Taxation of Nonresident Aliens

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I. INTRODUCTION

This outline addresses the taxation of resident aliens, nonresident aliens and pre-immigration planning. Virginia F. Coleman will be discussing the transfer taxation of nonresident aliens. Joseph S. Henderson will be discussing the effect of tax treaties on U.S. activities of nonresident aliens. Henry Christensen III will be discussing trusts and alternative foreign vehicles. M. Read Moore will be discussing considerations for underlying foreign corporations. Douglas L. Siegler will be discussing marital deduction planning for non-citizen spouses. Bruce Zagaris will be discussing ethical issues in offshore planning. Robert C. Lawrence, III, Ellen K. Harrison, and Carlyn S. McCaffrey will be discussing outbound and inbound grantor trusts and foreign non-grantor trusts. Paul R. Hocking will be discussing foreign trust and entity reporting. Frederick J. Tansill will be discussing asset protection trusts. Leslie C. Giordani and Robert W. Chesner, Jr., will be discussing private placement life insurance in the offshore marketplace. Michael G. Pfeifer will be discussing expatriation. Finally, John C. McDougal will be discussing "hot topics" in offshore tax compliance. Thus, as a group, you will learn the ins and outs of U.S. taxation of aliens.

II. RESIDENCE TESTS UNDER THE CODE

A. Income Tax

For U.S. federal income tax purposes, an alien is classified either as a resident or a nonresident with respect to the United States. An alien is classified as a resident if (i) he is a lawful permanent resident of the United States at any time during the calendar year, (ii) he meets the "substantial presence" test, or (iii) he makes the "first year" election. An alien's residence status is determined separately with respect to each calendar year.

1. Lawful Permanent Resident

An alien is considered to be a lawful permanent resident of the United States if he has been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws (i.e., he holds a "green card"). An alien who holds a green card will continue to be considered a U.S. resident until such time as his green card is revoked or abandoned.

Note that the filing of a nonresident income tax return (Form 1040NR) may affect the determination by the Immigration and Naturalization Service as to whether the individual qualifies to maintain a residency permit.

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2 This outline is an adaptation of earlier outlines.

3 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury Regulations promulgated thereunder.

4 §7701(b)(1)(A); Treas. Reg. §1.871-2(c). In addition, a former citizen or long-term resident who does not satisfy any of these tests will continue to be treated as a citizen or resident for tax purposes in certain circumstances. §§877(g) and 7701(n).

5 See presentation of Michael Pfeifer, infra.

6 §7701(b)(6)(B).
A green card is permanent. It lasts indefinitely unless abandoned. Whether it is abandoned is a question of fact and intent. Absence for more than one year requires a re-entry permit. However, failing to file required tax returns raises a rebuttable presumption that the taxpayer has abandoned his/her residence in the U.S. (8CFR §316.5) and therefore cannot return without a visa or re-entry permit. Note that the tax rule is different. The mere ownership of a green card, whether or not used for entry into the U.S., is sufficient to make the holder a tax resident.

An alien (i) who was not a U.S. resident during the previous calendar year, (ii) who obtains a green card during the current year, and (iii) who does not meet the substantial presence test (described in the next paragraph) with respect to the current year will be considered a U.S. resident as of the first day of the current year on which he was present in the United States while a green card holder.  

A former tax resident of the U.S. will be deemed a resident if he is physically present in the U.S. for 30 days during a calendar year, unless it is in connection with his performance of services for an unrelated employer.  (But see 2.a., infra.)

2. Substantial Presence Test

An alien meets the substantial presence test with respect to any calendar year (the "current year") if (i) he is present in the United States on at least 31 days during the current year and (ii) the sum of the number of days on which he was present in the United States during the current year and the two preceding calendar years equals or exceeds 183 days. For purposes of making this latter calculation, each day of presence in the current year is counted as a full day, each day of presence in the first preceding calendar year is counted as 1/3 of a day, and each day of presence in the second preceding calendar year is counted as 1/6 of a day.

For example, if an alien were present in the United States for 150 days (roughly 5 months) during the current year (which clearly exceeds the 31-day minimum presence requirement for the current year) and were present in the United States for as little as 99 days (slightly more than 3 months) during the immediately preceding calendar year, then he would be classified as a U.S. resident for the current year (150 + 33 (or 1/3 x 99) = 183). The alien would not, however, necessarily be classified as a U.S. resident for the immediately preceding calendar year, because, as mentioned above, the substantial presence test is applied separately with respect to each calendar year.

a. Days of Presence

An alien is considered to be present in the United States "on any day that he or she is physically present in the United States at any time during the day." Thus, partial days (e.g., the day of arrival and the day of departure) count as a day of presence in the United States.

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7 §7701(b)(2)(A)(ii).
8 §7701(b)(3)(A).
9 §7701(b)(3)(A)(ii). Any fractional days resulting from these calculations are not rounded to the nearest whole number. Treas. Reg. §301.7701(b)-1(c)(1).
10 See Treas. Reg. §301.7701(b)-1(e), Ex. 1.
11 Treas. Reg. §301.7701(b)-1(c)(2)(i).
Nevertheless, the following days of presence are excluded for purposes of the substantial presence test:

(i) Any day that the alien is present in the United States as an "exempt individual" (defined below);

(ii) Any day that the alien is prevented from leaving the United States because of a medical condition that arose while he was present in the United States (Form 8843);

(iii) Any day that the alien is in transit between two points outside the United States and is physically present in the United States for less than 24 hours;

(iv) Any day on which the alien is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States (unless he otherwise engages in a trade or business in the United States on that day); and

(v) Any day on which a regular commuter residing in Canada or Mexico commutes to employment in the United States.

"Exempt individuals" include:

- An individual (and that individual's immediate family) who is temporarily present in the United States as a full-time employee of an international organization or by reason of diplomatic status (or by reason of a visa that the Internal Revenue Service (the "Service") determines represents full-time diplomatic or consular status);

- An individual (and that individual's immediate family), other than a student, who is admitted temporarily to the United States as a nonimmigrant under Section 101(a)(15)(J) or (Q) of the Immigration and Nationality Act (generally, teachers and trainees) and who substantially complies with the requirements of being so admitted;

- An individual (and that individual's immediate family) who is admitted temporarily to the United States as a nonimmigrant under Section 101(a)(15)(F), (J), (M), or (Q) of the Immigration and Nationality Act (generally, students) and who substantially complies with the requirements of being so admitted; and

- An individual who is temporarily present in the United States to compete in a charitable sports event described in Section 274(l)(1)(B) (generally, professional athletes).

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12 §7701(b)(3)(D); §7701(b)(7); Treas. Reg. §301.7701(b)-3(a).
For purposes of the substantial presence test, the "United States" is defined to include the states, the District of Columbia, and the territorial waters of the United States. For this purpose, "United States" does not include the possessions and territories of the United States or the air space over the United States.15

b. Closer Connection Exception

An alien who meets the substantial presence test for the current year may nevertheless avoid being classified as a U.S. resident if: (i) he is present in the United States for fewer than 183 days during the current year; (ii) he maintains a tax home in a foreign country during the entire current year; (iii) he has a closer connection during the current year to the foreign country in which his tax home is located than to the United States; and (iv) he has not personally applied, or taken other affirmative steps, to change his status to that of a lawful permanent resident of the United States and timely files Form 8840.17 While the first and fourth prongs of this "closer connection" exception are relatively self-explanatory, the second and third prongs require some elaboration.

(i) Tax Home

For purposes of the second prong of the closer connection exception, an alien’s tax home is considered to be located at his regular or principal (if he has more than one regular) place of business. If the alien has no regular or principal place of business because of the nature of his business (or because he is not engaged in carrying on a trade or business), then his tax home is considered to be located at his "regular place of abode in a real and substantial sense." This tax home must be in existence for the entire year . . . and must be located in the same foreign country for which the individual is claiming to have the closer connection."19

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13 §7701(b)(5); Treas. Reg. §301.7701(b)-3(b). There are limitations on the length of time that an alien can qualify as an exempt individual by reason of being a teacher, trainee, or student. See §7701(b)(5)(E); Treas. Reg. §301.7701(b)-3(b)(7).
14 Treas. Reg. §301.7701(b)-1(c)(2)(ii). Also included in this definition are the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploitation of natural resources. Id.
15 Id.
16 For this purpose, "foreign country" includes possessions and territories of the United States, any territory under the sovereignty of the United Nations, any territory under the sovereignty of a foreign government, the territorial waters of a foreign country (as determined under U.S. law), and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of a foreign country and over which the foreign country has exclusive natural resource exploration and exploitation rights under international law. Treas. Reg. §301.7701(b)-2(b).
17 §7701(b)(3)(B) & (C). Is timely filing necessary?
18 Treas. Reg. §301.7701(b)-2(c)(1).
19 Id.
20 Treas. Reg. §301.7701(b)-2(c)(2).
(ii) Closer Connection

For purposes of the third prong of the closer connection exception, an alien is considered to have a closer connection to the foreign country in which his tax home is located than to the United States if he has maintained more significant contacts with the foreign country than with the United States. In determining whether an alien has maintained more significant contacts with a foreign country than with the United States, the following factors are considered:

- Location of the alien's permanent home;
- Location of the alien's family;
- Location of personal belongings;
- Taxation as a resident of the foreign country;
- Qualification for government-sponsored "national health insurance";
- Location of social, political, cultural, or religious organizations with which the alien has a current relationship;
- Location where the alien conducts his routine personal banking activities;
- Location where the alien conducts business activities (other than those that constitute the alien's tax home);
- Location of the jurisdiction in which the alien holds a driver's license;
- Location of the jurisdiction in which the alien votes;
- Country of residence designated by the alien on forms and documents; and
- Types of official forms and documents filed by the alien.

