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Featured Perspectives

The 1984 Italy-U.S. Tax Treaty: Who Said You Can't Teach an Old Dog New Tricks?

by Alessandro-Adelchi Rossi

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The United States is not unlike Italy after all — at least when it comes to folding tax provisions into bills that have little or nothing to do with taxes.

So was the case with the Health Insurance Portability and Accountability Act of 1996, legislation intended to help workers maintain health benefits coverage when changing jobs. Tacked onto that legislation was a section affecting wealthy Americans who move abroad, not exactly a group of folks that you would expect would worry about a lack of medical coverage.

Legislation addressing the expatriation by the rich was hardly a novelty. Congress enacted section 877[1] in 1966 to discourage U.S. citizens from surrendering their U.S. citizenship to avoid paying U.S. taxes on their U.S.-source investment income when the top individual tax rate was 70 percent.

In that same year, the rate of tax imposed on U.S.-source nonbusiness income of a nonresident alien individual was the same as under current law (30 percent). Thus, the tax incentive for individuals to relinquish U.S. citizenship and move abroad was considerable and, at least for taxation of U.S.-source investment income, substantially higher than it is today.[2]

But the law had no teeth, and it was difficult for the IRS to prove — as the law then stipulated — that a taxpayer had renounced citizenship solely to avoid taxes. In light of its perceived shortcomings, in 1996 the law was expanded and substantially strengthened. One major change was the extension of the expatriation tax provisions to apply not only to U.S. citizens who lose their citizenship but also to some long-term residents[3] of the United States whose U.S. residency is terminated.[4]

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[1]Unless otherwise stated, all section references are to the Internal Revenue Code of 1986 as amended and the regulations issued thereunder.

[2]Currently, the top rate on individual taxpayers is 35 percent.

[3]For this purpose, section 877(e)(2) defines long-term resident as an individual (other than a U.S. citizen) who was a lawful permanent resident of the United States for at least 8 out of the 15 tax years ending with the year in which the termination of U.S. residency occurs. However, an individual is not treated as a lawful permanent resident for any tax year if the individual is treated as a resident of a foreign country for that year under a tie-breaker provision in the treaty and the individual does not elect to waive the benefits of the treaty.

[4]For the purpose of section 877, an individual's long-term U.S. residency is treated as terminated when the individual (1) ceases to be a lawful permanent resident of the United States because the individual's green card status is lost (see

(Footnote continued on next page.)

As a result, non-U.S. citizens who happen to spend several years in the U.S. before returning to their home country may now fall in the net of legislation originally intended for wealthy Americans. For Italian individuals, however, the 1984 income tax treaty between Italy and the U.S. may come to the rescue.

General Application of Section 877

Section 877 generally provides that a citizen who loses U.S. citizenship, or a long-term resident who ceases to be taxed as a U.S. resident, is subject to the alternative method of taxation under section 877 for a 10-year period if:

- the average annual net income tax liability for the five tax years preceding expatriation is greater than $124,000 (subject to a cost-of-living adjustment for calendar years after 2004);
- the net worth as of that date is at least $2 million; or
- the person fails to certify under penalties of perjury that he complied with all of his U.S. tax obligations for the five preceding tax years or fails to submit such evidence of compliance if requested by the Treasury.[5]

When meeting one of these requirements, the expatriating individual is conclusively presumed to have terminated his citizenship or residency with a principal purpose of tax avoidance. Since 2004 the individual's motivation for expatriation is no longer relevant. Congress abandoned this motive test in favor of more objective standards because it concluded that the test was a source of difficulties in administering the alternative regime.

Under the alternative method of taxation, the former U.S. citizen or long-term U.S. resident will be subject to U.S. income tax on his U.S.-source income at the rates generally applicable to U.S. persons rather than at the rates applicable to other nonresident aliens. Also, and to make matters worse, a former U.S. citizen or long-term resident spending more than 30 days in the United States in any tax year may be subject to full U.S. taxation.[6]

The alternative method of taxation and the full U.S. taxation applicable to former U.S. citizens and long-term U.S. residents are discussed below.

