

Options for Tax Reform in the Inbound International Tax Provisions of the Internal Revenue Code

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

These options for tax reform (Options) were submitted on behalf of the American Bar Association Section of Taxation to the Senate Finance and House Ways and Means Committees on December 3, 2013.¹ They have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options were submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and make them simpler to understand and be administered.

These Options were prepared by individual members of the Committee on United States Taxation of the Activities of Foreigners and Tax Treaties (the Committee). Principal responsibility for preparing these Options was exercised by David G. Shapiro, current Chair of the Committee. Substantive contributions were made by Alan I. Appel, Janine Burman, Michael J.A. Karlin, Michael J. Miller, Stanley C. Ruchelman, Ian Shane, Matthew R. Sontag, and Jon M. Weiner. Helpful comments were received from Fred F. Murray, Joshua Milgrim, and William B. Sherman. The Options were reviewed by William B. Sherman and Alan I. Appel, former Chairs of the Committee. They were further reviewed by Joan Arnold, former Council Director for the Committee, and Brian Trauman, current Council Director for the Committee, and by Michael Hirschfeld, on behalf of the Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in preparing these Options have clients who may be affected by the federal tax principles addressed by these Options, no such member or the firm or organization to which such member belonged while participating in the preparation of the Options has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

¹ *Options for Tax Reform in the Inbound International Tax Provisions*, AMERICAN BAR ASSOCIATION, Dec. 3, 2013, <http://www.americanbar.org/content/dam/aba/administrative/taxation/120313letter.authcheckdam.pdf>.

I. Executive Summary

These Options offer proposals for simplification and clarification of various inbound international tax provisions of the Internal Revenue Code of 1986, as amended.

Over the years, to encourage compliance, various provisions have been added to the Code to promote compliance with federal tax law, including through information reporting and withholding. Unfortunately, some of these provisions have proven to be “traps for the unwary” and in some cases create compliance burdens that cannot reasonably be met. In addition, concern with U.S. taxpayers expatriating for tax purposes has resulted in laws that we anticipate will be difficult to enforce and that can result in significant double taxation. We note the following options for consideration to remedy these issues.

A. *Simplify Foreign Bank Account Information Reporting*

1. We propose that Congress consider integrating the filing requirements of the Bank Secrecy Act of 1970 and section 6038D to simplify compliance and minimize inadvertent noncompliance.²

B. *Reform and Simplify U.S. Taxation of Non-U.S. Persons, Including Withholding Tax*

1. We propose that Congress consider amending section 897 so that an interest in a domestic corporation is treated as a U.S. real property interest (USRPI) only if such corporation is or was a real estate investment trust (REIT) at the time its status needs to be determined. This would ensure that the rules relating to U.S. real property holding corporations, which were originally intended to prevent foreign investors from using the *General Utilities* doctrine to avoid section 897 entirely, do not inadvertently result in two levels of U.S. tax under section 897 following the repeal of the *General Utilities* doctrine in 1986.
2. We propose that Congress consider amending section 1446 so that partnership withholding under section 1446 is required only to the extent the partnership has net cash after paying ordinary-course business expenses (other than expenses paid to partners or related parties). In the alternative, we propose that Congress consider amending section 1446 so that withholding is computed after subtracting certain categories of income with respect to which the withholding agent receives no cash, such as foreclosure gain or cancellation of indebtedness income, from taxable income.
3. We propose that Congress consider repealing the “183-day rule” of section 871(a)(2), imposing tax on capital gains recognized by certain

²Unless otherwise indicated, all references to a section are to the current Code, and all references to a Treasury Regulation are to the regulations issued thereunder.

nonresident aliens, and instead rely on general rules of residence to determine taxation of capital gain.

C. *Simplify and Clarify Taxation of Foreign Sovereigns and Affiliated Entities*

1. We propose that Congress consider modifying section 892(a)(2)(A)(ii) to not apply to otherwise noncommercial income received by “controlled commercial entities,” or in the alternative, to treat a controlled entity as a controlled commercial entity only if a substantial percentage of its gross income is derived from commercial activities. In addition, we propose that the Treasury Department consider eliminating the rule deeming a U.S. real property holding corporation (USRPHC) to be engaged in commercial activities or, alternatively, modifying it so that the ownership of stock of a USRPHC does not cause a controlled entity to be deemed engaged in a commercial activity.
2. We propose that Congress consider modifying section 892 to treat gain arising from disposition of a partnership interest as “qualifying income” to the extent that the gain is attributable to assets that would give rise to qualifying income if sold directly by the partnership.
3. We propose that Congress consider amending section 892(a)(1) or section 897(h)(1) or both to clarify which provision should prevail when both provisions could be applicable to distributions received from certain qualified investment entities.

D. *Address Issues Relating to Taxation of Expatriates*

1. We propose that Congress consider amending the definition of long-term resident in section 877A to require a longer period of residence, such as 17 of 20 years, consistent with the U.K. residence standard for inheritance tax purposes; to count a year toward residence only if the individual was resident during 183 days of that year; and to take into account any year of residence for U.S. income tax purposes (not just years of lawful permanent residence). We further propose that Congress consider making annual adjustments to the \$2.0 million net worth threshold required for application of section 877A to account for inflation.
2. We propose that Congress consider amending section 904(c) to provide a special carryback rule in the case of deferred compensation items and assets taxed under section 877A, that are subject to foreign tax in a later year than they are subject to tax under section 877A.
3. We propose that Congress consider amending the requirement of security in connection with an election to defer tax under section 877A to permit placing illiquid assets in a trust, similar to a Marital Qualified Domestic Trust, with a U.S. trustee unrelated to the covered expatriate.
4. We propose that Congress consider amending section 877A(a)(3)(A) to include a reference to subsection (d) so that a covered expatriate will

- be entitled to the exclusion amount on deferred compensation as well as capital gain.
5. We propose that Congress consider allowing a covered expatriate to exclude mark-to-market gain on the deemed sale of a residence to the same extent an actual sale of that residence on the date of the section 877A deemed sale would have been eligible for the exclusion under section 121.
 6. We propose that Congress consider repeal of section 877A(f), which requires withholding on distributions from nongrantor trusts to covered expatriates. Alternatively, we propose that Congress consider limiting that provision by (1) excluding trusts in existence at least two years prior to the time the covered expatriate became a citizen or lawful permanent resident and to which no material assets were added after that date; (2) limiting withholding for other trusts to the ten-year (or, in certain circumstances, five-year) period following expatriation; (3) not treating a covered expatriate as a beneficiary of a trust merely because the trustee has the power to add him or her as a beneficiary; (4) treating the portion of a trust attributable to additions to the trust after the expatriation date as a separate trust for purposes of section 877A(f)(5); (5) adopting a simplified rule, analogous to Regulation section 1.1441-3(c), to allow a trustee of a foreign grantor trust to compute the taxable portion of a distribution; (6) allowing foreign trusts to establish a taxable year as any 12-month period that it uses for its books and records, unless required to use the calendar year for other purposes of the Code; (7) allowing a pre-immigration step-up of the basis of a trust's assets, and permitting a covered expatriate to transfer any unused portion of his or her section 877A(a)(3) gain exclusion to the trust; and (8) treating a nongrantor trust as a grantor trust (and thus subject to section 877A(a) and not section 877A(f)).
 7. We propose that Congress consider repealing section 2801, which subjects recipients of gifts from covered expatriates to tax. If the provision is retained, we propose that Congress consider (1) limiting the amount subject to section 2801 to the covered expatriate's net worth as of the expatriation date or alternatively, excluding any property derived by gifts or bequests to the covered expatriate from foreign persons; (2) excluding gifts, inheritances, and trust distributions that do not exceed the threshold for reporting gifts on Form 3520; (3) limiting its application to gifts made within ten years following expatriation and to bequests resulting from death within the earlier of ten years following expatriation and three years after the actuarial life expectancy of the covered expatriate as of the date of expatriation; (4) eliminating or substantially modifying the requirement of timely return filing in order for a gift or bequest reported on the return not to be treated as a covered gift or bequest; and (5) allowing deferral of payment of tax with respect

to gifts and bequests of illiquid assets, subject to provision of adequate security, and permitting rejection of gifts and bequests altogether.

II. Options for Consideration

A. Simplify Foreign Bank Account Information Reporting

1. Present Law

Under the Bank Secrecy Act of 1970³ (the BSA), certain U.S. persons holding any financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country are required to report these accounts to the government by filing Treasury Form TD F 90-22.1 (the FBAR).⁴

A U.S. person is required to file an FBAR by June 30 of the year following the year in which the aggregate value of all foreign financial accounts exceeds \$10,000.⁵ Additionally, the U.S. person has to note the existence of such accounts in certain questions on a U.S. federal income tax return.⁶

In general, the FBAR final regulations⁷ define (1) a U.S. person as a citizen, resident, or entity of the United States, including the U.S. possessions,⁸ and (2) financial accounts to include bank and securities accounts, insurance and annuity accounts with cash value, commodity futures and options accounts, and mutual fund accounts.⁹

The 2010 Hiring Incentives to Restore Employment (HIRE) Act added section 6038D to the Code.¹⁰ This section requires individual taxpayers to attach Form 8938 to their income tax return, for any year in which the taxpayer has an interest in a “specified foreign financial asset” that exceeds \$50,000. This additional reporting generally is effective for taxable years beginning after March 18, 2010. However, the reporting requirement was suspended by Notice 2011-55 until Form 8938 was released, with any reports for periods prior to the publication of the form to be attached to the first return filed after the form was published.¹¹ The Department of the Treasury released temporary regulations under section 6038D on December 19, 2011, effective for all taxable years ending after that date,¹² and the Service released Form 8938 in

³31 U.S.C. §§ 5311-5332 (2012).

