PREIMMIGRATION INCOME PLANNING AND

ETHICAL ISSUES IN REPRESENTING THE FOREIGN INDIVIDUAL

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Preimmigration Income Tax Planning

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I. Introduction

Income tax planning for the individual planning to immigrate to the U.S. involves an understanding of the jurisdictional concepts of U.S. tax law and the making of intelligent life decisions to take advantage of the rules. In comparison to a business investment in the U.S. which involves the use of funds to accomplish a specific goal, individuals wishing to come to the U.S. are making a series of personal changes that will affect all aspects of their lives. U.S. tax planning considerations are merely one part of the puzzle that must be solved. The key to the planning often requires a timely decision to accelerate or defer income, gain, or loss so as to avoid unnecessary exposure to tax while in the U.S. In addition, it entails knowledge of the tax cost involved in the event an individual wishes to continue to live in an accustomed life style.

This chapter will discuss the rules which affect individuals moving across borders and which should be considered before, during, and after the period of U.S. tax residence. The intent is to promote compliance with the law, to avoid unnecessary income tax exposure, and to assist the taxpayer in making intelligent decisions. After the rules are addressed, this chapter will discuss income tax planning opportunities for persons wishing to immigrate to the U.S. The chapter concludes with a discussion of ethical considerations that may apply when providing advice to the foreign individual.

II. Residence

There are two tests for determining U.S. residence for income tax purposes. These are the "substantial presence" test and the "green card" test. If an individual meets the conditions of either test, he will be considered to be a resident for income tax purposes.[2]

[2] Code §7701(b)(1)(A).

A. Green Card Test

A foreign individual becomes a resident with respect to a calendar year if he or she is a lawful permanent resident of the U.S. at any time during the calendar year.[3] A lawful permanent resident is an individual who has been lawfully granted the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws.

Resident status is deemed to continue unless it is rescinded or is administratively or judicially determined to have been abandoned. That occurs when a final administrative or judicial order of exclusion or deportation is issued with regard to the individual. For this purpose, an order that is no longer subject to appeal to a higher court of competent jurisdiction is a final judicial order.

B. Substantial Presence Test

1. In General

Under the substantial presence test, a foreign individual is treated as a U.S. resident for income tax purposes if he or she is present in the U.S. 183 days or more during a rolling 3-year period. The period begins anew for each year and comprises the second preceding year, the immediately preceding year, and the current year.[4] The individual must also be present for at least 31 days in the current year.[5] If the 31-day threshold is not met for a particular year, the individual cannot be treated as a resident during the year. The 31-day test has no relevance to years other than the current year being reviewed.

An individual is treated as being present in the U.S. on any day that he or she is physically present at any time during the day. It does not matter how short a period is involved. Thus, if a person were to arrive in the U.S. on a late flight landing at 11:00 P.M. on February 1, 1998, the individual would be deemed to be present in the U.S. for all of that day.

In computing the days present in the U.S., a weighting formula is applied under which days in the current year are given greater weight than days in the earlier two years. Days in the current year are fully weighted, days in the first preceding year are afforded a one-third weight, and days in the second preceding year are afforded a one-sixth weight.

To illustrate the effect of the weighting rule, assume that an individual will be present in the United States for 122 days in 1998. Assume further, that he will also be present in the United States for 122 days in each of 1997 and 1996. To determine his status for 1998, the individual will count all 122 days in the United States in that year, plus one-third of the 122 days in the United States in 1997

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[3] Regs. §301.7701(b)-1(b)(1).

[4] Code §7701(b)(3)(A)(ii).

[5] Code §7701(b)(3)(A)(i).

(40.67 days), plus one sixth of the 122 days in the United States in 1996 (20.33 days). The total of 122 + 40.67 + 20.33 equals 183 days. He will be a U.S. resident for 1998 because he meets the substantial presence test. If, in comparison, the individual were physically present in the U.S. for 121 days each year he would not be deemed a resident for tax purposes.

2. Excluded Days

In determining whether a foreign individual meets the substantial presence test based on days present in the U.S., certain days are excluded and are not counted as days present in the United States. A day is excluded if the individual falls within any of the following categories:

a. Exempt Individual

A day is exempt if the individual is an "exempt individual" on that day. An exempt individual is a foreign government-related individual, or a teacher or trainee, or a student, or a professional athlete.

(1) Government Official

A foreign government-related individual is an individual who is temporarily present in the U.S. as a full-time employee of an international organization, or by reason of diplomatic status, or by reason of a visa that represents full-time diplomatic or consular status. An individual who falls within any of the foregoing foreign government-related categories is considered to be temporarily present in the U.S. as long as he is not a lawful permanent resident under the green card test. For this purpose, the length of stay in the U.S. does not matter.

(2) Teacher or Trainee

A teacher or trainee is an individual, other than a student, who is admitted temporarily to the United States as a nonimmigrant under the provisions of the Immigration and Nationality Act relating to the admission of teachers and trainees into the United States. See §101(a)(15) of 8 U.S.C. 1101(a)(15)(J). The individual must substantially comply with the requirements of being admitted.[6] This entails avoiding activities that are prohibited by the Immigration and Nationality Act and which could result in the loss of J visa status. For this purpose, an individual is not deemed to be in substantial compliance for tax purposes merely by showing that a visa has not been revoked. An independent determination of substantial compliance may be made by the I.R.S.

This exception is designed to attract people for training during a limited period of time so that they may return home to engage in their trade or profession. It is not designed to allow people to remain indefinitely in the U.S. Consequently, time limits are provided. An individual is not treated as an exempt individual under the teacher or trainee provision if he or she has been exempt as a teacher,

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[6] Regs. §301.7701(b)-3(b)(6).

trainee, or student for any part of two of the six preceding calendar years.[7] However, if the individual has a foreign employer and receives compensation from that employer during prior years which is exempt from U.S. tax under Code §872(b)(3), the test is relaxed. In that situation, the individual will remain exempt in the current year unless he or she has been present in the U.S. as a teacher, trainee, or student for parts of four of the six preceding calendar years.[8]

Several examples in the regulations[9] illustrate the limitations on the teacher or trainee exception. In the first example, an individual is temporarily present in the U.S. during the current year as a teacher. The individual does not receive compensation in the current year from a foreign employer that is exempt. The facts state that the individual was treated as an exempt student for the prior three years. The example concludes that, although the year in issue is the first year that the individual is seeking to be exempt as a teacher, he will not be considered an exempt individual for the year because he has been exempt as a student for at least two of the past six years.

In the second example, the individual is temporarily present in the U.S. during the current year as a teacher and receives compensation in the current year from a foreign employer that is exempt. The facts state that the individual was treated as an exempt teacher for the prior two years, but his compensation for those years was not exempt because it was not received from a foreign employer. The example concludes that the individual will not be considered an exempt individual for the current year because he has been exempt as a teacher for at least two of the past six years.

The third example illustrates the rule applicable to teachers receiving exempt compensation in prior years. The facts are the same as in the second example, except that all of the individual's compensation for the two preceding years was exempt because it was received from a foreign employer. The example concludes that the individual will be an exempt individual for the current year because he has not been exempt as a student, teacher or trainee for four of the six preceding calendar years.

(3) Student

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A student is any individual who is admitted temporarily to the U.S. as a nonimmigrant under the provisions of the Immigration and Nationality Act relating to the admission of students into the U.S.[10] See, *inter alia*, §101(a)(15)(F) or (M) of 8 U.S.C. 1101(a)(15). The individual must

[7] Regs. §301.7701(b)-3(b)(7)(i).

[8] Regs. §301.7701(b)-3(b)(7)(ii).

[9] Regs. §301.7701(b)-3(b)(7)(v).

[10] Regs. §301.7701(b)-3(b)(4).

substantially comply with the requirements of being admitted.[11] As with a trainee, this entails avoiding activities that are prohibited by the Immigration and Nationality Act and which could result in the loss of visa status. Again, an independent determination of substantial compliance may be made by the I.R.S. The regulations focus on undertaking unauthorized employment as an act that could cause a student to fail the substantial compliance test.

(4) Professional Athlete

A professional athlete temporarily present in the U.S. to compete in a charitable sports event for which all the net proceeds are contributed to an organization described in Code §503(c) and exempt from tax under Code §501(a) and for which substantially all work is performed by volunteers is an exempt individual.[12] Professional golfers and tennis players are likely the intended beneficiaries of this exemption.

The regulations provide a narrow reading of this exemption. Only days on which the athlete actually competes in the charitable sports event are excluded. Thus, days on which the individual is present to practice for the event, to perform promotional or other activities related to the event, or to travel between events are included for purposes of the substantial presence test.

b. Medical Condition

An individual will not be considered present during days on which he intends to leave, but is unable to leave because of a medical condition or medical problem.[13] The medical condition or problem must have arisen while the individual was present in the U.S. Thus, if the condition or problem existed prior to the individual's arrival in the U.S., and the individual was aware of the condition or problem, the individual is not exempt on days during which he is prevented from leaving the U.S. Also, a day of presence will not be excluded if, after the medical condition or problem subsides, the individual is able to leave the U.S., but instead, remains in the U.S. beyond a reasonable period for making departure arrangements. A day will also not be excluded if the medical condition arose during a prior stay in the U.S. and the individual returns to the U.S. for treatment.

Two key elements for coverage under this provision are a demonstration that the individual intended to leave the U.S. on a particular day and a determination that departure was prevented by the medical condition. These are factual considerations. The regulations establish the points of reference for making these determinations. The inability to depart is easily determinable; the intent to depart may be a trap for the unwary. As a general rule, an individual will be presumed to have intended to leave during a period of illness if he leaves the U.S. within a reasonable period of time after becoming

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[11] Regs. §301.7701(b)-3(b)(6).

[12] Regs. §301.7701(b)-3(b)(5).

[13] Regs. §301.7701(b)-3(c)(1).

physically able to leave.[14] This is the minimum period within which arrangements to leave may be made. However, if at the time an individual's medical condition or medical problem arose, the individual was present in the U.S. for a definite purpose which by its nature could not be accomplished without being viewed to be a resident under the substantial presence test, the requisite intent to leave the U.S. will not exist.

Several examples in the regulations place this test in perspective.[15] In the first example, an individual arrives in the U.S. and is in a serious automobile accident on the way to an airport on March 31st to depart the U.S. The departure ticket indicates that the individual intended to leave the U.S. on March 31st, but was unable to leave as a result of the injuries suffered in the accident. He recovers from the injuries and is able to leave the U.S. on May 31st. He departs from the U.S. on that date. The example concludes that the individual's presence in the U.S. during the period from April 1st through May 31st will not be counted as days of presence in the U.S. The days up to and including the date of the accident will be counted.

In the second example, the facts are the same, except that the intended date of the return flight is May 31st, as evidenced by an airline ticket. The example concludes that the individual may not exclude any days of presence in the in the U.S. under the tests related to medical conditions.

c. Days in Transit

A foreign individual may exclude days of presence in the U.S. if the individual is in transit between two foreign points, and is physically present in the U.S. for a period of time that is less than 24 hours.[16] An individual is considered to be in transit if he pursues activities that are substantially related to completing his or her travel to a foreign point of destination. For example, an individual who travels between airports in the U.S. in order to change planes en route to his or her destination will be considered to be in transit. However, if the individual attends a business meeting while present in the U.S., whether or not that meeting is within the confines of the airport, he or she will not be considered to be in transit. This provisions is helpful for individuals who are strictly counting days in the U.S. and who are forced to be present in the U.S. overnight while transiting to a foreign destination.

3. Procedural Requirements

A foreign individual who believes that he or she is exempt on a particular day of presence in the U.S. and does not wish that day to count toward substantial presence in the U.S. must file a statement with

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[14] Regs. §301.7701(b)-3(c)(2).

[15] Regs. §301.7701(b)-3(c)(4).

[16] Regs. §301.7701(b)-3(d).

the I.R.S. on or before the due date of a tax return.[17] Form 8843 (Statement for Exempt Individuals and Individuals With a Medical Condition) is used for this purpose. The statement must contain sufficient information describing the reasons why the day's presence should be exempted under the applicable test described above. If an individual claims that a day is exempt because of a medical condition or problem that developed while present in the U.S., the statement must be signed by the treating physician. If a medical condition prevented an individual from leaving the U.S., the treating physician must certify that fact and that there was no indication of a pre-existing condition.

Unless the I.R.S. determines otherwise, a failure to timely file the statement will result in all days present in the U.S. being counted toward substantial presence.[18] The I.R.S. may waive the procedural requirement if the individual can show by clear and convincing evidence that he or she took (i) reasonable actions to become aware of the filing requirements and (ii) significant affirmative steps to comply with those requirements. Also, the I.R.S. may choose to ignore the requirement if in the best interest of the Federal government.[19]

4. Closer Connection Test

A foreign individual who meets the substantial presence test may nevertheless be considered to be a nonresident with regard to the current year if he can demonstrate that closer connections are maintained to another, single, foreign country.[20]

To come within this exception, three conditions must be satisfied. First, the individual must be present in the U.S. for fewer than 183 days in the current year. Thus, this exception applies to persons who are in the U.S. for more than 183 days during the rolling 3-year period, computed in light of the weighting rules discussed above, and who are present for up to 182 days in the current year.

Second, the individual must maintain a tax home in a foreign country during the year. The concept of a tax home originated in the context of the deduction of travel expenses incurred while away from home. While there is no uniform definition in the Court cases, and the view of the I.R.S. is somewhat different from that of many Courts, in broad terms a "tax home" is the place where a person generally should live in light of his employment responsibilities. Thus, if a person works in New York, it is reasonable for him to have a home in the New York area; living expenses incurred in New York would not be deductible. Living expenses incurred while temporarily outside New York would be deductible. However, if a person generally works in Los Angeles, but takes a short-term assignment in New York that is scheduled to last for less than one year, it would not be reasonable for him to

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[17] Regs. §301.7701(b)-8(c).

[18] Regs. §301.7701(b)-8(d)(1).

[19] Regs. §301.7701(b)-8(e).

[20] Regs. §301-7701(b)-2(a).

permanently move to New York. His “tax home” would continue to be Los Angeles. Expenses incurred while in New York temporarily would be deductible. Finally, if a person merely moves from job-to-job, staying at each place only temporarily, his “tax home” would be wherever he happened to be at the time.[21]

Third, the individual must have a closer connection during the year to a single foreign country in which he or she maintains a tax home than the connections maintained to the U.S. To meet this requirement, the individual must demonstrate that he has maintained more significant contacts with the foreign country than with the U.S. The regulations look to the following factors:

- The location of the individual's permanent home;
- The location of the individual's family;
- The location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his or her family;
- The location of social, political, cultural or religious organizations with which the individual has a current relationship;
- The location where the individual conducts his or her routine personal banking activities;
- The location where the individual conducts business activities (other than those that constitute the individual's tax home);
- The location of the jurisdiction in which the individual holds a driver's license;
- The location of the jurisdiction in which the individual votes;
- The country of residence designated by the individual on forms and documents; and
- The types of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States), Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding) or Form W-9 (Payer's Request for Taxpayer Identification Number).

If an individual moves during the year, he may demonstrate that he has closer connections to each of two foreign countries during the year and that his connections to each were, during the period of

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[21] See I.R.S. Publication 17 (Your Federal Income Tax for Individuals), Chapter 26 (Car Expenses and Other Employee Business Expenses).

residency in such country.[22] To come within this rule, the individual must remain a resident for tax purposes within one of the foreign countries for the entire year or must be subject to taxation as a resident in the one of the foreign countries for the period during which a tax home is maintained there and in the other foreign country for the balance of the year. An individual may not make this determination for three or more countries.

