Planning For Foreign Clients

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Domestic and Foreign Taxation and Estate Planning

I. <u>Income Tax: U.S. Persons and non-U.S. Persons</u>

Individuals are divided into two categories for U.S. federal income tax purposes: (1) United States persons and (2) nonresident aliens (or "non-U.S. persons"). Generally speaking, U.S. persons are subject to U.S. federal income tax on their worldwide income, whereas non-U.S. persons are subject to U.S. federal income tax only on their U.S. source income. Common examples of U.S. source income include rent from U.S. real estate, dividends from U.S. corporations or income from U.S. businesses. U.S. persons are also subject to various reporting rules that require reporting of foreign (non-U.S.) accounts and assets (e.g., a Report of Foreign Bank and Financial Accounts or "FBAR").

The test for determining whether an individual is a U.S. person for U.S. federal gift and estate tax purposes is different from the test used for U.S. federal income tax purposes.

For federal income tax purposes, a U.S. person means any one of the following:

- A U.S. citizen.
- A U.S. lawful permanent resident (i.e., a "green card holder").
- An individual who satisfies the "substantial presence test" (commonly referred to as the "day count test").

A. Substantial Presence Test

The substantial presence test looks at the number of days that an individual has spent in the U.S. over a three-year period—specifically, the calendar year in question and the preceding two years. This test is determined using a formula, and is satisfied when an individual spends:

- ➢ At least 31 days in the U.S. during the calendar year in question, <u>and</u>

- ➢ At least 183 days in the U.S. during a three-year period that includes the calendar year in question and the preceding two years. This three-year period is calculated under a weighted formula that adds together the following:

  - All of the days spent in the U.S. during the calendar year in question.

  - One-third of the days spent in the U.S. during the first year before the year in question.

  - One-sixth of the days spent in the U.S. during the second year before the year in question.

If an individual is physically present in the U.S. at any time during a particular day, that day generally is counted for purposes of the substantial presence test. For example, if an individual arrives in the U.S. on a Monday evening and leaves the U.S. on a Wednesday morning, three days would be counted in full.

B. Exceptions

There are various exceptions to the substantial presence test. For example, certain categories of individuals—including qualifying students, teachers and certain foreign government-related individuals (such as diplomats and employees of certain international organizations)—are exempt from counting their days of physical presence in the U.S. In other words, when performing the substantial presence test for these individuals, you would count only the days they are physically present in the U.S. as nonexempt persons (e.g., the days before an individual acquired an F-1 student visa and after their visa expired).

For individuals who do not fall under the above categories of exempt individuals, the "closer connection exception" may still apply. Under this exemption, individuals may be able to stay up to 182 days in one year without becoming a U.S. resident even if they otherwise satisfy the substantial presence test. In order to qualify for this exception, individuals must show that they had (1) a "tax home" in another country for the entire year (2) a closer connection to that other country and (3) timely file a Form 8840 with the IRS to claim the status. It is important to note that if the Form 8840 is not timely filed, the individual likely will not be able to claim this exception at a later date.

Tax Home Requirement

Generally, an individual's "tax home" is the place of the person's regular or principal place of business. If the individual has no regular or principal place of business, the tax home is the person's primary place of residence.

Closer Connection Requirement

Individuals have a closer connection to another country if they can establish that they have more significant contacts with that other country than with the U.S. This is demonstrated by the facts and circumstances of the individual. The IRS looks at these primary factors when making this determination:

- The location of a permanent home.

- The location of family members.

- The location of personal belongings, such as automobiles, furniture, clothing and jewelry.

- The location of social networks and social, political, cultural and religious affiliations.

- The location of personal banking activities.

- The location of other business activities (other than those that constitute the individual's tax home).

- The jurisdiction in which the individual holds a driver's license.

- Where the person is registered to vote.

- The types of official forms and documents filed, such as IRS tax forms that require representations about residence.

- The country of residence the individual designates on forms and other documents.

- Where personal, financial and legal documents are kept.

- The charitable organizations to which the person contributes.

The IRS may also consider other relevant facts.

This test is not available to individuals who have taken "affirmative steps" to obtain green card status, including the filing of any initial application.

Tax Treaty

If an individual is a resident of the U.S. and also a resident of another country due to the operation of the tax residency laws of such other country, it may be possible for the individual to make a treaty claim to be treated as a nonresident of the U.S. for income tax purposes. This relief is *generally not afforded to U.S. citizens*. It also generally applies only for purposes of computing an individual's U.S. income tax liability. This means, for example, that the individual will continue to have annual reporting obligations with respect to the foreign (non-U.S.) interests in the same manner as a U.S. resident individual, and that the individual's ownership of non-U.S. entities will be considered in determining whether the entity is subject to certain anti-tax deferral rules, which may have income tax consequences for any other owners of that entity who are U.S. persons.

Individuals who want to take the position that they are not resident in the U.S. because of an applicable treaty must disclose the treaty position (using Form 8833) each year.

C. State Income Taxes and Reporting

The rules above only apply when determining an individual's U.S. federal income tax status. Each state has its own rules that are used to determine whether an individual is resident for state income tax purposes. State income tax rules generally are not governed by the income tax treaties that the federal government has with other countries. Therefore, it is possible to be a nonresident for U.S. federal income tax purposes but still be a resident of a particular state and subject to state income tax on worldwide income.

