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CLARIFYING SUPBART F AND PFIC INCOME INCLUSION UPON RENUNCIATION OF U.S. CITIZENSHIP (IRC §§ 877A(g), 951, 965, 1291)

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SUMMARY OF PAPER

A U.S. shareholder of a foreign corporation may be subject to Subpart F income inclusion under Code Section 951 or passive foreign income company ("**PFIC**") income inclusion under Code Section 1291. Such income inclusion under the Subpart F or PFIC regime comes into play because of the shareholder's status as a "United States person" ("**U.S. shareholder**") as defined under Code Sections 951(b) and 957(c). In general, Code Section 957(c) defines a U.S. person as a citizen or resident of the United States, a domestic partnership, domestic corporation, and domestic trust. However, for purposes of Code Section 951, such U.S. person must own or is considered as owning, 10 percent or more of the voting stock of a foreign corporation.[7] For tax years beginning after January 1, 2018, a U.S. shareholder is any U.S. person who owns or is deemed to own, 10 percent or more of the voting stock or total value of all shares of the classes of stock of such foreign corporation.[8]

When a U.S. shareholder of a foreign corporation renounces his U.S. citizenship pursuant to Code Section 877A (g), such U.S. shareholder's status as a "United States person" terminates on the day of renunciation. As a corollary, he also terminates his U.S. shareholder status on that same day since he no longer holds 10 percent of a foreign corporation as a U.S. person. He is then required to file a final U.S. tax return for the taxable year ending on his or her date of renunciation (the "**Final Stub Period Return**"). Prevailing U.S. tax laws and regulations do not provide any definitive guidance on how to calculate the Subpart F income or PFIC income inclusion (as the case may be) of a former U.S. shareholder for purposes of filing his or her Final U.S. Tax Return.

The recent codification of Code Section 965 under the Tax Cut and Jobs Act of 2017 ("**TJCA**") creates additional complexity to the Final Stub Period Return of a U.S. shareholder who renounces in 2017 because Code Section 965 imposes a one-time repatriation tax ("**Transition Tax**"), for the last taxable year of a foreign corporation beginning before January 1, 2018, on a U.S. shareholder's pro rata share of such foreign corporation's

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[7] See Code Section 951(b).

[8] See Section 14215, Pub. L. 115-97 (H. Report. 114-466) dated December 15, 2017.

accumulated post-1986 deferred foreign income whether held in liquid or illiquid assets form. This provision applies to all specified foreign corporations ("**SFC**") that are controlled foreign corporations ("**CFCs**"), other than PFICs, and foreign corporations in which a U.S. person owns a 10 percent voting interest.[9] The complexity arises because such entities, which include CFCs, must determine their deferred foreign income based on the greater of the aggregate post-1986 accumulated foreign earnings and profits ("**E&P**") as of November 2, 2017 or December 31, 2017, not reduced by distributions during the taxable year ending with or including the measurement date.[10] Therefore the issue that arises is whether the Transition Tax would continue to apply to a U.S. shareholder who has renounced either before November 2, 2017 or prior to December 31, 2017 since the renouncing U.S. shareholder will not own any shares of the CFC as of the last day of the CFC taxable year, as otherwise required for a Code Section 951(a) income inclusion altogether.

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[9] However, for non-CFCs, the foreign corporation must at least have one U.S. shareholder that is a domestic corporation in order for the foreign corporation to be classified as a specified foreign corporation subject to Code Section 965. See p. 618. House Conference Report to Accompany H.R. 1 (December 15, 2017), H.R. 115-466.

[10] Id. p. 618.

DISCUSSION

I. Current Law and Reasons for Suggested Clarification

It is no secret that the number of Americans renouncing their citizenship has reached an all-time high since 2015. The Treasury Department has kept a tally on the number of U.S. citizens who renounce. For 2016 the total was 5,410[11] which is approximately up by 26 percent from 2015. And 2015 had a 58 percent hike from 2014 numbers, totaling 4,279[12] renouncers. For 2017, there were approximately 5,132[13] renunciations which is still a significant increase of approximately 20 percent from 2015. These spiking expatriation numbers mean that more and more U.S. citizens are leaving the citizenship-based, extraterritorial taxing regime of the United States. After renunciation, there is a last chance for the U.S. government to take one more bite out of the proverbial apple – i.e., when the U.S. expatriate files his or her last U.S. tax return to report his worldwide income subject to U.S. tax starting from January 1 and ending on his date of renunciation (*i.e.*, the Final Stub Period Return). It is therefore important for purposes of that Final Stub Period Return for the Treasury Department to provide definitive guidance on the amount of the renouncing U.S. shareholder's Subpart F income inclusion and PFIC "deemed disposition" income inclusion for the Final Stub Period Return.

Current U.S. tax laws do not provide any definitive guidance on how to determine the Subpart F income inclusion and PFIC deemed disposition income or gain amount that is recognized by a U.S. shareholder who renounces his U.S. citizenship for purposes of the Final Stub Year Return. There is also currently no guidance issued to date on how to compute for the Transition Tax, if any, for a U.S. shareholder who renounces his citizenship prior to November 2, 2017 where such shareholder held stock in a CFC with taxable year ending prior to January 1, 2018.

