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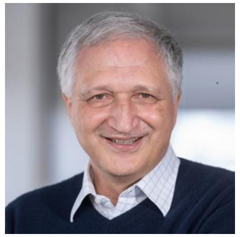
The Fog: The Interaction of Treaties & Domestic Tax Law

U.S. Activities of Foreigners and Tax Treaties

Ege Berber, Moderator
PriceWaterhouseCoopers
Washington, DC
+1-202-876 8243
ege.berber@pwc.com



Michael J. A. Karlin
Karlin & Peebles, LLP
5900 Wilshire Boulevard, Suite 500
Los Angeles, CA 90036
+1-323-852-0033
mkarlin@karlinpeebles.com
www.karlinpeebles.com

Qiguang (Hardy) Zhou
Feingold & Alpert, LLP
3 Columbus Circle, 15th Fl.
New York, New York 10019
+1-212-582-8027
hz@feingoldalpert.com

Elena Virgadamo
Deputy International Tax Counsel for Treaty Affairs, Department of the Treasury
Sacramento, CA
Elena.Virgadamo2@treasury.gov

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Agenda

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2. Section 960 – Tax Treaties and Indirect Tax Credits
3. Section 1411 – The Net Investment Income Tax
4. Section 7701(b) – Tax Treaties and Residence
5. Section 864(c)(8) – Sale of Partnership Interest by Foreign Person
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The Relationship of Tax Treaties and Domestic Law

Domestic Law and Treaties

- Establish a treaty’s standing versus domestic law (e.g., equal, conflict, last in time).
- Constitution vs. treaty
  - A treaty cannot be inconsistent with the Constitution. *See Missouri v. Holland*, 252 U.S. 416 (1920).
- Treaties have equal standing with US domestic laws.
  - The Constitution’s Supremacy Clause (Article VI, Section 2) provides: “This Constitution, and the laws of the United States which shall be made in pursuance thereof, *and all treaties made, or which shall be made, under the authority of the United States*, shall be the supreme law of the land.”
- Statute vs. treaty
  - Last-in-time rule - ***when there is a conflict*** between a self-executing treaty and a federal statute, U.S. courts must apply whichever of the two reflects the “latest expression of the sovereign will” of the United States.

Treaty Interpretation

- Courts should first try to resolve apparent conflicts by seeking an interpretation that avoids inconsistency.
    - "*Treaties are to be liberally construed, so as to effect the apparent intention of the parties*." *Nielsen v. Johnson*, 279 U.S. 47, 51 (1929).
    - "*It is [the Court's] responsibility to read the treaty in a manner consistent with the shared expectations of the contracting parties*." *Lozano v. Montoya Alvarez*, 572 U.S. 1, 12 (2014).
- The Code contains a separate provision indicating that it should be applied with regard to treaty obligations. "*The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.*" Section 894(a)(1).

The Later in Time Rule

- When a treaty and law are inconsistent, the last one in time will control.
- A treaty may supersede a prior act of Congress, and an act of Congress may supersede a prior treaty. *The Cherokee Tobacco*, 78 U.S. 616 (1870).
- Neither the treaty nor the tax law has a preferential status by reason of its being a treaty or law. Section 7852(d)(1).
- In turn, under the later in time rule, in the case of a conflict between a treaty rule and a statute, later in time provision prevails.
  - Preliminary issue: there must be a conflict between the statute and treaty rules. To the extent possible, they are interpreted in a harmonious way.
- Regulations may not override a treaty rule.
  - Section 7852(d) applies only to statutory changes.
  - Regulations are not indicative of the congressional intent that is needed to override a treaty. *See Trans World Airlines Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 252-253 (1984).

Tax Treaty Overrides

- Under established case law, for a later in time statutory provision to override a treaty rule, Congress must clearly express its intent to override.
  - *"A treaty will not be deemed to have been abrogated or modified by a later statute, unless such purpose on the part of Congress has been clearly expressed." Cook v. United States*, 288 U.S. 102, 120 (1933).
- Most recent tax legislation has been enacted as part of reconciliation legislation.
  - Reconciliation, first used in 1980, is an optional procedure.
  - Byrd Rule: A Senator may raise a point of order against an extraneous matter in order to strike such matter in the bill or to prevent its incorporation through the adoption of amendments or motions. *See* 2 U.S.Code 644.
  - Not much legislative intent may be drawn from legislative history of such legislation with respect to treaty overrides. Byrd rule would arguably be violated if such intent were to be manifested.

