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Section 877A, A Technical Journey Through An Imaginary Construct

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Introduction

> "Congress recognizes that citizens and residents of the United States have a right not only physically to leave the United States to live elsewhere, but also to relinquish their citizenship or terminate their residency. The Congress does not believe that the Internal Revenue Code should be used to stop U.S. citizens and residents from... [expatriating]; however, the Congress also does not believe that the Code should provide a tax incentive for doing so."[1]

Section 877 of the Internal Revenue Code of 1954[2] was first enacted as part of the Foreign Investors Tax Act of 1966[3] because of a concern that as a result of the limited tax jurisdiction asserted by the United States over the income and assets of individuals who are non-U.S. persons, an individual who was a U.S. citizen might wish to change his status to a non-U.S. citizen by relinquishing his citizenship and thereby avoid potential U.S. federal income tax on income from the U.S. or gains relating to the U.S. arising ***thereafter***. Section 877 attempted to make it more difficult for an individual giving up his or her citizenship for the principal purpose of the reduction of his future tax obligations from achieving the tax avoidance objective sought. It did so by imposing a special tax regime[4] applicable to a U.S. citizen who relinquished his U.S. citizenship principally for tax avoidance purposes (a "Section 877 taxpayer") for the ten-year period following a loss of citizenship. Under the special regime, a Section 877 taxpayer was subject to tax at the regular rates applicable to U.S. persons on income or gain from U.S. sources (if such tax exceeded the U.S. federal income tax that would be applicable to a non-resident alien

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1 Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS-1-09), March 2009 (the "Blue Book"), at 177.

2 Except as otherwise indicated, all Section references are to Sections of the Internal Revenue Code of 1986, as amended (the "Code").

3 Pub. L. No. 89-809, Sec. 103(f).

4 Section 877(b).

on such income). Moreover, the provision expanded the definition of U.S. source income to include gains attributable to sales or exchanges of shares or other interests of U.S. issuers whether or not such gains would be considered to be derived from U.S. sources under the generally applicable source rules.[5] In addition, an estate of a Section 877 taxpayer who died within a ten-year period of changing his status to a non-resident alien was subject to U.S. federal estate tax on certain property that would otherwise be considered non-U.S. situs property and therefore not subject to U.S. federal estate tax.[6] Similarly, gifts of U.S. situs intangibles that would not otherwise be subject to U.S. gift tax for gifts made by a non-domiciliary were for a ten-year period following a tax motivated expatriation subject to U.S. gift tax.[7]

Over the years, the expatriation provisions have been both modified and expanded. With effect from February 6, 1995, Section 877(e) was added to extend Section 877 taxpayer treatment to former long-term lawful permanent residents.[8] Additionally, the issue of whether an individual had a proscribed principal purpose was initially changed in 1996 to a presumption if certain thresholds were met[9] and then in 2004 mooted entirely, being replaced, with certain exceptions,[10] by objective income tax liability and asset thresholds. In addition, to further discourage expatriation the provisions were also amended in 2004 to provide that an expatriate meeting the objective income tax and asset tests who, in any year during a ten-year period

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5 Section 877(d). But cf. Section 865.

6 Section 2107.

7 Sections 2501 (a)(3) and 2511.

8 Pub. L. No. 104-91, Section 511(f)(1) and (g).

9 See Pub. L. No. 108-357, Sec. 804(a)(1); cf. Pub. L. No. 104-191, Sec. 511(a).

10 Section 877(c).

following expatriation, was present in the U.S. for more than 30 days and in certain limited cases up to 60 days was to be taxable as a U.S. person for such year.[11]

In certain cases, provisions of an applicable tax treaty could afford a Section 877 taxpayer an exemption from the special treatment of Section 877(b). This could occur where a Section 877 taxpayer became resident in a country with which the U.S. had a tax treaty that exempted from U.S. tax income or gains to which the special rules of Section 877(b) applied unless the treaty expressly reserved to the U.S. the right to tax a Section 877 taxpayer. In this connection, notwithstanding the Service's published position to the contrary, the U.S. Treasury Tax Court held the U.S. could not impose its special Section 877 taxpayer regime on the gain exempted by treaty unless a treaty provision expressly so authorized.[12] Faced with this judicial loss, the U.S. Treasury Department adopted a treaty negotiating position to negotiate for a savings clause that preserved the U.S. right to tax its former citizens and in certain cases its former long-term residents on certain future arising income. However, recognizing that it was difficult and time consuming to renegotiate tax treaties, the legislative history of the 1996 legislative changes expressed an intention to override any provision of a tax treaty inconsistent with the provisions of Section 877, but only for a ten-year period, with any inconsistent tax treaty provision that had not been modified after that ten-year period to continue to take precedence over any inconsistent provision of Section 877.[13] The U.S. Treasury instituted a program of renegotiating existing tax treaties to expand tax treaty savings clauses to include former

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[11] Section 877(g)(1).

[12] *Tedd N. Crow v. Commissioner*, 85 T.C. 376 (1985); Rev. Rul. 79-152, 1979-1 CB 237. The issue in *Crow* was whether the term "U.S. citizen" appearing in a savings clause that reserved to the U.S. the right to tax its citizens without regard to the treaty could be interpreted to mean former citizens. The Tax Court held it could not.

[13] H.R. Conf. Rep. No. 104-736, at 329 (1996).

citizens[14] and to cover former long-term residents as well.[15] Significantly, the U.S. has not completed the necessary modifications to all of its treaties. Furthermore, the ten-year period referred to above has by now expired and therefore any tax treaty provisions in conflict with the application of Section 877 continue to take precedence over Section 877.

Yet, with all these changes it is noteworthy that Congress remained concerned "that the present-law expatriation tax rules (as modified in 2004) are difficult to administer and could be made more effective."[16] The provisions enacted with effect from June 17, 2008 as part of the Heroes Earnings Assistance and Relief Tax Act of 2008[17] replaced the operative provisions relating to expatriation contained in Sections 877, 2107, 2501(a)(3), 2511 and 7701(n) with new Sections 877A, 2801 and 7701(b)(6), and modified certain portions of Section 877 that remain in effect for the purpose of providing definitions applicable under the new provisions. Section 877 and the parallel provisions relating to estate and gift tax as they then existed prior to the Act continue to remain in effect for expatriations occurring or deemed to have occurred before the effective date of the Act.[18]

This paper will explore from this technician's viewpoint the provisions of Section 877A and certain related provisions as they have been enacted by the Act, raising a number of issues which seem ripe for clarification and possibly modification, although it is unclear that either will

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14 See, e.g., Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Article 1(4).

15 See, e.g., Convention between the Government of the United States and the Republic of Latvia for the Avoidance of Double Taxation and for the Prevention of Fiscal Evasion with Respect to Taxes, Article 1(4). See also the discussion, infra, relating to tax treaties and the application of Section 877A.

16 Blue Book, at 177-178.

17 Pub. L. No. 110-245, Section 301(a) (the "Act").

18 Section 877(h).

occur any time soon.[19] That the provisions enacted by the Act appear to go far beyond their stated purpose of taking away a tax incentive for expatriation, and in a number of cases unnecessarily so, appears evident from the history of the debate regarding the expatriation provisions. The provisions as enacted provide significant tax impediments to expatriation and in that respect may violate the fundamental rights of citizens and residents to remove themselves from the U.S. As to issues of ease of administratability, if indeed this was one of the goals, the jury is out. Whether the new provisions will be easier to administer or enforce than Section 877 in light of their complexity, in certain cases conflicting tax treaty provisions and in certain instances their attempt to exert U.S. tax jurisdiction beyond the territorial borders of the U.S. will in many cases lead to a deafening silence and in others possibly challenges.[20]

Although skeptical about its wisdom, this paper is not about the wisdom of the so-called "exit tax" provisions as a policy matter. Nor is this paper about other possible issues regarding the "legality" of the provisions from a Constitutional perspective or whether the new provisions are consistent with the "rights" of citizens and residents to leave, although some mention will be made regarding the arguments concerning these issues raised by others; the reader may draw his or her own conclusions on these issues. Rather, this paper is about what the words of the statutory provisions appear to say, how or if they apply in certain circumstances and whether and to what extent the provisions are in conflict with existing principles of tax treaties. This paper is mostly about the mischief, some of which may even have been unintended, that runs like an alchemist's thread through provisions that deem things to occur when they have not, layering

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[19] See generally Department of Treasury, *General Explanations of the Administrative Fiscal Year 2011 Revenue Proposals*, February 2010, available at https://treas.gov/offices/tax-policy/library/greenbk10.pdf (last checked December 21, 2010).

[20] A thorough discussion of these and other issues are contained in Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (JCS-17-95) No. 7, June 1, 1995 ("JCS-17-95"). See also Joint Committee on Taxation, *Review of the Present-Law Tax and Immigration Treatment of Relinquishing of Citizenship and Termination of Long-Term Residency* (JCS-2-03), February 2003 ("JCS-2-03").

complexity upon complexity to thwart the few each year who may wish to move on. Since the provisions require hypothetical constructs of a deemed sale or distribution, this paper will attempt to come to grips with those constructs. So, we shall begin by searching for logical threads running through events we cannot actually see simply because they have not occurred but nevertheless must imagine as Congress has instructed us to so do when an expatriation has occurred (assuming we know when that has occurred) and impose that imagination on provisions of the Code and tax treaties which do exist.

The Deemed Sale Provisions, in General

As good a place as any to start our technical journey into the "never never land" of Section 877A is with the opening language of the provision. Section 877A(a)(1) provides that property[21] of a "covered expatriate"[22] (a term to which we will return in some detail below) shall be treated as sold on the day before the "expatriation date"[23] (another term with respect to which considerable ink will be spilled later on) for its fair market value.[24]

Apart from property expressly excluded from the deemed sale provisions of Section 877A, as discussed infra, the deemed sale provisions apply to all other property, regardless of whether gain on an actual sale of such property by a non-resident alien would continue to be subject to U.S. taxing jurisdiction. Thus, for example, property the gain on a sale of which by a non-resident alien would be subject to U.S. tax[25] is nevertheless subject to the mark-to-market

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[21] Section 877A(c) excludes certain property, namely a deferred compensation item, a specified tax deferred account and an interest in a non-grantor trust. The manner in which Section 877A deals with the taxation of the excepted category is discussed infra.

[22] As defined in Section 877A(g)(1).

[23] As defined in Section 877A(g)(3).

[24] Determined in accordance with valuation principles applicable for the federal estate tax. See Section 3A, Notice 2009-85, 2009-2 CB 598 (the "2009 Notice").

[25] See, e.g., Section 897(a).

provisions of Section 877A. While at least certain of the prior versions of the "exit tax" that were proposed[26] sensibly excluded from the deemed sale provisions a United States real property interest[27] ("USRPI"), the deemed sale provisions of Section 877A apply to such property as well. It should be evident that the inclusion of property the gain on sale of which would continue to be subject to U.S. tax jurisdiction regardless of the status of the individual as a U.S. person does not serve what appears to be the principal purpose of the expatriation provisions - removing tax considerations from the decision to expatriate.[28] It is unknown why this exclusion was not incorporated in the Act, but it appears it was not an oversight.[29] One can speculate that the failure to exclude such property was intended to impose an impediment to expatriation not necessary to the preservation of the tax base with respect to gains ultimately realized on an actual sale of such property. If so, the concerns expressed by some observers that the exit tax has been too broadly cast for its intended purpose and intentionally so would appear to have some merit.

One can better understand the inclusion within the sweep of Section 877A of property the gain on sale of which would not be subject to U.S. federal income tax after expatriation if as seems evident the intention is to ensure that appreciation to the date of expatriation is subjected to U.S. tax. But even in that case, it is not clear why Congress felt it necessary to impose the tax before a sale occurred. Rather, it would have been possible to allow a covered expatriate to elect to retain such property under U.S. tax jurisdiction either as had been proposed in an earlier

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[26] Earlier proposals of the mark-to-market tax: the Clinton Administration's Fiscal Year 1996 Budget Proposal (introduced as H.R. 981, 104th Congress); a bill introduced by Reps. Rangel and Matsui (H.R. 3099, 106th Congress), and similar bills introduced on June 26, 2002, by Reps. Rangel and Gephardt (H.R. 4880, 107th Congress) and on July 22, 2002, by Senators Harkin and Stabenow (S. 2769, 107th Congress); and a bill passed by the Senate on October 3, 2002 (as an amendment to H.R. 5063), all exempted interests in U.S. real property from the mark-to-market regime.

[27] Section 897(c).

[28] JCS-2-03, at 79.

[29] It had been in prior proposed versions of Section 877A that had not been enacted. See supra note 26.

version of the exit tax proposals or by using a device similar to a "Q-DOT,"[30] which would have secured any tax ultimately determined to be due. That these possibilities were not chosen speaks volumes on the true intention of the provisions.

That off our chests, let us begin with the statutory language that tells us a sale shall be treated as having occurred but does not reveal to us in so many words to whom the property which is the subject of the deemed sale has been sold. There is only one likely suspect: A covered expatriate to whom this Section is applicable turns out to be treated as both the seller and the purchaser of the property treated as having been sold.

Section 877A(a)(2) provides that in the case of any "sale under paragraph (1)":[31] notwithstanding any other provision of this title, any gain[32] arising "from such sale shall be *taken into account*"[33] for the taxable year of such sale;[34] and any loss "arising from such sale shall be *taken into account*" to the extent otherwise provided by this title, presumably to the same extent as if a sale occurred and the loss were realized therefrom, except that Section 1091 (relating to wash sales) shall not apply.[35] In essence, the net gains taken into account result in taxable gain

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30 See Section 2056A.

31 A phrase of which some mention will be made.

32 In excess of $600,000 as such amount may be adjusted for inflation. Section 877A(a)(3).

33 The phrase "taken into account" also raises some interesting issues as will be mentioned below.

34 For present purposes, it is sufficient to merely note that any previous deferrals in respect of property which is the subject of the deemed sale come to an end. Section 877A(h)(1). See also, Section 4, 2009 Notice.

35 A necessary carve out in the case of stocks or securities with a built-in loss, absent which Section 1091 could prevent the allowance of a loss otherwise allowed by Section 165. The reference to Section 1091 appears to be necessary if the construct is that the covered expatriate sold property to himself because losses are taken into account only to the extent otherwise provided by the Code and Section 1091 would appear to prevent the allowance of a loss in what would be a classical "wash sale." Of course, avoiding the application of the wash sales provisions is not a guarantee that a loss will be allowed; ordinarily, for a loss to be allowed, there actually must be a transaction of substance giving rise to such loss. See, e.g., Sections 165 and 1211. Cf. Section 7701(o). The entire construct of Section 877A, however, assumes there is no such transaction in the case of a hypothetical sale resulting from the operation of Section 877A, and nonetheless allows losses from the deemed sale in certain circumstances.

to the covered expatriate for his tax year in which the day before the expatriation date occurs as if the properties which are the subject of the deemed sale provisions had been converted to cash or exchanged for other property in a taxable transaction.