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[11] 81 FR 27198; 81 FR 50058; 81 FR 79098; 82 FR 10185.

[12] 80 FR 26618; 80 FR 45709; 80 FR 65851; 81 FR 6598.

[13] 82 FR 21877; 82 FR 36188; 82 FR 50960; 83 FR 5830.

A. Background on Code Section 877A

A review of the legislative history to Code Section 877A confirms that this statute was intended to impose tax on certain U.S. citizens who relinquish their U.S. citizenship and certain long term residents who terminate their U.S. residency such that these individuals would pay income tax on net unrealized gains on their property, as if the property had been sold for fair market value on the day before expatriation or residency termination ("**mark to market tax**"). Apparently, "***gain from the deemed sale is taken into account at that time without regard to other Code provisions***."[14] This deemed sale treatment is supposed to make certain that certain individuals who relinquish their American citizenship or long-term residency who are "covered expatriates" pay their fair share of Federal taxes by ensuring that covered expatriates pay the same tax for appreciation of assets, such as stocks or bonds, as they would pay if they sold them as U.S. citizens or residents.[15]

A covered expatriate is an individual who ceases to be a U.S. citizen or long-term lawful permanent resident of the United States on or after June 17, 2008 and who has income or net worth in excess of certain thresholds or who is unable to certify compliance with his or her U.S. tax obligations. [16] The three principal consequences to a covered expatriate are:

> First, a covered expatriate is treated under Code Section 877A as if such individual sold his or her worldwide assets on the day before expatriation. Therefore, net gain from the deemed sale of these assets, in excess of certain thresholds, must be included in the covered

[14] See JCT Technical Explanation of H.R. 6081, Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245), As Scheduled for Consideration by the House of Representatives on May 20, 2008, JCX - 44-08, Section III A. Revision of Tax Rules on Expatriation of Individuals.

[15] See, Statement by Senator Baucus on May 22, 2008 at the Senate Floor hearing to the Heroes Earning Assistance and Relief Tax Act of 2008 at https://www.congress.gov/congressional-record/2008/05/22/senate-section/article/S4772-2? See also, Senator Kerry statement on Senate Floor (May 22, 2008), 110th Congress, 2nd Session at Vol. 154, No. 87 of the Congressional Record re HR 6081 at https://www.congress.gov/congressional-record/2008/05/22/senate-section/article/S4772-2?

[16] See Code Section 877(a)(2), Rev. Proc. 2015-53 (Nov. 2, 2015). A covered expatriate is in particular an individual who has an average net income of more than $161,000 (2016 inflation indexed figure) for the five years ending with the taxable year of expatriation or who has a net worth of over $2 million on the expatriation date.

expatriate's income for the year of expatriation.[17]

> Second, under Code Section 877A, distributions to a covered expatriation following such individual's expatriation date from domestic non-grantor trusts and certain deferred compensation plans are subject to a 30 percent withholding tax, to the extent that these distributions would have been taxable had the expatriate been a U.S. person at the time of distribution.[18]
>
> Third, a succession tax is imposed under Code Section 2081 on U.S. citizens and residents and domestic trusts that directly or indirectly receive gifts or bequests from a covered expatriate.[19] The tax is imposed on the value of a covered gift or bequest at the highest applicable gift and estate tax rate in effect at the time of receipt of the covered gift or bequest (currently 40 percent). It applies regardless of whether the property transferred was acquired by the covered expatriate before or after the expatriation date.

Taxpayers who relinquish their U.S. citizenship or cease to be lawful permanent residents must file a dual status return in the year of expatriation, attaching Form 8854, *Initial and Annual Expatriation Statement*.[20] It includes a certification under penalties of perjury by such individual that he or she has been in compliance with all Federal tax laws during the five years preceding the year before expatriation. Failure to provide such certification will cause such individual to be treated as a covered expatriate under Code Section 877(g) whether or not they meet the tax liability test, or the net worth test. [21]A copy of the Form 8854 must also be filed with Internal Revenue Service (interchangeably, "**IRS**" or "**Service**") at the IRS Service Center in Philadelphia, Pennsylvania.

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[17] See Code Section 877A(a)(2).
[18] See Code Section 877A(d), (f).

[19] See Code Section 2801.

[20] See Notice 2009-85, IRB 2009-45.

[21] See Notice 2009-85, IRB 2009-45 (Section C).

II. Whether Subpart F income arises during the Final Stub Year Period of the U.S. shareholder if the CFC's taxable year ends after the U.S. shareholder's renunciation date.

