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A U.S. Tax Primer on Dual Status Individuals

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INTRODUCTION

With the recent increase in international enforcement activities by the U.S. Internal Revenue Service (IRS) over the past few years and the commencement of the delayed U.S. Foreign Account Tax Compliance Act (FATCA)[1] reporting and withholding requirements that collectively target foreign assets and income of U.S. taxpayers, dual U.S./non-U.S. individuals have been forced to address their U.S. tax compliance obligations. In many cases, such persons may have had limited or even no contact with the United States for a number of years and have considered themselves exclusively taxpayers and residents of their "home country." Their U.S. tax compliance responsibilities were largely ignored. Many are now dealing with those obligations for the first time and in many cases are paying a substantial "cost" for their past non-compliance.

A recent example of such non-compliance is London Mayor Boris Johnson, who is presumably a dual U.S./U.K. citizen. He was born in New York City in 1964, which makes him a U.S. citizen, but he lived in the United States for only five years. Mayor Johnson asserts that he has fully satisfied his U.K. income tax obligations.[2] Apparently, the IRS asserted a U.S. income tax liability against Mayor Johnson for the gain recognized on the sale of his London residence, which was not subject to U.K. income taxation. Mayor Johnson indicated that he would refuse to pay the claimed U.S. income tax liability. However, according to recent press reports, Mayor Johnson subsequently settled with the IRS prior to an upcoming U.S. visit. As discussed in this article, Mayor Johnson and oth-

[*] The author gratefully acknowledges the invaluable comments of his colleagues Lee Wendel and Alexios Hadji.

[1] FATCA was enacted March 18, 2010, as part of the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147 ("HIRE Act"). The term "FATCA" technically refers to Title V, Subtitle A of the HIRE Act. FATCA includes several statutory compliance obligations that were intended to improve the reporting to the IRS of foreign assets and foreign-source income of U.S. persons. One set of those compliance obligations, Part I of Subtitle A, is often referred to as "FATCA," and is set forth in §1471–§1474 of the Internal Revenue Code of 1986, as amended (the "Code").

Unless the context indicates otherwise, all "§" references are to the Code and all "Reg. §" references are to the regulations issued thereunder and set forth in 26 C.F.R.

These sections establish the basis for a global reporting procedure for foreign assets and income of U.S. persons and the failure to comply could result in a 30% U.S. withholding tax imposed on certain payments made to non-U.S. persons. The commencement of the FATCA withholding requirement and the accompanying reporting was postponed until July 1, 2014. *See* Notice 2013-43, 2013-31 I.R.B. 113 (July 12, 2013), §III, ¶A.

[2] See Beardsworth, *New York-Born London Mayor Refuses to Pay U.S. Capital Gains Tax*, BNA Daily Tax Rpt. G-1 (Nov. 24, 2014), which refers to an interview of Mayor Johnson on NPR Radio aired November 13, 2014, and Gupta, *New Analysis: Will London's Mayor Enter the OVDP?* 76 Tax Notes Int'l (Dec. 1, 2014), p. 745.

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ers similarly situated face a rude awakening to their U.S. tax obligations as U.S. citizens.

This article is intended as a guide for ''dual status'' individuals as to their U.S. tax obligations. Several special U.S. tax law provisions that apply to such persons are identified. The alternatives currently available to such persons to resolve their past noncompliance are summarized. Finally, the options available to such persons to comply with or eliminate their U.S. tax compliance obligations are presented.

U.S. Person — Income Tax Considerations

The initial consideration is to determine whether a person is subject to U.S. income tax compliance obligations as a U.S. person. For this purpose, a person is considered a U.S. person for income tax purposes if the person is either a U.S. citizen or a U.S. tax resident. A U.S. person for transfer tax purposes (estate and gift taxes) is somewhat different and is discussed below.

A person can acquire U.S. citizenship in several different ways.[3] The most obvious is being born in the United States. Also, U.S. citizenship is acquired if a person is born outside of the United States to two U.S. citizen parents or born outside of the United States to one U.S. citizen parent if born after December 23, 1952. Finally, U.S. citizenship can be acquired by either naturalization or derivation. ''Naturalization is generally available after five years of U.S. residence as a lawful permanent resident (''LPR'') . . . or three years of U.S. residence for an LPR who is residing in the U.S. with a U.S. citizen spouse.'' [4] Derivative citizenship was available from January 13, 1941, to February 26, 2001, for an LPR child who was under the age of 18 and residing in the United States in the legal and physical custody of a naturalized parent.

Two different standards apply to determine whether someone is a U.S. income tax resident. One is the LPR test, i.e., whether an individual applied for and received a ''green-card'' as evidence of U.S. permanent resident status.[5] The other is the ''substantial presence test,'' i.e., whether an individual who is neither a U.S. citizen nor an LPR has a ''substantial U.S. presence.'' A substantial U.S. presence occurs if the person is physically present in the United States for at least 31 days in the current year *and* at least 183 days, based on a weighted formula, during a three-year period using the current year and the two immediately prior years.[6]

There are two statutory exceptions to the ''substantial presence test.'' If an individual is present in the United States under certain visa categories, including a ''foreign government-related individual,'' teacher, trainee, student, or professional athlete, the person could be considered an ''exempt individual'' and not subject to the test.[7] In addition, if an individual otherwise satisfies the ''substantial presence test'' but is present in the United States on fewer than 183 days during the current year and is able to establish a ''closer connection'' to a tax home in a foreign country, the ''substantial presence test'' would not be satisfied.[8]

In addition, an individual who is a dual U.S. resident and tax resident of a foreign country with a U.S. income tax treaty could rely on the tie-breaking resident provisions of a U.S. income tax treaty with that foreign country to be treated as a nonresident alien for U.S. income tax purposes under the treaty provisions.[9] For example, in Article 4(4) of the U.S.-U.K. Income Tax Treaty, there is a series of four tests to determine whether a dual resident individual should be treated as a U.S. resident or as a U.K. resident.[10] For the reasons discussed below, an LPR could have ad-

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[3] *See* Robert L. Williams, *The American Diaspora — Innocents Abroad*, Tax Notes (Aug. 18, 2014), pp. 861–864.

[4] Immigration and Nationality Act of 1952 (''INA''), §§316(a) and 319(a); 8 U.S.C. §1427(a) and §1430(a).

[5] Section 7701(b)(6) defines the term ''lawful permanent resident.''

[6] Section 7701(b)(3)(A) sets forth conditions for the ''substantial presence test.'' According to Rev. Proc. 2015-7, 2015-1 I.R.B. 231, §3.01(6), the IRS will not rule as to whether an individual has met the requirements of the ''substantial presence test'' or exceptions to that test. The weighted formula is ⅙ of the days present in the U.S. two years earlier, ⅓ of the days present in the U.S. in the immediate preceding year, and all of the days present in the U.S. in the current year.

[7] Section 7701(b)(5) defines the term ''exempt individual'' for purposes of the ''substantial presence test.'' Such person may have to file annually Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition.

[8] §7701(b)(3)(B). A taxpayer who claims a closer connection with a foreign country must file Form 8840, Closer Connection Exception Statement for Aliens, to demonstrate that the taxpayer is entitled to this reporting position.

[9] *See* §894 and §7701(b)(6).

[10] *U.S. Treasury Technical Explanation* (Mar. 5, 2003) summarizes this paragraph as follows:

> If, under the laws of the two Contracting States, and, thus, under paragraph 1, an individual is deemed to be a resident of both Contracting States, a series of tie-breaker rules are provided in paragraph 4 to determine a single State of residence for that individual. These tests are to be applied in the order in which they are stated. The first test is based on where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closest (i.e., the location of his 'centre of vital interests'). If that test is also inconclusive, or if he does not have a permanent home avail-

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verse consequences if this treaty provision were asserted. Even if the U.S. resident would be treated as a nonresident alien based on the treaty tie-breaker rule, the IRS position has been that the individual is still subject to various U.S. income tax reporting and compliance obligations as a U.S. person.[11]

In December, the U.S. Department of the Treasury (''Treasury'') released final regulations for the reporting of Specified Foreign Financial Assets and the submission of Form 8938, Statement of Specified Foreign Financial Assets,[12] which included a special rule for dual resident taxpayers.[13] Under this new special rule, if a dual resident taxpayer who is treated as a foreign resident under a treaty tie-breaker rule satisfies his U.S. income tax reporting obligations, including attaching a completed Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), the taxpayer will not be required to report the taxpayer's Foreign Financial Assets. Treasury's rationale for the change in its position is that the filing of Form 8833 puts the IRS on notice as to the taxpayer's foreign status; consequently the additional filing of Form 8938 is not necessary. The instructions for Form 8938, which had been the only form instructions that addressed this issue, have been revised to indicate that the filing of this form by a dual resident taxpayer is not required.

Dual Status Individuals

Based on the above rules, for purposes of this article, a ''dual status individual'' for income tax purposes will be either: (1) a person who permanently resides in the United States either as a U.S. citizen or a U.S. resident and who is also a tax resident of another country; or (2) a U.S. citizen or a ''U.S. resident,'' who permanently resides outside the United States and who is also subject to income taxation by another country because of residence in that country.

In the case of an LPR with a tax home outside of the United States, there is a significant risk that the individual could be determined to have abandoned long-term permanent resident status and be subject to a removal proceeding under the U.S. immigration laws.[14] In a recent U.S. Tax Court case,[15] the court distinguished between the loss of LPR status for immigration purposes and the termination of the LPR's U.S. income tax status. A change in tax status requires either an administrative or judicial abandonment of LPR status by the submission of INS Form I-407 and the surrender of the LPR's green card. If an LPR makes a temporary visit abroad for a relatively short period, the LPR would generally not risk the loss of ''green card status.''[16]

OVERVIEW OF U.S. INCOME TAXATION OF DUAL STATUS INDIVIDUALS

General Rules

U.S. citizens and residents, as defined above, are subject to U.S. income taxation on their worldwide income regardless of the source of that income and the tax home of the taxpayer. For example, income earned for employment outside of the United States is subject to U.S. income taxation whether the U.S. person maintains a tax home in New York City or in New Zealand. Similarly, capital gain income recognized on the sale of shares of a foreign corporation or, as in Mayor Johnson's case, on the income from the sale of non-U.S. real estate is included in gross income for U.S. income tax purposes, unless a partial or full exemption might otherwise be available. There are, however, several statutory income tax provisions and tax treaty provisions that could mitigate the potential for double taxation in certain situations.

One of the more significant set of statutory income tax provisions that might provide a benefit for a dual status individual taxpayer is the U.S. foreign tax

able to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of the Contracting State of which he is a national. If he is a national of both States or of neither, the matter will be considered by the competent authorities, who will assign a single State of residence.

[11] See Reg. §301.7701(b)-7(a)(3), which provides in part, ''Generally, for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax liability, the individual shall be treated as a United States resident.'' See also Karlin, *Now You See Them: U.S. Reporting Requirements for Tax Treaty Nonresidents*, Tax Notes Int'l (July 16, 2012), pp. 267–275, for a detailed analysis of this issue. In addition, there is the argument that a U.S. Treasury regulation cannot modify the terms of a U.S. treaty, which is constitutionally considered to be the law of the land.

[12] T.D. 9706 (Dec. 12, 2014) issuing final Reg. §1.6038D-0 to §1.6038D-8.

[13] *See* Reg. §1.6038D-2(d).

[14] *See* INA, §212(a)(7)(A)(i)(1).