21 Treas. Reg. §301.7701(b)-2(d)(1).
22 Id.
23 §7701(b)(2)(A)(iii).
24 §7701(b)(2)(C); Treas. Reg. §301.7701(b)-4(c)(1).

22  Id.
23  §7701(b)(2)(A)(iii).
24  §7701(b)(2)(C); Treas. Reg. §301.7701(b)-4(c)(1).
would be considered a U.S. resident as of June 15. If, however, this same immigrating nonresident alien were to come to the United States to search for a house from February 1 through February 15, were to return to his country of residence, and were then to move to the United States on June 15, he could not exclude any of the days of presence in February for purposes of determining his residence starting date (because he was present for more than 10 consecutive days), in which case he would be considered a U.S. resident as of February 1.

This exclusion for up to 10 days of presence applies only for purposes of determining the alien's residence starting date; these excluded days of presence still count for purposes of determining whether the alien has met the substantial presence test.

3. **First Year Election**

An alien who does not qualify as a U.S. resident under the lawful permanent resident (i.e., green card) test or under the substantial presence test for a calendar year may nevertheless elect to be treated as a U.S. resident for such calendar year if (i) he was not a U.S. resident under the green card test or substantial presence test for the calendar year immediately preceding the election year, (ii) he qualifies as a U.S. resident under the substantial presence test for the calendar year immediately following the election year, and (iii) the minimum presence requirements (described immediately below) are satisfied for the election year.

There are two minimum presence requirements that an alien must satisfy in order to be eligible to make the first year election:

- The alien must be present in the United States for a period of at least 31 consecutive days in the election year; and
- The alien must be present in the United States for a number of days equal to or exceeding 75% of the number of days included in the "testing period." The "testing period" is the period beginning with (and including) the first day of the 31-day period of presence (described in (1) above) and ending with the last day of the election year. For purposes only of this minimum presence requirement, the alien will be deemed to be present in the United States for up to 5 days on which he was actually absent from the United States during the testing period. For purposes of the minimum presence requirements, the rules concerning days of presence discussed above generally apply.

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25 Treas. Reg. §301.7701(b)-4(d), Ex. 1.
26 Treas. Reg. §301.7701(b)-4(c)(1) & (d), Ex. 3.
27 Treas. Reg. §301.7701(b)-4(c)(1).
28 §7701(b)(4)(A).
30 §7701(b)(4)(A)(iv)(II).
31 Id.; Treas. Reg. §301.7701(b)-4(c)(3)(iv).
32 Id.
33 Treas. Reg. §301.7701(b)-4(c)(3)(iv). See supra Section II.A.2.a. Note that the exception described in Section II.A.2.a. for days of presence of certain crew members of **(Footnote continued)**
A first year election may prove beneficial either if the alien has foreign losses during the election year or if the alien wishes to avoid the limitations placed on nonresident aliens with respect to exemptions, the standard deduction, and itemized deductions. 34

An alien who was not a U.S. resident during the previous calendar year and who makes the first year election will be considered a U.S. resident as of the first day of the earliest "testing period" for which he satisfies the minimum presence requirements. 35

4. **Short-Term Nonresidency**

If an alien who was treated as a resident of the United States for three consecutive calendar years ceases to be treated as a resident and subsequently becomes a resident before the close of the third calendar year, he will be treated as an expatriate under section 877(b) during his hiatus. §7701(b)(10).

a. Taxed at progressive rates if greater than withholding tax on U.S. sources.

b. U.S. source income modified to include gain on sale or exchange of property located in United States, gain on sale or exchange of stock issued by domestic corporation or debt obligations of U.S. persons; income or gains of a controlled foreign corporation for the period ending before changing residence while he owned more than 50% of vote or value. §877(d).

c. Compare 30-day rule — "treated" as a resident. §877(g)(1).

5. **Termination of Residence**

- An alien who is a resident in the current year and is also a resident during the following year is taxable as a resident through the end of the current year.
- Is satisfying closer connection necessary?
- See also Pfeifer, infra.

B. **Estate and Gift Tax**

For U.S. federal estate and gift tax purposes, an alien is also classified either as a resident or a nonresident with respect to the United States. An alien is classified as a resident if he has his "domicile" in the United States. 36 An alien who is neither a citizen nor a domiciliary

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See Treas. Reg. §20.0-1(b)(1); Treas. Reg. §25.2501-1(b). For this purpose, the United (Footnote continued)
of the United States will be classified as a nonresident with respect to the United States.\textsuperscript{37} For estate and gift tax purposes, "domicile" is defined as follows:

A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.\textsuperscript{38}

Among the factors that have been considered in determining the location of an alien's domicile for estate and gift tax purposes are the following:

\begin{itemize}
  \item The duration of stay in the United States and in other countries;
  \item The frequency of travel both between the United States and other countries and between places abroad;
  \item The size, cost, and nature of the alien's houses or other dwelling places, and whether those places were owned or rented;
  \item The area in which the houses and other dwelling places were located (e.g., resort area v. non-resort area);
  \item The location of expensive and cherished personal possessions;
  \item The location of the alien's family and close friends;
  \item The places where the alien maintained church and club memberships and participated in community affairs;
  \item The location of the alien's business interests;
  \item Declarations of residence or intent made in visa applications, wills, deeds of gift, trust instruments, letters, and oral statements;
  \item Motivation, especially health, pleasure, and the avoidance of the miseries of war or political repression; and
  \item Visa status.\textsuperscript{39}
\end{itemize}

The estate and gift tax concept of residence is markedly different from the income tax concept of residence. Thus, neither an alien's possession of a green card nor his spending a substantial amount of time in the United States will be controlling for estate and gift tax purposes, except to the extent that it is indicative of his intent to acquire or maintain a U.S.

\textsuperscript{37}Treasury Regulation \$20.0-1(b)(2); Treasury Regulation \$25.2501-1(b).

\textsuperscript{38}Treasury Regulation \$20.0-1(b)(1). See also Treasury Regulation \$25.2501-1(b) (containing similar language).

domicile. Accordingly, even if an alien is classified as a U.S. resident for income tax purposes, he may continue to take the position that he is a nonresident for estate and gift tax purposes -- but only so long as he can plausibly maintain that he has not acquired a U.S. domicile. This is a very important distinction in practice.

III. RESIDENCE TESTS FOR STATE TAX PURPOSES

A. State tax rules for determining residency do not necessarily follow federal rules.

B. New York
   1. Any person domiciled in New York, unless such person does not maintain a place of abode in New York, maintains a permanent place of abode elsewhere and spends in the aggregate not more than 30 days of the taxable year in New York, or
      a. Derek Jeter (change of domicile).
   2. Any nondomiciliary who maintains a permanent place of abode in New York and spends in the aggregate more than 183 days in the taxable year in New York. (Statutory resident.)

C. California
   1. Other than transitory presence -- not a day count
   2. Domicile

D. Relevance of Federal Nonresident Status

   In most (but not all) states, the tax base starts with income as determined for federal income tax purposes. Therefore, even if a nonresident of the U.S. is considered a resident for state tax purposes, such resident's tax base for state tax purposes may be zero.

IV. RESIDENCE UNDER TAX TREATIES

A. Income Tax Treaties

   To be eligible for the benefits of an income tax treaty, an individual must qualify as a "resident" of one of the two countries that is a party to the treaty (sometimes referred to as a "contracting state"). The U.S. Model Income Tax Treaty defines "resident of a Contracting State" as "any person who, under the laws of that State, is liable to tax therein by reason of his

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40 But see §877(g), pursuant to when a former long-term resident (i.e., an alien who held a green card for eight years during a 17-year period) who spends (at least) 30 days in the U.S. will be treated as a resident for estate tax as well as income tax purposes. This rule ought not place an alien in a worse tax position than if he had not relinquished his green card and thus may reflect a presumption that green card holders are U.S. domiciliaries.