For taxable years of foreign corporations prior to December 31, 2017, Code Section 951(a) (1) states, in relevant part:

> If a foreign corporation is a controlled foreign corporation ("**CFC**") ***for an uninterrupted period of 30 days or more during any taxable year***, ***every person who is a United States shareholder (defined by Code Section 951(b)) of such corporation and who owns (within the meaning of Code Section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends…(***A) the sum of (i) his pro rata share (determined under paragraph 2) of the corporation's Subpart F income for such year (ii) his pro rata share (as determined under Code Section 955(a)(3)) as in effect before enactment…of the corporation's previously excluded subpart F income withdrawn from investment…, and (iii) his pro rata share (as determined under Code Section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations… in his/her gross income for such taxable year, and (B) the amount determined under Code Section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under Code Section 959(a)(2)...

(Italics and bold font added for emphasis). For taxable years of foreign corporations beginning after December 31, 2017,[22] Code Section 951(a) (1) states, in relevant part:

> If a foreign corporation is a controlled foreign corporation ("**CFC**") ***at any time during any taxable year***, ***every person who is a United States shareholder (defined in subsection (b)) of such corporation and who owns (within the meaning of Code Section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation***

[22] See Pub. L. 115-97, Secs. 14101(3)(1) and 14214(a), effective for distributions made after December 31, 2017 and to taxable years of foreign corporations beginning after December 31, 2017 and for taxable years of United States shareholders with or within which such taxable years of foreign corporation's end.

> ***ends…(***A) his pro rata share (determined under paragraph 2) of the corporation's Subpart F income for such year, and (B) the amount determined under Code Section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under Code Section 959(a)(2)...

(Italics and bold font added for emphasis). Under both pre and post December 31, 2017 versions of Code Section 951(a), it is clear that the determination of a U.S. shareholder's pro rata share of Subpart F income turns on (1) the CFC's subpart F income for the year, which is computed based on the CFC's taxable year, not the U.S. shareholder's taxable year; and (2) the U.S. person must continue to be a U.S. shareholder owning CFC stock on the last day in which such foreign corporation is a CFC.

A. Under Existing Treasury Regulations Section 1.951-1(b)(2), a U.S. Shareholder who renounces prior to the end of the CFC's taxable year would not have any Subpart F income inclusion for the Final Tax Year Return

Application of these two conditions to the determination of Subpart F income is clearly illustrated in Treasury Regulation Section 1.951-1(b)(2). Examples 2 and 3 of Treas. Reg. Section 1.951-2 provided two hypotheticals where (a) a U.S. shareholder divested himself of CFC stock such that CFC status ceased prior to the end of the CFC's calendar year (Examples 2) ; and (b) a U.S. shareholder acquired foreign corporation stock during the year such that the corporation was a CFC on the last day of its calendar year (Example 3) it was clearly established in both hypotheticals that the U.S. shareholder, whose taxable year was concurrent with the CFC's taxable year, would have to include in his gross income for such year his pro rata share of the Subpart F income attributable to such foreign corporation for the duration of those days in the year that it was a CFC. Treasury Regulations Section 1.951-2 provides in relevant part:

> **Treas. Reg. § 1.951-1(b)(2) Illustrations.** The application of this paragraph may be illustrated by the following examples:
>
> **Example 1**
>
> A, a United States shareholder, owns 100 percent of the only class of stock of M, a controlled foreign corporation throughout 1963. Both A and M Corporation use the calendar year as a taxable year. For 1963, M

> Corporation derives $100 of Subpart F income, has $100 of earnings and profits, and makes no distributions. A must include $100 in his gross income for 1963 under Code Section 951(a)(1)(A)(i).
>
> **Example 2**
>
> The facts are the same as in example (1), except that instead of holding 100 percent of the stock of M Corporation for the entire year, A sells 60 percent of such stock to B, a nonresident alien, on May 26, 1963. Thus, M Corporation is a controlled foreign corporation for the period January 1, 1963, through May 26, 1963. A must include $40 ($100 x 146/365) in his gross income for 1963 under Code Section 951(a) (1) (A) (i).
>
> **Example 3**
>
> The facts are the same as in example (1), except that instead of holding 100 percent of the stock of M Corporation for the entire year, A holds 60 percent of such stock on December 31, 1963, having acquired such interest on May 26, 1963, from B, a nonresident alien, who owned such interest from January 1, 1963. Before A's acquisition of such stock, M Corporation had distributed a dividend of $15 to B in 1963 with respect to such stock. A must include $21 in his gross income for 1963 under Code Section 951(a)(1)(A)(i), such amount being determined as follows…

The above examples in Treas. Regulation 1.951-2(b) do not squarely address the calculation of Subpart F income, if any, in a renunciation context. In Example 2 specifically, the U.S. person who held the foreign corporation stock remained a U.S. shareholder under Code Section 951(b) notwithstanding the reduction in his stock ownership *i.e.*, he remained a U.S. shareholder owning the requisite amount of foreign corporation stock on the last day of the CFC's taxable year. This is not the case with renunciations since the U.S. shareholder is deemed by Code Section 877A(a) to dispose of all his CFC stock on the day before expatriation. Indeed, a U.S. shareholder who renounces his U.S. citizenship during the CFC's taxable year will no longer be classified as a U.S. shareholder on the last day of such CFC's taxable year unless the close of the CFC taxable year coincides with the day prior to expatriation. The implication is that the CFC will lose its classification as a CFC as to such U.S. person on his renunciation date, resulting in a failure to meet the conditions giving rise to Subpart F income inclusion for a U.S. shareholder to own CFC stock on the last day of the CFC's taxable year under Code Section 951(a)(1). It therefore appears that a

U.S. shareholder who renounces during the CFC's taxable year should not have any Subpart F income inclusion in the year of renunciation because the CFC ceased to be a CFC before the last day of its taxable year.

