A Lawyer's Guide to International Taxation, Part II

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Part I of this article appeared in 30 CEB Cal Bus L Prac 1 (Winter 2014). It addressed inbound taxation, including income taxation, FIRPTA, estate and gift taxation, and various ownership structures for foreign investors. This Part II addresses outbound taxation (including taxation of controlled foreign corporations, foreign trusts, and passive foreign investment companies; the foreign tax credit; and IC-DISCs) and expatriation.

OUTBOUND TAXATION

An American operating a business abroad, investing in foreign property, or entering into an overseas joint venture may do so as a sole proprietor (*i.e.*, in his or her name directly or through an entity disregarded for income tax purposes), through an entity taxed as a partnership, or through a corporation or trust. The first two options do not present any tax planning opportunities. A U.S. sole proprietor will be taxed currently on his worldwide income. (The U.S., China, Mexico, Korea, and certain other countries tax on worldwide income; all other countries tax on territorial income.) Similarly, a foreign partnership will allocate taxable income to its U.S. partner currently, who will in turn be taxed currently. Tax deferral may be possible when a foreign business is conducted through a foreign corporation or owned through a foreign trust.

Controlled Foreign Corporations

The United States lacks jurisdiction to tax a foreign corporation that is not engaging in business in the U.S. and does not have U.S.-source income. That allows for U.S. tax deferral of foreign income earned by a foreign corporation, even when the corporation is owned by an American shareholder. To prevent tax abuse, and particularly the use of offshore tax havens, Congress enacted Subpart F of the Internal Revenue Code (IRC §§951–965), which deals with foreign corporations controlled by American shareholders.

Subpart F creates the concept of a controlled foreign corporation (CFC), which is a foreign corporation more than 50 percent of which (by vote or value) is owned by "U.S. shareholders." IRC §957(a). A "U.S. shareholder" is a U.S. citizen or resident shareholder who owns 10 percent or more of the CFC. IRC §951(b). Shareholders who own less than 10 percent are ignored for CFC purposes entirely. Ownership by related parties may be aggregated for purposes of both the 10-percent-shareholder test and the greater-than-50-percent-control test. For example, a foreign corporation equally owned by 11 U.S. taxpayers is not a CFC because none of the shareholders owns 10 percent or more. A foreign corporation owned half by a U.S. shareholder and half by a Belgian shareholder is not a CFC, because the U.S. shareholder owns only 50 percent, not more than 50 percent.

Internal Revenue Code §951, on which the rest of Subpart F is built, does not assess a tax. That section merely provides that the U.S. shareholder of a CFC must include in gross income certain items of the CFC's income on the shareholder's tax return, whether or not the CFC makes a distribution to the U.S. shareholder. Because that constructive distribution is treated by the shareholder as any other form of taxable income, the remaining provisions of Subpart F set forth the rules regarding the kinds of income that form the basis of a constructive distribution and what happens to the corporation when a constructive dividend is deemed distributed. A constructive dividend is the U.S. shareholder's share of (1) earnings invested in U.S. property (IRC §956) and (2) the foreign corporation's "subpart F income" (IRC §952).

> *NOTE:* Although the term "constructive dividend" is commonly used in this context, the amount of the constructive dividend is not treated as a dividend for tax purposes. The share of the CFC's income that a U.S. shareholder reports on his or her tax return is treated as ordinary income, regardless of the character of the income.

Earnings Invested in U.S. Property

Any earnings and profits of a CFC invested in U.S. property will generate a constructive dividend to the U.S. shareholder. The amount of the constructive dividend is the average amount of U.S. property held by the CFC at the end of a quarter, reduced by earnings and profits of the CFC previously taxed by the U.S. (as a constructive or an actual dividend to the shareholder). IRC §952(a). This rule prevents CFC shareholders from avoiding a tax on a dividend distribution by having the CFC directly invest in U.S. assets in a way that may benefit the U.S. shareholders.