41 Given the vast number of tax treaties that have been concluded by the United States and the potential numerous variations (both significant and insignificant) that may result from negotiations between the United States and each of its treaty partners, the discussion in the text below is confined to the most recent model tax treaties published by the U.S. Treasury Department and the Organization for Economic Cooperation and Development ("OECD"). See presentation of Joseph Henderson, infra.
domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The OECD Model Income Tax Treaty contains a similar definition of "resident of a Contracting State," but omits citizenship and place of incorporation from the enumerated criteria. An individual will not be considered a resident of a contracting state under either treaty if he is subject to tax in that state only with respect to income from sources in that state.

Given the broad definition of "resident of a Contracting State" contained in each of these treaties, an individual may potentially be considered a resident of both the United States and its treaty partner (a "dual resident"). To resolve the residence status of an individual who is considered a dual resident, each of the treaties contains a substantially identical tie-breaker provision. Under these provisions, a dual resident's residence status is determined as follows:

- The dual resident is deemed to be a resident of the country in which he has a permanent home available to him;
- If the dual resident has a permanent home available to him in both countries, he is deemed to be a resident of the country with which his personal and economic relations are closer (the "center of vital interests");
- If the country in which the dual resident has his center of vital interests cannot be determined [or if the individual does not have a permanent home available to him in either country], then the dual resident is deemed to be a resident of the country in which he has an habitual abode;
- If the dual resident has an habitual abode in both countries or in neither of them, he is deemed to be a resident of the country in which he is a national;
- If the dual resident is a national of both countries or of neither of them, then the competent authorities of the contracting states must settle the residence question by mutual agreement.

If an alien is considered a U.S. resident under the Code but is considered a nonresident with respect to the United States under an income tax treaty, he may elect to claim

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43 1995 OECD Model Income Tax Treaty, art. 4(1).
45 In a memorandum decision, the Tax Court stated, in dicta, that an individual's habitual abode is located in "the country where the individual stays most frequently." Podd v. Commissioner, 76 T.C.M. (CCH) 906, 910 (1998). To determine the country where the individual stayed most frequently, the court in Podd simply applied a mechanical day-count test (i.e., the court compared the number of days spent during the year in the United States with the number of days spent during that year outside the United States).
the benefits of the treaty and be subject to U.S. federal income tax as a nonresident alien.\textsuperscript{47} Notwithstanding this election, however, the alien will be considered a U.S. resident for all purposes of the Code other than the computation of his income tax liability.\textsuperscript{48} Thus, although the alien would be subject to tax as a nonresident alien, he would, for example, be treated as a U.S. resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under Section 957 of the Code, which could potentially affect the U.S. federal income tax liability of other shareholders of the foreign corporation.\textsuperscript{49}

B. Estate and Gift Tax Treaties

To qualify for the benefits of an estate and gift tax treaty, an individual must have been domiciled in one of the two contracting states at the time of his death or at the time that the gift was made, as the case may be. Under the OECD Model Estate and Gift Tax Treaty, "person domiciled in a Contracting State" is defined as "any person whose estate or whose gift, under the law of that State, is liable to tax therein by reason of the domicile, residence or place of management of that person or any other criterion of a similar nature. However, this term does not include any person whose estate or whose gift is liable to tax in that State only in respect of property situated therein."\textsuperscript{50} Under the U.S. Model Estate & Gift Tax Treaty, an individual’s domicile is determined initially under the domestic law of each contracting state.\textsuperscript{51}

Given the potential under each of these treaties for an individual to be considered a domiciliary of both the United States and its treaty partner (a "dual domiciliary"), a tie-breaker provision has been included in both of these treaties. The tie-breaker provisions in these treaties are substantially identical to those included in the model income tax treaties,\textsuperscript{52} except that they are written in the past (rather than the present) tense.\textsuperscript{53}

The U.S. Model Estate and Gift Tax Treaty (but not the OECD Model Estate and Gift Tax Treaty) contains a further tie-breaker provision that, when applicable, supersedes the general tie-breaker provision discussed in the previous paragraph. Under this provision, a dual domiciliary who was a citizen of one the contracting states (but not of the other) and who was domiciled in the other contracting state in the aggregate less than 7 years (including periods of temporary absence) during the preceding 10-year period is deemed a domiciliary of the contracting state of which he was a citizen.\textsuperscript{54}

C. Disclosure

1. Section 6114 requires notice of reliance on treaty.
2. Penalty is minor.

\textsuperscript{47} Treas. Reg. §301.7701(b)-7(a)(1).
\textsuperscript{48} Treas. Reg. §301.7701(b)-7(a)(3).
\textsuperscript{49} Id. See infra Section VIII.A.
\textsuperscript{50} 1982 OECD Model Estate & Gift Tax Treaty, art. 4(1).
\textsuperscript{51} 1980 U.S. Model Estate & Gift Tax Treaty, art. 4(1).
\textsuperscript{52} See supra Section IV.A.
\textsuperscript{53} See 1980 U.S. Model Estate & Gift Tax Treaty, art. 4(2); 1982 OECD Model Estate & Gift Tax Treaty, art. 4(2).
\textsuperscript{54} 1980 U.S. Model Estate & Gift Tax Treaty, art. 4(3).
V. INCOME TAXATION OF ALIENS

Under the Code, the manner in which an alien is subject to income tax depends on whether the alien is classified as a resident or a nonresident with respect to the United States.\textsuperscript{55}

A. Resident Aliens

Resident aliens, like U.S. citizens, are subject to U.S. federal income tax on their worldwide taxable income (i.e., on all of their income, no matter what the source, taking into account any allowable deductions) at graduated rates that can reach as high as 35%.

B. Nonresident Aliens

The manner in which nonresident aliens are taxed is somewhat more complicated.\textsuperscript{56}

1. Effectively Connected Income

If a nonresident alien is engaged in a trade or business within the United States, then he is subject to U.S. federal income tax on his taxable income that is effectively connected with the conduct of that trade or business ("Effectively Connected Income") at the same graduated rates that apply to U.S. citizens and resident aliens.\textsuperscript{57}

A nonresident alien's income will be considered Effectively Connected Income under the following circumstances:

\begin{itemize}
\item A nonresident alien's U.S. source fixed or determinable annual or periodical income (e.g., salaries, wages, interest, rents, dividends, and royalties) and U.S. source gain or loss from the sale or exchange of capital assets is considered Effectively Connected Income if either:
  \begin{itemize}
  \item The income, gain, or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business; or
  \item The activities of the U.S. trade or business were a material factor in the realization of the income, gain, or loss.\textsuperscript{58}
  \end{itemize}
\item All other U.S. source income, gain, or loss of a nonresident alien who is engaged in a trade or business within the United States is deemed to be Effectively Connected Income.\textsuperscript{59}
\item Certain foreign source rents, royalties, dividends, interest, and gain or loss derived from the sale or exchange of inventory property will be considered Effectively Connected Income if the nonresident alien is engaged in a trade or business
\end{itemize}

\textsuperscript{55} For a discussion of the classification of aliens as residents or nonresidents with respect to the United States for income tax purposes, see \textit{supra} Section II.A.

\textsuperscript{56} See §2(d) (providing that Sections 1 and 55 apply to nonresident aliens only as provided by Sections 871 and 877).

\textsuperscript{57} §871(b).

\textsuperscript{58} §864(c)(2).

\textsuperscript{59} §864(c)(3). The so-called "force of attraction."
within the United States and has a U.S. office or other fixed place of business to which such income, gain, or loss is attributable.\(^{60}\)

- The gain that a nonresident alien recognizes on the disposition of a U.S. real property interest\(^{61}\) is deemed to be Effectively Connected Income.\(^{62}\)

A nonresident alien’s Effectively Connected Income is computed after taking into account any allowable deductions related to such income.\(^{63}\) In addition, a nonresident alien is allowed to deduct (i) certain casualty or theft losses (if the loss is of property located within the United States), (ii) charitable contributions, and (iii) personal exemptions,\(^{64}\) regardless of whether these deductions are related to his Effectively Connected Income.\(^{65}\) To obtain the benefit of deductions, a nonresident alien must file a true and accurate U.S. federal income tax return.\(^{66}\)

2. Deductions and Credits

a. Section 882(c) provides:

"DEDUCTIONS AND CREDITS ALLOWED ONLY IF RETURN FILED.—A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary a true and accurate return, in the manner prescribed in subtitle F, including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits. . . ."

b. Example

Taxpayer owns rental real estate in the United States. It fails to file a U.S. income tax return for five years. In year six and prior to an IRS audit, it files income tax returns for years one through six. Are the deductions allowable?

Does "in the manner prescribed in subtitle F" include a requirement that it be filed timely, i.e., 18 months after end of year?