B. Calculation of Subpart F income for U.S. Shareholders of Nonconforming CFCs Who Renounce

The issue with calculating the Subpart F income inclusion, if applicable, to U.S. shareholders who renounce prior to the last day of the foreign corporation's taxable year in the year of renunciation is also further complicated in circumstances where the U.S. shareholder's taxable year and the foreign corporation's taxable year do not conform (i.e., "**a nonconforming CFC**"). Assume for example the following:

> John, a dual citizen of Canada and the United States, resides in Canada and owns all the equity of a Canadian corporation ("**Canco**"). Canco's fiscal year ends August 31. On June 30, 2017, John renounces his U.S. citizenship. For U.S. tax purposes, John will have to file a combined U.S. tax return with Form 1040NR on the top and Form 1040 as a schedule for the year of renunciation.

Based on the above example, we would consider the following outcome:

> First, John would be required to report his worldwide income subject to U.S. tax on a Form 1040 as schedule for the stub period beginning on January 1, 2017 and ending on June 30, 2017 (the "**June 2017 Filing**").
>
> Second, John would also be required to report any U.S.-sourced income he received or generated as a nonresident alien by filing a U.S. Form 1040NR as the main tax return for the period of July 1, 2017 through December 31,2017 (the "**December 2017 Filing**"). Prior to the year of renunciation, for fiscal years ending prior to August 31, 2017, Canco was a CFC on account of John's U.S. citizenship. Therefore, John would have included as part of his worldwide income subject to U.S. tax any Subpart F income inclusion with respect to Canco. However, on June 30, 2017, John renounced his U.S. citizenship and ceased to be a U.S. shareholder of Canco. As a corollary, starting on June 30, 2017- approximately two months

> before the end of its fiscal year on August 31, 2017 Canco no longer had a U.S. shareholder.
>
> Since Canco is no longer a CFC on the last day of its fiscal year (*i.e.*, August 31, 2017), there would be no Subpart F income inclusion recognized by John on his June 2017 Filing. Indeed, Code Section 951(a) (1) would not apply to John at all because he renounced before Canco's fiscal year end. Any Subpart F income that would have been includible in his Final Tax Return Year appears to have disappeared into the air simply because he renounced before August 31, 2017.

C. Application of Code Section 898(c) and Proposed Treasury Regulations

We note that the above result may vary if Code Section 898(c) comes into play. Code Section 898(c) (1) would cause a CFC (i.e., which is a "specified foreign corporation" under Code Section 898(b) (1)) to adopt the same fiscal year used by its majority U.S. shareholder (the "**majority U.S. shareholder year**"). If the majority U.S. shareholder is an individual, Code Section 441(a) would usually require such individual to have a calendar year. Thus, the CFC would also use the calendar year as its fiscal year. Applying this rule to our example, John is the sole owner and therefore majority U.S. shareholder of Canco. His fiscal year is the calendar year. Canco would therefore be required to also use the calendar year as its fiscal year pursuant to Code Section 898(c) with a one-month-deferral election available under Code Section 898(c)(2).

1. Proposed Treasury Regulations Section 1.898-4

In such circumstances, neither the Code nor regulations provide any specific guidance on how Subpart F income inclusion for the majority U.S. shareholder should be calculated to reconcile the Subpart F income generated by Canco during a fiscal year and those generated during a calendar year. While Proposed Treasury Regulations ("**Proposed Regulation.**") Section 1.898-4 has not yet been finalized since it was published in December 31, 1992, this Proposed Regulation provide some guidance on computing Subpart F income generated by a nonconforming CFC that uses a fiscal year different to the required one. Generally, Prop. Treas. Reg. Section 1.898-4(c) (1) provides that a U.S. shareholder must compute any Subpart F income inclusion relating to a nonconforming CFC including but not limited to Subpart F income. Prop. Reg. Sec. 1.898-4(c)(2) further provides that if no separate books are maintained for U.S. tax purposes, the income and E&P of such nonconforming CFC shall be computed in two steps:

> First, for the foreign annual accounting period of the specified foreign corporation which ends within its required year, the income (and E&P) of the specified foreign corporation is the entire income (or E&P) of the foreign annual accounting period, less the income (or E&P), if any, of that foreign annual accounting period properly allocable to the preceding taxable year, determined under a consistent application of the principles of Code Section 964 and the regulations under that section.
>
> Second, for the foreign annual accounting period of the specified foreign corporation which ends after its required year, the income (and E&P) of the specified foreign corporation is the income (and E&P) of each month (or quarter) which has ended within the required year determined on the basis of interim actual book closings and computed by a consistent application of the principles of Code Section 964 and the regulations under that section. If the amount of income properly includable in the gross income of United States shareholders in the preceding taxable year is different from the amount of income actually included by United States shareholders in the preceding taxable year, then an adjustment must be made by each United States person affected by means of an amended return for that preceding taxable year.

