



Expatriation:
The IRS
&
U.S. Taxes

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The IRS & U.S. Taxes

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Chapter 1 – Expatriation Introduction

An “Expatriate” is a U.S. citizen who relinquishes his citizenship, or a long-term resident (i.e. green card holder for 8 of last 15 years (IRC§877(e)(2)) who ceases to be a lawful permanent resident (IRC§877A(g)(2)).

A “green card holder” will cease to be a lawful permanent resident (i.e. become an expatriate) if the green card is revoked, abandoned, or the individual elects to be treated as a resident of a foreign country under a tax treaty (IRC Sec. 7701(e)(6).

Under the 2008 Tax Act (“HEART ACT”), two new taxes are imposed on “covered expatriates”:
A “Mark-to-Market Tax” (i.e. a “wealth tax” on expatriation); and
A “Succession Tax” (i.e. an “inheritance tax” on gifts, paid by the gift recipient).

An expatriate is classified as a “Covered Expatriate”, if on the date of expatriation, they have:
A net worth of \$2m or more (“net worth test”); or

A \$157,000 net income tax liability (2014) i.e., an average annual net income tax liability for the preceding 5 years which exceeds \$157,000 (“Income Tax Liability Test”), or

Failed to certify (by filing IRS Form 8854) that they have complied with U.S. tax requirements for the 5 preceding tax years (“Certification Test”) (See: IRS Sec. 877(g)(1)(A), 877(a)(2)(A), 877(a)(2)(B), 877(a)(2)(C).

For Covered Expatriates two new taxes are imposed as of the 2008 Tax Act:

1) IRC§877A: A “Mark-to-Market” Tax (i.e. a wealth tax on expatriation). A tax on the net unrealized gain (on the expatriate’s world-wide assets) to the extent it exceeds \$680,000 (2014). The net gain on the deemed sale in excess of \$680,000 is calculated as if such property was sold for its fair market value on the day before the expatriation date (IRC§877A(a)(1)). IRS Notice 2009-85, Rev Proc 2012-41, Rev Proc 2013-35.

2) IRC§2801: A “Succession Tax” (i.e. an inheritance tax on gifts, paid by the gift recipient). This tax applies to gifts to an individual, which exceeds \$14,000 (2013) during the calendar year, and is assessed at the highest marginal estate or gift tax rate in effect on the date of the transfer (IRC§2801(a)(1). In 2014, a 40% tax rate.

Chapter 2 – Investment Tax Planning and the Mark-to-Market Tax

The “mark-to-market” tax imposes a wealth tax on expatriation. The tax is imposed on the net unrealized gain, on the expatriate’s world-wide assets; to the extent the gain exceeds \$680,000 (2014).

Investment Tax Planning may eliminate the mark-to-market tax (on unrealized capital gain). If prior to expatriation the taxpayer creates an investment portfolio (e.g. stocks, bonds, hedge funds), which is owned by an offshore Private Placement Variable Life Insurance policy (e.g. Puerto Rico as the preferred jurisdiction because of highly favorable asset protection laws), investment portfolio earnings and unrealized appreciation may be exempted from income tax (and income tax reporting).

A Puerto Rico Private Placement Life Insurance policy acts as a “tax-free wrapper” for the investment portfolio allowing earnings growth to compound tax-free (not subject to either annual tax on earnings i.e. interest, dividends or capital gains, or the expatriation mark-to-market tax on unrealized gains).

The Puerto Rico PPLI may be funded with cash, or other assets. If a taxpayer has “underperforming” investment assets, the assets may be contributed to the PPLI. The taxpayer may then receive a tax loss (i.e. the tax payer receives a tax loss on the difference between the value of the asset when contributed vs. the acquisition cost).

Chapter 3 – U.S. Tax Planning for Passive Investments

By Gary Wolfe, The Wolfe Law Group and David Richardson, Mid-Ocean Consulting, Nassau, Bahamas (Originally Published in ABA/The Practical Tax Lawyer, Winter 2013)

In her 10/18/06 Wall St. Journal article, Insuring Against Hedge-Fund Taxes, Rachel Emma Silverman stated:

“A small but growing number of wealthy investors have discovered a legal way to invest in hedge funds without paying income taxes on the gains. It’s called “private placement” life insurance. These special insurance contracts allow policyholders to invest in a wide range of products, including hedge funds. The main attraction: Because the investments are held within an insurance wrapper, gains inside the policy are shielded from income taxes – as is the payout upon death. What’s more, policyholders may be able to access their money during their lifetimes by withdrawing or borrowing funds, tax-free, from the policy...”

“Private-placement insurance policies are essentially variable insurance policies, which allow policyholders to invest a portion of their premiums in separate investment accounts...”

“The strategy’s chief advantage is the tax benefits that all life-insurance policies offer: Assets inside a life insurance policy can grow tax-free, and the death benefit can also be paid out free of income tax...”

Tax Planning Strategy for Passive (Portfolio) Investments

U.S. taxpayers can achieve greater net-after tax returns and superior asset protection for their domestic or international investment portfolios by using a tax planning strategy utilizing private placement life insurance. The benefit is perhaps greatest when combined with investments like hedge funds that are taxed at ordinary income rates and also where taxable unrealized income tax and gains are flowed out annually to fund shareholders.

A summary of the benefits are as follows:

1. Taxable ordinary income and short-term capital gains (taxed at 35% federal tax rate) now wholly tax exempted.
2. For Foreign Trusts, investment portfolio income now compounds tax-free annually with no accumulation tax.
3. Pre-empts IRS tax audits on investment portfolio income since there is neither any income tax nor any reporting due on the investment portfolio income.
4. Absent a fraudulent conveyance, investment portfolio assets are immediately exempt from creditor seizure once held by the policy.

5. U.S. tax compliance is minimized for filings: that is, no TDF 90-22.1 (“FBAR” filing), or IRS Form 8938 (Statement of Specified Foreign Financial Assets).

For U.S. taxpayers, the strategy requires that the investments are owned and held by a Puerto Rico issued Life Insurance policy- Puerto Rico is a US Commonwealth Territory and considered “US” for many practical purposes, but with design and investment flexibility typically found “offshore”. In turn, the policy could be owned by a U.S. Grantor Trust, domiciled say, in the Bahamas. The Bahamas is particularly well suited in that under local law, insurance is expressly exempt from the claims of creditors, provided that premium(s) used to fund the policy are not subject to any prior claim at the time of transfer.

The tax planning strategy is particularly appropriate to international investors (who are treated as U.S. resident taxpayers) who invest in U.S. hedge funds, but also a very wide variety of portfolio investments.

Reporting Benefits

U.S. Taxable Residents with offshore structures ordinarily must file the following annual U.S. tax compliance:

- a. Annual Form 1040: report worldwide income (including hedge fund income)
- b. Foreign Financial accounts over \$10,000 file form TDF 90-22.1, Report of Foreign Bank and Financial Accounts, “FBAR Filing,” due June 30th following tax year (separate tax filing)
- c. Foreign Financial Assets valued in excess of \$50,000 file form 8938, “Specified Foreign Financial Assets” attached to form 1040 (Foreign Account Tax Compliance Act: “FACTA Filing”)

Note: Filing form 8938 (with form 1040) does not relieve U.S. taxable residents of the requirement to file “FBAR,” Form TDF 90-22.1 if FBAR filing is otherwise due.

In contrast to these reporting obligations, the aforementioned strategy is not only compliantly tax exempted, but also relieves the taxpayer of all the reporting obligations listed above and thus diminishing the likelihood of IRS audit.

In Greater Detail: U.S. Tax Compliance/Tax & Asset Protection Benefits

1. Income Tax (Form 1040)

Under IRC§72(e)(5), income from assets held under a qualifying life insurance policy (i.e. Puerto Rico Life Insurance policy), is not subject to income tax, nor is there tax reporting. Effectively, the investments otherwise taxable income and gains are not subject to U.S. income tax or tax reporting.

2. Report of Foreign Bank and Financial Account (“FBAR”: TDF 90-22.1)

The “FBAR filing” is a financial disclosure for U.S. taxpayer foreign financial accounts (i.e. a report of taxpayer’s foreign financial accounts if the account value is over \$10,000). As a U.S. territory, an account in Puerto Rico is not considered a foreign account so no “FBAR filing” is due for the Puerto Rico life insurance policy.

3. Statement of Specified Foreign Financial Assets (IRS Form 8938)

The Puerto Rico life insurance policy may be classified as a foreign financial asset (i.e. a foreign financial account maintained by a foreign financial institution, subject to reporting under IRS Form 8938. Since the U.S. taxpayer (IRC§679(a)(1) Foreign Grantor Trust (i.e. Bahamas Discretionary Trust) owns the policy, the U.S. taxpayer may file an abbreviated Form 8938 (only completing Parts 1 and IV) confirming that the specified foreign financial asset (i.e. Puerto Rico Life Insurance policy with more than \$50,000 cash value) was reported on the Foreign Grantor Trust (Nassau Trust) tax filings (Forms 3520, 3520-A)

4. Policy lifetime withdrawals may be tax-free and not subject to tax reporting (as either a return of premium/basis or a loan). The Modified Endowment Contract (“MEC”) rules may or may not apply depending on policy design.

5. IRS Private Letter Ruling 200244001 (May 2, 2002): IRS audit risks are minimized since assets held under a qualifying life insurance policy are neither subject to investor income tax, nor is there any required income tax reporting (under IRC § 72(e)(5)), reference: Rev. Rul. 81-225 (situation #5), Rev. Rul. 82-54, 1982-1 C.B.11.

In addition to the substantive tax and reporting benefits, for audit purposes there would be no presumed IRS tax avoidance, due to the fact that life insurance has been granted an “angel exception” (i.e., is an IRS approved transaction) (IRS Revenue Procedure 2004-65, 2004-66, 2004-67, 2004-68).

6. As a U.S. territory, Puerto Rico life insurance policies do not require filing of “FBAR” Form TDF 90-22.1 (Report of Foreign Bank and Financial Account). Since taxpayer’s foreign Grantor Trust (i.e. Nassau Trust) owns the Puerto Rico Life Insurance policy an abbreviated Form 8938 may be filed (only Parts I and IV).

In contrast, foreign life insurance issued to U.S. persons is subject to “FBAR filings” annually (if valued at more than \$10,000) with the report filed directly with the IRS (Treasury Department), and disclosure as a specified foreign financial asset (over \$50,000) with the annual filing of Form 8938, a separate tax compliance form filed with annual income tax returns (Form 1040).

7. Additional income tax benefits:

a. Assets inside a life insurance policy grow and compound income tax free.

b. Death benefit paid income tax free. (IRC§101)

8. Short-term capital gains exempt from income tax (41% Federal/California income tax, i.e. Federal 35% tax rate over \$379,150, California: 9.3% tax rate over \$48,029)

9. Bond interest exempt from income tax (taxed at 41% ordinary income rates Federal/California)

10. Under Puerto Rico law, the cash value benefits of a life insurance policy are expressly exempt from seizure by creditors (absent fraudulent conveyance funding of the policy). Act No. 399 of Sept. 22, 2004, as amended by Act No. 98 of June 20, 2011.

Under Act No. 98 (6/20/11), which amended Act no. 399 (9/22/04), the policy owner and policy beneficiary are statutorily protected from seizure.

In summary, a properly structured US compliant private placement life insurance as issued by a duly licensed Puerto Rican carrier, and as owned by a Bahamian Foreign Grantor Trust is very legitimate and tax effective way to hold portfolio investments (especially hedge funds), while at the same time having a minimal reporting burden associated with it, as well as providing significant asset protection.

Chapter 4 - U.S. Income, Estate & Gift Tax (2014)

Estate & Gift Tax

1. Estate and Gift Tax Exemption increases from \$5,250,000 to \$5,340,000, tax rate: 40% (excess over \$5,340,000)
2. Gift Tax Exclusion: \$14,000 per donee
3. Up to \$1,090,000 of farm or business realty can receive discount estate valuation
4. Estate Tax Deferral (Installments)

If one or more closely-held businesses make up greater than 35% of an estate, as much as \$580,000 of tax can be deferred, and the IRS will charge 2% interest (15 year tax deferral)

Pensions/Retirement Plans (2014)

1. Pay-in limitation for defined contribution plans increase to \$52,000 (based on up to \$260,000 in salary), which is a \$1,000 increase (for profit-sharing plans, KEOGH plans, et al)
2. Benefit limit for Defined Pension Benefit Plans is \$210,000.
3. 401(K) limit remains \$17,500

Social Security

Social Security wage base increases in 2014 to \$117,000 (up \$3300 from 2013 cap). The tax rate imposed on employers and employees remains 6.2% and the employer share of Medicare tax stays at 1.45%. The employee's share is 1.45%, but the 0.9% Medicare surtax kicks in for singles with wages exceeding \$200,000 and couples earning over \$250,000.

Income Taxes

US Taxpayers working abroad have a larger exclusion \$99,200 (2014).

2014 Top Tax Rates

Taxable Income / Over / Tax Rate

1. Married / \$457,600 / 39.6%
2. Singles / \$406,750 / 39.6%

Standard Deductions

1. Married: \$12,400
with one spouse over 65: \$13,600
with both spouses over 65: \$14,800
2. Singles: \$6,200
over 65: \$7,750

Itemized Deductions

High Income Earners have phase-out of itemized deductions 3% of the excess of AGI over:

1. Singles: \$254,200
2. Married: \$305,050

Total deduction can't exceed 80% of itemizations. Medicals, investment interest, casualty loss, are exempted.

Dividends/Capital Gains

20% top tax rate on dividends and long-term gains 2014; on taxable income in excess:

1. Singles: \$406,750
 2. Married: \$457,600
- 3.8% Medicare surtax boosts the rate to 23.8%

AMT

AMT exemptions increase for 2014

1. Singles: \$52,800
2. Married: \$82,100

AMT phase-outs start at income levels

1. Singles: \$117,300
 2. Couples: \$156,500
- 28% AMT tax bracket begins above \$182,500.

2014 U.S./California Income Tax

In 2014, the highest income tax rate is 51.7% (Federal tax rate: 44.3%, California tax rate: 13.3%). The 51.7% tax rate applies to wage earners.

For investors the top rate on net investment income is 50.92% (Federal tax rate: 43.4%, California tax rate: 13.3%).

The top tax rates apply to U.S. taxpayers who earn income over certain levels, see below. These top tax rates apply to international investors who are classified as U.S. tax residents under either the "Green Card Test" or the "Substantial Presence Test".

California Income Tax

Income over \$250,000 is taxed at 12.3%. Income over \$1m is taxed at 13.3% (additional 1% mental health tax). These tax rates apply through 2018.

2014 Highest California Tax Rate: 13.3%

U.S. Income Tax (2014): Income/Medicare Tax

1. Income Tax

Individuals (over \$406,750); Married (over \$457,000) Tax: 39.6%

2. Medicare Surtax

Net Investment Income

Individuals/Heads of Household

(Modified Adjusted Gross Income ("AGI") over \$200,000)

Married Taxpayers (over \$250,000)

Married filing separately (over \$125,000) Tax: 3.8%

The 3.8% Medicare surtax on net investment income is levied on the lesser of:

1. Taxpayer's net investment income; or

2. The excess of modified adjusted gross income over the applicable dollar threshold (modified AGI is AGI plus any tax-free foreign earned income).

Investment income includes: interest, dividends, capital gains, annuities, royalties and passive rental income. Tax-free interest is exempted, along with pay-outs from retirement plans such as 401(k)s, IRAs, deferred pay plans and pension plans.

Earned Income

(Wages and Self-Employment Income)

Individuals/Heads of Household

(Total Earnings over \$200,000)

Married Couples

Joint Returns/Earnings over \$250,000

Filing Separately/Earnings over \$125,000; Tax: 0.9%

This surtax applies only to the employee's share of Medicare tax.

Employers don't owe it. Employers will withhold the surtax once an employee's wages exceed \$200,000. Employees will then calculate the actual tax due on their Form 1040 tax returns.

2014 Highest U.S. Tax Rate (44.3%)

(Includes Medicare Surtaxes on Net Investment Income and Earned Income)

Summary 2014/Combined U.S./California Tax (Top Rates: 57.6%)

"Blended" U.S./California Tax (Top Rates: 51.7%)

For taxpayers (individual) who have income over \$406,750, including net investment income over \$200,000 (modified adjusted gross income), and earned income over \$200,000 (wages and self-employment income), the combined top tax rate is 57.6%, the "blended" top tax rate is 51.7%.

For investors (who do not have wages and self-employment income) the combined top tax rate is 56.7%; the "blended" top tax rate is 50.92%.

Chapter 5 - IRS Audits

The IRS 2012 Fiscal Year Performance Results (10/1/11 – 9/30/12, updated 12/31/13) confirm the IRS increased audits by more than 12%.

1. Total IRS Audits (FY 2012): 18,654,923
2. Total Additional Tax Assessed from Audits in FY 2012: \$38,699,308,000

According to the [IRS Data Book](#) (calendar year 2012 through 9/30/2012) in 2012, the IRS processed more than 237.3 million federal tax returns, and collected \$2.52 trillion in taxes, issued refunds (\$373.4 billion) net tax collections (\$2.15 trillion). Since the U.S. government spent \$3.79 trillion in expenditures, there was a "revenue shortfall in 2012 of: \$1.27 trillion.

The largest source of IRS tax receipts is from individual, estate and trust income taxes allocating for nearly 55% of gross tax collections (\$1,387,836,515)

IRS Audit Statistics

1. Corporate Tax: C-corporations (Form 1120) had 3.4 times the audit rate vs. S-corporations/Partnerships: C-Corp (1.64%), Partnerships (.47%), S-Corp (.48%)
2. Estate Tax: In calendar year 2011 (through 9/30/11): 12,582 Estate Tax Returns filed, 3,762 Audited (29.90%)
3. Gift Tax Returns: In calendar year 2011, 223,090 filed, 3,164 Audited (1.42%). Estate tax returns had 21 times the audit rate as gift tax returns. Estates \$5 million - \$10 million had a 60% audit rate. Estates over \$10 million, 100% audit rate.
4. Individual Taxes: In calendar year 2011 (through 9/30/11) 143,399,737 individual returns filed, 1,481,966 audited (1.03%).

Less than 1% of all individual tax returns reporting taxable incomes of between \$25,000 - \$200,000 were examined.

If returns reported business income, up to 4 times more likely to be audited than returns without business income.

If returns reported income of \$1 million or more, 12 times more likely to be audited than average individual tax returns.

The IRS 2012 Data Fact Book reported during Fiscal Year 2012, (through 9/30/12) the IRS employed 97,941 employees (Budget \$12.1billion), collected \$2.5 trillion in taxes, processed 237.3 million tax returns.

IRS 2011 audit activities are as follows:

1. Form 1040 - 143.4 million tax returns filed, audit rate 1.03%
2. Form 706 - 12,582 tax returns filed, 3,762 audited (29.9%). Estates between \$5 million and \$10 million audited nearly 60%, estates over \$10 million 100% audit rate.
3. Form 709 - 223,090 tax returns filed, 3,164 audited, (1.42%)
4. Form 1065 - 3,524,808 tax returns filed, 16,691 audited (.47%)
5. Form 1120S - 4,469,329 tax returns filed, 21,658 audited (.48%)
6. Form 1120 - 1,999, 266 tax returns filed, 32,701 audited (1.64%)
7. Form 1041 - 3,036,900 tax returns filed, 5,070 audited (.17%)

Chapter 6 – FATCA/FBAR

Summary of HIRE and Foreign Account Tax Compliance Act

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment (“HIRE”) Act (P.L. 111-147) (The “Act”), which included the Foreign Account Tax Compliance Act containing new foreign account tax compliance rules.

Under the Act, new reporting and disclosure requirements for foreign assets will be phased in between 2010 – 2014:

1. Foreign Institutional Reporting: Foreign Institutions have new reporting and withholding obligations for accounts held by U.S. Persons (generally effective after 12/31/12, commencing 1/1/13).
2. Foreign Financial Assets (\$50,000): Individuals with an interest in a “Foreign Financial Asset” have new disclosure requirements. If foreign financial assets are valued in excess of \$50,000, the U.S. Taxpayer must attach certain information to their income tax returns for tax years beginning after March 18, 2010. (U.S. Taxpayers are not required to disclose interests that are held in a custodial account with a U.S. financial institution).

The penalty is substantial (\$10,000, plus additional amounts for continued failures, up to a maximum of \$50,000 for each applicable tax period). The penalty may be waived if the individual can establish that the failure was due to reasonable cause and not willful neglect.

3. 40% Penalty: A 40% accuracy-related penalty is imposed for underpayment of tax that is attributable to an undisclosed foreign financial asset understatement. Applicable assets are those subject to mandatory information reporting when the disclosure requirements were not met. The penalties are effective for tax years beginning after March 18, 2010.

4. 6 Year Statute of Limitations: Statute of limitations re: omission of income in connection with foreign assets: The statute of limitations for assessments of tax is extended to six (6) years if there is an omission of gross income in excess of \$5,000 attributable to the foreign financial asset. The six-year statute of limitations is effective for tax returns filed after March 18, 2010, as well as for any other tax return for which the assessment period has not yet expired as of March 18, 2010.