[15] *Topsnick v. Commissioner*, 143 T.C. No. 12 (Sept. 23, 2014).

[16] See discussion at Kumpula, Cartwright, and Mehta, *Why Would I Abandon Lawful Permanent Resident Status or Relinquish U.S. Citizenship*, Am. Immigration Law Ass'n (2014), p. 239. *See also* Linda Dodd-Major, *Who Is a Green Card Holder and Why Does It Matter for U.S. Taxation Purposes?* 75 Tax Notes Int'l (Aug. 18, 2014), pp. 549–559.

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credit.[17] These provisions permit a U.S. person to claim a dollar-for-dollar tax credit for foreign income taxes imposed on his income. There are several limitations on the use of this credit, including that the foreign tax credit may not be used to offset the U.S. income tax imposed on U.S. income and the credit could be limited to certain categories of income. Consequently, a dual status individual that is subject to income taxation on the same income by both the United States and another country might not be able to use these provisions to eliminate the entire foreign income tax cost. Alternatively, instead of a credit, a U.S. person may claim an income tax deduction for the amount of the foreign income taxes paid as an additional itemized deduction that could reduce the taxpayer's U.S. taxable income.[18] As an itemized deduction, the tax benefit for this deduction could be subject to the current overall limitation on itemized deductions.[19]

Another U.S. statutory provision, which applies to U.S. persons who have a tax home outside of the United States and make an affirmative annual election to apply the provision, is known as the Foreign Earned Income Exclusion.[20] If a U.S. individual is a tax resident of and employed in a foreign country, an annual exclusion amount for foreign-source compensation income could be available that would exclude a stated maximum amount of compensation income from U.S. income taxation. U.S. citizens would be eligible if either the individual is a bona fide resident of the foreign country for an entire taxable year or the individual satisfies a physical presence test in the foreign country.[21] A U.S. tax resident would be eligible only if the physical presence test could be satisfied. The physical presence test requires that the individual during any consecutive 12-month period is present in one or more foreign countries for at least 330 full days in such period.[22] The annual exclusion amount, which is indexed for inflation, is $100,800 for 2015.[23] In addition, the eligible U.S. taxpayer could be entitled to an annual housing cost exclusion from gross income for reasonable foreign housing expenses. The annual foreign housing exclusion amount "is tied to the foreign earned income exclusion; it is subject to a 'floor' of 16% of the foreign earned income exclusion and a 'ceiling' of 30% of the foreign earned income exclusion."[24]

Income Tax Treaties

In addition to the above statutory provisions, income tax treaties between the United States and a foreign country are intended to either eliminate double taxation on a particular category of income or reduce the income tax rate imposed by one country with respect to income earned in the other country. The U.S. currently has a number of income tax treaties in effect and is continually negotiating amendments and revisions to existing tax treaties or new treaties with other potential treaty partners. Although the U.S. treaties generally start from a common framework,[25] each treaty is separately negotiated so a particular provision in one treaty may not be available in another treaty or might have different terms and conditions. Today, all modern U.S. income tax treaties include a Limitation on Benefits article that is intended to prevent "treaty shopping" and limit the tax treaty benefits only to "Qualified Persons" who are appropriate and eligible tax residents entitled to claim the treaty benefits. The Limitation on Benefits articles generally operate to deny treaty benefits to persons that have limited or nominal contacts with the treaty country in question.[26]

Generally, U.S. income tax treaties could benefit U.S. persons with respect to income earned in the treaty country or dual national citizens who maintain a tax home in a treaty country with respect to income earned in the United States. A dual national citizen who maintains a tax home in the United States and is not classified as a U.S. nonresident under the tax treaty would probably not benefit from a U.S. tax

[17] *See* §901–§909.

[18] *See* §164(a)(3).

[19] *See* §68, Overall Limitation on Itemized Deductions.

[20] *See* §911. For a detailed explanation of this provision, see Klasing and Francis, 918 T.M., *Section 911 and Other International Tax Rules Relating to U.S. Citizens and Residents*.

[21] *See* §911(d)(1)(A). Based on Rev. Rul. 91-58, 1991-2 C.B. 340, resident aliens of the United States who are citizens of foreign countries that have an income tax treaty with the U.S. may qualify for the foreign earned income exclusion under the bona fide residence test by application of the Non-Discrimination article, which is found in most of the income tax treaties to which the U.S. is a party. The ruling lists the eligible treaties as of the date of the ruling. According to Klasing and Francis, above n. 20, resident aliens who are citizens of countries that do not have an income tax treaty with the U.S. may be able to invoke a nondiscrimination provision in a Treaty of Friendship, Commerce, and Navigation in order to qualify for the foreign earned income exclusion under the bona fide residence test.

[22] *See* §911(d)(1)(B).

[23] *See* Rev. Proc. 2014-61, I.R.B. 2014-47, ¶32.

[24] Klasing and Francis, above n. 20, Detailed Analysis, C. Excludible Amounts.

[25] *See, e.g.,* U.S. Model Income Tax Convention dated November 15, 2006, available at http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf and U.S. Model Technical Explanation Accompanying the U.S. Model Income Tax Convention of November 15, 2006, available at http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf.

[26] *See* 2006 U.S. Model Income Tax Convention, Art. 22, Limitation on Benefits.

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treaty with the individual's home country with respect to U.S.-source income because it is unlikely that the individual's non-U.S. home country would impose an income tax on that income. (Other countries may have a ''territorial'' income tax system that limits taxes to those resident within that country and/or to income earned within that country.) A benefit might be possible on income earned in that foreign country. Each case should be reviewed with respect to its particular facts to determine whether any treaty benefit would be available.

As noted earlier, U.S. income tax treaties include tie-breaker provisions to determine a person's residence under the treaty in the case of a person who could be classified as a resident of both countries. Sometimes foreign persons prefer to remain in their home country but want a U.S. ''green-card'' in order to move to the United States if adverse political conditions develop in their home country. The problem is that an LPR could lose U.S. resident status if the LPR asserts non-U.S. resident status under the tie-breaker provisions of a U.S. tax treaty because of a closer connection to the foreign country.[27] The LPR would have to file a U.S. income tax return as a nonresident alien (Form 1040-NR) and would have to attach Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or §7701(b), to apply the tie-breaker resident tax treaty provisions. The form has a specific box to check for this reporting position. According to a 1996 Legal Opinion by the Office of the General Counsel of the Immigration and Naturalization Service, an LPR's filing of a nonresident income tax return raises a rebuttable presumption that an alien has abandoned LPR status.[28] The IRS subsequently concluded, ''The INS has advised that there may not be a formal determination that an alien has abandoned permanent residence unless and until the alien tries to return to the U.S. claiming to be a permanent resident. Thus, for purposes of the immigration laws, a determination of abandonment may not take place until many years after the actual act of abandonment.''[29] Consequently, an LPR by taking what may appear to be a favorable U.S. income tax reporting position could, in fact, jeopardize the LPR's permanent resident status and could cause the loss of the individual's green card.

Community Property Considerations

For U.S. persons who are married to foreign nationals and reside in foreign countries with community property laws, special income and asset ownership provisions could apply to attribute ownership of assets and income in the foreign community property jurisdiction to the U.S. person, even though the U.S. person is not the record owner. For example, based on general community property principles, 50% of shares of a foreign corporation owned for record purposes entirely by a nonresident alien spouse in a community property jurisdiction could be deemed to be beneficially owned as community property by the U.S. spouse. Consequently, 50% of the dividends paid by the foreign corporation should be reported by the U.S. spouse. Section 879 sets forth special rules for married couples where one spouse is a U.S. person and the other spouse is a nonresident alien with community income to determine the beneficial owner of the community income for U.S. income tax purposes. For example, dividends on a stock that is held as separate property is treated as the income of the person who owns the stock even if local law would treat that dividend as belonging one-half to each spouse.[30] In addition, the U.S. spouse could have U.S. tax and U.S. Treasury reporting obligations with respect to bank accounts held by the foreign corporation and, as discussed below, there could be other U.S. income tax consequences arising from the deemed ownership of shares of a foreign corporation. As is often the case, the analysis must be done on a case-by-case basis because the community property laws vary from country to country.

Special U.S. Income Tax Provisions for Foreign Situs Assets

As noted above, U.S. persons are taxed on their worldwide income regardless of the person's country of residence. In addition, the U.S. income tax laws have special income tax provisions that impose U.S. income taxes on passive income, generally interest, dividends, rent, and certain capital gains earned by foreign entities, which have a U.S. owner, even though the income is not currently distributed to the U.S. taxpayer owner. These rules apply to a U.S. person whether the U.S. person is a U.S. resident or a resident of a foreign country. Thus, these rules can act as a trap for the unwary, especially for dual-status citizens who reside outside of the United States and consider ownership of a corporation based in their home country a normal investment arrangement without any adverse U.S. income tax significance. Depending on the assets and income of the non-U.S. company, significant U.S. income tax consequences could arise due to this ownership interest. The following is a brief summary of the two most significant, and potentially

[27] *See* §7701(b)(6).

[28] *See* 73 Interpreter Releases 929 (July 15, 1996).

[29] TAM 200235026 (July 15, 2002).

[30] *See* Reg. §1.879-1(a)(7) *Ex.* 1.

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costly, provisions for the U.S. taxpayer — the controlled foreign corporation (CFC) and passive foreign investment company (PFIC) provisions — often referred to as the ''anti-avoidance rules.'' Briefly, a CFC issue could arise if the U.S. person *owns directly or indirectly at least 10% of the shares* of a foreign corporation and *one or more U.S. persons own more than 50% of the equity of the foreign corporation*. A PFIC issue could arise *if the U.S. person owns an equity interest in a foreign corporation that would be classified as a PFIC*. If a U.S. income tax treaty determines a U.S. person is to be classified as a resident of the foreign country, the reporting and ownership classifications of these provisions are still applied by the IRS and could affect other U.S. taxpayers with interests in the foreign corporation.[31] A U.S. person who is classified as a treaty nonresident would still have reporting obligations to report ownership of foreign corporations.[32] In addition, under the ''saving clause'' of a U.S. income tax treaty, generally a U.S. citizen would be taxed as if the treaty had not come into effect and thus would still be taxed under the CFC and PFIC provisions.

Controlled Foreign Corporation — CFC

If a U.S. person, either a U.S. citizen or a U.S. tax resident, *owns directly or indirectly* 10% or more of the voting stock of a CFC, then the U.S. person is considered a ''U.S. Shareholder.''[33] Entity and family attribution of ownership rules could apply to attribute ownership of additional shares to a U.S. person.[34] A CFC is defined as any foreign corporation if *more than 50%* of the total combined voting power of all classes of stock entitled to vote or *more than 50%* of the total value of the stock of such corporation is owned or considered as owned by one or more U.S. Shareholders on any day during the taxable year.[35] For CFC purposes, a U.S. Shareholder is defined as a U.S. person who owns, or is considered to own, directly or indirectly, 10% or more of the total combined voting power of all classes of stock entitled to vote of a CFC.[36] If a foreign corporation is a CFC for an uninterrupted period of 30 days or more during the taxable year, then a U.S. Shareholder, who owns stock in the CFC on the corporation's last day in such year that such corporation is a CFC, is subject to current U.S. income taxation of the U.S. Shareholder's *pro rata* share of the CFC's ''Subpart F Income'' and investments of earnings in U.S. property.[37] ''Subpart F Income'' includes the following categories of income:[38]

(1) Certain insurance income (§953);

(2) Foreign base company income (§954):
 (a) Foreign personal holding company income;
 (b) Foreign base company sales income;
 (c) Foreign base company services income;
 (d) Foreign base company oil related income;

(3) International boycott income (§952(a)(3) and §999);

(4) The sum of amounts of any illegal bribes, kickbacks, or other illegal or corrupt payments paid by or on behalf of the CFC directly or indirectly to an official, employer, or agent in fact of a government (§952(a)(4));[39] and

(5) Income derived from any foreign country for which §901(j) denies a foreign tax credit for taxes paid to such country because the United States has limited or severed its diplomatic relations with the foreign country in question (§952(a)(4)).