The closer connection exception is not available to a foreign individual who has personally applied, or taken other affirmative steps, to change his or her status to that of a permanent resident during the current year or has an application pending for adjustment of status during the current year.[23] Affirmative steps include the filing of the Bureau of Citizenship and Immigration Services ("B.C.I.S.") Form I-508 (Waiver of Immunities), Form I-485 (Application for Status as Permanent Resident), I-130 (Petition for Alien Relative) I-140 (Petition for Prospective Immigrant Employee), Department of Labor Form ETA-750 (Application for Alien Employment Certification) and Department of State Form 0F-230 (Application for Immigrant Visa and Alien Registration).

A filing requirement is a condition of coming within this exception to residence under the substantial presence test.[24] Form 8840 (Closer Connection Exception Statement for Aliens) is used to claim the closer connection exception.

C. Period of Residence

1. General Rule

Residence generally begins on the "residency starting date" and ends on the "residency termination date." These are defined terms under the regulations.

The residency starting date for an individual who meets the substantial presence test is the first day during the calendar year on which the individual is present in the United States. The residency starting date for an alien who meets the green card test is the first day during the calendar year in which the individual is physically present in the United States as a lawful permanent resident. If both tests are met, the residency starting date is the earlier of the two dates on which the tests were met.

Generally, the residency termination date will be the last day of the calendar year. Thus, it is not the last day of presence in the U.S. during the calendar year. This rule, however, is subject to an exception. If the individual establishes that, for the remainder of the calendar year, (i) his or her tax home was in a foreign country and (ii) he or she maintained a closer connection to that foreign country than to the United States, the residency termination date will be the last day of presence in

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[22] Regs. §301-7701(b)-2(e).

[23] Regs. §301-7701(b)-2(f).

[24] Regs. §301-7701(b)-2(g).

the U.S. under the substantial presence test and the last day of lawful permanent residence under the green card test. If the individual satisfied both residence tests, it is the latter of the two dates.

2. *De Minimis* Presence

An alien individual may be present in the United States for up to 10 days without triggering the residency starting date under the substantial presence test or extending the residency termination date under that test.[25] To come within this *de minimis* rule, the individual must establish that, during the period covering the 10 days of presence, (i) the individual's tax home was in a foreign country and (ii) he or she maintained a closer connection to that foreign country than to the U.S.

The regulations contain several technical rules. First, the days in the U.S. need not be consecutive, but the total cannot exceed 10 days. Second, if all the days that occur during a period of continuous presence cannot be excluded, none of the days can benefit from the *de minimis* rule. Finally, although the days in the *de minimis* period are not considered in determining the residency starting date, the days are taken into account in computing the substantial presence test.

3. Elective Residency Starting Date

If a foreign individual who otherwise does not meet the substantial presence test or the green card test for the current year is physically present in the United States for at least 31 consecutive days during the current year and for at least 75% of the subsequent days in balance of the year, the individual may elect to have the residency starting be the first day of that 31-day period.[26] This elective procedure applies only if the individual was not a resident in the immediately preceding year and continues to be a resident under the substantial presence test in the subsequent year. This means that the election cannot be made until it is known that residence is established for the subsequent year and an extension may be obtained. The election is important for individuals arriving in the U.S. from a jurisdiction that has a soak-up rule allocating tax residence to that country if an individual departing therefrom is not a resident of any other country.

4. No-Lapse Rules

The Code and regulations contain two rules designed to prevent an individual from managing his or her residence to avoid tax. The first of the no-lapse rules provides that an individual who was a U.S. resident during any part of the preceding calendar year and who is a U.S. resident for any part of the current year will be considered to be taxable as a resident at the beginning of the current year.[27] It also provides that an individual who is a U.S. resident for any part of the current year and who is also a U.S. resident for any part of the following year will be taxable as a resident through the end of the

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[25] Regs. §301.7701(b)-4(c)(1).

[26] Regs. §301.7701(b)-4(c)(3).

[27] Regs. §301.7701(b)-4(e).

current year. It does not matter that the individual has a closer connection to a foreign country than the United States during the current year.

The second no-lapse rule coordinates taxation with the expatriation provisions of Code §877.[28] The expatriation provisions will be discussed in more detail below. In brief, they extend U.S. jurisdiction to impose ordinary income tax on net income for a period of 10 years for items of income actually arising from U.S. sources or deemed to arise from U.S. sources. The no-lapse rule also applies to persons who have had U.S. residence in the past (the initial residency period), relinquish that residence for a period of years (the intervening period), and reestablish residence in the U.S. If the initial residency period covers at least three taxable years of at least 183 days, each, and residence is reestablished before the close of the third complete calendar year following the residency terminations date, the individual will be subject to tax during the intervening period in the manner prescribed by Code §877. The special tax regime applies only if it results in the imposition of a greater tax liability than the 30% withholding tax ordinarily imposed on persons who are neither citizens nor residents of the U.S. with regard to U.S. source income that is not effectively connected with the conduct of a trade or business in the U.S.

III. Residence under Income Tax Treaties

A. In General

Even though a foreign individual may be deemed to be a resident of the U.S. under domestic U.S. tax law, the individual may, nonetheless be taxed as if he were a nonresident with regard to the U.S. if so mandated by treaty.

With limited exception, the income tax treaties of the U.S. now in effect or awaiting Senate approval contain a residence provision. Under the provision, the standard for determining the residence of individuals and corporations is established. Residence status is important because only residents qualify for the benefits provided by the treaty.

Ordinarily, if an individual is taxed as a resident of a treaty country for purposes of the domestic tax laws of that country, the individual will be treated as a resident of that country for purposes of the income tax treaty. Where, under the domestic tax laws of each of the two treaty jurisdictions, the individual would be treated as a resident of that country, he is potentially subject to double taxation of income. This type of individual is commonly referred to as a “dual resident.” The residence article of an income tax treaty generally contains a tie-breaker provision under which the dual resident individual is classified as a resident of one, and only one, country for purposes of the income

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[28] Code §7701(b)(10); Regs. §301.7701(b)-5(a).

tax treaty.[29] In that way, the tie-breaker is one of the few provisions of an income tax treaty which overrides U.S. domestic law.[30]

B. Tie-breaker Provision

Under the tie-breaker provision, a series of tests is applied in a specific order to the particular facts and circumstances of the dual resident. Once the individual's residence is determined under a particular test, there is no need to proceed to another test. In general, exclusive residence is determined by applying the following tests in the following order:

- First, the individual is deemed to be a resident of the country in which a permanent home is available;

- If the individual has a permanent home in both countries or in neither country, he will be deemed to be a resident of the country with which his personal and economic relations are closer -- this is known as the center of the individual's vital interests;

- If the closer economic relations cannot be determined, the individual will be a resident of the country in which he has an habitual abode; and

- If he has an habitual abode in both countries or in neither one, he will be deemed to be a resident of the country of which he is a national.

If the issue cannot be settled by the application of these tests, the competent authorities of both countries (*viz*., the I.R.S. and its counterpart overseas) will decide by mutual agreement the country of which the individual will be considered an exclusive resident.

C. Use of the Tie-breaker

The tie-breaker rule is important for individuals who wish to retain a green card, but who do not wish to pay U.S. tax on income derived from sources outside the U.S. The closer connection test is not relevant for an individual who is a permanent resident of the U.S. If residence can be allocated exclusively to the jurisdiction that is the tax treaty partner of the U.S. and if a mechanism can be identified under local law that precludes imposition of that country's tax, the individual may be able to retain the benefits of the green card without incurring the tax detriments of U.S. tax residence.

In this regard, it should be noted that many countries defer the imposition of tax on certain types of income of newly arrived non-domiciled individuals. For example, foreign source earned income

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[29] See, for example, Article 3 (Fiscal Residence) of the Israel-U.S. Income Tax Treaty; Article IV (Residence) of the Canada-U.S. Income Tax Treaty; and Article 4 (Residence) of the U.K.-U.S. Income Tax Treaty.

[30] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1528 (1984).

generated from employment carried out entirely outside the U.K. and investment income of a non-domiciled individual who resides in the U.K. may be deferred until the compensation or the investment income or gains are remitted to the U.K. The State of Israel will not impose tax on gains from the disposition of foreign assets held offshore at the time an immigrant first establishes residence. Canada allows for a step-up in basis of capital property held at the time Canadian residence is established by an individual. The income tax treaty with a country whose laws contain any of those types of provisions must be examined closely to determine the interplay between foreign tax law and the income tax treaty benefit desired. In many instances, income that is taxed only upon remittance will not qualify for the full range of treaty benefits.[31] However, each treaty is unique and the specific terms of the applicable treaty must be examined. There may continue to be benefits for offshore investment income.

D. Reporting

The U.S. income tax regulations set forth certain rules of general application that must be followed in order for a dual resident to be able to take advantage of the tie-breaker tests and be treated as a resident of the other treaty country for purposes of an applicable treaty and other U.S. income tax purposes. These rules are similar to those discussed above in connection with individuals contending that they are exempt for certain days.[32] Under these rules, the individual must prepare an income tax return computing tax liability as a nonresident alien. The return is filed on Form 1040NR. Generally, the return is due on June 15th following the taxable year. The due date can be extended up to six months if timely requests are filed.

A disclosure statement is provided on Form 8833 (Treaty-Based Return Disclosure Under Section 6114 or 7701(b)) attached to the Form 1040NR which:

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[31] For example, Article 1(7) (General Scope) of the U.K.-U.S. Income Tax Treaty provides as follows:

> Where under any provision of this Convention income or gains arising in one of the Contracting States are relieved from tax in that Contracting State and, under the law in force in the other Contracting State, a person, in respect of the said income or gains, is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income or gains as is taxed in the other Contracting State.

See also Article 4(5) (Fiscal Domicile) of the Bangladesh-U.S. Income Tax Treaty; Article 4(5) (General Rules Of Taxation) of the Cyprus-U.S. Income Tax Treaty; and Article 6(6) (General Rules of Taxation) of the Israel-U.S. Income Tax Treaty.

[32] Reg. §301.7701(b)-7.

- Contains a statement that the taxpayer is claiming a treaty benefit as a nonresident of the United States; and

- Describes the facts relied upon to support the position taken, the nature and approximate amount of income that is exempted, and the specific treaty provision for which the taxpayer is claiming a treaty benefit.

The Form 1040NR and the attached statement are filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

IV. Taxation of Expatriates

Nonresident aliens who are former U.S. citizens or long-term green card holders are subject to a special tax regime under § 877 for 10 years following the loss or U.S. citizenship or the termination of the long-term resident status if certain conditions are met.

A. Background

Prior to the Health Insurance Portability and Accountability Act, P.L. 104-191, U.S. law provided for a 10-year extension of U.S. tax jurisdiction for U.S. source income, gains recognized from the sale of personal property located in the U.S., and gains recognized from the sale stock or debt of a U.S. corporation where a U.S. citizen relinquished citizenship and tax avoidance was one of the principal purposes for the expatriation. The Health Insurance Portability and Accountability Act, which is effective retroactive to February 6, 1995, modified U.S. domestic law by, *inter alia*, creating a presumption of tax avoidance if an expatriate meets certain objective standards and expanding the scope of the provision to cover long-term residents relinquishing that immigration status.

For individuals who relinquish their U.S. citizenship or terminate their long-term resident status after June 3, 2004, the American Jobs Creation Act of 2004 replaces the subjective tax-avoidance inquiry with objective standards, treats such individuals as U.S. citizens and residents for the tax year if they stay in the U.S. for more than 30 days in such year and expands the reach of gift tax on gifts of certain closely-held foreign corporations.

B. Code §877

If the expatriation provision applies, U.S. tax is imposed at ordinary graduated rates or at the rates of alternative minimum tax on items of U.S. source income.[33] U.S. source income has a broadened meaning to prevent tax avoidance. It includes:

[33] Code §877(b).

- Gains on the sale or exchange of property located in the U.S. other than stock or debt obligations,[34]

- Gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of U.S. persons, the U.S., or local political jurisdictions,[35] and

- Income or gain derived from stock in a foreign corporation if, within the 2-year period leading up to the act of expatriation, the individual owned directly, indirectly, or by attribution, more than 50% of the total combined voting power or value of the foreign corporation.

In that last set of circumstances, the language of the statute seems to indicate that the income subject to tax cannot exceed the earnings and profits accumulated by the foreign corporation within the 2-year period.[36] However, the explanation of the provision prepared by the Joint Committee Staff advises that all of the accumulated income of the foreign corporation will be subjected to tax upon distribution during the 10-year period if the 50% threshold regarding voting power is exceeded at any time within the 2-year period.

> Mr. B lost his U.S. citizenship on July 1, 1996 and is subject to Code §877. Mr. B has owned all of the stock of a foreign corporation, FCo, since its incorporation in 1991. As of FCo's December 31, 1995 year-end, FCo has accumulated earnings and profits of $500,000. FCo has earnings and profits of $100,000 for 1996 and does not have any Subpart F income. FCo makes a $100,000 distribution to Mr. B in each of 1997 and 1998. On January 1, 1999, Mr. B disposes of all his stock of FCo and realizes $400,000 of gain. Under prior law, neither the distributions from FCo nor the gain on the disposition of the FCo stock would be subject to U.S. tax. Under HIPA, the distributions from FCo and the gain on the sale of the stock of FCo would be treated as U.S. source income and would be taxed to Mr. B under Code §877, subject to the earnings and profits limitation. For this purpose, the amount of FCo's earnings and profits for 1996 is prorated based on the number of days during 1996 that Mr. B is a U.S. citizen. Thus, the amount of FCo's earnings and profits earned or accumulated before Mr. B's loss of citizenship is $550,000. Accordingly, the $100,000 distributions from FCo in 1997 and 1998 would be treated as U.S. source income taxable to Mr. B under Code §877 in such years. In addition, $350,000 of the gain realized from the sale of the stock of FCo in 1999 would be treated as U.S. source income taxable to Mr. B under Code §877 in that year.

[34] Code §877(d)(1)(A).

[35] Code §877(d)(1)(B)

[36] Code §877(d)(1)(C).

To protect the jurisdiction of the U.S. to impose tax on the designated items of income and gain, Code §877 prevents an expatriate from entering a nonrecognition transaction in which covered property, *viz*., property that is subject to tax in the hands of an expatriate upon disposition during the 10-year period, is exchanged in a rollover transaction for property that would not be taxed. Gain realized on the transaction will be recognized.[37] The I.R.S. is authorized to propose regulations to prevent avoidance of this rule. Regulations may provide that gain will also be recognized if the exchange of covered property for other property takes place during the 5-year period leading up to the date of expatriation.[38] They may also provide that the removal from the U.S. of appreciated tangible personal property such as art or collectibles or the occurrence of any other event which modifies the source of income or gain will be treated as a taxable event.[39]

tSection prevents an individual from entering a transaction which effectively diminishes the risk of ownership of covered property within the 10-year period.[40] Under this provision, the running of the 10-year period is tolled if, during that period, the individual holds a put option allowing him to sell the property to another person at a specified price or another person holds a call option allowing that person to purchase the property at a specified price, or the individual has entered into a short sale.