Property Need not be Owned nor Sold to be Treated as Having been Sold under Paragraph (1)

The phrase "sale under paragraph (1)" was intended to refer to a hypothetical sale deemed to occur solely by reason of the application of Section 877A with respect to all property (other than property excluded under Section 877A(c)) of a covered expatriate on the day before the expatriation date. Great emphasis is placed on the property of a covered expatriate on the day before the expatriation date both for purposes of determining whether an individual is considered a covered expatriate, and if so, what is the subject of the deemed sale. For this purpose, property of a covered expatriate is not limited to property actually owned, but rather includes property that would be includible in the estate of the expatriate if he died as a resident on the day prior to the expatriation date.[36] If on that date such individual were a long-term green card holder, but not a U.S. domiciliary, an issue arises as to whether non-U.S. situs property could be the subject of a sale under paragraph (1). In the latter connection, limiting the application of the deemed sale provisions of Section 877A to that which would be includible in the estate of the covered expatriate had he been a "resident" on the expatriation date suggests that all property regardless of its situs is a proper subject for the deemed sale provisions, effectively interpreting the term "resident" to have the definition of that term for estate tax purposes. Thus, it would seem that for this purpose a long-term green card holder would be conclusively

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Accordingly, that there is no actual transaction is not an impediment to the ability to take into account a loss that would be allowed had an actual transaction occurred.

[36] Section 3B, 2009 Notice.

presumed to be a domiciliary.[37] If the term "resident" were interpreted in a manner consistent with its meaning for income tax purposes, however, the application of the deemed sale provisions might be limited to U.S. situs property in the case of former long-term residents who are non-U.S. domiciliaries.[38]

No Transaction Required

The language "sale under paragraph (1)" not only does not require the property which is the subject of the deemed sale to be actually owned by a covered expatriate, it also does not require property considered to be owned by a covered expatriate to be involved in an actual transaction that would be considered a sale or exchange within the meaning of Section 1001. Rather, Section 877A assumes that no transaction cognizable under Section 1001 has occurred.[39]

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37 While in many cases a long-term green card holder would be considered a domiciliary, it appears possible for such a person not to be so considered.

38 For estate tax purposes, the term resident means domiciliary. Treas. Reg. Section 20.0-1(b)(1).

39 Treas. Reg. Section 1001-1(a) requires a conversion of property into cash or an exchange of property for other property to occur before gain or loss is required to be realized and therefore required to be taken into account under the Code. As to when property is considered to have been converted into other property, see *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991); see also Treas. Reg. Section 1.1001-3. It has been forcefully argued that the requirement for conversion is a Constitutional imperative and that *Eisner v. Macomber*, 252 U.S. 189 (1920) continues to stand for the proposition that in order for the inherent gain built into the ownership of property to be taxable there must be a "realization event" with respect to that property. See Mark E. Berg, *Bar the Exit Tax!: Section 877A, the Constitutional Prohibition Against Unapportioned Direct Taxes and the Realization Requirement* (the Tax Club, November 17, 2010) (and in particular to the authorities cited therein). Others have reached a contrary view. See, e.g., Noel B. Cunningham & Deborah H. Schenk, *Taxation without Realization: A "Revolutionary" Approach to Ownership*, 47 Tax L. Rev. 725 (1992) (relegating the realization requirement to one of administrative convenience rather than one of Constitutional dimensions); JCS-17-95 (raising and effectively dismissing the Constitutional issue); Statement of Joseph Guttentag, Subcommittee on Oversight, Comm. Ways & Means, House of Representatives, March 27, 1995; see also Fred Feingold, *Proposed Expatriation Rules*, Tax Review, No. 154 (April 12, 1995) (making the unremarkable observation that in light of the mark-to-market provisions of Sections 475 and 1256 and the cumulative effect of the views expressed by the commentators (certain of which are referred to supra) "it may be difficult to mount a successful constitutional attack on a tax imposed on unrealized gains", yet at the same time keeping an open mind to the possibility that *Macomber* may still have legs outside the circumstances presented in *Murphy v. United States,* 992 F.2d 929 (9th Cir. 1993) where there has been no change in form or ownership). Significantly, where Section 877A applies, there is no requirement for a conversion of property into cash or an exchange of one property for another. Indeed, nothing has happened to the property which is the subject of the deemed sale other than the Code deeming the sale to have occurred. Cf. *Prescott v. Commissioner*, 561 F.2d 1287 (8th Cir.1977) (holding that a taxable event can constitutionally include a deemed transaction that "occurred" solely by reason that the Code said it had, notwithstanding *Macomber.*) To be sure, *Macomber* did not deal with a transaction deemed to occur by virtue of the Code, but rather with a real live common on common stock dividend, holding that the issuance of such a stock dividend did not result in income

Notwithstanding that a transaction cognizable under Section 1001 has not occurred, or for that matter that no transaction has occurred at all, in the case of any "sale under paragraph (1)," notwithstanding any other provision of the Code,[40] any gain resulting "from such sale" shall be taken into account and any loss "from such sale" shall be taken into account to the extent otherwise provided by the Code.

"Gain or Loss" Taken into Account

The use of the phrase "taken into account" suggests that the mark-to-market requirement of Section 877A is nothing more than a method of accounting in a similar manner to the mark-to-market regimes of Sections 475 and 1256.[41] However, the mark-to-market regimes of Sections 475 and 1256 are limited to situations in which it appears that the built-in gain or loss could readily be determined without resort to outside appraisals, whereas the mark-to-market requirement of Section 877A applies also to property the value of which may not be readily ascertainable.[42] The one court that had occasion to consider the constitutionality of Section 1256[43] left open whether it would have reached the same decision if the accounting method employed by the taxpayer did not mark his positions to market for determining his entitlement to

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within the meaning of the Constitution. But see, *Commissioner v. Southlake Farms, Inc.*, 324 F. 2d 837 (9th Cir. 1963) (suggesting that Congress could have required a corporation to have taken into account the value of unharvested crops if it had enacted a method of accounting provision that did so, without discussing any potential limitations on the taxation of unrealized gains). No attempt will be made in this paper to resolve the Constitutional issues presented by Berg and others other than to note the analysis presented by Berg does have a seductive nature in light of the language of the cases he cites.

40 All gain above the exclusion amount referred to in Section 877A(a)(3) "arising" from the deemed sale of property shall be taken into account regardless of whether an actual subsequent sale at a gain would have resulted in gain that would have subjected a covered expatriate to tax thereon. However, any gain taken into account, determined without regard to the exclusion amount, is added to the cost basis of the property deemed sold. Section 877A(a)(2) (last sentence).

41 Cf. Section 453.

42 Cf. Section 7D, 2009 Notice making ascertainability of the value of an interest in a non-grantor trust a prerequisite for permitting a cleansing election.

43 *Murphy*, 992 F.2d 929.

"gain" and if he did not have the ability to "take" such gain, i.e., it was readily available to him in the form of funds in his bank account.

While the loss limitation provisions of Section 1091 do not apply in the case of a deemed sale under Section 877A, other loss limitation provisions, such as Section 1211(b) can apply.[44] Section 267, however, is not one of them. Section 267 denies a loss on a sale to a "related person." As previously noted, in the Section 877A construct of a hypothetical sale, it would appear that the hypothetical purchaser is the same person as the hypothetical seller, raising at first blush the prospect that common sense or even possibly Section 267 might bar the recognition of any loss. However, if this were so, the specific reference to Section 1091 as not being applicable would have no significance. To be sure, while under Section 267(a)(2) a loss realized on a sale to a related person within the meaning of Section 267(b) is not recognized, literally an individual is not related to himself for this purpose.[45] The Joint Committee Technical Explanation[46] appears to side with sanity by stating (somewhat ambiguously): "Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code except that the wash sale rules of Section 1091 do not apply."[47]

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[44] Section 9 of the 2009 Notice provides that regulations incorporating the guidance contained in the 2009 Notice will apply to individuals expatriating on or after October 15, 2009. An individual whose expatriation date is on or after June 17, 2008 but precedes October 15, 2009 may (but apparently is not required to) apply the rules described in the 2009 Notice.

[45] See Section 267(b)(2) and (c)(4).

[46] Joint Committee on Taxation, *Technical Explanation of H.R. 6801, the "Heroes Earnings Assistance and Relief Tax Act of 2008" as Scheduled for Consideration by the House of Representatives on May 20, 2008*, May 20, 2008 (JCX-44-08) ("2008 Joint Committee Report"), at 39.

[47] Id. (emphasis added). If the covered expatriate is deemed to have sold and repurchased the same property and the property is described in Section 1091, but for the Section 1091 carve-out, any loss "resulting" from such deemed sale and repurchase would not be allowed. Of course, that Section 1091 does not apply to a (deemed) sale does not make any loss resulting from such deemed sale necessarily allowable. Rather, losses that might otherwise not run afoul of Section 1091 have nevertheless been disallowed under general principles of economic substance, i.e., the loss was not incurred. It appears obvious, however, that the reference to Section 1091 not being applicable to a deemed sale under Section 877A was intended to permit the "recognition" of losses in a non-transaction, let alone a transaction that did not have any substance other than in the imagination of Congress.

The limiting language - to the extent otherwise provided in the Code - is somewhat confusing. Under general Code principles, for a loss to be taken into account several hurdles must be met: first, the loss must be realized within the meaning of Section 1001 or otherwise permitted to be taken into account under such provisions as Section 475 and 1256; second, the loss must be allowed under Section 165; and third, the loss must not be disallowed under another Code provision such as Sections 267 or 1091 or exceed the limits of Section 1211(b). While the realization requirement is ignored for purposes of determining the extent to which a loss is taken into account for purposes of Section 877A, other provisions limiting the extent to which loss may be recognized are not ignored. Thus, for example, the limitation on the use of capital losses under Section 1211(b) would prevent a loss so limited from being taken into account for this provision.[48] Similarly, a mark-to-market loss relating to personal use property for which a deduction could not be taken under Section 165 if the property had been sold would not be taken into account for purposes of Section 877A. However, if an actual sale to a third party would have produced a deductible loss, then a mark-to-market loss of such property would be taken into account. It is in this context that one should read the language of the 2008 Joint Committee Report, to the effect that covered expatriates are subject to tax on the net unrealized gain in their property.[49] Accordingly, there does not appear to have been any intention to bar losses that would be realized, recognized and otherwise taken into account on an actual sale from being netted against deemed gains, nor any intention to permit deducting a built-in loss that could not be deducted had an actual sale occurred against built-in gains. While the above conclusions seem sensibly to follow the language of what was enacted and most likely intended, in certain

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[48] See Section 3B, 2009 Notice.

[49] Covered expatriates "are subject to income tax on the *net* unrealized gain in their property as if the property had been sold for its fair market value on the day before the expatriation or termination of residency." 2008 Joint Committee Report, at 39 (emphasis added).

circumstances the actual language used regarding basis adjustments taken (too) literally may lead to results which may not have or possibly should not have been intended. Consider the following illustrations.

Assume the only property owned by a covered expatriate on the day before the date of expatriation had a built-in loss and constituted depreciable U.S. real property or property held for sale (i.e., dealer property) and in either case a USRPI[50] the loss on an actual sale of which would not be disallowed by Section 165 and that the covered expatriate had no income for the years in which the loss on the deemed sale is to be taken into account. Further assume the loss if realized would be considered ordinary rather than a capital loss.[51] The loss, if taken into account, would reduce the basis of the property going forward for purposes of determining the amount of any actual realized gain or loss on a subsequent sale or exchange of the property in question, literally without regard to whether such deemed loss had the effect of reducing deemed gains taken into account by virtue of Section 877A: there is no other provision that would disallow any loss resulting from an actual sale of the property in question. As so read, a subsequent actual sale of the property at a price in excess of its value on the day before the expatriation date, but nevertheless below its adjusted basis on such date, would give rise to a gain subject to FIRPTA[52] at least equal to the loss taken into account solely by virtue of Section 877A. To be sure, in the above circumstances the loss taken into account by virtue of Section 877A should give rise to a

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50 See Section 897(c) for the definition of USRPI. Of course, ordinarily whether the property were a USRPI should be of no moment to a covered expatriate having the misfortune to own such property on the day before the date of his expatriation since such property would be deemed to have been sold on a date when that person had not yet expatriated and therefore remained a U.S. person and the built-in gain or loss would have been considered to have been gain or loss of a U.S. person to which neither Section 897 nor Section 1445 applies.

51 See Section 1221(a)(1) or (2).

52 Section 897(a). As noted, it is by no means clear why Congress did not exclude USRPIs from property covered by the deemed sale provisions of Section 897A. Indeed, earlier versions of the proposed provision did exclude such property.

net operating loss which may be carried over and used against the gain arising by virtue of the adjustment to basis.[53] These machinations appear to be necessary if, as it would appear literally to be the case, an adjustment to basis is "proper" (perhaps giving new meaning to that term as well) where a deemed loss does not reduce deemed gain resulting from the application of Section 877A.[54]

Consider another application of the possible mischief created when things are deemed to occur. One could read the language in Section 877A(a)(2) (last sentence) - proper adjustment shall be made in the amount of any gain or loss subsequently realized - as having a limited purpose and therefore not affecting the adjusted basis of the property in question for other purposes where such adjusted basis could be relevant, such as, for example, Section 167(c). While there is no evidence from the legislative history of Section 877A that this was (or was not) intended, the literal language, however, appears to so require.[55] Were that to be the case, the basis for determining depreciation would be unaffected by the deemed gain or loss resulting from the operation of Section 877A, but the basis for determining a subsequent gain or loss would.

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53 Sections 172 (b)(1)(A)(ii) and (d)(4). While a net operating loss may be carried over for the period specified in Section 172(b)(1)(A)(ii), the extent to which such loss may be used for the purpose of reducing the amount subject to FIRPTA withholding is conditioned on a number of factors. See Rev. Proc. 2000-35, 2000-35 I.R.B. 211, Sec. 06(6). Moreover, for certain purposes the use of net operating losses may be limited. See, e.g., Sections 56(d) and 58.