Subpart F Income

Subpart F income is the most complex and the most planning-rich aspect of outbound taxation. Recall that Subpart F was enacted to combat tax abuse and not to impose a penalty. Subpart F attempts to determine when a foreign corporation is organized for a tax abusive purpose versus a business purpose. That determination is based in large part on the activities and the income of the foreign corporation.

Subpart F income consists of (1) income from the insurance of U.S. risks, and (2) "foreign base company income." IRC §952(a). In turn, the foreign base company income consists of (1) foreign personal holding company income (IRC §954(c)); (2) foreign base company sales income (IRC §954(d)); (3) foreign base company services income (IRC §954(e)); and (4) foreign base company oil-related income (IRC §954(g)) (not discussed in this article). The term "foreign base company" describes a foreign subsidiary corporation, and it is intended to apply to foreign subsidiaries in low-tax jurisdictions and tax havens.

Insurance income. Generally, a CFC's insurance income is any income earned by a foreign insurance corporation that meets two conditions: (1) the income is from premiums attributable to issuing (or reinsuring) a policy of insurance insuring against risks arising from or related to lives or activities in a country other than the country of the insurance company's place of incorporation, and (2) the company would be taxed (subject to certain modifications) as a domestic insurance company if the company were a domestic corporation. IRC §953(a). Thus, the rule applies only to foreign insurance companies that are also CFCs.

FPHC income. Foreign personal holding company (FPHC) income consists of (1) dividends, interest, rents, royalties, and annuities; (2) gain from certain property transactions; (3) gain from commodity transactions; (4) foreign currency gain; (5) "income equivalent to interest" (Treas Reg §1.954–2(a)); and (6) personal services income. IRC §954(c). With regard to item (2) above, when a CFC owns 25 percent or more of a foreign partnership, on sale of the CFC's interest in the partnership the CFC will be deemed to be selling its proportionate interest in the partnership assets. With regard to item (6) above, IRC §954(c)(1)(H) provides that FPHC income includes amounts received by a CFC under a contract under which the corporation is to provide personal services. The contract must satisfy one of the following two conditions: (1) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or (2) the individual who is to perform the services is designated (by name or by description) in the contract. IRC §954(c)(1)(H).

FPHC income also includes amounts received by the CFC from the sale or other disposition of such a services contract. IRC §954(c)(1)(H). An exception to the definition of FPHC income for CFC purposes relates to rents and royalties derived from the active conduct of a business so long as the income is not received from a related person. That exception requires the taxpayer to recognize the distinction between the active conduct of a business and a business that is not actively conducted. IRC §954(c)(2)(A).

Foreign-base company sales income. Under IRC §954(d), foreign-base company sales income includes income derived in connection with (1) the purchase of personal property from a related person and its sale to another person; (2) the sale of personal property to another person on behalf of a related person; (3) the purchase of personal property from any person and resale to another person; and (4) purchase of personal property from any person on behalf of a related person; provided, however, that the property was produced or manufactured outside the country where the CFC is created, and the property is sold for use outside the country of the CFC's incorporation. To state this rule differently, a CFC does not realize foreign base company sales income if (1) the purchase and resale of the personal property is not from or to a "related person" as defined in IRC §954(d)(3); (2) the personal property being purchased and resold is manufactured, grown, produced, or mined in the same country where the CFC is incorporated; (3) the personal property being purchased and resold is to be used or otherwise disposed of in the same country where the CFC is incorporated; or (4) the personal property is not simply purchased and resold but is altered or modified by the CFC to such a degree that the CFC can be deemed to have manufactured or produced the property.

The "manufactured" exception in IRC §954(d) is an excellent illustration of the thinking behind Subpart F. If a CFC organized in the Cayman Islands manufactures funny paper hats there, the income derived from the sale of the hats, even if sold to a related party, does not constitute Subpart F income. There is a legitimate business reason for organizing the foreign corporation in the Cayman Islands; the corporate structure is not tax driven, and therefore, Subpart F is not intended to apply. The earnings of the Cayman Islands corporation are not taxed to the U.S. shareholders until distributed out to them.