\(^{60}\) §864(c)(4).
\(^{61}\) "U.S. real property interest" encompasses both direct interests in U.S. real property and interests in certain domestic corporations, partnerships, trusts, and estates that hold U.S. real property. See §897(c) & (g); Temp. Treas. Reg. §1.897-7T(a); Notice 88-72, 1988-2 C.B. 383. "FIRPTA" income.
\(^{61}\) Only one personal exemption is allowed to a nonresident alien, unless he is a resident of a contiguous country. §873(b)(3).
\(^{62}\) §897(a).
\(^{63}\) §873(a).
\(^{64}\) Only one personal exemption is allowed to a nonresident alien, unless he is a resident of a contiguous country. §873(b)(3).
\(^{65}\) §873(b).
\(^{66}\) §874(a).

d. Protective filing and disclosure issues.

In computing the tax on his Effectively Connected Income, a nonresident alien is not entitled to the standard deduction, cannot qualify as a head of household, and must generally compute his tax based on the rate schedules for single individuals or married individuals filing separately. The alternative minimum tax may also apply to a nonresident alien, depending on his individual circumstances.

A nonresident alien who is a resident of a country with which the United States has concluded an income tax treaty may be able to reduce (or eliminate) the U.S. federal income tax on his Effectively Connected Income. For example, under both the U.S. and OECD Model Income Tax Treaties, simply engaging in a trade or business within the United States is not a sufficient basis for the imposition of U.S. federal income tax. Rather, a nonresident alien will be subject to U.S. federal income tax under these treaties only if he carries on business through a "permanent establishment" situated in the United States. A "permanent establishment" is defined as a "fixed place of business." Examples of a fixed place of business include a place of management, a branch, an office, a factory, a workshop, and a place where natural resources are extracted. If a nonresident alien is a partner in a partnership that has a fixed place of business in the U.S., such U.S. fixed place of business will be attributed to the foreign partner.

A nonresident alien who relies on a U.S. tax treaty for an exemption from U.S. tax on income that is effectively connected with a U.S. trade or business is required to file IRS Form 8833 to disclose such reliance. Query whether the failure to provide such disclosure may result in the denial of treaty benefits.

3. FDAP Income

A nonresident alien who has U.S. source fixed or determinable annual or periodical income (e.g., salaries, wages, interest, rents, dividends, and royalties) that is not

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67 §63(c)(6).
68 §2(b)(3)(A).
70 §871(b); §55.
71 1996 U.S. Model Income Tax Treaty, art. 7(1); 1995 OECD Model Income Tax Treaty, art. 7(1).
75 §6114; Treas. Reg. §301.6114-1.
76 Cf. §874(a) (denial of deduction to nonresident alien who fails to file a return).
considered Effectively Connected Income ("FDAP Income") is subject to U.S. federal income tax on such income at a flat 30% rate (without the benefit of any related deductions).\(^77\)

There are a number of special rules that must be considered in determining whether particular income is FDAP Income, including the following:

- Gain from the sale of property (e.g., the stock of a domestic corporation) is generally not considered to be FDAP Income.\(^78\)
- Certain gains from the sale of property (e.g., certain gains from the sale of patents, copyrights, or other intangibles)\(^79\) are deemed to be FDAP Income.
- Interest on bank deposits and so-called "portfolio interest," both of which would otherwise fall under the rubric of FDAP Income, are statutorily excepted from the application of the flat 30% tax.\(^80\) This is an important exemption because it does not depend on a treaty. Not available to banks or 10 percent shareholders.
- Applies to partnership borrowers.
- Separation of contingent interest.
- Partnership lenders and ten percent test.
- A nonresident alien may make an election to treat his U.S. source rental income (which, in many cases, would be FDAP Income) as Effectively Connected Income in order to offset this income with related deductions; thereby reducing his U.S. federal income tax liability with respect to such income.\(^81\) See Swallow, \textit{supra}.

Dividend Conversion. Can nonresident alien avoid withholding tax on dividends by entering into a swap? Payment taxpayer receives is "in lieu of" dividends and upside at end. Is it FDAP? Regulations provide it is sourced at residence of recipient. Treas. Reg. §1.863-7(b)(1).

\(^77\) §871(a); §873(a). This flat 30% tax is generally withheld at source. See §1441.
\(^78\) Treas. Reg. §1.871-7(a)(1). If, however, a nonresident alien is present in the United States for 183 days or more during the taxable year, his net capital gains (other than capital gains that constitute Effectively Connected Income) will be considered FDAP Income. See §871(a)(2). Normally, a nonresident alien who meets the requirements of §871(a)(2) would be classified as a U.S. resident under the substantial presence test and would be subject to U.S. tax on his worldwide income without regard to §871(a)(2); however, it is possible for an alien to be present in the United States for 183 days and still be classified as a nonresident alien under the Code (e.g., because the alien's days of presence were excluded on the ground that he was an "exempt individual"), in which case §871(a)(2) would be applicable. See \textit{supra} Section II.A.2.
\(^79\) §871(a)(1)(D).
\(^80\) See §871(h) and (i).
\(^81\) §871(d).
4. Partnership Withholding

Section 1446 requires a non-publicly traded partnership to withhold and pay over quarterly a tax on a foreign taxpayer's effectively connected taxable income at the highest individual or corporate tax rate, whether or not distributed.

- Capital gains rates are applicable
- Certification by a foreign partner of partner level deductions and losses (who is not a trust or estate). Form 8804-C.
- Certification relieves penalty but not liability of partnership.
- Partnerships refuse individual investors.

A nonresident alien who is a resident of a country with which the United States has concluded an income tax treaty may be able to reduce (or eliminate) the flat 30% tax on his FDAP Income. The exact amount of the reduction in this tax will vary from treaty to treaty.  

VI. ESTATE AND GIFT TAXATION OF ALIENS

Under the Code, the manner in which an alien is subject to estate and gift tax depends on whether he is classified as a resident or a nonresident with respect to the United States.  

A. Gift Tax

1. Resident Aliens

A resident alien who transfers property by gift is subject to U.S. federal gift tax. A transfer of property will be subject to gift tax "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." Moreover, "[d]onative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer." Rather, gift tax is imposed on the donor's act of making the transfer, and a transfer of property will be subject to gift tax if "the donor has so parted with dominion and control as to leave in him no power to change [the property's] disposition."  

82 For a summary of the income tax rates applicable to FDAP Income under income tax treaties concluded by the United States, see the Service's Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities (January 2006) and Joseph Henderson's presentation, infra.

83 For a discussion of the classification of aliens as residents or nonresidents with respect to the United States for estate and gift tax purposes, see supra Section II.B. and Virginia Coleman's accompanying outline.

84 §2501(a).

85 §2511(a).

86 Treas. Reg. §25.2511-1(g)(1).


Since 1976, a unified rate schedule has applied for both estate and gift tax purposes. These unified rates currently range from 18% to 46%.\textsuperscript{89} The unified rate applicable to a taxable gift is determined on a cumulative basis (i.e., by taking into account not only taxable gifts made during the current calendar year, but also taxable gifts made during preceding calendar years).\textsuperscript{90}

Resident aliens, i.e., domiciliaries, are only subject to gift tax once the amount of their cumulative taxable gifts exceeds the amount of the "unified credit."\textsuperscript{91}

In addition to the unified credit, resident aliens benefit from a number of gift tax exclusions:

- Resident aliens are entitled annually to transfer $12,000 worth of property to any person free of gift tax.\textsuperscript{92}
- Resident aliens are entitled to transfer an unlimited amount of property free of gift tax for the benefit of any person, provided that the transfer is either (i) a payment of tuition made directly to an educational institution or (ii) a payment for medical care made directly to a medical care provider.\textsuperscript{93}
- Resident aliens are entitled to transfer an unlimited amount of property to their spouses free of gift tax, provided that their spouses are U.S. citizens.\textsuperscript{94}
- Resident aliens are entitled annually to transfer $120,000 worth of property to their non-citizen spouses free of gift tax.\textsuperscript{95}
- Resident aliens are entitled to transfer an unlimited amount of property to charity free of gift tax.\textsuperscript{96}

A person who acquires property from a resident alien by gift will generally take a "transferred" basis in the property (i.e., a basis equal to the resident alien's basis in the

\textsuperscript{89} §2502(a); §2001(c).
\textsuperscript{90} §2502(a).
\textsuperscript{91} §2505. This credit is referred to as the "unified credit" because, like the unified rate schedule, it applies for both estate and gift tax purposes. For example, assuming the unified credit permits the transfer of $1,000,000 worth of property free of estate and/or gift tax, a resident alien who made $300,000 worth of taxable gifts prior to his death would be entitled to transfer $700,000 worth of property free of estate tax. However, had the same resident alien made $1,000,000 worth of taxable gifts prior to his death, he would not be entitled to offset any of his estate tax liability because he would already have exhausted the unified credit.
\textsuperscript{92} §2503(b)(1). This $12,000 exclusion is adjusted annually for inflation. §2502(b)(2).
\textsuperscript{93} §2503(e).
\textsuperscript{94} §2523(a). However, a resident alien may generally not transfer a life estate or other terminable interest in property to his citizen spouse free of gift tax. See §2523(b) and (f).
\textsuperscript{95} §2523(i). This exclusion is adjusted annually for inflation.
\textsuperscript{96} §2522(a).
property). Subject to certain limitations, this transferred basis may be increased (but never in excess of the fair market value of the property at the time of the gift) by the amount of gift tax paid on the transfer.