⁴31 C.F.R. § 1010.350 (2013).

⁵31 C.F.R. §§ 1010.350(a), 1010.306(c).

⁶With respect to 2012 returns, see, e.g., Question 6 on Form 1120, Schedule N; Question 7 on Form 1040, Schedule B; Question 10 on Form 1065, Schedule B; Question 3 on Form 1041, page 2.

⁷31 C.F.R. § 1010.350.

⁸31 C.F.R. § 1010.350(b).

⁹31 C.F.R. § 1010.350(c)(1)-(3).

¹⁰Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§ 511-513, 124 Stat. 71, 109-12 (2010).

¹¹Notice 2011-55, 2011-29 I.R.B. 53.

¹²T.D. 9567, 2012-8 I.R.B. 395.

connection with the release of the regulations. Under the temporary regulations, an individual (and potentially, for future years, a “specified domestic entity”) is required to file Form 8938 only if his or her interests in “specified foreign assets” had a value exceeding \$50,000 on the last day of the taxable year or \$75,000 at any time within the taxable year.¹³ For married couples filing a joint return, the thresholds are raised to \$100,000 and \$150,000, respectively.¹⁴ If an individual lives abroad and is qualified for the foreign earned income exclusion under section 911(d)(1), the thresholds are raised to \$200,000 and \$300,000, or if the individual is married and the couple files a joint return, to \$400,000 and \$600,000, respectively.¹⁵

“Specified foreign financial assets” are depository or custodial accounts at foreign financial institutions and, to the extent not held in an account at a financial institution: (1) stocks or securities issued by foreign persons; (2) any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person; and (3) any interest in a foreign entity defined in section 1473.¹⁶ The information to be included on the statement includes identifying information for each asset and its maximum value during the taxable year.¹⁷

When the BSA was enacted in 1970, the Department of the Treasury delegated authority to the Service for the filing and enforcement of section 5314 of the BSA,¹⁸ which authorized the Secretary to require certain U.S. persons to file reports for transactions with a foreign financial agency. In 1970, the Service created the first FBAR (Form 4683), to help taxpayers in complying with BSA reporting requirements. At that time, the FBAR was attached to the income tax return.

The Tax Reform Act of 1976¹⁹ amended section 6103 to restrict the access to tax returns and to tax return information outside of the Service. To maintain access to FBAR information for other criminal, tax, and regulatory investigations and proceedings, and to comply with the original intent of the BSA legislation, the Department of the Treasury removed the FBAR from the income tax return. Thus, with the passage of the Tax Reform Act of 1976, the Service’s responsibility was generally limited to processing FBAR information²⁰ and the FBAR is not considered “return information.” Accord-

¹³Temp. Reg. § 1.6038D-2T(a)(1).

¹⁴Temp. Reg. § 1.6038D-2T(a)(2).

¹⁵Temp. Reg. §§ 1.6038D-2T(a)(3), -2T(a)(4).

¹⁶Temp. Reg. § 1.6038D-3T.

¹⁷Temp. Reg. § 1.6038D-4T.

¹⁸31 U.S.C. § 5314 (2012).

¹⁹Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

²⁰Although the FBAR is received and processed by the Service, it is not considered “return information” and its distribution to other law enforcement agencies is not limited by the nondisclosure rules of section 6103. See STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN SENATE AMENDMENT 3310, THE “HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT,” UNDER CONSIDERATION BY THE SENATE (JCX-4-10), at 48 (Feb. 23, 2010).

ing to a 2010 Treasury Inspector General for Tax Administration audit, “[h]owever, from 1992 to 2003, authority over the FBAR has slowly reverted to the [Service].”²¹

In 1992, the Secretary delegated to the Service authority to investigate possible violations of the BSA, including the FBAR requirement.²² Although the Service’s Criminal Investigation Division would investigate FBAR matters and recommend criminal actions to the Department of Justice, the Director of the Financial Crimes Enforcement Network (FinCEN), a separate agency within the Department of the Treasury, retained authority to assess civil money penalties related to the FBAR.²³

However, in 2003 the Secretary delegated the authority to determine and enforce civil penalties to the Service, reflecting the fact that the FBAR’s major purpose is to identify potential tax evasion:

The most far-reaching recommendation in the initial report involved FinCEN’s delegation of authority to impose civil money penalties for FBARs violations to the IRS. This recommendation was based on FinCEN’s need to concentrate its scarce enforcement resources on reporting requirements such as suspicious activity and currency transaction reports filed by financial institutions, as opposed to individual taxpayers, as well as the greater availability of IRS resources for FBAR enforcement. Further, one could argue the FBAR is directed more towards tax evasion, as opposed to money laundering or other financial crimes, that lie at the core mission of FinCEN.²⁴

2. *Reasons for Change*

Although Form 8938 is not identical to the FBAR, the two forms are very similar; consequently, the additional form causes duplication of the reporting to many taxpayers. However, because the forms are not identical, different definitions of terms, filing procedures, and deadlines increase and complicate the filing requirements of many taxpayers and unnecessarily expose taxpayers to inadvertent violations of their compliance responsibilities. Moreover, since both the Service and FinCEN should be able to obtain the reporting information with the integration of the forms, it is not clear that the added benefit of the second form exceeds the added risk for taxpayers.

In addition, many taxpayers may believe that because they have filed Form 8938 with their tax returns and reported financial accounts thereon, they have satisfied the FBAR filing requirements. This is a “trap for the unwary”

²¹Treasury Inspector General for Tax Administration, Audit Report 2010-30-125.

²²Treas. Dir. 15-41 (Dec. 1, 1992).

²³FIN. CRIMES ENFORCEMENT NETWORK, DEPT. OF THE TREAS., A REPORT TO CONGRESS IN ACCORDANCE WITH § 361(B) OF THE UNITING AND STRENGTHENING AMERICA BY PROVIDING APPROPRIATE TOOLS REQUIRED TO INTERCEPT AND OBSTRUCT TERRORISM ACT OF 2001 (USA PATRIOT ACT) 4 (2003).

²⁴*Id.*

that can lead to harsh penalties, even when the government has received (on Form 8938) all the information that is required to be reported on the FBAR.

3. *Options for Consideration*

We propose that Congress consider integrating the FBAR and Form 8938 to simplify reporting and improve compliance by providing a single form that is attached to the income tax return (the Combined Form), and amending the nondisclosure rules of section 6103 to the extent necessary to permit continued FinCEN use of the Combined Form. We propose that Congress consider increasing the account balance threshold that triggers the FBAR filing requirement, which has never been increased since FBAR reporting was first required over 40 years ago, to coincide with the Form 8938 threshold.

We further propose that Congress consider maintaining a separate Combined Form filing requirement where a tax return will not be filed, with a filing deadline that is the same as it would have been had an income tax return been filed. For example, the Combined Form for an individual would be due the date the income tax return is due or would be due if the individual were required to file a return and had requested an automatic extension. In addition, we propose that FinCEN consider adopting the “timely mailing is timely filing” rule of section 7502 with respect to a separately filed Combined Form. Under this option, the BSA requirement to separately report cash transactions of \$10,000 or more would be maintained.

B. *Reform and Simplify U.S. Taxation of Non-U.S. Persons, Including Withholding Tax*

1. *Simplify and Reform*

a. *Present Law.* Pursuant to the Foreign Investment in Real Property Tax Act²⁵ (FIRPTA), section 897 and the regulations thereunder provide special rules applicable to the disposition of USRPIs by foreign persons. These rules require that gain or loss from such disposition must be taken into account as if the foreign person were engaged in a U.S. trade or business during the taxable year of the disposition and, further, as if any gain or loss recognized were effectively connected with such trade or business.²⁶ The FIRPTA rules also generally override any nonrecognition treatment that would otherwise be available to a foreign person engaging in qualifying transactions, such as corporate reorganizations.²⁷

USRPIs include any interest (other than an interest solely as a creditor) in real property located in the United States or the U.S. Virgin Islands, specifi-

²⁵ Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, § 1122, 94 Stat. 2599.

²⁶ I.R.C. § 897.

²⁷ § 897(d); Reg. § 1.897-5T. These provisions are discussed further below.

cally including an interest in a mine, well, or natural deposit.²⁸ Real property for this purpose also includes certain personal property that is used to exploit natural products in or upon the land, such as oil and gas well machinery and equipment.²⁹ The regulations provide guidance and additional detail regarding when an interest is held solely as a creditor, including the separation of a given interest-holder's equity stake in a given USRPI from its creditor interest in that same USRPI.³⁰

In addition to real property and certain personal property, a USRPI also generally includes any stock or other interest (again, other than solely as a creditor) in any domestic corporation unless it can be demonstrated that the domestic corporation was not a USRPHC at any time during the five-year period ending on the date of the disposition of such interest.³¹ A USRPHC is defined, in essence, as any domestic corporation that owns USRPIs that are greater, in fair market value (FMV) terms, than the sum of the corporation's nonreal property assets that are used or held for use in a trade or business plus that domestic corporation's foreign real property interests.³² For purposes of this test, the domestic corporation at issue is considered to own a proportionate share of the assets held by any partnership in which it is a partner, with a similar "look-through" rule applied to any controlling interests held in subsidiary corporations.³³

Section 1445 provides a withholding requirement to enforce the tax imposed upon foreign persons' dispositions of USRPIs under section 897.³⁴ While tied in purpose to section 897, the impact of section 1445 on any given transaction must be evaluated separately, as the section is independently applicable. Unless an exception applies, section 1445 requires the acquirer of any USRPI disposed of by a foreign person to withhold ten percent of the

²⁸ § 897(c)(1)(A); Reg. § 1.897-1(c)(1).