Congressional Intent to Override Tax Treaties

- There are examples of clear intent to override treaties from Congress.
  - Section 7874(f) providing a rule that demonstrates such intent:

    "*Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section*."
  - See also the express Congressional intent to override with respect to section 897 in P.L. 96-499, Sec. 1125(c).
    - Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) - Congress decided to tax foreigners on their gains from dispositions of stock in U.S. real property holding companies.
    - The tax conflicted with many U.S. tax treaties which at the time exempted foreign investors resident in the other treaty country from tax on stock gains. Congress directed that the tax apply despite conflicting treaties.
    - Congress adopted a five-year delayed effective date for investors who were protected by a treaty exemption in order to give the Treasury Department time to renegotiate the treaties and to remove the exemption. At the end of the five years FIRPTA was to prevail over (override) those tax treaty exemptions that had not been renegotiated by then.

Tax Treaty Interpretation – Undefined Terms

- Many U.S. tax treaties include a rule of interpretation for undefined terms.
  - Art. 3(2) of the 2016 U.S. Model reads:

  *As regards the application of this Convention at any time by a Contracting State, any term not defined herein shall, **unless the context otherwise requires**, or the competent authorities agree to a common meaning [...], have the meaning that it has at that time under the law of that Contracting State for the purposes of the taxes to which this Convention applies.*

  - A plain reading of this wording may suggest to require an ambulatory approach.
    - What if the later in time meaning contradicts the intentions of the contracting parties at the time of making the treaty?
    - What are the limits to the ambulatory approach?
  - In which circumstances does the context otherwise require?
- Not every U.S. treaty includes the phrase "unless the context otherwise requires". *See e.g.*, US-France Treaty Art. 3(2) and the Technical Explanation to that treaty stating that France considered the introduction of such language would be *unnecessary and confusing*.

Section 960
Indirect Foreign Tax Credits and Tax Treaties

Indirect Tax Credits and Treaties

- Thanks to the uncertainty arising due to the recent regulatory changes to the foreign tax credit area, the following question resurfaced:

  Is there a treaty-based credit for taxes deemed paid under section 960?
- TCJA repealed section 902 and made conforming changes to section 960.
- All US treaties, except the US-Chile Treaty and the US-Croatia Treaty, were concluded before the TCJA.
- The reservation in the US-Chile Treaty replaced the relevant part of the relief from double taxation article. *See also* Article 23(2) of the US Croatia Treaty.
  - Indirect foreign tax credit language is replaced with a provision that permits a US corporate shareholder owning at least 10% of the vote or value of the company resident in the Contracting State to deduct the amount of dividends received from the subsidiary in computing its taxable income. This, in effect, equates to the current-law dividends received deduction under Section 245A.
  - A significant shift in the US tax treaty policy.
  - Impact on former treaties?

Indirect Tax Credits and Treaties

- Double tax relief provisions of U.S. tax treaties typically include a limitation clause:

  In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow.

- The meaning and scope of this clause is heavily debated. Arguably, such limitation is restricted to basketing limitation under section 904 and alike and does not extend to definitional matters.
- Definition of dividend.
- The impact of *Toulouse* case. *Toulouse* did not concern the creditability of a foreign tax under the treaty.

Section 1411
The Net Investment Income Tax

The NII and the FTC and Social Security Agreements

- Is a foreign tax credit allowable against the net investment income (NII) tax?
  - By statute? No.
  - By treaty? Maybe.
- NRAs are not subject to the NII. But what about U.S. citizens living in a country with which we have a social security agreement (often referred to as a totalization agreement)? A case that considered this was dismissed by the taxpayer – see below.

Taxes Covered (France 1994)

1. The taxes which are the subject of this Convention are:

(a) in the case of the United States:

(i) the Federal income taxes imposed by the Internal Revenue Code (but excluding social security taxes) . . . (hereinafter referred to as "United States tax"). . .

