THE PROPOSED REGULATIONS SHINE A LIGHT ON THE MYSTERIOUS NATURE OF THE SECTION 2801 TAX AND ITS INTENTIONS

THE TAX CLUB

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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 U.S. citizenship for the principal purpose of the reduction of 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 on such income). Moreover, the provision expanded the definition of U.S. source income to

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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).

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 and of more interest for the purpose of this article, 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 a resident of, or in the case of an applicable estate or gift tax treaty, domiciled 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, or the imposition of the estate or gift tax in respect of certain assets of a Section 877(b) taxpayer unless the treaty expressly reserved to the U.S. the right to impose a tax on the income of, or the assets transferred by, a Section 877 taxpayer. In this connection, notwithstanding the Service's published position to the contrary, the U.S. 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] In response, 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 Sections 877, 2107 and 2501(a)(3), 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 the Code.[13] The U.S. Treasury

[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).

instituted a program of renegotiating existing tax treaties to expand tax treaty savings clauses to include former 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 income tax treaties and very few of its estate or gift tax 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 Sections 877, 2107, 2501(a)(3) and 2511 continue to take precedence over these provisions.

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]

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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 p.30, 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).

A number of significant issues arising under the so-called exit tax provisions imposed by Section 877A and related provisions have been explored in some detail elsewhere.[19] It has been observed that in a number of respects the mark-to-market exit tax provisions of Section 877A go far beyond the stated purposes of removing a tax incentive for expatriation, and in a number of cases unnecessarily so. Whether the mark to market regime of Section 877A as enacted imposes so significant a tax impediment to expatriation that it violates the fundamental rights of citizens and residents to remove themselves from the U.S. is better left for consideration elsewhere;[20] whether the exit tax regime of Section 877A will be easier to administer or enforce than the Section 877 regime it replaced in light of its complexity, the potential conflicting tax treaty provisions and issues relating to impermissible extra-territorial application is beyond the scope of this article.[21]

Although skeptical about its wisdom, this article is not intended to pass judgment on the policy considerations relating to the exit tax provisions nor their "legality"; readers are invited to draw their own conclusions. Rather, this article is about the mysterious nature of the Section

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[19] See Feingold, Section 877A, A Technical Journey through an Imaginary Construct, Tax Review No. 281 (January 2011).

[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").

[21] The reported number of annual expatriations occurring prior to the enactment of the Act was 470; expatriations have risen steadily since the Enactment of the Act, with 4,279 occurring in 2015. See International Tax Blog, http://intltax.typepad.com/intltax_blog/number-of-expatriates/. These numbers, however, may not give a true indication that the Act has not been an impediment to expatriation. Rather, the enactment of FATCA (Sections 1471-1474) no doubt has influenced many non-resident U.S. citizens who had little to be concerned about with U.S. taxation, in general, or the exit tax, in particular, to relinquish their citizenship to avoid onerous reporting requirements and difficulties with retaining their non-U.S. banking relationships while remaining U.S. citizens. When one discounts for this factor, it is likely, based on anecdotal evidence, that many U.S. persons who would like to change their status feel economically compelled not to do so because of the confiscatory nature of the exit tax provisions. Of course, putting up impediments to reduction of U.S. tax through a change of status is not confined to expatriation, See, e.g., Sections 367, 684, 7874. However, at least in certain cases, the constitutional issues alluded to before do not arise in so clear a manner in the situations covered by those provisions.

2801 tax enacted with the exit tax provisions, and how or whether the application of Section 2801 may conflict with existing estate and gift tax treaties.[22]

The Section 2801 Tax,[23] in General

In general, Section 2801(a) imposes a transfer tax, applicable to "covered gifts" and "covered bequests." Where applicable, and subject to certain exclusions,[24] the Section 2801 tax is imposed at the highest estate tax rate in effect on the date of the covered gift or bequest,[25] on the excess, if any, of the value of a "covered gift" or "covered bequest" over the dollar value in effect under Section 2503(b).[26] A covered gift or covered bequest is a gift or bequest that is directly or indirectly made by a "covered expatriate," and received by a person considered to be a U.S. citizen or resident.

While the income tax provisions relating to Section 877A came into effect on the date of enactment of the Act, the IRS early on stated that the tax imposed by Section 2801, which also came into effect on enactment of the Act, would be deferred until the issuance of further guidance.[27] On September 10, 2015, proposed regulations were issued which would continue to postpone the date for reporting a transfer subject to Section 2801 and the payment of the tax

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[22] A number of commentators have discussed certain of the effects of the section 2801 tax. See, e.g. Ladislaw, *Proposed Regulations on Gifts and Bequests from Covered Expatriates*, 149 Tax Notes No. 10, December 7, 2015; Freda, *Proposed Expatriate Tax May Mot Apply Under Estate, Gift Treaties, Practitioner Says*, G-1, Bloomberg Daily Tax Report, October 23, 2015; Schoenbaum, 6986 T.M. *Estates and Gift Tax Treaties*; American Bar Association, International Tax Planning Committee of the Income and Transfer Tax Planning Group of Real Property, Trusts, and Estates Law Sections (December 2015).

[23] For convenience, we will refer to the tax imposed by Section 2801(a) as the "Section 2801 tax."

[24] For example, for gifts or inheritances for which a marital deduction would apply and for gifts or bequests to charity. Section 2801(e)(3).

[25] See Section 2001(c).

[26] Currently $14,000. Section 2801(c).

[27] See Notice 2009-85, 2009-2 C.B. 598 (the "2009 Notice"), Section 9.

required thereunder until a reasonable period after final regulations are promulgated and the relevant tax return (Form 708) upon which reporting is required is issued.[28] In light of the proposed regulations, one must assume final regulations will be promulgated and the new rules will come into effect at some point, although it is not yet clear when that will be. Significantly, when they come into effect the Section 2801 tax, as advertised in the 2009 Notice, will be retroactive so that a transfer subject to the Section 2801 tax that occurred after the effective date of the Act will be taxable whether or not the transfer occurred many years prior to the promulgation of final regulations.[29]

Comparison of the Section 2801 Tax with the Estate and Gift Tax

The Section 2801 tax is imposed on a direct or indirect transfer by a covered expatriate of cash or property regardless of the nature or situs of the cash or property. While the Section 2801 tax is similar in nature to the estate tax imposed by Section 2001 and the gift tax imposed by Section 2501(a), which are imposed in connection with the transfer of a taxable estate or gift as the case may be, there are differences between the estate and gift taxes on the one hand and the Section 2801 tax on the other. First, the estate and gift taxes are payable in the first instance by the transferor (the executor in the case of the estate tax and the donor in the case of the gift tax), with the transferee becoming liable only if the tax imposed is not sooner paid by the transferor.[30]

[28] Prop. Reg. § 28.6071-1(d).

[29] Prop. Reg. § 28.2801-1(b) and -4(g). See *Redstone v. Comm'r*, T.C. Memo 2015-237, 21-23 (T.C. 2015). In *Redstone*, the Service sought to assess tax with respect to a gift the taxpayer had received 27 years before. The taxpayer contended that the assessment was barred by laches. The Tax Court initially stated that "[i]t is well settled that the United States is not subject to the defense of laches in enforcing its rights." However, the court went on to say that "the inapplicability of the laches doctrine is especially clear where (as here) the Government seeks to enforce tax claims that are governed by an express statute of limitations," and then pointed out that the taxpayer had not met the procedural requirements or the burden of proof that would apply had a laches defense been available. The inclusion of these last two rebuttals begs the question of whether the court would have been receptive to a laches argument in a case where there was no explicit statute of limitations, and the taxpayer met the applicable procedural requirements and burden of proof.

[30] Sections 2002, 2502(c) and 6324.