2. Nonresident Aliens

A nonresident alien is subject to gift tax with respect to a narrower class of property than a resident alien. A nonresident alien is subject to gift tax only when he makes a gift of real or tangible personal property situated in the United States. Thus, a gift of U.S. real estate by a nonresident alien will be subject to gift tax, but a gift of intangible personal property by a nonresident alien will not be subject to gift tax.

Nonresident aliens are not entitled to the "unified credit" accorded to resident aliens. Nevertheless, nonresident aliens are entitled to the $12,000 annual exclusion for gifts to any person, the unlimited exclusion for gifts to defray educational or medical expenses, the unlimited exclusion for gifts to citizen spouses, and the $120,000 annual exclusion for gifts to non-citizen spouses.

Nonresident aliens are permitted to transfer an unlimited amount of property to charity free of gift tax; provided, however, that the gift is made either to (i) a U.S. corporate charity or U.S. war veterans organization; or (ii) a trust, community chest, fund, foundation, or fraternal society (wherever organized), but only if the gift is to be used within the United States.

The basis of property acquired by gift from a nonresident alien is determined in the same manner as the basis of property acquired by gift from a resident alien.

B. Estate Tax

1. Resident Aliens

Resident aliens are subject to U.S. federal estate tax on the transfer of their taxable estates. A decedent's taxable estate is equal to his gross estate, which consists of "the value at the time of his death of all [of his] property, real or personal, tangible or intangible, etc., less..."
wherever situated,"107 less certain deductions.108 Thus, just as resident aliens are subject to income tax on their worldwide income, they are also subject to estate tax on their worldwide assets.

Resident aliens are permitted an unlimited deduction from their gross estates for property transferred to a U.S. citizen spouse.109 A transfer to a non-citizen spouse is not deductible unless it is made through the medium of a "qualified domestic trust."110 A "qualified domestic trust" is a trust that meets the following requirements:

- The trust instrument must require that at least one trustee be a U.S. citizen or a U.S. corporation;
- The trust instrument must require that no distribution of trust corpus may be made unless a U.S. citizen or a U.S. corporation who is a trustee has the right to withhold the tax imposed by Section 2056A from the distribution;
- The trust must meet the (numerous) requirements imposed by the Treasury Regulations, which are designed to ensure the collection of the tax imposed by Section 2056A; and
- An election must be made by the decedent's executor to have Section 2056A apply to the trust.111

Resident aliens are entitled to deduct from their gross estates certain expenses, indebtedness, taxes, losses, and charitable contributions.112

As mentioned above, the estate tax rates currently range from 18% to 47%.113 The tax rate applicable to a resident alien's taxable estate is determined after taking into account his lifetime taxable gifts.114

A person who acquires property from a resident alien decedent will generally take a "stepped-up" basis in the property (i.e., a basis equal to the fair market value of the property at the date of the decedent's death).115

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107 §2031(a).
108 §2051.
109 §2056(a). However, resident aliens are generally not entitled to deduct a transfer of a life estate or other terminable interest in property to a citizen spouse. See §2056(b).
110 §2056(d).
111 §2056A(a).
112 See §2053-55.
113 §2001(c)(1).
114 §2001(b). The amount of estate tax is actually determined by (i) applying the appropriate rate(s) from the unified rate schedule to the combined value of the lifetime gifts and estate of the decedent and (ii) deducting the portion of such tax that is attributable to the lifetime gifts. Id.
115 See §1014. This rule also applies to property owned by certain types of trusts created by the decedent. However, there are a number of important exceptions to this general rule. The basis of stock in a foreign corporation that is classified as a passive foreign (Footnote continued)
2. Nonresident Aliens

Nonresident aliens are subject to estate tax only with respect to the portion of their taxable estates that is situated in the United States. Both the stock of a U.S. corporation and U.S. real estate are considered situated in the United States for estate tax purposes.

Nonresident aliens are subject to the same restrictions as resident aliens with respect to the deductibility of transfers to spouses. Nonresident aliens are entitled to deduct a portion of certain expenses, indebtedness, taxes, and losses from their gross estates. Nonresident aliens are also entitled to deduct certain charitable contributions from their gross estates. However, to benefit from the foregoing deductions, nonresident aliens must disclose their worldwide assets to the Service in their estate tax returns. Most aliens do not claim deductions.

Nonresident aliens are entitled to a credit against their estate tax liability; however, the amount of this credit is only $13,000, which is much lower than the unified credit allowed to U.S. citizens and resident aliens, and permits a nonresident alien to transfer only $60,000 worth of property free of estate tax.

A person who acquires property from a nonresident alien decedent (or from certain types of trusts created by the decedent) will generally take a "stepped-up" basis in the property (i.e., a basis equal to the fair market value of the property at the date of the decedent's death), regardless of whether the property was includible in the nonresident alien's gross estate for estate tax purposes. However, in certain situations, a person acquiring property from a nonresident alien decedent (or from certain types of trusts created by the decedent) will generally take a "stepped-up" basis in the property (i.e., a basis equal to the fair market value of the property at the date of the decedent's death), regardless of whether the property was includible in the nonresident alien's gross estate for estate tax purposes.

investment company, which stock is acquired by bequest, devise, or inheritance from an individual who was a U.S. citizen or resident alien at any time during his holding period in the stock, will not be "stepped-up" to fair market value, but will, instead, be equal to the decedent's adjusted basis immediately before his death. §1291(e). (Proposed Treasury Regulations Section 1.1291-6(b)(4)(iii) would replace this rule providing that the basis of the stock would be equal to the lower of the fair market value of the stock or the decedent's basis therein immediately before his death.) (See Section 1296(i) for a special rule concerning the basis of stock of a passive foreign investment company with respect to which the decedent had made a mark-to-market election.)

116 §2101(a); §2106(a).
117 §2104(a).
118 It is important to note that this rule applies not only to private companies, but also to the stock of publicly traded corporations, even if held through non-U.S. brokerage accounts.
120 §2106(a)(3). See supra text accompanying notes 109-110.
121 §2106(a)(l).
122 §2106(a)(2)(A).
123 §2106(b).
124 See §1014(b); Cinelli v. Commissioner, 32 T.C.M. (CCH) 674, 679 (1973), aff'd, 502 F.2d 695 (6th Cir. 1974) (basis of foreign real estate inherited from nonresident alien stepped-up to fair market value); Ujvari v. United States, 212 F. Supp. 223 (S.D.N.Y. (Footnote continued)
nonresident alien decedent will not be eligible for a step-up in basis unless the property was includible in the nonresident alien's gross estate (whether or not estate tax was actually payable). \(^{125}\)

C. Generation Skipping Tax

Nonresident aliens are subject to the generation skipping tax but only on gifts subject to gift or estate tax. For example, this tax is not applicable to lifetime skips of intangible property.

D. Estate & Gift Tax Treaties

The United States has a considerably smaller network of estate and gift tax treaties than of income tax treaties. These treaties contain alternative situs rules, additional deductions and exemptions, and provisions designed to prevent double taxation that may aid a nonresident alien in reducing his U.S. federal estate and gift tax liability. The most important changes are changes in situs of securities, grant of marital deductions and unified credit. A more complete discussion of the varying provisions of these treaties is beyond the scope of this outline.

VII. IMPACT OF CHANGE OF RESIDENCE ON ABILITY TO CLAIM TREATY BENEFITS

Once a nonresident alien becomes a resident alien for income and/or estate and gift tax purposes, his ability to claim the benefits of income and/or estate and gift tax treaties concluded by the United States (vis-a-vis the determination of his U.S. tax liability) may come to an end.

If an immigrating nonresident alien ceases to be considered a resident of the country from which he emigrated, then he will no longer be able to claim the benefits of the income and estate and gift tax treaties concluded by the United States with that country to reduce his U.S. tax liability, but may be able to claim the benefits of U.S. treaties to reduce his foreign tax liability.