The amount of Subpart F Income allocated to a U.S. Shareholder is reduced by the amount of the current year distributions made by the CFC to the U.S. Shareholder.[40]

In the case of a CFC owned by a U.S. Shareholder, the U.S. person could be subject to U.S. income taxation on allocable income of a foreign corporation whether or not the foreign corporation makes a current year distribution to the U.S. Shareholder. If a U.S. person owns less than 10% of the shares of a CFC, then with respect to that shareholder the PFIC rules discussed below could apply.

Passive Foreign Investment Company — PFIC

A PFIC is any corporation formed outside of the United States (a ''foreign corporation'') if such corporation meets *either* an income test *or* an asset test.[41]

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[31] *See* Reg. §301.7701(b)-7(a)(3), which would attribute ownership of the shares of a foreign corporation to a U.S. person to determine whether the foreign corporation is a CFC.

[32] *See* Reg. §1.6038-2(j)(2)(ii).

[33] *See* §951(b).

[34] *See* §958(a), Direct and Indirect Ownership, and §958(b), Constructive Ownership.

[35] *See* §957(a).

[36] *See* §951(b).

[37] *See* §952(a)(1) and §952(a)(2). For this purpose, *pro rata share* is based on the U.S. Shareholder's direct or indirect ownership of CFC shares, without the application of the constructive ownership rules.

[38] *See* Yoder, Lyon, and Noren, 926 T.M., *CFCs — General Overview*, at VII.B.

[39] See §162(c) for a description of illegal bribes, kickbacks, and other illegal payments.

[40] *See* §951(a)(2)(B).

[41] For a more detailed discussion of the PFIC provisions, see Dennehy, Ehrlich, and McGee, *A Tax Primer on PFIC Taxation*, 125 Tax Notes (Nov. 30, 2009), pp. 993–1005; see also Blanchard, 6300 T.M., *PFICs*.

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The *income test* is satisfied if 75% or more of the gross income of the foreign corporation for any taxable year is passive income.[42] For this purpose, passive income includes dividends, interest, rents, royalties, gains from the sale or exchange of property that gives rise to any of the aforementioned categories, gains from commodities transactions (including futures, forwards, and similar derivative transactions) unless such transactions are bona fide hedging transactions reasonably necessary to the business of the foreign corporation as a producer, processor, or merchant with respect to such commodity, foreign currency gains, income equivalent to interest, income from notional principal contracts, and certain payments in lieu of dividends.

The *asset test* is satisfied if the average percentage of the foreign corporation's assets that produce passive income or that are held for the production of passive income is at least 50%.[43] The measurement of the corporation's assets is made at each fiscal quarter end and then averaged. All foreign corporations (except publicly traded corporations and CFCs) apply the test on the basis of the value of the corporation's assets, unless they elect to apply the test based on the adjusted tax basis of the corporation's assets as determined for purposes of computing the foreign corporation's earnings and profits.[44] A foreign corporation may have the option to use either the fair market value of its assets or the adjusted tax basis of its assets in applying the PFIC asset test. However, once the foreign corporation makes such election, it cannot change its election without the consent of the IRS. Also, the PFIC rules do not apply if the U.S. person would also qualify as a U.S. Shareholder of a CFC. In that case, the CFC consequences would override the potential adverse PFIC consequences.

Generally, under the default rule, a U.S. person who is a shareholder of a PFIC is subject to U.S. income taxation when there is an ''excess distribution'' by the foreign corporation or any gain is recognized on the disposition of stock of the PFIC.[45] Distributions from a PFIC fall into two categories: ''excess'' and ''non-excess'' distributions. An ''excess distribution'' is defined as that portion of a PFIC distribution that exceeds 125% of the average distributions made to a shareholder within the three preceding years included in the shareholder's holding period. If the shareholder's holding period is less than three years, the shareholder's actual holding period is used.[46] A ''non-excess'' distribution is the part of a distribution that is not an ''excess distribution.''

A ''non-excess'' distribution is treated as an ordinary distribution from a foreign corporation and is generally treated as a dividend. Because a PFIC by definition cannot be considered a ''qualified foreign corporation,'' a dividend is subject to U.S. income taxation as ordinary income.[47]

The portion of a PFIC distribution that is an ''excess distribution'' is subject to a special income tax regime. The U.S. PFIC shareholder must first allocate the ''excess distribution'' *pro rata* to each day in the shareholder's holding period for the shares.[48] The portion of the ''excess distribution'' allocated to the current year and to pre-PFIC years is included in the shareholder's gross income as ordinary income. The portion of the ''excess distribution'' allocated to the PFIC period during the taxpayer's holding period, other than the current year allocation, is subject to a ''special deferred tax'' computation based on the top marginal income tax rate for each of those years. The special deferred tax amounts for each PFIC year are aggregated. In addition, the PFIC shareholder must then compute an interest charge on the special deferred tax amounts based on the applicable federal underpayment tax rates for the years in question.[49] The sum of the special deferred tax amounts and the accompanying interest charges are then reported as an additional income tax liability on the U.S. PFIC shareholder's income tax return for the current year.

It is important to note that the PFIC ''excess distribution'' income recognition rules, summarized above, do not apply if:

(1) The U.S. PFIC shareholder makes a ''Qualified Electing Fund'' election (known as a ''QEF Election'') to report the shareholder's *pro rata* share of the PFIC's ordinary income and capital gains for the current year;[50] *or*

(2) The PFIC shares are marketable stock and the U.S. PFIC shareholder elects to ''mark to market'' the annual change in the value of the PFIC shares and reports in the current year the current year increase in value as ordinary income or the current year decrease in value as an ordinary loss.[51]

The potential adverse U.S. income tax cost for ownership of a PFIC could be high, especially if the

[42] *See* §1297(a)(1).

[43] *See* §1297(a)(2).

[44] *See* §1297(e).

[45] *See* §1291(a).

[46] *See* §1291(b)(2)(A).

[47] *See* §1(h)(11)(C)(iii).

[48] *See* §1291(a)(1)(A).

[49] *See* §6621(a)(2).

[50] *See* §1293.

[51] *See* §1296.

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U.S. person is not aware of his ownership of the PFIC for several years. A PFIC situation could arise even if a few shares of the foreign company in question are owned by the U.S. person. Furthermore, performing PFIC computations for corporations and shareholders that have not been collecting the required information from the outset can be a challenging or impossible task, depending on what records are available.[52]

Moreover, there is a special U.S. income tax adjusted basis provision that applies to PFIC shares owned by a U.S. person. Ordinarily upon the death of a U.S. decedent, the adjusted basis of the decedent's appreciated property is increased to the date-of-death fair market value of the property.[53] In that case, the decedent's ''built-in gain'' at the time of death escapes income taxation. If a basis adjustment would be permitted, then a U.S. person could hold the PFIC shares until death and the potential PFIC U.S. income tax cost could be avoided. In order to prevent this outcome, in the case of PFIC shares owned by a U.S. decedent, the basis of the PFIC shares will not receive a ''step-up'' in basis to the date-of-death fair market value. Instead, the U.S. decedent's adjusted basis and the ordinary income taint carry over to the U.S. decedent's successor.[54]

Annual Income Tax Reporting Obligations and FBARs

Dual status nationals who do not reside in the United States do not escape the extensive supplemental annual tax reporting required of U.S. citizens and residents. U.S. persons who reside outside of the United States are generally subject to the same reporting obligations as persons resident in the United States. As noted earlier, most of these reporting obligations continue to apply to U.S. persons who claim nonresident alien status based on a U.S. income tax treaty tie-breaker provision.

U.S. persons with gross income above certain amounts, regardless of their tax residence, are required to file an annual U.S. personal income tax return whether or not they have any U.S. income tax payment obligation. The minimum filing amounts vary depending on the U.S. person's filing status and are indexed for inflation each year.[55] The due date for individual income tax returns and the payment of the balance of the prior year's income tax liability is generally the 15th day of the fourth month following the end of the taxable year, generally April 15. If the U.S. person has a tax home in a real and substantial sense outside of the United States, then the due date for the filing of the return and the payment of the balance of any tax is the 15th day of the sixth month, generally June 15, unless the taxpayer has U.S.-source compensation income. [56] A six-month extension of the time to file, but not to pay the balance of any income tax that is due, is generally available.[57]

In general, a U.S. person with an outstanding income tax liability of $1,000 or more that is not otherwise satisfied by income tax withholding has quarterly estimated income tax payment obligations. If the minimum amount of a quarterly income tax payment is not made timely, a penalty in the form of an interest charge is assessed.[58]

A U.S. person who owns certain types of foreign assets, regardless of where the person currently resides, has annual U.S. tax reporting obligations depending on the type of asset. If the annual return for that particular type of asset is not timely filed, monetary penalties may be assessed until the return is filed. In appropriate circumstances, criminal penalties may also be assessed.[59] The following is a list of the various forms that could apply to report a U.S. person's ownership of or interest in particular types of foreign assets or entities and the Code section that establishes the legal basis for that particular tax form or report:

(1) Form 8938, Statement of Foreign Financial Assets (§6038D, Information with Respect to Foreign Financial Assets); as discussed earlier, a dual resident taxpayer under a U.S. income tax treaty may not be required to file this report;[60]

(2) Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain

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[52] The IRS has acknowledged this difficulty in its Frequently Asked Questions guidance for the Offshore Voluntary Disclosure Program, discussed below, where it stated that: ''A lack of historical information on the cost basis and holding period of many PFIC investments makes it difficult for taxpayers to prepare statutory PFIC computations and for the Service to verify them. As a result, resolution of voluntary disclosure cases could be unduly delayed. Therefore, for purposes of this program, the Service is offering taxpayers an alternative to the statutory PFIC computation that will resolve PFIC issues on a basis that is consistent with the Mark to Market (MTM) methodology authorized in Internal Revenue Code §1296 but will not require complete reconstruction of historical data.'' See http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers.

[53] *See* §1014(a).

[54] *See* §1291(e).

[55] *See* §6012(a)(1).

[56] *See* Reg. §1.6081-5(a)(5).

[57] *See* §6081(a).

[58] *See* §6654.

[59] See IRS Offshore Voluntary Disclosure Program, Frequently Asked Questions, No. 5, for a list of the monetary civil penalties for the failure to timely file most of these U.S. tax reports. http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers-2012-Revised.

[60] A revised version of Form 8938, dated December 2014, was released in IRS FATCA News & Information, 2015-1 (Jan. 5,

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Foreign Gifts (§6039F, Notice of Large Gifts from Foreign Persons, and §6048, Information with Respect to Certain Foreign Trusts);[61]

(3) Form 3520-A, Information Return of Foreign Trust with a U.S. Owner (§6048);

(4) Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations (§6038, Information Reporting with Respect to Certain Foreign Corporations and Partnerships; §6038B, Notice of Certain Transfers to Foreign Persons; and §6046, Returns as to Organization or Reorganization of Foreign Corporations and as to Acquisitions of Their Stock);

(5) Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (§6038A, Information with Respect to Certain Foreign-Owned Corporations);

(6) Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation (§6038B, Notice of Certain Transfers to Foreign Persons);

(7) Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships (§6038, Information Reporting with Respect to Certain Foreign Corporations and Partnerships; and §6038B, Notice of Certain Transfers to Foreign Persons);

(8) Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities (§6031, Return of Partnership Income; and §6038, Information Reporting with Respect to Certain Foreign Corporations and Partnerships); and

(9) Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund (§1298(f), PFIC Special Rules — Reporting Requirements).