If the Proposed Treasury Regulations under Section 898 were applied to our example on John and his Canco, John would have to use separate accounting periods to determine the amount of his Subpart F income inclusion from Canco. For example, to compute his Subpart F income for calendar year 2016, John would have to compute Canco's E&P during the two separate periods:

(1) the first period from January 1 to August 31, 2016 which is part of Canco's fiscal year ending August 31, 2016, and

(2) the second period from September 1 to December 31, 2016 which is part of Canco's fiscal year ending August 31, 2017.

For John's Subpart F income reporting for the 2017 Stub Year ended June 30, 2017, it remains unclear whether John would have to calculate Subpart F income for the period from January 1 to June 30, 2017 under Code Section 951(a)(1).

We propose that Treasury provide more guidance on the Subpart F income inclusion for a nonconforming CFC by finalizing the proposed Treasury Regulations under Section 898 and providing definitive guidance on how to determine Subpart F income inclusion amounts for a U.S. shareholder who renounced his citizenship for purposes of filing his Final Stub Year Period.

III. Whether the Transition Tax would apply to a U.S. shareholder of a CFC who renounces his U.S. citizenship prior to November 2, 2017 or December 31, 2017 where such CFC's last taxable year ends prior to January 1, 2018.

Code Section 965 imposes a one-time tax on a taxpayer who is a United States shareholder (a "**U.S. Shareholder**") of a deferred foreign income corporation ("**DFIC**") for the last taxable year of such corporation that begins before January 1, 2018 (the "**Inclusion Year**"). A DFIC is a specified foreign corporation of a U.S. Shareholder which has an accumulated post-1986 deferred foreign income[23] greater than zero determined as of November 2, 2017 or December 31, 2017 (each such date, a "**measurement date**"), whichever is greater (the "**Section 965(a) earnings amount**").[24] The portion of the Section 965(a) earnings amount that is taken into account under Section 951(a) (1) by a U.S. Shareholder with respect to a DFIC after taking into account any reduction for the aggregate foreign E&P deficit with respect to at least one E&P deficit foreign corporation[25] that is allocable to such U.S. shareholder is the Section 965(a) inclusion amount.[26]

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[23] Code Section 965(d)(2) defines accumulated post-1986 deferred foreign income as the post-1986 earnings and profits except to the extent such E&P (A) are attributable to income of the specified foreign corporation that is effectively connected with the conduct of a trade or business within the United States and subject to tax under Chapter 1 ("**ECI**") or (B) in the case of a CFC, if distributed, would be excluded from the gross income of a U.S. shareholder under Code Section 959 as previously taxed income ("**PTI**"). E&P is calculated in accordance with Code Sections 964(a) and 986. See also Section 2.05, Notice 2018-26, IRB 2018-16 (April 2, 2018).

[24] Code Section 965(d)(1). See also, Section 2.01 of Notice 2018-26, IRB 2018-16 (April 2, 2018).

[25] Id. at Section 2.02, an E&P deficit foreign corporation is any specified foreign corporation with respect to which a taxpayer is a U.S. shareholder, if as of November 2, 2017 (i) such specified corporation has a

A specified foreign corporation[27] is described in Code Section 965(e)(1) as: (A) any CFC, and (B) any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder. Therefore, a U.S. Shareholder of a CFC with a Section 965(a) earnings amount would be subject to the Transition Tax based on such U.S. shareholder's Code Section 965(a) inclusion amount.

Code Section 965 uses existing definitions under Subpart F of Code to operate. In particular, the term "U.S. shareholder" is determined also under Code Section 951(b) as any U.S. person that owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the stock of a foreign corporation (for taxable years of foreign corporations beginning before January 1, 2018), or the total value of all classes of stock of a foreign corporation (post December 31, 2017).[28] Although not explicitly defined in Code Section 965 itself or its legislative history, it is also assumed that the term "**CFC**" is a controlled foreign corporation within the meaning of Code Section 957. Indeed, Section 2.06 of Notice 2018-26 explicitly states:

> *For purposes of Sections 951 and 961, a specified foreign corporation described in Section 965(e) (1) (B) [i.e., a CFC]* ***is treated as a CFC solely for purposes of taking into account the subpart F income of such corporation*** *under Section 965(a) (and for purposes of determining a United States shareholder's pro rata share of any amount with respect to a specified foreign corporation under Section 965(f).*

(Italics and bold font added for emphasis).The U.S shareholder's pro rata share of the CFC's Code Section 965(a) earnings amount which would be subject to the Transition Tax (i.e., the Code Section 965(a) inclusion amount) is computed by increasing the subpart F income of the CFC's last

deficit in post-1986 E&P; (ii) such taxpayer was a U.S. Shareholder; and (iii) such taxpayer was a U.S. shareholder of a such corporation. See also Code Section 965(b)(3)(C).