The basic component of Subpart F income is that a person related to the CFC is involved in the transaction, usually as either a buyer or a seller. Thus, if the CFC purchases the personal property from a stranger and resells it to another stranger, the income generated by the CFC from that transaction is not foreign-base company income, even if all the other attributes of a tax haven operation are present. IRC §954(d)(1).

A "related person" includes an individual, trust, estate, partnership, or corporation. An individual, trust, estate, or partnership is related to the CFC if one of those entities even indirectly owns more than 50 percent of the total combined voting power of the CFC. IRC §954(d)(3). In the case of corporations, the rules are somewhat more complex. Another corporation will be deemed related to the CFC if (1) the other corporation owns more than 50 percent of the CFC's voting stock; (2) the CFC owns more than 50 percent of the other corporation's voting stock; or (3) a person or group of persons owns more than 50 percent of the outstanding voting stock of both the CFC and the other corporation. IRC §954(d)(3). A related person can be either a foreign person or a domestic person (*i.e.*, a citizen, resident, or nonresident). See IRC §954(d)(3).

EXAMPLE

Apple Inc. wholly owns a subsidiary corporation in Ireland. The Irish subsidiary co-owns all of Apple intellectual property. The Irish subsidiary is a CFC. The Irish subsidiary purchases iPads from the manufacturer in China and resells to customers throughout the world. Because the Irish subsidiary does not purchase from Apple or sell to Apple, its income does not constitute foreign-base company sales income. To date, Apple's Irish subsidiary has accumulated over $100 billion in earnings and profits that have never been taxed by the U.S.

Foreign-base company services income. Foreign-base company services income is income derived from the performance of services, if, but only if, those services (1) are performed by the CFC for or on behalf of a related person, and (2) are performed outside the country of incorporation of the CFC. IRC §954(e).

A CFC's shareholder can disregard insurance income and foreign-base company income if (1) the combination of the two is less than the lesser of $1 million or 5 percent of gross income (the de minimis exception) (IRC §954(b)(3)(A)), or (2) the CFC's income is subject to a high tax (greater than 90 percent of the highest U.S. corporate tax rate) by the foreign country (IRC §954(b)(4)). Note that the logic of Subpart F is again apparent here. If the CFC has very little Subpart F income, or if its earnings and profits are subject to a high tax rate, then it was likely not organized for a tax avoidance purpose.

Taxation of Foreign Trusts

For U.S. income tax purposes, a trust may be either a grantor trust under IRC §671 or a non-grantor trust, and the assets of the trust may either be included in the settlor's or beneficiary's U.S. estate under IRC §2036 or be excluded from the estate. These rules apply equally to both domestic and foreign trusts, with certain caveats as follows:

A foreign trust settled by a U.S. person will always be a grantor trust if there is a U.S. beneficiary. IRC §679(a)(1). A foreign trust settled within 5 years prior to the settlor's immigration to the U.S. will likewise be treated as a grantor trust. IRC §679(a)(4).

Internal Revenue Code §7701(a)(30)(E) provides that the term "United States person" includes any trust if (a) a court within the U.S. is able to exercise primary supervision of the administration of the trust (the so-called court test), and (b) one or more U.S. persons have the authority to control all substantial decisions of the trust (the so-called control test). A trust will be treated as a U.S. person on any day that the trust meets both the court test and the control test. A foreign trust is any trust other than one described in IRC §7701(a)(30)(E).

If a trust is deemed to be a foreign trust for U.S. tax purposes, any transfer of appreciated property to the trust will be treated as a sale to the trust, and the trust will be subject to substantially increased reporting requirements under IRC §§684 and 6048. If a foreign trust is classified as a grantor trust, there is no tax on the transfer of assets into trust (the grantor is deemed to sell assets to himself or herself), but the reporting requirements still apply. IRC §§671, 679.

Under IRS Notice 97–34, 1997–1 Cum Bull 422, 1997 IRB Lexis 179, a transfer of assets to a foreign trust must be reported on IRS Form 3520 and the trust must file IRS Form 3520-A annually. A beneficiary who receives a distribution from a foreign trust must likewise report the distribution on IRS Form 3520.