5. Passive Foreign Investment Companies: The Act imposes an information disclosure requirement on U.S. Persons who are PFIC shareholders. A PFIC is any foreign corporation if:

- a. 75% or more of the gross income of the corporation for the taxable year is passive income; or

b. The average percentage of assets held by such corporation during a taxable year which produce passive income or which are held for the production of passive income are at least 50%.

6. Foreign Trusts with U.S. Beneficiaries: The Act clarifies if a foreign trust is treated as having a U.S. Beneficiary; an amount accumulated is treated as accumulated for the U.S. Person's benefit even if that Person's trust interest is contingent.

The Act clarifies that the discretion to identify beneficiaries may cause the trust to be treated as having a U.S. Beneficiary. This provision is effective after March 18, 2010.

7. Rebuttable Presumption/Foreign Trust – U.S. Beneficiary: The Act creates a rebuttable presumption that a foreign trust has a U.S. Beneficiary if a U.S. Person directly or indirectly transfers property to a foreign trust (unless the transferor provides satisfactory information to the contrary to the IRS). This provision is effective for property transfers after March 18, 2010.

8. Uncompensated Use of the Foreign Trust Property: The Act provides that the uncompensated use of the foreign trust property by a U.S. Grantor, a U.S. Beneficiary (or a U.S. Person, related to either of them), is treated as a distribution by the trust. The use of the trust property is treated as a distribution to the extent of the fair market value of the property's use to the U.S. Grantor/U.S. Beneficiary, unless the fair market value of that use is paid to the trust.

The loan of cash or marketable securities by a foreign trust, or the use of any other property of the trust, to or by any U.S. Person is also treated as paid or accumulated for the benefit of the U.S. Person. This provision applies to loans made and uses of property after March 18, 2010.

9. Reporting Requirements, U.S. Owners of Foreign Trusts: This provision requires any U.S. Person treated as the owner of any portion of a foreign trust to submit IRS-required information and insure that the trust files a return on its activities and provides such information to its owners and distributees.

This new requirement imposed on U.S. Persons treated as owners is in addition to the current requirement that such U.S. Persons are responsible for insuring that the foreign trust complies with its own reporting obligations. This provision is effective for taxable years beginning after March 18, 2010.

10. Minimum Penalty re: Failure to Report Certain Foreign Trusts: This provision increases the minimum penalty for failure to provide timely and complete disclosure on foreign trusts to the greater of \$10,000 or 35% of the amount that should have been reported.

In the case of failure to properly disclose by the U.S. Owner of a foreign trust of the year-end value, the minimum penalty would be the greater of \$10,000 or 5% of the amount that should have been reported. This provision is effective for notices and returns required to be filed after December 31, 2009.

Foreign Financial Assets

U.S. Taxpayers who hold any interests in specified foreign financial assets during the tax year must attach their tax returns for the year certain information with respect to each asset if the aggregate value of all assets exceeds \$50,000. An individual who fails to furnish the required information is subject to a penalty of \$10,000. An additional penalty may apply if the failure continues for more than 90 days after a notification by the IRS to a maximum of \$50,000. The penalty may be avoided if the Taxpayer shows a reasonable cause for the failure to comply.

The Joint Committee on Taxation, Technical Explanation of the Hiring Incentives to Restore Employment Act (JCX-4-10) clarifies that although the nature of the information required to be disclosed is similar to the information disclosed on an FBAR, it is not identical.

For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50%, may still be required to disclose the interest with his tax return if the \$50,000 value threshold is met. In addition, this provision is not intended as a substitute for compliance with the FBAR reporting requirements, which remain unchanged.

For purposes of IRC Code §6038(D) as added by the HIRE Act, a specified foreign financial asset includes:

1. Any depository, custodial, or other financial account maintained by a foreign financial institution, and
2. Any of the following assets that are not held in an account maintained by a financial institution:
 - a. Any stock or security issued by a person other than a U.S. Person
 - b. Any financial instrument or contract held for investment that has an issuer or counterparty other than a U.S. Person, and
 - c. Any interest in a foreign entity (IRC §6038(D)(b) as added by the 2010 HIRE Act).

The information required to be disclosed with respect to any asset must include the maximum value of the asset during the tax year (IRC §6038(D)(c) as added by the 2010 HIRE Act).

For a financial account, the Taxpayer must disclose the name and address of the financial institution in which the account is maintained and the number of the account.

In the case of any stock or security, the disclosed information must include the name and address of the issuer and such other information as is necessary to identify the class or issue of which the stock or security is a part.

In the case of any instrument, contract, or interest, a Taxpayer must provide any information necessary to identify the instrument, contract, or interest along with the names and addresses of all issuers and counterparties with respect to the instrument, contract, or interest. Under these rules, a U.S. Taxpayer is not required to disclose interests held in a custodial account with a U.S. financial institution. In addition, the U.S. Taxpayer is not required to identify separately any stock, security instrument, contract, or interest in a disclosed foreign financial account.

An individual who fails to furnish the required information with respect to any tax year at the prescribed time and in the prescribed manner is subject to a penalty of \$10,000 (IRC §6038(D)(d) as added by the 2010 HIRE Act). If the failure to disclose the required information continues for more than 90 days after the day on which the notice was mailed (from the Secretary of Treasury), the individual is subject to an additional penalty of \$10,000 for each 30-day period (or a fraction thereof) with the maximum penalty not to exceed \$50,000.

In addition to the \$10,000 penalty (up to \$50,000) under IRC §6038(D) a 40% accuracy-related penalty is imposed on any understatement of tax attributable to a transaction involving an undisclosed foreign financial asset.

The statute of limitations for omission of gross income attributable to foreign financial assets (omission of gross income in excess of \$5,000 attributable to a foreign financial asset), is extended to six years.

The IRC §6038(D) penalties are not imposed on any individual who can show that the failure is due to reasonable cause and not willful neglect. (IRC §6038D(g), as added by the 2010 HIRE Act.)

The information disclosure with respect to foreign financial assets supplements the FBAR reporting regime. The HIRE Act broadens reporting requirements and extends the rules to ownership of foreign assets such as foreign stocks, securities, interests in foreign companies not covered by the FBAR reporting. The threshold reporting requirement amount for FBARs (\$10,000) is increased to \$50,000. While the FBAR reporting covers those having signatory or other authority, the new reporting regime focuses on ownership.

IRS Form 8938: Statement of Specified Foreign Financial Assets

“FATCA” Tax Reporting

Under the Foreign Account Tax Compliance Act (“FATCA”) for tax years beginning after March, 18, 2010, specified persons (i.e. U.S. Citizens, resident aliens), who have an ownership interest in specified foreign financial assets (i.e. foreign financial accounts, foreign stock, any interest in a foreign entity) must file Form 8938 (attached to their form 1040 tax return) if the value of the foreign financial assets exceeds applicable “reporting threshold”.

The value of a specified foreign financial asset, for Form 8938 reporting purposes is the asset's fair market value.

For Individuals: more than \$50,000 on the last day of the tax year, more than \$75,000 at any time during the tax year. If living abroad; \$200,000 on the last day of the tax year or more than \$300,000 at any time during the tax year.

For Married Taxpayers: more than \$100,000 on the last day of the tax year, more than \$150,000 at any time during the tax year, if living abroad: \$400,000 on the last day of the tax year, or more than \$600,000 at any time during the tax year.

The IRS anticipates issuing regulations that will require domestic entity to file Form 8938, if it holds specified foreign financial assets whose value exceeds the applicable reporting threshold. Until the IRS issues such regulation, only individuals must file Form 8938.

Foreign Trusts

The value of an interest in a foreign trust, during the tax year, (if taxpayer doesn't know its fair market value is the Maximum Value of the interest in the foreign trust calculated as the sum of the following amounts:

1. The value of all of the cash (or other property) distributed during the tax year from the trust to the beneficiary, plus
2. The value (using the IRC§7520 Valuation Tables) to receive mandatory distributions as of the last day of the tax year;

Foreign Grantor Trusts

A U.S. Taxpayer, who is the owner of a foreign grantor trust, does not have to report specified financial assets, held by the trust if:

1. The US Taxpayer reports the trust on a timely filed form 3520 for the same tax year;
2. The trust timely files Form 3520-A (Annual Information Return of Foreign Trust with a U.S. owner) for the same tax year;
3. Taxpayer identified on form 8938 how many of these forms they filed.

Specified Foreign Financial Assets

Foreign financial accounts include any depository (or custodial) account maintained by a foreign financial institution, any equity or debt interest in a foreign financial institution including any financial account maintained by a financial institution organized under the laws of a U.S. possession (America Samoa, Guam, The Northern Mariana Islands, Puerto Rico or the U.S. Virgin Islands)

A foreign financial institution is any financial institution that is not a U.S. entity, and satisfies one of the following conditions:

1. It accepts deposits;
2. It holds financial assets for the account of others;
3. It is engaged in the business of investing or trading in securities, partnership interests, or commodities;
4. It includes investment vehicles such as foreign mutual funds, hedge fund and private equity funds.

Interests in Specified Foreign Financial Assets

A U.S. Taxpayer:

1. has an interest in a specified financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distribution from asset dispositions is required to be reported on U.S. income tax returns;
2. who is the owner of a disregarded entity, has an interest in any specified foreign financial assets owned by the disregarded entity;
3. who has an interest in a financial account that holds specified foreign financial assets, do not have to report the assets held in the account;
4. does not own an interest in any specified foreign financial asset held by a partnership, corporation or estate, as a result of their status as a partner, shareholder or beneficiary;
5. who is the owner, under the grantor trust rules of any part of a trust, has an interest in any specified foreign financial asset held by that part of the trust;
6. does not have an interest in a foreign trust or a foreign estate specified foreign financial asset, unless they know (or have reason to know) of the interest. If they receive a distribution from the foreign trust or foreign estate, they are considered to know of the interest.

Exceptions to Tax Reporting (Form 8938)

U.S. Taxpayers do not have to report a specified foreign financial asset on Form 8938:

1. If the financial account is maintained by a U.S. payer which includes: a U.S. financial institution, a domestic branch of a foreign bank or insurance company, a foreign branch or subsidiary of a U.S. financial institution;

2. If the U.S. Taxpayer reports the specified foreign financial asset on timely filed IRS forms:

a. Form 3520: Annual Return to Report Transactions with Foreign Trusts and Receipt of certain foreign Gifts

b. Form 5471: Information Return of U.S. Persons with Respect to Certain Foreign Corporations

c. Form 8865: Return of U.S. Persons with Respect to Certain Foreign Partnerships

Civil Penalties (Form 8938)

1. Failure to File Penalty: A penalty of \$10,000 for each 30 day period not filed, (within 90 days after the IRS notifies of the failure to file) after the 90 day period has expired, up to \$50,000 maximum penalty.

2. Accuracy-Related Penalty: A 40% penalty on a tax underpayment as a result of an undisclosed, specified foreign financial asset.

3. Fraud: A 75% penalty on a tax underpayment, due to fraud.

Criminal Penalties (Form 8938)

Criminal penalties may be imposed for:

1. Failure to file Form 8938;

2. Underpayment of tax;

3. Failure to report asset.

Statute of Limitations

1. For failure to file Form 8938, failure to report a specified foreign financial asset, the statute of limitations remains open until 3 year after the date Form 8938 is filed.

2. For failure to include in gross income, an amount relating to one or more specified foreign financial assets, and the amount omitted in more than \$5,000, any tax owed for the tax year, can be assessed at any time within 6 years after the tax return is filed.

U.S. Taxpayer Tax Compliance Issues

FBAR rules are not found in the Code. Rather, they are set forth in the Bank Secrecy Act, first enacted by Congress in 1970. Since 2003, however, the IRS bears responsibility for enforcing these rules.

The FBAR rules require that every U.S. Person report (i) any financial interest or authority over a (ii) financial account in a foreign country with (iii) an aggregate value over \$ 10,000 at any time during the taxable year. The report must be filed on a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (hence the acronym “FBAR”). U.S. Persons must also disclose the existence of the account on their Form 1040, Schedule B, Part III. This is commonly referred to as “checking the ‘B’ box.”

Taxpayers who fail to disclose the account on their Form 1040 could be subject to criminal sanctions for filing a false tax return.

The FBAR report is due on June 30th. This due date is not subject to extensions. The FBAR report must be filed separately from the U.S. Person’s tax return.

Financial Interest Or Authority

A U.S. Person has a financial interest in a foreign account if he or she is the legal or beneficial owner. Attribution rules apply in making this determination. A person serving as a shareholder, partner, and trustee may also be deemed to hold a financial interest if the owner of the account is (i) a person acting as an agent on behalf of the U.S. Person, (ii) a corporation where the U.S. Person owns, directly or indirectly, more than 50 percent of the outstanding stock, (iii) a partnership in which the U.S. Person owns more than 50 percent of the profits, or (iv) a trust in which a U.S. Person has either a present interest in more than 50 percent of the assets or from which the U.S. Person receives more than 50 percent of the income. If these thresholds are met, the U.S. Person has an FBAR reporting obligation, regardless of whether he or she has any authority over the account.

Non-owners with authority over a foreign account are also subject to the FBAR reporting rules. Authority means the U.S. Person has the ability to order a distribution or disbursement of funds or other property held in the account. This is not limited to signature authority, but includes the ability to order distributions by verbal commands or other communication. Authority does not include persons who have the right to invest, but not distribute, the foreign account funds.

There is no limitation for taxpayers who have authority over a foreign account, but only in an official capacity. (For example, the president of a corporation, the general partner of a partnership, or the manager of an LLC may be subject to these rules.)

Both the entity, as beneficial owner, and the representative, who has control over the account, may be required to file an FBAR report. Similarly, when more than one U.S. Person has authority over an account, i.e., president and vice president, both persons may have an FBAR reporting obligation.

Even when the account is subject to joint control, and the signature of someone other than the taxpayer is required to cause a distribution, the taxpayer is still considered to have authority over the account for FBAR reporting purposes.

Financial Account In A Foreign Country

The term financial account is broadly defined as any asset account and encompasses simple bank accounts (checking or savings), as well as securities or custodial accounts. It also includes a life insurance policy or other type of policy with an investment value (i.e., surrender value). Foreign country naturally refers to any country other than the United States. Puerto Rico, U.S. possessions and territories are included as part of the United States (as they should) for these purposes. Accounts held by U.S. Persons in these areas are not foreign accounts subject to FBAR reporting.

The IRS has indicated that a traditional credit card with a foreign bank is not a foreign account. However, use of a credit card as a debit or check card could trigger foreign account status and thus an FBAR reporting obligation.

\$10,000 Threshold

To be reportable, the account must have assets the value of which during the year, exceeds \$10,000.

The Instructions to the FBAR report state that if the aggregate value of all financial accounts exceeds \$10,000 at any time during the year, the U.S. Person must file an FBAR report. A U.S. Person who possesses multiple foreign accounts, all of which have less than \$10,000, but which collectively exceed \$10,000, may have an FBAR reporting obligation.

Taxpayers may transfer an appreciating asset to a foreign account, such as stock or securities. As these assets increase in value, they may trigger an FBAR reporting requirement. Whether the account generates any income is not relevant.

Penalties

In an attempt to improve compliance, Congress enhanced the FBAR penalties in 2004. Under pre-2004 law, civil penalties applied only to willful violations. In 2009, civil penalties up to \$10,000 may be imposed on non-willful violations. This penalty may be avoided if there was reasonable cause and the U.S. Person reported the income earned on the account. 31 U.S. C. §5321(a)(5).

Although reasonable cause is not defined, the IRS will likely apply the reasonable cause standard for late-payment/late-filing penalties.

The penalty for willful violations is far more severe. It is equal to the greater of \$100,000 or 50 per-cent of the balance of the account at the time of the FBAR violation. No reasonable cause exception exists for a willful violation. 31 U. S. C. §5321(a)(5)(c).

The IRS has six years to assess a civil penalty against a taxpayer that violates the FBAR reporting rules.

Amended Tax Returns (Voluntary Disclosure)

U.S. Taxpayers who fail to report offshore accounts by filing FBAR (TD F 90.22-1) face criminal and civil penalties:

1. Failure to Report Income

(3 Felonies and 1 Misdemeanor) up to 14 years in jail, plus 75% Civil Tax Fraud Penalty, 25% Failure to Pay Tax Penalty.

2. Failure to File FBAR's

(a maximum annual penalty of 50% of the account balance, up to 10 years in jail a \$500,000 fine).

3. Perjury

Taxpayers Form 1040/Schedule B must declare whether Taxpayers have any authority over, or interest in foreign accounts with a total of more than \$10,000.

In the IRS 6/24/09 FAQ update the IRS stated:

What is the distinction between filing amended returns to correct errors and filing a voluntary disclosure?

An amended return is the proper vehicle to correct an error on a filed return, whether a taxpayer receives a refund or owes additional tax. A voluntary disclosure is a truthful, timely and complete communication to the IRS in which a taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining the taxpayer's correct tax liability and makes arrangements in good faith to fully pay that liability. Filing correct amended returns is normally a part of the process of making a voluntary disclosure under IRM 9.5.11.9. Taxpayers and practitioners trying to decide whether to simply file an amended return with a Service Center or to make a formal voluntary disclosure under the process described in IRM 9.5.11.9 and the March 23, 2009 memoranda should consider the nature of the error they are trying to correct.

Taxpayers with undisclosed foreign accounts or entities should consider making a voluntary disclosure because it enables them to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution. Making a voluntary disclosure also provides the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues. It is anticipated that the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts and assets. However, there will be some cases, such as where a taxpayer has reported all income but failed to file the FBAR (FAQ 9), or only failed to file information returns (FAQ 42), where it

remains appropriate for the taxpayer to simply file amended returns with the applicable Service Center (with copies to the Philadelphia office listed in FAQ 9).

The IRS stated position is that a Taxpayer's voluntary disclosure entitles the Taxpayer to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution.

In reality, a taxpayer who makes a voluntary disclosure may:

1. Spotlight their "tax crimes"
2. If the voluntary disclosure is not accepted, jeopardize them and subject them to criminal prosecution

The IRS SBSE 3/23/09 memorandum, Subject: Routing of Voluntary Disclosure Cases, which addresses a change in the processing of voluntary disclosure requests containing offshore issues.

1. Such requests will continue to be initially screened by Criminal Investigation to determine eligibility for voluntary disclosure, and, if involving only domestic issues will be forwarded to Area Planning and Special Programs for Civil Processing;
2. Voluntary disclosure eligibility for offshore issues will be initially screened by Criminal Investigation and forwarded to the Philadelphia Offshore Identification Unit (POIU) for processing.

Voluntary Disclosure risks include:

1. Heightened risk of criminal prosecution (since initial screening is by the IRS Criminal Investigation Division);
2. A voluntary disclosure may be used as an evidentiary admission of Taxpayer's unreported income;
3. A voluntary disclosure may waive Taxpayer's 5th Amendment right against self-incrimination;
4. While a voluntary disclosure is pending the IRS may request more information, commence an audit or initiate criminal prosecution.

As an alternative strategy to a voluntary disclosure, the "quiet filing" (for the Tax Years at issue) of an amended tax return (or original tax return) may instead:

1. Pre-empt criminal charges for the failure to file FBAR returns, Form 1040 tax returns and failure to pay tax;

2. Pre-empt a 75% civil tax fraud penalty, for failure to file or pay tax and a 25% failure to pay tax penalty;

3. If the income is properly reported (i.e., no substantial understatements which are subject to a 6 year statute of limitations), the tax filing will commence the 3-year statute of limitations (for each year) for IRS audit.

Statute of Limitations

*On 6/24/09, in FAQ #31, the IRS confirmed they will be able to assess taxes under a 6 year statute of limitations if the IRS can prove a substantial omission of gross income:
How can the IRS propose adjustments to tax for a six-year period without either an agreement from the taxpayer or a statutory exception to the normal three-year statute of limitations for making those adjustments?

Going back six years is part of the resolution offered by the IRS for resolving offshore voluntary disclosures. The taxpayer must agree to assessment of the liabilities for those years in order to get the benefit of the reduced penalty framework. If the taxpayer does not agree to the tax, interest and penalty proposed by the voluntary disclosure examiner, the case will be referred to the field for a complete examination. In that examination, normal statute of limitations rules will apply. If no exception to the normal three-year statute applies, the IRS will only be able to assess tax, penalty and interest for three years. However, if the period of limitations was open because, for example, the IRS can prove a substantial omission of gross income, six years of liability may be assessed. Similarly, if there was a failure to file certain information returns, such as Form 3520 or Form 5471, the statute of limitations will not have begun to run. If the IRS can prove fraud, there is no statute of limitations for assessing tax.

*See: 31 U.S.C §5321(b)(1) re: 6 year statute.

Annual Filing Requirements and Reasonable Cause Exception

In April 2003, the Financial Crimes Enforcement Network delegated authority of the TD F 90-22.1 form (i.e., FBAR form) to the Internal Revenue Service (see IR 2003-48 (4/10/03); 31 CFR §103.5(6)(b)(8)). The IRS enforces all penalties associated with the FBAR with the same power it enforces tax reporting and payment compliance.

The IRS has been given the authority to enforce the filing rules and audit the reports as appropriate.

The FBAR filing is due by June 30th of the year following the year of the report with no provisions for extensions. The due date means the date it must be received by the US Treasury. Mailing it on the date it is due will result in a late filing. The FBAR form, filed separately from the income tax, must be mailed to US Department of Treasury, PO Box 32621, Detroit, Michigan 48232-0621.