54 Section 877A(a)(2) (last sentence). Perhaps to be "fair," one may wonder what would occur if the otherwise allowable deemed loss in excess of deemed gain did not give rise to an adjustment to basis. Certainly, it could not have been the intention to permit the carryover of such loss against future gains attributable to the adjustment in basis. But perhaps a better way to deal with this and other situations not yet thought of where similar administrative issues might otherwise arise would be to "interpret" the phrase "loss taken into account" as limited to the amount of gain deemed to be taken into account. Unfortunately, it is difficult to reach that sensible result from the language used.

55 To be sure, Section 167(c) refers to the adjusted basis of property as provided in Section 1011 for purposes of determining gain on the subsequent sale of such property. Section 1011 provides that the adjusted basis for determining gain or loss on the sale or other disposition of property shall be the basis of such property determined under Section 1012 ***or other applicable provisions of Subchapter O.*** Section 1012 refers to the historical cost of the property in question as adjusted by the provisions of Section 1016. The adjustment referred to in the last sentence of Section 877A(a) is not referred to in Section 1016 or any other provision of Subchapter O that this observer could find.

Covered Expatriate

Section 877A applies to a "covered expatriate," a term defined in Section 877A(g)(1) in general as an "expatriate" who "meets the requirements" of subparagraphs (A),[56] (B),[57] and (C)[58] of Section 877(a)(2). Section 877(a)(2) is a part of Section 877. Interestingly, Section 877 does not apply to any individual whose expatriation date, as defined in Section 877A(g)(3), is on or after the date of enactment of Section 877A (June 17, 2008).[59] The definition of threshold importance, "covered expatriate," is therefore defined as an individual meeting the requirements of a provision that literally could not apply to an individual covered by Section 877A, leaving open for argument that Section 877A could have no application to anyone and one could stop reading Section 877A. A more sensible "interpretation" is that the reference to Section 877(a)(2) in Section 877A(g)(3) is intended to define an individual as a covered expatriate if such individual meets the description of those individuals subject to the provisions of Section 877 as it was in effect prior to the enactment of Section 877A, rather than the requirements of the provisions of Section 877 no longer in effect with respect to expatriations occurring on or after June 17, 2008.[60] Indeed, the Joint Committee Report indicates that the legislative intention was to expressly incorporate into the definition of persons covered by Section 877A (covered expatriates) the same requirements as contained in Section 877(a)(2). Furthermore, the 2009 Notice concludes in its discussion that Section 877A(g)(1)(A) defines the term covered

56 An average annual income tax threshold.

57 A net worth test.

58 A certification requirement.

59 Section 877(h).

60 Compare Section 877A(g)(5), defining the term long-term resident by reference to the meaning given that term in Section 877(e)(2).

expatriate as a person meeting the minimum income tax liability and net worth tests that are the same tests contained in Section 877(a)(2). On the basis of the foregoing, it appears unlikely a court would interpret the linchpin definition of covered expatriate to exclude everybody. Nevertheless, the statutory language of Section 877A(g)(1)(A) could have been made clearer if at the beginning of amended Section 877(h) the following words were inserted: "Except as specifically incorporated by reference in Section 877A(g)(1)(A)...."

We will therefore assume that the provisions of Section 877A apply to an individual meeting the description contained in Section 877(a)(2),[61] who is an "expatriate" as defined in Section 877A(g)(2), whose "expatriation date," as defined in Section 877A(g)(3), occurs on or after June 17, 2008[62] and who does not fall under an exception contained in Section 877A(g)(1)(B).[63] The term expatriate is defined in Section 877A(g)(2) as any U.S. citizen who relinquishes his citizenship or any "long-term resident" who ceases to be a long-term resident within the meaning of Section 7701(b)(6).

The date relinquishment of citizenship occurs is rather straightforward. It occurs on the earliest to occur of voluntary renunciation,[64] a voluntary relinquishment by virtue of the

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[61] Requiring assets of at least $2 million or an average tax liability above a statutory threshold which currently is $139,000. If an individual does not meet either of these thresholds and certifies that he is tax compliant for previous years, that individual is not within the class of persons who could be a covered expatriate.

[62] See Pub. L. No. 100-245, Sec. 301(a) (2008).

[63] Under Section 877A(g)(1)(B), an individual is not a "covered expatriate," if: (1) such individual was born with dual U.S. and foreign citizenship and as of the expatriation date, the individual continues to be a citizen of, and is taxed as a resident of, such foreign country and the individual has been a resident of the United States (under the substantial presence test of Section 7701(b)(1)(A)(ii)) for not more than 10 taxable years during the 15-year taxable period ending with the taxable year of expatriation; or (2) such individual is a U.S. citizen who relinquishes his or her U.S. citizenship before reaching age 18 1/2, provided that such individual was a resident of the United States (under the substantial presence test of Section 7701(b)(1)(A)(ii)) for no more than 10 taxable years prior to such relinquishment.

[64] Section 877A (g)(4)(A) (but subject to approval by the issuance of a certificate of loss of nationality).

performance of an act of expatriation,[65] the date a certificate of loss of nationality is issued by the Department of State,[66] or the date that a court of the United States cancels a naturalized citizen's certificate of naturalization.[67]

Application of Expatriation Date to Certain Long-Term Residents

By contrast, in certain circumstances, the date when a long-term resident ceases to be considered as such can be less than straightforward. Section 877A(g)(2)(B) provides that the a long-term resident shall cease to be considered as such for purposes of this provision by reference to Section 7701(b)(6). Before describing what Section 7701(b)(6) provides in this regard, it is useful to first determine if the individual concerned was a long-term resident, absent which the provisions of Section 877A could not apply to such individual. The term long-term resident is defined by reference to the definition contained in Section 877(e)(2).[68] Section 877(e)(2) defines the term long-term resident as an individual, other than a U.S. citizen, who has been a lawful permanent resident of the U.S. in at least eight taxable years during the 15 taxable years ending in the taxable year in which the cessation of the status occurs.[69] Literally, Section 877(e)(2) measures the prior 15-year period as ending by cross-reference to certain subparagraphs that were contained in Section 877(e)(1) prior to its amendment by Section 301(c)(2)(A) of the Act. Those subparagraphs do not appear in Section 877(e)(1) as amended. Section 877(e)(1) as amended cross references to Section 7701(b)(6) which, as more fully

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65 Section 877A(g)(4)(B) (but subject to approval by the issuance of a certificate of loss of nationality).

66 Section 877A(g)(4)(C).

67 Section 877A(g)(4)(D).

68 Section 877A(g)(5).

69 For this purpose, for any year an individual is treated as a resident of a country with which the U.S. has a tax treaty, such year does not count as a year in which such individual was a lawful permanent resident. Section 877(e)(2).

described below, is not identical to Section 877(e)(2), at least insofar as it speaks to when a lawful permanent resident who commences being considered a resident for treaty purposes of a country with which the U.S. has a treaty is considered to have lost his status as a long-term resident. The 2009 Notice essentially ignores the misplaced cross-reference and effectively treats the 15-year measuring period as ending on the cessation of treatment of lawful permanent residence within the meaning of Section 7701(b)(6). The legislative history is consistent with this interpretation.[70]

Under Section 877(e)(1) prior to its amendment (which as noted continues to apply to expatriations occurring before June 17, 2008), an individual is treated as subject to the expatriation provisions if such individual commences to be treated as a resident of a foreign country under the provisions of a treaty and does not waive the benefits of such treaty. With regard to the first requirement, the language literally would point to the time when the individual first commenced the status of being a resident of the foreign country for treaty purposes as measuring the end of the 15 year period for determining whether such individual was a long-term resident. However, meeting the first requirement does not of itself trigger the end of the measuring period unless there had been "no treaty waiver."

While one would sensibly think that the cross-reference to Section 877(e)(2) should also describe the date of the cessation of treatment as a long-term resident for purposes of determining when, or literally if, an individual is to be treated as an expatriate, this Section does not do so. Rather, an expatriate is defined, insofar as that term applies to non-U.S. citizens, as any long-term resident, defined as noted above, "who ceases to be a lawful permanent resident of the United States within the meaning of Section 7701(b)(6)…," a provision effective for expatriations occurring on or after June 17, 2008.

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70 See 2008 Joint Committee Report, at 40.

Thus, in the case of a long-term green cardholder one can only determine whether Section 877A applies by looking to see whether the cessation of status had occurred prior to June 17, 2008 within the meaning of Section 7701(b)(6) as amended by the Act. But whether, unfortunately for the technicians amongst us, Section 7701(b)(6) as so amended applies depends on whether the expatriation date occurred before the effective date of the Act.

Section 7701(b)(6) as amended provides that a lawful permanent resident will cease to be treated as a lawful permanent resident (which as noted is an act of expatriation if the expatriate was a *long-term* lawful permanent resident) if such person loses his status as a lawful permanent resident whether or not such loss was voluntary. Even if an individual has not lost his status as a lawful permanent resident, such individual shall, for purposes of determining whether such individual has the status of being a lawful permanent resident (the loss of which status being an act of expatriation) will no longer be considered to have such status literally only if three conditions are met. The first two conditions are identical to the conditions set forth in Section 877(e)(1) prior to its amendment by the Act, namely the individual commences to be considered a resident of a foreign country for purposes of a treaty and such individual does not waive the benefits of such treaty. The third requirement in Section 7701(b)(6) (as amended) was not contained in Section 877(e)(1) prior to its amendment. The new requirement is that the individual "notifies the Secretary of the commencement of such treatment."

Each of the three requirements must be met for the status of lawful permanent resident of an individual who lawfully retains his status as such to be treated as having ceased such status for the purposes of determining the expatriation date under Section 877A(g)(3)(B). The first of these requirements is that the individual commences to be treated as a resident of a foreign country for the purposes of a treaty. An individual will be so treated if such individual is a

resident of such country within the meaning of the treaty in question, which ordinarily requires that the individual be liable to tax as a resident of such country, and if also a resident of the U.S., is treated as resident of the foreign country under the tie-breaker rules contained in the Fiscal Domicile Article of the treaty.[71] Consider the case of a long-time green card holder who moves to Italy on, say, January 1, 2008 and for purposes of the tax laws of Italy commences to be treated as a resident of Italy for purposes of its tax and therefore a resident of Italy from January 1, 2008. Since such individual has not formally relinquished his green card, that individual is also treated as a resident of the U.S. and will be considered a dual-resident taxpayer.[72] Assuming such individual qualifies to be treated as a resident of Italy for treaty purposes by virtue of the tie-breaker rule of Article 4 of the U.S.-Italy treaty, the individual would be entitled to be subject to tax in the U.S. as a non-resident alien individual, presumably with effect from January 1, 2008.[73]

It would seem, therefore, that the first requirement of Section 7701(b)(6) would be met before June 17, 2008 since the entitlement to be treated as a resident of a treaty country commenced before that date. While, as noted below, it is questionable whether in the posited case a treaty waiver could have occurred before that date, we need not concern ourselves with that issue since the provision does not require that there be a waiver, but rather a "non-waiver."

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71 See, e.g., Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains (the "U.S.-U.K. Treaty"), Article 4; Convention Between the Government of the United States of America and the Government of the Republic of Italy for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion (the "U.S.-Italy Treaty"), Article 4.

72 See Treas. Reg. Section 301.7701(b)-7(a)(A).

73 Id.

In this connection, the regulations provide that an individual who determines he is entitled to be treated as a resident of a foreign country pursuant to a treaty for a year *shall* be treated as a non-resident alien for such year for purposes of determining his tax liability.[74] The preceding sentence appears to be consistent with the provisions of tax treaties that contain Fiscal Domicile Articles of the type contained in the U.S. Model Treaty.[75] Under these provisions, there are no administrative conditions imposed for treaty entitlement. Nevertheless, the regulations provide that an individual who determines he qualifies to be considered a treaty resident and therefore to have his tax computed as if he were a non-resident alien "shall make a return on Form 1040NR on or before the date prescribed by law (including extensions) for making an income tax return as a non-resident."[76] The regulations appear to assume that an individual who qualifies as a resident of a foreign country pursuant to a treaty is not required to take the position that he is entitled to treaty benefits and could in effect waive such benefits, possibly by filing a Form 1040. At the minimum, this would suggest that it could not be known until the filing date of the tax return for the year in which an individual is entitled to claim treaty benefits whether the individual chooses to make such claim. Thus, it could be argued that until a return for the year was filed that "irrevocably" waives entitlement to treaty benefits, the no treaty waiver requirement cannot be met. At the minimum, a waiver could not occur at least until the return for the year were filed that was inconsistent with the treaty claim. Under this reading, as

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[74] Treas. Reg. Section 301.7701(b)-7(a). While the use of the term "shall" in the regulation referred to literally appears to provide that an individual who determines he is entitled to make the treaty claim is required to be treated as qualifying for such treatment regardless of whether it is ultimately determined the taxpayer so qualifies, it does not appear that the language would be so interpreted. However, it does raise as an issue whether a determination by the individual concerned that he qualifies for such treatment places the burden on the Internal Revenue Service to establish that he does not. Cf. Section 7491.

[75] United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model Treaty"), see, e.g., U.S-U.K. Treaty, Article 4; the U.S.-Italy Treaty, Article 4, among others.

[76] Treas. Reg. Section 301.7701(b)-7(b). The regulations go on to provide that a statement on Form 8833 must be attached to such a return (Treas. Reg. Section 301.7701(b)-7(c)). Form 8833 requires that the basis for the treaty claim be set out.

of the first date treaty entitlement commenced, for example January 1, 2008 in the illustration referred to above, there could have been no waiver and therefore, the second requirement had also been met on January 1, 2008.

Conversely, one could argue that the filing of the Form 1040 could be viewed as a waiver that had effect for the entire 2008 tax year. On this basis, it would seem that the requirement of there being no treaty waiver would have been met for the period treaty residence commenced but that condition would have retrospectively expired on the first date the no-waiver requirement was not met, i.e., the first date of the taxable year covered by the Form 1040 that was filed. Stated differently, the filing of the Form 1040 (i.e., treaty waiver) should be given effect on the date to which it first applied, i.e., January 1, 2008. Under this interpretation, it would appear that the filing of a resident return would retroactively prevent the second requirement - no treaty waiver - from having been met prior to June 17, 2008.