U.S.-Source Expansion

For the purpose of the expatriation rules, the range of income items treated as U.S.-source is expanded compared with the range of items generally considered U.S.-source.[7] For example, gains from the sale or exchange of a U.S. corporation's stock or debt obligations of U.S. persons are treated as U.S.-source income. Thus, the normal source rules applicable to these gains do not apply for purposes of the alternative tax calculation under section 877.[8] Similarly, gain or income derived from stock in a foreign corporation is generally treated as U.S.-source income for purposes of section 877(b) if an expatriate owned, or is treated as owning at any time during the two-year period ending on the date of expatriation, more than 50 percent of the total combined voting power or total value of the corporation's stock.[9] Also, some property transferred in nonrecognition exchanges by an individual subject to section 877 during the 10-year period starting with the date of expatriation will be treated as sold for its fair market value on the date of the exchange.[10]

By way of illustration, consider an Italian citizen, X, who loses his green card on January 1, 2007, and is subject to section 877. On June 30, 2008, X transfers the stock he owns in a U.S. corporation, USCo, to a wholly owned Italian corporation, ITCo, in a transaction that qualifies for tax-free treatment in the United States. USCo does not have any interest in U.S. real property. At the time of the transfer, X's basis in the stock of USCo is $1 million and the fair market value of the stock is $1.5 million.

Without section 877, X would not be subject to U.S. tax on the $500,000 of gain realized on the exchange, as income from the sales of property by a nonresident is sourced outside the U.S.[11] Moreover,

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the cross reference to 7701(b)(6)(B) under section 877(e)(1)(A)), or, alternatively, is treated as a resident of a foreign country under a tie-breaker provision in the treaty and the individual does not elect to waive the benefits of the treaty (see section 877(e)(1)(B)), and (2) the individual complies with the section 7701(n) reporting requirements discussed below.

[5]Section 877(a)(2).

[6]Section 877(g).

[7]Section 877(d)(1).

[8]The special source rules apply only for purposes of calculating the nonresident alien's tax liability under section 877(b). Thus, an expatriate subject to tax under section 877 remains a nonresident alien for purposes of other IRC provisions. For example, income treated as having a U.S. source solely by reason of section 877 is not subject to withholding under section 1441.

[9]Section 877(d)(1)(c).

[10]Section 877(d)(2). The statute provides for additional expatriation rules and exceptions that are beyond the scope of this article.

[11]Section 865(a)(2).

X would not be subject to U.S. tax on any distribution of the proceeds from a subsequent disposition of the USCo stock by ITCo.

However, under the expatriation rules, X would generally be deemed to have sold the USCo stock for $1.5 million on the date of the transfer and would be subject to U.S. tax in 2008 on the $500,000 of gain realized.[12]

Therefore, under section 877, and when meeting specific conditions, an Italian citizen and former longtime U.S. resident may be subject to the alternative tax of section 877(b). This alternative tax generally applies for 10 years after residence was lost to a former long-term resident if his prior U.S. tax liability or net worth exceeds the prescribed threshold.

Denial of Favorable Tax Treatment

Former citizens and residents are also denied favorable tax treatment in a few other contexts. For example, section 121 — which generally excludes from gross income up to $250,000 ($500,000 for joint return filers) of gain on a sale or exchange of a taxpayer's principal residence — does not apply to a former U.S. citizen or resident alien to whom section 877 applies for the tax year during which the sale occurs.[13]

Also, taxation under this alternative method also has some U.S. estate tax ramifications. The gross estate of a decedent, who, at the time of death, was subject to section 877, is determined in the same manner as the estate of a nonresident alien subject to some modifications. Although the gross estate is generally determined using the situs rules applicable to a nonresident alien, the situs rule for corporate stock is expanded to include a portion of the value of the stock of a foreign corporation.[14]

Reporting Requirements

To make matters worse, a new rule was added in 2004 to generally tax a former U.S. citizen or long-term resident on worldwide income for any tax year in which the former U.S. citizen or long-term resident is physically present in the United States for 30 days or more.[15] In other words, meeting the 30-day presence test will cause the alternative method of taxation to no longer apply to the former citizen or long-term resident; instead, he will be treated as a U.S. citizen or resident for the tax year and will therefore be subject to full U.S. taxation on all of his worldwide income, regardless of the source and nature of the income.