The Section 2801 tax, however, is payable only by the recipient of the bequest or gift who is a "U.S. citizen"[31] or U.S. resident and to that extent is similar to an inheritance tax, a feature which could have relevance under Section 2801(d)[32] and existing estate and gift tax treaties.[33] Second, the Section 2801 tax is designed to apply where the estate and gift tax could not because of the non-U.S. person status of the decedent or donor: indeed, the Section 2801 tax is intended as a substitute for the estate or gift tax that would have been payable by a covered expatriate on a transfer to a U.S. recipient had the covered expatriate not expatriated[34] but which is not payable because of the status of the covered expatriate as a person not subject to estate or gift tax on the transfer of non-U.S. situs property. As a result, the Section 2801 tax is not intended to apply with respect to property transfers of U.S. citizens or residents[35] and for this purpose the proposed regulations would interpret the term resident to mean domiciliary.[36] A transfer by a non-U.S. person is also excepted from the Section 2801 tax but only if the transfer is treated as being subject to an estate or gift tax on a timely-filed return.[37]

Third, while a foreign estate tax paid with respect to property situated within the country imposing the tax may be credited against the federal estate tax,[38] there is no foreign tax credit

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[31] As discussed, infra p. 23, Section 2801(e)(4)(A) treats a U.S. resident trust in the same manner as a U.S. citizen for the purpose of the imposition of the Section 2801 tax.

[32] Discussed, infra pp. 9-10.

[33] Discussed, infra p. 30.

[34] Sections 2103, 2104; 2511(a).

[35] Cf. section 877A(g)(1)(C).

[36] Prop. Reg. § 28.2801-2(b). See discussion infra as to whether this interpretation is correct in light of the statutory language.

[37] Section 2801(e)(2).

[38] Section 2014(a) and (b). See also discussion infra p. 30 relating to the interaction of estate and gift tax treaties.

applicable against gift taxes imposed. By contrast, Section 2801(d) allows for a reduction in the Section 2801 tax for foreign gift or estate tax paid with respect to a covered gift or bequest by the amount, if any, of the gift or estate tax paid to a foreign country with respect to the covered gift or bequest in question[39] so that a foreign tax paid with respect to a covered gift or bequest is effectively credited against the Section 2801 tax. Unlike the credit for foreign estate taxes paid afforded by Section 2014, there is no requirement in Section 2801(d), and the proposed regulations would impose no requirement, that the foreign estate or gift tax be paid with respect to property situated in the foreign country imposing the tax for the reduction under Section 2801(d) to apply.[40] On the other hand, the regulations promulgated under the estate tax provisions make it clear that creditable foreign taxes include inheritance taxes,[41] but there is no similar reference in the proposed regulations under Section 2801(d), leaving one to wonder whether the omission was an oversight and will be corrected in the final regulations or was intended. Since the Section 2801 tax is by its very nature similar to an inheritance tax, it would seem odd indeed to exclude a foreign inheritance tax imposed on a U.S. recipient subject to foreign transfer tax in respect of a covered gift or bequest from the reduction in tax afforded by Section 2801(d) simply because the tax is payable by the recipient rather than the donor or estate and one would hope that this will be clarified in the final regulations.[42] In any case, the proposed regulations provide that in order to obtain the reduction in the Section 2801 tax afforded by

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[39] Section 2801(d). The proposed regulations interpret the term "foreign country" to include possessions and political subdivisions of foreign states. Prop. Reg. § 1.2801-4 (e). This interpretation is consistent with Reg. Sec 20.2014-1(a) applicable to credits for foreign estate tax.

[40] Compare Section 2014 (b) and Reg. Sec 20.2014-1(b) which limits the credit for foreign estate tax paid to the taxes imposed on property situated within the foreign country imposing the tax.

[41] See Reg. Sec. 20.2014-1(a).

[42] As discussed infra p. 30, the issue may be moot in the case of an inheritance tax covered by an applicable estate and gift tax treaty.

Section 2801(d) to the U.S. recipient for the foreign estate or gift tax imposed on the covered gift or bequest, the U.S. recipient must attach to the Form 708 required to be filed a copy of the foreign estate or gift tax return reporting the gift or bequest and a copy of the receipt or cancelled check for payment for the foreign estate or gift tax.[43]

Whether Section 1015(d)(2) is Applicable to the Section 2801 Tax Imposed on the Receipt of a Covered Gift

It is possible that the differences described above between the estate and gift tax for which the Section 2801 tax acts as a partial replacement and the Section 2801 tax were of a sufficient magnitude that Congress felt it more convenient to include the provisions of Section 2801 in a separate Chapter of the Code[44] rather than as an amendment to the estate and gift tax provisions contained in Chapters 11 and 12 of the Code.[45] Whether intended by Congress or not, the inclusion of Section 2801 in Chapter 15 of the Code rather than as an amendment to the estate and gift tax provisions that appear in Chapters 11 and 12 of the Code also appears to be the basis for a conclusion in the proposed regulations that the Section 2801 tax is not a gift tax for purposes of Section 1015(d).

Under Section 1015, the donee of a gift generally acquires a basis in the property equal to the donor's basis.[46] The basis to the donee so determined is, however, increased (but not above the fair market value of the gift) by the amount of the gift tax paid with respect to the gift.[47] In determining the amount of gift tax paid with respect to a gift for purposes of the rule in Section

[43] As well as certain additional information. See Prop. Reg. § 28. 2801-4(e).

[44] Chapter 15.

[45] Cf. Section 2107.

[46] Section 1015(a). If such carryover basis exceeds the fair market value of the gifted property, then for purposes of determining loss, the basis of the property to the donee shall not exceed the fair market value of the gifted property.

[47] Section 1015(d)(1)(A).

1015(d)(1)(A), Section 1015(d)(2) provides that the amount of gift tax paid (with respect to any gift) is an amount which bears the same ratio to the amount of gift tax paid under Chapter 12 "with respect to all gifts made by the donor for … [the applicable period]." The phrase "gift tax paid under Chapter 12" was, of course, intended to refer to the gift tax then contained in Chapter 12 of the Code at a time when there was no Chapter 15.[48] If, as it appears was intended by the enactment of Section 2801, the Section 2801 tax imposed on the receipt by a U.S. recipient of a covered gift is in substitution for the gift tax that would have been imposed but for the expatriation of the donor, then it would seem a sensible rule would treat the Section 2801 tax paid on the receipt of a covered gift in the same manner as a gift tax paid for purposes of Section 1015(d)(2) notwithstanding that the Section 2801 tax is imposed under Chapter 15 and not Chapter 12. Nevertheless, the proposed regulations would reach the contrary result, stating without any discussion that: "section 1015(d) does not apply to increase the basis in a covered gift to reflect the tax paid under this section."[49] While not explained further in the Preamble to the proposed regulations, the rule proposed to be adopted in the regulations may be based entirely on the reference to Chapter 12 in Section 1015(d)(2), which reference the regulations promulgated under Section 1015(d) has ignored. Given the reference to Chapter 12 in Section 1015(d)(2), if the rule in the proposed regulations denying a basis step-up under Section 1015(d)(2) for the Section 2801 tax paid by the U.S. recipient of the covered gift were to be adopted in the final regulations, it might be difficult for a court to hold such a rule to be invalid, even though treating the Section 2801 tax imposed on the U.S. recipient of a covered gift as

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[48] Indeed, Treas. Reg. § 1.1015-5(a) refers only to the gift tax paid with respect to the gift without any further limitation to gift taxes paid under Chapter 12

[49] Prop. Reg. § 28.2801-6(a).

sufficiently similar to a gift tax for purposes of Section 1015(d) would appear more consonant with the general thrust of Section 2801.[50]

Exclusion from the Term "Covered Expatriate" and its Effect on Whether there is a Covered Gift or Covered Bequest

The terms "covered gift" and "covered bequest" mean any gift or bequest, not otherwise excluded from being considered a covered gift or covered bequest,[51] that is acquired directly or indirectly from an individual who is a "covered expatriate" at the time of the covered gift or in the case of a bequest, at the time of his or her death. For this purpose, the term "covered expatriate" has the meaning assigned to that term in Section 877A(g)(1),[52] except that for the purpose of Section 2801, Section 877A(g)(1)(C) excludes from the definition of covered expatriate a person who at the time of the gift or at his or her death is a U.S. citizen or resident.