If there is an emergency, the form can be hand-delivered to a local IRS office for forwarding to the Treasury Department in Detroit.

An amended FBAR may be filed by completing a revised FBAR with the correct information writing the words "Amended" at the top of the revised FBAR and stapling it to a copy of the original FBAR. For Taxpayers amending a late-filed FBAR, they should include a statement explaining their reasons for a late filing (i.e., request a reasonable cause exception from penalty).

A failure to file a FBAR has civil and criminal penalties (which are in addition to any income tax penalties if the income is not reported). The IRS must assess the civil penalties within 6 years of the FBAR violation (31 USC 5321(b)(1)).

For a willful failure to file, the civil penalty increases from \$10,000 (non-willful failure to file) to the greater of \$100,000 or 50% of the account balance in the foreign account for the tax year. The civil penalties for non-willful failure to file may be waived by the IRS if the Taxpayer can show reasonable cause. If the Taxpayer has a reasonable cause exception, the FBAR should be filed with an explanation (i.e., the reasonable cause, with an express request for waiver of penalties).

The waiver of civil penalties for a reasonable cause exception may include among other factors:

1. All the income from the foreign account was included on the US Taxpayer's return.
2. The Taxpayer was unaware of the requirement to file (for example, lack of understanding of what constitutes a financial interest).
3. Once the Taxpayer became aware of the filing requirements, he filed all delinquent reports (up to 6 years).

Civil and Criminal Penalties

Each U.S. Person who has a financial interest in, or signature or other authority over, one or more foreign financial accounts (value over \$10,000, at any time during a calendar year) is required to report the account on Schedule B/Form 1040, and TD F 90-22.1 (Report of Foreign Bank and Financial Accounts (FBAR)), due by June 30 of the succeeding year (I.R.M. 5.21.6.1. (2/17/09)).

Failure to file the required report or maintain adequate records (for 5 years) is a violation of Title 31 with civil and criminal penalties (or both). For each violation a separate penalty may be asserted.

(I) Non-Willful Violation

Civil Penalty – Up to \$10,000 for each violation. 31 U.S.C. § 5321(a)(5)(A)

(II) Negligent Violation

Civil Penalty – Up to the greater of \$100,000, or 35 percent of the greatest amount in the account. 31 U.S.C.

(III) Intentional Violations

1. Willful – Failure to File FBAR or retain records of account

Civil Penalty -Up to the greater of \$100,000, or 50 percent of the greatest amount in the account.

Criminal Penalty -Up to \$250,000 or 5 years or both

31 U.S.C. §5321(a)(5)(C), 31 U.S.C. § 5322(a) and 31 C.F.R. §103.59(b) for criminal

2. Knowingly and Willfully Filing False FBAR

Civil Penalty – Up to the greater of \$100,000, or 50 percent of the greatest amount in the account.

Criminal Penalty – \$10,000 or 5 years or both

18 U.S.C. § 1001, 31 C.F.R. § 103.59(d) for criminal

3. Willful – Failure to File FBAR or retain records of account while violating certain other laws

Civil Penalty – Up to the greater of \$100,000, or 50 percent of the greatest amount in the account.

Criminal Penalty – Up to \$500,000 or 10 years or both

31 U.S.C. § 5322(b) and 31 C.F.R. §103.59(c) for criminal

Criminal Penalties: Willful Failure to File (Defenses)

Under IRS Form 1040, at the bottom of Schedule B, Part III, on Page 2, Question 7(a) states: “at any time during the previous year, did you have any interest in or signatory or other authority over a financial account in a foreign country, such as a bank account, a security account, or other financial account? The answer is either yes or no. If yes, Question 7(b) requires the name of the foreign country (with the account). Question 8 requires confirmation of receipt of distribution from the account, or if the Taxpayer was a grantor of, or transferor to a foreign trust (which requires filing Form 3520).

A willful failure to file a FBAR can lead to a felony of up to 10 years in jail and a \$500,000 fine. The IRS must prove willfulness in order to assert the \$500,000 monetary penalty and the imprisonment for up to 10 years (see 31 USC 5321(a)(5)(B); CCA 200603026; Eisenstein, 731 F.2d 1540 (CA – 11, 1984)).

Willfulness must be proven by the IRS under the standard of clear and convincing evidence. If the Taxpayer knew about the requirement to file, it would affect his defense. If the Taxpayer failed to report the foreign account interest or other income on his income tax return, it would affect his defense.

If a failure to file is deemed to be part of a criminal activity involving more than \$100,000 in a 12-month period, the penalty limit increases to \$500,000 with up to 10 years in jail. The issue of whether a failure to file is willful or non-willful is based on the facts of each case. Willfulness has been defined as the voluntary, intentional violation of a known legal duty, see Cheek 498 US 192, 67 AFTR 2d 91-344 (Supreme Court 1991).

A Taxpayer's good faith belief that he does not have to file (or even his negligent failure to file) can be a defense to the charge of willful failure to file (i.e., a defense to criminal charges).

A defense may include that the Taxpayer was advised by his advisor that no FBAR was required.

Failure to maintain adequate records of the foreign account for the years the FBAR filing is due may result in additional civil and criminal penalties.

Chapter 7 - Grantor Trust (U.S. Income Tax)

(Subpart E of Subchapter J of Chapter 1 of Subtitle A IRC 1954)

IRC Sec. 671-679 determines whether a trust is a “grantor trust” for U.S. federal income tax purposes. If a trust is a grantor trust, all items of income, deduction and credit in respect of the trust property will be reported on the grantor’s U.S. federal income tax return, and any income tax liability will be paid by the grantor and not from the trust (Treas. Reg. 1.671-3 (a)(1)).

IRC Sec. 673-679 identify persons as “owners” of portions of trusts with which they have relationships. IRC Sec. 671 specifies the consequences of being treated as the owner [IRC Sec. 671: The neck of the funnel through which Sec. 673-678 passes].

Tres. Reg. 1.671-2(e)(1)

“A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.” (A Settlor is the person who intentionally causes the trust to come into existence.)

IRC Sec. 671 identifies a grantor as owner of any “portion” of a trust; items of income, deductions and credits attributable to that portion of the trust are taken into account in computing the grantor’s taxable income and credits.

A “Portion” includes:

- Ordinary income;
- Income allocable to corpus;
- An entire trust;
- An undivided fractional interest in the trust;
- An interest represented by a dollar amount;
- Specific trust property.

IRC Sec. 671: Grantor Trust Status

The person designated by Subpart E as “owner” of a portion of a trust must take into account in computing their tax liability the items of income, deductions and credits attributable to that portion of the trust (that would otherwise be reportable by the trust itself).

Tax Compliance

IRC Sec. 6012(a)(4) requires an income tax return from “every trust having for the taxable year any taxable income, or having gross income of \$600 or over, regardless of the amount of taxable income. Subpart E may attribute part or all of a trust’s income to the grantor.

IRC Sec. 6501 statute of limitations protects a taxpayer against assessments occurring later than three years after the filing of the relevant tax return. For the statute of limitations, in the case of a grantor trust the statute begins to run only on the filing of the grantor's return (not the filing of any trust tax return). (See: *Lardas v. Commr.*, 99 T.C. 490 (1992); *Olson v. Commr.*, 64 T.C.M. 1524 (1992), *Bartol v. Commr.*, 63 T.C.M.2324 (1992), Field Serv. adv. 200207007 (Nov. 6 2001).

Under Treas. Reg. 1.671-4(a), items attributed to a grantor are not to be reported by the trust on Form 1041; instead such items should be "shown on a separate statement attached to Form 1041, and reported by the grantor".

Grantor Trust

If the trust is a grantor trust for income tax purposes, a sale of assets to the trust by the grantor is disregarded. (See Rev. Rul. 85-13, 1985-1 C.B. 184).

If the non-contributing spouse has a discretionary interest as to both income and principal, the trust is a grantor trust under IRC Sec. 677(a)(1) to the contributing spouse. No income tax realization event occurs and the policy proceeds are excluded from both estates (Ltr. Rul. 9413045).

Intentionally Defective Grantor Trust

An "Intentionally Defective Grantor Trust" ("IDGT") takes advantage of the differences between the estate tax inclusion rules of IRC Sections 2036-2042, and the grantor trust income tax rules of IRC Sec. 671-678. An IDGT is an irrevocable trust that effectively removes assets from the grantor's estate. As a result, a sale of assets to an IDGT can freeze an individual's estate by converting appreciating assets into a non-appreciating asset with a fixed yield.

For income tax purposes, the trust is "defective" and the grantor is taxed on the trust's income. Accordingly, sale of assets between the IDGT and the grantor are not taxable. The grantor is treated for income tax purposes to have made a sale to himself eliminating capital gain tax on sale.

(Additionally, interest payments by the IDGT to the grantor are not income.)

Since the IDGT is "defective" for income tax purposes, all of the trust's income is taxed to the grantor, which produces an additional "tax-free gift" to the IDGT (Rev. Rul. 2004-64, 2004-2(C.B. 7)).

As a grantor trust, the IDGT:

- Can be the owner of S-corporation stock (it is a permitted shareholder);
- Can purchase an existing life insurance policy on the grantor's life, without subjecting the policy to taxation under the transfer for value rule;

The sale of the policy is a sale to the grantor-insured and the transfer for value exception under IRC Sec. 101 (a)(2)(B) should apply.

If the IDGT is structured as a “Crummey Trust”, the contribution will qualify for the IRC Sec. 2503(b) gift tax annual exclusion. Under IRC Sec. 678(b), a grantor will be treated as the owner of the trust, rather than the beneficiary with respect to power over income (and corpus), which are subject to “Crummey Withdrawal” rights (See IRS PLR 200606006, 200603040, 200729005, 200942020).

Under an IDGT, Grantor Trust Status:

1. Power of Substitution: The Grantor (or spouse) has the power to reacquire trust assets in a non-fiduciary capacity (IRC Sec. 675(4); Treas. Reg. Sec. 1.675-1(b)(4). In Rev. Rul 2008-22, 2008-1 CB 796, the IRS ruled that a grantor’s retained power, exercisable in a non-fiduciary capacity, to acquire trust property by substituting property of equivalent value will not by itself cause estate tax inclusion under IRC Sec. 2036 or 2038.

2. Swapping Assets: If the grantor sells assets to the IDGT, the trust assets are excluded from the grantor’s estate at death, but the IDGT assets would not receive a tax basis step-up under IRC Sec. 1014. If the assets sold to an IDGT have a low basis, the lack of basis step-up is an income tax disadvantage which may be ameliorated by the grantor exchanging high-basis outside of the IDGT, with low-basis assets inside of the IDGT, achieving a “basis step-up”. The swap of assets with an IDGT should not be treated as a gift for purposes of IRC Sec. 1014(e).

3. Power to Make Loans without Adequate Security: The power exercisable by a grantor or a non-adverse party that permits the grantor or the grantor’s spouse to borrow trust property without adequate security (IRC Sec. 675(2)). Grantor trust status is achieved if the grantor’s spouse holds such power under IRC Sec. 672(e). Unlike Sec. 675(3), which requires an actual borrowing by the grantor, the existence of a power under IRC Sec. 675(2) may cause grantor trust status.

Even if the loan provides for adequate interest, grantor trust status is secured if the trustee has the power to lend unsecured. To avoid estate tax inclusion, the lending power should not include the authority to make loans without adequate interest. In order to minimize the risk of estate tax inclusion, the power to lend without security should be held by a non-adverse party and not the grantor (e.g. a trust protector).

4. Power to Add Beneficiaries: The power to add to the class of beneficiaries (other than the grantor’s after-born or after-adopted children) to receive the trust’s income or corpus held by the grantor, or a non-adverse party will cause grantor trust status. To avoid estate tax inclusion, the grantor should not hold such a power, but the power could be held by the grantor’s spouse without inclusion if the spouse did not contribute to the trust and is not controlled by the grantor. A marital agreement should be entered into in advance of the transfer to ensure that the spouse did not make a contribution to the IDGT. The IRS has privately ruled that the power to add beneficiaries held by a trustee triggers grantor trust status (IRS PLR 199936031; 9709001; 9010065).

5. Payment of Life Insurance Premiums: A grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of life insurance policies on the grantor or the grantor's spouse (IRC Sec. 677(a)(3)). IRS Field Attorney Advice 20062701 F indicates that the power to purchase life insurance on the grantor's life results in grantor trust status. Treasury Regulations establish that the grantor is taxed on any trust income actively used to pay premiums. Under PLR 8852003, the IRS has privately ruled that the power to pay premiums is sufficient.

Income Tax - Transfer for Value (IRC Sec. 101(a)(2))

If insurance policy transferred for valuable consideration, unless exception applies, general rule that policy proceeds are not includable in gross income does not apply.

Not Income Tax Realization Event

- Rev. Rul. 85-13 (1985-1 CB 184): Transfer between grantor and his grantor trust, not an income tax realization event;

- IRC Sec. 1041: Transfers between spouses (if no NRA spouse), no income tax realization, transferee spouse "carry-over" income tax basis.

Exceptions from application of the transfer for value include transfers where the transferee takes a carry-over basis (IRC Sec. 101(a)(2)(A)), transfers to the insured, a partner of the insured, a partnership in which the insured is a partner and a corporation in which the insured is a shareholder or officer (IRC Sec. 101(a)(2)(B)).

Under Rev. Rul. 2007-13, 2007-11 IRB 684, a transfer to a grantor trust with respect to the insured qualifies as a transfer "to the insured" for purposes of the transfer for value rule. Under this Revenue Ruling, a grantor who is treated for federal income tax purposes as the owner of a trust (that owns a life insurance contract on the grantor's life) is treated as the owner of the contract for purposes of applying the transfer for value limitations under IRC Sec. 101(a)(2).

Grantor Trust - Avoids Application of Transfer for Value Rules

Treas. Reg. 1.671-2 (e)(1): A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Under IRC Sec. 671-677, only a person who makes a gratuitous transfer to a trust can be treated as an "owner", necessary to engage in disregarded transactions with the trust. The Trust Donor is treated as the owner for grantor trust purposes.

Grantor Trust Status

IRC Sec. 677 (a)(3): Trust is a grantor trust to the extent trust income may be used to pay premiums on insurance policies on the grantor's life, or the grantor's spouse. However, grantor

trust status may apply only to the portion of the trust the income from which is currently used to pay premiums (See: Weil, 3TC 579 (1944); Iverson, 3 TC 756 (1944)).

Settlor power, held in a non-fiduciary capacity, to substitute property of equivalent value under IRC Sec. 675(4)(C), causes a trust to be a grantor trust.

Estate Tax

Where trust assets consist of an insurance policy on the grantor's life, a power to substitute assets may not result in estate tax inclusion under IRC Sec. 2042(2), if the grantor held the power in a fiduciary capacity (See: Estate of Jordahl, 65 TC 92 (1975); Aug. 1977-1, (CB 1) (See: Ltr. Rul. 200603040)).

IRS

Trust property may not be includable in the gross estate under IRC Sec. 2035, 2036, 2048 or 2039 if the power of substitution is held in a fiduciary capacity.

Grantor Trust Rules - IRC Sec. 672(e)

Spousal Unity Rule; i.e., grantor is treated as holding any power or interest held by the grantor's spouse.

Gift Tax

Creation of an irrevocable trust may subject the grantor to the gift tax: Treas. Reg. 25.2511-2(d).

Grantor Trust Status (ILIT)

A related and subordinate party could be named as trustee with the power to make discretionary distributions, not on an ascertainable standard, in order to make the ILIT a grantor trust. If the grantor cannot remove and replace the trustee, the initial appointment of a related and subordinate party trustee may not cause the powers of the trustee to be attributed back to the grantor for estate tax purposes (Ltr. Rul. 9636033).

Grantor trust status confirmed if a person who is not a contributor to, or beneficiary of, the trust, has the power to add to the class of beneficiaries (e.g. charity or other descendants (IRC Sec. 674(b)(5), 674(b)(6). See: Madorin, 84 TC 667 (1985)).

Grantor Trust - (Ownership of Assets)

Under Rev. Rul. 85-13, and Proposed Treas. Reg. Sec. 1.671-2(f) “a person that is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion of the trust [See: REG- 209826-96, 1996-2 (C.B. 498)].

Termination Grantor Trust Status

A grantor trust loses its status as a grantor trust on the death of its grantor (D.G. McDonald Trust, 19 TC 672 (1953), acq. 1953-2 C.B.3 (Chase Nat’l Bank v. Commr., 225 F.2d 621 (8th Cir. 1955)); Proposed Treas. Reg. Sec. 1.671-4(h)(2)).

Adverse Party

IRC Sec. 672(a) defines an “adverse party” as “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust.”

A trustee may be an adverse party if the trustee has the power to distribute all of the trust income and property to himself but is not an adverse party if the trust terms fix all the beneficial interests even if the trustee is a beneficiary (See: Johnson v. Commr., 108 TC 448 (1957), Floyd G. Paxton, 57 TC 627 (1972).

Beneficiaries can be adverse parties if they have a power the exercise or non-exercise of which would adversely affect the beneficiary’s own beneficial interest.

IRC Sec. 672(b) defines a “nonadverse party” as “any person who is not an adverse party”.

A trust is classified as a grantor trust if more than half of the trustees are related or subordinate to the grantor.

IRC Sec. 674(a) provides that the grantor of a trust is to be treated as the owner of any portion of such trust, in respect of which the beneficial enjoyment of such portion is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.

IRC Sec. 674(c) provides an exception to the general rule of IRC Sec. 674(a) for distribution powers of the “independent trustee”, none of whom is the grantor, and no more than half of whom are related or subordinate to the grantor or are subservient to the wishes of the grantor (IRC Sec. 672(c) defines: “related or subordinate party”.)

Related or Subordinate Party

IRC Sec. 672(c) defines a “related or subordinate party” as any “non-adverse party” which includes:

1. IRC Sec. 672(c)(1): The grantor’s spouse (only if they are living together);

2. IRC Sec. 672(c)(2): Grantor's father, mother, children, brother, sister (including half-brothers/sisters). See: Rev. Rul. 58-19, 1958-1, CB 251);

3. IRC Sec. 672(c)(2): An employee of the grantor, or the grantor's corporation.

Not Related or Subordinate Party

Under IRC Sec. 672(c) the following are not related or subordinate parties:

1. Nieces, nephews, grandparents, spouses of children, spouses of grandchildren, spouses of brothers and sisters;

2. Partners of the grantor;

3. Director of a corporate grantor (i.e. stock holdings of the grantor and the trust are significant, re voting control). See: Rev. Rul. 66-160, 1966-1, CB 164;

4. The grantor's lawyer, accountant or trust company (See: Zand v. Commr., 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998); Estate of Hilton W. Goodwyn, 35 TCM 1026, 1038 (1976) re lawyers-trustees not "related or subordinate parties" and lawyer-trustees were independent trustees under IRC Sec. 674(c).

Power Subject to Condition Precedent

IRC Sec. 672(d) states that a person is deemed to have a power described in subpart E "even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power".

Grantor's Spouse

The Tax Reform Act of 1986 added IRC Sec. 672(e), which treats the grantor as holding any power or interest held by the grantor's spouse if the grantor's spouse was living with the grantor at the time of the creation of the power or interest (i.e., if the spouse and the grantor are eligible to file a joint return with respect to the period in question).

Grantor as Foreign Person - ("Inbound Trusts")

If a foreign person is an "owner" of any portion of a trust, and the trust has as a beneficiary a U.S. person who has made one or more gifts to that foreign person, IRC Sec. 672(f)(5) designates the U.S. beneficiary, not the foreign grantor-donee, as the owner of the trust to the extent of the gifts (with an exception for gifts that qualify for the annual exclusion under IRC Sec. 2503(b)).

IRC Sec. 672(f)(5) precludes foreigners immigrating to the U.S. from giving property to another foreigner, who agrees to use the property to fund a U.S. trust for the benefit of the immigrating foreigner, who then denies he was the grantor of the trust. Under IRC Sec. 672(f)(5), the

immigrating foreigner receives the same treatment he would have received had he created the trust directly (Treas. Reg. Sec. 1.672(f)-5(a)(1)).

In the Small Business Job Protection Act of 1996, Congress expanded IRC Sec. 672(f) so that subpart E now generally applies only when its effect is to designate as owner of part or all of a trust a U.S. citizen, resident or domestic corporation (IRC Sec. 672(f)(1), a “controlled foreign corporation”, defined in IRC Sec. 957 is treated as a domestic corporation. IRC Sec. 672(f)(3)(A).

IRC Sec. 672(f) reverses prior law under which subpart E designated non-resident aliens as owners of trusts, thereby allowing U.S. beneficiaries to receive the income from such trusts tax-free.

Grantor Trust: Co-ownership and Reversionary Interest

IRC Sec. 673(a) now treats the grantor who retains any reversionary interest as owner of the entire trust (Treas. Reg. 1.671-3(b)(3)); Priv. Ltr. Rul. 9519029 (Feb. 10, 1995). IRC Sec. 672(e) treats the grantor as owner of any interest their spouse owns. Unless the value of the reversionary interest at inception is less than 5% of the value of the property transferred. (IRC Sec. 673(b) excepts from the general rule any reversionary interest that follows the death before attaining age 21 of a lineal descendant of a grantor.)

A grantor who has retained a reversionary interest in the corpus of a trust is treated as owner of the corpus portion of that trust (Treas. Reg. Sec. 1.673(a)-1(a), 1.677(a)-1(g) Ex. (2).