II. <u>Gift and Estate Taxes: U.S. Persons and U.S. Residence</u>

In addition to income taxes, the U.S. also imposes certain "transfer" taxes, which include (1) a gift tax on gratuitous transfers made by an individual during his or her lifetime, (2) an estate tax on a decedent's assets transferred at death to the decedent's beneficiaries and (3) a generation-skipping transfer tax, which is an ad valorem tax imposed in addition to gift and estate tax for transfers made to certain transferees (typically grandchildren or more-remote descendants).

Individuals who are U.S. citizens or U.S. residents are subject to gift and estate taxes on their worldwide assets. Conversely, individuals who are not citizens or residents of the U.S. are subject to transfer tax only on certain assets that are treated as located, or sitused, in the U.S.

The U.S. Internal Revenue Code defines "resident" differently for income and gift and estate tax purposes. Because of this difference, a non-U.S. person could conceivably be resident for income tax purposes, but nonresident for gift and estate tax purposes (and vice versa). It is crucial to understand the different definitions of residency.

A. Defining Residency

For U.S. income tax purposes, a non-U.S. citizen is resident in the U.S. if that individual (1) is a U.S. lawful permanent resident (i.e., a "green card" holder) or (2) satisfies the substantial presence test. (See above.)

For U.S. gift and estate tax purposes, a non-U.S. citizen is resident in the U.S. if that individual's **domicile** is in the U.S. Under the Treasury Regulations 26 CFR § 20.0-1(b), "**[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.**" As a result, if an individual does not intend to remain in the U.S. indefinitely, that individual is not domiciled in the U.S. Moreover, an intent to change domicile does not effectuate such a change without the person actually physically moving. **Therefore, to be domiciled in the U.S., an individual must both (1) be physically present in the U.S. and (2) have an intention to stay in the U.S.**

<u>Physical Presence</u>

Physical presence is relatively self-explanatory, although the Treasury Regulations' use of the words "living there" does suggest more than a transient stay in the U.S. But the Treasury Regulations also indicate that a "brief period of time" is enough to be physically present in the U.S. The more difficult determination for establishing domicile is whether one intends to stay in the U.S.

<u>Intent to Stay in the U.S.</u>

An individual's intent to stay in the U.S. is inherently subjective, and there is no applicable test or checklist that exists when making this determination. However, the I.R.S. and U.S. courts do take into account certain factors, none of which are determinative in and of themselves, when deciding on an individual's intent to stay in the U.S.:

- **Stating Intent on Official Forms and Documents:** Examples include filing tax returns, creating wills or trusts, and sending letters or emails from a residence in the U.S.

- **Location of Ownership interests:** Having large ownership interests in business entities or properties in the U.S.

- **Family:** Having many family members located in the U.S.

- **Work Permits and Visas:** Owning a visa, green card and/or a U.S. social security number.

- **Primary Residence:** Maintaining a home in the U.S. that is furnished and has personal possessions.

- **Duration of Stay in the U.S.:** Spending significant amounts of time in the U.S., instead of short trips.

- **Community Engagement:** Being involved in local organizations such as religious, political, and social organizations.

B. Gift and Estate Taxes for Non-Resident Aliens

Under certain circumstances, foreign (non-U.S.) citizens who are not U.S. residents (non-resident aliens) may still be subject to U.S. estate and gift taxes. For estate taxes, examples would include owning shares of a U.S. corporation and real estate in the U.S. For gift taxes, examples would include gifts of tangible personal property located in the U.S., real property in the U.S., and cash drawn from U.S. bank accounts.

There is an annual exclusion from U.S. gift tax for "present interest" gifts. In 2024, the annual exclusion amount is $18,000 per donee per year. U.S. citizens and domiciliaries can also "gift split," allowing married donors to exclude up to $36,000 per donee per year. Gift splitting is *not permitted* if either spouse is a non-U.S. domiciliary. An unlimited amount can be gifted to a spouse who is a U.S. citizen, whereas gifts to a non-U.S. citizen spouse are offset by an increased annual exclusion. **However, the IRS limits tax free gifts to a non-citizen spouse to $100,000, indexed annually for inflation. See I.R.C. §2523(i). For 2024, the limit is $185,000.**

C. Qualified Domestic Trust (QDOT)

A QDOT is a trust for the benefit of a surviving non-citizen spouse that defers the federal estate tax following the death of the first spouse. QDOTs are specifically permitted pursuant to I.R.C. § 2056A.

In order for a trust to qualify as a QDOT, it must meet the following requirements:

1. A QDOT must qualify for the marital deduction as provided for in Internal Revenue Code §2056.

    - The most common way to achieve this goal is for the Trust to pay all the net income to the surviving spouse annually. (Another option is to grant the surviving spouse a general power of appointment over the trust property.)

    - The surviving spouse can be the only lifetime beneficiary of a QDOT.