In this connection, Section 877A(g)(1)(C) appears in Subtitle A of the Code and not Subtitle B. For purposes of the Code other than Subtitle B, in the case of an alien, the term "resident" has the meaning assigned to that term under Section 7701(b) and not the meaning of that term as used for the estate and gift tax provisions, which appear in Subtitle B.[53] Thus, literally, an alien who meets the definition of resident under Section 7701(b) would be considered a resident for purposes of Section 877A(g)(1)(C), a provision contained in Subtitle A, regardless of whether such person was a U.S. domiciliary. Accordingly, depending on the

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[50] See the discussion infra p. 25 relating to Section 164; See also the discussion, infra p. 30 relating to the interaction of U.S. estate and gift tax treaties with Section 2801.

[51] Transfer for which the marital or charitable deductions would apply are excluded from covered gifts and covered bequests. Section 2801(e)(3).

[52] In general, it means an individual who relinquished U.S. citizenship or lost his status as a long-term green card holder after June 17, 2008 if at the time of such event the individual met certain minimum asset and average income tax liability tests. To be sure, there are certain exceptions, but those exceptions are not relevant to the issues discussed herein.

[53] The term "resident" means domiciliary for estate and gift tax purposes. See Treas. Reg. § 20.0-1(b)(1) and Treas. Reg. § 25.2501-1(b).

application of Section 7701(b) to the facts of a particular case, an individual could be considered a U.S. domiciliary (and therefore a resident for gift or estate tax purposes) but not a resident for purposes of Subtitle A (i.e., for any purpose other than the estate tax, the gift tax or the Section 2801 tax), or in a given year a resident for income tax purposes but not a resident for gift and estate tax purposes.

If at a time of an otherwise covered gift or bequest, i.e., any gift by a covered expatriate not expressly excluded from being considered a covered gift,[54] the donor was a resident for U.S. federal income tax purposes ("an income tax resident"), then it would appear that such gift could not be a covered gift because at the time made the donor could not be considered a covered expatriate for purposes of Section 2801. Nevertheless, the proposed regulations adopt the definition of resident contained in the regulations under Subtitle B so that a U.S. income tax resident who otherwise is a covered expatriate but was not domiciled in the U.S. at the time of a gift or immediately prior to his death would be considered a covered expatriate for purposes of Section 2801.[55] In this connection, the Preamble to the proposed regulations states as it must that Section 877A(g) adopts the income tax definition of the term "resident." Nevertheless, the Preamble goes on to state that since Section 2801 "imposes a tax subject to Subtitle B" that therefore the definition of resident under Subtitle B generally should apply for purposes of Section 2801.

It is true that Section 2801 is contained in Subtitle B, and that along with Section 2801 the gift and estate tax provisions are incorporated therein. It is also true that adopting the domicile definition of the term resident for purposes of Section 877A(g)(1)(C) would be

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[54] See discussion of Section 2801(e)(2), infra p. 16 and Section 2801(e)(3).

[55] See Prop. Reg. § 28.2801-2(b).

consistent with an intention not to impose both a gift or estate tax and a Section 2801 tax on the same transfer when all transfers by the transferor are subject to a gift or estate tax regardless of where the transferred property is situated. However, Section 2801(f) makes it clear that for the purpose of the definition of covered expatriate as used in Section 2801 one must refer to Section 877A(g)(1)(C), which because it is in Subpart A, incorporates the income tax definition of the term resident. To be sure, such an interpretation would permit a covered expatriate to avoid the Section 2801 provisions by the expedient of becoming a U.S. income tax resident for the year in which a gift is intended to be made to a U.S. person. Nevertheless, it is difficult to see how a contrary interpretation could be supported by the statutory language. Moreover, as described infra, the possibility of both an estate or gift tax and a Section 2801 tax being imposed on the same transfer does not appear to be precluded in the case of transfers of U.S. situs property by non-U.S. persons.[56]

To be sure, for other purposes of Section 2801, such as determining whether the recipient of the gift or bequest is a person required to pay the Section 2801 tax, the Code does not preclude the adoption of a regulation defining the term resident as elsewhere defined in regulations interpreting other provisions of Subtitle B. Thus, the rule in the proposed regulations that for an individual not considered to be a U.S. citizen to be liable to pay the Section 2801 tax, such person must be a U.S. domiciliary is not precluded by the statute and therefore would be given effect if adopted in the final regulations. Adoption of this rule in the proposed regulations would in many cases appear to have the effect as if the Section 2801 tax, which is payable only by a U.S. recipient, may be imposed only if an individual who is a U.S. recipient would be liable to pay a gift tax (or on his death, an estate tax) on a further immediate transfer of the property

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[56] See Section 2801(e)(2)(A) and (B) and discussion infra pp. 16-20.

regardless of whether such immediate transfer would otherwise have been subject to estate or gift tax.

Covered Gifts or Bequests do not Include Gifts or Bequests Otherwise Subject to Gift or Estate Tax if Timely Reported as Such

Section 2801(e)(2)(A) excludes from the definition of covered gift "any property shown on a timely-filed return of tax imposed by chapter 12 which is a taxable gift of the covered expatriate." Section 2801(e)(2)(B) excludes from the definition of a covered bequest "any property included in the gross estate of the covered expatriate for purposes of chapter 11 and shown on a timely-filed return of tax imposed by chapter 11 of the estate of a covered expatriate."

While the term "taxable gift" is not further defined in Section 2801(e)(2)(A), the lead-in caption of Section 2801(e)(2) which reads: "Exceptions for transfers otherwise subject to estate or gift tax" makes it clear that gifts which would be subject to gift tax regardless of the status of the donor would be excludable under Section 2801(e)(2)(A). To qualify for the exclusion, a gift must be subject to the gift tax. Thus, for example, since a gift of non-U.S. situs property of an alien non-U.S. domiciliary would not be included within the term taxable gift under the Code[57] such a gift would not be excludable from the term covered gift. By contrast, apart from the application of an applicable treaty provision,[58] a gift of, for example, tangible property located in the U.S. would be subject to gift tax and therefore excludable from covered gifts. Under Section 2501(a)(3)(A), since with an exception that could not be applicable to a covered expatriate, a gift of intangibles made by a covered expatriate would not constitute a taxable gift notwithstanding

[57] Treas. Reg. § 25.2511-3(a).

[58] See discussion infra p. 30.

there is no express exclusion for such gifts from the term taxable gift as used in Section 2503, such a gift would not be excludable from being a covered gift.

A bequest from a covered expatriate may be excludable from constituting a covered gift under Section 2801(e)(2)(B) to the extent the bequest consists of property that is includable in the gross estate of a covered expatriate. Since apart from tax treaty considerations, non-U.S. situs property of a covered expatriate is not includable in the gross estate of an alien non-U.S. domiciliary,[59] such property is not excludable by virtue of Section 2801(e)(2)(B) from being included as a covered bequest.

The proposed regulations adopt the principle that for an exclusion from covered gift or bequest to apply to property excludable under Section 2801(e)(2)(A) or (B), the transfer of the property in question (by gift or bequest) must not only be subject to gift or estate tax, as the case may be, but also must be reported as being subject to the gift or estate tax on a timely-filed gift or estate tax return.[60] This interpretation appears to be in accord with the statutory language. Significantly, however, the proposed regulations add an additional requirement for the exclusion from covered gift or covered bequest of property excludable under Section 2801(e)(2)(A) or (B) to apply that is not contained in the statute: in the case of an otherwise covered gift, "the donor also timely pays the gift tax, if any, shown as due on that return"; in the case of an otherwise covered bequest, "the estate also timely pays the estate tax, if any, shown as due on the return."[61] Since the timely payment requirement added by the proposed regulations is not contained in Section 2801(e)(2)(A) or (B), such timely payment requirement should not be held to affect

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[59] Section 2103. See also discussion infra p. 30 regarding the application of estate and gift tax treaties.