[26] Id.

[27] Code Section 965(e)(1) provides that "specified foreign corporation" means any CFC and any foreign corporation with respect to which one or more domestic corporations is a United States shareholder. See also, Section 2.06 of Notice 2018-26, IRB 2018-16 (April 2, 2018).

[28] See footnote 1503, p. 613 of H. Rpt 114-466.

taxable year ending before January 1, 2018 by its accumulated post-1986 deferred foreign income.[29]

Therefore, the issue that arises is whether the Transition Tax would continue to apply to a U.S. shareholder who has renounced in 2017 (either before November 2, 2017 or prior to December 30, 2017) if renunciation effectively terminates CFC status and eliminates Subpart F income altogether. Specifically, Code Section 965(a) creates an increase to subpart F income as defined in Code Section 952(a) for deferred foreign income. Code Section 951(a)(1)(A)(i) creates an inclusion in gross income for subpart F income as defined in Code Section 952(a). Code Section 951(a) is the provision that brings in the requirement for ownership of the CFC stock on the last day of the CFC taxable year. Therefore, the requirement of stock ownership on the last day of the CFC taxable year ought to apply to a Code Section 965(a) inclusion, just like any other inclusion of subpart F income. If the U.S. shareholder renounces in 2017 such that it is no longer a U.S. shareholder owning CFC stock on the last day of the CFC's taxable year in 2017, then there is no Subpart F inclusion under either Code Section 951(a)(1)(A)(i) and Code Section 965(a) that can be computed from which such U.S. shareholder could derive a pro-rata share subject to the Transition Tax. Assume for example the following:

> John, a dual citizen of Canada and the United States, resides in Canada and owns all the equity of a Canadian corporation ("**Canco**"). Canco's taxable year ends December 31. Canco has positive earnings and profits ("**E&P**") on the Code Section 965 measurement dates of November 2, 2017 and December 31, 2017 and does not have previously taxed income or effectively connected income for any taxable year. On October 31, 2017, John renounces his U.S. citizenship. For U.S. tax purposes, John will have to file a combined U.S. tax return with Form 1040NR on the top and Form 1040 as a schedule for the year of renunciation:

Code Section 965(a) creates an increase in subpart F income under Code Section 952 for a DFIC for the last taxable year of such corporation beginning before January 1, 2018. Code Section 965(f)(1) further provides that a U.S. Shareholder's prorated share of any amount with respect to the specified foreign corporation ("**SFC**") (which is a DFIC) shall be

[29] See p. 606 of H. Rept. 114-466. See also, Section 2.13 of Notice 2018-26, Internal Rev. Bull. 2018-16 (April 2, 2018).

determined under rules similar to Code Section 951(a)(2) by treating such amount in the same manner as subpart F income.[30]

In the above hypothetical situation, the last taxable year of Canco beginning before January 1, 2018 would be the taxable year of Canco beginning January 1, 2017. For the Transition Tax to apply, Canco must be a deferred foreign income corporation ("**DFIC**") within the meaning of Code Section 965(d)(1). The hypothetical situation above represents that Canco satisfies this condition and is therefore a DFIC. The issue is whether John would still be allocated any portion of Canco's deferred foreign income subject to the Transition Tax notwithstanding that he ceased to be a U.S. Shareholder of Canco as of October 31, 2017. With respect to this issue, Notice 2018-07 states that,

> "a DFIC is, **with respect to any United States shareholder**, any specified foreign corporation **of such United States shareholder** that has an accumulated post-1986 deferred income…"[31]

(Bold font added for emphasis). Based on the above, it would appear reasonable to conclude that the Transition Tax would not apply to John because a DFIC must have at least one U.S. shareholder for Code Section 965 purposes. Since John renounced prior to the end of Canco's taxable year, there was no U.S. shareholder to which a pro-rata share of the DFIC's subpart F income could be allocated under Code Section 965. Our conclusion is based on the following analysis:

1. A U.S. shareholder is defined under Code Section 951(b), for purposes of taxable years ending before January 1, 2018, as a U.S. person who owns directly, indirectly or constructively at least 10 percent of the total combined voting power of the foreign corporation. Here, John is a U.S. Shareholder because he is a U.S. person who owns 100 percent of voting shares of Canco.

2. Canco is a SFC pursuant to Section 965(e)(1)(A) because it is a CFC.

3. Canco is a DFIC because it is a CFC with accumulated post-1986 deferred foreign income as of measurement dates (November 2 or

[30] See Section 2.07 of Notice 2018-07.

[31] Id.

December 31) that is greater than zero.

4. Because Canco is a DFIC, Code Section 965(a) operates to treat the amount of accumulated post-1986 deferred foreign income of Canco as of November 2, 2017 or December 31, 2017, whichever date yields the greater amount, as an increase of subpart F income within the meaning of Code Section 952(a).