Suppose, however, the individual instead timely files a non-resident return (Form 1040NR) consistent with Reg. Section 301.7701(b)(7) and attaches the appropriate Form 8833 setting out the basis for determining that the individual was entitled to be treated as a resident of a foreign country for treaty purposes. The filing of the Form 1040NR claiming the status of a non-resident alien would clearly be consistent with the individual not having waived his treaty claim. Therefore, the individual, having commenced being considered a resident of the treaty country on January 1, 2008 and not having waived his treaty claim, would have met the first two requirements of Section 7701(b)(6). If, however, the IRS were to examine the issue of whether such individual qualified as a non-U.S. resident for treaty purposes and it was finally determined he did not, then it seems the individual, although attempting to meet the first requirement - commencing to be treated as a treaty resident - did not do so and therefore could not have

expatriated within the meaning of the statutory provisions, even though the individual did not "waive" a thing. It would not make sense to inflict the provisions of Section 877A on an individual for whom it has been determined against his will that he did not successfully claim treaty residence.[77]

Suppose the individual initially timely filed a Form 1040 (therefore supposedly waiving his treaty entitlement), and then within the applicable period of limitations files an amended return as a non-resident alien. In that case, it would seem the individual has effectively disavowed his waiver.[78] Stated differently, the filing of Form 1040 does not appear to operate as a bar to the filing of an amended return in which treaty residence may be claimed and indeed this appears to be the unofficial position, albeit unpublished, of various IRS personnel currently faced with this issue in various cases.

If a timely-filed non-resident return is not a pre-requisite to obtaining the benefits of being considered a resident for treaty purposes, it may well be that the determination of whether the treaty resident status has commenced may not be known for a considerable period. Until a claim of treaty residence were made on a return, it would not be clear that the first requirement of being treated as a treaty resident could have been met. Indeed, even if the individual did file a Form 1040NR timely for 2008, taking into account extensions, that return would not even be due until perhaps October 15, 2009. If on or before the due date, for example October 15, 2009, the

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77 Of course, the deemed sale provisions of Section 877A can be inflicted on an individual who does not intend to relinquish his status as a lawful permanent resident, but nevertheless loses his status as such, even where he is otherwise treated as a resident for U.S. federal income tax purposes for the year of such loss. Cf. Section 877A(g)(1)(C).

78 There is nothing in any tax treaty provision, the applicable statute or the regulations that appears to require a timely filed return to make the treaty claim. Cf. *Casanova Co. v. Commissioner*, 87 T.C. 214 (1986), acq'd 1990-2 C.B. 1 (holding a procedural rule for obtaining the benefits of a treaty not to prevent the application of a substantive treaty entitlement to which the taxpayer was entitled). Indeed, the regulations do not speak to that possibility. See also, PLR 8709003 (holding that a the taxpayer was entitled to treaty benefits even though the necessary form was filed up to three years after the taxable year).

individual filed a Form 1040NR claiming treaty residence, then it would appear that on the filing date at least there is an indication that the first requirement (commencement of status) has been met with retrospective effect.

Thus, it appears that one cannot be certain that the non-waiver requirement has been met at least until the tax return for the year has been filed and possibly later if an amended return were filed. Indeed, consider the case where an individual had filed no tax return for the year. By not filing a return, it could hardly be said there had been a treaty waiver and it would seem a late filed return could resolve the issue at least conditionally unless it could be argued that the failure to timely file a Form 1040NR is an irrevocable waiver,[79] which argument as noted above is somewhat of dubious persuasiveness.

The above discussion ignores the last requirement of Section 7701(b)(6), i.e., notification. There is nothing in the statute or its legislative history which gives guidance as to how or when the notification required by Section 7701(b)(6) is to be given. The 2009 Notice, after confirming that notification is a requirement, states that such notification is to be provided on Forms 8833 and 8854. As noted previously, Form 8833 is the form attached to a Form 1040NR upon which the claim of treaty residence is made. Form 8854 is a form required to be filed in accordance with Section 6039G after an expatriation act has occurred. An individual who files a Form 1040 (to which a Form 8833 would not be attached) has not provided the required notification.

In this connection, former Section 7701(n), in effect for expatriations occurring before June 17, 2008, provided that until notification was given an individual who would otherwise be considered a former long-term resident or former citizen shall continue to be treated as a citizen or resident for income tax purposes, presumably until the required notices were given. Thus, for

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[79] Exalting the procedural rules contained in the regulation as having substantive significance for treaty purposes. Cf. *Casanova*, 87 T.C. 214.

expatriation acts that occurred or were deemed to have occurred prior to June 17, 2008, until the required notice was given, the individual remained subject to tax as a citizen or resident. In the case of former green card holders, however, the provision that would treat an individual as continuing to be subject to tax as a resident for purposes of the Code until notice were given would appear not to bar an individual from availing himself of a treaty claim: nothing in former Section 7701(n) or former Section 6039G (the latter provision also applicable to acts of expatriation deemed to have occurred prior to June 17, 2008) appears to intentionally have overridden a contrary treaty provision and therefore those provisions had application only to former citizens and "former" long-term residents who could not avail themselves of a treaty claim.

It seems the reason the provision extending status as a U.S. citizen or resident was deleted for expatriations occurring on or after June 17, 2008 was because under the Section 877A so-called exit tax/deemed sale provisions, the taxable event in many cases occurs on the day prior to the expatriation date and, with few exceptions, all built-in gain is triggered. As a result, there was no longer any need to continue to impose taxation on income arising after such date that would not otherwise be imposed under the general Code principles. As noted above, while the failure to provide the return required by Section 6039G no longer can have the effect of causing an individual to be treated as if he continued to be taxable as a resident, such failure remains an obstacle to an individual who has not relinquished or lost his status as a permanent resident ceasing to be treated as a lawful permanent resident of the U.S. As so read, it would seem (a) such an individual could not be treated as an expatriate within the meaning of Section 877(A)(g)(2)(B) even if such individual claimed the benefits of being treated as a treaty resident and did not otherwise waive such benefits, until notification presumably as required by Section

6039G were provided;[80] and (b) significantly, the provisions of Section 877A may not be applied to a long-term lawful permanent resident who retains his formal status as such but who nevertheless claims the benefits of treaty residence until notification is given as prescribed by Section 6039G.

To be sure, the failure to give notice required by Section 6039G can give rise to civil penalties[81] and, if the failure is intentional, possibly criminal penalties.[82]

As noted above, the failure to provide the required notice could not affect whether an expatriation had occurred prior to June 17, 2008 simply because Section 877(e)(2) had no such notice requirement. Thus, an individual who commenced being treated as a treaty resident prior to June 17, 2008 and who did not "waive" such treatment could be treated as having expatriated prior to June 17, 2008, whether or not the notification required by Section 6039G was given prior to that date.

Suppose an individual qualifying as a long-term permanent resident, who while not formally relinquishing such status, is entitled to be treated as a resident of a foreign country for treaty purposes commencing on January 1, 2008, as posited above, not only does not waive the benefits of claiming such treaty residence but affirmatively avails himself of such benefits by timely filing (taking into account extensions) a Form 1040NR after June 17, 2008. While the filing of the Form 1040NR to which it is presumed the required Form 8833 is attached has occurred after June 17, 2008, the issue arises as to whether the date of the deemed cessation of status of lawful permanent residence within the meaning of Section 7701(b)(6) and therefore the expatriation date did not occur until after June 16, 2008, in which case Section 877A applies, or

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80 Treas. Reg. Section 301.7701(b)-7(c) and Section 8, 2009 Notice.

81 See Section 6039G(c)(2).

82 See Section 7203. Section 7203 imposes a criminal penalty for the intentional failure to timely file an information return.

is treated as having occurred retroactive to the date of commencement of treatment of residence for treaty purposes (in our example before June 17, 2008), in which case Section 877A does not apply, but old Section 877 does apply. The answer to the question seems to depend on whether by its terms Section 877(e)(1) as in effect prior to June 17, 2008 applies. As noted above, in the case posited the two requirements for deemed cessation of lawful permanent residence could have appeared to have occurred prior to June 17, 2008: commencement of status as a treaty residence and no waiver.

Example 8 of the 2009 Notice answers this question without any discussion, treating the cessation of lawful permanent residence to have occurred on January 1, 2008 and as a result applying old Section 877 rather than new Section 877A. By using the retroactive nature of the "non-waiver" of treaty benefits, the Service appears to have applied old Section 7701(n), which provided that the effect of a failure to give the notice required by Section 6039G merely permitted the IRS to continue to treat the individual who did not give the Section 6039G notice as continuing to be taxable as a resident. Example 8 does not expressly deal with a situation where treaty residence commenced on or after June 17, 2008. Consider the case where an individual first commenced residence for treaty purposes on January 1, 2009 and does not "waive" the benefit of such treaty. Assume further that such individual timely filed his Form 1040NR for 2009 on June 15, 2010. Having commenced status as a treaty resident on or after June 17, 2008 and not having waived the benefit of the treaty, such individual has met the first two requirements of the flush language of Section 7701(b)(6). In cases where treaty residence status commences on or after June 17, 2008, the statute and 2009 Notice are clear that the notice required by Section 6039G is a third requirement, a requirement that did not exist for individuals first claiming treaty residence for periods prior to June 17, 2008. It is by no means clear that

Example 8 of the 2009 Notice, by treating the cessation of lawful permanent residence to have occurred retroactive to the commencement of treaty residence, where such commencement occurred prior to June 17, 2008, is dispositive of the issue where treaty residence commenced on or after June 17, 2008 and indeed a good technical argument could be made that in such case until the Section 6039G notice (Form 8854) is provided, the cessation of treatment as a lawful permanent resident for an individual who has retained his status as such could not occur.

The date of when cessation of status is deemed to occur is, of course, of considerable significance. If such cessation is deemed to occur on January 1, 2009, the taxable event for the deemed sale applicable under Section 877A has occurred on December 31, 2008. By contrast, if the cessation is deemed to occur only when the notice is given, which is not likely to occur at least until sometime in 2010, then under our example the deemed sale and therefore the taxable event could not occur until the day before the notice was given, which as noted would at the earliest be sometime in 2010.[83]

To suggest that Example 8 of the Notice also intended to be applicable to situations in which the commencement of treaty residence occurs on or after July 17, 2008 would make the giving of the required Section 6039G notice superfluous on the issue as to when an expatriation by virtue of the commencement of treaty residence occurs, which appears to be contrary to the cross-reference to Section 7701(b)(6) in Section 877A(g)(3)(B). Moreover, in such case there could be a number of administrative difficulties. For example, if as posited above, a treaty residence claim could be made for 2009 by the filing of an amended 2009 tax return and the notice were attached to such amended return, the expatriation date would be deemed to occur on the date treaty residence commenced (or January 1, 2009) and the deemed sale and therefore the

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[83] For present purposes, we will put aside whether the failure to ever give the notice could prevent the application of Section 877A and focus only on when the expatriation date occurred.

taxable event arising by virtue of such deemed sale as having occurred in 2008, making the 2008 tax return that was filed for such year incorrect. While certainly the IRS could seek to assess the tax due for the earlier year within the applicable period of limitations, there does not appear to be any requirement to file an amended return for such prior year, particularly where the previously filed return was correct when filed. Moreover, during the period prior to the filing of the amended return, it would seem the individual correctly could provide a Form W-9 (indicating he is a U.S. person) and could not be required to file a Form W-8CE.[84] Presumably a trustee of a trust otherwise required to withhold on distributions[85] to such a retroactive covered expatriate could have relied on not having received a Form W-8CE.[86]

If the expatriation date does not occur until the giving of the Section 6039G notice, then it appears that the status of being a resident of a treaty country would exist at the time of the deemed sale required by Section 877A and the provisions of an applicable treaty would in a number of instances prevent the U.S. from taxing the deemed sale.[87] As will be discussed in the Section of this paper dealing with the interaction of Section 877A and tax treaties, except in the case of distributions from trusts and in respect of eligible deferred compensation items, there is nothing in Section 877A or in its legislative history which would appear to override a contrary

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84 See discussion, infra.

85 See Section 877A(f)(4).

86 See Section 8D, 2009 Notice. Cf. Treas. Reg. Section 1.1441-1(b)(1), which requires as a default position withholding under Section 1441 on a payment to a foreign person unless there is evidence otherwise.

87 There are a number of treaties that contain provisions which would be contrary to the imposition of tax on a deemed sale if such sale were deemed to occur when an individual is entitled to be treated as a resident of that country. See, e.g., U.S-U.K. Treaty, Article 22.

treaty provision.[88] In fact, the legislative history of Section 877A lacks any indication of an intent to override any existing treaties.[89]

Interests in Grantor Trusts

Certain property of a covered expatriate is excluded from the deemed sale provisions of Section 877A. Section 877A(c)(3) excludes an interest that a covered expatriate may have in a trust in which he is not considered the owner for purposes of Sections 671 through 679, such interest referred to as an interest in a non-grantor trust. This language suggests that property owned by a "grantor trust" with respect to which the covered expatriate is considered the owner for purposes of Sections 671-679 on the day before the expatriation date would be a proper subject of the mark-to-market regime of Section 877A.[90] However, this would appear to be true only in certain instances. For purposes of determining tax liability under the mark-to-market regime, a covered expatriate is deemed to own an interest in property only if such interest would be included in his gross estate were he to die on the day before the expatriation date.[91] Property not so includible would not appear to be a proper subject for the mark-to-market regime. As a result, property of a grantor trust that would not be includible in the grantor's estate (e.g., it was the product of a previous completed gift) would not be the subject of a mark-to-market tax.

To be sure, Section 3A of the 2009 Notice provides that for purposes of determining tax liability under the mark-to-market regime of Section 877A, a covered expatriate shall also be considered to own his or her beneficial interest in each trust (or portion thereof) that would not be includible in his or her gross estate. This language, however, appears to be directed to the

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88 *Crow*, 85 T.C. 376.

89 See generally, the 2008 Joint Committee Report.

90 Section 1, 2009 Notice; Blue Book at 182.

91 Section 3A, 2009 Notice.

extent to which the property of a trust should be considered in determining whether an expatriate meets the net worth test of being a covered expatriate. For that purpose, a covered expatriate's beneficial interest of a trust is determined by reference to Notice 97-19.[92] Notice 97-19 generally looks to a number of factors for determining beneficial interest, including the trust provisions, precatory letters, patterns of distributions and if all else fails what would occur under intestate distributions. In general terms, under these rules, a covered expatriate who is a grantor of a so-called defective grantor trust in which he is not a beneficiary and the property of which would not be includible in the estate of such grantor, would not be deemed to have an interest in the property of such trust and therefore the provisions of Section 877A would have no application to him.[93] By contrast, a covered expatriate who is an owner within the meaning of Sections 671 through 679 of a grantor trust, the assets of which would be includible in such person's gross estate were he to die on the day before the expatriation date, would be deemed to sell his interest in the assets of the trust on the day before the expatriation date.