IRC Sec. 674: Powers over Beneficial Enjoyment

IRC Sec. 674(a) treat any grantor as owner of any portion of any trust “in respect of which the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable by a grantor or non-adverse party, or both, without the approval or consent of any adverse party.”

IRC Sec. 674, 677: Power to Apply Income to Support of a Dependent

A grantor is not subject to tax under neither IRC Sec. 677(b) nor Sec. 674(a) merely because in the discretion of another person, the trustee or the grantor (or the grantor’s spouse, IRC Sec. 672(e)), acting as trustee, income may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor’s spouse) whom the grantor is legally obligated to support or maintain. Under IRC Sec. 677(a), the grantor is treated as the owner of the income portion, to the extent of the grantor’s obligation of support.

Grantor Trust - Power to Distribute Corpus

IRC Sec. 674(b)(5) provides two exceptions (to IRC Sec. 674) for powers to distribute corpus:

1. Power to distribute corpus to or for one or more beneficiaries if the power is limited by a reasonably definite standard in the trust instructions (IRC Sec. 673(b)(5)(A), i.e. a “clearly measurable standard under which the holder of a power is legally accountable (Treas. Reg. Sec. 1.674(b)-1(b)(5)(i)). Examples of reasonably definite standards are standards relating to a beneficiary’s “education, support, maintenance or health”, “reasonable support or comfort”, to enable a beneficiary to maintain an “accustomed standard of living”, to allow a beneficiary to “meet an emergency”, or to pay a beneficiary’s “medical expenses” (Treas. Reg. Sec. 1.674(b)-1(b)(5)(iii), Ex. (1)).

2. Power to distribute corpus to or for any “current income beneficiary”, whether subject to a standard or not, if the distribution must be chargeable against the proportionate share of corpus held in trust for payment of income to the beneficiary “as if the corpus constituted a separate trust” (IRC Sec. 674(b)(5)(B).

Grantor Trust - Exception: (Independent Trustee)

Exceptions to the general rule of IRC Sec. 674(a) are contained in IRC Sec. 674(c), which provides exceptions if the powerholder is an “independent trustee”; i.e. not the grantor, grantor’s spouse, no more than half of whom are related or subordinate parties who are subservient to the grantor’s wishes.

The exceptions:

1. The power of a trustee to distribute, apportion or accumulate income to or for one or more beneficiaries (IRC Sec. 674(c)(1).

2. The power of a trustee to sprinkle corpus to or among one or more beneficiaries, regardless of whether they are income beneficiaries (IRC Sec. 674(c)(2).

Grantor Trust/Exception: (Powerholder is a Trustee, other than the Grantor or the Grantor’s Spouse)

IRC Sec. 674(d) protects a power to distribute, apportion or accumulate income to or for the beneficiaries if the power is limited by a “reasonably definite external standard” (Treas. Reg. 1.674(d)(1), 1.674(b)-1(b)(5) which “defines a reasonably definite standard”). The “standard” must be set forth in the trust instrument.

Grantor Trust - Power to Remove Trustee

Under Treas. Reg. Sec. 1.674(d)-2(a), *W. Clarke Swanson, Jr. 1950 Trust*, 33 TCM 296, 302 (1974), *aff’d* 518 F.2d 59 (8th Cir. 1975), if the grantor or the grantor’s spouse has the power to remove the trustee and make either of them the trustee, neither the exception under IRC Sec. 674(c) or IRC Sec. 674(d) applies.

Grantor Trust - Power to Add Beneficiaries

A power to add beneficiaries does not qualify under IRC Sec. 674 exceptions if any person has the power to add to the group of beneficiaries, other than providing for after-born or after-adopted children. A power in a non-adverse party to add charitable beneficiaries or trigger IRC Sec. 674 (See: *Madorin v. Commr.*, 84 TC 667 (1985). Priv. Ltr. Rul. 9838017 (6/19/98), Priv. Ltr. Rul. 9710006 (11/8/96), Priv. Ltr. 97090001 (11/8/96)).

IRC Sec. 675 - Grantor Administrative Powers

IRC Sec. 675 contains provisions designed to prevent a grantor from maintaining dominion and control over a trust through certain types of administrative powers vested in either the grantor or others.

1. Power to Deal with Trust Property for Less Than Adequate and Full Consideration.

IRC Sec. 675(1) describes a power exercisable by the grantor or any non-adverse party to enable the grantor or any person to “purchase, exchange or otherwise deal with or dispose of the corpus or the income there from for less than an adequate consideration in money or money’s worth.”

2. Grantor Borrowing. IRC Sec. 675(2) relates to a power enabling a grantor to borrow without adequate interest or security. IRC Sec. 675(3) relates to actual borrowing.

Power to Borrow without Adequate Interest or Security

IRC Sec. 675(2) describes a power exercisable by the grantor or any non-adverse party to enable the grantor to borrow either principal or income “directly or indirectly, without adequate interest or adequate security”. If so, grantor is treated as the owner of some portion of the trust. If the trustee (who is not the grantor or the grantee’s spouse) has the power to lend on such terms to anyone, the power is disregarded for purposes of IRC Sec. 675(2). In addition, there are no other restrictions on the trustee’s identity; even a related or subordinate party may serve as trustee.

Actual Borrowing

IRC Sec. 675(3) states that actual borrowing by the grantor causes grantor trust status, if the grantor has “directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year.” IRC Sec. 675(3) does not apply to a loan to a grantor that provides for adequate interest and adequate security if made by a trustee “other than the grantor and other than a related or subordinate trustee subservient to the grantor”. If a loan to a grantor provides for adequate interest and adequate security, and is made by a non-captive trustee, there are no grantor trust consequences.

In *Zand v. Commr.*, 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998), the court held that certain loans qualified under the exception of IRC Sec. 675(3) because they provided for adequate interest and security and a majority of the trustees who made them were neither related nor subordinate to the grantor under IRC Sec. 672(c), despite the fact these two trustees were also the grantor's lawyers.

General Powers of Administration

IRC Sec. 675(4) describes three powers of administration and treats the grantor as owner of a portion of the trust if any of these powers is exercisable in a "non-fiduciary capacity" by any person without the approval or consent of any person in a fiduciary capacity. Treas. Reg. Sec. 1.675-1(b)(4) limits the applicability of the provision to powers held by a "non-adverse party". If a power is exercisable by a trustee, it is presumed to be exercisable in a fiduciary capacity.

The three powers:

1. The power to vote or direct the voting of stock or securities of a corporation in which the holdings of the grantor and the trust are "significant from the viewpoint of voting control."
2. The power to control the investment of the trust funds either by directing investments or by retaining proposed investments "to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control".
3. The power to reacquire trust property by substituting other property of an equivalent value.

Revocable Trusts

If a trust is wholly revocable by the grantors, IRC Sec. 676 treats the grantor as owner of the entire trust because the grantor has the power to revest in himself all of the trust property.

IRC Sec. 677

Income for Benefit of Grantor or Grantor's Spouse

1. Income Distributable to the Grantor or Grantor's Spouse.

If a grantor retains a mandatory income interest, or creates a mandatory income interest in the grantor's spouse, IRC Sec. 677 treats the grantor as owner of the income portion of the trust, under IRC Sec. 677(a)(1), the "income is distributed to the grantor or the grantor's spouse." IRC Sec. 677(a) requires that the income be distributed "without the approval or consent of any adverse party."

2. Income Accumulated for the Grantor or Grantor's Spouse

IRC Sec. 677(a)(2) applies if income may be accumulated without the consent of an adverse party for future distribution to the grantor or the grantor's spouse.

3. Income Applicable to Payment of Life Insurance Premiums

IRC Sec. 677(a)(3) applies if income is or may be applied without the consent of an adverse party to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse. The grantor is treated as the owner of some portion of any trust required or permitted to pay premiums on policies of life insurance on the life of either the grantor or the grantor's spouse. The courts have limited the amount of income on which a grantor is subject to taxation to that which the trustee actually uses to pay premiums on specified policies (Joseph Weil, 3 TC 579 (1944)).

4. Income Applicable to Discharge of Indebtedness

IRC Sec. 677(a) treats the grantor as owner of a portion of a trust if its income can be used to pay off debts of the grantor such as rent, household expenses or mortgage debt (See: Treas. Reg. Sec. 1.677(b)-1(d); Jack Wiles, 59 TC 289 (1972), *Jenn v. U.S.* 70-1 USTC Para. 9264 (S.D. Ind. 1970).

5. Income Applicable to Discharge of Support Obligations IRC Sec. 677(b) is an exception to the general rule of IRC Sec. 677(a). According to IRC Sec. 677(b), IRC Sec. 677(a) does not apply if trust income may be "applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support".

Under Treas. Reg. Sec. 1.677(b)-1(f), if income must be applied in discharge of a support obligation of the grantor, IRC Sec. 677(b) does not apply; instead IRC Sec. 677(a) applies. For IRC Sec. 677(b) to apply, the power to use trust income to discharge the grantor's support obligations must be that of "another person, the trustee, or the grantor acting as trustee or co-trustee". Under Treas. Reg. Sec. 1.677(b)-1(e), if the power is that of the grantor acting in a non-fiduciary capacity, the grantor is treated as owner of the trust's income, to the extent of his or her dischargeable obligations, regardless of whether the trust discharges them.

Under IRC Sec. 677(b), for trust distributions in discharge of a grantor's support obligations:

- If a distribution comes out of current income, the grantor is treated as owner of the trust, but only to the extent of the obligation discharged (*Brooke v. U.S.*, 300 F.Supp. 465 (D. Mont. 1969), *aff'd* 468 F.2d 1155 (9th Cir. 1972).
- If the distribution comes out of either principal or accumulated income, IRC Sec. 677(b) treats the amount distributed as deductible by the trust under IRC Sec. 661(a)(2) and taxable to the grantor under IRC Sec. 662, (Rev. Rul. 74-94, 1974-1 C.B. 26); Treas. Reg. Sec. 1.677(b)-1(c).

IRC Sec. 678 - Non-Grantors Treated as Grantors

Under IRC Sec. 678, one other than the grantor is treated as owner of any portion of a trust that he can by exercise of a power exercisable by himself, vest in himself a portion of a trust.

Released or Modified Power

IRC Sec. 678(a)(2), applies if a person other than the grantor has “previously partially released or otherwise modified” a power described in IRC Sec. 678(a)(1), and “retains such control as would subject a grantor of a trust to treatment as the owner thereof”, IRC Sec. 678(a)(2) treats anyone who has released or modified an IRC Sec. 678 power as though he created a continuing trust.

Obligations of Support

IRC Sec. 678(a), if a powerholder can direct a trust to expend either its income or its principal to discharge a legal obligation, he is treated as the powerholder, if principal or accumulated income is used to discharge the powerholder’s support obligation, the powerholder is treated as a beneficiary who receives a taxable distribution under IRC Sec. 661 and 662.

IRC Sec. 679 - Foreign Trusts with U.S. Beneficiaries (“Outbound Trusts”)

If a U.S. person transfers property to a foreign trust that has one or more U.S. beneficiaries, IRC Sec. 679 treats the transferor as owner of the portion of the trust attributable to the property transferred (IRC Sec. 679(a)(1)). There are exceptions:

A transfer by reason of the death of the transferor (IRC Sec. 679 (a)(2)(A));

A transfer “in exchange for consideration of at least the fair market value of the transferred property” (IRC Sec. 679(a)(2)(B)).

If a foreign trust accumulates income during a year in which it has no U.S. beneficiary, if the trust acquires a U.S. beneficiary in a later year, a U.S. transferor (who would have been treated as owner of a portion of the trust during the prior year, but for the fact that it had no U.S. beneficiary) is taxable in the first year IRC Sec. 679 applies, on additional income equal to the trust’s undistributed net income for all prior taxable years (to the extent such undistributed net income remains in the trust at the end of the taxable year immediately prior to applicability of IRC Sec. 679) attributable to the portion to which IRC Sec. 679 applies (IRC Sec. 679(b)).

Direct/Indirect Transfers

Under the IRC Sec. 679(a)(1) a U.S. person’s transfer to a foreign trust includes both indirect and direct transfers, either of which classifies the U.S. person as the owner of the trust attributable to the property transferred if the foreign trust has one or more U.S. beneficiaries.

Indirect transfers include:

1. A transfer by either a foreign or domestic entity in which a U.S. person has an interest “may be regarded as an indirect transfer to the foreign trust by the U.S. person if the entity merely serves as a conduit for the transfer by the U.S. person or if the U.S. person has sufficient control

over the entity to direct the transfer by the entity rather than himself.” (S. Rep. 938, 94th Cong., 2d Sess. 219 (1976)).

2. If a foreign trust borrows money or property and a U.S. person guarantees the loan, the U.S. person is making an indirect transfer to the trust.

3. An intermediate transfer to either another person or an entity that makes the actual transfer to the foreign trust is to be disregarded “unless it can be shown that the ultimate transfer of property to the trust was unrelated to the intermediate transfer. In such a case, the person making the intermediate transfer would be treated as having made the ultimate transfer directly.” See: *Haeri v. Commr.*, 56 TCM 1061 (1989) (transfer by agent). Treas. Reg. Sec. 1.679-3 provides elaborate guidance with respect to indirect transfers.

IRC Sec. 679: U.S. Persons

IRC Sec. 679 applies only to a “U.S. person” which IRC Sec. 7701 (a) (30) defines as “a citizen or resident of the U.S.”, including a resident alien (See: Treas. Reg. Sec. 1.679-1(d); *Haeri v. Commr.*, 56 TCM 1061 (1989); Rev. Rul. 90-106, 1990-2 (B162)). A “U.S. person” includes: a U.S. partnership or corporation, any estate other than a foreign estate (defined in IRC Sec. 7701(a)(31)(A). A U.S. person includes a “U.S. Trust” (i.e. a domestic trust) which is a trust if “a court within the U.S. is able to exercise primary supervision over the administration of the trust”, and “one or more U.S. persons have the authority to control all substantial decisions of the trust”. (Treas. Reg. Sec. 301.7701-7(a)(1).

IRC Sec. 679 only applies to transfer to a “foreign trust” (i.e. not a domestic trust) only if a trust has a U.S. beneficiary. (IRC Sec. 7701(a) (31)(B) defines a foreign trust as any trust that does not qualify as a U.S. person.

U.S. Beneficiary

Under IRC Sec. 679(c), a foreign trust always has a U.S. beneficiary unless “under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person (IRC Sec. 679(c)(1)(A). Under Treas. Reg. Sec. 1.679-2(a)(2)(i), this determination is independent of whether there is an actual distribution of income or corpus to a U.S. person during the year. If the trust authorizes accumulations for possible distributions to any U.S. person in the future, the trust has a U.S. beneficiary throughout the intervening period. Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 2). Even if the only interest a U.S. person has a right to receive is corpus upon termination, the trust has a U.S. beneficiary. Treas. Reg. 1.679-2 (a)(2)(iii), Ex (3).

In addition, a foreign trust always has a U.S. beneficiary if “no part of the income or corpus” of the trust could be paid to or for the benefit of a U.S. person “if the trust were terminated at any time during the taxable year”. (IRC Sec. 679(c)(1)(B).

If any person has the authority to distribute trust income or corpus to unnamed persons generally or to any class of persons which include “U.S. persons”, the trust has U.S. beneficiaries (Treas. Reg. 1.679-2(a)(2)(i), this determination is independent of whether a U.S. person’s trust interest is contingent).

If any person has a power of appointment pursuant to which income or corpus may pass to a U.S. person, the trust has U.S. beneficiaries (Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 11)).

If any person has the power to amend the trust so as to include U.S. persons as beneficiaries, the trust has U.S. beneficiaries (S. Rep 938, 94th Cong., 2d Sess. 219 (1976)).

Under Treas. Reg. 1.679-2(a)(4), the determination of whether income or corpus may be paid to or for the benefit of a U.S. person, the IRC consults “writings, oral agreements between the trustee and persons transferring property to the trust, local law, and the trust instrument”.

IRC Sec. 679(c)(2) provides attribution rules that can cause income paid to or accumulated for a foreign corporation, partnership, trust or estate to be treated as though it were paid to or accumulated for the benefit of a U.S. beneficiary: these attribution rules apply if a corporation is a controlled foreign corporation, as defined in IRC Sec. 957(a) (See: IRC Sec. 679(c) (2)(A)).

If a U.S. person is a partner of a foreign partnership (IRC Sec. 679(c) (2) (B)), or if a U.S. person is a beneficiary of a foreign estate or trust (IRC Sec. 679(c)(2)(C)). See: Treas. Reg. Sec. 1.679-2(b)(2) and (3), (Ex. 4 & 5).

A foreign trust has U.S. beneficiaries the day after the trust beneficiaries move to the U.S. (Treas. Reg. Sec. 1.679-2(a)(3)(ii), (Ex 1)). Under IRC Sec. 679(c)(3), a beneficiary who first becomes a U.S. person more than 5 years after the date of a transfer to a foreign trust is not a U.S. person with respect to that transfer (See: Treas. Reg. Sec. 1.675-2(d)(3)(ii), (Ex 2)). The determination whether a trust has a U.S. beneficiary for purposes of IRC Sec. 679 occurs on an annual basis (Treas. Reg. 1.679-2(a)(1)).

If a foreign beneficiary becomes a U.S. person, IRC Sec. 679 begins to apply with the transferor’s first taxable year in which the foreign beneficiary is a U.S. person. The U.S. transferor has “additional income” pursuant to IRC Sec. 679(b) in the taxable year in which the trust acquires a U.S. beneficiary. Treas. Reg. 1.679-2(c)(1)(3), (Ex 1).

When a trust ceases to have any U.S. beneficiaries, the U.S. transferor continues to be treated as owner until the beginning of the following taxable year (Treas. Reg. Sec. 1.679-2(c)(2)(3), (Ex 2)).

Under IRC Sec. 679, with respect to a foreign trust, to which no U.S. resident has ever transferred anything, if a non-resident alien becomes a U.S. resident within 5 years of an actual transfer (Treas. Reg. 1.679-5), it is a U.S. grantor trust.

If a non-resident alien transfers property to a foreign trust and during the succeeding 5 years becomes a U.S. resident, IRC Sec. 679 applies as though the transferor had, on that later date, transferred “an amount equal to the portion of such trust attributable to the property actually transferred”. (IRC Sec. 679(a)(4)(A), which includes undistributed net income of the trust for periods before the transferor became a U.S. resident (IRC Sec. 679(a)(4)(B)).

If a U.S. trust becomes a foreign trust, under IRC Sec. 679 the trust becomes a foreign grantor trust (Treas. Reg. 1.679-6) and IRC Sec. 679 applies as though the grantor had on that date transferred “an amount equal to the portion of such trust attributable to the property previously transferred (IRC Sec. 679(a)(5), including undistributed net income of the trust for periods before the trust became a foreign trust.” (IRC Sec. 679(a)(5)).

Chapter 8 - Domicile (Law)

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Definition of Residence for California Income Tax Purposes

A. Taxation of California Residents and Nonresidents

1. California residents are subject to California income taxation on their worldwide business and non-business income. The California tax on taxable income is a graduated tax ranging from 0% to 10.3% (imposed on income in excess of \$1 million).
2. Nonresidents are only subject to California income taxation on their California source business and non-business income.

The California income tax for each nonresident is computed by multiplying (i) the California income tax which would be owed if the nonresident were a California resident by (ii) a fraction the numerator of which is the nonresident's adjusted gross income from California sources and the denominator of which is the nonresident's worldwide adjusted gross income.

B. Determination of Residence for California Income Tax Purposes

1. California has not adopted the federal income tax rules (IRC § 7701(b)) for determining resident status for California income tax purposes.
2. Under the California Revenue and Taxation Code ("R&T") and the regulations there under, an individual is a resident of California for California income tax purposes if such individual is:
 - a. present in California for other than a "transitory or temporary purpose"; or
 - b. domiciled in California and leaves California for a "temporary or transitory purpose." See R&T Code § 17014(a); and Reg. 17014(a).
3. Temporary or transitory purpose test is satisfied if an individual is present in California:
 - a. For a brief rest or vacation (i.e. definite short stay). See R&T Reg. § 17014(a);
 - i. Not a California resident if (i) here not more than six months and while here person is only on vacation to rest, or as a guest, but does not conduct any business and (ii) maintains a permanent abode at place of domicile. See R&T Reg. 17014(b);
 - ii. Presumption. Individual is a resident if here more than nine months. See R&T Reg. 17016;
 - b. Or, to perform a contract or engagement (i.e., complete a particular transaction or engagement with a short duration). See R&T Reg. § 17014(a).
4. Temporary or transitory purpose is not satisfied if an individual is present in California:
 - a. To improve such person's health and person has an illness which requires long recuperation;

b. To retire;

c. For business purpose which will last for a long or indefinite period.

C. Factors which are relevant in determining residence: (close connection or contacts)

1. Length of physical presence in California.

a. Physical presence in California is the most persuasive indicator of residence. The longer the taxpayer remains in California, the more likely that the taxpayer will be found to be a California resident for tax purposes.

b. A taxpayer is presumed to be California resident if the taxpayer is present in California for at least nine months. The presumption is a statutory presumption which is rebutted by satisfactory evidence that the taxpayer is present in California for temporary or transitory purposes.