Also, under another provision added in 2004, an individual who ceases to be a U.S. citizen or long-term resident will retain his U.S. status for U.S. tax purposes until he (1) gives notice to the secretary of state or the secretary of homeland security of an expatriating act or termination of residence and (2) provides a statement in accordance with section 6039G.[16] Both the notice and the statement may be given by filing Form 8854.

Furthermore, in 2004 the information reporting requirements[17] for individuals subject to section 877, and for individuals not subject to section 877 who have expatriated or have terminated their long-term resident status, were revised to require an annual statement to be filed under section 6039G on Form 8854.[18]

Thus, Form 8854 serves as both the initial and annual expatriation information statement for U.S. tax purposes and is also considered sufficient notice to the secretary of state or the secretary of homeland security of an act of expatriation or termination of residence.

[12]The example assumes that X does not enter into a gain recognition agreement with the U.S. tax authorities under the section 367 regulations. Should he enter into such agreement, X would not be required to recognize for U.S. tax purposes in 2008 the $500,000 of gain realized on the transfer of the USCo stock to ITCo. However, under the gain recognition agreement, for the 10-year period ending on December 31, 2016, any income (e.g., dividends) or gain from the ITCo stock would be treated as U.S.-source income; therefore, X would be subject to tax on the income or gain under section 877. If ITCo disposes of the USCo stock on January 1, 2013, X's gain recognition agreement would terminate on that date, and X would be required to recognize as U.S.-source income the $500,000 gain that he previously deferred under the gain recognition agreement.

[13]Section 121(e).

[14]Section 2107(b). The impact, if any, of the expatriation rules on the 1955 Italy-U.S. estate tax treaty is beyond the scope of this article.

[15]Section 877(g). Section 877(g)(2) provides for some exceptions for employment-related presence in the U.S.

[16]Section 7701(n).

[17]Section 6039G.

[18]U.S. citizens and long-term residents subject to section 877 must file Form 8854 for each of the 10 years during which the alternative method applies, even if no U.S. federal income tax is due for any of those years. The penalty for failure to file this statement is $10,000, unless the individual can show that the failure is due to reasonable cause and not to willful neglect. However, U.S. citizens and long-term residents to whom section 877 does not apply must file Form 8854 only once so as to notify the U.S. authorities of their intention to terminate U.S. tax residence. While for these individuals there is no due date to file Form 8854, failure to file it will result in continuing U.S. tax status until this filing requirement is met.

Section 877 and the Treaty

Under the saving clause of the 1984 Italy-U.S. tax treaty currently in force (the 1984 treaty), the United States preserves its right to tax former U.S. citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax.[19]

The former citizens are taxable in accordance with section 877 for 10 years following the loss of citizenship. Because the saving clause applies only to former citizens, it follows that the U.S. domestic expatriation rules conflict with the 1984 treaty to the extent they apply to former long-term residents.

The Italy-U.S. tax treaty and protocol signed on August 25, 1999 (the 1999 treaty), added language[20] to expand the application of this rule for former U.S. citizens to former long-term residents whose loss of such status had as one of its principal purposes the avoidance of tax.[21] However, the 1999 treaty is still pending as it has not yet been ratified. Therefore, the 1984 treaty, which contains clauses that help former U.S. long-term residents avoid U.S. taxes, remains valid.

While most countries, in their domestic legislations, take the approach that tax treaties are binding rights and obligations on the contracting countries under public international law,[22] the U.S. has notoriously adopted a general rule according to which neither a treaty provision nor a statutory provision has a preferential status merely by reason of its being a treaty or a statute.[23] Thus, in the United States, when a statute and a treaty provision conflict, the later in time generally controls, although such provisions should be given a harmonious construction whenever possible.[24]

Hence, the issue is whether the statutory provisions of section 877 as modified in 1996 and 2004 override the preexisting U.S. treaty obligations with Italy, as discussed below.

Interaction of 1984 Treaty and Section 877

In line with the later-in-time approach, the 1996 House report on the expatriation rules indicates that their purpose is not to be defeated by any treaty provision to the extent that section 877 provides, as it does,[25] for a foreign tax credit for items taxed by another country.[26]

Therefore, in the event of a conflict, the expatriation rules under U.S. domestic law generally would prevail over the earlier 1984 treaty.

