii) a trust described in section 501(c)(18).

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or Chapter 3 withholding on payments to foreign persons.) A payment is a taxable payment to the extent it would be included in gross income of the covered expatriate if such person were subject to tax as a U.S. citizen or resident.

If a deferred compensation item is not an eligible deferred compensation item (and is not subject to section 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. If a deferred compensation item is subject to section 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.[207]

These rules 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.

The deferred compensation rules may lead to double taxation, because the covered expatriate may be taxed on distributions from the plan by a foreign country of which he is or becomes a resident. It is true that there is some greater likelihood that a foreign country will allow a credit for the 30% withholding on taxable payments with respect to an eligible deferred compensation item, because at least the U.S. tax will be imposed in the year of the distribution. But this is not the case for the taxation of distributions with respect to non-eligible items. That tax is imposed in the year of expatriation and the distribution taxable outside the United States may occur many years later. The foreign country is not likely to give credit for the U.S. tax paid for the year of expatriation.

(iv) Specified tax deferred accounts. Special rules also apply to interests in specified tax deferred accounts.[208] If a covered expatriate holds any interest in a specified tax deferred account on the day before the expatriation date, he is treated as receiving a distribution of his

[207] Note that deemed distributions are not subject to early distribution tax, meaning any increase in tax imposed under section 72(t), 220(e)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), or 530(d)(4).

[208] Section 877A(e) defines "specified tax deferred account" as an individual retirement plan (as defined in section 7701(a)(37)), a qualified tuition plan (as defined in section 529), a Coverdell education savings account (as defined in section 530), a health savings account (as defined in section 223), and an Archer MSA (as defined in section 220). However, simplified employee pensions (within the meaning of section 408(k)) and simplified retirement accounts (within the meaning of section 408(p)) of a covered expatriate are treated as deferred compensation items and not as specified tax deferred accounts.

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entire interest in such account on the day before the expatriation date. Appropriate adjustments are to be made for subsequent actual distributions.[209]

(v) Interests in trusts. In the case of a domestic trust that becomes a foreign trust due to the expatriation of an individual, the general income tax rules pertaining to transfers by U.S. persons to foreign trusts (i.e., section 684) apply before the rules of section 877A.

In the case of any grantor trust of which the covered expatriate is treated as the owner, 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 nongrantor trust, such trust remains a grantor trust for purposes of the provision.[210]

In the case of nongrantor trusts of which the covered expatriate was a beneficiary on the day before the expatriation date, the mark-to-market tax does not apply, as noted above. However, in the case of any direct or indirect distribution from such the trust to a covered expatriate, the distribution is subject to tax at 30% under section 871 and the trustee must deduct and withhold a 30% tax on 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. The covered expatriate is treated as having waived any right to claim any reduction in withholding under a treaty. In addition, if the nongrantor 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.

This provision is problematic. We must wonder how it can be enforced against the trustees of a foreign trust. And while it is clear that an express unilateral legislative override of a treaty obligation cannot be challenged by a taxpayer in a U.S. court, even though the override is a breach

[209] As with deferred compensation items, these deemed distributions are not subject to early distribution tax. See footnote 207.
[210] Throughout this discussion, we assume that a trust is, in its entirety, either a grantor trust or an ordinary trust. To the extent that a covered expatriate is treated as owner of only part of a trust, the rules described here apply only to that part; the ordinary trust rules apply to the rest.

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of the treaty by the United States, it is not at all clear that the United States can legislate an involuntary waiver of a treaty.

Further, for every year that the nongrantor trust does not make a distribution to the covered expatriate, Notice 2009-85 provides the covered expatriate must file Form 8854, *Initial and Annual Expatriation Statement*, annually after the expatriation, to indicate that the trust has not made any distributions that year. In the alternative, the expatriate may elect to include any interest in a nongrantor trust in gross income for the purposes of the mark-to-market tax.

If a trust that is a nongrantor 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 the covered expatriate.

(vi) Special rules. Any period for acquiring property which results in the reduction of gain recognized with respect to property disposed of by the taxpayer terminates on the day before the expatriation date. For example, the time to complete a deferred like-kind exchange or an involuntary conversion terminates on that day.

Any extension of time for payment of tax ceases to apply on the day before the expatriation date, and the unpaid portion of such tax will become due and payable at the time and in the manner to be prescribed.