2. *The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date or signature of the Convention in addition to, or in place of, the existing taxes.* [Emphasis added]

Taxes Covered (2016 Model)

1. This Convention shall apply to taxes on income imposed on behalf of a Contracting State irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of property.

3. The existing taxes to which this Convention shall apply are . . .

b) in the case of the United States: the Federal income taxes imposed by the Internal Revenue Code (which do not include social security and unemployment taxes) . . .

4. This Convention also shall apply to any identical or substantially similar taxes that are imposed after the date of signature of this Convention in addition to, or in place of, the existing taxes.

The Questions: For purposes of the treaty, what is a "Federal income tax"? What is "any identical or substantially similar tax"?

Treaty Provisions re Double Taxation

Most treaties include provisions along the following lines:

Relief From Double Taxation

2. (a) *In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof),* the United States shall allow to a citizen or a resident of the United States as a credit against the United States income tax *[Emphasis added]*:

(i) the [foreign country] income tax paid by or on behalf of such citizen or resident; and

(ii) in the case of a United States company owning at least 10 percent of the voting power of a company that is a resident of [the foreign country] and from which the United States company receives dividends, the [foreign country] income tax paid by or on behalf of the distributing corporation with respect to the profits out of which the dividends are paid.

The Question: What is the meaning of the highlighted phrase?

U.S.-Korea Social Security Agreement

Article 2 For the purpose of this Agreement, the applicable laws are:

b. As regards the United States, the laws governing the Federal Old-Age, Survivors and Disability Insurance Program:

i. Title II of the Social Security Act and regulations pertaining thereto, except sections 226, 226A and 228 of that title and regulations pertaining to those sections, and

ii. Chapter 2 and Chapter 21 of the Internal Revenue Code of 1986 and regulations pertaining to those chapters.

. . .

3. This Agreement shall also apply to future laws which amend or supplement the laws specified in paragraph 1 of this Article.

The Question: What is the meaning of the highlighted word?

The Cases: Toulouse, Kim and Christensen

- Catherine S. Toulouse v. Commissioner, 157 T.C. No. 4 (Aug. 16, 2021).
- Paul Young Kim v. United States, No. 5:22-cv-00691-SPG-SP, (C.D. Cal. Mar. 28, 2023).
- Matthew and Katherine Christensen v. United States, No. 20-935T (U.S. Court of Claims) (Oct. 23, 2023).
- These cases all deal with the question of whether a treaty requires the United States to give a foreign tax credit for the net investment income tax imposed by section 1411.

Catherine Toulouse

- Taxpayer claimed an FTC carryover for French and Italian tax against net investment income (NII) tax on French and Italian income.
- Taxpayer conceded that the Code does not allow such a credit but argued that the treaties with France and Italy provided a basis for the credit that is independent of the Code-enacted FTC, questioning the purpose of the treaties if the credit must be provided in the Code.
- The Tax Court (Judge Goeke) decided on summary judgment that:
  - Congress only allowed an FTC against taxes imposed under Subtitle A Chapter 1 of the Code (income tax).
  - There is no provision for a credit against the NII tax, which is placed in its own separate Chapter 2A.
  - These treaties do not provide an independent basis for an FTC against the NII tax.

Paul Young Kim

- Taxpayer claimed that he was exempt from the NII tax based on the U.S.-Korea social security totalization agreement.
- In the alternative, he claimed that he was entitled to an FTC under the 1976 income tax treaty between the two countries.
- On a motion to dismiss by the government:
  - The District Court declined to dismiss the totalization agreement claim, although it expressed scepticism about the claim – the taxpayer subsequently dismissed the case, so it was not fully litigated.
  - The court agreed with the Tax Court in Toulouse that the treaty did not allow an FTC, pointing to similarities in the language of the French and Korean treaties.

Matthew and Katherine Kaess Christensen

- Taxpayers argued that the French treaty required that they be given an FTC against the NII tax.
- The facts were very similar to the Toulouse case.
- The Federal Court of Claims allowed the credit.
  - But it agreed with the Toulouse decision in relation to Article 24(2)(a) that no credit was allowed due to the “in accordance with the provisions and subject to the limitations” language.
  - However, the court pointed out that no such language appears in Article 24(2)(b) of the French treaty, which allows an FTC for U.S. citizens residing in France.
- The government filed a notice of appeal on December 18, 2023.