[60] See Prop. Reg. § 28.2801-3(c)(1) and (2).

[61] Prop. Reg. § 28.2801-3(c)(1).

whether a gift or bequest of otherwise excludable property was a covered gift or bequest, even were it to be incorporated in final regulations.

Consider the case of a covered expatriate who sells his interest in U.S. real property to a U.S. family member at a purchase price later determined to contain a bargain element. Such a sale to the extent of the bargain element would constitute a taxable gift to the family member who purchased the property. Because it is likely that the final determination of the bargain element would not be made until well after the gift tax return would be due for the year in which the bargain sale occurred, the late filing of the gift tax return of itself would literally appear to disqualify the gift element from being excluded from being a covered gift even though the gift element would be subject to gift tax.[62] As a result, not only would the covered expatriate seller /donor be subject to gift tax on the deemed gift portion of the value of the transferred property for which there had not been adequate consideration, but the U.S. purchaser/donee would be deemed to have received a covered gift to the extent of the bargain element and would be subject to the payment of the Section 2801 tax on such portion. In this illustration, transfer taxes aggregating 80% of the bargain element would be imposable (40% gift tax on the donor, or if not paid by the donor on the donee, plus a 40% Section 2801 tax on the donee). The intention of Section 2801 is to impose a transfer tax that would have been imposable but for the expatriation. If such tax is otherwise imposable (and indeed if in fact it is imposed), it seems inconsistent with the legislative intent to impose a second transfer tax. Yet in the circumstances posited, there is nothing in the statutory language or the proposed regulations which would preclude that result.[63]

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[62] Section 2801(e)(2)(A); Prop. Reg. § 28.2801-3(f), Example 2.

[63] Cf. Section 2801(d).

Assume for the moment that to avoid that result, the donor/seller either timely filed a U.S. gift tax return reporting the sale transaction as being subject to gift tax with respect to any bargain element or otherwise provided adequate disclosure,[64] but took the position no gift tax was due because there was no bargain element. Under a literal reading of the statute, this disclosure would make an otherwise excludable gift excludable, even if it were later determined that there was a bargain element and therefore a gift tax was due, since no gift tax would be shown as due on the timely-filed gift tax return. While this result seems plausible where it was reasonable to take the initial position that there was no bargain element, it seems less so if there were no reasonable basis for not showing that a gift tax was due.

Suppose the estate of a covered expatriate makes a bequest to a person that could be subject to the Section 2801 tax of an interest in a partnership formed under foreign law that owns U.S. real property not used in a U.S. trade or business and takes the position on a timely-filed estate tax return that the bequest should be treated as a bequest of U.S. situs property subject to estate tax[65] and timely pays the estate tax shown as due on such return. Could the Service, in a proceeding involving the U.S. beneficiary, later take the position that the bequest was not

[64] Cf. Section 6501(e)(2); Treas. Reg. § 6501(c)-1(f)(3) and (4).

[65] See and compare Rev. Rul. 55-701 (holding that a partnership is situated where the partnership business is carried on); GCM 18718, 1937-2 C.B. 476 (holding that a nonresident alien's interest in a French civil law partnership that was engaged in business in the United States was not US situs property) (declared obsolete by Rev. Rul. 70-59, 1970-1 C.B. 280). This issue is one over which much ink has been spilled by commentators. See, e.g., Howard J. Barnet, Jr., *Estate and Gift Tax Situs Issues for Direct Investment in the United States*, The Tax Club, December 18, 2013. The uncertainty is not limited to the estate tax context; there are also unanswered questions with respect to the gift tax. For example, consider a covered expatriate making a gift to a US person of an interest in a partnership formed under foreign law, where the foreign law treats the holder of a partnership interest as owning a share of the partnership's assets rather than owning interest in an entity. It is not clear whether that covered expatriate would be deemed to have made a gift of an intangible partnership interest, and thus not taxed under section 2501, or of the tangible property owned by the partnership, and thus subject to tax under section 2501 if that property has US situs. Previous decisions have treated gifts and bequests of partnership interests as gifts and bequests of intangibles for gift and estate tax purposes. *See Blodgett v. Silberman*, 277 U.S. 1 (U.S. 1928); *Pierre v. Commissioner,* T.C. Memo 2010-106 (2010). However, these decisions have been grounded in the characterization of the partnership interest under the law of the state where the partnership was organized. It remains to be seen how a court would treat a partnership interest where local law treated the partners as owning the property of the partnership.

excluded from being a covered bequest because it consisted of a foreign situs property excludable from taxable bequests even though U.S. estate tax was paid by the estate? Does it make a difference if at the time of the determination affecting the beneficiary the estate could no longer obtain a refund of the estate tax paid because of the statute of limitations? In this connection, Section 2801(e)(2)(A) would appear to exclude from covered bequests property shown as being subject to estate tax on a timely-filed estate tax return which is a taxable bequest by the covered expatriate. That language could suggest the mere reporting of the bequest as being subject to estate tax on a timely-filed estate tax return, while necessary for the exclusion to apply, is not controlling and as a result in a case where a transfer is reported as subject to gift or estate tax, it would appear the IRS could theoretically be permitted to question the application of the gift or estate tax and therefore the exclusion from a covered gift or covered bequest in a proceeding against the U.S. recipient. Whether the IRS would do so where it has assessed and collected the gift or estate tax appears unlikely. Suppose, however, the transferor later changes its position and files a claim for refund. Would the mere filing of a claim for refund, even before its resolution, adversely affect whether the property is excludable? Noteworthy in this connection, Prop. Reg. § 28.2801-3(a)(1) and (2) literally appear to require the gift, in fact, be a "taxable gift" for the exclusion to apply, raising the issue of whether the term "taxable gift" or "taxable bequest" could be construed to mean a gift or bequest ultimately determined as being subject to gift or estate tax.

Burden of Proof as to Whether Gift or Bequest is a Covered Gift or Bequest

Note that a determination of whether a covered gift has been received must be made within the time prescribed for filing (the new) Form 708 (yet to be issued). In general, the proposed regulations inform us that the filing date is on or before the 15th day of the 18th calendar

month following the year in which the covered gift or bequest was received[66] and may be extended[67] for six months.[68]

The determination of whether a gift or bequest is a covered gift or covered bequest would entail determinations of whether the donor or decedent was a covered expatriate for purposes of Section 2801, and whether the subject of the gift or bequest was otherwise excludable from being considered a covered gift or bequest. In a number of instances these determinations may not be straightforward even if the recipient had all of the facts.[69] Moreover, in many instances the facts to make the necessary determinations would not be in the possession of or easily obtainable by the recipient. Nevertheless, the proposed regulations adopt the principle that it is the responsibility of the U.S. recipient that could be liable to pay the Section 2801 tax to make these determinations.[70] While this proposed rule may merely have intended to put U.S. recipients on notice of their burden of proof concerning whether the gifts or bequests they have received are covered gifts or covered bequests, it could be read as increasing the burden on any U.S. recipient who receives a gift from a non-resident alien donor and reports such gift on a Form 3520 by effectively requiring the donee to obtain the status of the decedent or donor as a covered

[66] Prop. Reg. § 28.6071-1(a).

[67] Prop. Reg. § 28.6071-1(b).

[68] In no case will the due date for filing the requested return be before a "reasonable period" after the date of publication of the final regulations. Prop. Reg. § 28.6011-1(d). Interestingly, under the general rule of Section 6501, the statute of limitations for imposing the Section 2801 tax would not start to run until the filing of the relevant Form 708 which could not be filed until the form is issued. Thus, for example, the statute of limitations for imposing the Section 2801 tax for covered gifts made in 2008 but after June 17, 2008 (the effective date of the enactment of Section 2801) remains open and will continue to remain open for three years after the new Form 708 were filed. An interesting question may arise if the Form 708 is not issued for a "sufficiently long" period so that a taxpayer may argue for the application of the equitable doctrine of laches. See discussion supra note 29.