In addition to the reporting to the IRS, U.S. persons have a separate and independent reporting obligation to the U.S. Treasury under the U.S. Bank Secrecy Act.[62] U.S. persons, regardless of their residence, who are directly or indirectly the beneficial owner of or have signature authority over a foreign bank or investment (securities) account, if the annual aggregate balance of such accounts is more than $10,000 at any time during the year, are required to file a Report of Foreign Bank and Financial Accounts (''FBAR'') with the Treasury Department.[63] Reporting is also required for non-U.S. bank or investment accounts owned by entities, U.S. or foreign, if a U.S. person who owns more than a 50% ownership interest in the corporation, partnership, or trust. The relatively new form for this reporting is FinCEN Report 114, which now must be filed electronically. (This new form replaces the previous FBAR form, TD F 90-22.1.) Unlike the IRS filing deadlines, the annual FBAR is due on or before June 30 of the following year, and there are no extensions. Another significant difference between the income tax provisions and the FBAR statutory provisions is the statute of limitations period for the assertion of penalties for non-compliance. For income tax purposes, the statutory period for the assertion of income taxes and penalties does not commence until the return/report in question has been filed. The FBAR statutory period for the assessment of penalties is six years from the June 30 due date of the FBAR in question, whether or not a report has been filed.[64]

Transfers of Property to Foreign Entities

As noted above, there are special reporting requirements for transfers by U.S. persons to foreign entities. In addition to these special reporting requirements, there are possible income tax consequences for certain transfers of appreciated property.[65] For example, a transfer of appreciated property to a foreign corporation could be a taxable event in which a taxable gain might have to be recognized, except for certain property used in the active conduct of a trade or business.[66] Similarly, a transfer of appreciated property to a foreign non-grantor trust or a foreign estate could be a taxable event in which a taxable gain might have to be recognized.[67] Also, the conversion of a foreign grantor trust with a U.S. person as the grantor to a foreign non-grantor trust or the conversion of a U.S. trust to a foreign trust could be taxable events. Because such transfers could be taxable events, the U.S. tax

2015).

[61] Form 3520 is also used to report the receipt of foreign bequests.

[62] *See* 31 U.S.C. §5314.

[63] *See* U.S. Treasury, Financial Crimes Network, BSA Electronic Filing Requirements for Report of Foreign Bank and Foreign Accounts (FinCEN Form 114), issued June 2014. http://www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf

[64] *Compare* §6501(c)(8)(A) *with* 31 U.S.C. §5321(b)(1).

[65] See IRS website, www.irs.gov/Business/Comparison-of-Form-8938-and-FBAR-Requirements, for a comparison of Form 8938, Statement of Specified Foreign Financial Assets, and FinCEN Form 114, Report of Financial Bank and Financial Accounts (FBAR).

[66] *See* §367(a)(1).

[67] *See* §684(a). *See also* Levin, *Transfers to Foreign Trusts Could Trigger Gain Recognition*, Est. Plan. J. (Oct. 2010) p. 14.

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law has imposed special reporting provisions for those transfers. In the case of a transfer of appreciated property to a foreign partnership, there had been an excise provision that would have applied but that was repealed in 1997 without any specific statutory replacement.[68] Regulations under §704(c) have been expected to address this situation but have not yet been issued.

Generally, for U.S. grantor trust income tax purposes, in the case of a direct or indirect transfer of property without full and adequate consideration by a U.S. person to a foreign trust that has one or more U.S. beneficiaries, the U.S. grantor is treated as the owner of the portion of the foreign trust attributable to such property.[69] Consequently, the U.S. transferor would be subject to U.S. income taxation on the income earned by the property contributed to the foreign trust, even though the property might otherwise be distributed to a U.S. trust beneficiary.

State and Local Income Taxation

In addition to the federal income tax, many states and local jurisdictions impose separate income taxes on persons who are resident within the state and local jurisdiction. In a number of jurisdictions, the starting point for the determination of the state and local income tax is based on either federal adjusted gross income or federal taxable income. Most jurisdictions, however, have their own criteria to determine whether a particular person is a resident of that particular jurisdiction and federal income tax status is not determinative. Consequently, it is possible for a person, who is not considered a U.S. tax resident because he or she is an ''exempt individual'' for federal income tax purposes, to be considered as a resident of a particular state or city based on presence there for more than 182 days.[70] In addition, generally U.S. income tax treaties do not apply to state and local income taxes. For example, Article 2(3)(b) of the U.S. Model Income Tax Convention provides, in part, ''The existing laws to which this Convention applies are in the case of the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding social security and unemployment taxes), and the Federal excise taxes imposed with respect to private foundations.''[71] Consequently, it is possible to have a situation where a dual status taxpayer or an item of income might not be subject to federal income taxation because of a tax treaty provision but would be subject to state and local income taxation. Based on the foregoing, each individual's particular facts should be carefully considered for both federal and state and local income tax consequences.

OVERVIEW OF U.S. TRANSFER TAXATION OF DUAL STATUS INDIVIDUALS

In addition to the U.S. federal income taxes discussed above, the U.S. federal government has three types of transfer taxes that could be imposed on the transfer of worldwide assets by U.S. persons and the transfer of U.S.-situs assets by non-U.S. persons. The transfer taxes are an estate tax, a gift tax, and a generation-skipping transfer tax (''GST''), which supplements the estate and gift taxes. Plus, 19 states impose an estate or inheritance (succession) tax and one state, Connecticut, imposes a gift tax. The following discussion is limited to the federal transfer taxes.

For purposes of the federal transfer taxes, different criteria apply to determine who is and is not a U.S. person. The federal income tax statutory concepts of LPR and substantial presence do not apply. Instead, U.S. persons for purposes of the federal transfer taxes are U.S. citizens and U.S. domiciliaries, not income tax residents. For U.S. transfer tax purposes, ''[A] person acquires a domicile in a place by living there, for even a brief period of time, with no definite intention of later removing therefrom.''[72] Determination of a person's domicile is based on a review of the particular facts and circumstances of the person's activities in and contacts with the United States and another country. For example, New York State law defines ''domicile'' as ''a fixed, permanent and principal home to which a person whenever temporarily relocated always intends to return.''[73] Two essential elements of U.S. domicile are physical presence in the United States and intent for the United States to be the

[68] Section 1131(a) of the Tax Relief Act of 1997 (Pub. L. No. 105-34) repealed then §1491–§1494. Then §1491 imposed a 35% excise tax on the built-in gain for a transfer of appreciated property to foreign entities.

[69] *See* §679(a)(1).

[70] For example, New York State and New York City determine state and city tax residence based on either domicile in the jurisdiction or maintenance of place of abode in New York State/City *and* physical presence in New York State/City for 183 days or more during the year, regardless of the individual's federal income tax status. N.Y. Tax Law §605(b)(1) and N.Y.C. Admin. Code §11-1705(b)(1).

[71] For example, N.Y.S. Tax Advisory Opinion TSB-A-10(7)I, dated Sept. 7, 2010, held that a U.K. citizen, who maintains a permanent place of abode in New York City and will be present in N.Y.C. for more than 183 days in the year, could be classified as a U.S. nonresident alien under the U.S.-U.K. Income Tax Treaty for U.S. federal income tax purposes and an N.Y.S./N.Y.C. tax resident for state and local income tax purposes.

[72] *See* Reg. §20.0-1(b)(1).

[73] N.Y. Surr. Ct. Proc. Act §103(15).

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person's domicile.[74] A domicile once acquired is presumed to continue until it is shown by sufficient evidence to have changed.[75] For U.S. tax purposes, many of the same factors considered in connection with a closer connection determination for income tax purposes are also relevant to a domicile determination. Nonetheless, a person could be an income tax resident of the United States but a domiciliary of a foreign country and, conversely but less likely, a nonresident alien for income tax purposes but a U.S. domiciliary.

Gift Taxes

Gifts of property within or outside of the United States by U.S. persons, citizens or domiciliaries, to any person, whether or not the recipient is a U.S. person, are subject to U.S. gift taxation based on the then-fair market value of the property transferred.[76] The actual gift tax liability is determined only after various exemptions, exclusions, and deductions are applied.

There is an annual exclusion for a gift of a ''present interest.''[77] Generally, a present interest is a gift where the recipient's enjoyment of the gift is not postponed into the future. There is a statutory exception for gifts to minors. The exclusion amount is currently $14,000 per donee per year and is indexed for inflation.[78] In addition, the direct payment of tuition to an educational organization and the direct payment for medical care are excluded from U.S. gift taxation without any limitation on the amount of the exclusion.[79]

In the case of gifts by non-U.S. persons, the U.S. gift tax applies to gifts of U.S.-situs property only.[80] For this purpose, U.S.-situs property generally includes tangible personal property located in the United States and U.S. real property.[81] The U.S. gift tax does not apply to intangible property. Thus, gifts of shares of U.S. companies would not be subject to U.S. gift taxation. Such shares, however, as discussed below, are subject to U.S. estate taxation.

In addition to the above exclusions, there is a lifetime unified credit for estate and gift taxes for U.S. citizens or domiciliaries only.[82] The equivalent dollar estate and gift tax exemption amount for the unified credit is currently $5,430,000, and is indexed for inflation.[83] If a U.S. person's lifetime taxable gifts do not exceed the equivalent exemption amount, a current gift tax would not be due. There is also an unlimited gift tax deduction for charitable gifts.[84] Unlike the U.S. income tax charitable deduction, a charitable deduction applies to gifts to eligible foreign persons and charitable organizations. A nonresident alien is entitled to a U.S. gift tax charitable deduction only for gifts of U.S.-situs property and, if given to a corporation, only to a U.S. charitable corporation.[85]

The United States has 17 estate and gift tax treaties with other countries which could apply in appropriate circumstances to reduce or eliminate U.S. gift tax liability. Again, the application of such treaties is on a case-by-case basis and each applicable treaty has to be applied to the particular facts.[86] In addition, any foreign gift tax paid on a gift subject to U.S. gift taxation could be claimed as a tax credit to offset the U.S. gift tax liability.[87]

Non-U.S. Citizen Spouse

Generally, the above gift tax exclusions and exemptions apply equally to gifts to U.S. persons and non-U.S. persons. In the case of gifts to a non-U.S. citizen spouse, however, different rules apply. Gifts to a non-U.S. citizen spouse, even if domiciled in the United States, may not be entitled to the same gift tax treatment as gifts to U.S. citizen spouses. For example, spouses are entitled to make an election to split gifts so a gift by one spouse could be divided equally between the two spouses and treated as made by each spouse. The spousal gift splitting election is only available if *both spouses are citizens or residents of the United States*, unless a gift tax treaty would otherwise permit gift-splitting with a nonresident alien spouse. [88]

A U.S. citizen or domiciliary, who is otherwise subject to U.S. gift taxes, is entitled to a dollar-for-dollar

[74] Domicile is the place to which, whenever a person is absent, such person intends to return. *Vlandis v. Kline*, 412 U.S. 441, 454 (1973) quoting Opinion of Attorney General of the State of Connecticut Regarding Nonresident Tuition, Sept. 6, 1972 (unreported).