5. Notice 2018-07 explicitly states that:

> *Section 965(f)(1) provides that the determination of any U.S. shareholder's pro rata share of any amount with respect to the SFC shall be determined under rules similar to the rules of Section 951(a)(1) by treating such amount in the same manner as subpart F income.*

6. Code Section 951(a) (1) provides that a U.S. Shareholder must include in income his or her prorata share of subpart F income. However, for the income inclusion to occur for Subpart F purposes, such particular U.S. shareholder must own stock in the foreign corporation on the last day of the taxable year of such foreign corporation.[32]

7. Although John continues to own Canco shares as of the last day of the taxable year of Canco, *i.e.*, December 31, 2017, he ceased to be a U.S. person as of October 31, 2017 and therefore was not a U.S. shareholder of Canco as of December 31, 2017.

8. Since John is not a U.S. shareholder of Canco as of December 31, 2017, it follows that Canco is no longer a CFC on the last day of its taxable year (*i.e.*, December 31, 2017) with respect to a U.S. shareholder. Consequently, there would be no Subpart F income inclusion recognized by John on his October 2017 Filing. Hence, although the amount of subpart F income as defined in Code Section 952(a) is technically increased as a result of the Subpart F income inclusion under Code Section 965(a), it appears that John should not have any Subpart F income inclusion for his Final Stub Period Return because he would not have been classified as a U.S. shareholder of Canco as of the last day of the taxable year of such foreign corporation.

[32] *See* Code Section 951(a)(1) and (2) and Treas. Regs. Sec. 1.951-1(a).

Based on the above analysis, any Subpart F income that would have been includible in John's Final Stub Period Return Year appears to have disappeared into the air simply because he renounced before December 31, 2017. Indeed, Code Section 951(a) (1) would not apply to John at all because he renounced before Canco's taxable year end.

A. Example in Section 3.02 of Notice 2018-26

Recent administrative guidance issued by the Service on the Transition Tax does not explicitly address how a U.S. shareholder of a CFC who renounces in 2017 would impact the Transition Tax liability of such U.S. shareholder. However, in Code Section 3.02 of Notice 2018-26, the Service addressed the issue of how to calculate for the cash position of an SFC that may not be owned by a particular U.S. Shareholder on all of the cash measurement dates. In the example provided in Section 3.02, the Service stated:

> (i) Facts. Except as otherwise provided, for all relevant periods, USP, a domestic corporation, has owned directly at least 10 percent of the stock of CFC1, CFC2, CFC3, and CFC4, each a foreign corporation. CFC1 and CFC2 have calendar year U.S. taxable years. CFC3 and CFC4 have U.S. taxable years that end on November 30. No entity has a short taxable year, except as a result of the transactions described below.
>
> (a) USP transferred all of its stock of CFC2 to an unrelated person on June 30, 2016, at which point USP ceased to be a United States shareholder with respect to CFC2.
>
> (b) CFC4 dissolved on December 30, 2010, and, as a result, its final taxable year ended on December 30, 2010.
>
> (ii) Analysis. Each of CFC1, CFC2, CFC3, and CFC4 is a specified foreign corporation. Taking into account the regulations described in this section 3.02, the cash measurement dates of the specified foreign corporations to be taken into account by USP in determining its aggregate foreign cash position are summarized in the following table:

	Cash Measurement Dates		
	Final	Second	First
CFC1	December 31, 2017	December 31, 2016	December 31, 2015
CFC2	N/A	N/A	December 31, 2015
CFC3	November 30, 2018	November 30, 2016	November 30, 2015

CFC4	N/A	N/A	N/A

In the above example, a U.S. person who was a U.S. shareholder of CFC2 (an SFC) transferred his shares to an unrelated person on June 30, 2016, effectively terminating the CFC status of CFC2. However, for purposes of calculating the cash position of the terminated CFC on the cash measurement dates under Code Section 965(a), the Service illustrated in the above example that the Service would look back to the last taxable year of the CFC, *i.e.*, December 31, 2015, as the first cash measurement date (and by implication, also the last cash measurement date). The fact that CFC2 is no longer a CFC as of the statutory cash measurement date of November 2, 2017 and December 31, 2017 appears to have no bearing on determination of the former U.S. shareholder's liability for the Transition Tax.

This example is problematic when applied, by analogy, to the situation of a U.S. shareholder who renounces his U.S. citizenship prior to November 2, 2017. It leaves open the possibility that a U.S. shareholder of a CFC who renounced his U.S. citizenship prior to the November 2, 2017 would still have Transition Tax exposure to the extent of his or her pro rata share of the terminated CFC's cash position as of its last taxable year as a CFC. A floodgate of Transition Tax filings would be then required from former U.S. citizens who were former U.S. shareholders of CFCs from time immemorial perhaps. Further clarification and guidance is direly needed to prevent inadvertent application of this example in Notice 2018-26 to renunciation cases.