If the immigrating nonresident alien continues to be considered a resident of the country from which he emigrated, then he will be required to determine his residence under the tie-breaker provision of the applicable treaty. \(^{126}\) If he is considered a resident of the United States under the tie-breaker provision, then he will no longer be able to claim the benefits of such treaty to reduce his U.S. tax liability, but may be able to claim the benefits of U.S. treaties to reduce his foreign tax liability. If, however, the immigrating nonresident alien is considered a

\(^{125}\) See §1014(b)(6)-(10); Treas. Reg. §1.1014-2. Most notably, this category includes property that was not acquired by bequest, devise, or inheritance from the nonresident alien, but rather was acquired by reason of (i) death on the termination of a life estate, (ii) form of ownership (e.g., joint tenancy), or (iii) exercise or non-exercise of a power of appointment (other than a general power of appointment exercised by will). §1014(b)(9).

\(^{126}\) See supra Section IV.
resident of the country from which he emigrated under the tie-breaker provision, then he will continue to be able to claim the benefits of such treaty to reduce his U.S. tax liability.

VIII. CHANGE IN TREATMENT OF OFFSHORE ENTITIES

The Code contains several regimes designed to prevent U.S. citizens and resident aliens from deferring U.S. federal income tax by holding assets in, or deriving income through, a foreign corporation. Absent these regimes, a U.S. citizen or resident alien could defer tax with respect to such assets or income by postponing distributions from the foreign corporation. In addition, the foreign corporation would itself only be subject to U.S. federal income tax on limited types of income.\textsuperscript{127}

As discussed below, each of the anti-deferral regimes in the Code alters the normal tax rules applicable to U.S. shareholders of foreign corporations by causing (or mimicking the effect of) current taxation of all or a portion of the foreign corporation's income in the hands of the U.S. citizen or resident alien shareholder. Naturally, once a nonresident alien has become a resident alien for income tax purposes, the applicability and impact of these anti-deferral regimes may become a major concern. Similarly and perhaps more importantly, shares of stock in a foreign corporation left to children resident or citizens of the United States may create significant tax issues.

The anti-deferral regimes of primary concern\textsuperscript{128} to any U.S. citizen or resident are the following: (i) controlled foreign corporation ("CFC"), (ii) passive foreign investment company ("PFIC"), and (iii) personal holding company ("PHC").\textsuperscript{129} A brief description of each of these regimes is included below.

A. Controlled Foreign Corporation

A foreign corporation is classified as a CFC if more than 50% of the total combined voting power or total value of the stock of the corporation is owned (directly or indirectly, actually or constructively) by one or more "U.S. shareholders" on any day during the taxable year.\textsuperscript{130} For this purpose, "U.S. shareholder" is defined as a U.S. person (including a resident alien) who owns (directly or indirectly, actually or constructively) 10% or more of the total combined voting power of the stock of the corporation.\textsuperscript{131}

If a foreign corporation is a CFC for an uninterrupted period of 30 days or more during a taxable year, then each U.S. shareholder (as defined in the previous paragraph) of the CFC who owns stock in the corporation (directly or indirectly, but not constructively) on the last day of such taxable year generally must include in his gross income his pro rata share of the CFC's "Subpart F income" and "Section 956 amount."\textsuperscript{132} "Subpart F income" is comprised, for

\textsuperscript{127} A foreign corporation is generally subject to income tax in the same manner as a nonresident alien. See \textit{supra} Section V.B.

\textsuperscript{128} Another anti-deferral regime to consider is the accumulated earnings tax. §531 \textit{et seq.} See accompanying outline by Nicholas Freud.

\textsuperscript{129} Rules applicable to foreign personal holding companies were repealed in 2004.

\textsuperscript{130} §957(a).

\textsuperscript{131} §951(b).

\textsuperscript{132} §951(a)(1).
the most part, of passive income (e.g., certain dividends, certain interest, certain rents, certain royalties, and gains on the sale of stock or partnership interests). Nevertheless, a foreign corporation’s "Subpart F income" may also include income from certain bona fide business transactions involving related parties. Importantly, the foreign corporation's Subpart F income for any taxable year cannot exceed its current earnings and profits for that year. In certain situations, the foreign corporation's earnings and profits may be reduced by its prior year deficits in earnings and profits or by the current year deficits in earnings and profits of related foreign corporations. The "Section 956 amount" is the amount the foreign corporation has invested in certain enumerated types of U.S. property. The foreign corporation's Section 956 amount is also limited by the amount of its earnings and profits.

The CFC regime does not alter the U.S. federal income taxation of the foreign corporation itself.

B. Passive Foreign Investment Company

A foreign corporation is classified as a PFIC if either (i) 75% or more of its gross income for the taxable year is passive income or (ii) 50% or more of the average value of the assets it held during the taxable year is comprised of assets that produce passive income. For this purpose, passive income generally includes certain dividends, certain interest, certain rents, certain royalties, and gains on the sale of stock or, in certain cases, partnership interests. Once a foreign corporation has been classified as a PFIC with respect to a shareholder, it will remain a PFIC with respect to that shareholder even if it no longer satisfies either of the two tests described above (unless certain elections are made).

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133 See §952(a)(2); §954(a)(1) and (c). Section 954 contains a de minimis exception as well as a high-tax exception that may cause amounts that would otherwise be treated as Subpart F income to be taken outside of the scope of the CFC regime. §954(b)(3)(A) and (4). In addition, Section 954 contains a full inclusion rule that deems all of a foreign corporation's income to be Subpart F income if certain types of Subpart F income constitute more than 70% of the foreign corporation's gross income. §954(b)(3)(B).
134 See §952(a)(2); §954(a)(2) & (3); §954(d); §954(e).
135 §952(a).
136 §956(a). "U.S. property" includes (i) tangible property located in the United States; (ii) stock of a domestic corporation; (iii) an obligation of a U.S. person; and (iv) a right to use in the United States a patent, copyright, or other intellectual property. §956(c)(1). Under certain circumstances, a foreign corporation will be treated as holding an obligation of a U.S. person if it is a pledgor or guarantor of that obligation. §956(d); Treas. Reg. §1.956-2(c). Certain types of property are specifically excluded from the definition of "U.S. property" so as not to discourage U.S. investment by foreign corporations; e.g., obligations of the United States, money, and bank deposits; property purchased in the United States for export; and stock or debt obligations of unrelated domestic corporations. §956(c)(2).
137 See §956(a)(1)(B) and (2). Literally, there is no U.S. shareholder requirement.
138 §1297(a).
139 §1297(b); §954(c).
will not be treated as a shareholder of a PFIC if he becomes a shareholder after December 31, 1997.\textsuperscript{141}

If a foreign corporation is classified as a PFIC, then certain larger than normal distributions from the foreign corporation (so-called "excess distributions") and all gain realized upon a sale or other disposition of the stock of the foreign corporation will trigger taxation under the PFIC regime.\textsuperscript{142} When an excess distribution is made or gain is realized on the sale or disposition of the stock of the foreign corporation, the excess portion of the distribution or the gain is allocated over the period that the U.S. citizen or resident alien held the stock of the foreign corporation.\textsuperscript{143} The portion allocated to the current year and to years prior to the time that the foreign corporation was classified as a PFIC is included by the U.S. citizen or resident alien in his gross income as ordinary income.\textsuperscript{144} The portion allocated to years (other than the current year) when the foreign corporation was classified as a PFIC is subject to tax at the highest rate in effect for the year to which the allocation was made, and this tax is subject to an interest charge that generally denies the shareholder any benefit that may have been derived from the deferral of taxation.\textsuperscript{145}

The punitive nature of the PFIC tax regime arises from (i) its applicability to any U.S. citizen or resident alien shareholder of the foreign corporation (no matter how little stock he owns, either directly or indirectly, in the foreign corporation), (ii) the taxation of capital gains at the higher ordinary income rates, and (iii) the imposition of an interest charge on the deferred taxes.

A U.S. citizen or resident alien shareholder of a PFIC has two alternatives to taxation under the general PFIC tax regime described above.

First, the U.S. citizen or resident alien may elect to treat the foreign corporation as a "qualified electing fund" ("QEF"), provided that the foreign corporation annually furnishes the shareholder with certain prescribed information.\textsuperscript{146} A U.S. citizen or resident alien who makes a QEF election is required to include annually in his income his pro rata share of the foreign corporation's earnings and profits.\textsuperscript{147} This inclusion is characterized as ordinary income to the extent that it is attributable to the ordinary earnings of the foreign corporation, and as long-term capital gain to the extent that it is attributable to the net capital gain of the foreign corporation.\textsuperscript{148} Since the losses of a foreign corporation will not pass through to the U.S. citizen or resident alien shareholder under the QEF regime, a shareholder who makes a QEF election may be subject to tax, over time, on amounts that do not actually represent net earnings of the foreign corporation.