²⁹ Reg. § 1.897-1(b)(4). For such personal property to qualify as USRPIs, however, either the property holder or a related person must own the underlying USRPI that is being exploited by such property.

³⁰ Reg. § 1.897-1(d).

³¹ § 897(c)(1). An exception to this general rule may apply if (1) the corporation has disposed of all of its USRPIs and satisfied certain other requirements for the "cleansing exception" set forth in section 897(c)(1)(B); (2) a class of stock of the corporation is regularly traded on an established securities market and certain other requirements are satisfied in accordance with section 897(c)(3); or (3) the corporation is a domestically controlled qualified investment entity within the meaning of section 897(h)(2). Bills were recently introduced in the House of Representatives and the Senate to broaden the exception of section 897(c)(3) for certain interests in REITs. See H.R. 2870, 113th Cong. § 2 (2013); S. 1181, 113th Cong. § 2 (2013). Similar bills have been introduced previously.

³² § 897(c)(2) (defining a USRPHC as any corporation if the FMV of its USRPIs equals or exceeds 50% of the total FMV of its USRPIs, foreign real property assets, and assets used or held for use in a trade or business); see also Reg. § 1.897-2.

³³ § 897(c)(4)(B), (c)(5); Reg. § 1.897-2(e)(2)-(3). A controlling interest means ownership of 50% or more of the FMV of all of the corporation's classes of stock. Reg. § 1.897-2(e)(3).

³⁴ See H.R. REP. NO. 98-861, at 941 (1984) (Conf. Rep.), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1629.

gross amount realized by the foreign person on the disposition and timely pay such amount over to the U.S. Treasury.³⁵ This withholding obligation presumptively applies to virtually any disposition by a foreign person of nonpublicly traded stock in a U.S. corporation unless the transferee receives, before the date of the transfer, a statement from such U.S. corporation that its stock does not represent a USRPI under the USRPHC rules.³⁶ An exception is provided for transactions in small percentages of the stock of a publicly traded corporation, but no other exceptions are available, such as for affiliated group transactions.

FIRPTA was enacted as section 1122 of the Omnibus Reconciliation Act of 1980,³⁷ with the withholding requirements under section 1445 enacted in the Tax Reform Act of 1984.³⁸ The purpose of FIRPTA, as set out in the Report of the Committee on the Budget, U.S. House of Representatives (the Report), was to “establish equity of tax treatment in U.S. real property between foreign and domestic investors.”³⁹ Congressional intent was explicitly not “to impose a penalty on foreign investors or to discourage foreign investors from investing in the United States,” but instead:

[T]he Committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in U.S. real property which affords the foreign investor a number of mechanisms to minimize or eliminate his tax on income from the property while at the same time effectively exempting himself from U.S. tax on the gain realized on disposition of the property.⁴⁰

The USRPHC rules, originally proposed as rules governing “real property holding organizations” but ultimately narrowed to apply only to corporations, were examined in detail by the Report. These rules were created because the use of a corporate vehicle could allow a foreign investor to escape tax on the appreciation of real property held by a corporation. The Report identified two mechanisms by which this could be accomplished.

First, the foreign person could have the corporation sell the real property and then liquidate. Under then-existing law, gains on sales of appreciated property in anticipation of liquidation were exempted from tax, thus resulting in no tax on the sale.⁴¹ On the subsequent liquidation, the gain recognized by the foreign shareholder would escape U.S. tax because capital gains of a nonresident alien on stock were then (and remain today) not subject to U.S. federal income tax.⁴² Thus, the foreign investor could realize the gains

³⁵ See I.R.C. § 1445(a).

³⁶ See § 1445(b)(3).

³⁷ Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599.

³⁸ Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

³⁹ H.R. REP. NO. 96-1167, at 511 (1980), *reprinted in* 1980 U.S.C.C.A.N. 5526, 5874.

⁴⁰ *Id.*

⁴¹ I.R.C. § 337 (1954).

⁴² I.R.C. §§ 865(c)(2), 871(a)(2), 872(a)(1).

from their investment without those gains ever having been subject to U.S. federal income tax.

Alternatively, the foreign investor could sell the stock of the corporation. For the same reasons described above, the foreign investor would not be subject to U.S. tax on the capital gain on the stock. The buyer, however, would receive a purchase-price basis in the stock, and could then liquidate the corporation without realizing gain or U.S. tax because, under then-existing law, domestic shareholders would receive a stepped-up basis in property distributed in liquidation by a corporation. Thus, under this mechanism, the gain on the real property would again remain untaxed.

Both of the strategies by which real property gains could be extracted from a corporation thus depended on the exemption from tax of gains realized in the process of liquidating a corporation. At the time FIRPTA was enacted, gain on sales of appreciated property in the 12 months following the adoption of a plan of liquidation was not subject to U.S. federal income tax.⁴³ Also, distributions of appreciated property to a shareholder in liquidation did not trigger U.S. federal income tax to the corporation on the appreciation.⁴⁴ Shareholders receiving such a distribution received a fair market value basis in the property, thus not preserving any of the untaxed gain for future taxation.

However, with the enactment of the Code in 1986, and the repeal of the *General Utilities* doctrine, the recognition of gain or loss upon liquidation of a corporation changed substantially. Under the revised section 336 now in effect, a liquidating corporation generally recognizes gain or loss on property distributed in liquidation as though that property were sold to the distributee at its fair market value. Instead of addressing property sold following adoption of a plan of liquidation, section 337 now provides for nonrecognition only on the liquidation of an 80%-owned subsidiary into its parent corporation.⁴⁵ However, even in this case, the gain ultimately remains subject to tax—the parent corporation takes a carryover basis in the distributed assets, rather than the fair market value basis under prior law, thus preserving any gain for later recognition.⁴⁶ Thus, following the changes made with the enactment of the Code in 1986, it generally is no longer possible for a foreign shareholder of a corporation to escape taxation on the appreciation of property, including real property, held in corporate form.

An exception applies in the case of a REIT, as defined in section 856. Pursuant to sections 857(b)(2)(B) and 561, a REIT is entitled to a deduction for dividends paid to its shareholders. Pursuant to section 562(b), any distribution pursuant to a complete liquidation occurring within 24 months after the adoption of a plan of liquidation is treated as a dividend for purposes of the dividends paid deduction, to the extent of the earnings and profits (computed

⁴³ See § 337 (1954).

⁴⁴ See § 337 (1954).

⁴⁵ § 337.

⁴⁶ § 337.

without regard to capital losses) of the liquidating corporation. Accordingly, notwithstanding the repeal of the *General Utilities* doctrine, as described in the preceding paragraph, it remains true that corporate tax may be avoided permanently in connection with the liquidation of a REIT under section 331. Further, if the liquidation is governed by section 331, each distributee shareholder will take a fair market value tax basis in the property received from the REIT in exchange for such shareholder's REIT shares. Thus, for foreign shareholders of a REIT, FIRPTA gains may go entirely untaxed if no tax is imposed at the shareholder level.

b. *Reasons for Change.* The USRPHC rules were explicitly created to prevent a foreign shareholder from escaping U.S. federal income tax on the appreciation of real property by holding that property through a corporation. Under then-existing law, the liquidation would allow the appreciation to permanently escape U.S. federal income taxation. As discussed above, the rules that made such a transaction possible were, except for REITs, repealed with the rest of the *General Utilities* doctrine in the enactment of the 1986 Code. As a result, the legislative purpose behind the USRPHC rules generally has been satisfied through alternative changes to the law. Outside the REIT context, the USRPHC rules now serve primarily as a trap for the unwary, potentially imposing U.S. federal income tax and ten percent gross-basis withholding, with accompanying interest and penalties for noncompliance, on transactions in corporate stock that fall outside of the legislative intent for the rules. In the case of a REIT, USRPHC rules are still needed to ensure that foreign shareholders will (if no exception applies) be subject to tax.

c. *Option for Consideration.* We propose that Congress consider amending section 897 so that an interest in a domestic corporation that is (or, during the applicable look-back period, was) a USRPHC is considered a USRPI only if the corporation is or was a REIT at such time as the status of such stock as a USRPI or non-USRPI must be determined.⁴⁷ In the wake of repeal of the *General Utilities* doctrine, as discussed above, a domestic corporation other than a REIT cannot avoid domestic corporate-level tax on gains from the sale of real property it holds. Thus, we believe that except in the case of a REIT there is no longer a need to treat an interest in a USRPHC

⁴⁷This proposal is similar to a bill introduced in the House of Representatives in 2010. See H.R. 4539, 111th Cong. § 2 (2d Sess. 2010). However, under the 2010 proposal, the USRPHC rules would have been eliminated entirely. In making this proposal, we do not comment on the continued advisability of FIRPTA as a policy matter, but only consider ways to make FIRPTA consistent with the repeal of the *General Utilities* doctrine, assuming that FIRPTA is to continue in existence.

as a USRPI to ensure domestic taxation of gains on sale of domestic real property.⁴⁸

2. Reform Partnership Withholding

a. *Present Law.* Enacted in its current form by the Technical and Miscellaneous Revenue Act of 1988,⁴⁹ section 1446(a) provides that, if a partnership has effectively connected taxable income (ECTI) for any taxable year, and any portion of such income is allocable under section 704 to a foreign partner, the partnership shall pay a withholding tax under this section at such time and in such manner as the Secretary shall by regulations prescribe.⁵⁰ Section 1446(c) defines ECTI as the taxable income of the partnership that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, subject to certain adjustments.