In addition to mandating gain recognition from the exchange of covered property for other property, § allocates to the expatriate any income or gain derived by the transferee from the transferred property in certain circumstances.[41] The provision applies if the transferee would be a controlled foreign corporation and the expatriate would be a U.S. Shareholder had the act of expatriation not occurred. The allocation continues for the 10-year period commencing with the act of expatriation. The allocation also covers income and gain from substitute property received by the foreign corporation in a tax-free transaction with third parties. Moreover, a sale of the shares of the foreign corporation by the expatriate is treated as a sale by the expatriate of the covered property owned by the foreign corporation.

A credit is allowed for any income taxes paid to a foreign country on income that is subject to U.S. tax under the expatriation provisions. Conflicts with treaty provisions are to be resolved through negotiation with the goal of allowing imposition of the tax. After 10 years, treaties are to override any conflict.

Comparable treatment over the 10-year period is provided under the estate and gift taxes for an expatriate.

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[37] Code §877(d)(2)(B).

[38] Code §877(d)(2)(D).

[39] Code §877(d)(2)(E).

[40] Code §877(d)(3).

[41] Code §877(d)(4).

C. Tax Avoidance Motive (Expatriations Before June 4, 2004)

For expatriations before June 4, 2004, the foregoing provisions apply only if tax avoidance is a principal purpose for the act of expatriation.[42] The existence of a tax avoidance motive is presumed if the average annual net income tax of the expatriate for the period of 5 taxable years ending before the date of expatriation exceeds U.S. $100,000.[43] The amount is adjusted for inflation, and in 2004, the triggering amount is $124,000.The statute defines the term "net income tax" to mean the sum of the regular tax liability Under Code §1 and the tax imposed by Code §55, reduced by certain credits, including the foreign tax credit.[44] Tax avoidance is also presumed if the individual has a net worth of U.S. $500,000 as of the date of expatriation. This amount is also adjusted for increases in cost of living beginning in 1997, and in 2004, the triggering amount is $622,000.

Individuals who fail to meet either threshold, nonetheless, may be subject to continuing U.S. tax jurisdiction if tax avoidance is one of the principal purposes of expatriation under the particular facts and circumstances involving the individual.

Exceptions to the presumption of tax avoidance exist if, within one year of the loss of citizenship, an individual applies to the I.R.S. for a ruling that tax avoidance is not present, the ruling is ultimately issued, and the individual's circumstances fall in any one of the following fact patterns:

- At birth the individual was a citizen of both the U.S. and another country and continues such dual citizenship,
- Within a reasonable period after loss of U.S. citizenship, the individual becomes a citizen of the country in which he was born, or in which his wife was born, or in which his parents or the parents of his wife were born,
- During the 10-year period ending on the date of loss of citizenship, the individual was present in the U.S. for less than 30 days,
- Renunciation of citizenship occurs before the individual attains the age of 18½ years, or
- The individual is described in I.R.S. regulations that may be drafted in the future.

For persons who have expatriated more than one year prior to the date of enactment, a 90-day period is provided within which a ruling request can be submitted.

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[42] Code §877(a)(1).

[43] Code §877(a)(2).

[44] Code §877(a)(2)(A) and §38(c)(1).

D. Notice 97-19 (Applicable to Expatriations Before June 4, 2004)

In Notice 97-19, the I.R.S. provided guidance regarding the application of the foregoing provisions.

Regarding the existence of a tax avoidance motive, Notice 97-19 provides that a former citizen is considered to have lost U.S. citizenship with a principal purpose of avoiding U.S. taxes if his tax liability or net worth exceeds certain amounts on the date of expatriation. Thus, the notice applies a results-based test which was rejected in Furstenberg v. Commr., 83 T.C. 755 (1984).

The Notice provides that, in measuring net worth, an individual is considered to own any interest in property if the disposition of that property by gift would be subject to gift tax for a citizen or resident of the United States. An interest in property includes money or other property, regardless of whether it produces any income or gain. In addition, an interest in the right to use property will be treated as an interest in property. Thus, for example, a nonexclusive license to use property is treated as an interest in the underlying property attributable to the value of the use of such property.

In determining the values of interests in property for purposes of the net worth test, individuals must use the valuation principles of the gift tax provisions embodied in Code §2512 without regard to any prohibitions or restrictions. Although individuals must use good faith estimates of values, formal appraisals are not required.

An individual's beneficial interest in a trust must be included in the calculation of net worth. For this purpose, the value of an individual's beneficial interest in a trust is determined under a two-step process. First, all interests in property held by the trust must be allocated to beneficiaries and potential beneficiaries based on all relevant facts and circumstances, including the terms of the trust instrument, letters of wishes, historical patterns of trust distributions, and any functions performed by a trust protector or similar advisor. Interests in property held by the trust that cannot be allocated based on the foregoing factors are allocated to the beneficiaries under the principles of intestate succession, determined by reference to the settlor's assumed intestacy, as contained in the Uniform Probate Code. Second, interests in property held by a trust that are allocated to the expatriate must be valued under the gift tax principles mentioned above.

The principle is illustrated by the following example. Individual B, a former long-term resident, expatriated on December 31, 1996. B is a potential beneficiary of two trusts during his lifetime. Trust 1's sole asset is an apartment building. Under the terms of Trust 1, B is entitled to receive 100 percent of the income generated by the apartment building during B's life. B's brother, C, is the remainderman. For purposes of computing B's net worth, Trust 1's interest in the apartment building is allocated between B and C. B is treated as owning a life interest in the apartment building. The value of the life interest must be determined under the gift tax evaluation rules.

The second trust in the example, Trust 2, was established by B's father for the benefit of B and C. Under the terms of Trust 2, the trust income and corpus may be distributed at the trustee's discretion to either B or C. For purposes of determining B's net worth, all of the interests in property owned by Trust 2 must first be allocated to either B or C based on all relevant facts and circumstances. If the

facts and circumstances do not indicate how the interest in the trust's property should be allocated between B and C, the trust property will be allocated under the rules of intestate succession as if B's father were intestate. If the Uniform Probate Code had allocated property of the father equally between B and C, B will be treated as owning half of the interests in property owned by Trust 2.

The Notice addresses the procedure that must be followed if a former U.S. citizen who would otherwise be subject to the expatriation rules wishes to obtain an I.R.S. ruling that tax avoidance is not a principal purpose of the loss of citizenship. The notice provides that former citizens who narrowly fail to satisfy the criteria of an enumerated category may also submit ruling requests. For example, assume that D, a former citizen of the United States by birth, expatriated on February 15, 1997. D's tax net tax liabilities exceeded U.S. $100,000 on average over the 5-year period preceding the act of expatriation, and accordingly, tax avoidance is considered to be a principal purpose of the expatriation under the objective standards of the new law. D has resided in the United Kingdom since 1985. D is not a citizen by birth of another country and does not plan to become a citizen of a country in which a parent or a spouse was born. D did not spend any time in the United States during the 10-year period prior to expatriation, except for one year involving a vacation in Hawaii for 35 days. This vacation causes D to narrowly fail to meet the conditions of the statue. D is eligible to submit a ruling request.

In further illustration, assume that individual E is a citizen of France and a long-term resident of the United States. E's parents emigrated from Africa to France in 1950 and acquired French citizenship in 1960. E's parents were employed by the French government and often traveled outside of France. In 1965, E was born while E's parents were stationed outside of France on a short-term assignment. By virtue of his parents' French citizenship, E became a citizen of France at birth. E resided in France from age one until age 21. E became a lawful permanent resident of the United States at age 21. E is now 31 years old and wishes to relinquish his green card and return to France. Assume that tax avoidance exists because the net worth test is met. E is not a citizen of France by virtue of being born in France. Thus, he narrowly fails to satisfy the criteria of an enumerated category because he was born outside of France when his parents were temporarily absent from the country. E is a citizen of France by birth, became a resident of France at age one, and plans to become a resident of France after terminating his U.S. residency. E is eligible to submit a ruling request.

The Notice clarifies that the decision to issue a ruling is within the sole discretion of the I.R.S. If the I.R.S. declines to rule, the individual will not be considered to have "submitted" a ruling request. If tax avoidance exists under the tax liability or net worth test, the individual will be subject to the expatriation rules unless a favorable ruling is obtained. The mere submission of a ruling request is not sufficient itself to avoid continuing U.S. tax jurisdiction. If a ruling request is pending at the time prescribed for filing an income tax return, the individual must report income as if the expatriation rules applied and the U.S. retained tax jurisdiction. If the individual obtains a favorable ruling at a later date, an amended return may be filed claiming a tax refund. An adverse ruling may be challenged by initiating a refund suit.

The Notice states that the burden of proof is on the individual to establish that expatriation does not have as one of its principal purposes the avoidance of U.S. taxes. To meet this burden, all relevant

information should be submitted with the request. Among the more important items of information are the date of expatriation and a full explanation of the individual's reasons for expatriating. All foreign countries where the individual is, or intends to be, a resident for tax purposes or a citizen must be provided, and also the countries where the individual's spouse and parents were born. A description must be submitted of the individual's ties to the United States and the individual's ties to the foreign country of residence for the five-year period that ends on the date of submission of the ruling request. This includes the location of the individual's permanent home, tax home, family and social relations, occupations, political, cultural, or other activities, business activities, personal belongings, the place from which the individual administers property, the jurisdiction in which the individual holds a driver's license, the location where the individual conducts routine personal banking activities, and the location of the individual's cemetery plot.

Also a fair market value balance sheet must be prepared which sets forth by category the individual's assets and liabilities immediately prior to expatriation. Typical categories are cash, marketable securities, closely-held stock, business assets, qualified and non-qualified deferred compensation arrangements, individual retirement accounts, installment obligations, U.S. real property, and foreign real property. The balance sheet must set forth (i) the source of income and gain that such property would have generated during the 5-year period prior to expatriation and immediately after expatriation, (ii) the source of income and gain that such property would have generated during the 5-year period prior to expatriation and immediately after expatriation, assuming that the special source rules applicable under the expatriation provisions were to apply, and (iii) the gain or loss that would be realized if the assets were sold for fair market value on the date of expatriation.

The individual must separately list each partnership in which an interest is held, each trust that the individual is considered to own under the grantor trust rules, each trust that the individual is considered to own under the estate tax rules, and each trust in which the individual holds a beneficial interest. The individual must describe the types of assets held by each partnership or trust and must indicate the methodology used to determine the individual's beneficial interest. In addition, the individual should indicate whether there have been or are expected to be significant changes in assets and liabilities for the period that begins five years prior to expatriation and ends ten years following the date of expatriation. The changes in the individual's assets and liabilities during such period should be explained. This is supplemented by a description of all exchanges of property and all removals of appreciated tangible personal property from the United States for a specified period. The period begins five years prior to expatriation, but not earlier than February 6, 1995, and ends on the date that the ruling request is submitted. A similar reporting obligation applies to property that has been exchanged or removed or that is expected to occur during the 10-year period following expatriation.

The taxpayer must also submit information regarding his tax return status. This includes a statement describing the nature and status of any ongoing audits, disputes or other matters pending before the I.R.S., a statement as to whether the individual satisfied his U.S. tax liability during the period that he or she was a U.S. citizen or lawful permanent resident of the United States, and copies of the individual's U.S. tax returns for each of the three years prior to expatriation.

Enhanced reporting requirements are provided for individuals having gross assets with an aggregate fair market value in excess of U.S. $10 million. These include a calculation of the individual's projected U.S. and foreign income tax liability for the taxable year of expatriation and the two taxable years following expatriation under three factual assumptions. The first calculation assumes that the individual expatriated with a principal purpose of avoiding U.S. taxes. The second calculation assumes that the individual did not expatriate with that purpose. The third calculation assumes that the individual remained a U.S. citizen or U.S. lawful permanent resident. The individual must also indicate whether a substantial change in projected U.S. and foreign income tax liability is expected as a result of a change in income for the remainder of the 10-year period following expatriation. The individual must provide an actuarial estimate of U.S. and foreign estate and other death taxes that would be owed on the individual's property were he to continue to own the same property owned on the date of expatriation. Finally, the individual must submit a statement as to whether he expects to make a gift during the 10-year period following expatriation that would otherwise be subject to tax if avoiding U.S. taxes were a principal purpose of the expatriation. If so, the individual should describe the gift, provide an estimate of its fair market value, and indicate projected timing for the gift and the anticipated identity of the donee.

E. Notice 98-34 (Expatriations Before June 4, 2004)

In Notice 98-34, 1998-27 I.R.B. 1, the I.R.S. announced that it will entertain two types of ruling requests from expatriates. Under the first type of request, an individual can rebut the presumption of tax avoidance merely by submitting a complete ruling request in good faith and receiving an I.R.S. ruling as to the existence of good faith and completeness. This ruling will not be a final determination and will be subject to subsequent examination by the I.R.S. Examples of this type of ruling are Private Letter Rulings 199932035, 199932027, 199932040, and199936049. In Private Letter Ruling 199948033, the presumption was found to be inapplicable because of a full and complete disclosure. However, the disclosure indicated that tax avoidance was a principal purpose of expatriation. Consequently, the I.R.S. ruled that the expatriation rules expressly applied to the individual.

Alternatively, an individual may request a ruling that a substantive ruling. However, the I.R.S. will issue a substantive ruling only where the facts submitted clearly demonstrate the absence (or presence) of a tax avoidance motive.