Consider the following case where C, a U.S. person, the grantor of a non-U.S. resident trust but not a beneficiary thereof, is treated as the owner of such trust for income tax purposes solely by reason of Section 679 because such trust has or may have a U.S. beneficiary. Assume C's transfer to the trust was a completed gift for estate tax purposes. It would seem that Section 877A would not deem C to have sold any interest in any property owned by the trust (as he had none) were he to expatriate. However, any such expatriation would cause such trust no longer to

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92 1997-1 C.B. 394.

93 There may be situations in which an individual is a so-called grantor and deemed owner of a trust in which he is also one of a class of contingent beneficiaries, but nevertheless the property of the trust would not be included in his estate. See infra note 111. However, in these situations it is likely the beneficiary has no ascertainable interest in the trust.

be considered a grantor trust in which C is an owner.[94] On the first date the trust were no longer treated as owned by a U.S. person, the U.S. person (C, in our illustration) who was considered the owner prior thereto shall be: "treated as having transferred, immediately before (but on the same date that) the trust is no longer treated as owned by that U.S. person, the assets … to a foreign trust."[95]

Focusing on the temporal provisions of the above quoted language, it appears that for purposes of applying the deemed sale provisions of Section 684, the deemed sale occurs on the day after the expatriation date since that is the first date that the trust would no longer be treated as owned by a U.S. person. On that date, there is no U.S. person that could be subject to tax by reason of the deemed sale provisions of Section 684.[96] This would suggest that the gain recognition mandated by Section 684 could apply only after the expatriation date and that therefore Section 684 could not conflict with Section 877A.

Section 4 of the 2009 Notice does not appear to require a contrary result, providing merely that "if the expatriation of an individual would result in recognition of gain under Section 684, the provisions of Section 684 apply before the provisions of 877A …"[97] leaving open the possibility that an expatriation of a U.S. owner of a grantor trust may not result in recognition of gain by virtue of Section 684. Of course, there may be circumstances where an expatriation could cause Section 684 to apply. For example, in certain circumstances the expatriation of an individual trustee may cause a trust to no longer be considered a U.S. resident trust,[98] or the

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94 Section 672(f).

95 Treas. Reg. Section 1.684-2(e).

96 Section 684(b)(1). Loss is not recognized under Section 684. Treas. Reg. Section 1.684-1(a)(2).

97 In accordance with Section 877A(h)(3).

98 See Sections 7701(a)(30)(E)(ii), 7701(a)(31)(B), 684(c). See also Treas. Reg. Section 1.684-4.

covered expatriate to no longer be considered the owner of such trust.[99] In the situation where the change of status of the trustee causes a non-grantor trust to no longer be considered a domestic trust, the trust is deemed to transfer its property to a foreign trust, triggering gain recognition under Section 684[100] on that date, unless the trustee who is not a U.S. person is replaced by a U.S. person within a 12-month period (or longer period if permission is obtained).[101] Such gain recognition would step-up the basis of any built-in gain assets of the trust, which basis step-up would be applied before the application of Section 877A(f) on subsequent distributions, as discussed supra.

Where a U.S. person were considered the owner of all or a portion of a trust, but would not be so considered if he were not a U.S. person,[102] an expatriation of such U.S. person (assuming he were no longer considered a U.S. resident) could convert the trust into a non-grantor trust. If the trust were a foreign trust, the conversion would also have the effect of treating the U.S. person as transferring property to the non-grantor foreign trust into which it was converted. However, as noted previously, such transfer would appear to occur on the day after the expatriation date and as a result Section 877A should have no application to such a deemed transfer.

While the exit tax under Section 877A should have no direct application to the conversion of a grantor trust in which the covered expatriate is considered the owner of a portion thereof into one that can no longer be treated as such, the conversion would appear to be a transfer of the property attributed to the covered expatriate under the grantor trust rules to a non-

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99 Section 672(f).

100 Treas. Reg. Section 1.684-4(a).

101 Treas. Reg. Section 301.7701-7(d)(2).

102 See Sections 679 and 672(f).

grantor trust. If such non-grantor trust were a foreign trust, subject to further guidance,[103] Section 2801 would appear to subject subsequent distributions from such trust to a U.S. beneficiary to tax.[104] By contrast, if the non-grantor trust were not a foreign trust, the conversion to a non-grantor trust would, subject to further guidance,[105] be treated as a transfer of the property of the trust attributed to the covered expatriate under the grantor trust rules to a U.S. person (i.e., the U.S. trust), and the U.S. person would appear to be subject to the tax imposed by Section 2801.[106]

The effect of these provisions would appear to require taxation as follows:

- If a covered expatriate were the grantor of a grantor trust and the property of the trust would be includible in his estate, the property of the trust would be deemed to be sold by the covered expatriate on the day before the expatriation date and any gain or loss resulting would be taken into account to the extent provided in Section 877A.

- If the assets of the trust would not be includible in the estate of the grantor, Section 877A either would not deem the assets of the trust to be sold by the covered expatriate or would not treat the covered expatriate as receiving any consideration, and in either case the covered expatriate would not be subject to U.S. tax by virtue of the expatriation.

- If, instead, the trust were not considered to be a grantor trust after the expatriation date,[107] regardless of whether Section 877A would be applicable to the property in the trust, Section 2801 would, subject to further guidance, require either current tax on the amount of the property in the trust, if the trust were a domestic trust, or a tax on distributions to a U.S. beneficiary, if the trust were a foreign trust.

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[103] Section 9, 2009 Notice.

[104] Section 2801(e)(4)(B).

[105] Section 9, 2009 Notice.

[106] Section 2801(e)(4)(A).

[107] See Section 672(f).

Interests in Non-Grantor Trusts

As noted previously, Section 877A(c)(3) excludes from the operation of the deemed sale provisions an interest of a covered expatriate in a "nongrantor trust." A covered expatriate may, however, be subject to tax and withholding.[108] The determination of whether a covered expatriate is considered the owner of a portion of a trust under Sections 671 through 679 is made immediately before the date of expatriation.[109] Also, as noted previously, the fact that a covered expatriate holds an interest in a trust that is not considered a non-grantor trust with respect to the covered expatriate does not necessarily mean that he will be subject to the deemed sale provisions of Section 877A with respect to the property of the trust. Significantly, however, Section 877A(f) does not cover the situation where a covered expatriate holds an interest in a trust in which he is considered the owner under the grantor trust provisions on the day before the expatriation date. This "gap" allows for one to side-step the deemed sale provisions, but the covered expatriate may still be subject to withholding taxes, as explained below.

Consider, for example, the case of a trust that would be considered a grantor trust on the relevant date because, for example, the covered expatriate was the sole grantor and is one of several possible contingent beneficiaries including his children,[110] but nevertheless the assets of which would not be included in the estate of the grantor.[111] In such a case, the grantor/covered expatriate would not appear to be deemed to have sold the property of the trust by virtue of

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108 Sections 877A(f)(4)(A).

109 Section 877A(f)(3); Section 7A, 2009 Notice.

110 Section 677(a).

111 Where the trust agreement specifies that distributions to the settlor are to be made in the absolute discretion of the trustees, with no enforceable standard provided, the transfer is generally held to be complete for gift tax purposes. See, e.g., *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941); *Rheinstrom v. Commissioner*, 105 F.2d 642 (8th Cir. 1939); *Estate of Holtz v. Commissioner*, 38 T.C. 37, 42 (1962). A different result obtains, however, where State law permits creditors of the settlor-beneficiary to pierce the trusts for satisfaction of claims. See, e.g., *Paolozzi v. Commissioner*, 23 T.C. 182 (1954).

Section 877A, even though the trust did not meet the definition of a non-grantor trust on the day prior to the expatriation date, although it would meet that definition thereafter.[112]

The provisions of Section 877A(f), which impose withholding and tax on income distributions to the covered expatriate, would not appear to apply even though the covered expatriate was a possible beneficiary on the day before the expatriation date. That the provisions of Section 877A(f) do not appear to apply in the above situation can be significant when considering the consequences when Section 877A(f) does apply.

Where Section 877A(f) does apply, subsequent distributions to a covered expatriate by the trust are subject to withholding and tax on the taxable portion of such distribution, which is the amount thereof that would subject a U.S. person to tax thereon if distributed to such person.[113] Furthermore, a distribution by the trust of appreciated property would trigger gain to the trust.[114] It should be noted that the effect of the Section 877A(f) provisions would depend on whether the trust in question were a foreign trust. If not a foreign trust, a subsequent distribution to a covered expatriate that exceeded the current income of the trust would not be taxable to the covered expatriate.[115] By contrast, if the trust were a foreign trust, a distribution would be taxable to a covered expatriate to the extent of current and undistributed net income.[116]

The requirement to withhold tax on and the taxability of the distribution to a covered expatriate exists regardless of the source of the income of the trust and regardless of whether the trust had any property within the jurisdiction of the U.S. Moreover, this requirement would

112 Section 672(f).

113 Section 877A(f)(2).

114 Section 877A(f)(1).

115 Section 662(a)(2).

116 Section 667(d).

apply in perpetuity.[117] It would also apply without regard to whether the income so distributed would otherwise be subject to an exemption from or reduced rate of tax applicable under a tax treaty because the covered expatriate "shall be treated as having waived" any such tax treaty benefit,[118] unless the covered expatriate agrees to such other treatment as the Secretary deems appropriate. Neither the statutory provisions, the Joint Committee Report nor the 2009 Notice refer to this "deemed waiver" as a treaty override. However, it should be clear that the deemed waiver is intended as such and therefore would be given effect as such at least with respect to all existing tax treaties. Less clear is whether such a treaty override could be upheld in the case of a treaty coming into force after the effective date of Section 877A. To be sure, as will be discussed, certain savings clauses permit taxation of former citizens and former long-term residents in certain cases but generally only for a ten-year period.

The 2009 Notice advises that the Service believes that other treatment may be appropriate if the covered expatriate: (a) files an election[119] that would treat the covered expatriate as having received the value of his interest in the trust, as determined for purposes of Section 877A, on the day before the expatriation date,[120] (b) receives a ruling from the IRS as to the value to be so included and (c) pays the tax required as a result of such deemed inclusion. It is unclear how the value of the interest would be determined. Presumably, the value would not be limited to the amount the covered expatriate would have included in his estate had he died on the day before the expatriation date. Rather, it would seem the value of the interest would have to take into account the distribution provisions of the trust, perhaps on a basis similar to the factors relevant

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117 Cf. Section 877(a)(1).

118 Section 877A(f)(4)(B).

119 On Form 8854.

120 Section 7D, 2009 Notice.

for determining the interest of the covered expatriate for purposes of determining the net worth test. If such amount could not be ascertained, the IRS will not provide a ruling.[121] Moreover, it seems this elective deemed distribution would have the same effect as an actual distribution of trust property on the day prior to the expatriation date. The Service would likely contend that such deemed distribution would have the same effect it would have under Section 877A(f)(1)(B),[122] requiring gain to be "recognized" by the trust on the distribution of appreciated property. In any event, until, if ever, such a ruling, and certification that the tax due from the covered expatriate on such deemed distribution had been paid, were obtained, "withholding" would continue to be required.

The upshot of these provisions is that in the case a covered expatriate were a beneficiary of a non-grantor trust on the day prior to his expatriation, he would suffer U.S. tax on any distributions received after the date of expatriation to the extent such distributions would have been taxable if he had remained a U.S. person. If the covered expatriate were to have disclaimed his interest in such trust prior to the day before the expatriation date, Section 877A(f) could not apply; however, such disclaimer might well constitute a gift. If the disclaimer occurred after the expatriation, it does not appear that a gift tax could apply, but if the disclaimer were considered a transfer of property to a U.S. person, Section 2801 might apply.

Of course, in the case where the covered expatriate were a beneficiary of a foreign non-grantor trust with no U.S. situs assets, it is unclear how the U.S. could seek to enforce the obligations of the non-U.S. trustee to withhold on subsequent distributions in certain cases.[123]

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[121] Id.

[122] Clinton Administration's Fiscal Year 1996 Budget Proposal (introduced as H.R. 981, 104th Congress), as described in JCS-17-19, at 36.

[123] Cf. *SDI Netherlands B.V. v. Commissioner*, 107 T.C. 161 (1996).

That this application of Section 877A might not be enforceable is, of course, no surprise (even to Congress)[124] and is the subject of some words elsewhere in this paper.

It should be noted that the election provided by the 2009 Notice when effective does not appear only to provide to the covered expatriate such benefits the covered expatriate could have obtained under an applicable tax treaty with respect to a subsequent trust distribution but for the "deemed waiver" of treaty benefits mandated by Section 877A(f)(4)(B). Rather, where the election is effective it appears "no subsequent distribution" from the trust to the covered expatriate will be subject to 30 percent withholding under Section 877A(f)(1)(A).[125] This language by itself does not necessarily mean that the covered expatriate would not be subject to tax under Section 871 or withholding under Section 1441 on any U.S. source fixed or determinable income subsequently received from such trust. However, any such subsequent distribution may be afforded the benefit of, or at least the covered expatriate will not be precluded from claiming the benefit of, an exemption or reduced rate of tax that may be applicable under a tax treaty. A covered expatriate who would not be entitled to claim the benefits of a tax treaty could, however, still obtain a benefit in making the election if subsequent distributions from a trust would not subject him to tax under other provisions of the Code. Thus, for example, a trust, the only assets of which would produce non-U.S. source income or other income that would not subject a non-resident alien to tax thereon, may wish to consider whether the immediate tax cost of making the (cleansing) election outweighs the benefit of avoidance of a continuing tax obligation.[126]

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[124] See JCS-17-19, at 61-64 and 67-68; JCS-2-03, at 5-6, and 8.

[125] Section 7D, 2009 Notice.

[126] Of course, this analysis raises the question of how covered expatriates who are beneficiaries of non-U.S. resident trusts with non-U.S. investments might factor in the likely unenforceability of a tax imposed on the non-U.S. source income of a nonresident alien.