2. Employment in California.

a. Employment in California is a very important determining residency in California. A presence in California to complete a particular transaction, complete a particular contract or fulfill a particular engagement constitutes presence for a temporary or transitory purpose. On the hand, indefinite employment in California, or employment for a long period of time constitutes presence which is not for a temporary or transitory purpose.

3. Contacts with California.

a. A taxpayer's contacts with California are very important in determining residency. A taxpayer with significant contacts in California is considered a California resident. Under these circumstances, the magnitude of the taxpayer's contacts indicates that the taxpayer's presence in California is not temporary or transitory.

b. The taxpayer's contacts in California are compared with the taxpayer's contracts in other states or countries to determine which place the taxpayer has the closest connections to.

c. Factors which indicate that the taxpayer is a California resident are:

i. He actively seeks and acquires a business in California;

ii. He is present in California for a business project requiring a long period to complete; or

iii. He incorporates a business in California even though the business is transacted outside of California;

iv. Maintenance of home in California;

v. Banking and checking accounts in California;

vi. Social clubs and other activities in California;

vii. Business in California;

viii. Family relationships in California including spouse and children.

d. Place where person votes, files tax returns or donates to charity are relevant for determining domicile not residence.

D. Proof of Nonresidence. R&T Reg. § 17014(d).

Proof of Nonresidence can be established through testimony or affidavits from individual, friends, employer, etc. that individual is in California for permissive purpose described in IIB above and for short duration.

Treasury Regulation Section 20.0-1 – Domicile

Under Treasury Reg. Section 20.0-1(a)(b), U.S. Estate Tax is imposed on either a citizen of the U.S. or an Estate Tax Resident (i.e., a “resident” decedent is a decedent who at the time of his death, had his domicile in the U.S.)

Treasury Regulations Section 20.0-1

(b) SCOPE OF REGULATIONS

(1) ESTATES OF CITIZENS OR RESIDENTS. Subchapter A of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a citizen or a resident of the United States at the time of his death. A “resident” decedent is a decedent who, at the time of his death, had his domicile in the United States. The term “United States”, as used in the estate tax regulations, includes only the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to their admission as States. See section 7701(a)(9). 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 indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. For the meaning of the term “citizen of the United States” as applied in a case where the decedent was a resident of a possession of the United States, see Section 20.2208-1. The regulations pursuant to subchapter A are set forth in Sections 20.2001-1 to 20.2056(d)-1.

(2) ESTATES OF NONRESIDENTS NOT CITIZENS. Subchapter B of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a nonresident not a citizen of the United States at the time of his death. A “nonresident” decedent is a decedent who, at the time of his death, had his domicile outside the United States under the principles set forth in subparagraph (1) of this paragraph. (See, however, section 2202 with respect to missionaries in foreign service.) The regulations pursuant to Subchapter B are set forth in Sections 20.2101-1 to 20.2107-1.

Domicile (Generally)

Domicile is a legal construct that describes the relationship the law creates between an individual and a particular locality or country.

Income tax rules do not apply for estate, gift, or generation-skipping tax purposes. Whether the transfer is subject to taxation generally depends on the domicile of the donor, or decedent, at the time of the gift or death. Reg. Section 20.0-1(b)(1), Reg. Section 25.2501-1(b).

Domicile is defined as the combination of physical presence in a place and the intent to remain there indefinitely.

Domicile is a function of a person's intent to remain in a particular residence indefinitely and even an illegal alien can establish a U.S. domicile. *Estate of Jack v. United States*, 54 Fed. Cl. 590 (Fed. Cl. 2002).

An individual can be both a non-resident alien and a resident alien during the same year. This generally occurs in the year the individual arrives in or departs from the United States.

The IRS will not rule on whether an alien individual is a non-resident of the United States, including whether the individual has met the requirements of the substantial presence test or exceptions to it. However, the IRS may rule regarding the legal interpretation of the definition of resident. Rev. Proc. 2007-7, 2007-1 I.R.B. 227, Section 3.01(7).

Domicile is the place where a person has his/her permanent principal home to which, whenever he/she is absent, he/she returns or intends to return. Domicile is important because it is used in determining in what state a probate of a dead person's estate is filed, what state can assess income or inheritance taxes, where a party can begin divorce proceedings, or whether there is "diversity of citizenship" between two parties which may give federal courts jurisdiction over a lawsuit. Where a person has several "residences" evidence may need to be examined to determine which is the state of domicile. A person may have only one domicile at a single point in time. A business has its domicile in the state where its headquarters is located. For tax purposes, a business' domicile is often a principal place of business.

Each State of the United States is considered a separate sovereign within the U.S. federal system, and each therefore has its own laws on questions of marriage, inheritance, and liability for tort and contract actions. Persons who reside in the U.S. must have a state domicile for various purposes. For example, an individual can always be sued in their state of domicile. Furthermore, in order for parties to invoke the diversity jurisdiction of a United States Federal Court, the plaintiffs may not have the same domicile as any defendant.

Domicile of Choice

One who is legally capable of changing his domicile may attain a domicile of choice by simultaneously being physically present in the new location while possessing the requisite attitude of mind. (RESTATEMENT (SECOND) OF CONFLICT OF LAWS §15 (1971). See *Bell v. Bell*, 326 Pa. Super. 237, 473 A.2d 1069 (1984). The court held that a husband had established domicile in Nevada even though he moved to that state for the purpose of obtaining a divorce.)

The requisite attitude of mind is the present intent to make a principal home in the place, with no present intent to move elsewhere. (RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 15 comment a (1971).)

Intent is usually determined by the person's conduct and surrounding circumstances. A person's own declaration of domicile is admissible as evidence, but is not very persuasive because of its self-serving nature. (See *Kjarstad v. State*, 703 P2d 1167 (Alaska 1985); *In re Esser's Will*, 38 Misc. 2d 963, 239 N.Y.S.2d 585 (Sur. Ct. 1963); *Meltzer & Weisberg v. Commonwealth Unemployment Comp. Bd. of Review*, 80 Pa. Commw. 178, 471 A.2d 157 (1984).)

Courts concentrate on such factors as substantial business and social contacts, type of home, membership in church or other organizations, registration to vote, place of driver's license and car registration, and similar elements demonstrating that a particular locality has the most significant relationship to the person.

Domicile – Defining Resident Status For U.S. Estate Tax Purposes

The alien must also be a nonresident to avoid global U.S. estate taxation. For U.S. estate tax purposes, the term “nonresident decedent” means a person who, at the time of death, had his domicile outside the United States. (Reg. § 20.0-1(b)(2). This regulation specifies that domicile is determined by application of the principles prescribed in Reg. § 20.0-1(b)(1).) The statutory term utilized is “resident,” but the import of this term really contemplates domicile, often a very different concept. (Even an illegal alien, though subject to deportation if discovered by immigration authorities, may be domiciled in the United States for estate tax purposes if the facts indicate an intention to remain in the United States ‘indefinitely. Rev. Rul. 80-209, 1980-2 CB 248. The ruling involved an illegal alien living in the United States for nineteen years, who owned property in the United States, was a member of social clubs, and participated in community activities.)

A person acquires a domicile in a location by living there, even for a brief period, with “no definite present intention” of later removing from that location. (Reg. § 20.0-1(b)(1). Physical presence is an important factor but is not controlling. See *Estate of Paquette*, 46 TCM 1400 (1983), where a Canadian citizen who had spent the winter months in Florida for twenty-five years and had purchased a home in Florida that was his sole residence was held to be a nondomiciliary of the United States. He had filed with the State of Florida a “Revocation of Declaration of Domicile and Citizenship.”)

Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, however. (Because this is a question of fact, the Service will not rule on the status of residency or domicile. See Rev. Proc. 95-3, 1995-1 IRB 85, § 4.02(1). Revenue Procedure 95-7, 1995-1 IRB 185.) If domicile exists in the United States, an intention to change domicile does not actually effect such a change unless accompanied by an actual removal from the United States. (See Rev. Rul. 58-70, 1958-1 CB 341, where an alien was planning to terminate domicile in a foreign country and establish domicile in the United States but did not accomplish this objective prior to death and was not treated as a resident for U.S. estate tax purposes.)

The Section 7701(b) definition of “resident alien” applies only for purposes of the income tax provisions. These rules do not apply for purposes of the U.S. estate tax, gift tax, and generation-skipping transfer (GST) tax provisions. Consequently, an alien holding a “green card” is a resident for U.S. income tax purposes, but this status is not determinative for U.S. estate tax purposes if his domicile is actually outside the United States.

Domicile – Definition Under U.S. Estate Tax Treaties

In a situation where a U.S. estate tax treaty may be applicable, the same inquiry will arise with respect to the location of the decedent's domicile. The U.S. bilateral estate tax treaties have their own rules to determine whether a foreign individual is a resident in the United States at the time of death. These same rules apply bilaterally, of course, to determine whether a U.S. individual is domiciled in the foreign tax treaty jurisdiction at the time of death.

Recognizing that dual domiciliary status may exist, estate tax treaties often prescribe tie-breaker rules to determine domicile, based on the following priorities:

1. Location of the permanent home
2. Location of the closest personal and economic interests (i.e., the "center of vital interests")
3. The individual's habitual abode
4. Citizenship - The benefits of a U.S. estate tax treaty available to a foreign client are ordinarily available only if the foreign client is a domiciliary of that country and not if he is actually domiciled in a third country.

For Estate And Gift Tax Purposes Residence Means Domicile

If an alien individual is not domiciled in the United States at the time he makes a gift, he is nonresident for gift tax purposes. (Treas. Reg. § 25.2501-1 (b); *F. Giacomo Fara Forni v. Commissioner*, 22 T.C.M. 975 (1954).) If he is domiciled outside the United States at the time of his death, he is nonresident for estate tax purposes. (Treas. Reg. § 20.0-1(b) (1); *Estate of Julius Bloch-Sulzberger v. Commissioner*, 6 T.C.M. 1201 (1947).)

Every individual must have a domicile. (See Restatements (Second) of Conflicts of Laws § 11(2) (1971).) At birth, a child normally acquires the same domicile as his father. If his father changes his domicile while the child is a minor, the child's domicile will normally follow that of the father. Once he is an adult, the individual is free to choose his own domicile.

To effect a change of domicile, there must be physical presence in a new jurisdiction with the intent to make that place his home and with no present intention of departing. A married woman traditionally takes the domicile of her husband but she is capable of changing her domicile (i.e., Domicile of Choice).

Determination of Federal Estate and Gift Tax Residence Domicile

A. An alien is a resident for federal gift and estate tax purposes (whether or not he is a resident for federal income tax purposes) if the alien is domiciled in the U.S. at the time of his death.

B. Declaration of Domicile. An alien acquires domicile in the U.S. if he is physically present in the U.S. with the intention of permanently residing in the U.S.

1. The issue of the alien's intent as to residency is determined by examining all of the facts and circumstances of the alien's case.

2. The following factors are significant in determining the issue of domicile:

a. The intent of the alien as evidenced by the objective acts of the alien;

b. The duration of the alien's stay in the U.S. and in other countries, and the frequency of travel by the alien between the U.S. and other countries, and between places abroad;

c. The size, cost and nature of the alien's house(s) or other dwelling place(s) in the U.S. and abroad, and whether those places were owned or rented;

d. The location of clothing and cherished personal possessions of the alien and his family;

e. The marital status of the alien and the residence of the alien's family and close friends;

f. The place where the alien maintains religious affiliation;

g. The extent the alien and his family participate in community activities in the U.S. and abroad;

h. The location of the alien's business interests;

i. Statements made by the alien in a declaration of will, deed, trust, divorce petition, contract, hotel registry or other legal document;

j. The alien's reasons and motivation for leaving his foreign home, such as health, pleasure, business, or avoiding of war or political oppression; and

k. The alien's U.S. visa classification.

Domicile: Non-U.S. Citizen Residency for Estate, Gift, and Generation-Skipping Transfer Taxes

A non-U.S. citizen is a U.S. resident for estate, gift, and GST tax purposes if he or she is domiciled in the United States at the time of the asset transfer in question. (Regs. §§ 20.0-1(b)(1), 25.2501-1(b); see also *Farmers' Loan & Trust Co. v. United States*, 60 F2d 618 (SDNY 1932); *Rodiek v. Comm'r*, 33 BTA 1020 (1936), *aff'd*, 87 F2d 328 (2d Cir. 1937).) "Domicile" is defined, for this purpose, as that combination of physical presence (even for a very brief period) and no present intention of departing. (Regs. §§ 20.0-1(b)(1), 25.2501-1(b).) Proof of the requisite intent to remain depends on all of the relevant facts and circumstances, including:

1. The length of the individual's stay;
2. The size, nature, and expense of the individual's dwelling within the United States and of any dwellings outside the United States;
3. The location of personal possessions;
4. The existence of social and church contacts; and
5. Club memberships, business accounts, driver's licenses, and such other indicia of permanence. (See *Cooper v. Reynolds*, 24 F2d 150 (D. Wyo. 1927); *Estate of Fokker v. Comm'r*, 10 TC 1225 (1948), *acq.* 1948-2 CB 2; *Rodiek v. Comm'r*, 33 BTA 1020 (1936), *aff'd*, 87 F2d 328 (2d Cir. 1937); *Bank of New York & Trust Co. v. Comm'r*, 21 BTA 197 (1930), *acq.* 1 CB 4.)

Domicile and Residence – The Same and Different

Another concept that closely resembles and is often confused with domicile is “residence.” Residence does not, however, generally involve the requisite attitude of mind – the intent to remain permanently or indefinitely in a locality. Primarily, residence requires only physical presence in a particular locality, or an actual place of abode there. (See *Stacher v. United States*, 258 F.2d 112 (9th Cir.), cert. denied, 358 U.S. 907 (1958); *Weible v. United States*, 244 E2d 158 (9th Cir. 1957).)

Residence is a necessary component of domicile, but the converse is not true. A person can have numerous residences, but only the place most significantly related to him, around which he organizes his life, is his domicile.

In other statutes, when the term “residence” is used, it is not always synonymous with “domicile.” For example, in construing the Immigration and Nationality Act (Immigration and Nationality Act §§ 310(a), 340(a), 8 U.S.C. §§ 1421(a), 1451(a)), the U.S. Court of Appeals for the Ninth Circuit said: “There is an essential difference between ‘domicile,’ which generally involves intent, and ‘residence,’ which generally involves an actual place of abode.” (*Stacher v. United States*, 258 E2d 112, 116 (9th Cir.), cert. denied, 358 U.S. 907 (1958).) The court found that residence, for purposes of that statute, did not involve intent. Therefore the interpretation of “residence” will depend on the purpose of the statute and the context in which it is used.

Domicile v. Residency

1. An Individual can have more than one place of residency
2. An Individual can have only a single domicile at one time
3. In *Elkins v. Moreno* (435 U.S. 647 (1978)) the IRS revoked its prior ruling and held that a non-immigrant alien who entered the United States with a G-4 Visa, formed the intent to remain indefinitely, died 13 years later, was domiciled in the U.S. (Rev. Rul. 80-363, 1980-2 C.B. 249, revoking Rev. Rul. 74-364, 1974-2 C.B. 321)
4. A non-domiciled resident alien:
 - a. Interest Income from U.S. Bank Accounts subject to U.S. income tax because he is resident (IRC § 871(i)(3))
 - b. U.S. Bank Account subject to U.S. estate tax (IRC § 2105 (b)(1))
 - c. Foreign Bank Accounts interest income subject to U.S. income tax but not estate tax (i.e., deposits foreign-situs property for estate tax)

Property of Nonresident Alien Treated as Located in the United States

Property Situs Rules - U.S. Estate Tax Treatment

For U.S. estate tax purposes, the gross estate of a deceased nonresident alien is that part of his estate that at the time of death is deemed located in the United States. (IRC § 2103.) The primary rules for determining the situs of specific assets are included in the Internal Revenue Code (the Code). (See particularly IRC §§ 2103-2105.) Tax jurisdictional rules might be moderated by U.S. estate tax treaties.

An executor for a nonresident alien decedent is permitted to choose to apply either the Code provisions or the estate tax treaty situs rules, depending on which rules are more deemed to be more favorable. The choice must ordinarily be for the exclusive application of the Code provisions, or the tax treaty provisions, rather than picking and choosing the best rules from either the Code or the tax treaty.

Property situated in the United States generally includes U.S.-based real property and debt obligations of U.S. persons. (IRC § 2104(c).) Special exemptions are available, however, for bank deposits and portfolio obligations (including U.S. government obligations), the interest on which would be exempt from U.S. income tax. (IRC § 2105(b).) For foreign individuals, this U.S. income tax exemption arises under IRC § 871(i).

Stock owned and held by a nonresident alien is treated as property situated in the United States if that stock has been issued by a domestic corporation. (IRC § 2104(a); Reg. § 20.2104-1(a)(5).) A non-resident alien may hold U.S. property indirectly through a foreign corporation, however, thereby generally avoiding any application of U.S. estate taxation.

Estate Tax Treaty Treatment

An estate tax treaty to which the United States is a party may alter these statutory rules concerning the primary situs of property for U.S. estate tax purposes. (Reg. § 20.2104-1(c), entitled "Death tax convention," indicates that the situs rules described in IRC § 2104 "may be modified for various purposes under the provisions of an applicable death tax convention with a foreign country.") The objective under many U.S. estate tax treaties is to shift the taxing jurisdiction from the property situs to the domicile of the decedent. The underlying premise is that the jurisdiction where the control of the wealth ultimately resides should have the primary right to tax the transfer of this wealth.

For determining whether taxation based on situs is applicable, a U.S. estate tax treaty ordinarily divides the U.S.-based assets of a foreign client into three groups:

1. Assets having a business connection with a "permanent establishment" in the United States
2. Tangible property, particularly real property and, in some situations, personal property

3. All remaining assets

The most recent U.S. estate tax treaties provide that only two classes of property (immovable or real property and business assets connected with a permanent establishment), and in some cases a third class (tangible personal property), are subject to estate tax in the non-domicile country.

Identifying Property Economically Owned by the Nonresident Alien Decedent

Nominal but not substantive ownership. The foreign client may be only the nominal owner and may hold the property on behalf of some other person. For example, the foreign client could hold the U.S. property as an agent for other parties, including for a corporation, or the foreign client could hold the property in some other fiduciary capacity. (See *Estate of Banac v. Comm'r*, 17 TC 748 (1951), acq. 1952-1 CB 1, where the Tax Court held that monies of a Yugoslav corporation deposited in the United States in the name of a nonresident alien under a power of attorney for the corporation were not includible in the nonresident alien's estate.)

The determination of actual ownership may necessitate reference to the laws of both the domicile and property situs jurisdictions to determine whether substantive ownership rights are held in that property. The process of real ownership determination may, in turn, require reference to conflict-of-laws rules to determine which jurisdiction's laws will enable the resolution of this inquiry.

Joint Ownership of Property

Property held in the United States may have been acquired with the proceeds of joint funds, but the technical property ownership may only be reflected in the name of an individual foreign client. For example, property held in the United States may have been acquired with foreign-source funds that really constitute the community property resources of two spouses. That ownership of community property funds may be determinable under the laws of a foreign jurisdiction. (In Revenue Ruling 72-443, 1972-2 CB 531, the Service ruled that one half of the value of real property situated in the United States that was acquired in the name of the decedent, who was a citizen and a resident of Norway, was included in his gross estate for the purpose of U.S. estate taxes. The state in which the property was located recognized the vested rights of the spouse in the funds used to purchase the property. Therefore, under Norwegian community property law, the decedent was treated as owning at the time of his death only a one-half interest in the property.) In this type of situation, each spouse may own, therefore, only a one-half interest in the property even though it is nominally held entirely in the name of one of the spouses.

Similarly, the property may be held in a tenancy in common or in a joint tenancy with the right of survivorship. In each instance, ascertain the precise source of the funds for the investment in and ownership of these properties.

Property rights of a decedent may cease to exist at the time of death. For example, as determined by reference to foreign law concepts (as mandated under applicable conflict-of-laws principles) the decedent may really own a life estate in certain property, with successors holding the remainder interest. These rules might apply even though the property has a U.S. situs because, under applicable conflict-of-laws principles, the property rights are to be determined under the laws of the domicile.

Double Taxation (Domicile) — Tax Treaties

In many instances the adverse tax consequences of a determination of double domicile have been alleviated by tax treaties between the contending jurisdictions. U.S. estate tax treaties vary. They generally provide that in the event the contracting parties both claim the decedent as a domiciliary for estate tax purposes, a credit will be given against each country's tax for tax on property situated in the other country. The amount of the credit cannot exceed the portion of the tax imposed by the country granting the credit attributable to such property.

The Internal Revenue Code (the Code) provides for a death tax credit for a citizen or resident of the United States with respect to property situated and taxed in a foreign country. (I.R.C. § 2014.)

If there is a treaty in force with a particular foreign country, the taxpayer may elect the provisions of the treaty or the Code, whichever is more favorable. (S. REP. No. 82-781, at 89-90 (1951); Treas. Reg. § 20.2014-4 (1973).)

The treaties also include "deemed to be situated" clauses. These clauses, varying from treaty to treaty, describe where assets are considered to be located for purposes of taxation. For example, under a former treaty with the United Kingdom, a corporate bond was deemed to have its situs at the decedent's domicile, and negotiable instruments were deemed situated where they were physically located. (Estate Tax Treaty with the United Kingdom, Apr. 16, 1945, U.S. United Kingdom, 60 Stat. 1391, T.I.A.S. No. 1547, superseded by Estate Tax Treaty with the United Kingdom and Northern Ireland, Oct. 19, 1978, 30 U.S.T. 7225, T.I.A.S. No. 9580.)