Observations on the Three Cases

- There is a 10-year statute of limitations on refund claims based on FTCs. The NII has been in effect since 2013, so claims relating to 2013 must be made by April 15, 2024.
- For claims under a totalization agreement, the statute of limitations appears to be 4 years from the date the claim could have been made. See 42 U.S.C. § 433.
- All three courts have held that the language “In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the principles hereof)” allows the United States to avoid giving an FTC by the simple expedient, as one commentator put it, of placing the NII tax outside of Subtitle A Chapter 1.
- More attention should be paid to our treaty partners’ views. Probably true of many “interpretative” overrides/declarations of consistency!

IRC Section 7701(b)
Tax Treaties and Residence

The Effect of Tax Treaties on Residence

- Should a treaty nonresident taxpayer be treated as a nonresident alien for U.S. tax purposes?
  - For purposes of calculating the individual's U.S. income tax liability
    - Yes – *see* Reg. § 301.7701(b)-7(1)
  - For all other purposes of the Code, including U.S. information reporting requirements
    - Maybe – *see* Reg. § 301.7701(b)-7(3) and the *Aroeste case*

Aroeste v. United States: Background

Mr. Aroeste
Born in Mexico and lived there all his life
In 1980, purchased a condo in Florida used for vacation and relaxation
In 1984, applied for a U.S. green card

Mrs. Aroeste
Remained in Mexico for over 60 years
Became a naturalized U.S. citizen in 2011
Parties agreed that Mrs. Aroeste was a citizen and thus a United States person, she was required to file a FBAR for the years at issue

Key Facts:

- During the tax years in issue (2012 and 2013), Mr. Aroeste had a financial interest or signature authority over five accounts in Mexico with an aggregate balance exceeded $10,000
- Initially, Mr. Aroeste and his wife filed 2012 and 2013 tax returns as married filing jointly, without submitting Forms 8833
- After Mr. Aroeste was audited by the IRS, he filed amended 2012 and 2013 tax returns as married filing separate and submitted Forms 8833
- In May 2020, the U.S. Treasury assessed $100,000 of total FBAR penalties against Mr. Aroeste for both 2012 and 2013

Key issue:

- Whether Mr. Aroeste, as a treaty non-resident, was a ‘United States person’ required to file a FBAR for 2012 and/or 2013?

Report of Foreign Bank and Financial Accounts (FBAR)

- Under the Bank Secrecy Act (BSA) regulations, **every U.S. person** who has a financial interest in, or signature or other authority over, foreign financial accounts that have an aggregate value exceeding $10,000 at any time during the calendar year must file an information report (Form 114) re those foreign accounts.
- For purposes of the BSA regulations, a U.S. person includes a citizen of the United States and a resident of the United States. ***A resident of the United States is an individual who is a resident alien under IRC section 7701(b) and its regulations.***
- ***The preamble to the BSA regulations provides that "a legal permanent resident who elects under a tax treaty to be treated as a non-resident for tax purposes must still file the FBAR."***

IRC 7701(b)

(b) Definition of resident alien and nonresident alien

(1) In general

For purposes of this title (other than subtitle B)

(A) Resident alien

An alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) such individual meets the requirements of clause (i), (ii), or (iii):

(i) Lawfully admitted for permanent residence

Such individual is a lawful permanent resident of the United States at any time during such calendar year.

(ii) Substantial presence test

Such individual meets the substantial presence test of paragraph (3).

(iii) First year election

Such individual makes the election provided in paragraph (4).

(B) Nonresident alien

An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)).

IRC 7701(b)(6)

(6) Lawful permanent resident

For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if

—(A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and

(B)such status has not been revoked (and has not been administratively or judicially determined to have been abandoned).

An individual shall cease 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 between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment.

Article 4 of the U.S.-Mexico Tax Treaty

- ***1. For the purposes of this Convention**,* the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. However, this term does not include any person who is liable to tax in that State in respect only of income from sources in that State.
- 2. Where by reason of the provisions of paragraph 1, ***an individual is a resident of both Contracting States, then his residence shall be determined as follows:***
- a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);
- b) if the 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 State, he shall be deemed to be a resident of the State in which he has an habitual abode;
- c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
- d) in any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement.