[75] *See Mitchell v. United States*, 88 U.S. 350 (1875); and *Nienhuys v. Commissioner*, 17 T.C. 1149 (1952).

[76] *See* §2501(a).

[77] *See* §2503(b)(1).

[78] *See* Rev. Proc. 2014-61, above n. 23, ¶35.

[79] *See* §2503(e).

[80] *See* §2511(a).

[81] *See* §2501(a)(2).

[82] There is no U.S. gift tax credit for non-U.S. persons absent a possible application of a U.S. gift tax treaty. Consequently, the full fair market value of taxable gifts made by non-U.S. persons is subject to U.S. gift taxation based on the graduated transfer tax rate schedule of §2001(c). The unified credit against the gift tax is only available for U.S. citizens or domiciliaries.

[83] *See* §2010(c), §2505(a); Rev. Proc. 2014-61, above n. 23, ¶33.

[84] *See* §2522(a).

[85] *See* §2522(b).

[86] *See generally* Schoenblum, 6896 T.M., *U.S. Estate and Gift Tax Treaties*.

[87] See §2501(a)(3)(B).

[88] *See* §2513(a).

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gift tax marital deduction for assets that pass either outright or according to special statutory terms and conditions to the donor's spouse.[89] If the recipient spouse is not a U.S. citizen, even if the spouse is a U.S. domiciliary, then the amount of the deduction is limited to a special annual exclusion amount, which is indexed for inflation. For 2015, the annual exclusion amount is $147,000.[90] This exemption only applies to gifts of a present interest and does not apply to transfers in trust unless there is a special provision included in the trust agreement (known as a "*Crummey* withdrawal provision")[91] or the actuarial value of a right to income that would qualify the transfer to the trust as a gift of a present interest. In addition, for amounts in excess of the annual exclusion amount, the transfer must otherwise be eligible for the gift tax marital deduction.

Gifts or Bequests by Non-U.S. Persons to U.S. Persons

As noted above, gifts of intangible property regardless of the situs of the property and gifts and bequests of non-U.S.-situs property by a non-U.S. domiciliary or non-U.S. citizen are not subject to U.S. gift tax. Nevertheless, U.S. recipients of foreign gifts or bequests are required to report the receipt of a foreign gift or bequest if the amount of the annual gift or bequest exceeds $15,601 in 2015.[92] According to the instructions for Form 3520, Part IV, which is used to report foreign gifts and bequests, the IRS has increased the minimum amount for reporting to more than $100,000 for gifts or bequests received from a nonresident alien individual or a foreign estate. (The $100,000 amount is not indexed for inflation.) There is an exception to the above general rules if the foreign donor who made the gift or the foreign decedent who made the bequest to a U.S. person has been classified as a U.S. "covered expatriate," which is discussed below.[93] In that case, any "covered gift or bequest" made by the "covered expatriate" could be subject to a U.S. inheritance tax, if not otherwise subject to U.S. transfer taxation. In this case, the U.S. "inheritance tax" is to be paid by the U.S. recipient of the gift or bequest.

Estate Taxes

A U.S. citizen, regardless of where the person resides, and a non-U.S. citizen who has a U.S. domicile are subject to U.S. estate taxation on their worldwide assets. The same concept of domicile applies for both U.S. gift and estate taxes. A U.S. income tax resident who has a foreign domicile and, as discussed above, a non-U.S. resident who does not have a U.S. domicile are subject to U.S. estate taxation on their U.S.-situs assets only. For estate tax purposes, U.S. intangible property, including shares of a U.S. corporation, is generally considered U.S.-situs property and subject to U.S. estate taxation, unless there is a statutory exception. U.S. bank deposits, portfolio interest obligations, and life insurance proceeds owned or received by a non-domiciliary alien decedent are exempt from U.S. estate taxation.[94]

Persons who are subject to U.S. estate taxation on their worldwide assets are also eligible for the lifetime transfer tax exemption equivalent. As noted earlier, for 2015, the exemption equivalent is $5,430,000. Non-U.S. citizens with a non-U.S. domicile are entitled to an equivalent exemption of only $60,000.[95] U.S. persons with assets outside of the United States that are subject to a foreign estate tax could be eligible for a U.S. estate tax credit for foreign death taxes paid to any foreign country with respect to property situated in that foreign country.[96]

For U.S. decedents who are eligible for one of the U.S. estate and gift tax treaties in effect, the treaty provisions could apply to limit either the U.S. or the foreign country estate tax that would be imposed on the person's assets. Also, a U.S. estate and gift tax treaty could change the U.S. estate tax situs rules for non-U.S. decedents under §2104. For example, Article III of the U.S.-Italy Estate Tax Treaty sets forth a series of situs provisions for particular types of assets.[97] In addition, certain U.S. estate tax treaties have an express provision for an exemption equivalent commensurate with a *pro rata* allocation of the U.S. citizen's exemption equivalent based on the proportion the value of the decedent's U.S. assets bears to the value of the decedent's worldwide assets.[98] Treaty countries with the express provision that permits the exemption equivalent are Australia, Finland, Greece,

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[89] See §2523(a).

[90] *See* Rev. Proc. 2014-61, above n. 23, ¶35.

[91] For a discussion of the *Crummey* trust provision, see Lischer, 845 T.M., *Gifts*, at IX.A.10.

[92] *See* §6039F and Rev. Proc. 2014-61, above n. 23, ¶39.

[93] *See* §2801.

[94] *See* §2105(a)–§2105(d).

[95] Technically, §2102(b) provides for a credit of $13,000, which is equivalent to an exemption of $60,000.

[96] *See* §2014(a).

[97] TAM 9128001 advised that under Article 9 of the U.S.-Federal Republic of Germany Estate Tax Treaty shares of a U.S. corporation held by a deceased German national domiciled in Germany are excludible from the decedent's gross estate for U.S. estate tax purposes. In this case, a U.S. nonresident estate tax return should still be filed to claim the estate tax treaty benefit.

[98] *See* §2103(b)(3)(A).

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Italy, Japan, Norway, and Switzerland.[99] Estate tax treaties with other countries may also permit estate tax credits but without an express reference to the ''specific exemption.''

Non-Citizen Surviving Spouse

As is the case for the gift tax, special rules apply to qualify a bequest to a surviving spouse who is not a U.S. citizen for the estate tax marital deduction. Generally, a U.S. citizen or U.S. domiciliary is entitled to a dollar-for-dollar estate tax marital deduction for assets that pass either outright or according to special statutory terms and conditions to the decedent's surviving spouse.[100] However, the unlimited spousal marital deduction does not apply if the surviving spouse is not a U.S. citizen,[101] unless the decedent's property is left to the surviving spouse in a Qualified Domestic Trust (''QDOT'').[102] If the QDOT is in compliance with the required terms and conditions and a timely QDOT election is made by the estate's executor, then an unlimited spousal estate tax marital deduction would be available for assets passing to and held by the QDOT.[103]

A QDOT must have a U.S. person as trustee; if the trust corpus is more than $2 million, either a U.S. corporate fiduciary is required or a bond or letter of credit must be posted as security.[104] In this case, unlike a standard marital deduction trust for a U.S. citizen spouse, upon the death of the surviving spouse, the then QDOT corpus is subject to U.S. estate taxation computed as part of the first deceased spouse's taxable estate. Consequently, the surviving spouse's lifetime exemption is not available to reduce the U.S. estate tax imposed on the QDOT corpus. If the surviving spouse becomes a U.S. citizen and has been a resident of the United States since the first spouse's death, then it may be possible to terminate the trust's status as a QDOT. Finally, income distributions to the surviving spouse are not subject to estate taxation but corpus lifetime distributions to the surviving spouse are subject to U.S. transfer taxation, except in the case of a ''hardship distribution.''[105] In addition, several other specific QDOT statutory requirements apply.

Compliance Considerations

U.S. estate tax returns for both U.S. persons and non-U.S. persons are due nine months after the date of death[106] and are eligible for a six-month extension.[107] However, unlike income tax returns, the IRS and the taxpayer may not agree to extend the statute of limitations for transfer tax assessments. Consequently, if the transfer tax return is selected for audit, the time for the audit may not be mutually extended. If an additional transfer tax assessment is to be made by the IRS, it must be made within the original statutory assessment period.

An automatic 10-year U.S. estate tax lien applies to the decedent's property until the decedent's federal estate tax is paid.[108] A similar lien applies for gift tax purposes. In the case of a U.S. decedent who is resident outside of the United States, including a U.S. citizen and a non-U.S. decedent with U.S.-situs property subject to U.S. estate tax, a procedure is available to apply to the IRS Cincinnati Service Center for a Transfer Certificate, Form 5173, from the IRS. The Transfer Certificate permits the U.S. person that is holding the decedent's property to transfer title of the decedent's property to third parties without being subject to the special U.S. estate tax lien.[109]

For 2011, the concept of ''portability'' of a deceased spouse's unused unified exemption amount to the surviving spouse was enacted for two years. Subsequently, ''portability'' was enacted on a ''permanent'' basis (at least until the law is again changed). Estate tax portability permits the deceased spousal unused exclusion amount (the ''DSUE'') to be used by the surviving spouse or the surviving spouse's estate if an election is made by the first decedent's estate.[110] When the decedent's property passes to the surviving spouse in a QDOT, the DSUE is first used to offset the estate tax imposed on the corpus of the QDOT and any remaining balance could be used by the surviving spouse's estate if the surviving spouse had been a U.S. domiciliary.[111] If the surviving spouse at the time of the spouse's death is neither a U.S. citizen nor a U.S. domiciliary, the surviving spouse may not use the DSUE amount to offset any U.S. estate tax on the deceased spouse's U.S.-situs property.[112] The estate representative of a U.S. non-domiciliary alien is generally not permitted to make a portability election because the decedent does not have use of the unified credit exemption. A U.S. estate tax treaty could modify the possible use of the DSUE in the case of non-domiciliary alien decedents.

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[99] *See* Rev. Rul. 90-101, 1990-2 C.B. 315.

[100] *See* §2056(a).

[101] *See* §2056(d).

[102] *See* §2056A(b)(12).

[103] *See* §2056A.

[104] *See* Reg. §20.2056A-2(d)(1)(i)(A)–§20.2056A-2(d)(1)(i)(C).

[105] *See* §2056A(b)(3) and Reg. §20.2056A-5(c)(1).

[106] *See* §6075(a).

[107] *See* §6081(a).

[108] *See* §6324(a)(1).

[109] *See* I.R.M. 4.25.14.3 (01-07-2014) Issuing Transfer Certificate in Estate Tax Cases.

[110] *See* §2010(c)(4).

[111] *See* Reg. §20.2010-3T(c)(2).

[112] *See* Reg. §20.2020-3T(e).