[69] The due date for filing a gift tax return is April 15 following the close of the calendar year. Section 6075. The due date for filing an estate tax return is 9 months after the date of the decedent's death. *Id.* Both due dates are well within the time the Form 708 must be filed once the form were to be issued. See supra note 63 regarding whether certain property could be considered U.S. situs property.

[70] Prop. Reg. § 28.2801-7(a).

expatriate and if the decedent or donor was a covered expatriate to obtain a copy of any relevant gift or estate tax return filed in connection with the transfer if the U.S. recipient wishes to exclude the transfer from being a covered gift or bequest.[71] Noteworthy in this connection is that a U.S. recipient who is a nonresident alien for income tax purposes does not appear to have a requirement to file a Form 3520, but such person if a U.S. domiciliary could be subject to a Section 2801 tax.[72]

In any case, the proposed regulations would permit the Service to disclose to a recipient making a request for such information, return information regarding the donor or executor that may assist the U.S. recipient in making the necessary determinations.[73] While in the case of a recipient receiving a bequest such disclosure may be authorized by Section 6103(e)(3), in the case of an inter-vivos gift, absent the consent of the donor, it does not appear such disclosure would ordinarily be permitted. Apparently seizing on this restriction, the proposed regulations would provide a rebuttable presumption that a donor is a covered expatriate and that a gift made by such donor is a covered gift unless the donor authorizes the disclosure.[74] In a case where the subject of the gift is property such as U.S. real property that would be subject to gift tax under the Code regardless of any tax treaty considerations, it is unclear why the U.S. recipient should, in the absence of the donee's consent, automatically be required to include the gift as a covered gift as the IRS could proceed to collect the gift tax either from the donor or the donee and it would seem the U.S. recipient could easily rebut the presumption that the gift was not a taxable

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[71] See Notice 2009-85, Section 8.

[72] See discussion supra p. 13.

[73] Prop. Reg. § 28.2801-7(b).

[74] While it is intended that the procedures for requesting information from the Service will be published in the Internal Revenue Bulletin (see Prop. Reg. § 28.2801-7(b)), the proposed regulations do not spell out the procedures for a living donor to provide his authorization.

gift but perhaps not so easily prove the taxable gift was reported as a taxable gift on a timely-filed return. While the IRS should be able to determine whether the transferor has reported the gift as taxable, as noted above, absent authorization from the donor, the IRS might not be able to disclose that information.

Application to Trusts in General

In the case of a recipient of a covered gift or bequest that is a trust, the liability for the Section 2801 tax depends on whether the trust is considered a domestic trust. The Code does not define the term "domestic trust" for purposes of Section 2801, but a trust that meets the definition of a U.S. person[75] is generally considered a U.S. resident trust; and a trust that does not meet the definition of a U.S. person is considered a foreign trust.[76] These definitions have been adopted in the proposed regulations.[77] Prior to the enactment of Section 2801 and ever since the repeal of Section 1491 over 18 years ago, whether a trust was considered a U.S. person and therefore a resident for U.S. federal income tax purposes, or a foreign trust taxable generally as a nonresident alien for U.S. federal income tax purposes had no significance for transfer tax purposes.[78] Pursuant to Section 2801, however, a trust which is considered a U.S. person is considered to be a U.S. citizen for purposes of Section 2801(a)[79] and therefore a person potentially subject to the payment of the Section 2801 tax regardless of the citizenship, residence or domiciles of its beneficiaries. By contrast, a foreign trust is not considered a U.S. citizen or

[75] See Section 7701(a)(30)(E) and Treas. Reg. § 301.7701-7.

[76] Section 7701(a)(31)(B).

[77] Prop. Reg. Sections 28.2801-2(c) and (d).

[78] Indeed, there can be no analogy to the gift or estate tax provisions contained in Subpart B since trusts are not persons primarily subject to tax under Chapters 11 or 12. Cf. Section 6324. Of course, whether a trust is considered a resident U.S. trust or a foreign trust may have significant income tax consequences. See, e.g., Section 684.

[79] Section 2801(e)(4)(A)(i).

resident and therefore is not subject to the Section 2801 tax absent an election to be treated as a U.S. citizen for purposes of Section 2801.[80] These special statutory rules do not appear to be based on any analogy to other provisions of Subpart B. Nor does there appear to be any analogy to the other provisions of Subpart B in the case of a foreign trust that elects treatment as a domestic trust and therefore is to be treated as a U.S. citizen for purposes of Section 2801(a) on which the tax under Section 2801(a) may be imposed. Rather, in each instance the special statutory rules relating to trusts have as their apparent purpose the prevention of the avoidance of the tax imposed by Section 2801 on U.S. citizen and resident recipients through the use of trusts. Absent these provisions, since a distribution from a trust could not be treated as a transfer from a covered expatriate that could implicate Section 2801,[81] trusts could have been used to circumvent the Section 2801 tax that would otherwise have been imposed on transfers by a covered expatriate to a U.S. citizen or resident.

Under the special statutory rule, a transfer by a covered expatriate to a domestic trust (or one considered as such) subjects the trust to the Section 2801 tax[82] regardless of the citizenship or domicile of its beneficiaries either at the time of the transfer or on a later distribution from the trust, effectively preventing the use of a domestic trust as a blocker against the imposition of the Section 2801 tax that would apply had the transfer been made directly to a U.S. recipient. However, the statutory rules relating to domestic trusts could impose greater Section 2801 tax liability than would be the case than if a domestic trust with non-U.S. domiciliary beneficiaries were not used at all and the transfer went directly to such beneficiaries. On the other hand, subsequent distributions by a domestic trust that had incurred a Section 2801 tax liability would

[80] Section 2801(e)(4)(B)(iii).

[81] Cf. *United States v. Marshall*, 798 F.3d 296, 299 (5th Cir. 2015).

[82] By analogy, see and compare *Fidelity Trust Company v. Commissioner*, 141 F.2d 54 (3rd Cir. 1944), with *Fletcher Trust Company v. Commissioner*, 141 F.2d 36 (7th Cir. 1944) and *U.S. v. Marshall*, supra note 79.

not be treated as covered gifts to its beneficiaries whether or not they were U.S. citizens or domiciliaries and regardless of whether the subsequent distribution was attributable to the receipt by the domestic trust of a covered gift. Thus, a transfer of a covered gift to a domestic trust would “cap” the amount of the Section 2801 tax that could ultimately be due on the transfer by a covered expatriate to a U.S. domiciliary to the current value of the amount transferred (multiplied by the current estate tax rate). In this respect, the result is consistent with the result that would obtain on a completed gift to a trust by a person subject to gift tax, as any later appreciation in the gifted property would be shielded from further gift or estate tax to the extent the assets remained in the trust. By contrast, as will be seen, transfers of a covered gift to a foreign trust would not cap the value of the potential amount subject to the Section 2801 tax in respect of subsequent distributions to a U.S. citizen or resident; the value at the time distributed (to the extent attributable to covered gifts) would determine the amount of the Section 2801 tax. To be sure, covered gifts to a foreign trust may never encounter a Section 2801 tax to the extent ultimately distributed to persons not subject to the payment of the Section 2801 tax.

There are other differences between covered gifts or bequests made to domestic and foreign trusts. For example, the Section 2801 tax paid by a domestic trust would not appear to be deductible in determining the taxable income of such trust. This conclusion, however, requires some elaboration.

Section 164 is the provision of the Code which contains the universe of taxes which may be deductible for purposes of the income tax. Section 275, on the other hand, eliminates certain taxes from the deductible Section 164 universe. Included in the universe of taxes which may not be deductible are estate, gift and inheritance taxes.[83]

[83] Section 275(a)(3).