Passive Foreign Investment Companies

A passive foreign investment company (PFIC) is any foreign corporation that meets either of two tests: (1) 75 percent or more of the corporation's gross income for the taxable year is passive; or (2) 50 percent or more of the corporation's assets are passive assets, *i.e.*, assets that do not produce business income. IRC §1297(a)(1)–(2). If a foreign corporation is both a PFIC and a CFC, then as to the U.S. shareholders (the 10-percent-or-greater shareholders), the foreign corporation is a CFC and not a PFIC. PFIC classification generally applies to foreign corporations that are mutual funds, investment funds, hedge funds, or private equity funds.

Note that the PFIC classification applies to all shareholders, not just the 10-percent-or-greater shareholders. Similar to foreign corporations classified as CFCs, the corporation itself is not taxed by the U.S., but only those shareholders that the U.S. can tax.

As a general rule, taxation of a PFIC shareholder depends on various factors, the most important of which is the PFIC's status or nonstatus as a qualified electing fund (QEF). IRC §1295. The shareholder of a QEF is required to take his or her share of the PFIC's ordinary income into his or her own income as a constructive dividend. IRC §1293(a)(1). If the actual dividend distribution from the PFIC to the shareholder exceeds the constructive dividend, the shareholder pays an interest charge on the excess distribution. IRC §1291(a)(1).

QEF status is elected by a shareholder, and the same foreign corporation may be a QEF PFIC as to one U.S. stockholder and a non-QEF PFIC as to another.

A shareholder who has elected QEF status follows the general rules familiar to U.S. shareholders of CFCs. Specifically, the QEF shareholder takes into income (1) his or her prorata share of the PFIC's ordinary earnings; (2) constructive distributions from earnings invested in (a) U.S. property and (b) excess passive assets; and (3) the PFIC's net long-term capital gain as a capital gain. IRC §1298.

Another possible election for the shareholder is the mark-to-market election under IRC §1296. The mark-to-market election allows the shareholder to report and be taxed on any year-to-year increases in the value of the securities owned by the PFIC.

A shareholder who has not made a QEF or mark-to-market election is subject to the interest charge on his or her share of the constructive dividend under the IRC §1291 excess distribution regime. No tax is paid on a constructive distribution, but interest is paid on the deferred tax liability. The interest is the underpayment rate charged by the IRS, but is compounded daily. IRC §1291(c)(3). The same rules apply to the gain realized on the disposition of PFIC stock. A QEF or mark-to-market election not made in the first year (*i.e.*, made in the second year and later) is pricey because the shareholder must first make a so-called purging election, under which all of the PFIC's holdings will be deemed sold and taxable gain recognized. IRC §1291(d)(2). Further, the disposition of the stock of a PFIC for which the shareholder has not made an election in the first year of ownership and which was not purged will be subject to tax at ordinary income rates. IRC §1291(a)(2).

The Foreign Tax Credit

U.S. taxpayers who pay foreign income or excess profits taxes to a foreign country can elect a direct credit or a deduction for foreign taxes paid. IRC §901(a). The decision whether to credit or deduct foreign income taxes must be made each year. Although it is generally accepted that a tax credit is far superior to a deduction in the normal situation, an example is often required to bring into focus the difference in result between the use of a credit and the use of a deduction.

EXAMPLE

Assume a U.S. taxpayer has total taxable income of $100,000, all of which is derived from France. Assume further that the overall tax rate in France is 50 percent and that the tax rate in the United States is likewise 50 percent. Without a tax credit, but allowing the taxpayer a deduction for foreign taxes paid, the effective rate of tax, on the above facts, is 75 percent, calculated as follows:

	Net Taxable Income	Tax	Net Income After Tax
France	$100,000	$50,000	$50,000
United States	$50,000	$25,000	$25,000

Because the taxpayer is a U.S. taxpayer, the taxable income for U.S. purposes is net taxable income, less the deduction allowed for the foreign taxes paid. If, however, the taxpayer chose to credit the French tax, the result (a 50 percent effective tax rate) is as follows:

	Net Taxable Income	Tax	Credit	Net Income After Tax
France	$100,000	$50,000	0	$50,000
United States	$100,000	$50,000	$50,000	$50,000

In addition to the election to take the credit or deduct the tax, a cash-basis taxpayer has an election to treat foreign taxes as if the taxpayer were utilizing the accrual method of accounting. See IRC §905(a). That election is necessary to allow the credit to have significance to cash-basis taxpayers who have uneven years of income and foreign taxes and who might otherwise lose the foreign tax credit. Unlike the election to credit rather than deduct, the election to accrue, once made, is binding for subsequent years.