§ 301.7701(b)-7 Coordination with income tax treaties

(a) Consistency requirement—(1) Application. The application of this section shall be limited to an alien individual who is a dual resident taxpayer pursuant to a provision of a treaty that provides for resolution of conflicting claims of residence by the United States and its treaty partner. ***A "dual resident taxpayer" is an individual who is considered a resident of the United States pursuant to the internal laws of the United States and also a resident of a treaty country pursuant to the treaty partner's internal laws.*** If the alien individual determines that he or she is a resident of the foreign country for treaty purposes, and the alien individual claims a treaty benefit (as a nonresident of the United States) so as to reduce the individual's United States income tax liability with respect to any item of income covered by an applicable tax convention during a taxable year in which the individual was considered a dual resident taxpayer, then ***that individual shall be treated as a nonresident alien of the United States for purposes of computing that individual's United States income tax liability under the provisions of the Internal Revenue Code and the regulations thereunder (***including the withholding provisions of section 1441 and the regulations under that section in cases in which the dual resident taxpayer is the recipient of income subject to withholding) with respect to that portion of the taxable year the individual was considered a dual resident taxpayer.

§ 301.7701(b)-7 Coordination with income tax treaties

(2) Computation of tax liability. If an alien individual is a dual resident taxpayer, then the rules on residency provided in the convention shall apply for purposes of determining the individual's residence for all purposes of that treaty.

(3) Other Code purposes. ***Generally, for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax liability, the individual shall be treated as a United States resident.*** Therefore, for example, the individual shall be treated as a United States resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under section 957 or whether a foreign corporation is a foreign personal holding company under section 552. In addition, the application of paragraph (a)(2) of this section does not affect the determination of the individual's residency time periods under § 301.7701(b)–4.

Aroeste v. United States: The Court's Findings

- The the U.S. District Court for the Southern District of California concluded that
  - Mr. Aroeste was a resident of Mexico under the tiebreaker provisions of the Mexico-U.S. income tax treaty in 2012 and 2013;
  - Mr. Aroeste's status as U.S. lawful permanent resident had ceased under IRC section 7701(b)(6) such that he was not obligated to file FBARs;
  - Mr. Aroeste's failure to timely file Form 8833 did not waive the benefits of the treaty but did subject him to a financial penalty of USD 1,000 for each delinquent Form 8833; and
  - Mr. Aroeste's failure to file Form 8854, *Initial and Annual Expatriation Statement*, with his tax returns did not preclude him from being treated as "having notified the IRS of commencement of treaty benefits" because the requirement to file this form was issued in IRS Notice 2009-85, which did not comply with the notice-and-comment procedure mandated by the Administrative Procedure Act and was not therefore valid.

Observations and Questions about the Aroeste Case

- Can we conclude that dual residents with treaty foreign residency (treaty nonresidents) are not required to file FBAR according to the *Aroeste* Case (assuming this case is final and binding)?
- How about other reporting obligations such as Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*?
- Will a green card holder be subject to expatriation tax under § 877A simply because he or she claims to be a treaty nonresident even if he or she does not file Form 8854, *Initial and Annual Expatriation Statement*?
- Would Mr. Aroeste be required to file FBAR if he met the substantial presence test by travelling to the United States and he continues to be a nonresident under the Mexico-U.S. treaty?
- As a policy matter, should treaty nonresidents be treated as nonresident aliens of the United States for all purposes of the Code?

IRC Section 864(c)(8)
Sale of Partnership Interest by Foreign Person

Sales of Partnership Interests by Foreign Persons

- In Rev. Rul. 91-32, the IRS ruled that "[g]ain or loss of a foreign partner that disposes of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be United States source ECI gain or will be ECI loss that is allocable to United States source ECI gain, to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to ECI (United States source) property of the partnership."
- In 2017, that position was dismantled by the Tax Court in *Grecian Magnesite v. Commissioner*, 149 T.C. 63 (2017), *affirmed*, 926 F.3d 819 (DC Cir. 2019).