2. At least one trustee of the QDOT must be a citizen of the United States.

3. A Bank with a US branch may be required to serve as trustee depending upon the size and types of assets involved.

    - A "large QDOT" is a QDOT with assets in excess of $2,000,000. A large QDOT requires:

- At least one of the trustees must be a U.S. bank or a trust company; or

- The U.S. trustee (an individual trustee) must furnish a bond or letter of credit equal to 65 percent of the fair market value of the assets in the trust.

o A "small QDOT" is a QDOT with assets of $2,000,000 or less. A small QDOT requires:

- No more than 35 percent of the trust assets can be real property located outside the United States; or

- The requirements for a large QDOT be met.

o Note: Up to $600,000 of the principal value of a US based primary residence (and furnishings) may be excluded from the calculations for purposes of determining whether a trust should be treated as a large QDOT.

4. The trustee must have the right to withhold the estate tax and pay it to the IRS.

5. The laws of a US state or the District of Columbia must govern the trust.

6. The executor of the deceased spouse's estate must elect to have the trust treated as a QDOT on a timely filed federal estate tax return.

A QDOT does not need to be created in the decedent's Will (or in a revocable living trust). The surviving non-citizen spouse may create the QDOT provided it is funded prior to the due date for the federal estate tax return (including extensions).

D. QDOTs and Planning Considerations for Clients with non-U.S. Citizen Spouses

When planning with a QDOT, it is important to keep in mind the following tax consequences:

1. The assets transferred into the QDOT are eligible for the unlimited marital deduction.

2. The QDOT is generally taxed as a simple trust for income tax purposes. This means that when the trust earns income, it MUST be distributed to the surviving spouse. The surviving spouse is then required to pay the income tax on that income based upon the surviving spouse's own tax rates.

3. **Each distribution of principal from the QDOT triggers the federal estate tax.** However, this may be waived if the surviving non-citizen spouse can prove a hardship.

4. Income distributions from a QDOT are not subject to the estate tax.

5. The Trustee must file Form 706-QDT annually. Form 706-QDT reports the amount in the trust as well as the distributions made from the trust.

6. A non-citizen spouse cannot use the applicable exclusion amount to shelter any distributions of principal from a QDOT.

A gift to a spouse, who is not a U.S. citizen, is also not eligible for the unlimited marital deduction. Furthermore, a transfer at death to a non-citizen spouse does not qualify for the unlimited martial deduction unless a QDOT is utilized.

III. <u>Foreign Individuals and Investments</u>

A. Foreign Investments in the U.S. (U.S. Income Taxes)

The following is a brief synopsis of the rules for foreign individuals who are considering investment in the U.S.:

➢ Income that is "fixed, determinable, annual, or periodical" (also known as "FDAP") is subject to income taxes. This primarily consists of passive investment income—such as interest, dividends, rents, and loyalties—and does not include (a) gains from the sale of real or personal property and (b) income specifically excluded from gross income (disregarding the owner's U.S. or non-U.S. status) such as tax-exempt interest. Deductions are not allowed against FDAP income and FDAP income is taxed at a flat 30% rate (or a lesser rate under a tax treaty or domestic law).

➢ Income that is "effectively connected with U.S. trade or business" (also known as "Effectively Connected Income," or "ECI") is subject to income taxes at the same graduated rates used by U.S. citizens. Note that deductions *are* allowed against ECI.

➢ Gain from the sale of U.S. corporate stock is generally not subject to U.S. capital gains taxes.

➢ Dividends from a U.S. corporation paid to a foreigner are subject to withholding taxes subject to tax treaty limitations.

- Gain from the disposition of U.S. real estate is subject to withholding taxes under the Foreign Investment in Real Property Tax Act ("FIRPTA"). Furthermore, the gain is generally taxed at the applicable short-term and long-term capital gains rates.

- Foreign corporate entities may be subject to U.S. corporate tax rates.

B. Foreigners Living in the U.S. (Residents)

Unlike most other countries, the U.S. taxes non-citizen residents on their worldwide income even if the gains accrued *prior* to their move to the U.S. and even if the proceeds are not remitted to the U.S. Furthermore, U.S. persons who are not citizens must still report and disclose the ownership of financial assets in foreign countries and risk substantial penalties for non-compliance (e.g., IRS Form 5471 and FBAR).

IV. Expatriation

Abandonment of U.S. citizenship or long-term residency (by non-citizens) may trigger U.S. income tax. The "expatriation tax" consists of two components: the "exit tax" and the "inheritance tax." Both may be triggered upon abandonment of citizenship or (for non-citizens) abandonment of a green card by a long-term resident.

A. Tax Expatriation Generally

U.S. citizens may expatriate by renouncing their U.S. nationality at a U.S. embassy or consulate.[1] The consul files a certificate of loss of nationality with the U.S. State Department. The

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[1] 8 U.S.C. §1481.

effective date of expatriation is the date of renunciation of citizenship.