Under a former estate tax treaty with Canada, corporate debt was deemed to have its situs at the place of incorporation and negotiable instruments at the residence of the maker. (Estate Tax Treaty with Canada, Feb. 17, 1961, U.S.-Canada, 13 U.S.T. 382, T.I.A.S. No. 4995. See *Borne v. United States*, 577 E Supp. 115 (N.D. Ind. 1983).

The court held that the U.S.-Canada Estate Tax Treaty only applied to taxes levied by the governments themselves and not those imposed by the countries' political subdivisions. The court noted, however, that the treaty allows "each respective country to receive a credit from the other country for the entire amount of tax charged by the national government even though that government allowed a credit on its own tax for taxes paid to political subdivisions of the country." *Id.* at 117.)

Under California law, domicile is described as that place where one has his permanent home (Barnett, *California Inheritance and Gift Taxes, A Summary*, 43 Cal. L. Rev. 51 (1959)). Domicile of Origin is the domicile the law assigns to each person at birth (Restatement [Second] of Conflict of Laws 14 (1971)). The domicile of origin is assigned unless domicile of choice is attained. U.S. jurisdictions generally will not find a domicile abandoned until a new one has been adopted.

In most U.S. jurisdictions, the rule is stated as a rebuttable presumption that the wife's domicile is the same as her husband's.

Under IRS Publication 555, Community Property, Revised May 2007, the IRS Publication states:

"You have only one domicile even if you have more than one home. Your domicile is a permanent legal home that you intend to use for an indefinite or unlimited period, and to which, when absent, you intend to return. The question of your domicile is mainly a matter of your intention as indicated by your actions. You must be able to show with facts that you intend a given place or state to be your permanent home. If you move into or out of a community property state during the year, you may or may not have community income.

Factors considered in determining domicile include:

- Where you pay state income tax,
- Where you vote,
- Location of property you own,
- Your citizenship,
- Length of residence, and
- Business and social ties to the community.

Amount of time spent. The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home or residence may continue for months or years while a domicile may be established the first moment you occupy the property. Your intent is the determining factor in proving where you have your domicile.

U.S. Gift Tax

1. U.S. citizens and residents are subject to gift tax on all direct or indirect transfers of property, wherever located, for less than full and adequate consideration.

2. Non-resident aliens are subject to gift tax only on gifts of tangible personal property and real property located in the United States. IRC § 2511(a).

3. Gifts of intangible property made outside the United States are not subject to gift tax. IRC § 2501(a)(2).

4. Rules and Calculation of Tax:

a) Since TAMRA, the same gift tax rates apply to non-resident aliens as U.S. citizens and residents.

b) Non-resident alien donors are not entitled to the unified credit against gift tax.

c) Non-resident aliens do qualify for the \$13,000 per year donee exception for gifts to persons other than spouses. (IRC § 2503) In 2012, \$139,000 annual exclusion for gifts to a spouse who is not a U.S. citizen. (§ 2523(i)(2))

d) Non-resident aliens are not entitled to the gift tax marital deduction, unless the gift is to a U.S. citizen (IRC § 2523(i)).

e) The charitable deduction is limited to gifts to certain charities (IRC § 2522(b)).

f) A non-resident alien may not split gifts with a spouse (IRC § 2513(a)(1)).

5. Gift tax treaties may change these rules.

a) Some of these treaties allow a marital deduction for gifts to non-citizen spouses and expand the availability of the charitable deduction.

b) For example, the Australian and Japanese treaties may give a donor domiciled in those countries the right to use a portion of the unified credit for gift tax purposes.

Applicability of U.S. Transfer Tax to Nonresident Aliens

Scope of U.S. Estate Taxation

U.S. estate and gift taxation applies to non-resident alien transferors who have property located in the United States (referred to here as foreign clients) in addition to citizens and residents of the United States. For nonresident aliens, the gross amount subject to U.S. estate

tax can be determined by reference only to property situated in the United States. (IRC § 2103. Any imposition of a transfer tax on nonresident aliens with respect to their transfers of non-U.S. assets would be both unenforceable and contrary to norms of international law.) In contrast, for U.S. citizens and residents any U.S. estate and gift tax exposure is determined by reference to personal status and not the specific location of assets. (IRC §§ 2031(a), 2511(a).)

U.S. Estate, Gift, and Generation Skipping Transfer Taxation of Non-Resident Aliens

1. Taxation based on citizenship and residence.

1.1 U.S. citizens and residents are subject to estate tax on all interests in property wherever located owned or controlled at death.

1.2 Individuals who are neither U.S. residents nor U.S. citizens (“non-resident aliens”) are only subject to U.S. estate tax on:

(a) Interests in “property deemed located in the United States” (“U.S. Property”) at the decedent’s death; or

(b) “U.S.-Property” transferred prior to death, but includable under IRC § 2035 (transfers within three years of death), § 2036 (transfers with a retained life estate), § 2037 (transfer taking effect at death), and § 2038 (revocable transfers). IRC §§ 2103-2105.

1.3 Citizenship.

(a) An individual’s status as a citizen is determined by the Immigration and Naturalization Act (8 U.S.C. § 1101 et seq.), except that persons who are U.S. citizens solely by reason of having been a citizen of a U.S. possession either by birth or residence within the possession are treated as nonresident aliens for estate and gift tax purposes.

(b) Persons who gave up U.S. citizenship are subject to special estate and gift tax rules. See IRC §§ 2107, 2501.

1.4 Residence/Domicile.

(a) For U.S. estate and gift tax purposes, a resident is one who, at the time of his death or at the time of gift, is domiciled in the United States. An individual is a U.S. domiciliary if he lives in the United States, even for a brief period of time, with the intention to remain indefinitely. Treas. Reg. §§ 20.0-1(b)(1), 25.2501-1(b).

(b) Note: This concept is different from the income tax rules regarding residency. See IRC § 7701(b).

(1) For income tax purposes, an alien is considered a U.S. resident for a calendar year if: (i) the alien is a lawful permanent resident of the United States at any time during the calendar year, (ii) the alien meets the substantial presence test, or (iii) the alien makes a first-year election under IRC § 7701(b)(4).

(c) A non-resident alien could be domiciled in the United States and in one or several other countries. Treaties address in various ways the potential for double taxation of estates that may result.

(d) A number of treaties either leave the question of domicile to be determined under the local laws of the two countries or have no provision regarding domicile. Under such treaties, an estate may be subject to taxation of worldwide assets by two countries, but the tax authorities of the signatories all allow tax credits for taxes on property situated in the other country.

Property Subject to Tax

U.S. Property for estate tax purposes includes:

- a. Real property located in the United States;
- b. Tangible personal property located in the United States (except works of art on loan for an exhibition);
- c. Stock of domestic corporations;
- d. Debt obligations of U.S. persons except obligations which qualify as “portfolio interest” obligations under § 871(h)(4).

In addition, a general power of appointment over U.S. Property will be subject to U.S. estate tax.

U.S. Property can also be subject to estate tax at death if it was transferred during lifetime in a manner which would render it includable under IRC §§ 2035 through 2038 IRC § 2104(b);

a. So, for example, U.S. real property or stock of a domestic corporation in a trust which is deemed to be a grantor trust for income tax purposes because the non-resident alien had a right to revoke or amend the trust during lifetime would be subject to estate tax at the non-resident alien settlor’s death.

b. Also, U.S. Property transferred to a trust which was not a “grantor” trust for income tax purposes, but over which the decedent-settlor retained control or an interest sufficient to make the assets includable under §§ 2036, 2037, or 2038 (such as a power to sprinkle income and principal) would be subject to estate tax at the death of the non-resident alien decedent.

U.S. property does not include any of the assets listed below unless they are held in connection with a U.S. trade or business of the decedent:

- a. Life insurance proceeds on the life of a non-resident alien (IRC § 2105(a));
- b. Real and tangible personal property located outside the U.S.;
- c. Stock of a foreign corporation;
- d. Bank deposits;
- e. “Portfolio interest” obligations (IRC §2105(b)); and

f. U.S. Property owned by a foreign partnership if, under foreign law, the partnership is regarded as an entity separate from its partners and if the death of the decedent did not terminate the partnership.

Rate and Calculation of Tax

For nonresident alien decedents dying after November 10, 1988 (the date of enactment of the Technical and Miscellaneous Revenue Act of 1988 (“TAMRA”) the estate tax rates are the same as for U.S. citizens.

Credits available to offset the tax include:

a. IRC § 2102(b): Unified credit of \$13,000 is equal to an exemption for \$60,000 of property. The unified credit amount is increased under some treaties. (versus \$1 million for U.S. Citizens and residents)

b. A credit for state death taxes paid.

c. A credit for federal estate tax paid on prior transfers of property included in the gross estate.

d. No credit for foreign death taxes paid.

Deductions available to offset the estate tax include:

a. Marital deduction.

1. Since the enactment of TAMRA, the marital deduction is available to non-resident alien decedents for gifts to (or in a QTIP trust for) a spouse who is a U.S. citizen.

2. The opposite is also true – gifts to or for the benefit of a spouse who is not a U.S. citizen (even if they are a U.S. resident) no longer qualify for the marital deduction. IRC § 2056(d). The estate tax can be postponed, but only if property is placed in a trust which qualifies as a Qualified Domestic Trust.

3. Qualified Domestic Trust (IRC § 2056A) must provide:

i. One of the trustees must be a U.S. citizen or a domestic corporation who has a right to withhold estate tax on financial distributions;

ii. The surviving spouse must be entitled to all the income from the trust, payable annually or more frequently;

iii. The executor must make an election; and

iv. The trust must comply with regulations applying to qualified domestic trusts to be issued in the future.

4. The estate tax is only postponed until there is a distribution of principal, either upon termination of trust, or earlier (except for lifetime distributions on account of “hardship”). The estate tax is imposed at highest rates applicable to the estate of the first spouse to die.

5. A credit for prior transfers will be available to the estate of the second spouse to die if the property is also taxable in his/her estate. IRC § 2056(d)(3).

b. The charitable deduction is available for gifts to certain qualified charities (IRC § 2106(a)(2)(A)).

c. The estates of nonresident aliens are entitled to deduct a portion of debts and expenses of administration. See IRC § 2106(a)(i); Treas. Regs. §§ 20.2106-1 and -2. The deductible portion of such items is determined by a fraction; the numerator of which is the value of the gross estate situated in the United States, and the denominator of which is the value of all property included in the gross estate. Treas. Reg. § 20.2106-2(a)(2). The deductible amounts may have been incurred or expended within or without the United States. As a condition to allowance of any such deductions, the estate tax return must disclose the decedent's gross estate situated outside the United States. Treas. Reg. § 20.2106-2(a)(2).

Only a proportional part of a recourse note secured by a mortgage on U.S. Property is deductible, while the mortgaged property is includable in full. Thus in some circumstances, the tax could exceed the decedent's equity interest in the property. However, where property is subject to a non-recourse mortgage, only the value of the equity of redemption is included, thus in effect giving a 100% deduction on the mortgage.

Chapter 9 - Expatriation

1. Expatriation: Green Card Holders
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Expatriation: Green Card Holders

The Heroes Earnings Assistance and Relief Tax Act of 2009 (“HEART”), P.L. No. 110-245, adds new IRC Sections: 877A (imposing a “mark to market tax” on asset “sale” net gains) and IRC§2801 adding a “succession tax” (on the receipt by a U.S. person of a gift from a “covered expatriate”).

Based upon these new taxes, certain “Green-Card Holders” may elect to expatriate. The act of relinquishing their “Green Cards” negates their U.S. domicile under the “intent test” (i.e., they intend to reside in the U.S. indefinitely.) Without the requisite intent, they may not be classified as a U.S. domicile. If the Green Card was held for 8 out of the last 15 years, the foreigner is a “long-term resident” subject to the expatriation rules.

Individuals who relinquish their U.S. citizenship, or whose long-term residency status is terminated (after June 16, 2008) are classified as “covered expatriates” subject to the “mark-to-market” tax and the “succession tax”.

Expatriation by a foreigner, who relinquished their U.S. domicile or long-term resident status, may trigger a “mark-to-market” tax to the expatriate on their assets and a “succession tax” on their gifts (taxed to the gift recipient) if the foreigner’s net worth, or U.S. income tax liability meets certain levels;

- 1) Net Worth: \$2M or more (on the date of expatriation), or
- 2) \$157,000 net income tax liability (2014).

The net income tax liability is the average annual net income tax liability for the 5 preceding years, (ending before expatriation) which exceeds \$157,000 (for tax year: 2014).

“Succession Tax” (IRC Section 2801)

A U.S. citizen, or resident alien, is subject to a special transfer tax (a “gift tax”) upon receipt of property by gift, devise, bequest or inheritance from a “covered expatriate”.

‘Mark-to-Market Tax’ (IRC Section 877A)

Under the “Mark-to-Market Tax” a covered expatriate is taxed on his wealth at the expatriation date and is considered to own an interest in property that would be taxable as part of his gross estate (for federal estate tax purposes), if they died on the day before the expatriation date.

Under this “expatriation tax”, they are taxed on the unrealized gain in their assets to the extent it exceeds \$680,000 (for 2014). (IRC Section 877A), Rev. Proc. 2011-52, Rev.Proc. 2010-40, IRS notice 2009-85.

Special tax rules apply for deferred compensation, tax deferred accounts and interests in non-grantor trusts, which are not subject to the “mark-to-market tax.”

Expatriation: Covered Expatriate

A covered expatriate is an individual who either:

1. Relinquishes their U.S. citizenship; or
2. Terminates their long-term residency status after June 16, 2008.

The act of expatriation, triggers two (2) taxes:

1. Under IRC Section 877A, a “mark-to-market tax” is imposed on the expatriate taxing net gains on assets (in excess of \$680,000 in 2014).
2. Under IRC Section 2801, a gift tax is imposed on a U.S. citizen or resident alien who receives property as a gift from a “covered expatriate.”

The expatriation date is the date:

1. A U.S. citizen relinquishes their citizenship;
2. A long-term resident alien ceases to be a lawful permanent resident.

A U.S. citizen relinquishes his U.S. citizenship at the earliest date when:

1. He renounces his nationality before a U.S. diplomat or consulate officer;
2. He provides a statement of voluntary relinquishment to the Department of State;
3. The Department of State issues the individual a certificate of loss of nationality, or
4. A U.S. Court cancels a naturalized citizen’s certificate of naturalization.

A lawful permanent resident (IRC Section 7701(b)(6), terminates their legal status if:

1. They commence to be treated as a resident of a foreign country under the provisions of an applicable tax treaty with the U.S.
2. Does not waive tax benefits available under an applicable tax treaty.
3. Notifies the IRS of the commencement of such treatment (e.g., by claiming treaty benefits on a Form 8833 filed with his U.S. income tax return (Form 1040 NR).

Tax Deferral (“Mark-to-Market Tax”)

Under IRC Section 877A, a covered expatriate can irrevocably elect, on an asset-by-asset basis, to defer the payment of the “mark-to-market tax” attributable to an asset, until the due date of the return for the year in which such property is sold or exchanged.

The taxpayer must:

1. Irrevocably waive the benefit of any U.S. tax treaty that would preclude assessment of the tax.
2. Provide adequate security (including a bond conditioned on the payment of tax and interest, and meeting the conditions of IRC Section 6325).

Interest accrues on the deferred tax at the normal underpayment rate.

Under the Reed Amendment:

“Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (PL 104-208)”, enacted 9/30/96, it bans re-entry to the U.S. of former citizens who expatriated for a principal tax avoidance purpose (in the Attorney General’s opinion).

Expatriation: Mark-to-Market Tax

Exclusion Agreement

Under the “Mark-to-Market Tax”, upon expatriation, the covered expatriate is taxed on the unrealized gain in their assets, to the extent it exceeds \$680,000 (for 2014) (IRC Section 877A).

The IRC Section 877A exclusion amount must be allocated pro-rata across all assets having built-in gain owned by the covered expatriate on the day before the expatriation date.

Gain is determined as if a sale of the property, for fair market value, had taken place on the day before the expatriation date.

Losses from the deemed sale are generally taken into account, as otherwise provided in the Internal Revenue Code (except the wash sale loss rules do not apply).

Asset Basis

Asset basis will be adjusted for purposes of determining gain or loss, on a subsequent disposition, by the amount actually taken into account in determining gain or loss without regard to the exclusion amount attributable to the asset.

Tax Deferral

Regarding the covered expatriate’s right to defer the payment of the mark-to-market tax, the tax deferral election only applies to the tax arising as a result of IRC Section 877A, and not to an individual’s regular U.S. tax liability for the year of expatriation.

The tax deferral election is made on an asset-by-asset basis. The tax for each property is determined by multiplying the total mark-to-market tax by the ratio of the gain on the deemed sale of the property over the total gain taken into account with respect to all property deemed sold.

The election defers payment of the tax until the due date for the return for the tax years in which the property is sold. Payment of the tax may not be extended beyond the due date for the return for the tax year in which the covered expatriate dies.

Under IRC Notice 2009-85, in computing a covered expatriate’s tax liability under the mark-to-market provisions, the taxpayer is deemed to own:

1. Any property that would be considered to be within his estate, were he to die on the day before his expatriation date;
2. Property held in a Grantor Trust;

3. Property owned through a non-grantor trust is disregarded.

Expatriation: Succession Tax

IRC Section 2801

IRC Section 2801 imposes a succession tax (at the highest applicable gift or estate tax rates), on the receipt by a U.S. person (i.e., citizen, resident alien) of a “covered gift” (i.e., a gift from a “covered expatriate”, IRC Section 877A).

The succession tax applies to gifts from individuals who expatriate on or after 6/17/08. The tax is assessed on the gift recipient. The tax is reduced by any foreign gift or estate tax paid.

The succession tax does not apply to (2014):

1. Annual Exclusion Gifts (\$14,000 per year, per donee, IRC Section 2503(b),
2. Gifts entitled to a charitable deduction,
3. Gifts entitled to a marital deduction, i.e., gifts to a U.S. citizen spouse;
4. Gifts to an alien spouse (\$14,000 annual gifts, under IRC Section 2503(b), \$139,000 per year alien spouse gifts (IRC Section 2523(i),
5. Gifts to a Qualified Domestic Trust that qualify for the marital deduction (IRC Section 2056(d), 2056 (A),
6. A taxable gift shown on a timely filed gift tax return,
7. Property included in the estate of a covered expatriate that is shown on a timely filed estate tax return.

Trusts

Special rules apply for covered gifts made to trusts:

1. If made to a domestic trust, the succession tax is assessed on and paid by the trust;
2. If made to a foreign trust, the tax will apply to the receipt by a U.S. person of a distribution (whether income or capital), attributable to a transfer from a covered expatriate).

The IRS is developing new Form 708 (re: IRC Section 2801) “U.S. Return of Tax for Gifts and Bequests received from Expatriates.”

Expatriation: Deferred Compensation

Certain property is excepted from application of the mark-to-market tax.

1. Deferred compensation.
2. Specific tax-deferred accounts.
3. Interests in non-grantor trusts.

Eligible Deferred Compensation

IRC Section 877A(c)(1) provides that the tax under the mark-to-market regime, provided in Section 877(a) does not apply to any deferred compensation item. In the case of an “eligible deferred compensation item” IRC Section 877A(d)(1)(A) provides generally that the payor must deduct and withhold a tax equal to 30% of any taxable payment to a covered expatriate with respect to such an item.

IRS Section 877A(d)(1)(B) provides that a taxable payment is any payment to the extent it would be includable in gross income of the covered expatriate if such person continued to be subject to tax as a citizen or resident of the U.S.

Since the covered expatriate must waive his right to claim treaty benefits with respect to an eligible deferred compensation item, the 30% withholding tax cannot be reduced or eliminated by treaty.

Deferred compensation is classified as “eligible deferred compensation” if either:

1. the payor is a U.S. person, or
2. the payor is a foreign person who elects to be treated as a U.S. person.

Deferred compensation specifically does not include deferred compensation attributable to services performed outside the U.S. while a covered expatriate was not a U.S. citizen or resident.

Tax on the payment of an “eligible deferred compensation item” is deferred until a covered expatriate received a taxable payment at which time tax is collected by a 30% withholding tax at the source.

For purposes of IRC Section 877A deferred compensation item means:

1. Any interest in a plan, described in IRC Section 219(g)(5) which means a plan described in IRC Section 401(a) that includes a trust exempt from tax under IRC Section 501(a), an annuity plan described in IRC Section 403(a).
2. An annuity contract described in the IRC Section 403(b).
3. A simplified employee pension (IRC Section 408(k)).
4. A simplified retirement account (IRC Section 408(p))
5. A trust described in IRC Section 501(c)(18).
6. Any interest in a foreign pension plan.
7. An item of deferred compensation as defined in IRS Notice 2009-85 (Section 5(B)(4)).
8. Any property that the individual is entitled to receive in connection with the performance of services, to the extent not previously taken into account under IRC Section 83.

Examples of items of deferred compensation include:

1. A cash-settled stock appreciation right.
2. A phantom stock arrangement.
3. A cash-settled restricted stock unit.
4. An unfunded and unsecured promise to pay money or other compensation in the future.