Section 164(a) starts off by permitting a deduction for the type of taxes listed therein ("listed taxes"). A state, local or foreign tax which is not a listed tax but which is not excluded from being deductible under Section 275(a)(3) may, however, still be deductible if paid or accrued in connection with the carrying on of a trade or business or with respect to a transaction entered into for the production of income (a "trade or business or production of income tax").[84] A trade or business or production of income tax that would be deductible under the second sentence of Section 164(a)(3) but which is incurred in connection with the acquisition or disposition of property is not deductible but is treated as part of the cost of the property acquired or disposed of,[85] thus affecting the cost basis of such property. Since the Section 2801 tax is neither includible as a listed tax nor a state, local or foreign tax, it could not be deductible under Section 164. While it may be possible to read the third sentence of Section 164(a) as permitting the Section 2801 tax to affect the basis to the U.S. recipient of property acquired as a covered gift or bequest, the little legislative history that exists concerning Section 164 suggests that the third sentence only has application to taxes that would otherwise be deductible under the second sentence.[86]

While the above suggests that the Section 2801 tax would not be deductible by a U.S. person that is the recipient of a covered gift or bequest, significantly however, Section 2801 provides that a deduction is permitted "under Section 164"[87] for a portion of the Section 2801

[84] Section 164(a) (second sentence).

[85] Section 164(a) (third sentence).

[86] Section 275(a)(3) may also preclude a deduction for the Section 2801 tax.

[87] Section 2801(e)(4)(B)(ii) and Prop. Reg. section 28.2801-4(a)(3)(ii).

tax paid by a U.S. recipient of a distribution from a foreign trust attributable to a covered gift or bequest to the foreign trust.[88]

For the reasons described above, the reference to the allowance of a deduction under Section 164 is somewhat puzzling, but likely was intended to mean that the Section 2801 tax is to be considered a listed tax but only for the purpose of the receipt of a covered distribution from a foreign trust. In any case, the amount permitted as a deduction is equal to the portion of the Section 2801 tax attributable to the distribution but only to the extent the distribution is included in the gross income of the U.S. recipient.[89] A U.S. recipient may or may not be required to include a distribution from a foreign trust in the recipient's gross income, depending on the amount, nature and source of the income of the trust and in certain cases the status of the U.S. recipient as U.S. citizen or resident for income tax purposes and therefore this rule may have very limited application.

Application to Foreign Trusts

The application of the Section 2801 tax to gratuitous transfers of covered gifts to foreign trusts is somewhat more complicated. Absent an election by the trust to be treated as a domestic trust for purposes of Section 2801, a gratuitous transfer to a foreign trust that would otherwise constitute a covered gift or bequest would not be subject to the Section 2801 tax. Significantly, however, any subsequent distribution by such a trust to a U.S. citizen (including for this purpose a domestic trust) or resident, including any direct, indirect or constructive transfer,[90] which was attributable to a covered gift or bequest to the trust would be subject to the Section 2801 tax.[91]

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[88] Prop. Reg. section 28.2801-4(a)(3)(ii).

[89] *Id.*

[90] Prop. Reg. § 28.2801-5(b).

[91] Section 2801(e)(4)(B)(i).

The proposed regulations would provide rules for determining the portion of a distribution from a foreign trust that would be attributable to a covered gift.[92] In essence, these rules would determine the applicable portion by multiplying the distribution by a ratio referred to as the Section 2801 ratio. The Section 2801 ratio is equal to the ratio of the value of the trust represented by the covered gift to the total assets of the trust measured immediately after the covered gift. Thus, if a $500 covered gift were made to a foreign trust that at the time made had $1,000 of assets not represented by covered gifts, one-third of future distributions would be treated as covered distributions.[93] If additional transfers are made to the trust, then the ratio must be recalculated. Suppose in the above illustration at the time when the value of the foreign trust had grown to $3,000, a subsequent contribution is made to the trust of $3,000 which is also a covered gift. In that case, it would seem the Section 2801 ratio, which had originally been one-third, would be modified to two-thirds (i.e., ($1,000 + $3,000)/$6,000)) and that modified Section 2801 ratio would be used for purposes of determining subsequent covered distributions. If instead the subsequent contribution of $3,000 was not a covered gift, the Section 2801 ratio would be modified to one-sixth (i.e., $1,000/$6,000), if the rules are to be consistently applied but it would be helpful if the final regulations included an illustration covering this possibility.[94]

As can be seen, the application of the rules in relation to a foreign trust is consistent with the Section 2801 tax being applicable to the value, including future growth in the value after expatriation of the assets a covered expatriate has indirectly gifted to a U.S. recipient through a

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[92] Prop. Reg. § 28.2801-5(c)(i).

[93] Prop. Reg. § 28.2801-5(c)(ii).

[94] The proposed regulations would provide that if the foreign trust does not have sufficient information to calculate the Section 2801 ratio, the distributee must proceed on the assumption the entire distribution is attributable to a covered gift. It is unclear what would constitute sufficient information for this purpose.

foreign trust, a result which Congress apparently intended. If a covered expatriate wished to "cap" the amount of a covered gift to a U.S. recipient with respect to assets that might appreciate in the future, but did not wish to make a present gift to an individual, the covered expatriate could either make a transfer to a domestic trust, or make a transfer to a foreign trust that elects to be treated as a domestic trust.[95] Since such a foreign trust election has no application other than for the purpose of Section 2801,[96] an electing foreign trust continues to be treated as a foreign trust for income tax purposes. The election, however, does subject the foreign trust to the Section 2801 tax. The election does not affect any distributions made prior to the effective date of the election.[97] Once made and unless withdrawn, the election remains in effect so that any further covered transfers to an electing foreign trust are subject to the Section 2801 tax.

The proposed regulations indicate that an election under this provision is to be made on a timely-filed Form 708[98] and for the election to be valid, the Section 2801 tax imposed by virtue of the election must be timely paid.[99] Significantly, if the IRS later disputes the amount of the Section 2801 tax that arises by virtue of the election, the proposed regulations provide that the IRS can send notice of such short-fall, which notice is not to constitute a notice of deficiency and therefore does not appear to initiate a procedure for resolving any dispute.[100] Only if the foreign trust timely pays the additional tax set forth in the IRS Notice as being equal to the short-fall, and

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[95] Section 2801(e)(4)(B)(iii). Thus, an electing foreign trust would remain a non-U.S. resident trust for income tax purposes.

[96] *Id*.

[97] Prop. Reg. § 28-2801-5(d)(2).

[98] Prop. Reg. § 28.2801-5(d)(3).

[99] As well as appoint a U.S. agent among other things. Prop. Reg. § 28-2801-5(d)(3)(ii).

[100] Prop. Reg. § 28.2801-5(d)(6).

enters into a closing agreement with the IRS will, the trust's election remain in effect.[101] If the foreign trust does not timely pay the additional tax set forth in a notice issued by the Service the election becomes an "imperfect election," retroactively to the first day of the year for which it was made[102] affecting future distributions from the foreign trust but according to the proposed regulations, apparently not affecting the foreign trust's liability for the Section 2801 tax which it agreed to pay. However, the non-payment by the foreign trust of a shortfall asserted in an IRS Notice does not appear to entitle the Service to collect the shortfall it has determined. Nor does the retrospective termination of the election appear to entitle the foreign trust to a refund of the Section 2801 tax it had paid. Rather, the portion of the transfer to the electing foreign trust upon which the Section 2801 tax has been paid will retain its status as a non-covered gift, but the portion of the transfer for which there has been "insufficient" Section 2801 tax paid will be treated as a covered gift for purposes of computing the Section 2801 ratio.[103]

Interaction between Section 2801 and Estate and Gift Tax Treaties

As noted previously, the Section 2801 tax is imposed on the receipt by a person considered to be a U.S. citizen or resident for purposes of Section 2801 of a direct or indirect transfer by gift or bequest from a covered expatriate of property not excluded from being considered a covered gift or bequest and that is not otherwise reported on a timely-filed gift or estate tax return as being subject to gift or estate tax. Since an individual who is a covered expatriate but who is also either a U.S. citizen or considered to be a U.S. resident at the time of a transfer that constitutes a gift or bequest is not considered a covered expatriate for the purpose of

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[101] *Id.*

[102] *Id.*

[103] Prop. Reg. § 28.2801-5(d)(iii)(D)(7).

applying Section 2801,[104] the universe of persons who could be considered to have made a covered gift or bequest is limited as a practical matter to persons whose worldwide transfers are not subject to estate or gift tax by reason of their non-U.S. citizenship or non-U.S. domicile status; and with respect to such persons only those gifts or bequests that are not otherwise timely reported as being subject to and actually are subject to U.S. federal gift or estate tax are within the universe of gifts or bequests that could subject a U.S. recipient to a Section 2801 tax.[105] As will be discussed below, a contrary rule that may be contained in an applicable estate or gift tax treaty provision could affect whether a gift from a covered expatriate who is neither a U.S. citizen nor a U.S. domiciliary at the time of the transfer, or a bequest from the estate of a decedent who was a covered expatriate and who was not a U.S. citizen or domiciliary at the time of his death, would be subject to the Section 2801 tax. However, the issue would appear to be moot to the extent of the amount, if any, of non-U.S. gift or estate tax incurred with respect to the transfer.[106] Nevertheless, where an existing U.S. estate or gift tax treaty applies and the non-U.S. estate or gift tax imposed on the transfer is less than the amount of the Section 2801 tax that would otherwise be imposed, an issue arises as to the operation of an applicable U.S. estate or gift tax treaty.