For purposes of determining the tax imposed under the mark-to-market tax, property held by an individual on the date that such individual first became a U.S. resident is treated as having a basis on such date of not less than the fair market value of such property on such date.[211] In effect, this allows a step-up in basis for such property for pre-residence gain. An individual may make an irrevocable election not to have this rule apply.

(vii) Interactions with income tax treaties. Section 877A imposes a tax on individuals as of the day before they ceased to be U.S. citizens or residents. Virtually every U.S. income tax treaty contains a savings clause that allows the United States to tax its citizens and residents

[211] This step-up in gain does not apply to United States real property, or assets used in the course of a U.S. trade or business. Notice 2009-45 I.R.B. 598, 3D.

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without regard to the treaty. (The purpose of tax treaties is generally to protect residents of one country from the taxation of the other country, not the country of residence.) While there are exceptions – such as the requirement that a country grant foreign tax credits or exemptions to its residents for taxes paid to the other country, since this will encourage investment by eliminating double taxation – no such exception appears relevant to the mark-to-market tax. Therefore, it will generally not be possible for covered expatriates to avoid the mark-to-market tax based on a treaty claim. The only exception, noted earlier, may relate to the potential application of non-discrimination rules to the definition of a covered expatriate.[212]

(d) Section 2801 – the tax on covered estates and gifts.

(i) Overview. Section 2801 imposes a transfer tax on the value of "covered gifts or bequests" received by a U.S. citizen or resident. A covered gift or bequest is any property acquired (A) by gift directly or indirectly from an individual who at the time is a covered expatriate, or (B) directly or indirectly by reason of the death of an individual who was a covered expatriate immediately before death.

The tax rate is the highest marginal rate of estate tax or, if greater, the highest marginal rate of gift tax, as in effect on the date of receipt of the covered gift or bequest.[213] To be clear, the highest marginal rate of the two taxes applies to both gifts and bequests, so that a bequest by the estate of a covered expatriate in 2010, when no estate tax was imposed on U.S. estates, was taxed at 35%.

The tax is imposed upon the recipient of the covered gift or bequest and is imposed on a calendar-year basis. It 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 the recipient during a calendar year exceeds the amount in effect under section 2503(b) for that calendar year ($16,000 for 2022).[214] 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.

[212] See text accompanying footnote 199 above.
[213] Section 2001(c) (estate tax rate table); section 2502(a) (gift tax table).
[214] Rev. Proc. 2021-45 ¶3.43.

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Where a covered gift or bequest is made to a domestic trust, the tax applies as if the trust were 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. A foreign trust may elect to be treated as a domestic trust for purposes of these rules.

(ii) Interaction with gift and estate taxes. Once a person becomes a covered expatriate, he remains a covered expatriate forever, even if he resumes residence in the United States. A covered gift or bequest nevertheless 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 for transfers for charitable purposes or to spouses, for purposes of determining estate and gift taxes.[215] Therefore, if a covered expatriate makes a gift or bequest following resumption of U.S. domicile or if he makes a gift or bequest of U.S. property and in either case the recipient is a U.S. person, it is critical that the gift or estate tax return be timely filed. Otherwise, it is theoretically possible for the gift or bequest to be subject to both gift or estate tax and to section 2801 tax.

(iii) Interaction with gift and estate tax treaties. The statute and the immediate legislative history of section 2801 are silent on the interaction between the provision and U.S. gift and estate tax treaties. Although the proposed regulations do not explicitly address this issue, their examples stipulate that the covered expatriate in them does not reside in a country with which the United States has a gift or estate tax treaty, implying that section 2801 is covered by gift and estate tax treaties.

[215] See sections 2055 (charitable bequest), 2056 (bequest to surviving spouse), 2522 (charitable gift) and 2523 (gift to spouse).

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Section 2801 tax should be a covered tax under our treaties. It appears to be a form of gift or estate tax. But in any event, it is a tax of "substantially similar character". Although the tax is imposed on U.S. persons, estate and gift tax treaty exemptions typically apply based on the domicile of donor, not on whether tax is imposed on donor or donee. (This is probably because in many cases, particularly civil law countries or countries that copied their laws from civil law countries, such as Japan, tax is indeed imposed on the donee not the donor.) This is clearly the case for newer treaties, which limit scope of tax on gifts and bequests to business property and real estate. It is less clear in the case of older treaties, which do not explicitly limit right to tax but establish situs rules and confirm the availability of tax credits.