Deferred Compensation Items and Specified Tax Deferred Account

Deferred compensation items and specified tax deferred accounts of a covered expatriate are specifically excluded from the class of property Section 877A(a)(1) treats as having been sold on the day before the expatriation date.[127] A covered expatriate's interest in deferred compensation items is, however, treated differently than his interest in a specified tax deferred account.[128]

A covered expatriate's entire interest in a specified tax deferred account[129] is "deemed" to have been distributed to him on the day before the expatriation date[130] and therefore the covered expatriate will be taxable on such amount although no early distribution penalty shall apply.[131] The 2009 Notice provides that the custodian of a specified tax deferred account must advise the covered expatriate of the amount of the covered expatriate's entire interest in such account as at the day prior to the covered expatriate's expatriation date within 60 days of being provided with a Form W-8CE.[132] A Form W-8CE is apparently a new form mentioned in Section 8D of the 2009 Notice. According to the 2009 Notice it is to be used in connection with deferred compensation items, specified tax deferred accounts and interests in non-grantor trusts for notification to payers that the individual is a covered expatriate. While the 2009 Notice requires the custodian of a specified tax deferred account to provide information relating to the covered expatriate's entire interest therein within the time described, it is unclear what penalties could be

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127 Section 877A(c)(1) and (2).

128 Compare Sections 877A(d) and (e).

129 See Section 877A(e)(2). For example an interest in an IRA.

130 Section 877A(e)(1)(A).

131 Section 877A(e)(1)(B).

132 Section 6, 2009 Notice.

imposed for an inadvertent delinquent notification by the custodian. Nor is it clear what penalty could apply to a covered expatriate who is delinquent in providing the Form W-8CE as required by the 2009 Notice.[133]

Deferred compensation items[134] are broken down into two broad categories: eligible deferred compensation items[135] and all other deferred compensation items.[136] In the case of an eligible deferred compensation item, a payer of such item to a covered expatriate is required to deduct and withhold a tax on the taxable portion thereof at a 30% rate.[137] The tax required to be withheld is treated as having been imposed under Section 871.[138] It should be noted that the requirement to deduct the tax is not, with one exception,[139] dependent on whether the deferred compensation item represents U.S. source income. Nor, as we will see, is it dependent on whether the covered expatriate is or is not a resident in a country with which the U.S. has a treaty that could affect the right of the U.S. to impose the tax. Indeed, in order for a deferred

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[133] Section 8D of the 2009 Notice provides that where a covered expatriate is required to provide a Form W-8CE, he must do so on the earlier of the date which is 30 days after the expatriation date or the date of the first distribution from a non-grantor trust for which an election under Section 877A(f)(4)(B) is not in effect. While the 2009 Notice states that a Form W-8CE is also required to be filed in the case of both eligible and ineligible deferred compensation items, discussed in the succeeding Section, and that in the case of ineligible deferred compensation items the payer must provide a written statement of the covered expatriate's accrued benefit (so that the covered expatriate can report such amount), the 2009 Notice does not indicate when the covered expatriate is to provide the W-8CE in that case.

[134] Broadly defined in Section 877A(d)(4) as including interests in pension plans, 401 accounts and other deferred compensation arrangements including compensatory stock options.

[135] Section 877A(d)(3).

[136] Section 877A(d)(2).

[137] Section 877A(d)(1)(A). The taxable portion is the portion that would be includible in the covered expatriate's income if he remained a U.S. person.

[138] Section 877A(d)(6)(B). It is unclear why Section 871 was not expressly amended to so provide, and whether a statement in Section 877A(d)(6)(B) that an amount is "subject to tax" under Section 871 is sufficient to make it so.

[139] See Section 877A(d)(5) (relating to non-U.S. source compensation attributable to services performed while the covered expatriate was not a U.S. citizen or resident).

compensation item to qualify as an eligible deferred compensation item, the covered expatriate must notify the payer, who must either be a U.S. person or must elect to be treated as a U.S. person for purposes of the withholding provisions of Section 877A(d)(1) and meet such conditions as may be prescribed for qualifying as such, that the covered expatriate is a covered expatriate, and irrevocably "elect" to waive any tax treaty benefits in respect of such deferred compensation.[140]

If any of the conditions for qualifying as an eligible deferred compensation item is not met, the deferred compensation item defaults into the non-eligible category. Two of the conditions for qualifying as an eligible deferred compensation item are dependent on the covered expatriate; namely notification of the payer and an irrevocable treaty waiver. The third condition is dependent on the service recipient or payer of the deferred compensation item. If that person is a non-U.S. person that chooses not to make the necessary election, any deferred compensation to which the covered expatriate is entitled in the future will be treated as non-eligible. The present value of a deferred compensation item that falls into the non-eligible category is treated as having been received by the covered expatriate on the day before the expatriation date, rendering the covered expatriation as taxable thereon notwithstanding there would be no entitlement to receive such amount.[141] Thus, a covered expatriate could find himself owing tax on amounts to which he is not currently entitled and without funds to pay such tax. As noted below, the deferred tax payment provisions do not even apply to this type of "income." If the covered expatriate has other assets subject to levy, quite possibly such property could be a source

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[140] Section 877A(d)(3).

[141] Section 877A(d)(2). The present value is to be determined using the principles of Prop. Treas. Reg. Section 1.409A-4 as if the end of the year were the day before the expatriation date. See Section 6, 2009 Notice.

of payment. If there is no such property subject to immediate levy, collection of the tax may not be immediately possible.

The effect of these provisions, therefore is: (a) in the case of a specified tax deferred account, to require a covered expatriate to pay tax on his entire accrued benefit as at the day before his expatriation date, effectively ending any deferral with respect to such account; and (b) in the case of other deferred compensation (i) if certain eligibility requirements are met to render a covered expatriate liable to pay tax on receipt, regardless of whether the amount thereof had accrued prior to the expatriation date,[142] or (ii) if the eligibility requirements are not met, to trigger a current tax on the accrued benefit to the day prior to the expatriation date. In the case of (a) and (b)(ii) above, there could be significant liquidity and resulting collectability issues. One can easily imagine this potential burden weighing on the mind of the prospective expatriate, thereby undermining the stated policy of removing tax considerations from the decision to emigrate.

Tax Payment Deferral

The payment of the tax liability resulting from a deemed sale may be deferred if the covered expatriate makes a deferral election, which election may be made on a property-by-property basis,[143] until the earlier of the date for filing the tax return for the year in which the property is actually sold or otherwise disposed of or, if earlier, the year of the death of the

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142 Except that deferred compensation accrued for services performed outside the U.S. after the expatriation date would not be subject to tax or withholding. Section 877A(d)(5).

143 Section 877A(b)(1).

covered expatriate.[144] Any tax so deferred bears interest from the date the tax would have been due without regard to the deferral, until the tax is paid.[145]

In order to make a deferral election, the covered expatriate must provide adequate security generally in the form of a bond or letter of credit,[146] enter into an agreement with the IRS and irrevocably "waive" any right under any treaty that would preclude the assessment or collection of the deferred tax.[147] Interestingly, there does not appear to be a requirement in Section 877A(b)(5) for the covered expatriate to waive his or her right to defend against the collection of the tax where the defense is not based on an applicable tax treaty. As will be seen later on, absent a treaty requirement, the collection of a tax judgment in a foreign tax jurisdiction would generally not be permitted. To be sure, the U.S. has several treaties which require the treaty partner to enforce U.S. tax judgments, but several of these treaties do not require such enforcement against that country's nationals.[148]

The waiver required by Section 877A(b)(5) may prevent the covered expatriate from availing himself of such a carve out in an enforcement provision of an applicable treaty. However, such waiver would not appear to waive any impediment to enforceability not contained in a tax treaty, such as under the law of the jurisdiction in which collection is sought. The template agreement attached to the 2009 Notice (the "Template Agreement") appears to deal with this issue. Recital Clause 3 of the Template Agreement states that the covered expatriate by signing the agreement consents to the collection of the tax and waives all defenses against and

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[144] Section 877A(b)(3).

[145] Section 877A(b)(7).

[146] Section 877A(b)(4).

[147] Section 877A(b)(5). Such waiver is to be made on Form 8854. Section 3E, 2009 Notice. See also the discussion relating to enforceability, infra.

[148] See discussion relating to interaction of Section 877A with treaties, infra.

restrictions on the collection of such tax. That recital clause provision goes well beyond the treaty waiver requirement of Section 877A(b)(5), which is contained in Clause 5 of the Template Agreement. Whether such a "waiver" would be enforced in the jurisdiction in which collection is sought is another matter. However, any attempt to claim the lack of enforceability would invariably be viewed as a breach of the tax payment deferral agreement, permitting the IRS to enforce its claim against the security that had been provided, assuming that Recital Clause 3 can be read as part of the operative provision of the Template Agreement.

It appears likely that the tax deferral election will be of limited utility. For example, in the very circumstance where the payment of the tax would be a hardship because of liquidity issues, it may be difficult to provide "adequate security" unless the security to be allowed includes mortgages on or other secured interests in the property for which a tax payment deferral is sought. It is by no means clear, however, that a mortgage or other lien on such property would be deemed to be adequate, even if such lien could be enforceable where the property was situated.[149] Such a mortgage or other lien could never provide security for an amount greater than the value of the property at the time the mortgage or lien was sought to be enforced. If the property declines in value so that its value is less than the "tax due" on the gain resulting from the deemed sale, the security would become inadequate.[150] This "problem" is partially dealt with in Clause 8 of the Template Agreement which gives the Commissioner the right to determine in the Commissioner's sole discretion[151] that the security initially provided is no longer adequate, in

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[149] To be sure, Clause 3 of the Template Agreement in the 2009 Notice states the Commissioner may accept collateral other than a bond or letter of credit.

[150] One of the earlier proposals to introduce an exit tax permitted an election to treat property subject to U.S. tax jurisdiction and thereby exempt such property from a deemed sale. See the discussion in Feingold, supra note 39.

[151] Clause 19 of the Template Agreement in the 2009 Notice provides that the agreement is to be construed in accordance with the laws of the U.S. It is unclear, however, what this means in light of the Supreme Court's holding

which case if the covered expatriate does not "top up" the security the tax payment deferral comes to an end and the security provided as collateral will be applied to the tax liability and interest due. Furthermore, if there is a determination by the Commissioner that the security is no longer adequate and the taxpayer fails to "correct such failure," not only will the tax be deemed to have been due retrospectively but an addition to tax will be imposed under Section 6651(a)(2).[152] In any case, the tax payment deferral does not apply to the tax resulting from the elective end of deferral required by Section 877A(f)(4)(B) nor the end of deferral required by Sections 877A(e)(1) or 877A(d)(2).

A New Inheritance Tax

Subject to certain exceptions and exemptions, Section 2801 imposes a new inheritance tax on a U.S. person who receives a "covered gift" or "covered bequest," with such tax imposed at the highest estate or gift tax rate in effect on the date of the receipt.[153]
Amounts not in excess of the annual gift tax exclusion are exempt from the tax imposed by Section 2801.[154] Additional exclusions apply (a) for gifts or inheritances for which a marital deduction would apply,[155] (b) for gifts to charity[156] and (c) for gifts or inheritances included on a timely-filed gift or estate tax return as subject to U.S. federal gift or estate tax as the case may be.[157] However, the lifetime exclusion in the case of gifts or bequests, currently $5 million for an

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in *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), that there is no federal common law at least in diversity cases. To be sure, this issue is unlikely to arise.

152 Clause 4 of the Template Agreement, 2009 Notice.

153 Section 2801(a).

154 Section 2801(c).

155 Section 2801(e)(3).

156 Id.

157 Section 2801(e)(2).

unmarried individual and up to $10 million for a married couple,[158] does not apply. Thus, a bequest or gift up to the lifetime exclusion amount from a covered expatriate to a U.S. person would be subject to the tax imposed by Section 2801 even though a bequest or gift of such amount from a U.S. person would not be subject to estate or gift tax. The policy reason for the different treatment is not clear.

To be sure, an individual wishing to expatriate and who had the wherewithal and inclination to do so could level the playing field by making gifts to U.S. persons up to the maximum exclusion amount prior to his or her expatriation. In the case of a pre-expatriation gift of property, the donee would generally acquire a basis in such property equal to the donor's basis, plus the amount of the gift tax paid in respect of such gift.[159] It should be noted that Section 2801 does not by its terms treat a U.S. recipient of property which is the subject of a covered gift as having purchased such property for its fair market value, nor does it otherwise address the basis to the U.S. recipient of property which is the subject of a covered gift. Accordingly, a recipient of property which is the subject of a covered gift would obtain a basis in such property as determined under Section 1015. As noted above, this would mean the recipient would acquire the donor's basis in such property. Whether the tax imposed by Section 2801 would increase the basis of such property under Section 1015(d) may well depend on whether the Section 2801 tax were treated as analogous to a gift tax.

Subject to the exclusions and exemptions referred to above, a covered gift or bequest made to a U.S. resident trust would subject such trust to the tax imposed under Section 2801.[160]

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[158] Section 2010(c) as amended by section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (2010).

[159] Section 1015(a) and (d).

[160] Section 2801(e)(4)(A).

While a covered gift or bequest made to a foreign trust would not subject such foreign trust to a tax imposed under Section 2801, any distribution made by such trust to a U.S. person attributable to such gift or bequest is subject to Section 2801.[161] However, in such case the U.S. person receiving the distribution may obtain a deduction under Section 164 for any tax imposed under Section 2801 so that income tax will be imposed on the amount of the distribution net of the tax imposed under Section 2801.[162] A U.S. person receiving a covered gift or bequest may obtain a credit for the amount of any non-U.S. gift or estate tax paid to a foreign country with respect to such covered gift or bequest.[163]

The term covered gift means any gift or bequest acquired directly or indirectly from a covered expatriate.[164] However, any gift or bequest received from an individual who otherwise is a covered expatriate, but who is taxable as a resident for U.S. federal income tax purposes in the year of such gift or bequest, is excluded from the operation of Section 2801.[165] The amount subject to the tax imposed by Section 2801 need not relate to property within the U.S., nor property owned by the covered expatriate at the time of his expatriation.

While the above fairly outlines the applicable provisions of Section 2801, several issues are likely to arise, including how would a U.S. person know that a gift or bequest was acquired directly or indirectly from a covered expatriate. One possibility is to require a U.S. person obtaining any gift or bequest to obtain a certification that such gift or bequest did not come

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161 Section 2801(e)(4)(B). Note also a foreign trust may elect to be treated as a domestic trust. Section 2801(e)(4)(B)(iii). It is unclear why such election would be made.

162 Section 2801(e)(4)(B)(ii).

163 Section 2801(d). While Section 2801(d) does not specifically refer to non-U.S. inheritance taxes, it would seem any such tax would be creditable in the same manner as estate taxes. Cf. Section 2014.