Long-term (non-citizen) residents may similarly terminate residency for federal income tax purposes upon formal relinquishment of the resident's green card. Under I.R.C. §877(e)(2), the term "long-term resident" means any individual (other than a U.S. citizen) who is a lawful permanent resident of the U.S. in at least 8 taxable years during the period of 15 taxable years ending with the taxable year during which the relinquishment occurs. The residency termination date for a green-card holder is the first day the then non-resident alien is no longer a lawful permanent resident.[2]

Additionally, if a green card holder has not maintained a continuous residence in the United States (either voluntarily or involuntarily), they can be deemed to have "abandoned" their status as a lawful permanent resident. 8 CFR §316.5(c). Generally, being outside of the U.S. for a continuous period of over 180 days will raise suspicion and concerns regarding abandonment of residence. Being away for over 365 days (one year) means the green card holder is presumed to have abandoned their residence with the intention of making a foreign country their home, and will need to justify their absence.[3] There are various factors that indicate whether or not an individual has intended to make a foreign country their home, including retaining employment in the U.S., obtaining employment abroad, location and residence of immediate family, and retaining access to a U.S. home. If a green card holder expects to spend one year or more outside the U.S.

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[2] Abandonment of permanent U.S. residency is accomplished by signing and submitting Form I-407 to the U.S. consulate. Long-term residents abandoning residency after June 3, 2004, must file a tax information statement with the IRS for any taxable year in which §877(b) or §877A applies on Form 8854 (expatriation information statement). The non-resident alien may also prove residency termination for a partial year by establishing residency at a foreign tax home for the remainder of the calendar year and a closer connection to that foreign country.
[3] Ilona Bray, Abandonment of Residence by U.S. Green Card Holders, https://www.alllaw.com/articles/nolo/us-immigration/abandonment-residence-green-card-holders.html.

for business purposes or otherwise, they can apply for a reentry permit using Form I-131 ("Application for Travel Document"). Form I-131 should be filled out *before* leaving the United States; otherwise, an application for an SB-1 immigrant visa will be required at the local U.S. consulate, which is a more onerous process.

B. **Section 877**

Section 877 treats an expatriate as a U.S. resident for U.S. income, estate, gift, and generation-skipping tax purposes for any calendar year during the 10-year period following expatriation (if expatriated on or after June 17, 2008), if present in the U.S. for more than 30 days.[4] Thus, although expatriation may have occurred in (for example) 2008, §877 characterizes a former resident as a U.S. resident for tax purposes for any year between 2008 and 2018, during which the former resident is physically present in the U.S. for more than 30 days.

If an expatriate is subject to §877, but not physically present in the U.S. for more than 30 days, he or she is potentially subject to an alternative tax regime. The alternative regime covers the 10-year period following the close of the taxable year in which 1) he or she expatriated, and 2) is *not* physically present in the U.S. for more than 30 days. Under §877, the term "alternative tax regime" subjects the covered expatriate to tax on U.S. source income at rates applicable to U.S. citizens for a period of 10 years following the date of expatriation, but *only if* the alternative tax regime produces a higher tax liability than would have been imposed on the non-resident alien under §871 of the code. Therefore, two tax calculations are necessary to determine which calculation produces the higher tax liability: (1) The income tax liability (calculated under §871 of

[4] I.R.C. §877(g)(1).

the code, which is the income tax scheme applicable to non-resident aliens under normal circumstances), and (2) the tax liability calculated under §877(b) & (d) (the alternative tax regime). The covered expatriate is subject to the higher of the two tax liabilities.

The principal income tax effect of §877 is to impose income tax on U.S. source income that is otherwise tax-exempt in the hands of a non-resident alien. For example, the covered expatriate may not avoid income tax on 1) bank account interest, 2) portfolio interest, or 3) capital gains earned from trading in U.S. stocks and bonds (generally avoided by non-resident aliens).

C. **The Exit Tax Under §877A**

The Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) added §877A, effective for individuals who expatriate on or after June 17, 2008. Section 877A(a) imposes a "mark-to-market" tax regime on "covered expatriates." Under §877A(a)(1), *all property of a covered expatriate is treated as being sold on the day before his or her expatriation date for its fair market value*.[5] The exit tax is an income tax on 1) unrealized gain from a deemed sale of worldwide assets on the day prior to expatriation; and 2) the deemed distribution of IRAs, 529 plans, and health savings accounts (taxed at ordinary income rates). The exit tax is generally payable immediately (*i.e.*, April 15 following the close of the tax year in which expatriation occurs).

A covered expatriate is deemed to have sold any interest in property held worldwide, other than property described in §877A(c) (deferred compensation, specified tax-deferred accounts, and interest in a non-grantor trust, which is discussed further below), as of the day before

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[5] Topsnik v. Commissioner of Internal Revenue, 146 T.C. No. 1 at *12 (U.S. Tax Ct. 2016).

expatriation.[6] The property subject to the mark-to-market regime of §877A(a) is of a type whose value would be includible in the value of a decedent's U.S. gross taxable estate (on the day before expatriation).[7]

The mark-to-market regime imposes an income tax on the unrealized gain on the covered expatriate's worldwide assets, but only to the extent the deemed gain (as of the day before the expatriation date) exceeds an inflation-adjusted safe harbor ($866,000 for 2024).[8] The rates of tax differ with the type of asset involved. Long-term capital gain assets and qualified dividends receive the applicable preferential rates. However, the unrealized gain in a life insurance contract is generally taxed at ordinary income rates.