Second, the U.S. citizen or resident alien may make a mark-to-market election with respect to the stock of the foreign corporation, provided that the stock of the foreign

\textsuperscript{141} \S 1297(e).
\textsuperscript{142} \S 1291(a)(1) and (2).
\textsuperscript{143} \S 1291(a)(1)(A).
\textsuperscript{144} \S 1291(a)(1)(B).
\textsuperscript{145} \S 1291(a)(1)(C); \S 1291(c).
\textsuperscript{146} \S 1295.
\textsuperscript{147} \S 1293(a)(1).
\textsuperscript{148} Id.
corporation is considered "marketable." Stock is generally considered "marketable" if it is regularly traded on certain qualified exchanges or if the foreign corporation is comparable to a regulated investment company and its stock is redeemable at net asset value. A shareholder who makes the mark-to-market election must annually include in income (as ordinary income) the excess of the fair market value of the foreign corporation's stock at the close of the taxable year over his basis in such stock. If the shareholder's basis in the stock of the foreign corporation exceeds the fair market value of such stock at the close of the taxable year, then the shareholder may deduct the difference (as an ordinary loss), but only to the extent of prior income inclusions under the mark-to-market regime.

The PFIC regime also does not alter the U.S. federal income taxation of the foreign corporation itself.

C. Personal Holding Company

A foreign corporation will be classified as a PHC if (i) at any time during the last half of the taxable year, more than 50% in value of the stock of the corporation is owned (directly or indirectly, actually or constructively) by 5 or fewer individuals, and (ii) 60% or more of the foreign corporation's ordinary income (less certain deductions) is comprised of "personal holding company income." "Personal holding company income" includes dividends, certain interest, certain royalties, annuities, income from trusts and estates, amounts received from personal service contracts, and amounts received from certain use of corporate property. For purposes of determining whether a foreign corporation satisfies the income test for classification as a PHC, only the foreign corporation's U.S. source income and Effectively Connected Income are considered.

Unlike the anti-deferral regimes described above, the PHC regime does not affect the U.S. federal income taxation of the shareholders of the PHC. Instead, the corporation is itself subject to a PHC tax on its "undistributed personal holding company income" at a rate of 35% (i.e., the highest current individual income tax rate). Like undistributed foreign personal holding company income, "undistributed personal holding company income" is somewhat of a misnomer, because it is not limited to the corporation's personal holding company income, but rather equals the corporation's taxable income (subject to a few adjustments) less dividends.

149 §1296(e); Treas. Reg. §1.1296(e)-1.
150 §1296(a)(1); §1296(c)(1)(A). Any gain realized upon a disposition of the stock of the foreign corporation will also be treated as ordinary income. §1296(c)(1)(A).
151 §1296(a)(2); §1296(c)(1)(B). Any loss realized upon a disposition of the stock of the foreign corporation will also be deductible as an ordinary loss, but only to the extent of prior income inclusions under the mark-to-market regime. §1296(c)(1)(B).
152 §542(a).
153 §543(a).
154 See Porto Rico Coal Co. v. Commissioner, 126 F.2d 212 (2d Cir. 1942).
155 §541.
paid. The PHC tax is in addition to any other tax (e.g., regular corporate income tax or alternative minimum tax) that the corporation is required to pay.\footnote{\textsection 545(a).}

\section*{D. Coordination of the Anti-Deferral Regimes}

The Code contains a number of provisions that attempt to coordinate the application of these anti-deferral regimes to an individual's ownership of stock in a foreign corporation.\footnote{\textsection 541.}

\section*{E. Transfers to Foreign Entities}

\subsection*{1. Section 367}

Once a nonresident alien becomes a resident alien, he will also become subject to the strictures of Section 367 of the Code. Generally speaking, Section 367 may prevent an otherwise tax-free transaction involving a foreign corporation\footnote{See, e.g., \textsection 951(c), (d), and (f) (CFC regime); \textsection 1297(d) and (e) (PFIC regime); \textsection 551(g) (FPHC regime); \textsection 542(c) (PHC regime).} (e.g., certain reorganizations or contributions of property) from qualifying as such under the Code, or may impose additional requirements before the tax-free nature of the transaction will be recognized.

\subsection*{2. Section 684}

Once a nonresident alien becomes a resident alien, any transfer that he makes to a foreign trust or estate will be treated as a deemed sale or exchange of the property transferred for an amount equal to the property's fair market value, unless the alien is treated as the grantor of the trust under the grantor trust rules in the Code.\footnote{Under future regulations, certain transactions involving foreign partnerships may also become subject to the strictures of Section 367. See \textsection 367(d)(3).} Upon such a transfer, the alien will, therefore, be required to recognize as gain the excess of the fair market value of the property over its adjusted basis in his hands.\footnote{\textsection 684(a).}

\subsection*{3. Section 679}

Once a nonresident alien becomes a resident alien, Section 679 may cause him to be subject to U.S. tax with respect to the income of certain foreign trusts. Section 679 generally provides that a U.S. person who directly or indirectly transfers property to a foreign trust that has a U.S. beneficiary will be treated as the owner of (and, therefore, will be subject to U.S. federal income tax with respect to) the portion of the trust that is attributable to the property that he transferred to the trust.\footnote{Id.} For purposes of Section 679, "U.S. person" is broadly defined to include nonresident aliens who directly or indirectly transfer property to a foreign trust, who later become U.S. residents, and whose residence starting date\footnote{\textsection 679(a)(1).} is within 5 years of the transfer to

\begin{itemize}
\item \textsection 545(a).
\item \textsection 541.
\item See, e.g., \textsection 951(c), (d), and (f) (CFC regime); \textsection 1297(d) and (e) (PFIC regime); \textsection 551(g) (FPHC regime); \textsection 542(c) (PHC regime).
\item Under future regulations, certain transactions involving foreign partnerships may also become subject to the strictures of Section 367. See \textsection 367(d)(3).
\item \textsection 684(a).
\item Id.
\item \textsection 679(a)(1).
\item See supra Section II.A.1., Section II.A.2.c., and Section II.A.3.
\end{itemize}
the foreign trust.\textsuperscript{164} In addition, every foreign trust is presumed, for purposes of Section 679, to have a U.S. beneficiary, unless it can be shown that (i) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person and (ii) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.\textsuperscript{165}

4. \textbf{Section 721(c)}

Section 721(c) authorizes the promulgation of regulations that would require a resident alien to recognize gain on a transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a U.S. person (\emph{e.g.,} a nonresident alien). Since such regulations have not yet been promulgated, Section 721(c) will not currently affect the U.S. federal income taxation of a resident alien's transfer of property to a partnership.

\section{IX. REPORTING AND DISCLOSURE REQUIREMENTS}

In addition to filing his income tax return on Form 1040 (rather than on Form 1040NR),\textsuperscript{166} a nonresident alien who becomes a resident alien may suddenly be required to file a number of additional forms or statements, including the following:

- Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations);
- Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund);
- Form 3520 (Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts);
- Form 3520-A (Annual Information Return of Foreign Trust with U.S. Owner);
- Form 8865 (Information Return of U.S. Persons With Respect to Certain Foreign Partnerships);
- Form 8858 (Information Return of U.S. Persons With Respect to Foreign Disregarded Entities);
- Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation); and

\textsuperscript{164} §679(a)(4).
\textsuperscript{165} §679(c)(1). Section 679 also treats a foreign trust as having a U.S. beneficiary if a beneficiary of the trust is either (i) a foreign corporation that is a CFC, (ii) a foreign partnership with a U.S. partner, or (iii) a foreign trust or estate with a U.S. beneficiary. §679(c)(2).
\textsuperscript{166} See Treas. Reg. §1.6012-1(b)(2)(ii) for a description of the procedures to follow when filing an income tax return for the year in which a change in residence occurs.

Of these forms, the most important for many immigrating nonresident aliens will be Form 3520. Once the nonresident alien becomes a resident alien, he will be required to report on this form (i) the creation of a foreign trust, (ii) transfers to foreign trusts, (iii) the fact that the alien is treated as the grantor of all or a portion of a foreign trust under the grantor trust rules in the Code, (iv) distributions from foreign trusts (including loans, which in some cases will be taxed to the recipient as a distribution), and (v) gifts or bequests received from foreign persons in excess of a specified threshold ($100,000 in the case of nonresident aliens and foreign estates and $12,375 (as adjusted for inflation) in the case of foreign corporations and foreign partnerships).  