However, the legislative history also indicated that Congress expected the Treasury Department to review all outstanding treaties to determine whether the expatriation tax provisions, as revised, potentially conflict with treaty provisions and to eliminate any potential conflicts through renegotiation of the affected treaties as necessary. The House report went on to state: "Beginning on the tenth anniversary of the enactment of the House bill, any conflicting treaty provisions that remain in force would take precedence over the expatriation tax provisions as revised." The House bill was enacted on August 21, 1996.

Yet this statement — which might have done the trick for Italian citizens who terminated their U.S. long-term residence status after August 21, 2006 — was not codified in the legislation. As one commentator noted,[27] because the statement is inconsistent with the normal later-in-time rule applicable under U.S. law, without legislative language to implement it, it would lack legal effect.

With Notice 97-19,[28] the IRS issued guidance regarding the interaction of section 877 and tax treaties entered into by the United States. In accordance with congressional intent, the tax authorities interpreted section 877 as consistent with U.S. income tax treaties in effect on August 21, 1996, but only until August 21, 2006.[29]

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[19]Para. 1, art. 1 of the protocol to the 1984 treaty.

[20]Protocol art. 1(1). This provision applies for a period of 10 years following the loss by an individual of his citizen or long-term resident status.

[21]This provision of the 1999 treaty is outdated. Section 877 was amended in 2004 so that the motive for expatriation is no longer relevant.

[22]*See* article 26 of the Vienna Convention of the Law of Treaties of May 23, 1969. The U.S. has signed the convention but has not yet ratified it. Thus, its status as customary international law for U.S. treaty interpretation purposes is uncertain, although U.S. courts regularly cite the convention, despite the fact that the U.S. is not a party.

[23]Section 7852(d)(1).

[24]*See* section 894(a)(1), under which code provisions are to be applied to any taxpayer with "due regard" to any U.S. treaty obligation.

[25]This credit is available only against the U.S. tax imposed as a result of the expatriation tax provisions and may not be used to offset any other U.S. tax liability.

[26]H.R. Rep. No. 496, 104th Cong., 2d Sess. 155 (1996). *See also* H.R. Conf. Rep. No. 736, 104th Cong., 2d Sess. 329 (1996).

[27]J. Kuntz and R. Peroni, *U.S. International Taxation* (WG&L), retrieved August 10, 2007, from RIA Checkpoint database.

[28]Notice 97-19, 1997-1 CB 394 (modified by Notice 98-34, Sec. IV, 1998-27 IRB 30). Both notices were partially obsoleted by Notice 2005-36, 2005-19 IRB 1007, but only to the extent necessary to reflect amendments made by the American Jobs Creation Act of 2004, which did not affect the interaction of section 877 with section 7701(b)(10).

[29]These coordination rules do not apply to an individual who gives up and then reacquires U.S. residency under the

(Footnote continued on next page.)

Thus, the IRS effectively gave legal effect to the stated congressional intent of preserving treaty benefits when the relevant treaty has not been revised.

Notice 97-19 also provides that the IRS will interpret all treaties, whether or not in force on August 21, 1996, that preserve U.S. taxing jurisdiction over former U.S. citizens or former U.S. long-term residents who expatriated with a principal purpose to avoid U.S. taxes as consistent with the provisions of section 877. As discussed above, the 1984 treaty preserves U.S. taxing jurisdiction over former U.S. citizens but not over former U.S. long-term residents.

Accordingly, under the notice, the 1984 treaty's provisions will not prevent the United States from retaining the right to tax its former citizens who become residents of Italy. Conversely, beginning August 22, 2006, those provisions take precedence over section 877 to treat an individual, who is a resident of Italy under article 4 of the 1984 treaty, as subject to U.S. tax only to the extent allowed by that treaty.

By not being subject to section 877 because of the 1984 treaty, a former U.S. long-term resident may also benefit from the section 121 exclusion from gross income of up to $250,000 ($500,000 in the case of a joint return) of gain on a sale or exchange of a taxpayer's principal residence. As previously discussed, this exclusion would otherwise be denied to former citizens and residents.