The HEART Act also added the "inheritance tax," a 40% flat tax on the gross value of a "covered gift" or "covered bequest" made to a U.S. beneficiary. The inheritance tax is imposed on the recipient of the gift (rather than the donor).

D. **Covered Expatriate**

Long-Term Permanent Resident (Green-Card Holder) — An expatriated green-card holder is subject to §877A as a covered expatriate only if they were a long-term permanent resident prior to expatriation. A long-term lawful permanent resident is a person who has been a green-card holder during 8 of the previous 15 years prior to expatriation. If a green-card holder expatriates before this 8-of-15-year test is met, §877A does not apply. A U.S. resident alien (under the U.S.

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[6] Deferred compensation, specified tax-deferred accounts and interest in non-grantor trusts are taxed independently of the mark-to-market tax, under §877A(c).
[7] Topsnik, 146 T.C. No. 1 at *15.
[8] John L. Campbell & Michael J. Stegman, Confronting the New Expatriation Tax: Advice for the U.S. Green Card Holder, ACTEC J. 266 (2009).

substantial presence income tax test)[9] is generally not subject to the §§877 or 877A tax if the resident has no green card.[10]

Statutory Tests — Section 877A applies to only covered expatriates who meet **any one of the following three tests**:[11]

1. The Net Worth Test: Having a net worth of $2 million or more on the date of expatriation. The $2 million threshold considers all assets worldwide. The expat is considered to own any interest in property that would be taxable as a gift under Ch. 12 of the I.R.C. (*i.e.*, the gift tax provisions) if the individual was a citizen who transferred that interest immediately prior to expatriation.

2. The Average Annual Income Tax Liability Test: Earning an average annual net income tax for the five years ending before the date of expatriation of more than a specified amount, adjusted for inflation ($190,000 for 2023).[12] An individual who files a joint tax return must take into account the net income tax reflected on the joint return.[13]

3. Failure to Certify Tax Compliance: Failure to certify satisfaction of federal tax compliance to the Secretary of Treasury for the five preceding taxable years or failure

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[9] I.R.C. §7701(b)(3); see Treas. Reg. §301.7701(b)-1(b)(3).

[10] Note that I.R.C. §877A(g)(1)(B) provides two technical exceptions to "covered expatriate" status. The two exceptions exclude individuals 1) born with dual citizenship, taxed as a resident of the other country (as of the expatriation date), and who have not lived more than 10 out of the last 15 years in the U.S.; and 2) who have relinquished U.S. citizenship before attaining the age of 18½, and have not lived in the U.S. for more than 10 years before the expatriation date.

[11] See §877(a)(2)(A)-(C). Note that statutory exceptions may apply to exclude certain persons from covered expatriate status (even if the tests are otherwise satisfied). These statutory exceptions pertain to certain persons who are dual citizens at birth and minors who have relinquished U.S. citizenship prior to reaching age 18½ years old and have been income tax residents of the U.S. for no more than 10 years within the 15-year period ending with the taxable year of the expatriation.

[12] I.R.C. §877(a)(2)(A); Rev. Proc. 2019-44.

[13] Section 2(B) of Notice 2009-85, referencing §III of Notice 97-19.

to submit such evidence of compliance as "may be required." (See below for more on Reporting Compliance.)[14] Individuals without considerable assets or income may nonetheless become covered expatriates by failing to certify tax compliance.

Exemption Amount $600,000 (Adjusted for Inflation) — Under §877A(a)(3), if a taxpayer's deemed gain is less than $600,000 (adjusted for inflation), there is no tax due.[15] For 2024, the exemption amount is $866,000 (up from $821,000 in 2023). If the covered expatriate's gain exceeds this amount, he or she must allocate the gain pro rata among all appreciated property.[16] Such allocation generally involves allocating the exclusion amount of each gain asset over the total built-in gain on all gain assets.[17]

Special Deferral Rules of §877A(b) — The exit tax deemed sale or distribution may leave insufficient liquidity to cover the tax, as no actual sales proceeds are available. Under certain circumstances, payment of the tax may be deferred until an actual sale of the property (or death). Section 877A(b) provides detailed rules permitting a covered expatriate to defer payment of the mark-to-market tax (on a property-by-property basis). Payment is tolled until the property is actually sold or exchanged, death, or the security required to make the deferral election fails to meet statutory requirements (whichever is earlier). To make the deferral election, the covered expatriate must provide "adequate security" and agree to pay statutory interest on the deferred

[14] Topsnik, 146 T.C. No. 1 at *13, quoting I.R.C. §877A(a)(2)(C).
[15] I.R.C. §877A(a)(1); Rev. Proc. 2019-44; See also Robert W. Wood, Expatriating and Its U.S. Tax Impact, BNA Daily Tax Report, No. 17 (Jan. 26, 2011).
[16] *Id.*
[17] *Id.*

tax.[18] If the covered expatriate elects deferral, gains deferred are based on the value of property as of the taxing date (*i.e*., as of the day prior to expatriation).

Reporting Compliance Under §877A — Under §6039G, IRS Notice 2009-85 requires additional reporting for covered expatriates for the years prior to and following expatriation.[19] For each of the five years prior to expatriation, Form 8854 must be filled out. Individuals who fail to file will be treated as covered expatriates under §877A(g). Following expatriation, Form 1040-NR is to be filed for each year a covered expatriate realized U.S. source income on which U.S. income tax was recognized.