(iv) Extreme taxation. In our view, the section 2801 tax on covered gifts and bequests, not the new mark-to-market tax, is the most forbidding rule relating to covered expatriates. Once an individual becomes a covered expatriate, a gift or bequest to a U.S. person at any future time or a distribution of capital by a trust that might occur many decades after the death of the expatriate will be subject to tax at the highest applicable rates of gift or estate tax. Here is an extreme example:

> An individual receives a green card at the age of 10. When she is 19, her parents decide to return to their country of origin to help her grandfather with the family business. She remains in the United States to attend college. While she is in college, her grandfather buys her an apartment in Manhattan for $2,000,000. On graduation, she sells her apartment for $2,500,000, gives up her green card and returns to work in her family business. She never again resides in the United States. Ten years later, she marries and has two children. As a result of her business acumen and inheritances from her parents and grandparents, she accumulates a vast fortune. Her children in turn produce several grandchildren. At age 87, more than 60 years after expatriating, she dies leaving $300,000,000 to a trust for her grandchildren, to be distributed to them when they reach the age of 40. One of her grandchildren moves to the United States when he is 35. The U.S. grandchild would be subject to tax on the distribution at a rate of 40%, even though it might be received nearly a century after the expatriation, even though only a tiny fraction of the wealth in question arose while

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the expatriate was a U.S. resident (and almost none of it in the United States) and even though the recipient of the gift did not become a U.S. person until many years after the expatriate's death.

Unlike the 10-year rule of the prior expatriate regime, the taint of being a covered expatriate never expires for gifts and bequests to U.S. persons. We may wonder how this rule could ever be enforced as a practical matter. How would the grandchild in the example ever be able to determine whether his grandmother had ever been a lawful permanent resident of the United States? But assuming that enforcement could be assured, the consequence of becoming subject to this new tax may be much more devastating than the mark-to-market tax or its predecessor.

(e) Will Section 2801 Ever Enter into Force? When the IRS issued Notice 2009-85, its first and to date only significant piece of guidance about the expatriation rules, it announced that satisfaction of the reporting and tax obligations under section 2801 for covered gifts or covered bequests received on or after June 17, 2008, was deferred pending the issuance of separate guidance by the IRS.[216] The IRS issued proposed (but not temporary) regulations under section 2801 in 2015. However, those regulations have not been finalized and so, nearly a decade and a half after enactment of section 2801, there is still no obligation for U,S, recipients of covered expatriates to report their gifts, bequests and trust distributions and pay the section 2801 tax. Perhaps the IRS has forgotten about section 2801 or perhaps its chronic lack of resources has kept finalizing the regulations on the back burner. But one has to wonder if regulations will ever be issued at all. The delays have made it extremely difficult to enforce, especially with regard to gifts made a long time ago. Prospectively, enforcement will also be very difficult. The Proposed Regulations contain a shocking presumption that *any* gift from a nonresident alien is from a covered expatriate, a presumption found nowhere in the statute. One can understand the IRS' frustration at how section 2801 gifts and bequests are to be captured when the recipient may have no idea, and no way of finding out, whether the donor, especially if deceased, had any U.S. ties. Moreover, the number of aliens who may be covered expatriates may have multiplied as a result of the pressure placed on U.S. citizens living abroad, especially so-called accidental Americans who acquired citizenship because of the expansive definition of citizenship in our immigration

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[216] Footnote 116 above.

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laws. (We have to pause here and wonder at how the United States makes it so difficult for people who want to reside in the United States to do so and at the same time casually confers citizenship on people who happen to have been born in the United States or who, because of their having a single U.S. citizen parent, may have become at birth U.S. citizens even if they never have been in the United States at all. The tax cost of relinquishing such citizenship will in many cases be unbearable for such persons and their descendants.)

(f) Planning. We have begun to consider planning in this area. But there are a vast number of unanswered questions. Planning at this stage needs to focus on whether, when and on what basis to move to the United States and whether, when and on what basis to leave.

Advisors to prospective green card holders need to consider whether a green card is really necessary to accomplish their client's goals. For some who come to the United States, a green card may indeed be a practical necessity. It may be the only reasonably available status, as may occur in the case of an individual who is marrying or is already married to a U.S. citizen or resident. It may be that the individual needs the freedom to work for any employer. Adult green card holders can petition for green cards for their children; the children can remain in the United States after they become adults even if the parents subsequently depart. Holders of non-immigrant status can bring their dependents to the United States, but children who become adults must find their own way to allow them to remain; they can usually obtain student status that will allow them to complete their studies as full-time students with limited rights to work but after that would need to obtain a status allowing them to take up employment.