Even assuming that the IRS, despite the position taken in Notice 97-19, may interpret the term "residents" in the 1984 treaty to include former long-term residents, the U.S. courts will likely reject a similar interpretation, as they did in the past.[30] The goal of treaty interpretation is to give the specific words a meaning consistent with the genuine shared expectations of the contracting parties.[31] In the 1984 treaty, there is no indication that that the contracting parties had the intention to define the term "residents" in article 4 more broadly than its literal meaning.

"in- and-out" rules of section 7701(b)(10). Under Notice 97-19, the provisions of a U.S. income tax treaty would prevail over the expatriation rules regardless of the passage of time from the enactment of the revised section 877 provisions.

[30]In Rev. Rul. 79-152, the IRS took the position that even in the case of treaties not containing a provision that permits taxation of U.S. citizens if the expatriation had as one of its principal purposes the avoidance of tax, the term "citizen" should be construed to incorporate such a rule, to promote the objective of section 877. This pronouncement precedes 1981, the year after which treaties entered into by the United States generally permit, for a period of 10 years, taxation of individuals who lost their citizenship principally for the purpose of avoiding U.S. tax. However, the IRS position was rejected by the U.S. Tax Court in *Crow v. Commissioner*, 85 TC 376.

[31]*Maximov v. United States,* 299 F.2d 565, 568 (2d Cir. 1962), *affd*. 373 U.S. 49 (1963).

Reporting Requirements as Amended in 2004

As discussed above, a number of changes were made in 2004. These amendments raise new issues of treaty conflict:

- *Motive*: In 2004 Congress abandoned the motive test, so that the individual's motivation test for expatriation is no longer relevant. The statute, however, contradicts the 1984 treaty, which defines citizen to "include a former citizen whose loss of such status had as one of its principal purposes the avoidance of tax."[32] The legislative history of the 2004 amendments contains no indication of whether Congress intended the amendments to override treaties. Thus, former U.S. citizens who have expatriated to Italy may contend that they are not subject to section 877 if they have not been determined to have expatriated for tax avoidance purposes.
- *30-day rule*: A rule was also added in 2004 to generally tax a former U.S. citizen or long-term resident on worldwide income, regardless of the source and nature of the income, for any tax year in which the former U.S. citizen or long-term resident is physically present in the United States for 30 days or more. A former U.S. long-term resident may contend that he is a resident of Italy under article 4 of the 1984 treaty and therefore not subject to full U.S. taxation.
- *Reporting requirements*: In 2004 Congress also strengthened the tax reporting requirements for former U.S. citizens and long-term residents. Under the new requirements, U.S. citizenship or residency is retained until the expatriating individual gives proper notice to the U.S. authorities of his intention to terminate U.S. tax residence and files Form 8854. If the individual is subject to section 877, he must continue filing Form 8854 for each of the 10 years during which the alternative method applies, even if no U.S. federal income tax is due for any of those years. Accordingly, an Italian citizen and a former U.S. long-term resident may contend that this reporting requirement violates the nondiscrimination provisions under article 24 of the 1984 treaty.

Under the later-in-time rule, these new provisions may override the 1984 treaty obligations of the

[32]Article 1(1) of the protocol.

United States, unless the relevant legislative history shows congressional intent to the contrary. However, legislative history is silent regarding the treaty override issue.

Therefore, it would seem that the later-in-time rule would apply and that former long-term residents are subject to the 30-day rule and to the U.S. compliance requirements. Also, former long-term residents should carefully monitor the nature of their income to determine if they fall within the expanded range of income items treated as U.S.-source under section 877. If that is the case and, therefore, the former long-term residents would — but for the 1984 treaty — be subject to the alternative method of taxation, they may have to file a U.S. income tax return on Form 1040-NR and disclose on Form 8833 the treaty-based position taken.[33] ◆

[33]Section 6114. The legislative history of section 6114 shows the U.S. Senate's assertion that the section 6114 reporting requirements did not violate any treaty nondiscrimination provision, and that — even if they did — Congress intended anyway to override the treaty provisions. S. Rep. 100-445, 100th Cong., 2d Sess. 328 (1988).