Although there are strict limitations on the amount of credit allowed, within the scope of those limitation provisions taxpayers are allowed to reduce their federal income tax, dollar for dollar. To be creditable against federal income taxes, the levy—*i.e.*, the foreign payment—must be an income tax within the general definition of that phrase under U.S. law. The levy must also be a tax, as distinguished from a fee, fine, or other payment to a foreign governmental agency. A payment in exchange for a specific economic benefit is not a tax, nor is a subsidy a tax.

In accordance with the deemed-paid credit, a domestic corporate shareholder, on receipt of dividends from a foreign corporation in which the domestic corporation owns at least a 10 percent interest, is allowed to credit the foreign taxes paid by that foreign corporation that relate to the dividend. IRC §902(a). The domestic corporate shareholder may take a credit against domestic income tax for the foreign-income and excess-profits taxes that have been paid by the foreign subsidiary corporation if certain conditions are met: (1) The domestic corporate shareholder must own 10 percent or more of the voting stock of the foreign corporation; (2) the foreign subsidiary's earnings and profits must have resulted from operations subject to the foreign country's or countries' income tax; and (3) some or all of those earnings and profits must be distributed to the domestic corporate shareholder as a dividend. See IRC §902.

IC-DISCs

An IC-DISC (interest charge—domestic international sales corporation) is Congress's tax gift to U.S. exporters. It is a U.S. corporation that is either a subsidiary or a sister company of a U.S. exporter, to which the exporter either pays a commission or sells its products, which are then exported by the IC-DISC. The exporter deducts the commission paid, and the IC-DISC is not taxed on the commission received, subject to the rules discussed below.

Usually it is the U.S. exporter that enters into contracts with its customers and arranges for shipment, billing, and collections. The U.S. exporter's business partners need not be aware of the IC-DISC's existence. It is often nothing more than a paper company.

The IC-DISC rules allow an exporter to either (1) convert ordinary income into a qualifying dividend, or (2) indefinitely defer U.S. income taxation on 50 percent of its net income from the first $10 million in foreign sales. It is a very significant tax benefit and is available to any business that exports, *e.g.*, movie producers, software developers, architects and engineers, and manufacturers of every stripe.

IC-DISC Eligibility Requirements

To qualify as an IC-DISC, a U.S. corporation must meet the following requirements:

- It must be duly incorporated and existing under the laws of any U.S. state;
- 95 percent or more of the corporation's gross receipts must consist of qualified export receipts (as defined in IRC §993(a)(1) and addressed in more detail below);

- The adjusted basis of the corporation's qualified export assets (as defined in IRC §993(b) and addressed in more detail below) at the close of the taxable year must equal or exceed 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year;
- The corporation must not have more than one class of stock and the par or stated value of its outstanding stock must be at least $2500 on each day of the taxable year;
- The corporation must make an election within 90 days of its first tax year (or, if it is an existing corporation, within 90 days of the start of a new tax year) to be treated as an IC-DISC by filing IRS Form 4876-A and receiving the consent of all shareholders;
- The corporation must maintain separate books and records;
- The corporation must not be a tax-exempt corporation, an S corporation, or certain other corporations that are ineligible to be DISCs; and
- The corporation must not be in the same control group as a foreign sales corporation.

IRC §992; Treas Reg §§1.992–1, 1.992–2.