Currently, there are in effect 17 U.S. treaties that could affect the taxation of estates and/or gifts. Whether and to what extent any of these treaties could affect the application of the Section 2801 tax depends on a number of considerations. In order to better appreciate the

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[104] Sections 877A(g)(1)(C) and 2801(f).

[105] See Sections 2801(e)(2) and (3), 2511, 2501(a)(2), 2103 and 2104. But see discussion, supra p. 17 relating to the requirements to timely report an amount subject to tax and the additional requirement imposed by the proposed regulations to timely pay the tax shown as due on such timely filed return for a transfer made by a covered expatriate not to be considered a covered gift or bequest.

[106] See Section 2801(d) and discussion supra p. 9.

significance of the application of an applicable estate and/or gift tax treaty to the Section 2801 tax, it is worth remembering that under the Code and apart from the application of any contrary tax treaty provision the U.S. may tax the estates of and/or gifts made by non-U.S. persons only in a very limited way. Thus, as noted previously, in the case of non-U.S. transferors, the U.S. taxes transfers only to the extent such transfers are of "U.S. situs" property. Moreover, with an exception applicable to an expatriate who relinquished his U.S. citizenship or long-term green card holder status before June 17, 2008, the U.S. does not impose a gift tax on a transfer of intangibles. Under our more modern estate and gift tax treaties,[107] sometimes referred to as "domicile treaties," as a general rule a transfer of property may be taxable only in the contracting state of the domicile of the decedent or donor. Two types of property located in the contracting state seeking to impose the tax are excepted from this general rule, namely: real property (and property considered as such) and other property attributable to a permanent establishment or fixed base located in the contracting state imposing the tax (the "situs state"). The excepted property may be the subject of an estate or gift tax of the situs state regardless of the citizenship or domicile of the decedent or donor.[108] Property which may not be taxable by a contracting state under a domicile type of treaty is effectively exempt from the estate or gift tax imposed by such contracting state.

These "newer" or more modern treaties differ considerably from older treaties referred to as situs type treaties. Under a situs type treaty, which generally applies only to the estate but not gift tax,[109] in general, the treaty provides so-called situs rules which provide primary taxing

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[107] See, e.g., U.S.-U.K. estate and gift tax treaty, Article 5; U.S.-Netherlands estate tax treaty, Article 8.

[108] See, e.g., Articles 6 and 7 of the treaties with the United Kingdom and with the Netherlands.

[109] But see U.S.-Japan estate and gift tax treaty.

jurisdiction to the contracting states in which property is deemed to be situated for purposes of the treaty but requires the non-situs contracting state to allow a credit for taxes imposed by the situs contracting state. While in many instances the treaty situs rules provide rules similar to the situs rules provided by the Code, there are instances where a treaty situs rule provides a much more specific rule not found in the Code.[110] Significantly, property considered not to have a U.S. situs under the situs rule contained in such a treaty would generally not subject a non-U.S. citizen domiciled in such treaty country or his estate to a U.S. transfer tax under the Code.[111] However, the result may depend on the language of the treaty provision.[112] Thus, in many instances a situs type treaty containing a clause similar to that contained in Article III(1) of our estate tax treaty with Italy literally provides an exemption from U.S. estate tax for property treated as having a situs in the other contracting state.

The issue that arises with respect to the Section 2801 tax is whether an exemption provided for the estate or gift tax under an applicable treaty, for example in the case of non-U.S. situs property of a decedent or donor who is considered domiciled in the treaty country, applies for purposes of the imposition of the Section 2801 tax. As an initial matter, one might consider whether the Section 2801 tax is a tax covered by an applicable estate or gift tax treaty. In this connection, each of our estate or gift tax treaties expressly covers the U.S. estate and (where

[110] See Article III(1)(g), of both the U.S.-Australia estate tax treaty and the U.S.-Australia gift tax treaty relating to the situs of a partnership interest which appears to follow an old IRS published ruling. See Rev. Rul. 55-701, supra note 63.

[111] See, e.g., Article III(2), U.S.-South Africa; III(2), U.S.-Norway.

[112] Compare the language of Article III (1), U.S.-Italy estate tax treaty (the situs of property shall for the purposes of imposing the tax and for the purposes of the credit be determined exclusively under the specific situs rules and where none exist under the laws of the contracting state seeking to impose the tax), with Article III, U.S.-Swiss estate tax treaty (which does not contain such language).

applicable) gift taxes.[113] In addition, under each of our estate or gift tax treaties, the treaty also applies to any identical or substantially similar tax (to the estate or gift tax) which is imposed after the date of the treaty "in addition to or in place of the existing taxes," although in certain instances the taxes imposed must be of a "substantially similar character.[114] As discussed previously, the Section 2801 tax is intended to be in substitution for the gift or estate tax that would apply if the covered expatriate had not expatriated and would likely be treated in the same manner as an inheritance tax. It would appear that notwithstanding that U.S. estate and gift taxes are payable in the first instance by the transferor and that the Section 2801 tax is payable only by the transferee, this should not affect whether the Section 2801 tax is a tax substantially similar to the estate or gift tax for purposes of an estate or gift tax treaty. Indeed, the U.S. Treasury Explanation of the U.S. Model (which is a domicile type Model) states:

> "Double taxation can also arise if one state taxes on the basis of the domicile of the transferor and the other, as in an inheritance tax context, taxes on the basis of the domicile of the transferee. In this situation the model gives the primary taxing right to the state of the transferor's domicile."[115]

This language strongly suggests that the Section 2801 tax would be a tax covered by an applicable estate or gift tax treaty whether of a domicile or situs type. However, whether this would be so in the case of a treaty that did not expressly refer to inheritance taxes may be an open question. In this connection, in a number of cases even the older situs estate tax treaties make a specific reference to inheritance taxes,[116] while other older estate tax treaties make no

[113] See U.S. Model, Article 2.

[114] *Id.*

[115] U.S. Treasury Department Technical Explanation of the U.S. Model Estate and Gift Tax Treaty (1980), CCH Tax Treaties ¶ 217.

[116] See, e.g., U.S.-Italy, Article I (2).

reference to inheritance taxes.[117] In light of the Section 2801 tax being imposed on the recipient of a covered bequest, it would appear that it would, or at least should, be considered sufficiently similar to an estate tax which is the subject of a situs treaty possibly whether or not the treaty language specifically refers to an inheritance tax. Indeed, the proposed regulations appear to indirectly imply that an estate or gift tax treaty may have an application to the Section 2801 tax by carving out of its examples a covered expatriate who is resident in a country with which the U.S. has an applicable estate or gift tax treaty.[118]

A determination that the Section 2801 tax is a tax that could be covered by an applicable estate or gift tax treaty gets one only so far: an issue of critical significance is whether the person on whom the liability for the tax lies is entitled to a benefit under such treaty. In that connection, in general tax treaties contain a so-called savings clause which reserves to the U.S. the right to tax transfers and deemed transfers by its citizens and domiciliaries as if the treaty did not come into force.[119] Under the U.S. Model[120] and certain treaties,[121] the reservation extends to former citizens of the U.S. whose loss of citizenship had as one of its purposes the avoidance of tax (including for this purpose income tax), but only for 10 years following such loss.[122] However, our older situs treaties do not contain such an expanded savings clause and certain of our domicile treaties also do not contain such a clause. Moreover, not all expanded savings clauses

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[117] See, e.g., U.S.-Ireland, Article I (2).