However, avoiding or at least delaying obtaining a green card by securing one of the long-term non-immigrant statuses mentioned above[217] is a way to stretch out the length of time an individual can remain in the United States without subjecting himself or herself to the expatriation rule when they leave. For immigrants who are uncertain about their long-term plans, seven years may not be nearby long enough to decide where they will end up. It makes little sense to saddle themselves and their U.S. families with the potential not only of the mark-to-market tax but especially the tax on covered gifts and bequests.

[217] See text accompanying footnote 121 above.

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Planning for departure will depend on a variety of facts and circumstances. For aliens who are considering giving up their green cards before becoming covered expatriates, advice should be sought early about timing and ample time should be allowed to orchestrate the departure. Consideration should be given to the use of a tax treaty to terminate residence by claiming residence in the treaty partner. For citizens as well as long-term residents who meet one or other of the financial thresholds, planning should include actual sales of assets wherever possible, especially for moves to countries that do not provide a landed basis. The U.S. principal residence should be sold to take advantage of the $250,000 or $500,000 exclusions under section 121, since that exclusion may not apply to limit the gain realized on becoming a covered expatriate. For married couples, planning may focus on the possibility of only one of the spouses being a covered expatriate or staggering the timing of spousal departures. This may similarly be the case for families with children. The following example may illustrate this point:

> H and W are married. They have two children, both born in the United States. H is a U.S. citizen and a senior executive of a multinational corporation; W is a citizen of country X and a home maker. They decide to move to country X. H and W have a net worth of $10 million. In preparation for expatriation, H and W begin filing separate returns and, as a result, after a year or two W no longer meets the five-year income tax test. W gives $3.5 million of her net worth to H, leaving her with a net worth of $1.5 million. H and W expatriate. H is a covered expatriate; W is not. When H dies, he leaves his net worth to W. When she dies, she leaves her net worth to the children.

The bequest by H to W is not a covered gift or bequest because although H was a covered expatriate, W was not a U.S. person at the time of receipt of the gift. It would also seem, unless the IRS decides to adopt an extremely aggressive interpretation of section 2801, that the children have not received a covered gift or bequest, because their mother, W, was not a covered expatriate, notwithstanding that her wealth ultimately derived from gifts or bequests from a covered expatriate.

Where covered expatriates want to make gifts to U.S. persons, we can see possibilities for planning by making gifts of undivided interests in property spread out over a period of years.

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And, it must be said, it is inevitable that covered expatriates will decline to make gifts to their U.S. relatives and instead will make them to non-U.S. members of the family in the hope that they will later, perhaps many years later, make gifts to U.S. family members. For both the U.S. recipients and the IRS, determining whether or not such gifts are linked may be impossible as a factual matter.

(g) Some final thoughts. The 2008 changes to the expatriation rules represent much of what is broken about our system of enacting tax legislation.

The changes were not even enacted because they will actually raise revenue, for it must be obvious that in the real world they will lose revenue. Here are some of the behaviors promoted by these laws: They will deter wealthy foreigners from moving to the United States; they will encourage wealthy resident aliens to leave before seven taxable years as a lawful permanent resident are up. (Seven, not eight – the very first day of the eighth year as a lawful permanent resident is what brings the expatriation rules into play.) They will deter covered expatriates from leaving their wealth to their U.S. relatives and to seek indirect methods to benefit them, some of which methods will be proof against countermeasures or enforcement. U.S. relatives will expatriate before they inherit that wealth. Other planning will spring up to mitigate the effect of the new laws.

In fact, the real reason the changes were enacted because they were scored as raising revenue. In the case of section 2801, we believe that the revenue estimates were based on 10-year old estimates that appear not to have been updated and were almost certainly wrong even when they were first propounded.

There did not seem to be any other reason to change the law in an area that had been comprehensively addressed by Congress twice before in the previous decade or so, most recently in 2004. Congress entirely failed to make the case for a change in approach so soon afterwards, other than asserting dissatisfaction with the untested provisions enacted in 2004. Congress seems to have rejected or ignored most of the comments made by such bodies as the AICPA and the American College of Trust and Estate Counsel (ACTEC). The rejection of so many of the ACTEC comments is especially distressing because of the extraordinary quality and depth of the technical analysis undertaken by the ACTEC members, led by the authors' former colleague Ellen

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Harrison.[218] The ACTEC comments, rather more politely than we would, described what became section 2801 as "unenforceable and bad policy" and expressed concern at the absence of protections against double taxation.