Qualified export receipts are defined in IRC §993(a)(1) to include receipts and services related to such receipts from the sale, exchange, lease, or rent of export property. Services related to the sale, exchange, lease, or rent of export property may include warranty, maintenance, repair, and transportation. Qualified export receipts do not include receipts and related services from the sale, exchange, lease, or rent of property for ultimate use in the U.S. IRC §993(a)(2).

Export property means property (1) manufactured, produced, grown, or extracted in the U.S. by someone other than the IC-DISC; (2) sold, leased, or rented in the ordinary course of business outside the U.S., and (3) having at least 50 percent foreign content. IRC §993(c)(1). The second item above will be deemed satisfied if the property is delivered to a carrier or freight forwarder for shipment outside the U.S. With the exception of copyrights used in the motion picture or recording industries, export property does not include intellectual property of any kind. IRC §993(c)(2).

Qualified export assets must be documented in the IC-DISC application and must include assets used primarily in connection with the sale, lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, and certain accounts receivable, bank accounts, producer's loans (loan by the IC-DISC of its accumulated tax-deferred profits to its U.S. parent manufacturing company), and obligations. IRC §993(b).

If a corporation fails to qualify as an IC-DISC because it does not meet the 95 percent gross receipt test or the 95 percent export assets test, it can still qualify by distributing to its shareholders all of its gross receipts or assets that are not qualified. IRC §992(c).

Tax Status of IC-DISCs

IC-DISCs are C corporations but are exempt from federal income tax. IRC §991. State taxation is less certain, with approximately half of the states following the federal tax treatment and the remainder taxing IC-DISCs. As a practical matter, IC-DISCs are often organized in Delaware or another state that does not tax income. (Practitioners should note that California law does not conform with federal law regarding IC-DISCs and that California will tax the amount deducted for federal purposes. See Rev & T C §23051.5(b)(1).)

Following organization, the corporation (1) files IRS Form 4876-A within the time prescribed in the Internal Revenue Code, (2) enters into a commission agreement with the U.S. exporter outlining the services to be performed by the IC-DISC for the sale of export property, (3) opens a bank account with a minimum capital contribution of $2500, (4) maintains its own books and records to track commission payments, and (5) annually file IRS Form 1120-IC DISC and any required state income tax returns.

IC-DISC as Transfer Pricing Mechanism

The IC-DISC is effectively a transfer pricing regime, *i.e.*, income is transferred from the U.S. exporter to the IC-DISC by allowing the exporter to deduct the commission paid. IRC §994; Treas Reg §1.994–1(a). The income is transferred either by paying the IC-DISC a commission for its services or by selling products to IC-DISC, which it then exports. Even though all transactions with IC-DISCs have no substance, the distinction between the payment of commission and the resale of products is not purely semantic. A commission IC-DISC is protected by the safe-harbor rules of IRC §994 (discussed below), while a buy/sell IC-DISC must satisfy the transfer pricing rules of IRC §482.

To qualify for the safe-harbor of IRC §994, the commission cannot be greater than (1) 4 percent of the IC-DISC's qualified export receipts on reselling the property plus 10 percent of its export promotion expenses, or (2) 50 percent of the combined taxable income from export sales of the exporter and the IC-

DISC plus 10 percent of the IC-DISC's export promotion expenses. IRC §994(a). Note that it is 4 percent of up to $10 million in export sales (always $400,000) or 50 percent of taxable income generated on the first $10 million in export sales (this varies based on profitability)—which are two very different measures. The 4 percent method may be calculated using the marginal-costing method to determine the profit from the sale of export property. The marginal-costing method takes into account only the direct labor and material costs of production, resulting in a higher profit. Treas Reg §1.994–2(a).

IC-DISC Ownership and Other Issues

The ownership of an IC-DISC is not restricted, and there is no limitation on the number of IC-DISCs that may be formed. It may be a subsidiary of the exporter, may have common shareholders, or may have one of the more advanced ownership structures discussed below. The exporter itself may be a C or an S corporation, an LLC taxed in any form, or an individual. S corporations, partnerships, and other disregarded entities are often used as shareholders of IC-DISCs to allow for flow-through income tax treatment of dividend distributions by IC-DISCs.