Withholding tax imposed on partnerships pursuant to section 1446 is based upon allocations of ECTI. It therefore is imposed regardless of when or whether the partnership makes distributions to partners.

b. *Reasons for Change.* Section 1446 imposes a requirement to withhold tax on income rather than on cash or property that represents income. In this respect, it is quite different from other forms of Chapter 3 withholding and, indeed, most forms of withholding required by the Code. It requires the partnership to pay a withholding tax on a foreign partner's share of ECTI at the highest rate of tax specified in section 1 (noncorporate partner) or section 11 (corporate partner), currently 39.6% and 35%, respectively. In computing

⁴⁸As noted above, *see supra* note 31, bills were recently introduced in the House of Representatives and the Senate to broaden the exception of section 897(c)(3) for certain interests in REITs. *See* H.R. 2870, 113th Cong. § 2 (2013); S. 1181, 113th Cong. § 2 (2013). Even if enacted into law, these proposals would not address the fact that, in our view, USRPHC rules for non-REITs are unnecessary following the repeal of *General Utilities*.

⁴⁹Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1012(s)(1) (A), 102 Stat. 3342, *further amended by* Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7811(i)(6), 103 Stat. 2106. Section 1446 originally was enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1246(a), 100 Stat. 2085. The 1986 version was structured as a tax on distributions, which could produce startling instances of overwithholding (*i.e.*, a foreign partner could contribute \$1,000 on day one and suffer withholding of \$350 tax when the same \$1,000 was returned the next day) and retroactively was replaced by section 1446 in its current form.

⁵⁰I.R.C. § 1446(a). Section 1446(f) authorizes issuance of such regulations as may be necessary to carry out the purposes of this section. Not long after enactment, the Service issued Revenue Procedure 89-31, 1989-1 C.B. 895, to provide guidance under section 1446. Revenue Procedure 89-31 generally followed the regime set forth in section 6655 for estimated tax payments by corporations and required a partnership to annualize its ECTI and pay over the withholding tax to the Service in quarterly installments and make a final payment with the annual tax return. *See id.* § 7. Revenue Procedure 89-31 also provided special rules for publicly traded partnerships and tiered partnerships. *Id.* §§ 10-11. On September 3, 2003, the Service issued proposed regulations that were generally consistent with Revenue Procedure 89-31. *See* T.D. 9200, 2005-23 I.R.B. 1158. On May 18, 2005, the Service issued the final Regulations, *see* Reg. §§ 1.1446-1 to 1.1446-5, and Temporary Regulations, *see* Temp. Reg. § 1.1446-6T, the latter also being issued as Proposed Regulations. *See* T.D. 9200, 2005-23 I.R.B. 1158.

ECTI, section 703(a)(1) does not apply; depletion deductions are allowed but not percentage depletion under section 613; there is no reduction for special allocations of income or other items allocable to U.S. partners; and finally, there is no reduction for partner-level items (such as losses, state taxes, and charitable contributions).

Section 1446 requires the withholding of tax by partnerships with foreign partners where the partnership has ECTI. The final regulations interpret the Code to require that in computing the ECTI on which tax is to be withheld, the deductions that a partner may be entitled to at the partner level are to be ignored. As a result, the "1446 tax," as it is referred to in the regulations, almost always will be greater than the foreign partner's actual tax. In some cases the partnership may owe a substantial 1446 tax when the foreign partner will owe no tax at all.

In this respect, section 1446 may be unique. There is not a single significant withholding provision, in the international or domestic area, where a recipient of income cannot escape excessive withholding through some form of statutory or regulatory relief. In every other case, at least in the international area, the foreign taxpayer can get the tax to be withheld more reasonably approximated to the actual liability by providing documentation in a form prescribed by the Service, by obtaining a ruling or determination, or by entering into an agreement with the Service.

In frequently requiring overwithholding of tax, section 1446, as implemented by the regulations, creates a burden that goes well beyond creating a cash flow problem for the foreign partner and potentially long-term interest-free deposits of tax with the U.S. Treasury. It places the burden of funding the overwithholding on the partnership and, if the partnership's cash flow is inadequate or the foreign partner's capital account is exhausted, the burden may fall directly on general partners, managers, and other responsible persons to fund what are, in substance, compelled distributions to the foreign partners. Moreover, this burden arises on the basis that section 1446 tax is a withholding tax, even though in substance it is a form of estimated tax. This burden, in our view, exceeds the relative simplicity that is the arguable benefit of section 1446 as drafted. Withholding taxes give rise to some of the toughest penalties in the Code and, because of section 1446's unique structure, these can fall on persons who have not in fact failed to "withhold" anything since there may have been no money or property in their possession or control.

Under section 1461, as a withholding agent, the general partner or the manager of the limited liability company is responsible for making the required partnership filings and for remitting the quarterly withholding payments to the Service. If the partnership does not make the required filings or remit the withholding taxes, the general partner, the manager, and the officers of a corporate general partner or manager may be subject to civil and, in a rare case, criminal penalties for failure to file and to pay tax (including the trust fund recovery penalty under section 6672) as well as interest for failure to pay estimated taxes and to remit tax when due. Thus, the financial con-

sequences of not complying with section 1446 withholding can be very significant. The numerous penalties and interest payments combined with the actual withholding tax liability itself can become a large financial burden to the withholding agent. Even though the actual income tax liability rests with the individual partners, if the withholding agent has failed to withhold or has withheld incorrectly, the withholding agent remains liable for the partners' payment of those taxes.

Section 1446 burdens the relationship between the partnership, its general partners or managers and other responsible parties, on the one hand, and the foreign partners on the other. Specifically, section 1446 acts to compel distributions to partners that might not otherwise be made under the terms of the partnership's governing documents. The section 1441 regulations do this too, but only in situations where partnerships actually have cash or property that gave rise to the withholding obligation and where the amount required to be withheld and the amount of the tax usually are similar or identical.⁵¹ Section 1446 does not provide for, and the members who prepared this Report were unable to design, a realistic mechanism, statutory or regulatory, by which the partnership or the general partner could retrieve the tax once the determination of overwithholding had been made.

c. *Options for Consideration.* We propose that Congress consider amending section 1446 so that withholding is required only to the extent the partnership has net cash after paying ordinary-course business expenses (other than expenses paid to partners or related parties of partners). In the alternative, we propose that Congress consider amending section 1446 so that the withholding tax is computed after subtracting certain categories of income (for example, foreclosure gain, cancellation of indebtedness income, and certain income paid into a lockbox to which the withholding agent has no access).⁵² Similar exemptions from withholding are available under the section 1445 withholding rules.⁵³ In such cases, the partnership could maintain a "deferred withholding" account and pay the withholding tax as soon as cash becomes available. Under either Option, anti-avoidance rules may be needed to prevent "earnings stripping" to related parties.

3. *Eliminate the 183-Day Rule of Section 871(a)(2)*

a. *Present Law.* Under section 871(a)(2), a nonresident alien individual who is physically present in the United States for a period or periods

⁵¹ See Reg. § 1.1441-5(b)(2)(i) (obligation of partnership to withhold); Reg. § 1.1441-3 (amount and timing of withholding).

⁵² A substantially similar proposal was made in comments by certain members of the Section of Taxation submitted on January 27, 2004. See *Comments Concerning Proposed Regulations Relating to the Obligation of a Partnership to Withhold Tax Under Section 1446 on Effectively Connected Taxable Income Allocable to Foreign Partners*, AMERICAN BAR ASSOCIATION, Jan. 27, 2004, <http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2004/0401ftf.authcheckdam.pdf>.

⁵³ See Reg. § 1.1445-2(d).

aggregating 183 days within a taxable year is subject to a 30% tax on his or her net capital gains for that year (the 183-day rule).

An individual who is present within the United States for 183 days within a taxable year generally is treated as a U.S. resident under the “substantial presence” test, rather than subject to the 183-day rule.⁵⁴ However, days spent in the United States do not count toward the substantial presence test if they were because of a medical condition that arose while an individual was present in the United States. Similarly, days spent in the United States by certain “exempt individuals” do not count toward the substantial presence test: foreign government-related individuals, teachers or trainees, students, or professional athletes temporarily in the United States to compete in a charitable sports event.⁵⁵

b. *Reason for Change.* The only individuals who are subject to the 183-day rule are individuals who are present in the United States but whose presence is exempted from the possible determination of residence in the United States, such as teachers, trainees, students, foreign government-related individuals, and professional athletes. Given the existence of section 7701(b), which establishes a general residency rule for all tax purposes, there does not seem to be any rational policy basis for subjecting these individuals to a special tax regime on capital gains. Indeed, such a regime seems contrary to the purpose of the exemptions for those individuals.

c. *Option for Consideration.* We propose that Congress consider eliminating the 183-day rule of section 871(a)(2) and instead rely on the general rules of taxation of residents and nonresidents for taxation of capital gains.