164 Section 2801(e)(1).

165 Section 877A(g)(1)(C).

directly or indirectly from a covered expatriate, upon which certification the U.S. person could rely absent knowledge to the contrary. For answers to this and other questions likely to arise under the new inheritance tax regime, we will just have to wait for future guidance. Significantly, until such future guidance is issued: "Satisfaction of the reporting and tax obligations for covered gifts or bequests received will be deferred."[166] Such deferral, however, does not appear to be intended as a free pass. Rather, the 2009 Notice states that guidance will provide a reasonable period of time between such guidance and the date prescribed for such reporting and tax payments.

Tax Treaty Implications

In order to better appreciate the tax treaty issues that may arise in connection with the application of Section 877A, certain basic principles bear repeating.

1. In general, tax treaties and statutory provisions are of equal force, each representing the supreme law of the land.[167]

2. Tax treaties in general cannot impose a tax obligation greater than that provided by the Code since all revenue bills must in theory originate in the House and treaties come into force with the advice and consent of the Senate.[168] Rather, tax treaties can only provide benefits, not detriments, and therefore where applicable serve to modify the generally applicable Code rules.[169]

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[166] Section 9, 2009 Notice.

[167] *Reid v. Covert*, 354 U.S. 1, 18 (1956); Section 7852(d)(1).

[168] U.S. Const. art. I, §7, cl.1 and art. II, §2, cl. 2.

[169] See Hearings on S. Exec. Doc. E before Subcommittee of the Senate Foreign Relations Committee, 89th Cong., 1st Sess. 4849 (1965); cf. Section 894(d)(1).

3. And while a tax treaty may provide a tax benefit, a later enacted provision of law that intends to specifically deal in some inconsistent way with the provisions of an earlier treaty may override such tax treaty benefit.[170]

4. Very generally, and subject to certain limitations, tax treaties provide benefits to persons resident in the country with which the U.S. has a treaty. However, the U.S. reserves in all of its treaties, in what is generally referred to as a "savings clause," the specific right to continue to tax its citizens as if the tax treaty did not exist.[171] The U.S. Tax Court refused to permit the IRS to interpret a savings clause that reserved to the U.S. the right to tax its citizens as being applicable to former citizens where the savings clause there involved did not so require.[172] As a result, the U.S. renegotiated a number of tax treaties to include within its savings clauses former citizens who expatriated with a bad tax motive and in more recent treaties to also include former long-term residents.

It should be noted that savings clause provisions of tax treaties, where applicable to expatriates, permit the U.S. to continue to exert tax jurisdiction for certain income derived after an expatriation and in some cases only after a tax-motivated expatriation. At the present time, there is no tax treaty provision which expressly reserves to the U.S. the right to apply its tax jurisdiction to income of an expatriate arising <u>before</u> an act of expatriation. Furthermore, as noted in the introductory remarks, since 2006 any existing tax treaty provision which is in conflict with Section 877 is <u>intended</u> to be given effect. Section 877A does not on its face purport to apply U.S. tax jurisdiction to the income of an expatriate arising after the expatriate is

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170 <u>See</u> *Crow*, 85 T.C. 376.

171 In certain treaties the clause has been extended to apply to former citizens and in certain cases former long-term residents. <u>See</u> U.S. Model Tax Treaty, Article 1(4). For a listing of the types of such clauses in existing treaties see Appendix A.

172 *Crow*, 85 T.C. 376.

no longer a U.S. person, but rather treats a covered expatriate as having realized income or gain while such individual was a U.S. person in circumstances where such income or gain would not have been taken into account by a U.S. person who was not a covered expatriate. The question is whether there are any inconsistent treaty provisions to the application of Section 877A.

With a possible exception applicable to certain long-term green card holders, on the face of things no specific treaty savings clause dealing with expatriation would appear to be needed to permit the U.S. to assert its tax jurisdiction since pursuant to Section 877A income or gain is required to be taken into account before the date of expatriation when in most instances the expatriate is a U.S. person to whom the general savings clause would ordinarily apply. Significantly, however, as has been demonstrated earlier, Section 877A does not provide that a taxable event has occurred prior to the expatriation date. Rather, it provides that the event giving rise to tax liability, the expatriation, results in gain being required to be "taken into account" before the event occurred so that a treaty benefit could not apply to prevent the taxation of the amount required to be taken into account, a point to which we will return below.

As has been noted previously, it is possible for a long-term green card holder to be a dual resident of the U.S. and the treaty country and, under an applicable tie-breaker rule of a treaty, to be treated as a resident of the treaty country.[173] However, as also noted, the commencement of residence for treaty purposes would be treated as an act of expatriation at least if such status is not waived and the required notice is given. Since the giving of the notice required by Section 6039G appears to be a condition to a deemed loss of permanent residence under Section 7701(b)(6), it is possible that an individual who retains his green card holder status will not be considered to have expatriated until after the required notice is given, in which case, notwithstanding the retrospective nature of the "gain" required to be taken into account one day

[173] Treas. Reg. Section 301.7701(b)-7(a).

prior to the expatriation date, the individual concerned may be able to claim the benefits of an applicable tax treaty provision at the time the income is required to be taken into account. Nor does it appear that in such case the savings clause of any tax treaty would change the result. Thus, by its requiring a notice before a dual resident taxpayer may be considered to have expatriated, Congress has apparently impaled itself when it comes to long-term residents who claim treaty residence after the effective date of the Act.

To be sure, in a number of treaties the savings clause applicable to expatriates applies only if the expatriation has a bad tax motive. The Service would no doubt argue that since principal purpose is not a defined term in the treaty, under a provision such as Article 3(2) of the U.S. Model Treaty, such term should be defined under U.S. law and that anyone meeting the objective tests under Section 877(a)(1) and who is not excepted from such treatment, is deemed to have a bad principal purpose. This argument, too, might find resistance, particularly in the case of certain treaties, the legislative history of which appears to negate such purpose for nationals of a country returning to reside in that country, which incidentally was generally a fact pattern that would allow for an exception when purpose was a facts and circumstances test.[174]

Acutely conscious of the problems with our tax treaties and possibly not seeking to express so baldly an intention to override any inconsistent tax treaty, Section 877A attempts to moot the issue at least for citizens and long-term residents simply by deeming the gain to arise when in most instances there could be no treaty claim, i.e., the day before the expatriation date.

This retrospective treatment raises several fundamental issues:

1. While Congress may by design expressly override a contrary treaty provision, may an act of Congress be interpreted as having so intended where neither the language of the

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[174] See Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003.

provision nor its legislative history indicates that there was such an intention? The answer to this issue appears to be no.[175] The contrary argument is that the retrospective nature of the inclusion in income required by Section 877A is necessary to carry out underlying policy of removing tax incentives to expatriation. While this may be so, that argument starts to look like the failed argument in *Tedd N. Crow.*[176]

The holding in *Tedd N. Crow* might be read as precluding[177] the Service from getting around Congress' failure to expressly override a contrary treaty provision by interpreting a term as if it did. Perhaps it is a stretch to read that holding as precluding a statutory provision from requiring deemed inclusion. Section 877A effectively determines that a taxable (non-) event occurred prior to the expatriation date, which in most cases is prior to commencement of treaty residence, solely because an expatriation event has occurred, thereby implicitly overriding the effect of a contrary treaty provision that would not permit gain taken into account under normative accounting principles to be subject to tax. This, of course, is a more difficult problem than the case presented in *Crow*. It seems each contracting state may at least within certain limits determine under its law the manner in which it computes "income."[178] Furthermore, it seems each contracting state may amend its rules. Ordinarily any such amendment will be given

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175 Cf. *Crow*, 85 T.C. 376.

176 "According to respondent, the purpose of section 877 is to prevent tax-motivated expatriation, and only his construction of the saving clause will effect this goal. We agree with respondent that we 'must read the [treaty and the statute] to give effect to each if we can do so while preserving their sense and purpose.' Implicit in the above rule, however, is that 'A canon of construction is not a license to disregard clear expressions of congressional intent." *Crow*, 85 T.C. at 384.

177 One of the earlier proposals to introduce an exit tax permitted an election to treat property as remaining subject to U.S. tax jurisdiction and thereby exempt such property from a deemed sale. See the discussion in Feingold, *Proposed Expatriation Rules*, Tax Review No. 154 (April 12, 1995).

178 Certainly each state may provide characterization rules which require certain income to be treated as U.S. source. Cf. *Boulez v. Commissioner*, 83 T.C. 584 (1984), aff'd, 810 F.2d 209 (D.C. Cir. 1987).

effect.[179] However, there are implicit limits to the discretion accorded an interpretation of a term not defined in the treaty. It would seem a contracting state is not free to insist on an interpretation that is inconsistent with either the literal terms of the treaty or its context. The issue, therefore, arises as to whether the literal terms of a treaty or its context preclude a mark-to-market rule for determining income in general or a retrospective mark-to-market rule in particular.[180]

The mark-to-market tax can and in many cases will lead to double tax if the property subjected to a deemed sale and tax by the U.S. when actually sold while the individual is a resident of a treaty country may be subject to a second tax in the country of residence. The treaty country may believe the U.S. has no right to impose its tax on notional income not cognizable under normal accounting principles, in essence because the context of the treaty would preclude such result. For example, such country may, as the U.S. did when Canada first imposed its own exit tax, take the view that such tax was not a creditable tax since it was not imposed on income, nor did such deemed transaction give rise to a basis step up in the U.S. To be sure, these issues were finally resolved through treaty negotiation.[181] Absent such agreement, it would seem that a double tax would most likely apply in many cases.

The above suggests that the imposition of a retrospective mark-to-market tax designed to circumvent a contrary treaty provision could lead to results clearly at odds with the avoidance of double taxation which treaties are designed to prevent and therefore might be viewed as an abrogation of the principles underlying tax treaties. Assuming for the moment that is true, that

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[179] See, e.g., U.S. Model Tax Treaty, Article 3(2).

[180] Related to that issue is the issue of who gets to determine its outcome. With respect to that latter issue, in the first instance the country of the contracting state seeking to impose the tax (i.e., the U.S.) would have its say.

[181] See Convention Between the United States of America and Canada with Respect to the Taxation of Income and Capital, Together with a Protocol to the Convention (the "U.S.-Canada Treaty"), Article 26.

does not necessarily mean Congress may not ignore a purpose of tax treaties or even the most fundamental purpose for which tax treaties are concluded. Putting aside the wisdom of doing so, Congress is free to override or revoke any or all treaties. But courts have required that such intent be specifically stated. The issue, of course, is whether the words used in Section 877A should be read as achieving such an objective. To be sure, the language of Sections 877A(d) and (f) expressly (if not eloquently) override contrary treaty provisions, and therefore it is clear that Congress knows how to expressly indicate its intent to effect a tax treaty override in the context of Section 877A. That Congress chose not to expressly state it was overriding tax treaty provisions in the deemed sale provisions, but apparently attempted to accomplish that objective by applying the tax retrospectively without being required to disclose its intention that it was overriding all tax treaties, is puzzling, but more importantly the issue is whether it is effective, an issue that perhaps one day will be determined by the courts.

<u>The Revenue Principle, (Un)enforceability, and Other Possible Jurisdictional Limitations</u>

When it comes to enforceability of the tax resulting from a deemed sale under Section 877A, there are several principles to be considered.[182] First, although seldom mentioned, there might well be an implied limitation on the jurisdiction of the U.S. to impose a tax beyond its ability to enforce such tax. Indeed, long ago the Supreme Court of the United States at least twice expressed that such a limitation existed in denying the enforceability of a tax imposed on a ship in international waters.[183] Particularly interesting in this connection are the words used by Justice Story:

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182 In addition to the issue of whether a mark-to-market tax may constitutionally be imposed (<u>see</u> discussion, <u>supra</u> note 39) or whether the application of the provisions may be in violation of an existing provision of a tax treaty that the provisions do not indicate there has been an express intention to override (<u>see</u> discussion, <u>supra</u>).

183 *The Appolon, Edon, Claimant,* 22 U.S. 362 (1824); *Crapo v. Kelly,* 83 U.S. 610 (1872).

> The laws of no nation can justly extend beyond its own territories, except so far as regards its own citizens .... And, however general and comprehensive the phrases used in our municipal laws may be, they must always be restricted in construction, to be places and persons, upon whom the Legislature have authority and jurisdiction...."[184]

The issue seldom arises in modern times possibly because of Congressional restraint. The Code does not generally attempt to impose tax on a non-U.S. person's non-U.S. income. Rather, the Code imposes two types of tax jurisdiction, *in personam* jurisdiction in the case of U.S. persons (imposing tax on the worldwide incomes of such persons) and subject matter or source jurisdiction in the case of non-U.S. persons (imposing tax on certain types of U.S. "source" income and on U. S. effectively connected income of such persons).

Under Section 877, except for one caveat, it could hardly be said that there was an attempt to impose a tax on a non-U.S. person's non-U.S. income. To be sure, Section 877 contained a broadened definition of U.S. source income,[185] but not so overly broad that it was out of tune with international standards.[186] By contrast, in certain instances Section 877A attempts to impose a tax on amounts that could not be mistaken for income over which the U.S. could conceivably have subject matter jurisdiction. Consider, in this connection (a) the effect of a deemed sale of non-U.S. situs real or personal property or (b) a distribution from a foreign trust of non-U.S. source income to a covered expatriate after the date of expatriation.[187] Dealing with

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184 *Appolon*, 22 U.S. at 369-70.

185 Section 877(d).

186 Cf. *Di Portonova v. United States*, 690 F.2d 169 (Ct. Cl. 1982) (dismissing the taxpayer's claim that the tax imposed by virtue of Section 877 was not permitted where the tax was imposed on income from U.S. oil and gas rights).

187 The issue also may arise in the case of the payment of deferred compensation in respect of non-U.S. source activities that occurred during the period the covered expatriate was a U.S. person. However, there appears to be two differences: first, absent an election, such amounts will be deemed to be received during the period the covered expatriate was a U.S. person, bringing the issue closer to the situation of a deemed sale; and second, if an election is made the issue appears to be waived.

the latter instance first, it could hardly be argued that imposing the tax on such a distribution is consistent with the reasonable exercise of either *in personam* or subject matter jurisdiction. As so viewed, it appears that the imposition of such tax in such circumstances could be the subject of a challenge on the basis of lack of jurisdiction.[188] Turning to the former case, the issue is somewhat more obscure. As noted earlier, Section 877A attempts to treat the taxable event in the case of a deemed sale of property as occurring when the covered expatriate is a U.S. person, effectively converting amounts that might not be subject to either *in personam* or subject matter jurisdiction to amounts which on their face are subject to *in personam* jurisdiction. This directly raises the issue whether Congress may avoid the implied jurisdictional limitation issue described above simply by treating income to have been earned by a U.S. person who has expatriated while he was still a U.S. person, where the U.S. generally does not treat non-covered expatriates as having income at all in these circumstances, let alone income to which it could exercise its *in personam* jurisdiction.[189]

Enforceability in a Foreign Court

In the preceding section, the issue of whether a U.S. court might refuse to enforce a tax imposed by Section 877A where the imposition of the tax might be construed as beyond the jurisdiction of the U.S. was discussed. Notwithstanding the possibility that a court in the U.S. might for the reasons noted refuse to enforce such a tax, there can be no assurance that this would be the result. Moreover, there will be circumstances where the argument for lack of jurisdiction might be tenuous, for example, in the case of a deemed sale of property situated in

[188] While as noted later on, in many cases the enforceability of such a tax would be highly doubtful, there can be instances where there could be enforcement against other property within the jurisdiction of the U.S. It is in such a case that it is possible the issue might arise.