Ineligible Deferred Compensation

Ineligible deferred compensation means any deferred compensation item that is not an eligible deferred compensation item. With respect to ineligible deferred compensation, an amount equal to the present value of an individual's account is treated as received and taxable on the day before expatriation, and must be included in the covered expatriate's Form 1040 (or other schedule as provided in Treas. Reg. Section 1.6012-1(b)(2)(ii)(b) for the portion of the taxable year that includes the day before the expatriation date.

Within 60 days of the receipt of a properly completed Form W-8CE, the payor of the ineligible deferred compensation item must advise the covered expatriate of the present value of the covered expatriate's accrued benefit in the deferred compensation item on the day before the expatriation date.

Expatriation: Specified Tax Deferred Accounts

The mark-to-market tax regime does not apply to specified tax deferred accounts. Under IRC Section 877A(e)(1)(A), if a covered expatriate holds any interest in a specified tax deferred account on the day before the expatriation date, such covered expatriate is treated as having received a distribution of his or her entire interest in such account on the day before the expatriation date.

Within 60 days of receipt of a properly completed Form W-8CE, the custodian of a specified tax deferred account must advise the covered expatriate of the amount of the covered expatriate's interest in his account on the day before his expatriation date.

IRC Section 877A(e)(2) provides that the term "specified tax deferred account" means an individual retirement plan (under IRC Section 7701(a)(37)), a qualified tuition plan under IRC Section 529, a Coverdell education savings account (under IRC Section 530), a health savings account (under IRC Section 223), an Archer MSA (under IRC Section 220).

Expatriation: U.S. Income Tax Rules

Under IRC Sec. 877(a), a U.S. citizen (or long-term resident) who elects to become a non-resident alien (by losing their U.S. citizenship or relinquishing their green card) is taxable (under U.S. income tax rules) for 10 years after renunciation of their citizenship, unless the loss of citizenship (or residency status) did not have as one of its principal purposes the avoidance of either federal income taxes or federal transfer taxes.

An expatriate is taxable under special U.S. taxation rules under which they are not deemed to be a “U.S. person” but are deemed to be a non-resident alien subject to a special income tax regime.

These special U.S. income tax rules require the following treatment:

1. The net income tax provisions (or the alternative minimum tax) apply so investment income, and income connected with U.S. trade or business income is subject to graduated income tax rates (IRC Sec. 877(b)(1)).
2. Deductions are allowed to the extent they are connected with the income required to be included in gross income (IRC Sec. 877(b)(2)).
3. Gains on the sale or exchange of property (other than individual stock or debt obligations) located in the U.S. are treated as income from sources within the U.S. subject to graduated tax rates (limited to the capital gains tax rate limitation (IRC Sec. 877(c)(1), Property exchanged tax-free for this type of property is to be similarly treated.
4. Gains on the sale or exchange of U.S. debt obligations or U.S. stock (domestic corporations) are treated as income from sources within the U.S. and are subject to graduated income tax rates (subject to capital gains tax rate limitation), (IRC Sec. 877(c)(2)).

A special gain recognition rule applies to prevent an expatriate from avoiding these rules by making a tax-free exchange of U.S. property for foreign property and thereafter selling the foreign-based property immune from U.S. tax (IRC Sec. 877(c)). This assumes the exchange is not for foreign real property, in which event like-kind treatment is not available (IRC Sec. 1031(h)). Consequently, such a like-kind exchange continues the U.S. income taint for purposes of the expatriate income tax provision (although subsequent enforcement of the U.S. income tax liability may be compromised if the expatriate’s assets have been removed from the U.S.).

The burden of proof that loss of citizenship did not have avoidance of U.S. tax (i.e. U.S. income, estate, gift and generation-skipping transfer (GST) taxes) is on the taxpayer if the IRS establishes that it is reasonable to believe that an individual’s loss of citizenship would, but for this provision, result in a substantial reduction for the taxable year in the taxes on his probable income for that year (IRC Sec. 877(e)).

Income Tax Treaties

Many U.S. bilateral income tax treaties include Article 1(3) of the U.S. Model Income Tax Treaty which provides that a Contracting State (to the treaty), may tax transfers and deemed transfers of its domiciliaries, and by reason of citizenship may tax transfers and deemed transfers of its citizens for a period of 10 years following loss of citizenship.

Expatriation and the Ten Year Rule

Expatriates who left the U.S. prior to June 17, 2008 are covered under prior tax rules, contained in three separate Tax Acts, which each subject U.S. expatriates to a ten-year “alternative tax regime” on U.S. source income; i.e. for ten years after expatriation, the expatriate is required to file a U.S. income tax return, to report U.S. source income.

The Three Tax Acts

1966 Act

1. Foreign Investors Tax Act of 1966 (1966 Act), added IRC Sec. 877 to impose tax on the U.S. source income of former U.S. citizens who expatriated for a principal purpose of tax avoidance, for ten years following expatriation. These rules were subsumed into the 1996 Act.

1966 Act & 1996 Act

2. Health Insurance Portability and Accountability Act of 1996 (1996 Act)

This 1996 Act expanded the 1966 Act. Expatriates who left the U.S. prior to 2004 (September 23, 2004) are covered for U.S. tax compliance purposes under the 1966 and 1996 Acts, for the period up through 2014 (i.e. 2004 plus ten years). This Act included a “presumptive tax avoidance purpose” if the expatriate’s net average U.S. income tax liability was \$100,000 or more, in the five years preceding expatriation, or his net worth at expatriation exceeded \$500,000.

2004 Act (American Jobs Creation Act)

The 2004 Tax Act covers expatriates who left the U.S. between 2004-2008 (9/23/04 through 6/16/08). Under this Act, expatriation commencing 2004, subjects the expatriate to U.S. income tax reporting through 2014 (2004 plus 10 years) on U.S. source income, expatriation up to 6/16/08, subjects the expatriate to U.S. tax reporting through 2018 (6/16/08 plus 10 years), on U.S. source income.

The 2004 Tax Act removed the requirement that an individual have a “principal tax avoidance purpose”. Instead, the presumptive tax avoidance purpose limits were included under the “income tax liability test” and this was changed to “greater than \$124,000 (indexed annually beginning in 2005). The “net worth test” standard was increased to \$2m (not indexed). The 2004 Tax Act added a third test, providing that the expatriate certify that he has fully complied with all U.S. tax requirements for the five years preceding expatriation.

2008 Act (Heroes Earnings Assistance and Relief Tax Act) (Effective 6/17/08)

The 2008 Act repeals the 2004 Act, “alternative tax regime” (prospectively post-6/16/08), eliminates the 10 year forward tax reporting requirement. Instead, it imposes a “mark-to-market” tax (from a “deemed sale” of an individual’s world-wide assets, on the day prior to the expatriation date) on imputed gains on all assets in excess of \$680,000 for 2014 (IRC Sec. 877A).

A “succession tax” (IRC Sec. 2801) paid by the U.S. recipient of a gift or bequest from a covered expatriate (2013: 40% tax).

Additionally, it imposes a 30% withholding tax on a covered expatriate’s receipt of:

1. An eligible deferred compensation item (i.e. an interest in a qualified plan or other arrangement described in IRC Sec. 219(g)(5), interests in foreign pension, retirement or similar plans, any item of deferred compensation, interests in property to be received in connection with the performance of services not previously taken into account in accordance with the IRC Sec. 83. Deferred compensation attributable to services performed outside the U.S. while a covered expatriate was not a U.S. citizen or resident is not included. Tax on the payment of an “eligible deferred compensation item” is deferred until a covered expatriate receives a taxable payment (i.e. a payment that would be taxable if the individual were a U.S. person), at which time tax is collected by means of a 30% withholding tax, withheld by the U.S. payor.
2. In the case of deferred compensation items that are not eligible deferred compensation, an amount equal to the present value of an individual’s account is treated as received and taxable on the day before expatriation (30% tax).
3. “Specific Tax Deferred Account” (i.e. IRA, Education & Health Savings Account) is treated as distributed on the day before expatriation (and taxed at 30% on the present value of the account).
4. Non-Grantor Trust: The trustee shall withhold tax at 30% from the taxable portion of a direct or indirect distribution from a non-grantor trust to a covered expatriate.

Under the 2008 Tax Act, IRC Sec. 2801 imposes a “succession tax” at the highest applicable estate or gift tax rates (in 2013, 40% tax rate) on the receipt by a U.S. person of a “covered gift or bequest” (i.e. a direct or indirect gift from a covered expatriate within the meaning of IRC Sec. 877A, effective on or after June 17, 2009.) This tax is assessed on, and intended to be paid by, the recipient of a covered gift or bequest (reduced by any foreign gift or estate tax paid).

The IRC Sec. 2801 succession tax does not apply to:

1. IRC Sec. 2503(b) annual exclusion gifts (2014: \$14,000 per donee)
2. Gifts/Bequests entitled to a marital or charitable deduction;
3. Gifts to a U.S. citizen spouse;

4. Gifts to an alien spouse either up to \$139,000 per year (2012), See: IRC Sec. 2503(b) and 2523(i), or bequests to an alien spouse left to a qualified domestic trust (IRC Sec. 2056(d), and 2056A;

5. A taxable gift shown on a timely filed gift tax return or to property included in the estate of a covered expatriate that is shown on a timely filed estate tax return;

6. Gifts and bequests made by a covered expatriate, during any period following expatriation, when the expatriate is again subject to tax as a citizen or resident of the U.S.;

IRC Sec. 2801 has special tax rules for trusts:

1. On transfer to a domestic trust, the succession tax will be assessed on and paid by the trust;

2. For a covered gift or bequest made to a foreign trust, the succession tax will apply to the receipt by a U.S. person of a distribution, whether of income or capital, attributable to a transfer from a covered expatriate.

3. In calculating his income tax liability, on the receipt of a taxable distribution from a foreign trust, attributable to a covered gift or bequest, a U.S. recipient will be entitled to deduct under IRC Sec. 164, the amount of tax imposed under IRC Sec. 2801 that is attributable to gross income of the recipient but not to the capital portion of the distribution.

1996 Act

Under the 1996 Act, the 1966 alternative tax regime was expanded:

1. "Covered expatriates" were enlarged to include "long-term resident aliens" defined as "lawful permanent residents" (i.e. "green card holders") resident for tax purposes in 8 of the prior 15 taxable years (1996 Tax Act, new IRS Sec. 877(e).

2. Expatriation was considered to have occurred at the date prescribed for citizens under nationality law (i.e. as of the date of an expatriating act). Such individuals remained subject to IRC Sec. 877 for ten years following the furnishing to U.S. State Department of Statement confirming their loss of citizenship.

3. Expatriation was considered to have occurred at the date presented for long-term residents under the tax residence rules. IRC Sec. 877(e) refers to IRC Sec. 7701(b)(6) for purposes of determining when an individual ceases to be a lawful permanent resident. An individual granted lawful permanent residency status will remain a tax resident until such status has been revoked or administratively or judicially determined to have been abandoned. Treas. Reg. Sec. 301.7701(b)-1(b), states that abandonment will be considered to occur as of the date an individual provides written notice of such action to the U.S. Citizen and Immigration Services

("USCIS"), an agency of the Dept. of Homeland Security, the successor to the Immigration and Naturalization Service ("INS"), or a consular officer, or the INS issues an order of revocation or abandonment. In the latter case, it is the date of issuance that marks cessation of residence and not the prior effective date of such an order.

The 1996 Act introduced the "presumptive tax avoidance purpose."

A tax avoidance motive was presumed if an individual's net average income tax liability in the 5 years preceding expatriation was \$100,000 or more ("income tax liability test") or if his net worth exceeded \$500,000 ("net worth test"). This test was for 1996-2004. For 2004, the "2004 Tax Act" modified the expectation rules to increase these amounts to \$124,000 (indexed annually beginning in 2005) and \$2m (not indexed), respectively. The "2008 Tax Act" further modified these rules, creating a "mark-to-market" tax on "gains" in excess of (in 2014): \$680,000, defining a "covered expatriate" with either an average net income tax liability for the 5 years preceding expatriation, for persons expatriating in 2014 exceeds \$157,000, or net worth of \$2m (or more).

Exceptions were available for certain categories of individuals if they obtained a ruling from the IRS that tax avoidance was not a principal purpose of their expatriation (1996 Act, adding IRC Sec. 877(c)(2) which sets out the categories of expatriating citizens who could apply for a ruling. See: IRS Notice 97-19, 1997-1 C.B. 394 (requirements of ruling procedure) and IRS Notice 98-34, 1998-2 C.B. 29 re: long-term residents.

The 1996 Act significantly enlarged the categories of income considered to be U.S. source income:

1. Income and gains derived from former controlled foreign corporations ("CFC"), considered controlled by an expatriate within two years prior to expiration were considered to be from U.S. sources if realized within the ten-year post-expatriation period (1996 Act), adding new IRC Sec. 877(d)(1)(c).
2. Certain gains from otherwise non-taxable exchanges and "other similar occurrences" that resulted in a change of future income sources from U.S. to non-U.S. (1996 Act, adding new IRC Sec. 877 (d)(2).
3. If during the 10 year period following expatriation a taxpayer contributed property giving rise to U.S. source income to a foreign corporation that had the taxpayer remained a U.S. person, would have been a CFC, then the foreign corporation was disregarded and the expatriate was considered to receive the underlying U.S. source income directly (1996 Act, adding new IRC Sec. 877(d)(4)).

The 1996 Act required the expatriating U.S. taxpayer to provide information reporting:

1. An information statement to the Dept. of State, including a Statement of net worth, when disclosing an expatriating act (which was forwarded to the IRS).
2. A departing long term resident was required to provide the same information statement directly to the IRS with their tax return for the year of expatriation (1996 Act, adding new IRC Sec. 6039(g)).
3. An expatriate was required to file a U.S. tax return, including a worldwide income statement, for any of the ten years following expatriation in which he had U.S. sourced income subject to tax (IRS Notice 87-19). The failure to include a worldwide income statement would cause a tax return not to be considered a true and accurate return, leading to a loss of entitlement to deductions and credits under an audit (See Treas. Reg. Sec. 1.874-1).
4. All expatriating citizens' names were to be published by the IRS (after U.S. notification) in the Federal Register. Immigration Authorities were required to furnish the names of all persons whose green cards were revoked or abandoned. (1996 Tax Act, new IRC Sec. 6039 G(d)).

2004 Tax Act

Under the American Jobs Creation Act of 2004 ("2004 Act"), the 10-year alternative tax regime on U.S. source income was revised:

1. It removed the argument that an individual have a principal tax avoidance purpose [for expatriates]
2. It changed the income tax liability threshold to greater than \$124,000 (indexed annually beginning in 2005) (See Rev. Proc. 2007-66, 2007-45 IRB 970 (10/18/07)).
3. The net worth test standard was increased to \$2m (not indexed) (2004 Act, amending IRC Sec. 877(a)(2)).
4. It added a third test, providing that an expatriate certify that he has fully complied with all U.S. tax requirements for the five years preceding expatriation (2004 Act, adding new IRC Sec.877(a)(2)(C). This requirement is now satisfied by completion and filing of Form 8854. An expatriating individual will be subject to tax under IRC Sec. 877, if he has not complied with his tax obligations, regardless of whether he meets the income tax liability or net worth thresholds.

The 2004 Act added new IRC Sec. 7701(n) provided that an individual will continue to be treated as a U.S. citizen or long-term resident, until he gives both notice of his expatriation to the Department of State or Department of Homeland Security, respectively, and furnishes an information statement required by amended IRC Section 6039(G). The instructions to revised IRS Form 8854 detail the specific acts by which U.S. citizenship and long-term residence may be terminated.

The 2004 Act strengthened the information reporting rules by requiring that an expatriate file an annual information statement for each of the 10 post-expatriation years, regardless of whether the expatriate had any U.S. source taxable income for such year (2004 Act amending IRC Sec. 6035 G(a)).

The annual return requirement is satisfied by filing revised Form 8854, which requires that a current balance sheet and world-wide income statement be prepared for each year. Annual information reporting is done on Form 8854, Part III. If an expatriate has taxable U.S. source income and is required to file Form 1040 NR for the year, Form 8854 should be attached to it, or if no U.S. source income, Form 8854 is filed solely.

Exceptions to the provision were limited to certain dual nationals at birth having no “substantial contacts” with the U.S. and minors expatriating before age 18 ½ who were born in the U.S. to non-citizen parents and who have not been in the U.S. more than 30 days in any of the 10 years preceding expiration. “Substantial contacts” with the U.S. will be construed if the individual ever held a U.S. passport, was a U.S. tax resident (IRC Sec. 7701(b)), or spent more than 30 days in any of the 10 years preceding expatriation. This exception is only available to individuals who were dual citizens at birth and remain a citizen of the other country.

The 2004 Tax Act added new IRC Section 877(g); under it, an individual otherwise subject to the tax expatriation rules will be subject to income and transfer taxes on his world-wide income and property as a U.S. citizen or resident during any of the post-expatriation years in which he is physically present in the U.S. for more than 30 days.

As stated, for those U.S. taxpayers who expatriated through 2008 (prior to the 2008 Tax Act, i.e. 6/17/08), they are subject to the alternate tax regime (10 years) through 2018.

2008 Tax Act

As stated previously, the 2008 Tax Act repeals the 10 year “alternative tax regime” prospectively, imposing a “mark-to-market tax” (on imputed gains), a “succession tax” (on gifts/bequests paid by the recipient), a 30% withholding tax on: receipt of deferred compensation, the present value of a “specified tax deferred account”, and the taxable portion of a distribution from a non-grantor trust.

Expatriation: Non-Grantor Trusts

A covered expatriate's interest in a non-grantor trust is not subject to the "mark-to-market tax". Instead, the taxable portion of distributions to a covered expatriate, who was a beneficiary (but not an owner) of a trust on the day before the expatriation date are subject to a 30% withholding tax.

Under HEART (tax legislation), a trustee shall withhold tax (at 30%) from the taxable portion of a distribution from a non-grantor trust to a covered expatriate.

The "taxable portion" is that part of a distribution that would be taxable if the expatriate remained a U.S. person.

If the trust distributes appreciated property, gain is recognized to the trust as if it had sold the property to the expatriate.

Under HEART, a withholding tax is imposed on post-expatriation taxable distributions to a covered expatriate from any trust of which the expatriate was a beneficiary immediately prior to expatriation.

If a trust that was a non-grantor trust (prior to expatriation) becomes a grantor trust (as to a covered expatriate), following expatriation, the conversion of status will be treated as a taxable distribution to the covered expatriate to the extent of his interest in the trust as an owner.

Trust Valuation Election

A covered expatriate may elect to obtain a letter ruling from the IRS as to the value of his interest in a non-grantor trust as of the day before his expatriation date.

Under the valuation ruling, the covered expatriate will be considered to have received the value of his trust interest immediately prior to expatriation, and tax will be due on his trust interest with his tax return, for the period ending on his expatriation date.

Once the tax is paid, no subsequent distribution will be subject to the 30% withholding tax (under an IRC Section 887A). The covered expatriate will be entitled to claim trust benefits vis-à-vis any distribution from the trust under an applicable income tax treaty.

Election – Advantage

The advantage of this election is that it limits the taxation of distributions from non-grantor trusts to the value of the trust interest existing at the date of expatriation (the trust interest is no longer subject to an indefinite tax).

Election – Disadvantage

Upon expatriation, the IRS has no ability to collect the withholding tax from a foreign non-grantor trust re: covered expatriate's trust beneficial interest.

Expatriation: Foreign Tax Credits

An expatriate's income, subsequent to expatriation, is not likely to be U.S. source income and will be taxed by the expatriate's country of residence upon receipt.

The expatriate may only receive a foreign tax credit, applied against any U.S. tax due on the income, if the income is foreign income and not U.S. source income (IRS Section 906(b)(4), Section 871(a)).

An expatriate's income, subsequent to expatriation, must be evaluated as either U.S. source income, or foreign source income in order to determine proper application in the U.S. of any foreign tax credits for the income. In particular, the following income must be evaluated as either U.S. source income or foreign source income (for proper application in the U.S. of foreign tax credits):

1. Gains arising from the subsequent actual disposition of a covered expatriate's assets.
2. Deferred compensation.
3. Non-grantor trust distributions received subsequent to expatriation.

Under IRC Section 877A(d)(1), (f)(1), if amounts received subject to tax are not U.S. source income (i.e., income from foreign sources IRC 906(b)(4)), Section 871(a) will not apply and the expatriate (who becomes a non-resident alien upon expatriation and must file Form 1040 NR) should receive foreign tax credits (for foreign taxes paid to the expatriate country of residence) against any U.S. tax due under Form 1040 NR).

Expatriation: Tax Reporting Form 8854

A covered expatriate must file an information return on IRS Form 8854 in each tax year he is subject to the mark-to-market tax. (IRC Section 6039G; IRS Notice 2009-85).

IRS Form 8854 is used to provide notice that the individual has relinquished their U.S. citizenship or long-term residency status. Form 8854 is filed in addition to any other requirement for filing a tax return.

A covered expatriate with eligible deferred compensation items must annually file Form 8854 to certify either that no distributions have been received or to report distributions that have been received. There is no time limit on this obligation.

Under T.R. Section 1.6012-1(b): a covered expatriate with taxable income (i.e., eligible deferred compensation, or distribution from non-grantor trusts) for which taxes are not fully withheld at the source, must file a tax return on Form 1040 NR.