C. *Taxation of Foreign Sovereigns and Affiliated Entities*

1. *Modify Rules for Income Received by a Controlled Commercial Entity*

a. *Present Law.* Pursuant to section 892(a)(1), income of foreign governments received from certain specified investments in the United States (including stocks and bonds) generally is excluded from gross income and thus exempt from taxation under Subtitle A. For this purpose, the term foreign government means the “integral parts” and “controlled entities” of a foreign sovereign. Pursuant to section 892(a)(2)(A)(i), the general exclusion of section 892(a)(1) does not apply to any income derived from the conduct of any commercial activity (whether within or outside the United States). Pursuant to section 892(a)(2)(A)(ii), the general exclusion of section 892(a)(1)(A) also does not apply to income received by a “controlled commercial entity” (CCE) even if such income otherwise meets the requirements for exclusion under section 892(a)(1) and does not constitute income from a commercial activity to which the exception of section 892(a)(2)(A)(i) applies.

⁵⁴ See I.R.C. § 7701(b)(3).

⁵⁵ § 7701(b)(3), (b)(5).

A CCE is defined as any entity engaged in commercial activities (whether within or outside the United States) if the government holds (directly or indirectly) any interest in such entity that (1) by value or voting interests, is 50% or more of the total of such interests in such entity, or (2) provides the foreign government with effective control of such entity.⁵⁶ Under the “upward attribution rule” set forth in the regulations, the commercial activities of a partnership (other than a publicly traded partnership) are attributed to each partner in the partnership. Under a “USRPHC rule” set forth in the regulations, every USRPHC is deemed to be engaged in commercial activity and therefore is deemed to be a CCE if such USRPHC is controlled by a foreign sovereign. Pursuant to section 897(c)(2), a domestic or foreign corporation can constitute a USRPHC solely by reason of owning stock of another USRPHC, so a controlled entity that does nothing more than own stock of one or more USRPHCs may therefore be deemed engaged in commercial activity for purposes of section 892.

The result of the foregoing rules is that once a controlled entity is considered to be engaged in even a modicum of commercial activity anywhere in the world (except for very limited inadvertent activity), such that it becomes a CCE, *all* of its income (including its noncommercial income, which may vastly exceed its commercial income) is ineligible for exemption under section 892 (the “all or nothing rule”).

Proposed Regulations issued on November 3, 2011,⁵⁷ would permit certain inadvertent commercial activity of a controlled entity to be disregarded for purposes of the all or nothing rule, provided that the failure to avoid conducting the activity was reasonable, the commercial activity is “promptly cured,” and certain record maintenance requirements are satisfied.⁵⁸ The Proposed Regulations would also create an exception to the upward attribution rule in certain circumstances where the partner to which a partnership’s commercial activities would otherwise be attributed does not have the right to participate in the management and conduct of the business of the partnership.⁵⁹ The Proposed Regulations would further provide that the disposition of a USRPI does not by itself constitute the conduct of a commercial activity,⁶⁰ but do not modify the USRPHC rule. Taxpayers are permitted to rely on the proposed regulations until final regulations are issued.

b. *Reasons for Change.* We believe that the all or nothing rule described above does not advance the purposes of section 892. We believe that as applied to income earned by a CCE, the exception of section 892(a)(2)(A)(i) is sufficient to ensure that commercial income not be eligible for exemption under section 892. We do not believe that it is also necessary or

⁵⁶I.R.C. § 892(a)(2)(B).

⁵⁷See Prop. Reg. § 1.892-5, 76 Fed. Reg. 68119 (2011).

⁵⁸Prop. Reg. § 1.892-5(a)(2), 76 Fed. Reg. 68119 (2011).

⁵⁹Prop. Reg. § 1.892-5(d)(5)(iii), 76 Fed. Reg. 68119 (2011).

⁶⁰Prop. Reg. § 1.892-4(e), 76 Fed. Reg. 68119 (2011).

desirable to deny the sovereign exemption to otherwise qualifying income unrelated to any commercial activity.

c. *Options for Consideration.* We propose that Congress consider amending section 892(a)(2)(A)(ii) to eliminate the blanket denial of the sovereign exemption to all income received by a CCE. Since all income derived by the conduct of any commercial activity would remain ineligible pursuant to section 892(a)(2)(A)(i), we do not believe that implementation of this option would give rise to any abuse. If this option is not adopted, we propose that Congress consider modifying the definition of controlled commercial entity to require a minimum level of commercial activity (without the necessity of satisfying the strict requirements of the exception for inadvertent commercial activity under the proposed regulations). For example, a controlled entity could constitute a CCE only if some substantial percentage of its gross income (for example, 25%) is derived from commercial activities.

In addition, we propose that the Treasury Department consider finalizing the portions of the proposed regulations that would limit application of the upward attribution rule and preclude a controlled entity from being considered engaged in commercial activity solely by reason of having disposed of a USRPI. Finally, we propose that the Treasury Department consider eliminating the above-described USRPHC rule or, alternatively, modifying it so that the ownership of stock in a lower-tier USRPHC does not cause a controlled entity to be deemed engaged in commercial activity.

2. *Revise Rules Relating to "Qualifying Income"*

a. *Present Law.* Pursuant to section 892(a)(1), income of foreign governments received from certain specified investments in the United States generally is excluded from gross income and thus exempt from taxation under Subtitle A. The class of qualifying income that may potentially be excluded under section 892(a)(1) includes (1) income from investments in the United States in stocks, bonds, or other securities; (2) income from investments in the United States in financial instruments held in the execution of governmental financial or monetary policy; and (3) interest on deposits in banks in the United States of moneys belonging to the foreign government. The class of qualifying income does not appear to include any portion of the gain arising from the disposition of a partnership interest, even if all or a portion of the gain arising from a disposition by the partnership of all of its assets would constitute qualifying income.

b. *Reason for Change.* We believe that gain arising from the disposition of a partnership interest should constitute qualifying income to the extent that such gain is attributable to assets of the partnership that would give rise to qualifying income if such assets had been sold by the partnership.

c. *Option for Consideration.* We propose that Congress consider amending section 892 to include a "look-through rule," whereby gains recognized by a foreign government from the disposition of a partnership interest are considered qualifying income, potentially eligible for exemption

under section 892(a)(1), to the extent attributable to assets of the partnership that would give rise to qualifying income if such assets had been sold by the partnership.

3. *Coordination with Section 897(h)*

a. *Present Law.* Pursuant to section 892(a)(1), income of foreign governments received from certain specified investments in the United States (including stocks and bonds) generally is excluded from gross income and thus exempt from taxation under Subtitle A. Section 897(h)(1) characterizes certain distributions received by a foreign shareholder from a qualified investment entity (including a REIT that satisfies the domestic control requirements of section 897(h)(4)(B)) as gain recognized from the sale or exchange of a USRPI. In the case of a foreign government shareholder, it is not clear whether section 897(h)(1) was intended to override the exemption set forth in section 892(a)(1) for income from investments in stocks. The Service has issued guidance taking the position that section 897(h)(1) overrides section 892(a)(1),⁶¹ but whether that position represents a proper application of current law is not clear.⁶²

b. *Reason for Change.* Clarification is required with respect to the interaction of sections 892(a)(1) and 897(h)(1).

c. *Option for Consideration.* We propose that Congress consider amending section 892 or section 897 or both to clarify which provision overrides the other.

D. *Issues Relating to Expatriation*

1. *Revise Definition of “Covered Expatriate”*

a. *Present Law.* Pursuant to section 877A, special tax rules apply to covered expatriates. Subject to certain very limited exceptions, a covered expatriate is any individual who relinquishes citizenship or ceases to be a “long-term resident” if (1) the average annual net income tax of such individual, for the period of five years ending before the date of the loss of U.S. citizenship or cessation of long-term residency, was greater than a specified,

⁶¹Notice 2007-55, 2007-2 C.B. 13.