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Generation-Skipping Transfer Tax ("GST")

In addition to the U.S. gift and estate taxes, since 1986 the U.S. tax law has had a transfer tax called the GST. It generally applies to supplement either the gift or estate tax if there is a transfer from a person who is at least two generations older than the transferee.[113] The GST tax rate and the GST tax exemption are equivalent to the estate tax rate and the estate tax exemption equivalent. The GST applies to any GST transfer made by a U.S. person not grandfathered or exempt. In the case of a transfer made by a non-U.S. person, the GST generally does not apply if a U.S. gift or estate tax does not apply.[114]

RESOLUTION OF U.S. TAX NON-COMPLIANCE FOR PAST U.S. TAX OBLIGATIONS

The foregoing discussion has identified situations where a U.S. dual status person could have a U.S. tax obligation but for some reason the person did not fully comply with that obligation. In the estate tax area, this situation would often arise when a non-U.S. person died owning U.S.-situs property and attempted to transfer title to that property or a U.S. citizen resident outside of the United States died without any U.S.-situs property. In the income tax area, in the past the income tax compliance obligations of dual status individuals, especially those who resided outside of the United States, might have been ignored or unknown. As noted initially, the recent international enforcement activities of the IRS, with increased penalties for non-compliance, and the commencement of the FATCA compliance and reporting requirements have caused such persons to recognize the need to address their past U.S. non-compliance and to take appropriate actions to be in current compliance.

Prior to the Offshore Voluntary Disclosure Programs (OVDPs) discussed below, taxpayers would prepare and file amended tax returns reporting previously unreported income or assets and paying the additional taxes and interest. Often the taxpayer would try to negotiate with the IRS a reduction in the penalties that might otherwise be assessed. Today, this is still the procedure used generally for transfer tax matters and for exclusively domestic income tax matters, i.e., situations that do not involve any unreported foreign income or assets. In the case of unreported foreign income or assets, the IRS had several preliminary programs to incentivize U.S. persons with certain foreign activities to report those activities to the IRS. These programs were precursors to the 2009–2014 IRS OVDPs discussed below. To date, the OVDPs have raised $6.5 billion in back taxes, interest, and penalties since 2009[115] and have identified substantial future foreign-source income receipts and assets subject to future U.S. income and transfer taxes. The following discussion addresses U.S. persons who are non-compliant for U.S. income tax purposes with respect to their foreign income and foreign assets.

Overview and History of OVDP

In 2009, the IRS announced its first OVDP to provide an incentive for U.S. taxpayers to comply with their U.S. income tax obligations with respect to foreign-situs assets and income. The OVDP was modeled on prior voluntary disclosure programs, and offered taxpayers an opportunity to come forward to report past income tax reporting non-compliance and pay their outstanding past due taxes, accrued interest, and certain penalties.

The 2009 OVDP covered a six-year period of non-compliance. Taxpayers were excused of any criminal liability for delinquent FBAR reporting of the taxpayer's foreign accounts and for delinquent filing of the various special income tax reports related to foreign assets owned by the U.S. taxpayer, discussed earlier. In exchange for this relief, the taxpayer had to pay the past due additional income taxes (including any PFIC and CFC related taxes), accrued interest thereon, the failure to file and pay (''delinquency penalties'') and accuracy-related penalties, and a special OVDP non-compliance penalty of 20% of the highest balance of the fair market value of the taxpayer's foreign non-compliant assets. The 2009 OVDP was closed to taxpayers on October 15, 2009.

The 2009 OVDP was subsequently replaced by the 2011 OVDP.[116] The 2011 OVDP increased the special non-compliance penalty to 25%. Certain taxpayers, however, were eligible for a reduced non-compliance penalty of either 5% or 12.5% depending on the particular facts. In practice, very few of the taxpayers who applied for the reduced OVDP penalty were accepted. In addition, so as not to disadvantage participants in the 2009 OVDP, participants in the 2011 OVDP had to pay back taxes and interest on up to eight years as well as accuracy-related and/or delinquency penalties for those years. The deadline for participation in the 2011 OVDP was August 31, 2011.

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[113] *See* Chapter 13, §2601 *et seq.*

[114] *See* Reg. §26.2663-2(b)(2).

[115] *See* FS-2014-6 (June 2014).

[116] *See* IRS News Release 2011-14 (Feb. 8, 2011).

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In 2012, the OVDP was reopened for an indefinite period with several modifications.[117] The 2012 OVDP further increased the special OVDP non-compliance penalty to 27.5%, which is now referred to as the "Title 26 Misc. Offshore Penalty." Also, the 2012 OVDP introduced a streamlined program for nonresident dual citizens and green card holders who resided overseas, had $1,500 or less of unpaid income tax per year, and answered a risk questionnaire to substantiate that the taxpayer's previous failures to comply were due to non-willful conduct. Again, the special safe harbors that were established were narrowly applied and not available to many taxpayers who believed that they were appropriate candidates for the streamlined program. Consequently, the 2012 OVDP was further modified by the 2014 OVDP.[118]

The 2014 OVDP is the current program available to non-compliant U.S. taxpayers who want to take advantage of its provisions and "safe harbors." The 2014 OVDP expanded and modified the prior streamlined procedure, as summarized below, which is now available to U.S. residents as well. In addition, the 2014 OVDP streamlined alternative eliminated the required risk questionnaire and added a new requirement for a certification of non-willful conduct by taxpayers participating in the program. Also, the 2014 OVDP increased the Title 26 Misc. Offshore Penalty to 50% for taxpayers who either: (1) had foreign accounts at a financial institution identified by the IRS as under investigation by the U.S. government; or (2) were advised by a facilitator identified by the IRS as under investigation by the U.S. government. The tax compliance considerations related to the 2014 OVDP are discussed below.

Current Alternatives for Non-Compliant U.S. Persons

Currently, a non-compliant U.S. person has three possible alternatives. One is not to enter the OVDP, which is essentially the pre-OVDP approach. It is often referred to as "Quiet Disclosure." The other two alternatives are the 2014 OVDP and the 2014 OVDP Streamlined Alternative. These alternatives are summarized below.

Quiet Disclosure Alternative

In the case of the Quiet Disclosure Alternative, the standard statute of limitations for income tax assessments and collections of interest and penalties applies. Generally, a three-year statute of limitations period applies commencing with the later of the due date of the return or the date the return was filed.[119] If there is a substantial omission of income, defined as unreported income that is more than 25% of the taxpayer's gross income reported on the taxpayer's return as filed, or if there is an omission of an asset with a value of $5,000 or more from Form 8938, Statement of Foreign Financial Assets, a six-year period applies.[120] If a U.S. person has not filed an income tax return for a given year, the statute of limitations period for assessment of taxes does not start. Thus, if a dual status individual who has been living outside of the United States has not filed an income tax return for a number of years, technically each of the years for which returns were not filed is open for possible assessment by the IRS. As a practical matter, in the past, especially if the taxpayer comes forward before "discovery" by the IRS, frequently the IRS would require the taxpayer to provide up to only 3–6 years of past due returns and would not consider earlier years. It is possible in the case of foreign-situs assets that this approach will no longer be available for taxpayers who do not elect to use the currently available 2014 OVDP or 2014 OVDP Streamlined Alternative.

In the case of the various information returns listed earlier, generally the time for assessment of any tax with respect to any tax return, event, or period to which such information was related expires three years after the information return is received by the IRS. If the failure to file the information return is due to reasonable cause, the extended limitations period applies only to items on or items related to the late filed information return.[121] As is the case for income tax returns, if no information return is filed, the statute of limitations period for possible assessment of additional taxes and penalties related to the taxpayer's income taxes remains open indefinitely.

As noted earlier, the statute of limitations period in connection with penalties for late filed FBARs is different than the period for income tax-related assessments. Instead, it is based on the U.S. Bank Secrecy Act, which sets a six-year statute of limitations period from the due date of the report, whether or not a report has been filed.[122] Consequently, the maximum period for non-filing FBAR penalties is limited to six years, unless the taxpayer consents to a longer period as part of the 2014 OVDP.

As explained below, the limitations periods for possible assessments under either the 2014 OVDP or the 2014 OVDP Streamlined Alternative are limited to fixed time periods. Consequently, in the case of a U.S.

[117] *See* IRS News Release 2012-5 (Jan. 9, 2012).

[118] *See* IRS News Release 2014-73 (June 18, 2014).

[119] *See* §6501(a).

[120] *See* §6501(e).

[121] *See* §6501(c)(8)(A) and §6501(c)(8)(B).

[122] *See* 31 U.S.C. §5321(b)(1).

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taxpayer who has not filed any returns for a number of years, either of the OVDP alternatives may be preferable. Conversely, for someone who is only filing amended returns with a fixed number of open years, the Quiet Disclosure approach may have certain advantages.

Another important consideration when one compares the alternatives is what penalties could be assessed against the taxpayer under each alternative.

The delinquency penalties include the failure to file a return and the failure to pay the tax. The penalty for failure to timely file a U.S. return is 5% of the amount of the unpaid U.S. income tax liability for the taxable year plus an additional 5% for each additional month of the failure to file up to a maximum of 25%.[123] The penalty for failure to timely pay the tax due is 0.5% of the amount of unpaid U.S. income tax liability for the taxable year plus an additional 0.5% for each additional month of the failure to pay up to a maximum of 25%.[124] If both penalties apply, the sum may not exceed 5% per month for the first six months. For subsequent months, the late penalty applies until it reaches its maximum of 25%. Consequently, the maximum combined penalty would be 47.5% of the additional tax due.[125]

In addition to the delinquency penalties, the accuracy-related penalty of 20% of the portion of the underpayment of tax subject to a specific accuracy penalty could be imposed on returns that have an open statute of limitations period. The accuracy negligence penalty could apply for any failure to make a reasonable attempt to comply with the U.S. tax law or any careless, reckless, or intentional disregard of the U.S. tax law.[126] An accuracy-related penalty could be imposed for a substantial understatement of the income tax liability — the underpayment of tax exceeds the lesser of 10% of the tax required to be shown on the return or $5,000.[127] The accuracy-related penalty could be increased to 40% if the underpayment of tax is attributable to an undisclosed foreign financial asset on most of the information returns listed earlier.[128] An accuracy-related penalty could be significant because it could be imposed on an annual basis and, unlike the Title 26 Misc. Offshore Penalty, is not a one-time-only penalty.

It is important to note that the accuracy-related penalty is in addition to the annual penalty that could be imposed for failure to timely file any of the information returns listed earlier. Different monetary penalties apply for most of the information returns. In some cases, the monetary penalty could increase if the return is not filed within a reasonable period following notice by the IRS that the return is past due.

The FBAR, discussed above, which is filed annually with the U.S. Treasury Department to report foreign bank and investment accounts, has its own penalties for failure to file timely an FBAR. The maximum penalty for a non-willful failure to file the FBAR form is $10,000 for each year for each account. The maximum penalty for a willful failure to file is *the greater of* $100,000 or 50% of the account balance at the time of the violation for each year for each account. In addition, in appropriate situations, criminal penalties may be imposed.[129] For taxpayers with multiple accounts, especially with high balances in each account and multiple years of non-compliance, the potential FBAR-related penalties could be significant and could exceed the current balance of a foreign account.

Generally, under the Quiet Disclosure alternative, the various penalties summarized above could be waived by the IRS if the taxpayer can establish that the taxpayer's failure was due to reasonable cause and not due to willful neglect. The waiver of a penalty for reasonable cause requires that the taxpayer exercised ordinary business care and prudence in determining his tax obligations and acted in good faith.[130] No waiver of the penalties under the OVDP and OVDP Streamlined alternatives is possible, although several of the filing penalties would be waived. If a taxpayer has made an OVDP submission and would like to request a waiver of some or all of the assessable penalties, the taxpayer would have to opt out of the OVDP and lose whatever benefits might have been available to the taxpayer under the OVDP. In that case, the taxpayer would be subject to the general examination and penalty criteria set forth above.