If the covered expatriate elects to defer payment of the mark-to-market tax, he must also file an annual tax Form 8854, through the year that the deferred tax and all interest is paid.

IRS Notice 2009-85 (2009-45 I.R.B. 598) (Oct. 15, 2005), confirms that certification of 5-year tax compliance (the "Certification Test") must be made on Form 8854 and filed on or before the due date of the tax payor's return for the year of expatriation. For U.S. citizens (or long-term residents) who fail to certify the 5-year tax compliance (upon expatriation) they will be treated as covered expatriates, even if they fail the income tax liability or net worth tests at the date of expatriation.

IRS Notice 2009-85 confirms that the date of cessation of lawful permanent residence, by a long-term resident who "tie breaks" his residence to a foreign country, occurs when the individual's foreign residence "commences" for tax treaty purposes (under an applicable U.S. income tax treaty). The date of expatriation is not the date that notice of such expatriation is provided to the IRS (under IRS forms: 8833, 8854), filed with the individual's tax return for the year of expatriation (which frequently occurs as many as 18 months after the foreign residence "commencement date").

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Expatriation: U.S. Gift Tax

Under IRC Sec. 2501(a)(3)(B) gift tax exemptions are eliminated for U.S. citizens who lose their citizenship within 10 years of a gift of U.S. property if the loss of citizenship had as one of its principal purposes the avoidance of U.S. gift, estate or income taxes.

The following property is deemed located in the U.S. and subject to U.S. gift tax when transferred by gift by reason of the gift tax “repatriation” provision:

1. Shares of stock in a U.S. corporation;
2. Debt obligations of a U.S. person, including bank deposits;
3. Debt obligations of the U.S. government or a state or local government;
4. Intangible property of any type issued by or enforceable against a U.S. resident or corporation.

Accordingly, the usual gift tax exemption is denied for intangible property transferred by a non-resident alien and a U.S. gift tax is due on the donative transfer of U.S. situs intangibles by a U.S. tax expatriate individual, even when the physical transfer of a stock certificate or evidence of the debt obligation occurs by gift outside the U.S. (IRC Sec. 2511(b)).

In contrast, the general rule for a non-resident alien is that they are subject to U.S. gift tax on the transfer of all property situated or deemed situated within the U.S. with the exception that intangible property is not deemed to be situated within the U.S. for gift tax purposes (IRC Sec. 2501(c)(2)). Real property and tangible personal property that are physically located in the U.S. are deemed to be situated in the U.S. for gift tax purposes (Treas. Reg. Sec. 25.2511-3(b)(1)).

Under U.S. Gift Tax Treaties, the term “citizen” includes a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax (including for this purpose, income tax) but only for a period of 10 years following such loss.

Expatriation: Lack of Tax Avoidance Purpose

For expatriates who leave the U.S. prior to the 2004 Tax Act (from 2004 on), they are under the 10 year alternative tax regime (i.e., they are taxed on U.S. source income through 2014).

U.S. tax avoidance is not restricted to the avoidance of a specifically designated tax. For example, the tax expatriation provision included in the estate tax provisions is not limited to a federal estate tax avoidance purpose. If expatriation for estate tax avoidance purposes is identified, the income tax expatriation tax provision could be applied.

U.S. expatriates must negate an IRS argument that any tax avoidance purpose exists upon the termination of U.S. citizenship (or, if applicable, the termination of U.S. residency). A “no tax avoidance” purpose may be explained by a development of law in a foreign country; e.g. several decades ago, certain South American countries announced the planned expropriation of properties of non-citizens, so certain U.S. citizens became citizens of those countries to avoid the expropriation of their substantial business and investment properties located in those countries.

Additional non-tax expatriation motivations may include:

1. Their preferred domicile is a foreign jurisdiction; e.g. Israel, France, United Kingdom, Spain or Greece;
2. To avoid possible U.S. tort liability risks;
3. To live in a preferred retirement location; e.g. the Caribbean, the Mediterranean or the South Pacific.
4. To enable closer management of a foreign business;
5. To move to their spouse’s foreign jurisdiction (i.e. non-U.S. country of origin and domicile).

In the event of an IRS tax audit, the U.S. expatriate must demonstrate legitimate non-tax motivations for their change in U.S. status.

Expatriation: U.S. Estate Tax

Under IRC Sec. 2107(a), if a U.S. citizen terminates U.S. citizenship primarily for tax avoidance purposes, the application of the U.S. estate tax is more expansive to the estates of these individuals than for non-resident aliens. Absent the applicability of these special estate tax rules, the estate of a non-resident alien (i.e. a former U.S. citizen) would only include property situated or deemed situated in the U.S. that is owned by the non-resident alien at the date of death (IRC Sec. 2103), which includes stock of and debt obligations of U.S. corporations, as well as real and tangible personal property that is physically located in the U.S. (IRC Sec.2104).

The special expatriation estate tax rule (former U.S. citizens) requires the inclusion in their gross estate of a portion of the value of the stock owned by a decedent in a foreign corporation if:

1. The decedent owned directly 10% or more of the voting power of all classes of stock in the foreign corporation, and
2. The decedent owned directly and by attribution more than 50% of the voting power of all classes of stock of the foreign corporation.

Estate Tax

The estate tax includable amount in the decedent's U.S. gross estate is determined by applying to the fair market value of the stock owned outright by the decedent a fraction, the numerator of which is the fair market value of the corporation's U.S. assets and the denominator of which is the total fair market value of the corporation's entire assets (IRC Sec. 2107(b)).

Ownership includes stock that was previously transferred but that would be subject to U.S. estate tax transfer provisions (IRC Sec. 2035-2038, IRC Sec. 2107(b)).

Determination of the estate tax includable amount (i.e. the fraction computation) is based on a gross assets test (debts and liabilities are ignored for purposes of this computation). If a significant risk exists that this element of tax expatriation provision will apply, the foreign assets could be leveraged upward to reduce the percentage of corporate stock value that is includable in the gross estate.

Once the IRS establishes that it is reasonable to believe that the individual's loss of U.S. citizenship would result in a substantial reduction in transfer taxes, the burden of proving the lack of a principal tax avoidance purpose is on the executor of the estate (IRC Sec. 2107(e)).

The executor's rebuttal must include income, estate and gift taxes.

Unlike a U.S. citizen, if an alien resident in the U.S. permanently relocates to his home country (or to a third country) his status as a U.S. resident terminates for U.S. estate tax purposes and the exposure of his estate to U.S. estate tax terminates except as to assets located in the U.S.

Unlike the U.S. income tax, no tax expatriation provision applies for U.S. estate tax upon the termination of U.S. residency (as determined for U.S. estate tax purposes) by an alien individual.

Under the U.S. Estate Tax Treaty Model Rules (Article 1(3)), "citizen" includes a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax (Including for this purpose, income tax) but only for a period of 10 years following loss of citizenship. These treaty provisions do not apply to alien residents who terminate their U.S. residency status for U.S. estate tax purposes.

Expatriation: Charitable Lead Trusts

Regarding U.S. persons who expatriate, classified as “Covered Expatriates”, if prior to expatriation they establish and fund a Charitable Lead Trust, open trust distribution, they (or their heirs) may be subjected to three separate taxes under the 2008 Tax Act (“HEART ACT”):

Non-Grantor Trust (30%-Withholding Tax)

1. If the trust is a non-grantor trust, the covered expatriate is subject to 30% withholding tax (IRC Sec. 871) on the taxable portion of the distribution to the covered expatriate.

“Mark-to-Market” Tax

2. If the trust is a grantor trust, a “Mark-to-Market” tax (IRC Sec.877A) on “deemed gains in excess” of \$680,000 (2014), on property that an individual is considered to own as part of his world-wide estate (property considered owned through a grantor trust is included as part of his world-wide estate, were he to die on the day before his expatriation date). See: IRS Notice 2009-85, 2009-45 I.R.B. 598 (Oct. 15, 2009).

“Succession Tax”

3. IRC Sec. 2801 imposes a “succession tax”, (tax: 40%/2013), i.e. an “inheritance tax”, assessed and paid by the gift recipient, of a “covered gift or bequest” (a direct or indirect gift from a “covered expatriate”, under IRC Sec. 877A).

Under IRC Sec. 2801, for covered gifts or bequests made to trusts, the succession tax is paid as follows:

1. For a “covered gift or bequest” made to a foreign trust, the succession tax will apply to the receipt by a U.S. person of a distribution, whether income or capital, paid by the recipient.
2. For a “covered gift or bequest” made to a domestic trust, the succession tax is assessed and paid by the trust.

Under a charitable lead trust, the trust income is paid to charity for a term, and the remaining trust assets are paid to the designated remainder beneficiaries.

If the remainder beneficiary is a “covered expatriate”, they are subject to either a 30% U.S. withholding tax (on the taxable portion of the trust distribution) on a non-grantor trust distribution, or a “Mark-to-Market” tax on a grantor trust distribution (deemed gain in excess of \$680,000).

If the remainder beneficiary is a U.S. person, they are subject to a 40% succession tax, paid by the gift/bequest recipient.

The succession tax under IRC Sec. 2801 will not apply to the following gifts/bequests:

1. Annual exclusion gifts (under IRC Sec. 2503(b), \$14,000 per donee (2014));
2. Marital deduction gifts and bequests (to a U.S. citizen spouse);
3. Charitable deduction gifts;
4. Gifts to an alien spouse, subject to IRC Sec. 2503(b), 2523(i), limits \$139,000 (2014);
5. Bequests to an alien spouse, if left to a qualified domestic trust (“QDT”) under IRC Sec. 2506(d), 2056A;
6. Taxable gift shown on a timely filed gift tax return (Form 709);
7. Property included in the estate of a covered expatriate shown on a timely filed estate tax return (Form 706);
8. Gifts/bequests made by a covered expatriate, during any period following expatriation, when the expatriate is again subject to tax as a citizen or resident of the U.S. (IRC Sec. 877A(g)(1)(C) and 2801(c)(1)(A));
9. A U.S. recipient of a covered gift or bequest in calculating his income tax liability on the receipt of a taxable distribution from a foreign trust, attributable to a covered gift or bequest, will be entitled to deduct under IRC Sec. 164, the amount of tax imposed under IRC Sec. 2801, that is attributable to gross income of the recipient but not to the capital portion of the distribution.

Expatriation: U.S. Income Tax Filing and Reporting

Under IRC Sec. 6039G, Tax Act 2008, the ensuing IRS Notice 2009-85 (IRS Notice 2009-85) expands the U.S. tax filing and reporting that is due from covered expatriates in years following the year of expatriation.

Prior to the 2008 Tax Act, (“HEART Act”), a covered expatriate was required to file annual information returns on Form 8854 for the 10-year post-expatriation period that he remained subject to tax under the alternative tax regime, whether or not he had any income tax liability. For every year that a covered expatriate had U.S. source income on which tax due was not fully withheld at the source, a covered expatriate was required to file a Form 1040 NR.

IRS Notice 2009-85, (as authorized by the 2008 Tax Act) imposes annual filing requirements (Form 8854) to certify either that no distributions have been received or to report distributions that have been received by a “covered expatriate” having either:

- A. Deferred Compensation; or
- B. Non-Grantor Trust Interests

Eligible Deferred Compensation Items (i.e. A U.S. payor of qualified retirement plan interests, IRC Sec.219(g)(5) arrangements, interests in a foreign pension, any item of deferred compensation, property interests to be received in connection with the performance of services to the extent not previously taken into account in accordance with the IRC Sec. 83. Deferred compensation attributable to services performed outside the U.S. while a covered expatriate was not a U.S. citizen or resident is not included.

Tax on the payment of an “eligible deferred compensation item” is deferred until a covered expatriate receives a taxable payment (i.e. a payment that would be taxable if the individual were a U.S. person), at which time tax is collected by means of a 30% withholding tax (however, no withholding tax is due under IRC Sec. 1441, or wage withholding under IRC 3401). The 30% withholding tax is considered payable under IRC Sec. 871.

An item is considered to be eligible deferred compensation if either:

1. The payor is a U.S. person, or
2. The payor is a foreign person who elects to be treated as a U.S. person for this purpose, provided that the covered expatriate notifies the payor of his status and makes an irrevocable waiver of any right to claim benefit under a U.S. income tax treaty.

In contrast, deferred compensation items that are not eligible deferred compensation or a covered expatriate’s interest in a “specified tax deferred account” (i.e. an individual retirement account and certain education and health savings accounts) is treated as received and taxable on the day before expatriation (and subject to a 30% withholding tax on the “deemed

distribution”). No early distribution tax is assessed, and appropriate adjustments will be made to subsequent distributions to reflect the prior taxation.

IRS Notice 2009-85 Notice confirms that the present value of a covered expatriate’s accrued benefit will be treated as received by the taxpayer on the day before expatriation and must be included on the taxpayer’s tax return for the portion of the year preceding the expatriation date. IRS Notice 2009-85 discusses appropriate adjustments that may be made to subsequent distributions from an ineligible deferred compensation plan to ensure that amounts included in future distributions will not be taxed a second time.

The IRS Notice 2009-85 confirms that the rules pertaining to deferred compensation items do not apply to any deferred compensation attributable to services performed outside the U.S. while a covered expatriate was not a U.S. citizen or resident, whether before or after expatriation.

The IRS Notice 2009-85 Notice permits a taxpayer to use any reasonable method consistent with existing guidance pertaining to the sourcing and taxation of deferred compensation (Treas. Reg. Sec. 1.86-1-4(b)(2), Rev. Rul. 79-388, 1979-2, C.B. 270, Rev. Proc. 2004-37, 2004-1C.B. 1099.

Interests in Non-Grantor Trusts. The “taxable portion” of distributions for a covered expatriate, who was a beneficiary but not also an owner of a trust on the day before the expatriation date, are subject to a 30% withholding tax.

IRS Notice 2009-85 clarifies that a trust beneficiary is a person permitted to receive a direct or indirect distribution under a trust’s terms or local law, having power to apply trust income or corpus for his own account, or a person to whom income or corpus would be paid if current trust interests were terminated.

IRS Notice 2009-85 does not address beneficial interests in non-grantor trusts that may arise after the date of expatriation, pursuant to a discretionary trust power to add or exclude beneficiaries.

IRS Notice 2009-85 provides that if a trust was a non-grantor trust prior to expiration becomes a grantor trust as to a covered expatriate, following expatriation, the conversion of status will be treated as a taxable distribution to the covered expatriate to the extent of his interest in the trust as owner.

Annual Tax Filings

The IRS Notice 2009-85 states that a covered expatriate having eligible deferred compensation items or interests in non-grantor trusts must annually file Form 8854 to certify either that no distributions have been received or to report distributions that have been received. Unlike under prior law, there apparently is no time limit on this obligation.

IRS Notice 2009-95 confirms that in accordance with Treas. Reg. Sec. 1.6012-1(b), a covered expatriate having taxable income (i.e., eligible deferred compensation or distributions from non-grantor trusts) for which taxes are not fully withheld at source must file a tax return on Form 1040 NR. Since foreign fiduciaries may not withhold and remit a 30% tax on distributions from non-grantor trusts, covered expatriates have an affirmative tax filing obligation. Any covered expatriate who has elected to defer payment of the Mark-to-Market tax must also file an annual Form 8854 through the year that the deferred tax and all interest is paid.

Form W-8CE

IRS Notice 2009-85 confirms that a covered expatriate who has a deferred compensation item, a specified tax deferred account, or a beneficial interest in a non-grantor trust generally must file Form W-8CE with the relevant payor on or before the earlier of: the day prior to the first distribution, on or after the individual's expatriation date, or 30 days after the expatriation date.

With respect to a distribution of an eligible deferred compensation item, on an interest in a non-grantor trust, Form W-8CE generally provides notice to the payor that the individual has waived any otherwise applicable treaty benefits.

In the case of a non-grantor trust, if the covered expatriate has indicated on the form that he will request a letter ruling from the IRS as to the value of his beneficial interest on the day before his expatriation date, the trust is "required" to furnish the individual's information necessary to calculate such value.

The instructions to Form W-8CE indicate that the necessary information includes (but is not limited to):

1. A copy of the trust deed;
2. A list of the assets (and their value) held on the day before the expatriation date;
3. Information regarding other potential trust beneficiaries;
4. Birth dates for all necessary lives for the trust's perpetuity period;
5. Policies followed by the trustees when making discretionary distributions that might constitute an "ascertainable standard"; and
6. Any other relevant information.

For an ineligible deferred compensation item, Form W-8CE is notice to the payor that the individual is a covered expatriate who is treated as receiving an amount equal to the present value of his accrued benefit on the day before his expatriation date. It is also notice to the payor that adjustments may have to be made to future distributions to account for the tax required to be paid by the covered expatriate as a result of his expatriation.

For a specified tax deferred account, Form W-8CE is notice to a payor that the individual is a covered expatriate for whom adjustments may be required on future distributions from the account.

Within 60 days of receiving Form W-8CE, the payor is required to provide a statement to the covered expatriate of the account balance on the day before the expatriate date.

The IRS Notice 2009-85 does not address certain tax issues arising under the 2008 "HEART Act":

1. Whether, and on what terms, the deferred tax election can apply;
2. How the 2008 Tax Act rules are to be coordinated;
3. Regarding the "Mark-to-Market" tax imposed on gains deemed to arise on the day before expatriation, income generally will be residence (i.e. U.S.) based which should not result in "double taxation". However, gains arising from the subsequent actual disposition of a covered expatriate's assets, deferred compensation and non-grantor trust distributions received subsequent to expatriation may not be U.S. source income and may be also taxed by the expatriate's country of residence at realization or receipt.

An expatriate who makes a coerced waiver of treaty benefits in order to comply with U.S. reporting obligations, so the expatriation is considered complete under IRC Sec. 877(a)(2)(C) and Sec. 877(g)(1)(A) should not be forced to preclude himself from claiming treaty benefits under residence-based tax treaties.

Treaty issues may include (where a covered expatriate resides in a U.S. treaty partner following expatriation), 30% tax withholding on: (imposed under IRC Sec. 871):

1. Payments of eligible deferred compensation;
2. Distributions from non-grantor trusts.

IRC Sec. 906(b)(4), regarding allowance of foreign tax credits to non-resident aliens (which a covered expatriate becomes), provides that a foreign tax credit is not allowed against any tax imposed by IRC Sec. 871(a).

Under IRC Sec. 871(a), tax is imposed on U.S. source income of non-resident aliens. Income subject to tax under IRC Sec. 877A(d)(1) and (f)(1) will not be from U.S. sources which would be entitled to foreign tax credits.

Under the 2008 Tax Act expatriation rules, the "Mark-to-Market" tax on a covered expatriate is taxed on his wealth on the date of expatriation. However, there appears to be no income cap on taxable amounts received from non-grantor trusts. The election to be treated as receiving

the value of an individual's interest in such a trust may not be possible to accurately ascertain the value of a beneficiary's contingent, discretionary interest in such a trust.

About the Author – Gary Wolfe, Esq.



Gary S. Wolfe received his Juris Doctorate from Loyola Law School in 1982, where he was President of the Tax Law Society.

From 1982 through the present, Gary has been in private practice in Beverly Hills and Los Angeles.

Gary is an international tax attorney representing clients for IRS audits, international tax planning, and asset protection.

Previously, Gary was the managing partner of a tax and business law firm, which represented Fortune 500 companies (IBM, ITT) and financial institutions (Sterling Bank, First Charter Bank.) Gary now provides case management for international litigation.

In 1997, Gary completed the Team Beverly Hills civic leadership training.

From 1997-1999 Gary was Vice-President and Member of the Board of Trustees of The Greystone Foundation, Beverly Hills, California.

From 1995-2001, Gary was the Chief Financial Officer and a Member of the Board of Directors of the Le Faubourg Honore Homeowners Association, Beverly Hills, California.

Since 2004, Gary has been conducting private seminars throughout California on the IRS, International Tax and Asset Protection.

Gary is an international tax expert and a nationally published tax author. In 2013 he published articles in the ABA (ALI-CLE) publication: The Practical Tax Lawyer (Winter, 2013 Edition), "U.S. Tax Planning for Passive Investments," (Spring 2013 Edition), "Why U.S. Tax Evasion is a Bad Idea (UBS/Wegelin Bank)," and in the Summer 2013 Edition he published 2 articles:

- 1) "International Tax Planning for U.S. Exports (IC-DISC)" (with Ryan Losi, CPA)
- 2) "International Tax Evasion, Money Laundering, and Other Crimes"

In the Autumn 2013 Edition of the ABA/The Practical Tax Lawyer he published 2 articles:

- 1) "EB-5 Visas (Immigrant Investor Visas)" (with Mark Ivener, Esq.)
- 2) "Offshore Hedge Funds and Reinsurance" (with Allen Walburn, Esq.)

For the February 2014 edition of EB-5 Investor Magazine, he published: "EB-5 Investors and the Perils of U.S. Estate and Gift Taxes (with Mark Ivener, Esq.)"

Books by Gary S. Wolfe:

[Offshore Tax Evasion: IRS Offshore Voluntary Disclosure Program](#)

[Offshore Tax Evasion: IRS Tax Compliance FATCA/FBAR](#)

[Offshore Tax Evasion: U.S. Tax & Foreign Entities](#)

[International Tax Evasion & Money Laundering](#)

[Tax Planning for U.S. and State Exports: IC-DISC](#)

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