Grecian Magnesite

- In *Grecian Magnesite*, the Tax Court held that the gain derived from the sale of the partnership interest could not be treated as a sale of the underlying assets
- The Tax Court also rejected the IRS argument that the gain was attributable to a U.S. office of the taxpayer. The taxpayer did not in fact have its own U.S. office, but the IRS argued that the office of the partnership should be attributed to the taxpayer 7 and that the sale was attributable to that office.
- On appeal, the IRS did not challenge the position that the taxpayer had sold a single asset, the partnership interest, rather than an interest in the underlying assets. But it continued to contend that the gain was attributable to a U.S. office.
- In 2019, the DC Circuit upheld the Tax Court and rejected the IRS argument, holding that what the statute required was that the sale (not the gain) be attributable to the permanent establishment and that the sale was not so attributable.

Congress' Response: IRC Sections 864(c)(8) and 1446(f)

- Section 864(c)(8)(A) provides that gain or loss of a nonresident alien individual or foreign corporation (a "foreign transferor") from the sale, exchange, or other disposition ("transfer") of an interest in a partnership that is engaged in any trade or business within the United States is treated as ECI gain or loss.
- Section 864(c)(8)(B) limits the amount of ECI gain or loss to the portion of the foreign transferor's distributive share of gain or loss that would have been effectively connected if the partnership had sold all of its assets at fair market value (the deemed sale limitation).
- Section 1446(f) imposes complex withholding requirements to enforce payment of tax imposed by section 864(c)(8).

Do Treaties Prevent Taxation Under Section 864(c)(8)?

- Most U.S. treaties contain an article preventing U.S. tax on a capital gain realized by a treaty resident. The U.S. Model Income Tax Treaty of 2016 provides a typical exception to this rule:

  Gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of [the treaty partner] has in the [United States], including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in [the United States].
- The question can be broken down into two:
  - First, does the typical gains article by its terms permit the taxation of section 864(c)(8) gain?
  - Second, if not, would section 864(c)(8) override treaties with such an article?

The Government's Position

- In the preamble to the final regulations, the government states that:

  > The final regulations clarify that a gains article that permits the taxation of gain from the alienation of property forming part of a permanent establishment or fixed place of business in the United States also permits the taxation of gain from the alienation of a partnership interest, to the extent the partnership's assets deemed sold under section 864(c)(8) form a part of the U.S. permanent establishment or fixed place of business of the partnership.

- The regulations actually say nothing about permission; only that gain or loss will be considered attributable to alienation of assets forming part of the permanent establishment.

  > Gain or loss from the alienation of a partnership interest will be considered gain or loss attributable to the alienation of assets forming part of a permanent establishment or fixed place of business in the United States to the extent the assets deemed sold under section 864(c)(8) form a part of the U.S. permanent establishment or fixed place of business of the partnership.

Problem with the Government Position

- This is a dubious piece of treaty interpretation. Treaties permit gain from alienation of a permanent establishment, but does that do more than allow U.S. taxation of a treaty resident partner on his allocable share of a sale <u>by the partnership</u> of the permanent establishment?
- A partner selling a partnership interest is not selling a permanent establishment. The partner is selling a capital asset, as confirmed by the courts in *Grecian Magnesite*.
  - *Grecian Magnesite* was not overruled by Congress.
  - Congress only provided that gain on sale of a partnership interest would be treated as ECI, subject to the deemed ECI limitation.
  - But see *Rawat v. Commissioner*, TC Memo. 2023-14 (NRA taxed on section 751 gain on pre-2018 sale partnership interest).

Prioritizing ECI Over Non-ECI

- There is also the problem created by the way the deemed ECI limitation works.
- The statute prioritizes ECI gain over non-ECI gain.
- But is prioritization valid under the standard treaty language above, which allows taxation of "gains from the alienation of the permanent establishment"?
- Shouldn’t a foreign partner's gain be attributed to both ECI assets and the non-ECI assets and, even if some gain is taxable, shouldn’t it be apportioned in some manner?

Tax Treaties and Section 877A(f)

Section 877A

- §877A(a)(1): "All property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value."
- **Under §877A(f), distributions to a covered expatriate following her expatriation date from domestic non-grantor trusts are subject to a 30% withholding tax, to the extent that these distributions would have been taxable had the expatriate been a citizen or resident of the United States at the time of distribution.**
- §877A(g)(2): "The term "expatriate" means—

  (A) any United States citizen who relinquishes his citizenship, and

  (B) any long-term resident of the United States who ceases to be a lawful permanent resident of the United States (within the meaning of section 7701(b)(6))."