As explained above, the Quiet Disclosure alternative could be the least expensive of the possible alternatives but it has the greatest possible penalty exposure unless the taxpayer could establish a reasonable cause for the failure to comply with the U.S. income tax compliance and reporting obligations. The reasonable cause argument must be accepted by the IRS agent, who is assigned to review the taxpayer's Quiet Disclosure filing, before any of the penalties would be waived.

2014 OVDP Alternative

The 2014 OVDP alternative filing procedures now incorporate several standard forms and procedures

[123] *See* §6651(a)(1).

[124] *See* §6651(a)(2).

[125] *See* §6651(b)(2).

[126] *See* §6662(c).

[127] *See* §6662(d).

[128] *See* §6662(j).

[129] *See* 31 U.S.C. §5321(a)(5).

[130] See §6664(c)(1) for the reasonable cause standard for the negligence penalty and I.R.M. 20.1.1.3.2 (11-25-2011) Reasonable Cause.

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that the IRS has developed over the past few years based on the earlier OVDPs. As explained below, the 2014 OVDP alternative has several advantages over the Quiet Disclosure alternative if the various penalties discussed above would not be waived for reasonable cause. One of the advantages of the 2014 OVDP alternative over both the Quiet Disclosure alternative, discussed above, and the 2014 OVDP Streamlined alternative, discussed below, is that the IRS will issue a formal Closing Agreement (IRS Form 906) to the taxpayer that would limit the IRS from reopening any of the taxable years covered by the 2014 OVDP. A Closing Agreement is not available under the two other alternatives. Consequently, any taxable years that are not closed for tax assessment purposes would remain open for a future possible IRS assessment.

The Title 26 Misc. Offshore Penalty remains at 27.5% as established under the 2012 OVDP. But, as noted above, the penalty could be increased to 50% if the taxpayer's undisclosed account had been or is at a foreign financial institution identified by the IRS as under investigation by the U.S. government or the taxpayer has been or is advised by a facilitator that has been identified by the IRS as under investigation by the U.S. government. The list of current institutions or facilitators with accounts subject to the 50% penalty is available at http://www.irs.gov/Businesses/International-Businesses/Foreign-Financial-Institutions-or-Facilitators. As of December 31, 2014, 12 institutions are listed.

The two most significant ''savings potential'' opportunities under the 2014 OVDP alternative are that the 2014 OVDP is limited to a maximum of eight years, even if there is no statute of limitations that applies to earlier years, and the multiple penalties for late filing of the information returns and the FBARs would not be imposed. This could be significant especially where the 40% accuracy penalty related to the foreign information returns could be imposed. If a taxpayer participates in the 2014 OVDP, the IRS will not review the taxpayer's non-reporting for the prior taxable years.

The payment of the unpaid taxes, accrued interest thereon, any related delinquency and accuracy-related penalties, and the Title 26 Misc. Offshore Penalty are now due when the full OVDP submission is made to the IRS following approval by the IRS to participate in the program. Prior to the 2014 OVDP, the Title 26 Misc. Offshore Penalty was not payable until the IRS Closing Agreement was signed and submitted to the IRS by the taxpayer.

The 2014 OVDP, similar to the prior OVDPs, has special compliance procedures for taxpayers who have not filed information returns or FBARs but have fully reported their income and paid their income tax liabilities. If these procedures are followed, the IRS would not assert any related late-filing penalties provided the taxpayer can establish reasonable cause for the late filing. The Delinquent FBAR Submission Procedure provides that if the taxpayer is in full income tax compliance and has not filed the FBARs, is not under a civil examination or criminal investigation by the IRS, and has not already been contacted by the IRS about the delinquent FBARs, the taxpayer may follow a special delinquent FBAR submission procedure.[131] Under this procedure, the IRS will not impose a penalty for the failure to file the delinquent FBARs if the taxpayer properly reported on the taxpayer's U.S. tax returns, and paid all tax on, the income from the foreign financial accounts reported on the delinquent FBARs. Similarly, the Delinquent Information Return Procedure provides that if the taxpayer is in full income tax compliance except with respect to certain information returns and the taxpayer has reasonable cause for not timely filing the information returns, is not under a civil examination or criminal investigation by the IRS, and has not already been contacted by the IRS about the delinquent information returns, the taxpayer may follow a special delinquent information return submission procedure.[132] Under this procedure, the information returns should be filed together with a reasonable cause statement for not filing the information returns.

2014 OVDP Streamlined Filing Alternative

The 2014 OVDP Streamlined Filing alternative now offers different procedures for persons who are resident outside of the United States (''Foreign Filing'') and for the first time for persons who are resident in the United States (''Resident Filing''). Thus, U.S. citizens who could not qualify for the nonresident alternative could possibly take advantage of the new ''resident filing'' alternative. The Streamlined Filing alternatives are only available to individual taxpayers and estates. Consequently, trusts that are delinquent could not use it. Also, taxpayers that had not made an OVDP submission prior to July 1, 2014, must choose between the 2014 OVDP and the 2014 OVDP Streamlined Filing alternatives. Once a taxpayer makes a decision, the taxpayer may not transition to the other alternative. For example, in the case of a taxpayer who decides to make a 2014 OVDP Streamlined Filing submission, if the IRS subsequently determines the taxpayer's conduct to have been willful, the taxpayer cannot convert the submission to a 2014 OVDP submission. The taxpayer would

[131] *See* http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-FBAR-Submission-Procedures.

[132] *See* http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-International-Information-Return-Submission-Procedures.

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then be subject to the same criteria as if the taxpayer had made a Quiet Disclosure submission.

Most importantly, the taxpayer is required to certify under penalty of perjury that the taxpayer's non-compliance was due to non-willful conduct.[133] The IRS announcement of the 2014 OVDP states that non-willful conduct is conduct due to negligence, inadvertence, mistake, or conduct that is the result of a good faith misunderstanding of the requirements of the law. According to recent statements by IRS representatives, the IRS has refused to, and made a deliberate decision not to, provide specific guidance as to what constitutes non-willful conduct.[134] Consequently, taxpayers and their advisers must make their own determination as to whether the taxpayer's conduct was non-willful and a false certification could subject the taxpayer to a possible perjury violation.

In addition, as is the case for the OVDP submissions, the taxpayer must not be currently subject to a civil or criminal examination by the IRS.

Foreign Filing. The taxpayer must be a "nonresident" of the United States as defined for this special purpose. A "nonresident" is an eligible person who within the three most recent years for which a due date for a U.S. income tax return has passed, *in at least one of those three years*, did not have a U.S. abode *and* was physically outside of the United States for at least 330 full days. If the taxpayer cannot satisfy this test, even if the taxpayer has a permanent home outside of the United States, the taxpayer would not be eligible for the foreign filing alternative.[135] The taxpayer must file all delinquent or amended tax returns including all information returns and pay the full amount of tax and interest due for those three taxable years. No penalties, *including the Title 26 Misc. Offshore Penalty*, would be imposed on the taxpayer. In addition, the taxpayer must file all delinquent FBARs for the prior six years.

Resident Filing. The taxpayer must have previously filed a U.S. income tax return for each of the three most recent years for which a due date has passed. Thus, this Streamlined Filing procedure is only available for the filing of amended income tax returns. The taxpayer must file amended tax returns including all information returns and pay the full amount of tax and interest due for those three taxable years. Also, the taxpayer must file all delinquent FBARs for the prior six years. The accuracy- and delinquency-related penalties, the information return penalties, and the FBAR penalties are not due.[136] The key difference is that a Title 26 Misc. Offshore Penalty of 5% of the highest aggregate balance or value of either the foreign financial accounts to be reported on the FBARs for the six-year covered period or the foreign financial assets that should have been reported on Form 8938 for the three-year covered period would be due.

A dual status taxpayer today who is not currently in full compliance with his U.S. income tax obligations has several different alternatives to become fully compliant. Each of these alternatives has different potential tax and penalty costs and eligibility depends on the particular facts and circumstances of each taxpayer. Not all taxpayers could qualify for a reasonable cause waiver of penalties or for a non-willful certification for the streamlined filing alternatives. Some taxpayers may prefer the higher degree of certainty provided by an IRS Closing Agreement. Consequently, each dual status taxpayer should evaluate his particular situation to determine how best to proceed.

For those dual status taxpayers who are delaying a decision or who believe that the IRS will not discover them or their offshore assets, the taxpayer could be in a far worse situation if the IRS discovers them or their foreign assets first. In that case, none of the 2014 OVDP alternatives would be available to the delinquent taxpayer. Moreover, chances for a favorable determination that the taxpayer had reasonable cause for non-compliance are unlikely, especially in light of the recent publicity concerning FATCA and the enforcement of U.S. income tax compliance obligations with respect to foreign assets. Such taxpayers would be well advised to act promptly and avoid being considered a "recalcitrant account holder"[137] for FATCA compliance purposes, which could draw the IRS's attention to the taxpayer before the taxpayer decides to make an OVDP submission.

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[133] The certification is submitted on IRS Form 14653, Certification by U.S. Person Residing Outside of the United States for Streamlined Offshore Procedures, or IRS Form 14654, Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures, which include the following statement: "I recognize that if the Internal Revenue Service receives or discovers evidence of willfulness, fraud or criminal conduct, it may open an examination or investigation that could lead to civil fraud penalties, FBAR penalties, information return penalties, or even referral to Criminal Investigation." According to a January 19, 2014, article in Bloomberg Law BNA International Tax Monitor by Alison Bennett, "The IRS has made it clear that it won't accept applications for the streamlined version of the OVDP unless the taxpayers spell out how and why they failed to report income, pay tax and submit required information returns."

[134] *See* Statement of Jennifer Best, Senior Adviser to IRS Deputy Commissioner (International), *Official Says IRS Won't Define Standard for Non-Willful Conduct Under Streamlined OVDP*, 216 Daily Tax Rep. G-8 (Nov. 7, 2014).

[135] *See* http://www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-Outside-the-United-States.

[136] *See* http://www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-in-the-United-States.

[137] For FATCA compliance purposes, a "recalcitrant account holder" is defined as an account holder who fails to comply with requests for documentation related to a foreign account. Reg. §1.1471-5(g).

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ALTERNATIVES FOR A FULLY COMPLIANT DUAL NATIONAL

Once a dual status individual who had not been fully compliant with respect to U.S. income tax obligations becomes fully compliant, the individual has two options: (1) maintain U.S. taxpayer compliant status by timely filing all U.S. income tax returns and reports and paying the income taxes thereon, filing any U.S. gift tax returns and accompanying tax payments, and ultimately having the decedent's representative file a U.S. estate tax return and accompanying payment, if due; or (2) expatriate from the United States. Expatriation would require the dual status individual to relinquish his U.S. citizenship or relinquish his permanent resident status. In the case of an individual who is a U.S. income tax resident based on the substantial presence test, the individual would have to monitor their visits to the United States to avoid being present for 183 days or more under either the three-year look-back formula or during the current taxable year. As a practical matter, under the three-year look-back formula, as long as the individual limits U.S. presence to 120 days or less per year, the 183-day threshold would not be reached.[138] If U.S. nonresident status is obtained based on either the closer-connection-to-a-home-country exception or the tie-breaker provisions of a U.S. income tax treaty, the individual should maintain his foreign contacts and relationships and limit additional U.S. contacts to the extent possible.

Today, a number of dual status nationals are reaching the conclusion that continued U.S. citizenship or retention of LPR status is no longer necessary or desirable in light of the increased U.S. tax compliance obligations. In fact, the number of persons who have relinquished their U.S. citizenship over the past few years has increased dramatically.[139] As explained below, there is a potential U.S. income tax and a potential U.S. inheritance tax for certain U.S. citizens and ''long-term permanent residents'' who expatriate.