After July 6, 1998, the following information will be required in order for the I.R.S. to rule that the submission is complete and in good faith:

- The date (or expected date) of expatriation;
- A full explanation of the individual's reasons for expatriating;
- The individual's date of birth;

- All foreign countries of which the individual is a resident for tax purposes or intends to obtain residence for tax purposes, and a statement regarding the liability of the individual to worldwide income and estate taxation. If not subject to worldwide taxation, an explanation of the local tax rules must be submitted;

- All foreign countries of which the individual is a citizen and/or intends to acquire citizenship after expatriation;

- The countries where the individual's spouse and parents were born, and where they currently reside, and a statement as to whether the individual's spouse has expatriated or intends to expatriate;

- The country where the individual's tax home is located;

- A description of the individual's connections to the U.S. and the individual's connections to the foreign country of residence under principles that appear in the closer-connections provisions of the income tax regulations addressing residence of non-citizen individuals; the description should cover the period beginning 5 years prior to the expatriation through the date of submission of the ruling request;

- A detailed balance sheet setting forth the individual's U.S. and foreign assets and liabilities immediately prior to expatriation, including U.S. and foreign marketable and unmarketable securities, investments in partnerships, pension rights for services performed in the U.S. and outside the U.S., loans to U.S. and foreign persons, interests in non-grantor trusts, assets held by grantor trusts of which the U.S. person is a grantor, intangibles used inside and outside the U.S., U.S. and foreign real property, business property located inside and outside the U.S., installment obligations, mortgages, and other liabilities;

- A statement and accompanying explanation as to whether there have been or are expected to be significant changes in the individual's assets and liabilities for the period beginning 5 years prior to expatriation and ending 10 years following the date of expatriation;

- A description of all exchanges of U.S. property for non-U.S. property and all removals from the U.S. of appreciated tangible personal property for the period beginning 5 years prior to expatriation (but not before February 6, 1995) and ending on the date that is 10 years following expatriation;

- A statement describing ongoing matters pending before the I.R.S. and the status of the individual's tax liability while a U.S. citizen or lawful permanent resident and copies of the tax returns regarding the 3 years leading up to the date of expatriation, the year during of expatriation, and for all subsequent years;

- A copy of the information statement required to be filed by expatriates, providing information similar to that described above;

- A calculation of the individual's projected U.S. and foreign income tax liability upon a deemed disposition at fair market value of all of the individual's assets immediately following expatriation assuming that the individual did not expatriate with a principal purpose to avoid U.S. taxes, and again, assuming that the individual did not become an expatriate;

- A projection of the individual's U.S. and foreign income tax liability for each of the three years following expatriation, including a description of the foreign income tax treatment (e.g., tax-exempt income and rates of tax) assuming that the individual did not expatriate with a principal purpose to avoid U.S. taxes, and again, assuming that the individual did not become an expatriate; the projection should be accompanied by an explanation if a substantial change is anticipated in the projected U.S. or foreign income tax liability;

- A statement indicating whether the individual has transferred any property by gift with an aggregate value of $100,000 or more including gifts to the individual's spouse during the period beginning 5 years prior to expatriation and ending on the date of the submission of the ruling request and if such gifts were made, the details thereof;

- A statement indicating whether the individual expects to make any substantial gifts during any year of the 10-year period following expatriation; if so, projections of the U.S. and foreign gift taxes must be provided assuming that the individual did not expatriate with a principal purpose to avoid U.S. taxes, and again, assuming that the individual did not become an expatriate;

- If an individual is of the age of 60 years or older on the date of expatriation, the present value of the estimated U.S., foreign and other death taxes that would be imposed as a result of the individual's death, and a description of the foreign tax treatment that would arise assuming that the individual did not expatriate with a principal purpose to avoid U.S. taxes, and again, assuming that the individual did not become an expatriate;

- If the individual is the grantor of a grantor trust, a description of the U.S. and foreign tax treatment to both the trust and the individual of the expected trust income and distributions for each of the 3 years following expatriation, assuming that the individual did not expatriate with a principal purpose to avoid U.S. taxes, and again, assuming that the individual did not become an expatriate;

- If the individual is a beneficiary of a non-grantor trust, a description of the U.S. and foreign tax treatment of the expected trust distributions to the individual for each of the 3 years following expatriation, assuming that the individual did not expatriate with a principal purpose to avoid U.S. taxes, and again, assuming that the individual did not become an expatriate; and

- Any other information reasonably required by the Service after its review of the submission.

F. Expatriations After June 3, 2004

The American Jobs Creation Act of 2004 replaces the subjective tax-avoidance inquiry with objective standards, treats such individuals as U.S. citizens and residents for the tax year if they stay in the U.S. for more than 30 days in such year and expands the reach of U.S. gift tax on gifts of certain closely-held foreign corporations.

For individuals who relinquish their U.S. citizenship or terminate their long-term resident status after June 3, 2004, § 877 applies, without regard to tax motivation, to any former U.S. citizen or long-term resident: (i) whose net worth as of the date of loss of citizenship or termination of long-term resident status equals or exceeds $2,000,000, (ii) whose average annual net income tax liability for the five preceding taxable years exceeds $124,000 (as adjusted annually for inflation, *e.g.*, $127,000 for 2005 and $131,000 for 2006), or (iii) who fails to certify under penalty of perjury that all of his or her federal tax obligations for the 5 preceding taxable years have been met. As a result of this objective test, ruling requests to the I.R.S. regarding the tax-avoidance motive are no longer necessary.

Exceptions to the automatic application of § 877 are available to two categories of individuals who have had limited contact with the U.S.:

- Dual citizens -- the individual became at birth a U.S. citizen and a citizen of another country and continues to be a citizen of such other country, and the individual has had no substantial contacts with the U.S.

  For this purpose, an individual is treated as having no substantial contacts with the U.S. only if the individual (i) was never a resident of the U.S. (as defined in Code § 7701(b), (ii) has never held a U.S. passport, and (iii) was not present in the U.S. for more than 30 days during any calendar year during the 10-year period prior to the individual's loss of U.S. citizenship.

- Certain minors -- (i) the individual became at birth a U.S. citizen, (ii) neither parent of such individual was a U.S. citizen at the time of such birth, (iii) the individual's loss of U.S. citizenship occurs before such individual attains age 181/2 and (iv) the individual was not present in the U.S. for more than 30 days during any calendar year during the 10-year period prior to the individual's loss of U.S. citizenship.

In addition, new § 877(g) provides that a former U.S. citizen or long-term resident will be treated for all Federal tax purposes (income, estate and gift tax) as a citizen or resident of the U.S. for the taxable year in which the individual is physically present in the U.S. for more than 30 days. For this purpose, a day of presence in the U.S. is disregarded (up to 30 additional days per calendar year) if the individual is performing personal services for an unrelated employer and the individual falls within one of the following two categories:

- Individuals with ties to other countries -- the individual becomes a citizen or resident of and becomes fully liable for income tax in the country of birth of such individual, the spouse or either of the parents of such individual; or

- Minimum prior physical presence in the U.S. -- the individual was physically present in the U.S. for less than 31 days per year in the 10-year period prior to the loss of U.S. citizenship or termination of residency.

Some advisers believe that this provision leads to an unintended tax planning opportunity for individuals who become resident in a country that has in effect an income tax treaty with the U.S. Under the revised law, the expatriation rules are not applicable to an expatriate who spends more than 30 days in the U.S. Rather, the individual is a resident of the U.S. for all purposes of the Code in such year. But this means that the provision in U.S. income tax treaties allowing the U.S. to apply its expatriation rules becomes inapplicable, as by its terms, those provisions do not apply to the individual. He or she is a resident. This presumably causes the individual to be a dual resident, and accordingly, subject to the tiebreaker rules of an income tax treaty. If the individual maintains his principal home in the treaty jurisdiction, the tiebreaker would allocate his or her residence to the foreign country. Once that occurs, the general treaty rules of taxation arguably would apply and U.S. tax jurisdiction would be limited. Whether the I.R.S. would willingly accept this result is a different matter.

Code §2501(a)(5) overrides the general rule that gifts of shares of stock of a foreign corporation are not subject to U.S. gift tax. See generally Code §2511. It does so by providing that U.S. gift tax applies to the "U.S.-asset value" of the stock of foreign corporation given by expatriates subject to the special regime of Code §877 if two conditions are met. The first is that, at the time of the transfer, the the donor must own within the meaning of § 958(a) 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. The second is that, in addition to such 10% ownership under Code §958(a), the the donor must own or must be considered to own under the rules of Code §958(b)more than 50% of the total combined voting power of all classes of stock entitled to vote of the corporation. The U.S.-asset value is the fair market value of the stock of the foreign corporation multiplied by a fraction, the numerator of which is the fair market value of the U.S.-situated assets owned by theforeign corporation and the denominator of which is the total fair market value of all assets owned by such foreign corporation.

G. Long-term Residents Covered

Comparable treatment is provided for a long-term resident of the U.S. who (i) ceases to be a lawful permanent resident of the U.S. by relinquishing his green card or (ii) is treated as a resident of another country under the tiebreaker provision of an income tax treaty. Consequently, a long-term resident of the United States will be subject to the foregoing provisions of the expatriation rules if he ceases to be a lawful permanent resident of the U.S. under the green card test. He will also be subject to those rules if he commences to be treated as a resident of a foreign country under the provisions of an income tax treaty between the U.S. and the foreign country unless the benefits of the treaty are waived.

A long-term resident means an individual, other than a citizen, who is a lawful permanent resident of the U.S. for immigration purposes in at least 8 taxable years during the period of 15 taxable years ending with the year in which the green card is relinquished or the person claims benefits as a resident of a tax treaty jurisdiction.[45] In counting years, if a green card holder is treated as a resident of a foreign country for the taxable year under a tie-breaker provision of an income tax treaty, he is not considered to be a lawful permanent resident for the year unless he chooses to waive treaty benefits.

Care must be taken to avoid mistakenly believing that the period for establishing long-term residence is 8 full calendar years. Presumably a period of as little as 6 years and 2 days may suffice if the period begins on December 31st of one year and ends on January 1st immediately following the sixth anniversary in the U.S.

For purposes of determining the tax imposed on a long-term resident during the 10-year period of continued tax jurisdiction, the basis maintained in assets owned on the date residence is established will not be less than the fair market value as of that date.[46] Thus, a step-up is allowed if those assets are ultimately sold after the green card is relinquished. The step-up in basis is not allowed in connection with a sale during the period of actual residence. It will be prudent for a foreign individual obtaining a green card to establish fair market value at the time residence is established and it will also be prudent for an individual contemplating a departure from the U.S. to consider deferring the sale of those assets until after residence is relinquished in order to minimize taxable gain.

For expatriations before June 4, 2004, the statute provides that none of the exceptions to the tax avoidance presumption that apply to citizens relinquishing citizenship are applicable to long term residents.[47] Nonetheless, Notice 97-19 advises that the I.R.S. expects to issue regulations that will permit a former long-term resident who is within certain categories to request a ruling. Apparently, the I.R.S. determined that if rulings would not be issued to long-term residents, those individuals would first attempt to become citizens. At that point, they would be entitled to request a ruling. To avoid this two-step expatriation, the Notice refers to the authority of the I.R.S. to exempt categories of former long-term residents from the scope of Code §877 as the basis for issuing rulings.

A former long-term resident may request a ruling if covered by any of the following fact patterns:

- On the date of expatriation, the individual is a citizen of the country in which the individual was born, or the country where the individual's spouse was born, or the country where either of the individual's parents was born, and the individual becomes, not later than the close of

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[45] Code §877(e)(2).

[46] Code §877(e)(3).

[47] Code §877(e)(1).

a reasonable period after the individual's expatriation, fully liable to tax in such country by reason of the individual's residence;

- The individual was present in the United States for not more than 30 days during each year of the 10-year period prior to expatriation; or

- The individual ceases to be taxed as a lawful permanent resident, or commences to be treated as a resident of another country under an income tax treaty and does not waive the benefits of such treaty applicable to residents of the foreign country before the individual reaches age 18½ years.

As with a former citizen, a former long-term resident who narrowly fails to satisfy the criteria of an enumerated category may also submit a ruling request.

H. I.R.S. Rulings (Applicable to Expatriations Before June 4, 2004)

Several private letter rulings issued by the I.R.S. are illustrative of the rulings policy towards expatriates. In P.L.R. 9732025, the individual was a naturalized U.S. citizen, but continued at all relevant times to be a citizen of his country of birth. He lived abroad from 1973, albeit not in his country of birth. However, he was married to a citizen of the country of his residence, had no assets or family in the U.S. and did not visit the U.S. at any time after 1982. Under Code §877(c)(2)(A(ii)(I), the individual was entitled to seek a ruling from the I.R.S. that the renunciation of citizenship was not tax motivated even though the individual's net worth exceeded U.S. $500,000. The I.R.S. issued a favorable ruling to the individual. Among the factors looked to by the I.R.S. were the following:

- The total net worth was less than U.S. $1 million which was substantially attributable to the value of his principal residence.

- His assets had not increased materially during the 5-year period prior to the renunciation of citizenship.

- The individual was present in the U.S. for not more than 30 days during each year of the 10-year period preceding the renunciation of citizenship.

In P.L.R. 9801049, the individual was a dual citizen of the U.S. and his country of birth. The individual obtained U.S. citizenship by reason of the nationality of his mother. He obtained citizenship in the country of birth because of his father's citizenship there. The individual first came to the U.S. to study. It was at that time that he first perfected his claim to U.S. citizenship. After the completion of his studies, he returned to his country of birth to pursue business as an executive. Ultimately, his employer assigned him to the U.S. for several years. Upon the completion of his tour of duty in the U.S., he has resided in a third country, working for the same group. As a resident of the third country, the individual is subject to tax on worldwide income.

Regarding personal matters, the individual's personal assets are administered at his permanent residence in the third country. His parents are both deceased, and are buried in the individual's country of birth. The individual has no family in the U.S. He is not married and has no children. All U.S. tax liabilities regarding other matters have been resolved. The U.S. has income tax treaties in force with both the country of the individual's birth and the country of his residence.

The fair market value of his gross assets exceeds $10 million. Aside from a small bank account and a small retirement and pension account, the individual has no assets in the U.S. The vast majority of the individual's assets consist of foreign bank deposits and foreign securities. In addition, the individual owns property, both real and personal, located in his country of birth and his country of residence. During the three years prior to the anticipated date of expatriation, the individual liquidated a very large percentage of his securities portfolio and paid U.S. tax on the capital gains. The remaining unrealized gains constitute only a small percentage of the individual's net worth. Any future disposal of assets would be taxable in the individual's country of residence at a rate which is greater than the U.S. rate.

The individual provided the I.R.S. with current estimates of his expected U.S. and foreign tax liabilities less than three scenarios, as required in Notice 97-19, 1997-10 I.R.B. 40. The scenarios included the taxes that would be due if the individual remained a citizen of the U.S., the taxes if he expatriated with a principal purpose of avoiding U.S. taxes, and the taxes if he expatriated without the tainted purpose. Because the effective foreign tax rate on his investment income and compensation income in his country of residence equal or exceed the U.S. tax rate on such income, the residual U.S. income tax liabilities were he to remain a U.S. citizen would not be significant. Also, actuarial estimates of the U.S. and foreign estate taxes that he could owe at death are not significant, based upon the individual's age and health. In any event, the present value of his U.S. estate tax exposure is exceeded by the present value of his foreign estate tax exposure. The individual also expected to make no gifts over the ten-year period following expatriation.

The I.R.S. ruled that the individual was eligible to submit a ruling request that tax avoidance was not one of the principal purposes of expatriation because at birth, he became eligible to be a citizen of the United States and was a citizen of another country. Moreover, based solely on the information and representations submitted, the I.R.S. ruled that the individual's loss of U.S. citizenship did not have for one of its principal purposes the avoidance of taxes in the circumstances.

P.L.R. 9807020 involves a long-term permanent resident of the U.S. who relinquished his green card. In the ruling, the individual moved to the U.S. from the country of his birth at the request of his employer. At that point he applied for and was granted a green card. Upon retirement, he and his wife moved back to his country of birth and the country of his citizenship. It is also the country where most of the members of his family live. Prior to retirement, the individual and his wife, a U.S. citizen, made annual trips to that country to scout out the territory. At retirement, they began to establish a life together there, but made annual trips to visit family in the U.S. The individual lived in an apartment in the foreign country. The individual and his wife were residents of that country for tax purposes. Because of the limited amount of time spent in the U.S., the individual could no longer

retain his lawful permanent resident status in the U.S. Consequently, he submitted the proper INS form stating that he was voluntarily abandoning his status as a lawful permanent resident of the U.S.

At the time of the expiration of A's Green Card, his net worth exceeded $500,000. The fair market value of his assets, however, did not exceed $10 million. His assets consisted primarily of non-dividend paying stock of his former employer, an individual retirement account subject to tax in his country of residence, and certain real property in the country.

The I.R.S. ruled that, pursuant to Notice 97-19, the individual was eligible to request a ruling to the effect that tax avoidance was not a principal purpose of his expatriation. On the date of his expatriation, the individual was a citizen of the country in which he was born and was fully liable to tax there by reason of his residence. Also, his parents were born there. The I.R.S. went on to conclude that the termination of permanent resident status did not have as one of its principal purposes the avoidance of U.S. tax.