As noted above, the IC-DISC is exempt from tax, and tax on its income is deferred to the extent not distributed to its shareholders. The tax may be deferred only on the first $10 million of qualified export receipts. IRC §995(b)(1)(E). When qualified export receipts exceed $10 million, shareholders are taxed on the excess as a deemed dividend from the IC-DISC at the preferential dividend rate. IRC §995(b)(1)(E). The shareholders pay an annual interest charge (at the 1-year Treasury constant maturity yield rate (which is currently 0.11 percent) on the tax that is deferred. IRC §995(f)(1). The interest charge is computed on IRS Form 8404.

If the IC-DISC distributes its income currently, shareholders are taxed at the preferential 20 percent qualifying dividend tax rate. Treas Reg §1.995–1(a)(2). Thus, even without a deferral, the use of an IC-DISC structure allows the exporter to deduct a commission paid to an IC-DISC at its ordinary income tax rate (currently, a maximum of 39.6 percent for individuals and 35 percent for corporations), and then tax the same commission amount to the shareholders at the 20 percent tax rate.

If the shareholder of the IC-DISC is located in a favorable tax treaty country, the dividend may be either significantly reduced or eliminated entirely.

The benefits of IC-DISCs are not limited to reducing the exporter's income tax liability. Assume that the IC-DISC is owned by an irrevocable trust settled by the owner of the exporter for the benefit of his or her children. Each commission payment to the IC-DISC not only generates an income tax deduction for the exporter, but also transfers wealth to the younger generation and retains the wealth inside of an irrevocable trust, protected from the claims of creditors.

EXAMPLE

Jerry and Elaine manufacture and distribute breakfast cereal. In 2014 their sales were $14 million, of which $10 million (conveniently) were attributed to sales in Europe and the remainder in the U.S. Their net income was $3.5 million, with $2.4 million attributable to Europe. Jerry and Elaine form a Delaware corporation, transfer ownership to an irrevocable trust, and name their child Cosmo as the trust beneficiary. The trust makes an IC-DISC election for the Delaware corporation and has the corporation enter into a commission agreement with Jerry and Elaine. The commission that Jerry and Elaine can pay to the IC-DISC is the greater of $400,000 (4 percent of foreign sales) or $1.2 million (50 percent of net income attributable to foreign sales). Each year they deduct $1.2 million (realizing an economic benefit of $475,200 at the 39.6 percent tax rate) and transfer the same amount out of their estate. If the IC-DISC retains the $1.2 million, a nominal interest charge is paid. If the IC-DISC dividends out the $1.2 million, Cosmo pays a 20 percent tax on dividends received, *i.e.*, $240,000 (assuming the trust currently distributes all of its income). Even with a current dividend and no deferral, Jerry and Elaine achieve an income tax arbitrage of $235,200 per year.

EXPATRIATION

Expatriation refers not simply to leaving the U.S. and living abroad, but rather to surrendering U.S. citizenship or permanent residency. If someone does surrender U.S. citizenship, moves abroad, and acquires a new citizenship, the U.S. government may be unable to recover taxes due to it by the expatriate, because the U.S. will no longer have personal jurisdiction over that person. Consequently, the expatriation rules of the Internal Revenue Code seek to exact a tax from the expatriate while the U.S. still has jurisdiction. This tax is commonly referred to as the "exit tax."

Expatriation may present a long-term income tax advantage. U.S. taxpayers are subject to federal income taxes on their worldwide income, while nonresident aliens (individuals who are neither U.S. citizens nor U.S. residents) are subject to tax only on their U.S.-source income.

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The current expatriation rules are governed by the so-called Reed Amendment (8 USC §1182(a)(10(E)) passed in 1996 as part of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (Pub L 104–208, 110 Stat 3001) and by the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) (Pub L 110–245, 122 Stat 1624). The Reed Amendment allows the U.S. Attorney General to deny reentry of a former citizen to the U.S. if the Attorney General determines that expatriation was for the purpose of tax avoidance. To date, the Reed Amendment has not been invoked in any case.