[138] In the case of an individual present in the United States for 120 days a year for three consecutive years, the three-year look-back formula would apply as follows: 120/6 + 120/3 + 120 = 180 days.

[139] The IRS is required by §6039G(d) to publish in the *Federal Register* a quarterly report of the name of each individual who has relinquished U.S. citizenship during the preceding quarter. According to the BNA Daily Tax Report, ''The number of Americans renouncing U.S. citizenship stayed near an all-time high in the first half of 2014.'' Griffiths, *Americans Give Up Passports as Asset-Disclosure Rules Start*, 153 Daily Tax Rep. G-2 (Aug. 8, 2014). In 2013, 3,000 persons relinquished their U.S. citizenship, the highest number ever reported. Tax Notes Int'l (Feb. 17, 2014) p. 615.

Expatriation from the United States

Over the past decade several changes have been made to the U.S. income and transfer tax provisions that apply to U.S. persons who relinquish their U.S. citizenship and to long-term permanent residents who relinquish their LPR status. Today, the income and transfer tax provisions that address such persons are covered by §877A, Tax Responsibilities of Expatriation, and §2801, Gifts and Bequests from Expatriates -Imposition of Tax, respectively. These provisions are summarized below.

'Covered Expatriate'

Both of the above provisions apply only to a person who would be considered a ''covered expatriate.'' A ''covered expatriate'' is defined as an individual who meets *any one* of the following three tests:[140] (1) the individual's average annual net income tax liability for the five taxable years prior to expatriation is greater than an amount indexed for inflation; for 2015, the amount is $160,000;[141] the income tax liability is determined after application of tax credits including the foreign income tax credit; (2) the individual's net worth as of the date of expatriation is greater than $2,000,000 (which is not indexed for inflation); or (3) the taxpayer fails to certify under penalty of perjury that the taxpayer has fulfilled the taxpayer's U.S. tax compliance obligations for the five preceding taxable years. If a taxpayer is not covered by any of the above three tests, the taxpayer could expatriate from the United States without additional U.S. tax consequences, provided the appropriate procedures are followed to relinquish the taxpayer's U.S. passport or green card, file a final U.S. income tax return,[142] pay the income taxes on the taxpayer's worldwide income for the final period of U.S. taxpayer status, and timely file Form 8854, Initial and Annual Expatriation Statement, to substantiate that the taxpayer is not a ''covered expatriate.'' Effective September 12, 2014, the U.S. Department of State increased the fee for processing a renunciation of U.S. citizenship from $450 to $2,350. If the expatriate fails to file Form 8854 to report the expatriation, the expatriate would be treated as a ''covered expatriate'' for failure to fulfill all U.S.

[140] See §877A(g)(1) with reference to §877(a)(2)(A)–§877(a)(2)(C). For guidance on determining whether an individual is a ''covered expatriate'' by reason of the tax liability test or the net worth test, see Notice 97-19, 1997-1 C.B. 394, §III.

[141] *See* Rev. Proc. 2014-61, above n. 23, ¶3.30.

[142] See §7701(b)(1)(B) for the determination of the person's last day as a U.S. person and allocation of income during the last year. In the case of a resident alien, Form 1040-C, U.S. Departing Alien Income Tax Return, or Form 2063, U.S. Departing Alien Tax Statement, should be filed by an alien before the alien leaves the United States.

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tax compliance obligations, whether or not the tax liability test or the net worth test is satisfied.[143]

There are two exceptions to the above general rule. If the expatriate individual acquired dual citizenship of the United States and another country at birth, as of the expatriation date continues to be a citizen of and is taxed as a resident of such other country, and has been a resident based on the income tax definition of resident of the United States for not more than 10 taxable years during the 15 taxable years prior to expatriation, then the expatriate would not be considered a ''covered expatriate.''[144] Also, if the expatriate individual relinquishes U.S. citizenship before such individual attains the age of 18½ and has been a resident based on the income tax definition of resident of the United States for not more than 10 taxable years prior to expatriation, then the expatriate would not be considered a ''covered expatriate.''[145]

One non-tax consideration of expatriation by a U.S. citizen is known as the ''Reed Amendment,'' which was enacted in 1996.[146] Under this provision, a former U.S. citizen who officially renounced U.S. citizenship and who is determined by the U.S. Department of Homeland Security to have renounced citizenship for the purpose of avoiding taxation by the United States is inadmissible into the United States for a subsequent visit.[147] In practice, according to U.S. immigration lawyers, this provision had been rarely applied and the chances for it being invoked to deny admission into the United States had been very low.[148] However, anecdotal observations by attorneys who practice in this area note that U.S. immigration officers are starting to raise questions upon re-entry to the United States by U.S. expatriates. Some attorneys also question if this statute is constitutional. Regardless, the U.S. Citizen and Immigration Service and the IRS are increasingly sharing taxpayer enforcement information.

A U.S. LPR who relinquishes his green card could also be considered a ''covered expatriate.'' A U.S. permanent resident who has held a green card in at least eight taxable years during the period of 15 taxable years ending with the taxable year of expatriation would be subject to the same three tests as a U.S. citizen expatriate. An individual would not be treated as a U.S. resident for this purpose for any year in which he is a resident of a foreign country based on an income tax treaty tie-breaker provision, discussed above, and he does not waive the benefits of the tax treaty.[149] If the U.S. LPR in question satisfies any one of the three tests, the U.S. resident would be classified as a ''covered expatriate'' and subject to the same tax provisions as a U.S. citizen who is so classified.[150] U.S. persons who relinquish their green card and are not classified as a ''covered expatriate'' would not be subject to the tax provisions of §887A and §2801, discussed below.

'Tax Costs' of U.S. Expatriation — U.S. Exit Tax and U.S. Inheritance Tax

As mentioned above, ''covered expatriates'' are subject to a U.S. exit tax under §877A on their worldwide assets beneficially owned on the day immediately prior to expatriation. All property of a ''covered expatriate'' is treated as sold on the day before expatriation and gain and loss on the deemed disposition must be recognized.[151] Net gain is recognized only to the extent that the deemed gain exceeds in the aggregate an amount indexed for inflation, which is $690,000 in 2015.[152] The exclusion amount will be allocated *pro rata* to each asset with built-in gain, limited to the amount of the built-in gain, and the asset will receive the same tax treatment (e.g., ordinary or capital gain) as though it had been sold in any other year.[153] The U.S. exit tax is payable with the covered expatriate's final U.S. income tax return for the year of expatriation. A ''covered expatriate'' may elect to defer payment of the mark-to-market tax on a property-by-property basis until the property is actually sold or disposed of or the death of the ''covered expatriate.'' If a tax payment deferral is elected, the ''covered expatriate'' would have to post adequate security for the deferred U.S. income tax obligation and interest will have to be paid on the deferred tax payment.[154] In addition, there are special income recognition provisions that apply to any deferred compen-

[143] *See* Notice 2009-85, 2009-45 I.R.B. 598, §8-C.

[144] *See* §877A(g)(1)(B)(i). President Obama's 2016 Budget Proposal includes a proposal to modify the terms of the compliance certification for U.S. citizens with minimal contacts with the United States, who are referred to as ''accidental dual citizens.''

[145] *See* §877A(g)(1)(B)(ii).

[146] The ''Reed Amendment'' was enacted as part of the Illegal Immigration Reform and Responsibility Act of 1996, Pub. L. No. 104-208 (Sept. 30, 1996).

[147] *See* Pub. L. No. 104-208 and 8 U.S.C. §1182. By its terms, this rule applies only to expatriating U.S. citizens and does not apply to expatriating LPRs.

[148] *See* Kumpula, Cartwright, and Mehta, above n. 16, p. 247.

[149] *See* §877(e)(12).

[150] *See* §877A(g)(5) with reference to §877(e)(2).

[151] See Berg, *Bar the Exit (Tax)! Section 877A, the Constitutional Prohibition Against Unapportioned Direct Taxes and the Realization Requirement*, 65 Tax Lawyer 181–216 (Winter 2012), which asserts the deemed asset sale provision of §877A is unconstitutional on the basis that it is an unapportioned direct tax imposed on something that is not income within the meaning of the Seventeenth Amendment.

[152] *See* Rev. Proc. 2014-61, above n. 23, ¶3.31.

[153] *See* Notice 2009-85, 2009-45 I.R.B. 598, §3-B.

[154] *See* §877A(e).

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sation item, any specified tax deferral accounts such as IRAs and education and health savings accounts, and any interest of the ''covered expatriate'' in a non-grantor trust.[155]

In addition to the above exit tax on the unrealized appreciation of the ''covered expatriate's'' worldwide assets and any deferred income items, §2801 would impose a form of inheritance tax on most gifts or bequests made by a ''covered expatriate'' to U.S. persons subsequent to expatriation, if not otherwise subject to U.S. transfer taxation. Specifically, if a U.S. person receives a ''covered gift or bequest'' from a ''covered expatriate'' or the estate of a ''covered expatriate'' that is not otherwise subject to U.S. gift or estate taxation, the U.S. recipient of the ''covered gift or bequest'' would be liable for a U.S. inheritance tax based on the then–fair market value of the property received multiplied by the highest gift or estate tax rate then in effect.[156] This inheritance tax applies to any property transfer by the ''covered expatriate,'' including property acquired subsequent to the taxpayer's expatriation. Currently, the highest U.S. transfer tax rate is 40%. The U.S. inheritance tax would be reduced by any gift or estate tax paid to a foreign country with respect to the ''covered gift or bequest.'' Special rules apply to impose the U.S. inheritance tax on transfers to domestic trusts and to distributions to U.S. persons by foreign trusts, unless the foreign trust elects to be treated as a domestic trust.[157] It is important to note that the special U.S. inheritance tax does not apply to a property transfer that would be eligible for a charitable or spousal transfer tax exemption if the transferor were a U.S. person and to annual exclusion gifts of a present interest. From an estate tax planning perspective, the expatriate would lose eligibility for the estate and gift tax unified credit exemption following expatriation. Consequently, the expatriate may want to use the expatriate's available lifetime exemption to make gifts prior to expatriation.

CONCLUSION

As discussed above, dual status U.S. individuals generally have the same U.S. tax status and compliance and reporting obligations as U.S. persons. There are a number of special statutory and possibly tax treaty provisions that may apply to ameliorate the U.S. tax obligations. In order to apply these provisions, however, U.S. tax compliance requirements must be strictly followed. Recently, the IRS has adopted several special programs to encourage U.S. income tax compliance by dual status persons who had not been in full compliance with their U.S. tax obligations. For the reasons summarized above, such persons are strongly encouraged to take appropriate steps to become fully compliant with such obligations as soon as possible. Once a dual status individual is in full compliance, the person could then determine if any changes in that person's U.S. tax status should be undertaken. The potential ''tax cost'' of the termination of the person's U.S. tax status should be identified so the individual can evaluate whether the potential U.S. costs, as well as the non-tax considerations, support the ''termination'' of the individual's U.S. tax status. Moreover, certain types of tax planning and possible transfers may be undertaken before expatriation to minimize any potential exit tax and subsequent inheritance tax that could be imposed on a U.S. expatriate or on recipients of his gifts or bequests.

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[155] *See* §877A, §877A(e), §877A(f), and §877A(g).

[156] *See* §2801(a).

[157] *See* §2801(e)(4).

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