I. Reporting

For expatriations prior to June 4, 2004, a reporting obligation is imposed on a person renouncing citizenship or relinquishing residence. Prior to the act of renunciation, the individual must provide the appropriate government agency with:

- His taxpayer identification number,
- The mailing address of his principal foreign residence,
- The foreign country in which he is residing, the foreign country of citizenship,
- In the case of an individual having a net worth of at least U.S. $500,000 (as adjusted for inflation), information detailing assets and liabilities, and
- Such other information as the I.R.S. may prescribe. This information is to be turned over to the I.R.S. which will publish the names of each individual losing U.S. citizenship and subject to continuing tax jurisdiction. Exceptions may be provided by I.R.S. regulation.

For expatriations prior to June 4, 2004, Form 8854 (Expatriation Initial Information Statement) is filed only once with the I.R.S.

For expatriations after June 3, 2004, for expatriates subject to the special tax regime, a properly completed Form 8854 (Initial and Annual Expatriation Information Statement) must be filed to (i) establish that an individual has expatriated or terminated the long-term resident status and (ii) to comply with the annual information reporting requirement under § 6039G for 10 years following the loss of U.S. citizenship or the termination of long-term resident status. An individual does not lose his or her U.S. citizen or resident status for tax purposes and start the running of the 10-year period until a properly completed Form 8854 is filed with the I.R.S. center in Philadelphia, Pennsylvania

19154 (in addition to meeting the applicable requirements for the Department of State or the Department of Homeland Security).

V. Taxation of Trusts, Grantors, and Beneficiaries

A. In General

1. Non-grantor Trusts

A trust is treated as a separate taxable entity,[48] except in cases where the grantor (*viz*., the person who settles or transfers property to the trust) or a person with a general power of appointment over the assets has certain powers or interests with respect to the trust.[49] A non-grantor foreign trust is generally taxed like a nonresident alien individual.[50] Hence, it is subject to tax on its U.S. source income and its foreign source income that is treated as being effectively connected with the conduct of a U.S. trade or business. Taxable income is computed much the same way as for an individual, but with certain modifications.[51] One significant modification is that a non-grantor trust is entitled to deduct distributions paid, or required to be paid to a beneficiary.[52] Distributions which are deductible for the trust generally are includable in the gross income of the beneficiaries.[53] In this manner, non-grantor trusts are treated as conduits of income between the trust and the beneficiary.

The amount which is deductible for the trust and includable in the income of the beneficiaries generally is limited by the distributable net income ("D.N.I.") of the trust for the taxable year ending with, or within, the taxable year of the beneficiary. Distributable net income generally means the taxable income of the trust, computed with certain adjustments. Among these adjustments are rules requiring a foreign trust to compute its D.N.I. by including foreign source income otherwise not subject to income tax, to include U.S. source income that is exempt under treaty, and capital gains.[54] These adjustments increase the D.N.I. of a trust in recognition of the broader definition of taxable income applicable in the wholly domestic context (viz., that of a U.S. citizen). Prior to The Small

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48 Code §641(a).

49 Code §671.

50 Code §7701(a)(31) as in effect prior to August 20, 1996.

51 Code §641(a).

52 Code §651(a) for current inclusion trusts and Code §661(a) for other trusts and for estates.

53 Code §652(a) for current inclusion trusts and Code §662(a) for other trusts and for estates.

54 Code §643(a).

Business Job Protection Act, P.L. 104-188 ("the Act"), distributions to trust beneficiaries in excess of the current year's D.N.I. were taxed to the beneficiaries under a throwback rule. The throwback rule was applied up to the amount of the D.N.I. of previous years.[55] The Act limits this treatment to (i) trusts formed prior to March 1, 1984, which benefit from multiple use of the tax brackets and (ii) foreign trusts.[56]

2. Grantor Trusts

Under the grantor trust rules, the grantor of a trust is taxed as the owner of the trust (or a portion thereof) if the grantor retains certain rights or powers.[57] A grantor of a trust generally will be treated as the owner of any portion of a trust when one or more of the following circumstances exist:

- The grantor has a reversionary interest in either the corpus or the income therefrom, and if, as of the inception of that portion of the trust, the value of that interest exceeds 5% of the value thereof;[58]
- The grantor has the power to control beneficial enjoyment of the income or corpus;[59]
- The grantor retains certain administrative powers, including the right to substitute property in the trust and the right to borrow from the trust on an interest-free basis;[60]
- The grantor has a power to revoke the trust;[61]
- The income of the trust is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the lives of, the grantor or the grantor's spouse[62]

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[55] Code §§665-668.

[56] Code §665(c).

[57] Code §§671-679.

[58] Code §673.

[59] Code §674.

[60] Code §675;

[61] Code §676.

[62] Code §677.

- The grantor of the trust is a U.S. person, the trust is foreign, and one or more actual or potential beneficiaries are U.S. persons.[63]

B. Law Applicable to Foreign Trusts

Special rules now apply to foreign trusts which limit the scope of the grantor trust rules.

1. Trust must have U.S. Grantor

Under Code §672(f), foreign trusts are considered grantor trusts only if the person treated as the grantor is a U.S. citizen, resident or a domestic corporation. A similar result is achieved if the grantor is a controlled foreign corporation for purposes of Subpart F, at least to the extent of the direct and indirect interests of the U.S. Shareholders of the corporation. Thus, the grantor trust rules apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income of a U.S. citizen, resident or a domestic corporation. Current law applies as of the date of enactment which is August 20, 1996.

Several exceptions exist to the rule described above. Under one exception, the grantor trust rules apply to a trust if the power to revest absolutely the title to the trust property is exercisable solely by the grantor, either without the approval of another person or with the approval or consent of a related or subordinate party who is subservient to the grantor.[64] The power to revest, however, must be a substantial power. Final regulations provide that the exception applies only if the power to revest is exercisable for one or more periods aggregating 183 at least days during the taxable year of the trust.[65] The 183 days need not be consecutive. A power to revest that is exercisable each year from January 1st through May 31st and again from September 1st through December 31st would be eligible for the exception.

A related or subordinate person is any nonadverse party who falls within the following list of persons:

- The grantor's spouse, if living with the grantor, or
- The grantor's father, mother, issue, brother or sister, or
- An employee of the grantor, or
- A corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or

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[63] Code §679.

[64] Code §672(c).

[65] Regs. §1.672(f)-3 (a)(2).

○ A subordinate employee of a corporation in which the grantor is an executive.

Under a second exception, the grantor trust rules apply to a trust if the only amounts distributable from the trust during the lifetime of the grantor are to the grantor or the grantor's spouse.[66] Care must be taken, here, to avoid disguised distributions. One illustration of a disguised distribution is the payment of unreasonable fees by the trust for the performance of services. Thus, the regulations provide that payments of reasonable nongratuitous administrative expenses by the trust to another person, will be not considered to be amounts distributable from the trust.[67] Another example of a payment that will not be viewed to be a disguised distribution is an amount paid in discharge of a legal obligation of the grantor or the grantor's spouse. If the obligation was entered into for adequate and full consideration in money or money's worth, it will not be characterized as a disguised distribution. Finally, amounts that are distributed to support a family member of the grantor or spouse will not be treated as a distribution to the recipient that causes the exception to be inapplicable. In general, however, the family member must be an individual who would be treated as a dependent under Code § 152(a)(1) through (8). To illustrate, the family member must be permanently and totally disabled or, in the case of a child, less than 24 years of age.

The foregoing exceptions do not apply to the extent of transfers of property (other than in a sale for full and adequate consideration or gifts excluded under Code §2503(b)) made by a U.S. beneficiary of the trust to the foreign grantor.[68] A person cannot give away property prior to the establishment of U.S. residence only to receive a gift from the donee in the earlier transaction.

The new law also does not apply to trusts established to pay compensation,[69] or to certain trusts in existence as of September 19, 1995, provided such trust is treated as owned by the grantor or another person under Code §§676 or 677 (other than §677(a)(3) relating to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse).[70] For example, a pre-September 20, 1995, trust will continue to be treated as a grantor trust under the law in effect prior to the Act, if the trust is a grantor trust because it is revocable by the grantor or a nonadverse party (or both), or if the income of the trust is or, in the discretion of the grantor or a nonadverse party (or

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66 Code §672(f)(2)(A)(ii).

67 Reg. §1.672(f)-3.

68 Code §672(f)(5).

69 However, proposed regulations on employee trusts provide a limited application for this rule. See Prop. Reg. §1.671-1(h) which limits the extent to which an employer may be treated as the owner of a foreign employees' trust. This limitation does not appear to apply to "rabbi trusts" established for particular employees of foreign corporations. See Reg. §1.672(f)-3.

70 Code §672(f)(2)(B).

both), may be distributed to the grantor or the grantor's spouse or held or accumulated for future distribution to the grantor or the grantor's spouse. However, these transitional rules are applicable only to the extent that the trust was funded before September 20, 1995, and only with respect to assets transferred in trust prior to that date and income therefrom.

If these exceptions do not apply, a foreign grantor trust will be treated as a grantor trust until August 20, 1996 and then as a nongrantor trust.

2. Loans to U.S. Beneficiaries

Effective for loans made after September 19, 1995, in the case of a loan of cash or marketable securities by a foreign nongrantor trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such a grantor or beneficiary), the full amount of the loan is treated as if distributed to the beneficiary, even if the loan bears interest at an adequate rate and is subsequently repaid.[71] The effective dates of the legislation are somewhat uncoordinated. If the loan made after September 19, 1995, is made by a foreign grantor trust established by a foreign person, the rules mandating inclusion of the loan as a trust distribution first have effect on August 20, 1996, when the foreign grantor trust is characterized for the first time as a nongrantor trust. At that point, the trust begins to have D.N.I.. Consequently, not all of the loan is taxed if D.N.I. for the post August 19,1996, period is less than the principal balance of the loan.

In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan, such as repayment, is disregarded for all purposes of the Internal Revenue Code. This treatment does not apply to loans made to organizations that are exempt from U.S. income tax.[72]

An exception to this treatment is made if the loan from the trust is a qualified loan pursuant to regulations of the I.R.S. In Notice 97-34,[73] the I.R.S. advised when loans would be deemed to qualify under this exception. The standards for qualification are as follows:

- The obligation must be reduced to writing;
- The term of the obligation must not exceed five years;
- All payments on the obligation must be denominated in terms of U.S. dollars;
- The yield to maturity of the obligation must not be less than 100% nor greater than 130% of the AFR in effect for the day on which the obligation is issued;

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[71] Code §643(i).

[72] Code §643(i)(3).

[73] Notice 97-34, 1997-25 I.R.B. 1.

- The U.S. beneficiary must agree to extend the period for assessment of any income or transfer tax attributable to the transfer, and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation; and

- The U.S. beneficiary must report the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.

3. Reporting Obligations for Foreign Trust Created by U.S. Person

Reporting obligations are imposed on responsible parties in connection with reportable events regarding foreign trusts and, in certain circumstances that will be determined, U.S. trusts having substantial activities or assets abroad.[74] Reporting must include the amount of money or property transferred and the identity of the trust, the trustee, and beneficiaries of the trust and is required within 90 days of the specified event. The reportable events in the event of a foreign trust created by a U.S. person and the persons who must report may be summarized as follows:

Event	Responsible Person
The creation of a lifetime trust by a U.S. person	The grantor
The transfer of money or property to a foreign trust by a U.S. person, including a transfer by reason of death	The transferor
The death of a citizen or resident of the U.S. who was treated as a grantor of a grantor trust or otherwise was subject to estate tax with regard to a portion of the trust's assets	The executor of the decedent's estate.

The reporting obligation of the grantor is satisfied by the filing of Form 3520.[75]

The reporting provisions do not apply to a transfer of property in exchange for fair market value consideration, determined generally without taking into account an obligation of the trust, its grantor, a beneficiary, or a person related to any of the above, or to a transfer to a trust that is part of a

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[74] Code §6048.

[75] Notice 97-34, 1997-25 I.R.B. 1., §III.B.

deferred compensation plan or that is a charitable trust. In Notice 97-34, the I.R.S. issued guidance explaining when, *inter alia*, obligations will be taken into account.

In order for an obligation of the trust to be taken into account, it must be a qualified obligation. To be qualified, an obligation must meet all of the following tests:

- The obligation must be reduced to writing;
- The term of the obligation must not exceed five years;
- All payments on the obligation must be denominated in terms of U.S. dollars;
- The yield to maturity of the obligation must not be less than 100% nor greater than 130% of the AFR in effect for the day on which the obligation is issued;
- The U.S. transferor must agree to extend the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation; and
- The U.S. transferor must report the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.

Notice 97-34 advises that a U.S. person will not be treated as making a transfer for fair market value merely because he recognizes gain on the transaction. Thus, for example, if a taxpayer recognizes gain on the contribution of property to a foreign trust by reason of Code §684, the transfer will not be treated as a transfer for fair market value because the transferor did not receive actual fair market value consideration pursuant to the deemed sale.

A U.S. person that is treated as a grantor of a grantor trust is responsible for ensuring that the trust (i) makes a return for the year which sets forth a full and complete accounting of all trust activities and operations, the name of the U.S. agent, other information required by the I.R.S. and (ii) furnishes information required by the I.R.S. to the U.S. grantor or to any U.S. person who receives a distribution from the trust. The obligation is effective for years beginning after December 31, 1995. Notice 97-34 advises that the information must be filed on Form 3520-A. Among other things, the U.S. owner must ensure that a trustee who is authorized to sign Form 3520- A:

- Files the Form 3520-A,
- Writes "FOREIGN GRANTOR TRUST" at the top of the form,
- Completes the identifying information on the form as if the foreign trust were the U.S. owner required to file the form,

- Signs the form,
- Attaches a Foreign Grantor Trust Information Statement to the form,
- Sends a Foreign Grantor Trust Owner Statement to each U.S. owner of a portion of the trust, and
- Sends a copy of a Foreign Grantor Trust Beneficiary Statement (see part 5 of the Foreign Grantor Trust Information Statement) to each U.S. beneficiary who received a distribution from the trust during the taxable year.

The Foreign Grantor Trust Information Statement includes a balance sheet, a profit and loss statement, and a list of credits. The Notice provides the format for reporting the information. In general, the form must be filed and the required statements furnished to the U.S. grantors and U.S. beneficiaries by the fifteenth day of the third month after the end of the trust's taxable year (or later, if pursuant to an extension of time to file).

A foreign grantor trust having a U.S. grantor must appoint a U.S. agent for the limited purpose of receiving service of process of any I.R.S. subpoena or summons for the production of records and testimony. The authorization of agent agreement must be executed by the foreign trust and the U.S. agent prior to the due date of the U.S. owner's Form 3520 for the taxable year that he or she is considered the owner of the trust. The authorization must remain in effect for as long as the statute of limitations remains open for the U.S. owner's relevant taxable year. If the agent resigns, liquidates or its responsibility is terminated, the U.S. owner must ensure that the foreign trust notifies the I.R.S. within 90 days, by filing an amended Form 3520-A with the Philadelphia Service Center.

A foreign trust will not be treated as having a U.S. agent unless the foreign trust identifies the name, address and taxpayer identification number of the U.S. agent on Form 3520-A. Even if the foreign trust identifies a U.S. agent on Form 3520-A, however, the foreign trust may be treated as providing incorrect information and, therefore, the U.S. owner may be subject to penalty if the U.S. agent or the foreign trust does not comply with its obligations to produce records requested by the Service in reliance on the bank secrecy laws of the country where the trust's bank accounts are located.