⁶²There is also a question as to whether section 897(h)(1) was intended to apply in the case of a liquidating distribution or other transaction treated as a sale or exchange (*e.g.*, under section 302). The Service has issued guidance taking the position that section 897(h)(1) applies. *See* Notice 2007-55, 2007-2 C.B. 14. On June 10, 2008, the Section of Taxation submitted comments to the Service and the Department of Treasury, responding to Notice 2007-55, recommending that section 897(h)(1) not apply in such circumstances. *Request for Guidance on Certain Tax Issues Arising in REIT Liquidations, Including Issues Relating to Notice 2007-55*, AMERICAN BAR ASSOCIATION, June 10, 2008, <http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2008/080610realestate200755.authcheckdam.pdf>. Bills were recently introduced in the House of Representatives and the Senate to prevent section 897(h)(1) from applying in such circumstances. *See* H.R. 2870, 113th Cong. § 2 (2013); S. 1181, 113th Cong. § 2 (2013). Similar bills have been introduced previously as well.

inflation-indexed amount (\$155,000 for 2013), (2) the individual's net worth as of such date was \$2.0 million or more, or (3) such individual fails to certify, under penalty of perjury, that he or she has met the requirements of Title 26 for the preceding five years or fails to submit such evidence of such compliance as the Secretary may require.⁶³

A long-term resident means any individual (other than a U.S. citizen) who is a lawful permanent resident of the United States (*i.e.*, who holds a so-called green card) in at least eight taxable years during the period of 15 taxable years ending with the year in which he ceases to be a lawful permanent resident.⁶⁴ For purposes of this "8 of 15 test," any portion of a year counts as a year, so six full years and two separate days in two taxable years is sufficient to trigger long-term residency. An alien individual who resides in the United States but never becomes a lawful permanent resident will not at any time be considered a long-term resident and thus will never become a covered expatriate.

b. *Reasons for Change.* We believe that, in order to justify the imposition of a special expatriation regime, a greater long-term presence should be required. We also believe that, for purposes of determining long-term resident status, it is appropriate to take into account all of the years in which the individual was a U.S. resident, whether or not such individual was a lawful permanent resident. Treating lawful permanent residents less favorably may have the effect of discouraging physicians, entrepreneurs, and other desirable immigrants from seeking lawful permanent residence. Finally, we believe the \$2.0 million net worth threshold should be indexed for inflation, to ensure that the expatriation rules will continue to apply only to high net worth (or high-earning) individuals who may have tax avoidance motives for expatriating and who can afford the expensive legal advice that is needed to properly navigate such rules.

c. *Options for Consideration.* We propose that Congress consider amending the definition of long-term resident to require a substantially greater period of U.S. residency, such as 17 of 20 years (which is the rule applied by the United Kingdom for inheritance tax purposes).⁶⁵ This would limit application of the expatriation rules to individuals who truly have a long-term connection with the United States. In addition, we propose that Congress consider having a year count towards the minimum threshold only if the individual has had the requisite residence status for at least 183 days during the year. We further propose that all years of U.S. residency be taken into account, rather than only years in which the individual was a lawful permanent resident. Finally, we propose that Congress consider an annual inflation adjustment to the \$2.0 million figure applicable for purposes of the net worth test of sections 877A(g)(1) and 877(a)(2)(B).

⁶³I.R.C. §§ 877A(g)(1), 877(a)(2), (e).

⁶⁴§ 877(e)(2).

⁶⁵Inheritance Tax Act, 1984, c. 51, § 267(1)(b) (U.K.).

2. Address Double-Tax Issues Arising from Timing Differences

a. *Present Law.* Section 877A(a) generally subjects a covered expatriate to mark-to-market treatment, as if the covered expatriate had sold all of his or her assets for fair market value on the day before the expatriation date. For purposes of this mark-to-market tax, the basis of the covered expatriate's assets is deemed to have been stepped up to fair market value on the date the expatriate became a resident, unless the covered expatriate elects otherwise.⁶⁶ In the case of an asset located outside the United States, any foreign taxes imposed upon a subsequent sale of the asset may be carried back, for purposes of the foreign tax credit, for no more than one year.⁶⁷ Consequently, if the asset is sold more than one year later, the timing mismatch will preclude a foreign tax credit, thereby resulting in double taxation.

Similar rules apply in the case of deferred compensation items (other than certain "eligible deferred compensation items" addressed below). In the case of any such "ineligible deferred compensation item," the covered expatriate is deemed to have received an amount equal to the present value of his or her accrued benefit, on the date before the expatriation date.⁶⁸ If the services relating to such accrued benefit were performed outside the United States, payment of the deferred compensation may be subject to foreign tax. Any such foreign taxes, however, may be carried back for no more than one year.⁶⁹ Thus, if the accrued benefit is received (or otherwise subject to foreign tax) subsequent to the following year, the timing mismatch will preclude a foreign tax credit, thereby resulting in double taxation.

Different rules apply to certain eligible deferred compensation items, which are not taxed until paid. When eligible deferred compensation items are paid, they are subject to a 30% withholding tax,⁷⁰ which is deemed to be imposed under section 871.⁷¹ If the services relating to such eligible deferred compensation items were performed outside the United States, foreign taxes may be imposed, but generally will not be creditable. The covered expatriate is a non-resident alien and therefore eligible for foreign tax credits only to the limited extent permitted under section 906.⁷² Section 906 allows a nonresident alien to claim a credit only for foreign taxes paid or accrued with respect to income that is effectively connected with the conduct of a trade or business in the United States, which would not include income arising from the performance of personal services outside the United States. Moreover, section 906(b)(3) expressly provides that any foreign tax credit otherwise allowed under section 906(a) shall not be allowed against any tax imposed by section 871(a).

⁶⁶ § 877A(h)(2).

⁶⁷ I.R.C. § 904(c).

⁶⁸ § 877A(d)(2).

⁶⁹ § 904(c).

⁷⁰ § 877A(d)(1)(A), (d)(3).

⁷¹ § 877A(d)(6)(B).

⁷² It is assumed herein that the covered expatriate does not become a U.S. citizen or resident in such later year.

Thus, in the case of a covered expatriate who is subject to mark-to-market treatment under section 877A(a), or taxed on ineligible deferred compensation items under section 877A(d)(2), and who in either case is later subject to foreign income tax, the foreign tax credit rules applicable under present law create a timing mismatch that precludes double tax relief.

b. *Reasons for Change.* We do not believe the expatriation provisions of section 877A were intended to compel double taxation, as required under present law. We believe the foreign tax credit provisions of the Code should be liberalized to prevent this unintended result.

c. *Options for Consideration.* We propose that Congress consider amending section 904(c) to adopt a special carryback rule in the case of foreign taxes paid or accrued with respect to (1) any asset subject to mark-to-market treatment under section 877A(a), and (2) any ineligible deferred compensation items subject to tax as of the day prior to the expatriation date under section 877A(d)(2). The special carryback rule would permit such foreign taxes to be carried back indefinitely or, alternatively, for an extended period, such as 15 years. A corresponding amendment would be made to section 6511(d)(3), to ensure that the statute of limitations period would remain open, solely for purposes of claiming any refund due as a result of such foreign tax credit carryback.

We also propose that Congress consider amending section 906 to permit covered expatriates to claim foreign tax credits for foreign taxes paid or accrued with respect to eligible deferred compensation items. As modified, section 906 would allow a covered expatriate to determine foreign tax credits in the same manner as if he or she were a U.S. resident with no gross income or deductions other than eligible deferred compensation items and related expenses.

3. *Modify Election to Defer Tax to Address Cash-Flow Issues*

a. *Present Law.* A covered expatriate may elect to defer payment of the mark-to-market tax imposed on the deemed sale.⁷³ The election to defer is irrevocable and is made on a property-by-property basis. If the election is made with respect to a particular property, the deferred tax attributable to such property is due when the return is due for the taxable year in which the property is eventually disposed of or, if the property is disposed of in a transaction in which gain is not recognized in whole or in part, at such other time as the Secretary may prescribe. In any event, the deferral period must end by the due date of the return for the taxable year in which the expatriated individual dies.

To elect deferral of the mark-to-market tax, the covered expatriate must furnish "adequate security" to the Secretary.⁷⁴ Adequate security may be in the form of a bond or other security mechanism, such as a letter of

⁷³ See § 877A(b)(1).

⁷⁴ § 877A(b)(4).

credit, that adheres to the Secretary's requirements. In the event that the security provided with respect to a particular property subsequently fails to meet the requirements of these rules and the individual does not correct such failure, the deferred tax and accrued interest with respect to such property will become immediately due.

b. *Reasons for Change.* For certain types of assets held by the expatriate, such as a limited partnership interest, it will be difficult to satisfy the security obligations because the assets may be illiquid or have little value if sold on a fire sale basis. If a covered expatriate does have enough liquid assets to purchase a bond, presumably the covered expatriate also is able to pay the mark-to-market tax without needing a deferral and therefore a bond. In other words, the requirement for a bond means that those covered expatriates who most need a deferral because of a lack of liquid assets with which to pay the mark-to-market tax are the very ones who will not qualify for a deferral because of a lack of liquid assets with which to obtain a bond.

c. *Option for Consideration.* We propose that Congress consider amending the requirement for security in the case of deferred payment to permit a covered expatriate to elect to place the property in a trust similar to a Marital Qualified Domestic Trust (QDOT). The purpose of a QDOT is to preserve the marital deduction when the surviving spouse is not a U.S. citizen and the trust assets are likely to be subject to the federal estate tax if the marital deduction is not available. In the same way as a QDOT works to secure assets subject to estate tax when a deceased spouse leaves assets to a non-U.S. spouse, so a trust structure could be used to secure a covered expatriate's property subject to the mark-to-market tax imposed on the deemed sale, when the covered expatriate makes an election to defer payment. We believe that the proposed trust structure could be established prior to expatriation or within a designated time period immediately thereafter. The covered expatriate making the deferral election would establish a trust with an institutional U.S. trustee unrelated to the covered expatriate. The trustee would then allow the covered expatriate to use the assets but ensure that the proper tax was paid to the government when the trust property was sold or upon the death of the covered expatriate.

4. Modify Gain Exemption to Apply to Deferred Compensation as Well as Gain

a. *Present Law.* Covered expatriates are subject to the mark-to-market tax on the net unrealized gain on their worldwide property as if each asset had been sold for its fair market value on the day immediately prior to the expatriation date. Any net gain on the deemed sale is recognized to the extent that it exceeds a specified inflation-indexed "exclusion amount" (that is, \$668,000 for 2013).