Under the §877A mark-to-market regime, a covered expatriate with an interest in a nongrantor trust (or certain deferred compensation assets) must annually file Form 8854. Form 8854 reflects distributions from the trust. The filing requirement appears to have no time limit under IRS Notice 2009-85. The notice also affirms that a covered expatriate must file a Form 1040-NR in the event he or she earned taxable income and U.S. income taxes are not fully withheld at the source.[20] As foreign institutions or persons will likely not withhold at the source (under §1441), this requirement usually creates a mandatory filing obligation for covered expatriates.

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[18] IRS Notice 2009-85 contains detailed rules on the deferral election.

[19] Notice 2009-85, 2009-2 C.B. 598 (Oct. 15, 2009). The IRS has promulgated guidance regarding 877A in Notice 2009-85 (the notice). Although courts (including the U.S. Tax Court) are not legally bound by the notice, it is an official statement of the IRS' position and may, thus, serve as persuasive authority a court may consider in interpreting §877A. The notice explains that for purposes of certifying tax compliance for the five years before expatriation pursuant to §877(a)(2)(C): "All U.S. citizens who relinquish their U.S. citizenship and all long-term residents who cease to be lawful permanent residents of the United States (within the meaning of section 7701(b)(6)) must file Form 8854 in order to certify, under penalties of perjury, that they have been in compliance with all federal tax laws during the five years preceding the year of expatriation. Individuals who fail to make such certification will be treated as covered expatriates within the meaning of section 877A(g)."

[20] Treas. Reg. §1.6012-1(b).

Last, Notice 2009-85 affirms that a covered expatriate with a beneficial interest in a nongrantor trust (or deferred compensation asset) must file Form W-8CE (which identifies the payor). This filing is required on the earlier of the date of the first distribution from the trust (subsequent to expatriation) or 30 days after the date of expatriation.

Tax Basis — Section 877A(a) requires "proper adjustments" for any gain or loss realized with respect to an asset deemed sold. Basis is adjusted upward (stepped up) by the amount of gain attributable to the deemed sale, to avoid double taxation upon the later actual sale of the property. Similarly, basis is reduced to the extent of a deemed loss.[21] Certain types of property are ineligible for the in-bound step up. Assets or property that would have been taxed if the individual had never become a permanent resident (*e.g.*, U.S. real property interests or property that was used or held for use in connection with the conduct of a trade or business within the U.S.) are not eligible for the step-up.[22]

E. **Potential Planning Strategies**

Outright Gifts to Spouse and Others — The proposed expatriate may gift assets sufficient to reduce his or her net worth below the $2 million net worth test (for characterization as a covered expatriate). For example, before expatriation, an expatriate may use the §2503(b) annual exclusion (currently $18,000 per donee) to make non-taxable gifts or, alternatively, make larger gifts by utilizing his or her unified estate and gift tax credit.

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[21] I.R.C. §877A(a), (h)(2).
[22] Notice 2009-85 at §3.D.

Gifts should be made *at least three years prior* to expatriation to avoid §2035, which adds the value of gifts made within three years of a decedent's death (or deemed expatriation death) to the deceased's taxable estate (also known as the three-year "claw back" rule). Unless an exception applies,[23] all gifts made during the three years prior to expatriation are not only included as assets subject to deemed sale, but are likely included in calculating the inheritance tax.

A potential expatriate may also make unlimited tax-free gifts to a U.S. citizen spouse (prior to expatriation).[24] Interspousal gifts are generally not subject to the three-year "clawback" rule of §2035.[25] If, however, the recipient spouse is also expatriating, the marital gifting strategy will function only if the recipient spouse avoids covered-expatriate status. Otherwise, the proposed transfers will subject the spouse to §877A.

For potential non-citizen covered expats (long-term green-card holders), another possible strategy to avoid U.S. transfer taxes on foreign assets is to make transfers after permanently departing the U.S., but before actually expatriating. Although the green-card holder would remain a U.S. resident for U.S. income tax purposes, domicile (for estate and gift tax purposes) may be moved outside the U.S.[26] Transfers made while a non-resident, non-citizen for estate and gift tax purposes are not subject to U.S. transfer taxes, unless the property gifted is tangible and located in the U.S.[27] Under such circumstances, the mark-to-market tax regime may arguably be avoided on

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[23] See, e.g., I.R.C. §2053(b)-(f).
[24] I.R.C. §2523.
[25] I.R.C. §2053(c)(3).
[26] See below regarding the establishment of domicile; see Treas. Reg. §25.2501-1(b).
[27] I.R.C. §2501; Treas. Reg. §25.2501-1(a).

assets gifted three years before expatriation and completely avoided if the gifts sufficiently reduce new worth.[28]

Gifts to Trusts/General Transfer Tax Strategies — As a permanent legal resident (green-card holder), the future covered expatriate (domiciled in the U.S.) may take advantage of a full unified estate and gift tax credit ($13,610,000 in 2024) by implementing general U.S. transfer tax avoidance strategies before expatriation (three years before expatriation). These strategies include utilizing valuation discounts for potential transfers, gifts to domestic irrevocable trusts, grantor retained annuity trusts, qualified personal residence trusts, intentionally defective grantor trusts (with the toggle-off switch), charitable lead trusts, charitable remainder trusts, etc.