The agent will not be viewed to be a permanent establishment merely because of its appointment in compliance with the law. If an agent is not appointed, the I.R.S. is given discretion to determine the income of the trust and the amounts included in income of beneficiaries and the grantor.

If a foreign grantor trust transfers property to another person, information must be provided with regard to the transfer. In particular, the Form 3520-A requires the following information:

- The name, U.S. taxpayer identification number (if any), and country of organization or residence of the person to whom the property was transferred;

- A general description of the transfer, and any wider transaction of which it forms a part, including a chronology of the transfers involved and an identification of the other parties to the transaction to the extent known;

- A description of the property transferred, including the estimated fair market value and the adjusted basis of the property;

- A description of the consideration received by the trust, including its estimated fair market value, and for stock or securities, the class or type, amount, and characteristics of the interest received. If no consideration was received by the trust, indicate whether the trust or a U.S. owner exercises any powers over the entity to which the property was transferred (including a description of those powers), and identify the name, U.S. taxpayer identification number (if any), and country of organization or residence of all beneficial owners of such entity;

- To the extent known, a description of any subsequent transfer of the property, including the name, U.S. taxpayer identification number (if any), and country of organization or residence of the person to whom the property was subsequently transferred;

The statement must also contain a description of the trust ownership structure setting forth the name, U.S. taxpayer identification number (if any), and country of organization of all entities in which the trust has an ownership interest, including an ownership chart showing the trust's position in the chain of ownership and the percentages of ownership.

4. Reporting Obligations for U.S. Recipient of Distributions From Nongrantor Foreign Trust

A U.S. person who receives any distribution from a foreign trust must make a return with respect to the trust which includes the name of the trust, the aggregate amount of the distributions received, and any other information required by the I.R.S. For this purpose, the term "distribution" is defined literally so that all flows of cash from a trust to a beneficiary are taken into account. It is of no consequence that the flow of cash may be treated technically as a gift from a grantor of the trust. A similar rule is provided for transfers to foreign trusts.

A foreign non-grantor trust that makes a distribution to a U.S. beneficiary must provide the beneficiary with a foreign non-grantor trust beneficiary statement. The statement must include all the following items of information:

- An explanation of the appropriate U.S. tax treatment of any distribution or deemed distribution for U.S. tax purposes, or sufficient information to enable U.S. beneficiary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes;

- A statement identifying whether any grantor of the trust is a foreign partnership or a foreign corporation;

- A statement that the trust will permit either the I.R.S. or the U.S. beneficiary to inspect and copy the trust's permanent books of account, records, and such other documents that are necessary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes;

- The first and last day of the tax year of the foreign trust to which this statement applies;

- A description of property (including cash) distributed or deemed distributed during the tax year, and the fair market value of the property distributed; and

- A statement as to whether an agent has been appointed for service of process; generally, this requirement applies only if the trust is a grantor trust and a U.S. person is deemed to be the grantor.

If records are not provided to substantiate the tax treatment of the distribution (i.e., capital gain, income, accumulation distribution, or return of capital), the statute provides that the distribution will generally be treated as an accumulation distribution covering one-half the years in which the trust has been in existence.[76] However, as a matter of regulatory relief, the I.R.S. will allow the U.S. beneficiary to treat a portion of the distribution as a distribution of current income. The amount treated as current income will be based on the average of distributions from the prior three years. Only the excess of the 3-year average will be treated as an accumulation distribution.

The interest charge on the accumulation distribution will no longer be imposed at a flat 6% rate. Instead, the charge will be imposed on a compounded basis determined by reference to the interest rate for the underpayment of tax.[77] Consequently, a substantial interest charge will be imposed on the recipient if financial records are not made available to the I.R.S. in the form of a return.

5. Penalties for Noncompliance

Penalties are provided for failing to report fully and on a timely basis.[78] The penalty is generally 35% of the gross amount reportable. This means, the gross value of the property transferred, the gross value of the portion of the trust's assets treated as owned by a U.S. grantor as of the close of the year, or the gross amount of the distributions received. The penalty is reduced to 5% if the failure relates to the grantor's obligation to report the activities of the trust. If the failure continues for more than 90 days after notification by the I.R.S., an additional $10,000 per month penalty is imposed. A reasonable cause exception is provided. However, failure to report because of the application of a foreign statute which imposes a criminal or civil penalty on the act of disclosure is not to be considered as reasonable cause.

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[76] Code §6048(c).

[77] Code §668(a)(1).

[78] Code §6677.

C. Other rules

1. Change of Residence Status of Grantor

As mentioned above, a foreign trust may be a grantor trust if both the grantor and one or more actual or potential beneficiaries are U.S. persons. For purposes of determining whether a U.S. person transfers an asset to a foreign trust having U.S. beneficiaries, a foreign grantor will be treated as a U.S. grantor if he becomes a U.S. resident within 5 years after a transfer to a trust is effected.[79]

The individual will be deemed to have transferred to the trust an amount equal to the portion of the trust attributable to the property transferred by such individual. This deemed transfer occurs on the residency starting date. However, the amount transferred includes undistributed net income for periods before the residency starting date. Thus, if a foreign individual transfers U.S. 1,000 to a foreign trust in 1998 and the trust earns U.S. $150 for the period running through December 31, 1999, the amount deemed transferred to the trust is U.S. $1,150 if the individual becomes a U.S. resident effective on January 1, 2000. The earnings, however, are treated as capital as of that date and are not taken into account in computing distributable net income or accumulated net income. This rule will not be applied to cause the individual to be taxed on income of the trust derived before actual U.S. residence is established by the grantor.

In determining whether a foreign trust has U.S. beneficiaries, a foreign beneficiary who becomes a U.S. person within five years of the date of the transfer to the trust will be treated as a U.S. beneficiary.[80] Consequently, a change in residence of the beneficiary may have a tax effect for the grantor.

2. Payments Through Third Parties

Payments to U.S. persons may be treated as trust distributions to the extent routed through third parties.[81] This rule is designed to prevent adoption of an indirect flow of cash from a trust through a third country resident. The I.R.S. has issued final regulations[82] which address this issue. In general, the intermediary is disregarded and the amount will be deemed to have been paid directly by the foreign trust to the U.S. beneficiary if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax. A transfer of property will be deemed to have been made pursuant to that type of plan if the following factors are present:

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[79] Code §679(a)(4)(A).

[80] Code §679(b) and (c)(3).

[81] Code §643(h).

[82] Reg. §1.643(h)-1.

- The U.S. person is related to a grantor of the foreign trust or has another relationship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor would make a gratuitous transfer to the U.S. person.

- The U.S. person receives from the intermediary, within a 48 month period surrounding the intermediary's receipt of property, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and

- The U.S. person cannot demonstrate to the satisfaction of the I.R.S. that –

  - The intermediary has a relationship with the U.S. person that justifies a gratuitous transfer to the U.S. person,

  - The intermediary acted independently of the grantor and the trustee,

  - The intermediary is not an agent of the U.S. person under generally applicable U.S. agency principles, and

  - The U.S. person timely complied with the reporting requirement of section 6039F, if applicable, if the intermediary is a foreign person.

Nonetheless, the preamble to the final regulations cautions that the presumption goes only so far. The I.R.S. may find that a transfer was made pursuant to a tax avoidance plan even if none of the specified factors are present.

The timing of the income recognition event for the beneficiary will depend on the status of the intermediary. If the intermediary is an agent of the foreign trust – as determined under principles of agency law generally applicable in the U.S. – the amount is treated as paid to the U.S. person in the year it is paid by the intermediary to the U.S. person or made available to the U.S. person. The amount of the distribution is the value of the property at the time it is taken into income. In comparison, if the intermediary is an agent of the U.S. person under such agency principles, the amount is treated as paid to the U.S. person in the year it is paid by the foreign trust to the intermediary. The amount of the distribution is value at the time of receipt by the intermediary.

A *de minimis* rule is provided for distributions that do not exceed in the aggregate U.S. $10,000.

Examples in the final regulations[83] demonstrate the application of the presumptions in various factual contexts. In Example 1, trust documentation indicates that a foreign trust is to make a distribution to a U.S. person. The distribution is channeled to a nonresident, non-citizen individual who makes a gift to the U.S. person. The distribution and the gift are collapsed. In Example 2, a grandmother and a mother are nonresident, non-citizen individuals. The grandmother funds a foreign trust and the trust ultimately distributes shares of stock to the mother. The mother sells the shares and uses the

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[83] Regs. §1.642(h)-1(g).

proceeds to acquire shares in a second company. Within six months from the date of the trust distribution, the mother makes a gift of shares to the daughter. No other facts are present. The example concludes that the trust distribution and the gift are collapsed. In Example 3, the facts are similar except that the mother has her own stock portfolio which throws off an income stream that is greater than the value of the trust distribution and has a history of giving gifts to the daughter in the U.S. The example concludes that the gift and the trust distribution are separate transactions, even though carried out close in time. In Example 5, a foreign trust makes a distribution of shares to a nonresident, non-citizen individual. That individual subsequently makes a gift to a U.S. person of shares of stock of a different corporation, but of roughly similar value. The example concludes that the latter transaction is merely a transfer of substituted property and should be collapsed into the trust distribution.

3. Gifts from Corporations and Partnerships

Transfers that are directly or indirectly made from a partnership or foreign corporation which is treated as a gift or bequest by the recipient may be recharacterized by the I.R.S. as a transfer from a trust.[84] Under final regulations,[85] a U.S. person who receives a purported gift or bequest directly or indirectly from a partnership must report the amount received as ordinary income. If a U.S. person receives a purported gift or bequest directly or indirectly from a foreign corporation, the purported gift or bequest generally must be reported by the recipient as a distribution from the foreign corporation. This rule is subject to several exceptions. It will not apply if the donee can establish that a U.S. citizen or resident alien who directly or indirectly holds an interest in the partnership or foreign corporation treated the gift as a distribution from the partnership or foreign corporation and a subsequent gift to the donee. Similarly, it will not apply if a noncitizen, nonresident individual treated the gift as a distribution from the partnership or foreign corporation and a subsequent gift to the donee and the donee properly reported the gift on his U.S. income tax return as required by Code §6039F. It also does not apply where the donee that is a U.S. corporation which establishes that the purported gift or bequest was properly treated for U.S. income tax purposes as a contribution to capital that is free of income tax by reason of Code §118. Finally, it does not apply to transfers to charitable organizations or where the transferor is a U.S. partnership owned entirely by U.S. persons.

Gratuitous transfers from foreign corporations or partnerships to trusts followed by one or more gratuitous transfers from the trusts to U.S. beneficiaries are collapsed under the regulations. Consequently, the trust distribution is converted into a gratuitous transfer from the corporation or the partnership.[86] This section does not apply if the U.S. tax would be greater by treating the transaction as a trust distribution. Thus, if the distribution from the trust would be treated as an accumulation distribution that is subject to the throwback rules, the form of the transaction may be honored for U.S. income tax purposes.

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[84] Code §672(f)(4).

[85] Regs. §1.672(f)-4(a).

[86] Regs. §1.672(f)-4(c).

To prevent abuse, a transfer from a wholly owned entity that is an eligible entity for purposes of the characterization rules known as "check-the-box" must be treated as a corporation for purposes of the income inclusion rules applicable to gifts.

4. Gift Reporting

In addition to the reporting obligations described above, a U.S. person who receives in the aggregate more than $10,000 of foreign gifts or bequests during the year, must notify the I.R.S. of the receipt of the gifts.[87] The $10,000 threshold is subject to a cost of living adjustment beginning in 1997. For 2006, the reporting thresholds were as follows: all gifts from foreign corporations or partnerships in excess of $12,760 are reportable; gifts by nonresident, noncitizen individuals and foreign estates are reportable if in excess of $100,000 (not subject to cost-of-living adjustments). In determining whether the thresholds are met, gifts from related parties are aggregated.

While a gift is not taxable, this provision is intended to assist the I.R.S. in determining whether the gift is an indirect trust distribution. The failure to comply with the notification requirement may result in a 5% penalty per month up to a 25% maximum penalty and the I.R.S. may determine the tax consequence of the gift. This provision is effective after the date of enactment.

VI. Taxation and Income Tax Planning

A. General Tax Rules For Nonresident

Individuals who are neither citizens nor residents are subject to two regimes of tax on income that arises in the U.S. First, U.S. domestic law imposes a 30% tax on the gross amounts received as salaries, wages, annuities, compensations, remunerations, and other fixed or determinable annual or periodical income to the extent the income is received from sources within the U.S., provided that the item is not effectively connected with the conduct of a trade or business within the U.S.[88] No deductions are allowed in computing the tax. An individual is taxed at ordinary graduated rates and is subject to the alternative minimum tax on income which is effectively connected with the conduct of a trade or business within the United States.[89] If Code § 871(b) applies to an item of income, Code § 871(a) does not apply.

The term "engaged in a trade or business within the United States" includes the performance of personal services within the United States at any time during the taxable year.[90] Thus, an individual is subject to ordinary rates of tax for compensation received for services performed in the current

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[87] Code §6039F.

[88] Code §871(a)

[89] Code §871(b) and Regs. §1.871-8(b)(2).

[90] Code §864(b) and Regs §1.864-2(a).

year. If the services were performed in a prior year and no services are performed in the current year, the compensation would be subject to the 30% tax, but for a special rule.[91] Under that rule, deferred compensation continues to be taxable in the U.S. at ordinary graduated rates if attributable to services performed in an earlier year beginning after December 31, 1986. A similar rule applies to deferred payment sales[92] and for sales of property removed from a U.S. trade or business and sold within the following 10-year period.[93] Deferred payments from those sales will be treated as effectively connected income if the income would have been so treated in the year in which the sale took place.

Capital gains of persons who are neither residents nor citizens are generally not subject to U.S. income tax unless the gain is attributable to an office maintained in the U.S. and the individual is present in the U.S. for at least 183 days during the taxable year.[94] In that case, the net gain is treated as taxable U.S. source capital gain.[95]

B. General Tax Rules for Resident

Once an individual becomes a resident of the U.S., he or she is taxable on worldwide income and gain. This rule is deceptively complex because income must be computed under U.S. tax concepts including rules applicable to the timing of income recognition, rules applicable to the computation of gain, and rules designed to eliminate the benefit of deferral in connection with investments outside the U.S.

1. Income Recognition

With certain exceptions for the recognition of interest and interest equivalents,[96] income of most individuals is computed in accordance with the cash method of taxation.[97] Thus, income is subject to tax generally when received.[98] If deferred income is received during a period of residence, it is taxable upon receipt, if that is the method of accounting utilized by a taxpayer.

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[91] Code §864(c)(6)(A).

[92] Code §864(c)(6)(B).

[93] Code §864(c)(7).

[94] Code §871(b)(2).

[95] Code §865(e)(2)(A).

[96] Code §1272 regarding the accrual of income from original issue discount.

[97] Code §446(c)(1).

[98] Code §451(a).

If a taxpayer derives capital gains during a period of residence, the gain will be fully taxable. Ordinarily, the measure of the gain is the difference between the amount realized, *viz.*, the sales proceeds plus any debt assumed or taken subject to by the purchaser, and the adjusted cost basis.[99] The adjusted cost basis for capital assets not subject to depreciation is equal to the original purchase price[100] increased by any capitalizable expenditure.[101] No step-up in basis is allowed for assets owned at the time a person becomes a resident of the U.S., except for the limited purpose of the expatriation provisions discussed above.