The HEART Act introduces a mark-to-market regime for expatriates, by taxing the expatriate on all of the accrued appreciation in his or her property on the date of the expatriation. See IRC §877A. Expatriation is reported by filing IRS Form 8854. This is a one-time filing requirement, and it replaces the 10-year filing requirement that existed prior to the HEART Act.

Covered Expatriates

New IRC §§877A and 2801 introduced by the HEART Act apply to "covered expatriates." A covered expatriate is defined in IRC §877A(g) with reference to IRC §877(a)(2) as a person who relinquishes his or her U.S. citizenship or permanent resident status (held for at least 8 of the prior 15 years) and who (1) has an average annual net income tax liability for the preceding 5 years of $157,000 (for 2014), (2) has a net worth of $2 million or more, or (3) fails to certify compliance with U.S. tax obligations for the prior 5 years.

An individual who was born a citizen of the U.S. and another country and still retains his or her citizenship and residency in the other country will not be subject to the exit tax if he or she was not resident in the U.S. for more than 10 of the preceding 15 years. IRC §877A(g). This provision covers dual citizens who spend most of their time living in the other country in which they are citizens.

Amount and Payment of Exit Tax

The mark-to-market rules of the HEART Act subject covered expatriates to a tax on the unrecognized gain in their property to the extent that such gain exceeds $680,000 (for 2014). IRC §877A(a)(3). Effectively, the covered expatriate is treated as if he or she sold all of his or her assets, worldwide, for their fair market value on the day before expatriation.

The payment of tax may be deferred if the covered expatriate posts a bond to secure the payment of tax. The election to defer may be made on a property-by-property basis. The deferred tax liability accrues interest at the underpayment rate. IRC §877A(b).

[I]n California, spouses may enter in a transmutation agreement, making certain assets the separate property of the spouse that will remain a U.S. citizen, thus reducing the assets of the expatriating spouse.

The IRS has published Notice 2009–85, 2009–2 Cum Bull 598, 2009 IRB Lexis 653, to provide substantive guidance on these rules. For example, the Notice provides that when determining what assets to include in the tax base of the exit tax, the estate tax rules (*i.e.*, rules for determining what assets would have been included in the expatriate's estate if he or she had died on the day before the expatriation) are to be used, and the assets will be subject to the mark-to-market rules, using the valuation principles used in the estate tax arena.

If the covered expatriate owns tax-deferred accounts (*e.g.*, a 401(k) plan), he or she must file IRS Form W-8CE with the plan. Filing of the form notifies the plan that all payments from the plan to the covered expatriate are subject to income tax withholding at the rate of 30 percent. IRAs and certain other specific plans are subject to an immediate exit tax. See IRC §877A(e).

A new set of rules has been introduced by the HEART Act that tax gifts made by covered expatriates to U.S. citizens and residents (other than to a spouse or a charity). See IRC §2801. This gift tax liability is imposed on the recipient of the gift. While the old rules applied for only 10 years following expatriation, the new rules apply without a time limitation. The new gift tax rules apply whether the gift was made directly or through a trust.

Expatriation Planning Opportunities

Expatriation planning is all about planning in advance. For example, the exit tax applies to the extent that all assets owned by the expat have a built-in gain in excess of $680,000. If the expatriate owns a residence, he or she is not allowed to increase that threshold by the IRC §121 gain-exclusion amount. A personal residence should be sold prior to expatriation, taking advantage of the §121 gain exclusion. Further pre-expatriation planning can be accomplished when only one spouse expatriates and the other remains a U.S. citizen. For example, in California, spouses may enter in a transmutation agreement, making certain assets the separate property of the spouse that will remain a U.S. citizen, thus reducing the assets of the expatriating spouse.

Only assets with a built-in gain present a problem in the mark-to-market regime. Slowly converting property into liquid form may solve that problem. Using valuation rules applicable in the estate tax arena speaks to the value of using valuation discount structures (such as the family limited partnership) to obtain a valuation discount for purposes of the exit tax.

It is also generally desirable to position the expatriate to own fewer assets in the U.S. and more assets outside the U.S.