There may in fact be a case to be made for the mark-to-market approach. Mark-to-market is a fancy expression for an exit tax and was rejected in 1996 because it was uncomfortably similar to Soviet-style exit taxes imposed in the 1970s on Jews and other seeking to emigrate. The passage of the years has not invalidated this comparison, even if it has pushed it beyond the memories of our legislators. But perhaps it may be defended on the grounds that some democracies, notably Australia, Canada, the Netherlands and Germany, have adopted tax rules along the same lines (albeit more moderate ones) and above all because it would mean that an expatriate could pay the tax and be done with the U.S. tax system.

But if allowing expatriates to pay a toll charge to leave the United States was the purpose of section 877A, what then can be said in defense of section 2801? Section 2801 pursues the U.S. families of expatriates until their death and long afterwards. It will be very, very difficult to enforce, as exemplified by the IRS's delay in finalizing regulations for it. It will almost certainly prove to lose revenue, however it may have been scored or enforced, because it puts in place such a tremendous incentive for wealthy aliens not to move to the United States in the first place, to leave if they are already here and to keep their wealth out of the hands of U.S. members of the family. It may lead to difficult discussions with our treaty partners, unless the United States concedes that it does not apply to gifts and bequests by treaty country domiciliaries.

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[218] See ACTEC International Estate Planning Committee Expatriation Subcommittee Comments Concerning Expatriation Legislation (October 10, 2007), reproduced at https://www.actec.org/resources/actec-comments-concerning-expatria/ (viewed March 3, 2022); AICPA Comments on Proposed Expat Legislation (January 16, 2008), reproduced at https://www.aicpa.org/advocacy/tax/trustestategift/downloadabledocuments/tech-comments-expat-3-31-02.doc (viewed March 3, 2022); AICPA Offers Technical Analysis of Tax Proposals to Catch Tax-Motivated Expatriation (March 21, 2002), reproduced at https://www.aicpa.org/advocacy/tax/trustestategift/downloadabledocuments/tech-comments-expat-3-31-02.doc (viewed March 3, 2022). The recommendations ignored by Congress included increasing the 8 of 15 years rule to 15 (AICPA) or 17 (ACTEC) of 20 years; excluding gains from assets that remained subject to U.S. taxing jurisdiction, especially U.S. real property interests taxable under section 897; a recommendation by the AICPA to permit the continued application of the section 121 for the sale of a principal residence; ACTEC's recommendation that either the succession tax be limited to the covered expatriate's net worth on date of expatriation reduced by exit tax paid and the applicable exclusion amount or as an alternative to a "cap" described above, use a sliding scale of declining rates based on the period of time between expatriation and the gift or bequest to a U.S. person.

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Congressional concerns about individual expatriation, especially by green card holders, seem particularly unreasonable in the modern era of mobility of capital and people. While we understand the desire to exact a reasonable level of taxation on wealth created in or derived from presence and activity within the United States, we would also expect the United States to adopt taxation policies designed to encourage inward migration of wealth and talent and to accept that people will want to come to the United States for long periods of time but not necessarily for the rest of their lives. There is a reasonable balance to be struck here. It is very hard to argue that section 877A and especially section 2801 come close to achieving such a balance.

Which leads us to some questions, which we have already addressed more than once to wealthy prospective immigrants, especially those likely to be accompanied by their children or to have children or grandchildren born or residing in the United States: Do you really want a green card? Are you sure your objectives cannot be met with a non-immigrant visa? And now that you have been here for a few years with your green card, should you not be considering the costs of staying much longer?

5.2 Issues for All Expatriates.

(a) Timing of Departure. For any individual, timing of departure is critical. It is particularly critical for individuals who may become covered expatriates. Intending expatriates need to study the requirements described in Part 5.1(b) above with considerable care, and green card holders should be aware of how the eight of fifteen years rule (which in practice is a six year plus rule) will apply to them.

(b) Taxation of Deferred Receipts. Section 877A may cause the acceleration of income and gains. But whether it does or not, aliens should be aware of the rules of sections 864(c)(6), 864(c)(7), and 864(c)(8).

Section 864(c)(6) effectively applies where the U.S. trade or business of a foreign person generates income or gain, and the income or gain will be taxed as income effectively connected with a U.S. trade or business even if the income is not taken into account until a later year when

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the foreign person is not engaged in such a trade or business.[219] For example, if in Year 1 a foreign person sold a U.S. business asset and reported the gain on the installment method, gain will be taxed in Year 2 even though the foreign person ceased (perhaps as a result of the sale) to be engaged in a U.S. trade or business.