Under current law, net capital gains of individuals are subject to a maximum U.S. Federal income tax of 15% or 28%, depending on the character of the asset; collectables are generally taxed at the higher rate. Either such rate compares favorably with the tax rate for ordinary income, 35%. State and local tax may also be imposed.

2. Anti-deferral Provisions

U.S. tax law contains several provisions which are designed to prevent taxpayers from deriving any appreciable tax benefit by investing outside the U.S. through foreign corporations. These provisions include (i) Subpart F, under which the earnings of a controlled foreign corporation from investment incomethat is considered to be Foreign Personal Holding Company Income are deemed to be distributed to the U.S. persons who are 10% or greater shareholders[102] and (ii) the Passive Foreign Investment Company ("P.F.I.C.") provisions, designed to eliminate the benefit of deferral whenever an excess distribution is received from a foreign company that is viewed to be a P.F.I.C.[103] In broad terms, these provisions either impose tax, computed at ordinary income tax rates, on income of foreign holding companies that are not necessarily received by a U.S. person or impose a penalty tax when dividends are received or gains are derived. These provisions apply to both U.S. citizens and U.S. residents.

C. Income Tax Planning

The planning suggestions that are available to most wealthy foreign individuals prior to the establishment of residence is premised on the acceleration of gain to a period of nonresidence, the deferral of certain types of earned income to periods of nonresidence, the step-up in basis of assets prior to the establishment of residence, and avoiding the transformation of capital gains taxed at favorable rates into ordinary income taxed at rates that are as high as 35%.

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[99] Code §1001.

[100] Code §1012.

[101] Code §1016.

[102] Code §951.

[103] Code §1291.

To obtain the benefit of a step-up in basis, the individual must enter into a transaction, involving the assets, and the transaction must have economic substance. If the transaction has no independent significance, no economic substance, or business purpose aside from the potential U.S. tax benefit, or that it is an integral part of a larger transaction, it may be ignored or collapsed into a single transaction without the contemplated step-up in basis.

With the foregoing in mind, several suggestions are submitted for consideration.

1. Liquidation of Holding Company

One way for individuals to obtain a step-up in basis in assets is to undergo a transaction that results in the recognition of income. One of the easiest ways to recognize income is to liquidate a corporation. Ordinarily, that transaction is a taxable event for both the corporation and its shareholders who are individuals or who are themselves corporations that do not own 80% of the shares of the company.

If the shareholder is not a U.S. citizen or resident at the time the liquidation proceeds are received, no U.S. tax is due, except in unusual circumstances not here relevant. An individual who is neither a U.S. citizen nor a U.S. resident is generally subject to tax only on U.S. source income. Nonetheless, U.S. tax principles are applicable for purposes of determining the basis maintained in the assets received in the liquidation distribution if those assets are sold after U.S. residence is established.[104]

Under U.S. tax law principles, an individual who is a shareholder at the time of the liquidation recognizes gain or loss on the receipt of property as part of a liquidation distribution.[105] Applying U.S. tax principles to a liquidation of a foreign holding corporation owned by a nonresident of the U.S., the nonresident individual will obtain a stepped-up basis in the assets received as part of the liquidation proceeds.

To be prudent, the liquidation must occur at a point in time when the individual is no longer subject to tax in his former country of residence. This may be accomplished in one of two ways. A formal liquidation may take place after the departs his former jurisdiction and before U.S. residence is established. Alternatively, it may be obtained if the holding company is an eligible entity within the meaning of the check-the-box regulations of entity characterization and the individual checks the box

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[104] See, for example, Biddle v. Commr., 302 U.S. 573 (1938), where the Supreme Court held that U.S. tax concepts control the characterization of a transaction of a foreign person not subject to U.S. tax if that characterization is important for computing U.S. tax on a subsequent event. See also Gutwirth v. Commr., 40 T.C. 666 (1960), where the Tax Court held that improvements made to a factory and equipment prior to the time the owner became a U.S. resident were treated as increasing their basis regardless of the fact that the improvements were deducted for Belgian tax purposes.

[105] Code §331(a).

effective prior to the residence starting period. The latter is generally viewed to be the more prudent method because it should have no consequence in the home jurisdiction.

In determining the U.S. tax liability of an individual or corporation, whether foreign or domestic, the U.S. generally applies its own set of rules. This holds true with regard to the categorization of domestic and foreign entities. Under the check-the-box regulations, certain business entities are classified automatically as corporations for U.S. tax purposes.[106]

In the international context, the regulations classify as corporations certain foreign business entities (including entities organized in U.S. possessions, territories, and commonwealths) that are listed in the regulations.[107] The listed entities are corporations whose shares are not closely held and can be traded on a securities exchange. Examples include a P.L.C. in the U.K., an AG in Germany and Switzerland, an N.V. in the Netherlands, a corporation in Canada, and an S.A. in France.

A business entity that is not required to be classified as a corporation is an eligible entity.[108] An eligible entity may elect how it will be categorized for U.S. income tax purposes. An eligible entity that has at least two members may elect to be classified as an association or a partnership, and an eligible entity with a single owner may elect to be classified as an association or to be disregarded as an entity that is separate from its owner.[109]

The regulations provide default classification rules for foreign entities that aim to match expectations. Thus, if a foreign entity is not required to have a member that is personally responsible for its obligations, it will have a default classification of a corporation. An eligible entity that wants the default classification need not file an election. If it wishes to change the default classification, a change in classification will have tax consequences for U.S. purposes.

As a result, if an organization classified as an association elects to be classified as a partnership, the organization and its owners must recognize gain, if any, under the rules applicable to liquidations of corporations. If the members are not U.S. citizens or residents at the time of the election, the gain will not be recognized, but the basis will be stepped up.

An eligible entity that wants to change its classification may elect the desired classification by filing the election with the I.R.S. Center with which its returns are filed.[110] The Election is filed on Form 8832. The election is effective on a date specified on the election if that date is not more than 75 days

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[106] Regs. § 301.7701-2(b)(1) through (7).

[107] Regs. § 301.7701-2(b)(8)(i).

[108] Regs. §301.7701-3(a).

[109] Regs. §301.7701-3(b)(1).

[110] Regs. §301.7701-3(c)(1)(i).

prior to the date on which the election is filed, or on the date filed if no such date is specified on the election.[111] A copy of the election must be included with the Federal tax return for the year in which the election is effective.[112] If the entity is not required to file a return, the direct or indirect owners of the entity must include copies of the election with their federal tax returns. Only one indirect owner need file the copy. The election is not voided if there is a failure to file. If the election is retroactive, it must be signed by each person who was a member during the intervening period and who is not a member at the time of filing.

2. Sale of Shares to Partnership

This alternative takes advantage of Code §707(a) which recognizes that a partner may engage in a transaction with his partnership and the transaction will be treated for tax purposes as if it occurred between the partnership and a person other than a partner.

The plan is relatively simple. The individual and members of his family would form a limited partnership under the laws of a tax favored jurisdiction. Unless local law requires otherwise, the individual would be the sole general partner[113] and potentially the holder of a significant number of limited partnership shares. The partnership would purchase the assets at a price supported by an evaluation. Again, the transaction must occur prior to the establishment of U.S. residence for tax purposes.

The partnership would hold the investment assets and would not be liquidated.

Here, the transaction must be cast in the form of a sale and consideration such as cash or a note must be given. If a note is given, principal and interest must be paid in order to minimize the risk that the transaction is in essence a capital contribution to a partnership. In comparison to a sale, a capital contribution would force the partnership to report a carryover basis in the assets. The tax benefit would be lost.

One way of resolving the issue is for the partnership to borrow the necessary funds from a financial institution. The investment assets could be pledged in support of the loan. Use of bank financing will also address another potential problem that might exist in connection with a note. If the consideration for the sale is a purchase money note, a technical issue exists regarding potential deferral of gain because of the installment sale method of accounting. Under the installment sales method of accounting, a seller of shares of stock who receives a note reports gain periodically when and as

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[111] Regs. §301.7701-3(c)(1)(iii).

[112] Regs. §301.7701-3(c)(1)(ii).

[113] In some jurisdictions such as the Cayman Islands, a local entity must be a general partner of a limited partnership. The local entity need not be the sole general partner.

principal payments are made under the note.[114] A sale of shares in return for a note automatically triggers application of the installment sales method of accounting in the absence of an affirmative election to recognize income at the time the note is received.

The election is ordinarily made in a timely filed tax return for the year of the sale. Hence the problem for a person who effects a sale while neither a citizen nor a resident of the U.S. A foreign individual has no reason to file a tax return to make the election. The I.R.S. has, in the past, issued a concession under which a foreign individual is deemed to have made an affirmative election to recognize income when property is sold prior to the establishment of residence in return for a note that continues in existence after the residency starting date.[115] While the concession should in principle continue to apply, the issue may be raised as part of an I.R.S. examination.

3. Sale to a Spouse

Under this alternative, the individual would sell the investment assets to his or her spouse. If the spouse is neither a citizen nor a resident of the U.S., the spouse will take a step-up in basis to the amount paid.

Under U.S. tax law no gain or loss is recognized on the sale of property between spouses.[116] Rather, the transaction is treated as a gift and the spouse would take over the basis previously maintained by the husband. There is, however, an exception to this rule. If the transferee spouse is neither a citizen nor a resident of the U.S., the nonrecognition rule is inapplicable. Gain will be recognized by the selling spouse and the purchasing spouse will take a stepped-up basis in the property.[117]

If this alternative is followed, the individual must receive valuable consideration, either in the form of cash or a note. If a note is given, principal and interest must be paid periodically and the formalities of debt must be followed, including pledges of security in support of the borrowing. The

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[114] Code §453A.

[115] See P.L.R. 8708002. A private letter ruling may be cited as authority only by the person to whom issued. Nonetheless, the ruling indicates the thinking of the I.R.S. at the time issued and in certain circumstances can be relied upon by others to avoid underpayment of tax penalties.

[116] Code §1041(a).

[117] A transfer between an individual and a corporation owned by the spouse of the individual is not covered by Code §1041, but a transaction between a sole proprietorship and the proprietor's spouse is covered. See Regs. §1.1041-1T. While the regulations are silent, we believe that a partnership would be viewed to be an entity for purposes of applying Code §1041 and that gain would be recognized. However, there is no case law or I.R.S. ruling on this point.

note must be repaid within a reasonable period of time. If not, the economics of a sale may be converted into a gift and the anticipated U.S. tax benefit will be lost.

4. Deferral of Certain Types of Earned Income

As mentioned previously, U.S. tax law contains rules which treat deferred compensation received by a person who is not a U.S. resident as if it were received during the year the services were performed. The intent of this provision is to freeze the characterization of compensation and to avoid plans generating deferred compensation in order to reduce or eliminate U.S. tax.

Nonetheless, deferred compensation may produce attractive results for an individual whose business responsibilities cause him to travel extensively outside the U.S. during his period of residence. If that type of individual receives compensation for the services in the year earned, he would be fully taxed on the income. The only benefit available to reduce U.S. tax would be the foreign tax credit. However, if the compensation for the performance of services abroad is deferred to a year in which the individual is no longer a U.S. resident, the compensation should not be taxable income. The income would be recognized under the cash method of accounting in a year of nonresidence. The rules under which the characterization of the income is determined in the year services are performed lead to the conclusion that the income would be viewed to be foreign source income. Income for the performance of services outside the U.S. is not subject to tax as effectively connected income in the hands of a nonresident foreign individual.

The foregoing result is premised on rulings issued by the I.R.S. in analogous areas of the law. In Rev. Rul. 79-6,[118] the I.R.S. ruled that severance payment for services performed in earlier years qualified as foreign earned income which could be excluded from income under Section 911(a). The severance payment was in the nature of compensation for past services and could be sourced with respect to the place where services were performed. In a private letter ruling[119] addressing a restricted stock compensation plan involving a noncitizen individual who was a U.S. resident at the time of a nonvested award and who became a nonresident before the end of the vesting period, the I.R.S. analyzed the places where services were performed during the vesting period. The I.R.S. ruled that the employee was subject to U.S. tax under Code §871(b) only on the portion of the income relating to the performance of services in the U.S. That portion was determined by multiplying the value of the stock at the time of vesting by a ratio in which the numerator consisted of the number of days during the vesting period on which services were performed in the U.S. and the denominator was the total number of days during the vesting period on which services were performed. The denominator included days worked in the U.S. as well as outside the U.S. Once the U.S. source portion of the compensation was determined the tax could be computed.

For the plan to achieve the desired result, the individual must not be viewed to have constructively received the compensation during the year services are performed. Constructive receipt of income

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[118] 1979-1 C.B. 244.

[119] Private Letter Ruling 8711107.

occurs when a person computing income under the cash method of accounting may not choose to disregard income that is made available. Thus, the regulations provide that, although not actually reduced to a taxpayer's possession, income is constructively received by an individual in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.[120] However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

In broad terms income should not be viewed to have been made available if, prior to the performance of the services, the individual and an employer with whom bargaining occurs at arm's length enter into an unfunded deferred compensation plan or a "rabbi trust" arrangement. The deferred compensation payment should be subject to a risk of forfeiture in order to add to the economic substance and presumably should be negotiated before the individual moves to the U.S. Under either such arrangement, the employer generally defers a deduction until income is recognized.[121]

5. Maintaining Favorable Capital Gains Tax Rates

If a foreign holding company will be owned by the individual, affirmative use of the check-the-box regulations allows for continued benefit of the reduced tax rates for capital gains. That benefit would be lost if the holding company retained corporate characterization.

As mentioned above, U.S. tax law provides that a foreign corporation in which U.S. Shareholders[122] own more than 50% of the voting power or value is treated as a controlled foreign corporation ("C.F.C."). Gain derived by a C.F.C. from the sale of shares of a corporation is a form of Foreign Personal Holding Company Income under U.S. tax law[123] that will be taxable in the U.S. under the Subpart F provisions[124] of the Code. This has the effect of converting capital gain from the sale of shares or other investment assets into ordinary income.

The anti-deferral tax regime applicable to foreign personal holding companies (Code § 551 *et seq.*) wasrepealed by the American Jobs Creation Act of 2004 effective for tax years of foreign corporations beginning after 2004.

6. Pecuniary Distributions From Trusts

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[120] Regs. §1.451-2(a).

[121] See, e.g., Code §83(h).

[122] Under Code §951(b), a U.S. Shareholder is a U.S. person who owns at least 10% of the voting power of a foreign corporation.

[123] Code §954(c).

[124] Code §951(a).

U.S. tax law contains an exception from the ordinary taxation rules applicable to trust distributions when the distribution is characterized as a pecuniary distribution. A distribution of a pecuniary amount is not considered to be a distribution of D.N.I.; consequently it is not taxable in the hands of a U.S. beneficiary.

Code §663(a)(1) provides as follows:

> There shall not be included as [distributions from D.N.I. any] * * * amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than three installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.

The income tax regulations explain how the provision works.[125]

a. The pecuniary distribution must be paid or credited as a gift. This means the amount of money or the identity of the specific property must be ascertainable under the terms of an inter vivos trust instrument as of the date of the inception of the trust.[126]

b. The trust instrument must not require that the pecuniary gift must be paid in four or more installments. The trust deed must provide that the pecuniary gift must be paid either at one time, or in two or three installments.

c. The trust deed must not require that the gift is payable only from income. As long as the instrument is silent as to the source of the payment or specifies that the gift can be paid from income or principal or both, the pecuniary gift will qualify.

d. Annuities are not allowed nor is a gift of a residuary interest in the corpus of the trust permitted.