The mark-to-market tax does not apply to interests in “deferred compensation items” as defined in section 877A.⁷⁵ There is no immediate tax upon expatriation with respect to eligible deferred compensation items. The payer must deduct and withhold from any “taxable payment” to the covered expatriate a tax equal to 30% of such taxable payment. There is a duty on the expatriate to notify the payer of his or her status as an expatriate in order to qualify for this favorable deferral treatment; otherwise, the mark-to-market tax will apply. If a deferred compensation item is not an eligible deferred compensation item, the deferred amount is deemed immediately includible in the expatriate’s income at U.S. income tax rates. The exclusion amount applies to any gain includable in gross income by reason of section 877A(a)(1);⁷⁶ however, deferred compensation is covered by section 877A(d), so the exclusion amount does not apply to deferred compensation.

b. *Reasons for Change.* A covered expatriate who is deemed to have sold assets and recognizes a capital gain is entitled to exclude the exclusion amount. However, the same covered expatriate cannot exclude any deferred compensation from the provisions of section 877A. We are not aware of any policy reason for the distinction.

c. *Option for Consideration.* We propose that Congress consider amending section 877A(a)(3)(A) to include a reference to subsection (d) so that a covered expatriate will be entitled to the exclusion amount on deferred compensation as well as capital gain.

5. *Grant the Covered Expatriate a Partial Exemption for Gain on the Sale of a Personal Residence Under Section 121*

a. *Present Law.* Under section 121, homeowners may exclude from income up to \$250,000 of gain realized per owner on the sale or exchange of a personal residence.⁷⁷ This exclusion is not available to a covered expatriate subject to the mark-to-market tax.

b. *Reasons for Change.* The objective of the mark-to-market tax under section 877A is to subject the covered expatriate to U.S. taxation upon the act of expatriation so as to discourage U.S. citizens and long-term residents from giving up their citizenship or residence in the U.S. for tax avoidance reasons. However, the denial of the benefits of section 121 places the covered expatriate in a worse position than if he or she had remained a U.S. citizen or long-term resident. We do not believe such a punitive result is consistent with the objectives of section 877A. We note that a covered expatriate who otherwise is eligible for the section 121 exemption could obtain it if he or she were to sell the residence prior to expatriating, but this effective requirement violates the economic efficiency principle.

⁷⁵ See § 877A(d)(4).

⁷⁶ See § 877A(a)(3)(A).

⁷⁷ See I.R.C. § 121(b)(2).

c. *Option for Consideration.* We propose that Congress consider allowing a covered expatriate to exclude gain on the deemed sale of a residence under section 877A to the extent the covered expatriate otherwise would have been eligible for the exclusion under section 121 in the case of an actual sale on the same date as the deemed sale under section 877A.

6. *Improve Administrability of 30% Withholding Tax on Payments from Nongrantor Trusts*

a. *Present Law.* Section 877A(c)(3) provides that the mark-to-market tax does not apply to any interest in a nongrantor trust. However, section 877A(f)(1) provides that if a nongrantor trust directly or indirectly makes a distribution to a covered expatriate, the trustee is required to deduct and withhold tax at 30% on the taxable portion of any distribution from a nongrantor trust to a covered expatriate. For this purpose, the taxable portion is defined as the portion of the distribution that would have been includible in gross income if the covered expatriate had continued to be subject to tax as a U.S. citizen or resident. Moreover, if the distribution consists of property the fair market value of which exceeds its basis, gain is to be recognized to the trust as if the property were sold to the expatriate at its fair market value. Section 877A(f)(5) provides that the withholding tax applies to a nongrantor trust only if the covered expatriate was a beneficiary of the trust on the day before the expatriation date.

Any tax subject to withholding under section 877A(f)(1) is treated as a tax imposed under section 871, presumably, although it is not explicitly stated, on the covered expatriate. The covered expatriate is deemed to have waived any right to claim any reduction in withholding under any U.S. treaty rules unless the covered expatriate agrees to such other treatment as the Service deems appropriate. Rules similar to those set forth in subchapter B of chapter 3 of the Code apply for purposes of the withholding obligation imposed on the trust.⁷⁸

In an effort to address the interaction of section 877A(f) and treaties, Notice 2009-85 provides that until further guidance is issued, a covered expatriate may preserve his or her right to claim a treaty benefit with respect to a distribution to which section 877A(f)(1)(A) applies by electing on Form 8854 to be treated as having received the value of his or her interest in the trust as determined for purposes of section 877A, on the day before the expatriation date.⁷⁹ The covered expatriate wishing to make the election is required to obtain a ruling on the value of his or her interest.

The Service has stated that if a trust that is a nongrantor trust immediately before the expatriation date subsequently becomes a grantor trust of which the covered expatriate is treated as the owner, directly or indirectly, then the conversion is deemed to be a taxable distribution under section 877A(f)(1)

⁷⁸ See §§ 877A(f)(4)(A), (d)(6).

⁷⁹ Notice 2009-85, 2009-45 I.R.B. 598.

to the covered expatriate to the extent of the portion of the trust of which the covered expatriate is then treated as the owner.⁸⁰

b. *Reasons for Change.* In general, the overall policy objective of section 877A appears to be to impose tax on covered expatriates on departure and not impose continuing tax liabilities following expatriation as had been the rule under the prior section 877 regime. There are exceptions to this approach that, with the exception of section 2801, appear to be related to concerns about liquidity and the ability of the covered expatriate to immediately pay a mark-to-market tax.⁸¹ Congress appears to have enacted section 877A(c) and (f) recognizing that the value of an interest in a nongrantor trust might not be ascertainable and that therefore, it was preferable and perhaps fairer to impose tax on the covered expatriate if and when he or she actually received a distribution. Nevertheless, for the reasons explained below, we believe these rules may prove impossible to administer and may have overly broad application.

First, we have reservations about the propriety of imposing a withholding obligation on foreign trustees who may have no connection to the United States other than by reason of their trusts having beneficiaries, or potential beneficiaries, who are former U.S. citizens or long-term residents. By way of comparison, we note that section 877A(f)(1) goes further than the new FATCA⁸² rules of Chapter 4. The new Chapter 4 rules only impose reporting and withholding obligations on foreign financial institutions that choose to accept them, and the “stick” that incentivizes such acceptance is limited to withholding on payments that undeniably have a U.S. nexus. However, section 877A(f)(1) requires foreign trustees to withhold, even if the payments and the trustees have no meaningful nexus to the United States.

Even apart from our concerns about the proper limits on the extraterritorial jurisdiction of the United States, we imagine that relatively few foreign trustees in this situation will comply. Accordingly, we think section 877A(f)(1) is unlikely to raise substantial revenue.

Furthermore, even where a foreign trustee is willing to satisfy its withholding obligations, section 877A(f)(1) may be unadministrable in many circumstances. Foreign trustees typically will have no familiarity with the U.S. tax laws and therefore are unlikely to be capable of performing the complex calculations and analyses required to properly withhold. For example, a trustee may have no records that would permit it to compute distributable net income (DNI) and undistributed net income (UNI) under U.S. principles, and it may use a fiscal year that is not the calendar year that all trusts are required to use under section 644(a). It may also be unable to compute the “taxable portion” of the distribution. Indeed, the amount of DNI out of

⁸⁰Notice 2009-85, 2009-45 I.R.B. 598.

⁸¹See § 877A(b) (deferral election; see *supra* Part II.D.4); § 877A(e)(2) (specified tax deferred accounts); § 2801 (gifts and bequests from covered expatriates to U.S. persons).

⁸²Foreign Account Tax Compliance Act, Pub. L. No. 111-147, § 501, 124 Stat. 71, 97 (2010).

which a trust distribution is made cannot be known until after the end of the trust's taxable year; and the taxable portion will be affected not only by the trust's financial performance but also by the amount of distributions made to all beneficiaries during the year.

In addition, section 877A(f)(1) is not limited to income produced by assets contributed to the trust before expatriation. To the extent that tax under section 877A(f)(1) is imposed on income derived from assets contributed to the trust post-expatriation (that is, on income derived from assets contributed by a nonresident alien to a foreign trust and subsequently distributed by the foreign trust to the nonresident alien), such treatment would not appear to be supported by the policy underlying section 877A. The propriety of such tax seems particularly doubtful to the extent accomplished by a treaty override, pursuant to section 877A(f)(4)(B).⁸³

For example, we note the differential treatment for trusts to which funds are contributed after the expatriation date and new trusts created and funded after that date. Distributions from the former are apparently subject to withholding even with respect to income derived from funds contributed post-expatriation, whereas distributions from the latter are not subject to tax at all. In our view, such disparate treatment is an unintended consequence and is not justified by the purposes of section 877A.

In our view, the rules of section 877A(f) also go further than necessary to the extent that the taxable portion of any distribution is attributable to built-in gains that accrued prior to the first day on which the covered expatriate was a U.S. resident.

c. *Options for Consideration.* We propose that Congress consider repealing section 877A(f). Alternatively, we propose that Congress consider amending it so that:

i. Withholding would not apply in the case of a foreign trust in existence at least two years prior to the date on which the covered expatriate became a U.S. citizen (including by being born) or a lawful permanent resident and to which no material assets were added after that date.

ii. For all other trusts, withholding would be limited to the ten-year period following the date of expatriation (five years in the case of a trust of which the covered expatriate was only a remainder beneficiary on the expatriation date and acquired a present interest in the trust only as the result of the death of another beneficiary). In the alternative, the covered expatriate would be permitted to elect (consistent with Notice 2009-85) to include his or her share of the value of the trust in income.