X. PRE-IMMIGRATION PLANNING OPPORTUNITIES

With proper planning, a nonresident alien who is contemplating a move to the United States can minimize the U.S. federal tax impact of his change in residence. Among the possible steps that can be taken by a nonresident alien prior to immigration are the following:

A. General Income Tax Planning

1. Acceleration of Income

Since a nonresident alien is subject to U.S. federal income tax on a more limited basis than a resident alien, it may be advantageous to accelerate the realization of income that is not subject to U.S. tax in the hands of a nonresident alien so that such income is realized (and subject to tax) during the pre-immigration period. (A new resident is taxed on a cash receipts basis.) For example, an immigrating nonresident alien may wish to accelerate the receipt of income attributable to the performance of services outside the United States, the payment of dividends by foreign corporations that he controls, and the realization of capital gains on the sale of most personal property (wherever located) and on the sale of foreign real property. If the property is sold in an installment sale, the receipt of payments in a post-immigration taxable year will not cause any of the gain realized on the pre-immigration sale to be subject to U.S. tax. See Priv. Ltr. Rul. 9412008 (Dec. 20, 1993) (tax consequences of installment sale by nonresident alien should be determined as if the nonresident alien had elected out of the installment method of reporting); Priv. Ltr. Rul. 8708002 (Oct. 29, 1986) (similar holding); S. Rep. No. 1000, 96th Cong., 2d Sess. 12 (1980) ("Under the installment method rules of present law, these gains do not become taxable as payments are received after the seller becomes a resident or citizen subject to U.S. income tax for a taxable year subsequent to the year in which the sale was made. It is intended that the election regulations will continue this treatment in appropriate cases.")
immigrating nonresident alien is a resident of a country with which the United States has concluded an income tax treaty, he may also wish to accelerate the realization of Effectively Connected Income if he does not carry on business through a permanent establishment situated in the United States.\textsuperscript{171}

It may also be advantageous for the nonresident alien to accelerate the realization of FDAP Income, which is subject to a flat 30\% tax when received by a nonresident alien, if it is expected that the nonresident alien will be subject to a higher effective tax rate post-immigration. If the nonresident alien is a resident of a country with which the United States has concluded an income tax treaty, the acceleration of FDAP Income may be advantageous because the treaty may reduce (or eliminate) the 30\% flat tax on such income.\textsuperscript{172}

2. \textit{Postponement of Deductions & Losses}

Given a nonresident alien's limited ability to benefit from deductions and losses (particularly capital losses), it may be advantageous for the nonresident alien to postpone, to the extent possible, the payment of deductible expenses and the realization of allowable losses until he becomes a resident alien. When postponement is not possible, the nonresident alien may find that acceleration of his change in residence (e.g., by making a first-year election\textsuperscript{173}) would be beneficial.

3. \textit{Step-Up in Basis}

Unlike certain other countries (e.g., Canada), the United States generally does not permit a nonresident alien to adjust his tax basis in the assets that he owns at the time he becomes a resident of the United States to reflect the fair market value of those assets.\textsuperscript{174} One means for a nonresident alien to obtain a step-up in low basis assets prior to becoming a resident alien is a sale of the assets followed by a reacquisition at fair market value. In order for such a sale to be respected, it must, of course, be genuine.\textsuperscript{175} Accordingly, this technique is probably only feasible with respect to publicly traded property (e.g., publicly traded stock that can be sold and repurchased on the open market). In any event, the tax consequences of such a sale in the nonresident alien's pre-immigration country of residence must also be considered.

A nonresident alien may also achieve a step-up in low basis assets by contributing the assets (during the pre-immigration period) to a corporation in an exchange that does not qualify for nonrecognition treatment under Section 351 of the Code. Upon such a contribution, the corporation would obtain a fair market value basis in the assets, and the pre-contribution gain would be insulated from U.S. tax on a subsequent liquidation of the corporation.

\textsuperscript{171} See \textit{supra} Section V.B.1.
\textsuperscript{172} See \textit{supra} Section V.B.2.
\textsuperscript{173} See \textit{supra} Section II.A.3.
The taxpayer should also consider electing to have a corporation deemed liquidated by "checking the box" and filing Form 8858.

4. **Avoiding Anti-Deferral Regimes**

A nonresident alien can take steps to minimize (or completely avoid) the post-immigration impact of the anti-deferral regimes described above.\footnote{See supra Section X.}

If the application of an anti-deferral regime depends on a specified level of ownership by U.S. persons (i.e., CFC), the regime can be avoided through transfers of stock to other nonresident aliens prior to becoming a U.S. resident. Such transfers may generally be accomplished, without U.S. tax consequences, either by sale or by gift. Care should be taken in choosing the recipient of stock, however, because the immigrating nonresident alien must be sure that any applicable constructive ownership rules will not cause the stock to be considered as continuing to be owned by him despite the transfer.

If the application of an anti-deferral regime depends on a foreign corporation’s ownership of assets that produce, or the actual receipt of, "bad" (generally, passive) income (e.g., CFC, PHC, and PFIC), the regime can be avoided by restructuring the activities of the foreign corporation so as to reduce the level of "bad" income or assets below the threshold required to trigger the regime. Such a restructuring might be accomplished through a tax-free reorganization, liquidation, or distribution of "bad" activities or assets during the pre-immigration period.

If the anti-deferral regime depends on the corporation’s being classified as a foreign person (e.g., CFC and PFIC), domestication of the foreign corporation, coupled with an "S" election\footnote{See generally Treas. Reg. §301.7701-3. Assuming, of course, that the foreign corporation is not a type of entity that is treated as a per se corporation under the check-the-box regulations. See Treas. Reg. §301.7701-2(b)(8).} to treat the corporation as a flow-through entity, may be considered as a possibility, but the long-term consequences should be considered carefully. Alternatively, an LLC may be used.

The nonresident alien could also choose to forego the prospect of tax deferral by electing under the "check-the-box" regime to treat the corporation as a flow-through entity (i.e., as a partnership if it has more than one member, or as a disregarded entity if the nonresident alien is the sole shareholder), which would result in a deemed liquidation of the foreign corporation.\footnote{See supra Section VIII.E.} Conveniently, the deemed liquidation would permit the corporation’s assets to receive a tax-free step-up.

5. **Transfers to Foreign Entities**

Any transfers that a nonresident alien is planning to make to a foreign corporation, foreign partnership, or foreign trust or estate should be accomplished during the pre-immigration period. Once the nonresident alien becomes a U.S. resident, Sections 367, 684, and 721(c) may potentially apply to the transfer and trigger the recognition of gain on the transfer.\footnote{See supra Section X.}
Care should be taken in making transfers to foreign trusts, however, because Section 679 will apply not only if transfers are made after the nonresident alien becomes a resident alien, but also if transfers were made at any time during the 5-year period prior to immigration.\textsuperscript{180}

6. \textbf{Timing of Change in Residence}

A nonresident alien may also be able to extend the pre-immigration planning period by (i) carefully planning trips (both for business and for pleasure) to the United States, (ii) availing himself of the "closer connection" exception to the substantial presence test, and/or (iii) claiming the benefits of an applicable income tax treaty.\textsuperscript{181}

B. \textbf{Estate & Gift Tax Planning}

To reduce the U.S. federal estate and gift tax impact of a change in residence, a nonresident alien should make gifts, to the extent possible, of non-U.S. situs assets prior to becoming a domiciliary of the United States. Such gifts will be exempt from gift tax,\textsuperscript{182} will not be subject to income tax in the hands of the recipient,\textsuperscript{183} and will reduce the size of the immigrating nonresident alien's gross estate for U.S. federal estate tax purposes.\textsuperscript{184} The nonresident alien will be able to continue to make tax-free gifts of non-U.S. situs assets after becoming a resident alien for income tax purposes, but only so long as he has not acquired a U.S. domicile.\textsuperscript{185}

In performing any estate and gift tax planning during the pre-immigration period, the provisions of applicable estate and/or gift tax treaties should be considered.\textsuperscript{186}

XI. \textbf{EFFECT OF SUBSEQUENT EXPATRIATION}

Once a nonresident alien has become a U.S. resident and subjected himself to worldwide income, estate, and gift taxation by the United States, he may find it difficult to extricate himself from the U.S. tax web. A U.S. citizen or long-term resident who expatriates from the United States (i.e., becomes classified as a nonresident alien with respect to the United States) may find that he continues to be subject to U.S. tax with respect to a broader range of income, assets, and gifts than other nonresident aliens. In addition, he will find that, if he is not careful, he will continue to be treated as a U.S. citizen or resident even if he satisfies none of the basic residence tests described above.\textsuperscript{187} See accompanying outline by Michael Pfeifer.

\textsuperscript{180} See id.

\textsuperscript{181} See \emph{supra} Sections II.A.2.b. & III.A.

\textsuperscript{182} §2511(a).

\textsuperscript{183} §102.

\textsuperscript{184} Provided that the gifts are outright and that the nonresident alien retains no interest in the gifted property. See §§2036 - 2038. \textit{But cf.} §2035 (including in a decedent's gross estate gifts made during the 3-year period prior to the decedent's death).

\textsuperscript{185} See \emph{supra} Section II.B.

\textsuperscript{186} See \emph{supra} Section VI.D.

\textsuperscript{187} See §§877(g), 7701(n).
XII. **NIRVANA**

A. The enlightened state of non-taxation for non-U.S. citizens.

B. Falling between the cracks.

C. See Pfeifer on Expatriation, *infra*. Is current cost worth it?