D. Use of Variable Annuities

For an individual planning to stay in the U.S. for a finite period of time who wishes to avoid subjecting an investment portfolio to U.S. tax, consideration should be given to the purchase of a variable annuity contract prior to the establishment of U.S. residence.

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[125] Regs. §1.663(a)-1.

[126] Regs. §1.663(a)-1(b)(1).

1. Tax Benefit of Variable Annuity

The benefit of the variable annuity is that an individual can accumulate profits on a tax-free or tax-deferred basis over a period of years until the annuity payments begin. When the annuity begins to make payments, a portion of each payment is attributed to the "investment in the contract." That portion can be returned to the individual tax free until the investment is entirely returned.[127] Under the regulations, the investment in a variable annuity contract is computed by reference to the amounts paid in by the annuitant and the number of payments anticipated during the term of the annuity. The term is based on life expectancy pursuant to I.R.S. issued mortality tables if the payment stream is for the life of the annuitant. If the payment stream is for a term of years which does not terminate on death of the annuitant, the term is based on the specified payout period.

The balance of the payments under the annuity contract is taxed as ordinary income, but over a period of time in the future.[128] This feature of the variable annuity — deferral of tax — comes at a price. For the annuity plan to provide the desired benefit, services of an insurance company and a mutual fund will be required. Each will charge a fee. In addition, the annuity turns what might be capital gains into ordinary income, thus potentially increasing the ultimate tax rate. However, if the build-up period of the variable annuity is relatively lengthy, deferral can be extremely long which should reduce the current value of the tax increase. Moreover, if the insurance company is based outside the U.S., the annuity payments could be completely free of U.S. tax if the annuity starting date occurs when the individual is no longer a resident.

2. Requirements for Annuity Treatment

In order to prevent the annuity arrangement from being operated as the equivalent of a brokerage account, U.S. tax law contains certain rules which must be followed as a condition of obtaining the anticipated tax benefits. The more important rules are as follows:

a. Diversification

A variable annuity contract issued by a U.S. insurance or annuity company must be adequately diversified for it to be treated as an annuity contract.[129] The position of the I.R.S. is that the diversification requirement also applies to foreign insurance or annuity companies selling policies to U.S. individuals.[130] However, this position is viewed by many advisers to be overreaching by the I.R.S., as the statute requiring diversification does not mention foreign insurance companies regulated by foreign law.

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[127] Code §72(b)(1).

[128] Code §72(a).

[129] Code §817(h).

[130] Notice 89-96, 1989-2 CB 417, section II. D.

To be considered diversified, the tax regulations provide a safe harbor under which adequate diversification is deemed to exist if (i) not more than 55% of the value of the total assets that support each segregated asset account may be represented by any single investment, (ii) not more than 70% percent of the value of the total assets that support each segregated asset account may be represented by any two investments, (iii) not more than 80% of the value of the total assets that support each segregated asset account is represented by any three investments, and (iv) not more than 90% of the value of the total assets that support each segregated asset account is represented by any four investments.[131]

For this purpose, all securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment. In the case of government securities, each government agency or instrumentality is treated as a separate issuer. This rule poses a problem for an annuity in a segregated account that is invested in a single mutual fund. However, if all of the beneficial interests in a mutual fund that is a regulated investment company or in a trust are held by one or more insurance companies in their general account or in segregated asset accounts, or by fund managers (or affiliated companies) in connection with the creation or management of the fund, the diversification requirements are applied under a look-through rule by taking into account the assets held by fund.[132] To come within this safe harbor, it is not unusual for an annuity company or an insurance company to form a "clone fund" which mirrors the investment portfolio of various popular mutual funds.

b. Limitation on Investment Control

The annuitant cannot achieve the tax benefits of an annuity if he has unfettered control of the investments in the segregated account. Consequently, he cannot manage the account in a way that is similar to the management of a brokerage account.[133] However, he can choose among existing funds that are maintained by the insurance company for its customers. The I.R.S. has ruled that the ability of a policy holder to choose among funds reflecting broad, general investment strategies such as stocks, bonds or money market instruments, either at the time of the initial purchase or subsequent thereto, does not constitute sufficient control over individual investment decisions so as to cause ownership of the private mutual fund shares to be attributable to the policy holders.[134] As long as the annuitant's discretion is limited to selecting among nonpublicly traded clone funds, each of which reflect different investment philosophies, or to having the advisor select the fund, the prohibited form

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[131] Regs §1.817-5(b)(1).

[132] Code §817(h)(4).

[133] Christoffersen v. U.S., 749 F.2d 513 (8th Cir. 1984).

[134] Rev. Rul. 81-225, 1981-2 C.B. 12; also, Rev. Rul. 82-54, 1982-1 C.B. 11.

of investor control should not exist.[135] Under current law, an investor in an annuity may switch his investment among the funds offered by the annuity company without incurring a tax problem.[136]

c. Penalties on Early Distributions and Loans

The beneficial tax treatment of an annuity at the time of distribution, *viz*., treating a portion of a payment as a return of capital, may be lost with regard to distributions that are not part of the annuity stream and to loans to policy holders. Cash withdrawals, amounts received as loans, and the value of any part of an annuity policy pledged or assigned, or amounts received on partial surrender under the deferred variable annuity policy are taxed in full if and to the extent that the cash surrender value of the policy exceeds the investment in the policy.[137] In essence, the cash surrender value in that set of circumstances reflects the gains and income of the segregated asset account. Consequently, the withdrawal or the loan is taxed.

In addition, any distribution other than a periodic annuity payment is subject to a tax penalty of 10% of the amount includable in gross income, generally the full amount received if not in excess of the surrender value of the policy.[138] Consequently, a policy holder that borrows against a policy or that cashes out early, will be affected by this rule. Similarly, if the annuity payments are received prior to the age of 59½ years or are not part of a series of relatively equal payments over the life of the policy holder, an additional 10% tax may be due.[139]

d. Identity of Policy Holder

The benefits of an annuity are generally limited to annuity policies owned by natural persons and their agents. A corporation is not entitled to the tax-deferred build-up of value within the contract.[140]

e. Premium Excise Tax

An excise tax of 1% of the premiums paid into a foreign annuity must be collected when the policy is owned by a U.S. individual. If the premium is paid at the time the annuitant is not a U.S. person, no excise tax is due.

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[135] Annuity, Inc. v. Blumenthal, 442 F.Supp. 681 (D.D.C. 1977), revd. on procedural grounds, 609 F.2d 1, (D.C. Cir. 1979), cert. den 446 U.S. 981 (1980)(in which an I.R.S. ruling (Rev. Rul. 77-85, 1977-1 C.B. 121); O'Brien v. Commr., 4 T.C.M. 554 (1945).

[136] Code §1035.

[137] Code §72(e).

[138] Code §72(s).

[139] Code §72(q).

[140] Code §72(u).

VII. Ethical Issues

Ethical issues that attorneys face in the course of practice are often complicated when the client is an individual who resides in a foreign jurisdiction. While those clients retain U.S. counsel to address legal issues in the U.S., often foreign legal issues are present as a subtext to the matter. As a result, legal counsel in the U.S. may find that he or she faces two broad issues: (a) Is he or she advising a client competently when issues of foreign law are ignored, even if a client instructs the counsel to ignore those issues? and (b) If the attorney knows his client is not in compliance with the laws of the client's country of residence, and fails to act, has the attorney violated the canons of ethics of his own jurisdiction?

A. Competence and Intentional Disregard

The first issue involves an attorney who is ignorant of foreign law, and matter goes to the duty of competence which legal counsel owes to the client. The second involves an attorney who knows the client is violating foreign law and the matter goes to the duty of the attorney to avoid violating law. If counsel is engaged to attend to a strictly local matter, he or she may be entirely unaware of the problem.

To illustrate these issues, a simple fact pattern may be helpful. Attorney X meets a new client. The client resides in a country that prohibits residents from maintaining investment accounts through trusts formed in certain blacklisted countries. The client tells the attorney that he has funds in just such an investment account. The client either forgets to mention the law to the attorney, or alternatively, explains that the law was recently passed by a rump parliament jury-rigged by a dictator not friendly to the U.S. and that the funds were transferred to a trust in a Caribbean jurisdiction days before the law was implemented. The law is far-reaching and imposes obligations to report violations on all persons having knowledge of violations. The client advises that he will use the funds in the trust to acquire an apartment in New York.

What are the ethical responsibilities of the attorney? If the client is silent and counsel does not raise questions spontaneously regarding the law in the country of residence, has counsel fulfilled his duty of competent representation? If the client provides full disclosure, will counsel be viewed to assist in the violation of a law?

Regarding competence, Canon 6 of the New York Lawyers' Code of Professional Responsibility provides that a lawyer should represent a client competently. A lawyer may not handle a legal matter that the lawyer knows, or should know, is beyond his or her level of competence. If the lawyer chooses to handle the matter, he or she must associate with a lawyer who is competent to handle it. As a result of these provisions, the duty of competence requires lawyer to recognize the existence of any foreign law issues, and thereafter, advise the client to seek competent foreign counsel or recommend competent foreign counsel to client. This would clearly be helpful in the context of an apparent violation of a law that is only selectively enforced. However, when the attorney knows the transaction violates the foreign usury law, this answer seems facile.

Regarding violations of law, Rule 1.2 of the Model Rules of Professional Conduct (2003) provides in part that a lawyer shall not assist a client in conduct the lawyer knows is criminal or fraudulent.

The rule does not state that it applies only to client conduct within the attorney's state of admission. Indeed, the commentary specifically notes that the obligation applies whether or not the defrauded party is a party to the transaction. It stands to reason that under the Model Rules, a tax lawyer must not assist or counsel a client to effectuate fraudulent avoidance of tax liability in any jurisdiction.

When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer must, therefore, withdraw from the representation of the client in the matter. See Rule 1.16(a). In some cases, withdrawal alone might be insufficient. It may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation or the like. See Rule 4.1.

From the viewpoint of the jurisdiction that licenses the attorney, it is unseemly for those who practice law to participate or advise on a plan that is in violation of law, regardless of the jurisdiction. Model Rule 8.5 provides as follows:

> A lawyer admitted to practice in this jurisdiction is subject to the disciplinary authority of this jurisdiction, regardless of where the lawyer's conduct occurs. A lawyer not admitted in this jurisdiction is also subject to the disciplinary authority of this jurisdiction if the lawyer provides or offers to provide any legal services in this jurisdiction. A lawyer may be subject to the disciplinary authority of both this jurisdiction and another jurisdiction for the same conduct.

Nonetheless, cultural differences may cause a particular foreign statute to be abhorrent; more so than differences in statutes in force in another state. For example, if a foreign jurisdiction makes it illegal to lend money in return for interest, what is the duty of a U.S. lawyer when a trust, formed by a resident of that jurisdiction, seeks to lend money to persons in the U.S.? Moreover, if the law is regularly circumvented through formalistic maneuvers or is only selectively enforced, is it unethical for a lawyer in the U.S. to participate in arranging the loan or providing tax planning in connection with the loan? Is it a breach of the New York Lawyers' Code of Professional Responsibility for a New York attorney to assist a client in violating her country's usury laws?

Based on a literal reading of the rules, and in the absence of other circumstances, it would appear that the attorney may have an affirmative duty to withdraw from representation. However, before acting, in-depth research is warranted because withdrawal is an extreme response, and probably uncommon. Perhaps the ethical constraints impose a higher level of care for activity outside the jurisdiction in which the attorney practices, but within the U.S., and a different level of care for matters of foreign law. If the matter violates the law of another state, consideration of that state's law in ethical matters is required because that law is entitled to full faith and credit under the U.S. Constitution. In comparison, in litigation, foreign law is considered to be a matter of fact to be proved and not a matter of law to be acknowledged by the Court.

B. Criminal Sanctions

Fifty years ago, issues such as these were theoretical. With the conversion of the world into a global village, the issues have become real. This is illustrated by the holding in Pasquantino v. U.S., 544

U.S. __ (2005), which applied the wire fraud statute to a transaction designed to prevent a foreign country from collecting tax.

In Pasquantino, the Federal Government established itself as a stakeholder with respect to the business morals of the population in relation to a foreign government's right not to be "cheated" out of taxes due. Tax advisers that assist clients in those matters may discover that the concept of conspiracy is relatively broad in its application. The operative concept on a go-forward basis might revolve around the practical meaning of the term "cheated."

Title 18 U.S.C. § 1343 is the wire fraud statute. It provides as follows:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than $ 1,000,000 or imprisoned not more than 30 years, or both.

Pasquantino involves New York residents who engaged in smuggling operations across the Canadian border. The plan for smuggling was simple. Periodically, the defendants would call a discount liquor shop in Maryland and order liquor at a relatively low price. One of the defendants would then drive to Maryland, purchase the liquor, and drive back to New York. Thereafter, he would cross the border into Canada.

The defendant was convicted of wire fraud because of the use of interstate telephone lines and the conviction, reversed by the Fourth Circuit, then reinstated an en banc panel of the Fourth Circuit, and affirmed by the Supreme Court. While much of the Court's discussion addresses the viability and scope of a legal doctrine known as "the revenue rule," which prevents courts from enforcing tax laws of other countries, the more sweeping part of the decision is the finding that Canada had a valuable property right in the form of its entitlement to collect taxes.

The Court concluded that the defendant participated in a scheme or artifice to defraud and the object of the fraud was money or property in the victim's hand. These are elements of the crime that must exist in order for the jury to convict. The Court found that they were present in the case. The fact that the victim of the fraud happened to be the government of Canada, rather than a private party, did not lesson the injury. The proscribed activities took place in the U.S. and the Federal Government had an interest in prosecuting the crime. The Court stated:

> Petitioners used U.S. interstate wires to execute a scheme to defraud a foreign sovereign of tax revenue. Their offense was complete the moment they executed the scheme inside the United States; "[t]he wire fraud statute punishes the scheme, not its success." *United States v. Pierce, 224 F. 3d 158, 166 (CA2 2000)* (internal quotation marks and brackets omitted); see *Durland, 161 U.S., at 313* ("The significant fact is the intent and purpose"). This domestic element of petitioners'

> conduct is what the Government is punishing in this prosecution, no less than when it prosecutes a scheme to defraud a foreign individual or corporation, or a foreign government acting as a market participant.

The lesson in Pasquantino is that foreign governments have a property right to their income taxes. Those who inappropriately attempt to prevent a foreign government from receiving what is rightly theirs do so at their peril. Disgorgement of the proceeds of fraud is an appropriate penalty and those who assist may find that the disgorgement order extends to legal fees.

VIII. Conclusion

Preimmigration income tax planning traditionally focused on the rules designed to keep offshore investment income from being taxed in the U.S. The elimination of the grantor trust rules now prevents income from being diverted to a person who is not subject to U.S. tax. As a result, the focus of the planning will likely shift. Goals of the investor will have to be prioritized and income recognition before and after the establishment of residence will have to be maximized. The principal goals in today's environment are the compliance with U.S. law, the avoidance of unnecessary tax, and the management of income flows into low-tax or no-tax periods. More and more, consideration is being given to use of variable annuities and other insurance products, although somewhat costly to implement. The tax adviser and the client must take steps prior to the client's arrival in the U.S. to achieve the important tax-related goals possible under prior law.

— End —