Hypothetical Aroeste case

- Assuming the facts are the same as those in *Aroeste case,* with the additional fact that Mr. Aroeste received distributions from a domestic non-grantor trust in 2013.
- Is Mr. Aroeste subject to 30% withholding tax on the distributions under §877A(f)?
- Does §877A(f) conflict with our tax treaties?
- Did Congress intend §877A(f) to override treaties?
  - §877A(f)(4): The covered expatriate is "treated as having waived any right to claim any reduction under any treaty with the United States in withholding on any [such] distribution."

Section 2801
Taxation of Gifts to and Inheritances Received by U.S. Persons from Covered Expatriates

The Expatriation Rule

- Section 2801, enacted by the Heroes Earnings Assistance and Relief Tax Act of 2008 (the “2008 Act”), provides that if a U.S. citizen or resident receives any covered gift or bequest, it is subject to a tax at the higher of the highest rate of estate tax and the highest rate of gift tax applicable on the date of receipt.
- Unlike all other transfer taxes, it is imposed on the recipient, not the donor or the decedent whose assets are the source of the gift.
- Section 2801 allows a reduction, in effect a credit, for foreign gift tax or estate tax with respect to a covered gift or bequest.
- Special rules apply to distributions from trusts.

U.S. Gift and Estate Tax 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, Netherlands, Norway, South Africa, Switzerland and the United Kingdom.
- A limited number of 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.
- Only the French and German treaties cover former long-term residents
- 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 (which is creditable against the U.S. estate tax)

Is Tax Under Section 2801 a Covered Tax?

- It would seem that Section 2801 tax is a form of gift or estate tax.
  - Section 2801 is placed within Subtitle B of the Code.
  - Section 2801 does not apply to transfers of property included in a gift tax return or an estate tax return – in other words, section 2801 is an alternative form of gift or estate tax.
  - Transfers are described as “covered gifts or bequests”.
  - Rates are coordinated with the gift tax and estate tax rates.
- Language is contained in most of our treaties to the effect that the treaty is shall apply to “any other taxes of a substantially similar character imposed by either contracting State subsequently to the date of signature of the present Convention.”

Does It Matter Who Is the Taxpayer?

- Section 2801 tax is imposed on the recipient. Gift and estate taxes are imposed on the donor or the estate of the donor.
  - This should not be a controlling difference, at least in the case of newer treaties and possibly in the case of older treaties.
  - Newer treaties do not differentiate between taxes that fall on the transferor and those that fall on the transferee. This is because treaty partners in civil law countries typically impose transfer taxes on donees and heirs, not donors and decedents.
  - Older treaties do not explicitly address this point but the clear implication is that they apply to gratuitous transfers of property. No older treaty states that it applies with respect to tax only if imposed on the donor or the estate of a decedent.

Treaty Savings Clauses

- Most treaties preserve the U.S. right to impose tax on gifts or bequests of citizens and domiciliaries
- Only four address former citizens or long-term residents who are no longer domiciled in the United States.
  - Austria, Article 9(1), and Denmark, Article 1(3) (expatriated citizens only); France, Article 1(4) and Germany, Article 11(1) (expatriated citizens and former long-term residents).
  - All refer to former citizens and long-term residents whose loss of status had a tax avoidance purpose and all expire 10 years after expatriation.
  - Tax avoidance is no longer used to define a covered expatriate.

Does Section 2801 Conflict With Our Treaties?

- Newer treaties: The question answers itself. It does.
- Older treaties: Less clear.
- Next question: Did Congress intend section 2801 to override treaties?
  - Legislative history is silent on section 2801 (and section 877A, the current income tax rule imposing tax on covered expatriates).
  - But there is a lot of legislative history with respect to section 877 when it was reformed in 1996 and first applied to former long-term residents – that suggests that treaties were overridden only until August 21, 2006.
  - Congress extensively considered treaties ahead of changes in 2004 but the legislative history of those changes was silent.

Questions?