Use of an Expatriation Trust — As an alternative to outright gifts or other general estate tax-saving vehicles, a potential expatriate may fund an irrevocable (self-settled) trust for himself, his spouse, and descendants. Gifts to a properly structured "expatriation trust" may likely be used to lower net worth to avoid the $2 million net worth threshold.

One strategy is to establish an expatriation trust, to reduce the potential expatriate's net worth below the $2 million net worth test. The expatriation trust should be formed as an irrevocable nongrantor discretionary U.S. domestic trust in a state permitting self-settled discretionary trusts. The expatriation trust should be drafted to complete the transfer for U.S. transfer tax purposes (using the settlor's unified credit). It is important that the trust qualify as nongrantor for U.S. income tax purposes (with trust income taxed to the trust). To avoid potential inclusion under §877A, the potential expatriate should also release any powers over trust assets (*i.e.*, powers of

[28] Note that §877A is located in Subtitle A (Income Taxes); see also I.R.C. §7701(b)(1).

appointment). As this vehicle remains a domestic trust under §7701, §684 (deemed mark-to-market sale) would not apply to the transfer of assets into the trust. The potential expatriate may retain the ability to remove and replace independent trustees. Following the passage of three years from funding, §877A would not apply to the assets held in trust.[29] Moreover, future distributions from the expatriation trust to U.S. beneficiaries (or the expatriate) would also avoid the §2801 inheritance tax.

Use of Domicile Planning — Alternatively, as discussed above, the non-citizen settlor may utilize foreign domicile transfer tax planning before expatriating. While maintaining U.S. income tax residency, the proposed expatriate establishes domicile outside the United States. Transfers of non-U.S. situs assets are then not subject to U.S. transfer tax. Moreover, the transfer of certain U.S. situs intangible assets avoids U.S. gift tax (including gifts to U.S. donees). For a resident alien with substantial non-U.S. assets and U.S. situs intangibles, U.S. transfer tax may be avoided. Following the passage of three years from such transfers, §877A does not apply the deemed sale rule to the assets transferred.[30] This strategy may also permit the potential expatriate to completely avoid the exit tax if transfers bring his or her net worth below $2 million.

Sale of Personal Residence — The sale of the expatriate's personal home (prior to expatriation for cash), removes the value of the home from the $2 million net worth test.[31] The actual sale prior to expatriation reduces net worth and avoids taxable gain. Note that, in the event

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[29] I.R.C. §2035; Treas. Reg. §25.2501-1(b).
[30] Id.
[31] If seller took back an installment note, however, the note would be property subject to the mark-to-market tax regime. Upon expatriation seller (if a covered expatriate) would have to recognize gain on the deemed sale of such installment obligation at fair market value. As noted, separate estate tax principles are used to determine what property is subject to the mark-to-market tax. Section 20.2033-1(b) of the estate tax regulations lists examples of property includible in a decedent's gross estate and provides, in relevant part, that "[n]otes or other claims held by the decedent are likewise included." See also Topsnik v. Comm'r, 146 T.C. 1 at *16 (U.S. Tax Ct. 2016).

of a deemed sale of the homestead upon expatriation, the popular §121 income tax exclusion—excluding gain from the sale of a personal residence—is likely not available to a covered expatriate.

V. **Pre-immigration Planning**

Under the U.S. check-the-box regime, a business entity may elect to be treated either as a corporation, a partnership taxed to its owners directly, or, for an entity with a single owner, as a disregarded entity (see Regs. Secs. 301.7701-1*et seq.*). A foreign corporation whose owners elect partnership or disregarded-entity status will be treated as making a liquidating distribution of its underlying assets to its owners on the effective date of the election. As a result, the basis of assets held by the foreign corporation is stepped up (or down) in the hands of the entity's owners to its fair market value (FMV) on the date of the election.

Under current rules, this liquidating distribution is *not taxable* since gain realized on non-U.S. assets is not subject to U.S. income tax when realized by a nonresident (see Sec. 871; U.S. tax generally not imposed on capital gains of nonresident aliens). However, for U.S. tax purposes, any step-up in the basis of the assets can reduce future realization of capital gain after the foreigner becomes a U.S. income tax resident.

Sale of appreciated assets — Some countries allow for an inflation adjustment to the basis of assets, while the United States does not, or have lower income tax rates. The result is that gain in the United States could be significantly more than in the taxpayer's current home country. As a result, taxpayers coming from those jurisdictions should consider selling those assets before immigrating. This could result in little tax in the taxpayer's home country while allowing the taxpayer to purchase new assets and enter the United States with a basis in the new assets equal to the fair market value.