[118] See Prop. Reg. § 28.2801-3(f), Examples 1 and 2.

[119] U.S. Model, Article 1(3).

[120] Article I (3), U.S. Model Estate and Gift Tax Treaty.

[121] See Article I (4), U.S.-France Estate and Gift Tax Treaty.

[122] U.S. Model, Art. 1(3); see also U.S.-France 2004 Protocol, Art. 1; U.S.-Germany, Art. 11(1)(a)(iii) as amended by Art. 4, 1998 Protocol to the 1980 U.S.-Germany Estate Tax Treaty.

cover long-term residents.[123] Where an expanded savings clause does not exist, it would appear one could not be read into the treaty.[124] Moreover, given the absence of legislative history indicating an intent to override any conflicting treaty provision, it does not appear likely that Section 2801 would be held to take precedence over a conflicting estate or gift tax treaty. In any case, even where an otherwise applicable estate or gift tax treaty contains an expanded savings clause of the type described, it is at least questionable whether the ten-year rule would be given any significance under Section 2801.[125] If the ten-year rule were to apply, one would have to determine whether the expatriation had as one of its principal purposes the avoidance of tax. In that connection, the Service's position has been that principal purpose is presumptively if not conclusively determined if one meets the income tax and asset test of being a covered expatriate.[126] However, in the case of treaties coming into force before those presumptions were created such a condition is far from clear.

Moreover, even where applicable savings clauses permit the U.S. to tax transfers of its citizens, domiciliaries, former citizens and in certain cases its former long-term residents as if the treaty had not come into force that does not mean the Section 2801 tax may be imposed. Since a U.S. recipient is not a transferor, the savings clause would literally have no application to such person. However, a covered expatriate would, of course, meet the definition of a former citizen

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[123] Cf. U.S.-Germany, 1998 Protocol, Art. 4; U.S.-France.

[124] See *Tedd N. Crow v. Commissioners*, 85 T.C. 376 (1985).

[125] See Schoenbaum, 6986 T.M. Estate and Gift Tax Treaties.

[126] Treasury Department's technical explanation of the Protocol to the U.S-France treaty states that "[t]he provision regarding former citizens and longer-term residents is consistent with the United States' reservation of its taxing rights provided for in sections 877, 2017, and 2501(a)(3) and (5) of the Internal Revenue Code. The Protocol provides that the determination of whether there was a principal purpose of tax avoidance with respect to former citizens or long term residents of the United States is made under the laws of the United States, which would include, for example, the irrebuttable presumptions based on average annual net income tax liability under section 877." CCH Treaties ¶3166.

or former long-term resident who could have had a principal tax avoidance motive.[127] Since for purposes of an applicable estate or gift tax treaty any exemption to the application of the Section 2801 tax flows from the status of the transferor, then it would seem that one would be required to take into account the potential application of any expanded savings clause contained in the treaty. Of course, even where an expanded savings clause is contained in the applicable treaty, if the covered gift or bequest occurs after the 10-year period following the expatriation, absent a further modification to existing treaties, it would seem a transfer would obtain the benefit of an applicable estate or gift tax treaty the U.S. has with the country of domicile of the transferor for purposes of the application of the Section 2801 tax. That having been said, it would be preferable for the final regulations to clarify that an exemption from the Section 2801 tax would apply to the same extent an estate or gift tax treaty would exempt a gift or bequest from a domiciliary of a contracting state from being subject to the federal estate or gift tax.

Conclusion

Much of the difficulty with analyzing the Section 2801 tax and its implications must be laid at the feet of the Congress which enacted it. To be sure, one can discern that the Congress did not wish to perpetuate a tax incentive for expatriation. This was not a novel concern as can be seen from the history of the expatriation provisions, nor is it limited to expatriation of individuals.[128] Nevertheless, there are limits to U.S. taxation beyond which the Congress has expressly chosen not to go. Consistent with international standards, an individual is free to choose to leave his country behind. Whether by Congress imposing an exit tax an expatriate will be dissuaded from leaving remains an open question. But even the exit tax imposed by Section 877A has a limit – appreciation up to the date of the change in status is made subject to tax, but

[127] Presumed to be in existence under U.S. law if the covered expatriate definition is met.

[128] See Sections 7874, 367, 684.

not appreciation thereafter. In other words, an expatriate is no longer subject to tax on his gains that accrue after expatriation.

The Section 2801 tax, by contrast is imposed on the value of cash or property transferred to U.S. persons by a covered expatriate regardless of whether such cash or property was owned by the covered expatriate on the date of his expatriation or has increased in value. In this respect, the Section 2801 tax is designed to be a further impediment to expatriation by discouraging using an expatriation as a means for reducing future U.S. gift or estate tax on gifts or bequests to U.S. persons left behind by an expatriating individual. How effective it will be in this regard remains to be seen, but it is likely to be effective in decreasing funds flowing into the U.S., and as a result could have the effect of decreasing tax revenue. For example, if the Section 2801 tax did not exist, an expatriate after settling up his exit tax liability might leave assets to a U.S. person who might spend such assets in the U.S. or die owning such assets. In either case, there would be additional U.S. tax revenue. Thus, it appears the Section 2801 tax will not have the effect of raising revenue in respect of individuals who will expatriate in any event and knowingly so. Rather, it appears to be an *in terrorem* measure designed to discourage expatriation by removing a possible gift or estate tax incentive for an expatriation for those who currently have or may in the future have U.S. relatives from leaving. To be sure, expatriates who leave with their families may feel they should not worry about a transfer to a person who could be liable to pay the Section 2801 tax. The best laid plans, however, sometimes go awry. Although unplanned, as time goes on children or grandchildren may permanently move to the U.S. A covered expatriate or perhaps a non-U.S. resident trust funded by the covered expatriate may then have to determine whether such children should receive outright gifts or distributions from non-U.S. resident trusts notwithstanding the Section 2801 tax, or whether such gifts or bequests are more tax efficiently

made to non-U.S. persons not subject to the payment of the Section 2801 tax and who do not bear the covered expatriate taint. If in the fullness of time such person determines to make a gift to a U.S. relative issues may arise whether such gift was indirectly made by a covered expatriate; however, this is not a new issue.[129] Since foreign taxes imposed on an otherwise covered gift or bequest would have the effect of substantially reducing or eliminating the Section 2801 tax, its imposition is designed to dissuade global tax reduction rather than U.S. tax reduction. Moreover, since in certain cases tax treaties may prevent the application of the Section 2801 tax, even this limited goal may not be realized.

The proposed regulations if finalized in their present form would do little to minimize the concerns of the few who might be affected by the Section 2801 tax and as a result its mere existence as a potential tax could indirectly adversely affect tax revenue. That aside, as noted in at least one situation the rules proposed to be adopted are in conflict with the statutory provisions they purport to interpret. In other situations, although not necessarily in conflict, the rules themselves appear overly complicated if not outright confusing. In light of this, one must conclude that it is the inherent difficulty with the Section 2801 tax and the small likelihood that it will raise any significant revenue that has already caused an eight-year delay in its implementation. There may well be further delays before the regulations are finalized and the relevant forms are issued. If so, at some point the application of the Section 2801 tax to transfers that were covered gifts or bequests occurring years before the rules are finalized may prove too difficult to enforce.[130]

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[129] Cf. Treas. Reg. Sec. 1.679-3(c)(2).
[130] Cf. *Redstone*, supra note 29 (gift tax imposed 27 years after gift).