⁸³The treaty override of section 877A(f)(4)(B) provides that the covered expatriate shall be treated as having waived any right to claim any reduction under any treaty with the United States in the withholding on any distribution. We understand that the Service considers such treaty override to extend to any claim of exemption from tax, and not merely to any claim of exemption from withholding.

iii. A covered expatriate would not be treated as a beneficiary of a trust merely because the trustee (or some other person) has the power to add him as a beneficiary.

iv. The portion of a trust attributable to additions to the trust made after the expatriation date would be treated as a separate trust for purposes of section 877A(f)(5).

v. In the case of foreign nongrantor trusts, or at least foreign nongrantor trusts of which the grantor was not, at the time of the funding of the trust, a U.S. person, adopting a simplified rule to make it possible for the trust to compute the taxable portion of the distribution, and permitting or directing the Service to adopt a provision analogous to Regulation section 1.1441-3(c) (estimate of earnings and profits by a corporation for purposes of withholding on the dividend portion of a corporate distribution).

vi. Unless a foreign trust is otherwise required to use the calendar year as its taxable year, it would be allowed to use any 12-month period on the basis of which it normally keeps its books and records.

vii. Section 877A(h)(2) would be modified to allow pre-immigration step-up of the basis of the trust's assets and the covered expatriate would be permitted to transfer to the trust any unused portion of the gain exclusion provided for in section 877A(a)(3).

viii. A trust would be treated as a grantor trust if the covered expatriate was the owner of the trust income prior to expatriation under the grantor trust rules and which he or she would be deemed to own following expatriation but for section 672(f). In such case, the covered expatriate would be deemed to have disposed of all of the assets of the trust at fair market value on the expatriation date and the policy of section 877A will have been served. We do not believe it is necessary to subject the post-expatriation income of such a trust to further taxation thereafter.

7. *Repeal Transfer Tax on Gifts and Bequests from Covered Expatriates*

a. *Present Law.*

Overview. Section 2801 provides that if a U.S. citizen or resident receives any covered gift or bequest, the recipient⁸⁴ is subject to a tax on the amount of the gift or bequest at the higher of the highest rate of estate tax and the highest rate of gift tax applicable on the date of receipt.⁸⁵ If the highest rate of gift tax is higher than the highest rate of estate tax, it is the gift tax rate that will apply to the covered gift or bequest, even if what is received relates to a bequest. Conversely, if the highest rate of estate tax is higher than the highest

⁸⁴Unlike all other transfer taxes imposed by Subtitle B, tax under section 2801 is imposed on the recipient, not the donor or the decedent whose assets are the source of the gift. I.R.C. § 2801(b).

⁸⁵The amount of a covered bequest is determined on the date of receipt, not the date of death. § 2801(a).

rate of gift tax, it is that rate that will apply, even if the receipt is attributable to a lifetime gift.

A covered gift or bequest is defined as any property acquired (1) by gift directly or indirectly from an individual who at the time of the acquisition is a covered expatriate within the meaning of section 877A(g)(1), which in turn cross refers to an expatriate who meets the requirements of subparagraph (A), (B) or (C) of section 877(a)(2); or (2) directly or indirectly by reason of the death of an individual who immediately before death was a covered expatriate.⁸⁶

Section 2801 also applies to transfers to domestic trusts by covered expatriates and it applies to distributions by foreign trusts to U.S. citizens or residents attributable to a gift or bequest from a covered expatriate.

An exception is made for gifts and bequests to charities and spouses.⁸⁷ It would appear that in the latter case, a gift or bequest to a noncitizen spouse would have to be in a form that would qualify for the marital deduction under the QDOT regime and the other provisions of sections 2056(d) and 2056A.

Interaction with Other Taxes. Section 2801 does not apply to any property included in a gift tax return or an estate tax return, but only if the gift tax return or estate tax return was timely filed. If the return is not timely filed or if the property is omitted, apparently for any reason at all, from a timely filed return, the gift or bequest may be subject to both estate or gift tax and the tax under section 2801.⁸⁸

Section 2801 allows a reduction, which is in effect a credit, for gift tax or estate tax paid to a foreign country with respect to a covered gift or bequest.

In the case of a distribution by a foreign trust, section 2801 allows an income tax deduction under section 164 for tax imposed by section 2801 on a distribution from a foreign trust to the extent tax imposed on the portion of the distribution that is included in gross income. In other words, a distribution from a foreign trust may be taxed both as income and as a covered gift or bequest.

b. *Reasons for Change.* We believe that section 2801 is a provision that is unlikely to raise substantial revenue directly and may result in substantial indirect revenue losses.

No separate estimate of the revenue anticipated from section 2801 was published at the time of enactment,⁸⁹ but we believe that its primary effects would be to deter gifts to U.S. persons and, worse, to deter immigration.

⁸⁶ § 2801(e).

⁸⁷ § 2801(e)(3).

⁸⁸ § 2801(e)(2).

⁸⁹ See JOINT COMM. ON TAXATION, ESTIMATED BUDGET EFFECTS OF H.R. 6081, THE "HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008" (JCX-45-08), at 3 (May 20, 2008). For fiscal years 2008–2018, the new mark-to-market rules were anticipated to raise \$411.0 million. *Id.* The estimate does not indicate whether this included the effect of section 2801 but if it did not, no separate estimate was provided.

Many members who prepared this Report believe that section 2801 deters prospective immigration to the United States by wealthy individuals, discourages lawful permanent residents from becoming citizens, and encourages resident aliens to depart from the United States before they meet the definition of a long-term resident. We also believe that section 2801 deters wealthy nonresident aliens (not just covered expatriates) and their trusts from making gifts to U.S. family members or to covered expatriates with U.S. family members.

Notably, the section 2801 tax is not limited to gifts and bequests of wealth held by covered expatriates on the date of expatriation. A covered expatriate can leave the United States with a net worth of as little as \$2.0 million and later directly or through trusts acquire post-expatriation wealth from earnings, investments or gifts, years, decades, or (in the case of a trust distribution from a trust of which a covered expatriate is a grantor) even centuries after expatriation. All of the post-expatriation wealth is potentially subject to taxation under section 2801 if subsequently given, bequeathed, or distributed from trusts to U.S. persons (even if they were nonresident aliens on the date of expatriation of the covered expatriate). We do not believe this result is necessary or supported by the policy objectives of the anti-expatriation rules.

Furthermore, we note that while section 2801 was intended to make the decision of whether or not to expatriate tax-neutral,⁹⁰ it has the effect of encouraging covered expatriates to make gifts or bequests solely to non-U.S. persons, so as to avoid the tax. Clearly, this effect is not tax-neutral. Moreover, we believe that discouraging nonresident aliens from transferring wealth to U.S. family members is ultimately likely to decrease U.S. tax revenues (and not otherwise a desirable policy).

In addition, section 2801 presents very substantial practical difficulties for U.S. taxpayers and the Service, which will inevitably worsen as time passes and the length of time aliens have been covered expatriates increases. Because, as noted above, a gift or bequest from a covered expatriate may occur years, decades, or centuries after expatriation, it may be difficult or impossible for U.S. taxpayers in receipt of such a gift or bequest, or for the Service, to determine that the donor was a covered expatriate. In the case of a bequest, the donor is by definition unavailable and in the case of a trust distribution, the trustee, let alone the beneficiary, may not know or have the means of finding out the grantor's status.

Finally, the U.S. recipient of a covered gift or bequest may encounter substantial difficulties in paying the tax if the gift or bequest consists of property that is not liquid. Section 2801 makes no provision for the U.S. recipient to defer payment of the tax in such circumstances. As a result, the U.S. recipient may be forced to reject the gift or bequest, assuming this is even possible.

⁹⁰STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 177 (Comm. Print 2009).

c. *Explanation of Proposal.* For all the reasons given above, we propose that Congress consider repealing section 2801. While we believe that section 2801 is overly broad in a number of ways described above, the primary reason to consider repealing it is to avoid discouraging wealthy individuals and their families from (1) migrating to or remaining in the United States, or (2) if they become covered expatriates, making gifts to U.S. family members following their expatriation.

Alternatively, we propose that Congress consider the following changes:

i. Limit the amount subject to section 2801 to the covered expatriate's net worth as of the expatriation date (and require that this amount be reported on Form 8854). Alternatively, exclude from the application of section 2801 any property derived from gifts and bequests to the covered expatriate from foreign persons.

ii. Exclude from the application of section 2801 gifts and inheritances (and trust distributions) that do not exceed the threshold for reporting gifts on Form 3520.

iii. Limit the application of section 2801 to (1) gifts made within the ten years following the expatriation date, and (2) bequests resulting from death occurring within the period ending on the earlier of (i) ten years after the date of expatriation and (ii) the date that is three years after the actuarial life expectancy of the covered expatriate as of the date of expatriation.

iv. Eliminate or substantially modify the requirement of section 2801(e)(2) that a gift or estate tax return be filed timely in order for a gift or bequest reported on such return not to be treated as a covered gift or bequest, provided that the gift or estate tax return is ultimately filed.

v. Allow the recipient of a covered gift or bequest to defer payment of tax in the case of gifts and bequests of illiquid assets and clarify that the recipient may provide security for the tax in the form of a binding pledge of such assets to the United States or may reject the gift or bequest altogether.