Similarly, section 864(c)(7) provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, and is disposed of within 10 years after the cessation, the determination of whether income or gain attributable to such disposition is taxable as effectively connected income is to be made as if the sale or exchange occurred immediately before such cessation. Once again, tax will be imposed even if the foreign person is not engaged in a U.S. trade or business in the year of sale. Note that the section contains no exemption for gain accruing post-cessation.

Section 864(c)(8) was enacted by the 2017 Act and provides, in relevant part, that if a nonresident alien owns, directly or indirectly, an interest in a partnership that is engaged in a U.S. trade or business, any gain or loss on the sale or exchange or other disposition of that partnership interest (or any portion thereof) will be treated as effectively connected with the conduct of that U.S. trade or business and be subject to tax in the United States to the extent the gain or loss does not exceed a specified amount.

(c) Sale of Principal Residence. We noted previously that Congress did not permit the section 121 exclusion for sale of a principal residence to apply to a covered expatriate. For departing aliens who are not covered expatriates, section 121 should apply and should exclude gain that would otherwise be taxable under the Foreign Investment in Real Property Tax Act.[220]

However, when the sale occurs in the year of departure (before or after the termination of residence) or in a later year, a departed alien couple will no longer be allowed to file a joint return. If the couple files separate returns, each may claim the exclusion with respect to the same home

[219] Section 871(b) (nonresident aliens) or 882 (foreign corporations).
[220] Section 897.

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but each has to satisfy both the ownership and use tests independently.[221] By contrast, if a couple files a joint return, the maximum amount of the exclusion is still $250,000, but is increased to $500,000 if either spouse meets the ownership requirement and both spouses meet the use requirements.[222]

In appropriate circumstances, therefore, it may make sense to sell the property not only before the date of departure to avoid non-excludible gain from a deemed sale under section 877A but before the year of departure to allow the sale to be reported on a joint return if one of the spouses would not meet the ownership requirement.

(d) Tax Compliance for Newly Nonresident Alien. The newly nonresident alien, whether or not subject to the expatriation rules, will nevertheless continue to be concerned with the U.S. tax system so long as he or she has assets, income or family located in the United States.

One immediate step that must be taken is to give notice of the new status to the financial institutions and businesses with which the taxpayer deals. In many cases, the taxpayer will have provided to such institutions and businesses an IRS Form W-9 (Request for Taxpayer Identification Number and Certification), which includes a certification that the taxpayer is "a U.S. citizen or other U.S. person", including a resident alien. The taxpayer must notify the recipients of any change of status, although oddly this requirement is not actually stated on the form or its instructions. (The opposite requirement is included on the instructions to Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding.) Typically, the notification is given using Form W-8BEN, which is used both to advise the recipient of the taxpayer's status as a nonresident alien and to make any relevant claim of reduced withholding either under a treaty or under a statute.[223]

If the taxpayer becomes a nonresident alien in the middle of the taxable year, the taxpayer will have to file a split year tax return for that year. The return is to be filed on Form 1040NR, with a

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[221] These requirements are that a taxpayer may exclude gain only if, during the 5-year period ending on the date of sale of the property, the taxpayer owned and used the property as his/her principal residence for periods aggregating two years or more.
[222] See section 121(b)(2)(A) and Treas. Reg. §1.121-2(a)(3).
[223] E.g., the portfolio exemption from tax and withholding under sections 871(h) and 1441(c)(9).

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separate schedule attached showing the income tax computation for the part of the taxable year during which the individual was a citizen or resident of the United States. A Form 1040, clearly marked "Statement" across the top, may be used as such a separate schedule.[224]

Generally, the newly nonresident alien cannot file a joint return for the year of departure, unless the election is made under section 6013(g) (not (h)) jointly with a U.S. citizen or resident spouse.

6. CONCLUSION

Anyone browsing through the shelves of a library or bookstore in search of a good read may be tempted to jump to the back of the book to see how it ends. This is often a disappointing experience. Unfortunately, however, we suspect the experience will prove to be no more satisfying for those of our readers who have got this far by plowing through the many 93 pages of this article than for those who skipped here first. We are pleased if we have enlightened you, but our message is that international estate planning remains a vast topic with many opportunities but extraordinary pitfalls, especially but by no means exclusively for those who do not regularly engage in its practice. We hope our approach has, at the very least, provided a framework for consideration of some significant issues.

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[224] Treas. Reg. § 1.6012-1(b)(2)(ii)(b).

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