[189] Cf. *SDI Netherlands*, 107 T.C. 161 (holding that royalties paid by a non-U.S. person to a non-U.S. person would not be considered U.S. source royalties even if a portion thereof related to U.S. exploitation and as such met the statutory definition of U.S. source income).

the U.S. Furthermore, for purposes of this section, it is assumed that the covered expatriate would not have sufficient assets subject to enforcement in the U.S. out of which any tax imposed as a result of Section 877A could be collected.

This leads to the issue of whether a foreign court armed with a judgment of the U.S. for taxes imposed by virtue of the operation of Section 877A would enforce that judgment. In that connection, it has long been recognized as the rule that the courts of one jurisdiction will not recognize the revenue laws of another.[190] That this rule is an impediment to the collection of tax judgments in foreign jurisdictions is well known.[191] It is also well understood that absent a treaty provision that would require a contracting state to enforce a tax judgment of the U.S., it is not likely that such judgment will be enforced.[192] For this reason attempts have been made in a number of treaties to reverse this impediment by requiring each contracting state to give administrative assistance to the collection of the tax liabilities imposed by the other contracting state. While a number of treaties now contain specific provisions that would allow a tax judgment of in one of the contracting states to be enforced in the other,[193] in a number of instances the relevant administrative assistance articles do not permit the enforcement of the tax judgments of the other contracting state.[194] Moreover, in instances where a treaty would permit the collection of a tax judgment, in many cases such permission is not extended to judgments

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190 See *Her Majesty the Queen in right of the Province of British Columbia v. Gilbertson*, 597 F.2d. 1161 (9th Cir. 1979); see also *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398 (1964).

191 See, e.g., FSA 200150001.

192 Id.

193 See, e.g., Convention Between the Republic of Austria and the United States of America for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Article 25; U.S.-Canada Treaty, Article 26.

194 See U.S.-U.K. Treaty, Art. 3(5); Convention Between the Government of the United States of America and the Swiss Confederation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Together with a Protocol to the Convention, Article 26; U.S.-Italy Treaty, Article 26.

against citizens of the other contracting state.[195] Where enforcement is not permitted against a citizen, there does not appear to be any requirement that the citizen be a resident of that State.

Even if the contracting state is permitted to enforce the U.S. tax debt, various features of Section 877A will make the contracting state justifiably reluctant to do so. The U.S. government achieves enforcement of its revenue rules in foreign jurisdictions by requesting the treaty party assist in recovering tax claims in accordance with its own laws and procedures.[196] Notwithstanding the various procedural requirements for making such a request, the contracting state may simply refuse a request to enforce a Section 877A tax debt because doing so may be contrary "to its sovereignty, security, or public policy."[197] In the case where the U.S. is requesting enforcement of provisions that are de facto treaty overrides,[198] the U.S. is essentially flouting the heavily negotiated aspects of reciprocity that are embodied in the convention.[199] In the case where the U.S. is seeking assistance in enforcing mark-to-market treatment on property that, following expatriation, was actually sold and which gave rise to income that the contracting state has already taxed, such assistance will lead to double taxation. Such enforcement would be an outright contravention of the convention against double taxation[200] and, more fundamentally,

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195 See, e.g., Convention Between the Government of the United States of America and the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Article 27(8)(a); Convention Between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Article 27(4); Convention Between the Government of the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income U.S.-Netherlands, Art. 31(4).

196 United Nations Secretariat: Tenth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, "*Mutual Assistance in Collection of Tax Debts*," September 2001, at 25.

197 U.S. Model Treaty, Article 26(7).

198 See discussion, supra.

199 *Mutual Assistance in Collection of Tax Debts*, supra note 196 at 11.

200 Id. at 29.

contrary to the underlying policy of the tax treaties, which is to protect [citizens] from double taxation.[201] This puts the compliant contracting state in the awkward position of either double taxing its own citizen or willingly decreasing its own tax base, which is a fundamental aspect of its sovereignty. For each of these reasons, the requested country may feel justified in refusing to comply under the "contrary to its sovereignty, security, or public policy" clause, thereby undermining the enforceability of Section 877A.

Conclusion

The very provisions of Section 877A which the pundits assume will prevent the bad actors from leaving with their fortunes intact may well have other consequences: keeping those who might have believed that fortunes could be made and enjoyed here and, of all things, kept, even if circumstances unrelated to taxes favored retirement "back home," from staying long enough to amass the fortune in the first place. So perhaps such persons will go prematurely and amass their fortunes elsewhere or, worse still, believing the U.S. to be the equivalent of the "roach motel," not come at all. Others born here, too, might decide to leave before their inheritance comes due or take other planning steps to mitigate the effect of the provisions. Still others, with considerable property outside the U.S. and little property in the U.S., might take a view on the unenforceability of the extra-territorial application of the provisions. To be sure, individuals who have left bearing the covered expatriate cross and later amass a fortune might wish to make a gift of some portion thereof to a U.S. person left behind. Should such individuals worry about Section 2801? Section 2801 is a provision that easily could be avoided simply by spending 183 days in the U.S. in the year of an inter-vivos gift or spending their last years in the

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[201] Id. at 8.

U.S.,[202] in each case weighing the tax cost of U.S. tax residence against the tax imposed by virtue of Section 2801.

Treaty partners might well take a dim view of the potential for double taxation implicit in the deemed sales provisions, as the U.S. did when Canada enacted a similar provision, finally dealing with the harshness of the impact by Protocol to ensure that the incidence of double taxation would be kept to a minimum. How dim a view our treaty partners might take when confronted with a retrospective application of the deemed sale provisions that implicitly is at odds with the savings clauses that have been negotiated remains to be seen. Perhaps these are all subjects for further amendments and a further tightening (legislatively or by regulation)[203] of the provisions that attempt to legislate against the free movement of persons (and perhaps freedom itself). If recent experience is any guide, each such amendment will lead to others as Congressional or regulatory imagination is met with the imagination of those who just wish not to be legally required to pay a tax that Congress imagines to be due. For those so inclined, we who remain tax lawyers will not likely throw up our hands and say there is nothing to be done, but rather we will keep the lights on. There is much to discuss!

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202 Section 877A(g)(1)(C).

203 See Section 877A(i).

APPENDIX A

COMPARISON OF SAVING CLAUSE PROVISIONS IN BILATERAL U.S. TAX TREATIES

Summarized below are the different types of saving clause provisions in bilateral U.S. tax treaties currently in force. The five tables are lists of U.S. income tax treaties that:

1. Contain saving clauses that preserve the right of the U.S. to tax current citizens but do not expressly mention former citizens;

2. Contain saving clauses that expressly apply to current citizens and to former citizens (for 10 years after the loss of citizenship if such loss had as one of its principal purposes the avoidance of tax), but do not expressly mention former long-term U.S. residents;

3. Contain saving clauses that expressly apply to current and former citizens after the loss of citizenship regardless of the reason for such loss;

4. Contain saving clauses that expressly apply to current and former citizen and long-term U.S. residents for ten years after the loss of citizenship if such loss had as one of its principal purposes the avoidance of tax; and

5. Contain saving clauses that expressly apply to current and former citizens and long-term U.S. residents regardless of the reason for such loss (for ten years after the loss of citizenship or residency).

In general, bilateral tax treaties to which the U.S. is a party set forth rules under which an individual may be considered a resident or domiciliary of a signatory nation. The U.S. will typically include a "saving clause" in order to preserve its right to tax certain U.S. individuals, or former U.S. individuals, who are residents of the treaty partner. Such provisions grant the U.S. continued taxing jurisdiction over such current or former U.S. persons. However, the precise language utilized in such provisions varies on a treaty-by-treaty basis. In the five tables, below, various saving clause formulations used in bilateral income tax treaties to which the U.S. is a party are identified.

Table One contains a list of 13 older treaties, currently in force, which do not permit the U.S. to tax its former citizens or former long-term residents under the applicable saving clause. Thus, these treaties may conflict with any attempt on the part of the U.S. to exert taxing jurisdiction over any individual other than a current U.S. citizen. Table Two lists 17 treaties which, by their terms, do not bring former long-term U.S. residents under the taxing jurisdiction of the U.S. Moreover, these treaties require a tax avoidance motivation on the part of the former U.S. citizen. Table Three lists 7 treaties which apply only to current and former U.S. citizens regardless of the reason for expatriation. The 14 treaties listed at Table Four apply to both current and former U.S. citizens and long-term residents, but require a tax avoidance motivation.

The three newest income tax treaties, listed at Table Five, apply to both current and former U.S. citizens and long-term residents, regardless of the reason for expatriation.

Table 1- Income tax treaties that contain saving clauses that preserve the right of the U.S. to tax current citizens but do not expressly mention former citizens or former long-term residents

Treaty Partner	Year Signed	Article No.	Notes
Bermuda	1986	4(1)	
China	1984	Protocol 2	1
Egypt	1980	6(3)	
Greece	1950	XIV(1)	
Iceland	2007	1(4)	
Korea	1976	4(4)	
Morocco	1977	20(3)	
Pakistan	1957	II(1)(i)	2
Philippines	1976	6(3)	
Poland	1974	5(3)	
Romania	1973	4(3)	
Trinidad & Tobago	1970	3(3)	
USSR	1973	7	3

Notes:

1. The Senate Foreign Relations Report and the Treasury Department Technical Explanation to the U.S.-China income tax treaty provide that the saving clause in such treaty is intended to apply to former U.S. citizens whose loss of such status had as one of its principal purposes the avoidance of U.S. tax.

2. The U.S.-Pakistan treaty does not contain a specific saving clause. Instead, the treaty provides that a resident of Pakistan does not include a U.S. citizen. However, the provision is intended to function in the manner of a saving clause.

3. The U.S.-U.S.S.R. income tax treaty that was signed in 1973 remains in effect for the following countries: Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan (See Rev. Proc. 93-22A).

Table 2- Income tax treaties that contain saving clauses that expressly apply to current citizens and to former citizens (for 10 years after the loss of citizenship if such loss had as one of its principal purposes the avoidance of tax), but do not expressly mention former long-term U.S. residents

Treaty Partner	Year Signed	Article No.	Notes
Austria	1996	1(4)	1
Cyprus	1984	4(3)	1
Germany	1989	Protocol: I	1
India	1989	1(3)	1

Treaty Partner	Year Signed	Article No.	Notes
Indonesia	1988	28(3)	1
Ireland	1997	1(4)	1
Israel	1975	Protocol: V(1)	1, 2
Italy	1984	Protocol: I(1)	1
Jamaica	1980	Protocol: I	1
Luxembourg	1996	1(3)	1
New Zealand	1982	1(3)	1
Norway	1980	Protocol: IX	
Portugal	1994	Protocol: 1(b)	1, 2
Spain	1990	Protocol: 1	1, 2
Tunisia	1985	22(2)	1, 3
Turkey	1996	1(3)	1
Venezuela	1999	17(3); Protocol: 1	4

Notes:

1. Per the Technical Explanation, a former US citizen is taxable in accordance with Section 877.

2. Competent authorities shall consult on the purpose of the loss of citizenship.

3. Tax avoidance motive must be acknowledged by the taxpayer or determined by a court. There is also no limit on the number of years that a country may tax its former citizens.

4. Former long-term residents are addresses in the Limitation on Benefits provision of the U.S.-Venezuela income tax treaty (Article 17(3)), which denies such persons the benefits of the treaty for 10 years if the loss of such status had as one of its principal purposes the avoidance of U.S. tax. The effect of this provision is to preserve the right of the United States to tax such former long-term residents.

Table 3- Income tax treaties that contain saving clauses that expressly apply to current and former citizens after the loss of citizenship regardless of the reason for such loss

Treaty Partner	Year Signed	Article No.	Notes
Czech Republic	1993	1(3)	1
Hungary	1979	1(2)	1
Kazakhstan	1993	1(3)	1
Russian Federation	1992	1(3)	1
Slovak Republic	1993	1(3)	1
Switzerland	1996	1(2)	1
Ukraine	1994	1(3)	1

Notes:

1. The treaty contains no restriction on the number of years that either country may tax a former citizen and no requirement that the former citizen expatriated for a tax avoidance purpose.

Table 4- Income tax treaties that contain saving clauses that expressly apply to current and former citizens and long-term U.S. residents for ten years after the loss of citizenship (or relinquishment of residency) if such loss had as one of its principal purposes the avoidance of tax

Treaty Partner	Year Signed	Article No.	Notes
Australia	2001	1(3); Protocol: I(a)	
Barbados	2004	1(3); Protocol 2: I	
Canada	1980	XXIX(2); Protocol: 24(2)(b); XIII(1)	
Estonia	1998	1(4)	
France	2004	29(2); Protocol: XIII(1)	
Japan	2003	1(4)(b)	
Latvia	1998	1(4)	
Lithuania	1998	1(4)	
Mexico	2002	Protocol: I(6)(a)	
Netherlands	2004	24(1); Protocol: 6(a)	1
Slovenia	1999	1(4)	
South Africa	1997	1(4)	
United Kingdom	2001	1(6)	
Thailand	1996	1(2)	

Notes:

1. The applicable saving clause does not, by its terms, apply to former U.S. citizens who are nationals of the Netherlands.

Table 5- Income tax treaties that contain saving clauses that expressly apply to current and former citizens and long-term residents (for ten years after the loss of citizenship or relinquishment of residency), regardless of the reason for expatriation

Treaty Partner	Year Signed	Article No.	Notes
Belgium	2006	1(4)	
Denmark	2000	Protocol: I	
Finland	1989	Protocol: I(1)(4)	
Sweden	1994	1(4); Protocol: I(a)	