Dispose of foreign corporations with passive income — A U.S. shareholder owning more than 10% (taking into account attribution and constructive ownership principles) of a foreign corporation may need to include in taxable income his or her pro rata share of the foreign corporation's "Subpart F" income, even if the shareholder receives no actual distributions (Sec. 951(a)). Even if Subpart F does not apply, a U.S. shareholder who recognizes gain from the sale of shares in a foreign corporation that has passive income as the majority of its income (or where the majority of its assets produce passive income) may be subject to an extremely punitive tax regime under which any such gain may be taxed at ordinary rates (the passive foreign investment company rules, Sec. 1291(a) *et seq.*). To avoid these regimes, a pre-immigrant taxpayer should consider disposing of those investments before entering the United States.

Plan with trusts — Before becoming a U.S. resident, a taxpayer can make irrevocable gifts to non-U.S. persons in trust where (1) the trust document indicates that it is not permitted to have U.S. beneficiaries, and (2) the trust is not otherwise considered a U.S. grantor trust. By doing so, the taxpayer may avoid U.S. income taxes on future income earned by the gifted assets and may also avoid later U.S. gift and estate taxes on the transfer of those assets, simply because the now-U.S. resident no longer owns the income-producing assets for U.S. tax purposes.

As a precautionary note, nonresidents who create foreign trusts that have (or may have) a U.S. beneficiary are subject to U.S. income tax on that foreign trust's income if the nonresidents themselves become U.S. taxpayers within five years of transferring property to the trust (Regs. Sec. 1.679-5(a)). Thus, a nonresident alien who intends to immigrate to the United States should create and fund the foreign trusts at least five years before becoming a U.S. person, in order to avoid being taxed on trust income.

Alternatively, a taxpayer can, before immigrating to the United States, transfer a portion of his or her assets to an irrevocable discretionary trust of which the taxpayer and other family members are permissible discretionary beneficiaries. While this will become a grantor trust for U.S. income tax purposes, subjecting its income to U.S. income tax in the hands of the grantor after the grantor becomes a U.S. resident (Secs. 671-677), the assets should not be subject to U.S. estate tax on the taxpayer's death (Sec. 679). Moreover, life insurance can be used to cut off the accumulation of any undistributed net trust income (thereby minimizing the income tax liability to the grantor) by using trust assets to purchase a life insurance policy.

Offshore Trusts — Even if the five-year waiting period, discussed above, cannot be observed, there are still significant transfer tax advantages to contributing foreign property to a trust prior to immigrating to the U.S. The creation of an irrevocable foreign trust prior to moving to the U.S. and its funding with some, but not all, of a non-resident alien's foreign assets can be an effective tool in protecting such assets from exposure to U.S. estate taxation after the non-resident alien's immigration to the U.S. As long as certain precautions are observed, the non-resident alien's non-U.S. assets that are in the trust will not be subject to any U.S. estate tax and the trust's income may also be exempt from state and local taxes, depending on local law, discussed further below.

To the extent that the non-resident alien intends on making lifetime gifts, it is advisable to make such gifts prior to becoming a U.S. domiciliary. This is because non-resident aliens are subject to U.S. gift tax only on gratuitous lifetime transfers of U.S. situs property (including U.S. real estate and tangible property located in the U.S. such as cars, art, jewelry and furnishings).

Notably, shares of a U.S. corporation are not considered U.S. situs property for gift tax purposes but are considered U.S. situs property for estate tax purposes. Thus, to the extent non-resident aliens who own U.S. shares and who intend on immigrating to the U.S. are contemplating making gifts prior to their move, they should consider making gifts of their U.S. shares. Such gifts will achieve two tax-saving goals: the gifts will be free of U.S. gift tax and will also serve to reduce the non-resident alien's U.S. estate for estate tax.

VI. **Forced Heirship Laws**

Many foreign countries have "forced heirship" laws that require a certain portion of assets to go to children or a surviving spouse, regardless of what the will states. This is common in civil law countries like France, Italy, Brazil, and various others. Attempting to transfer assets out of the country before settling forced heirship rights can create legal issues. Forced heirship laws are legal statutes in certain countries that limit the freedom of individuals to dispose of their estate as they wish. They require that a portion of a person's assets must pass to certain heirs, typically children, upon their death.

Forced heirship originated in civil law legal systems, such as those in France, Spain, Italy, and Latin American countries. The rationale was to prevent disinheritance of children and provide for their financial security.

The heirs entitled to the forced share cannot legally be disinherited or left out of the will. Attempting to do so would trigger clawback provisions after death.

Countries with forced heirship regimes

While the specifics differ, forced heirship is common globally. Countries with some form of forced heirship laws include:

- Most of continental Europe – France, Germany, Spain, Italy, Netherlands
- Latin America – Brazil, Mexico, Argentina, Colombia
- Japan and South Korea
- Some Middle East and North African countries

Implications when inheriting across borders

Forced heirship laws can create complications for cross-border inheritances. If U.S. heirs are set to receive assets from a country with forced heirship, children may have a claim to some of those assets regardless of the provisions in a will. Attempting to transfer foreign real estate or tangible property to the U.S. before resolving forced heirship claims can stall the process and create legal problems.

Similarly, forced heirs in another country could challenge a will probated in the U.S. that disinherits them by local laws. This can disrupt the inheritance and result in lengthy court disputes. To avoid problems, inheriting foreign assets may require proactively settling forced heirship rights in the origin country before assets can be released. It is crucial to understand and become familiar with relevant foreign laws.