B. Code Section 965(o) and Notice 2018-26 on Tax Avoidance

Lastly, another area of overlap between Code Section 877A and Code Section 965 which is in dire need of further guidance from the IRS is Code Section 965(o). Congress has specifically granted the Service authority to issue regulations or other guidance that may be necessary or appropriate to carry out the provisions of Code Section 965. The statute specifically mentions as areas for guidance and avoidance of abuse reductions in earnings and profits, changes in entity classification or accounting methods. The Service has addressed certain avoidance transactions in Section 3.04 of Notice 2018-26 on the authority of Code Sections 965(c) (3) (F) and 965(o). Pursuant to Section 3.04(a), the Service will issue regulations to disregard any transaction for purposes of determining a U.S. shareholder's liability for Transition Tax if the following conditions are satisfied:

1. The transaction occurs on or after November 2, 2017.
2. A principal purpose of the transaction is the reduction or avoidance of transition tax.
3. The transaction would otherwise reduce Transition Tax.

In Section 3.04(a)(i) of Notice 2018-26, the Service identified certain specific areas mentioned in Code Sections 965(c)(3)(F) and 965(o) which would be *per se* disregarded transactions, *i.e.*, cash reduction transactions, E&P reduction transactions, pro-rata share transactions, changes in entity classification or methods of accounting.[33] We believe that expatriations taking place prior to November 2, 2017 should not fall within the purview of tax avoidance transactions that are *per se* disregarded under the Notice 2018-26 (the "**Notice**") for the reasons below:

For expatriations occurring on or after that date but prior to the close of the CFC taxable year, the key element of the above-cited three prong anti-avoidance test would be whether "a principal purpose" of the expatriation was the reduction of transition tax.

2. Deemed Sale as Transfers under Code Section 877A versus Pro Rata Share Transfers under Notice 2018-26

The Notice addresses a number of transactions for which the motive of "a principal purpose" is either presumed to be present or is considered present *per se.*[34] In particular, "a principal purpose' is presumed for a pro-rata share transaction, which entails the transfer of the stock of a specified foreign corporation to a U.S shareholder or related person if the transaction would otherwise reduce the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income.[35] In the case of the expatriation of a covered expatriate, the property of the covered expatriate is deemed to be sold on the day prior to expatriation pursuant to Code Section 877A(a). Section 3.04(a)(iv) of the Notice specifies that the transferee of a pro-rata share transaction is a U.S. shareholder or related person.[36] This treatment makes

[33] .See Section 3.04(a)(ii) through (iv) of Notice 2018-26

[34] Id.

[35] See Section 3.04(a)(iv), page 26 of Notice 2018-26.

[36] Id.

us query whether the deemed sale rules under Code Section 877A(a) would be equivalent to a "transfer" that may be a pro-rata share transaction resulting in a tax avoidance transaction. Since the deemed sale on expatriation is considered to occur on the day prior to expatriation, it could be argued that the expatriating U.S. shareholder should be viewed as the transferee. As described earlier, it is possible for the expatriation otherwise to eliminate transition tax.

It is worth noting that the mark-to-market sale of Code Section 877A(a) applies only to covered expatriates. Would it therefore also mean that for an expatriate who is not a covered expatriate, no sale is deemed to occur at all? Nevertheless, the act of expatriation would appear otherwise to eliminate that expatriating U.S. shareholder's pro rata share under Code Section 951(a) (2) to nil since the expatriate will no longer be a U.S. shareholder as of the close of the CFC taxable year.

3. Transfers to Nonresident Spouses and Deemed Sales under Code Section 877A versus E&P Reduction Transactions under Notice 2018-26

Another *per se* disregarded transaction in Section 3.02 of the Notice are E&P reduction transactions. Pursuant to Section 3.02(iii), an E&P reduction transaction means a transaction between an SFC and any of (i) a U.S. shareholder of such SFC; (ii) another SFC, or (ii) any person related to the U.S. Shareholder of such SFC.[37] We wonder whether this broad definition would capture bona fide spousal transfers of CFC stock undertaken in 2017 as part of a U.S. shareholder's gift and estate plan.

The Notice further elaborates that a specified transaction will be treated as being per se undertaken with a principal purpose of reducing section 965 tax liability of a U.S. Shareholder for purposes of the anti-avoidance rule. For this purpose, a specified transaction means

> *An E&P reduction transaction that involves one or more of the following: (i) a complete liquidation of a specified foreign corporation*

[37] See Section 3.02(iii) p. 25 of Notice 2018-26.

> *to which Section 331 applies; (ii) a sale or other disposition of stock by a specified foreign corporation…*[38]

(Italics added for emphasis). Since an expatriation under Code Section 877A results in a deemed sale of assets by the U.S. person, it would again appear that expatriation could be classified as a specified transaction that would be *per se* disregarded under Section 3.02(iii) of Notice 2018-26.

In light of the considerable uncertainty regarding these matters, the Service may wish to consider providing guidance regarding deemed sale transfers under Code Section 877A and the *per se* disregarded transactions under Notice 2018-26 vis-à-vis the Transition Tax.

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[38] See Section 302(iii) p. 26 of Notice 2018-26.

IV. Whether PFIC income should be calculated for any capital gain from a deemed disposition of PFIC stock upon renunciation.

Code Section 1291(a) (1) applies the punitive PFIC tax regime to any excessive distribution from a PFIC. Code Section 1291(a) (2) states that such excessive distribution rule applies to any capital gain from disposing PFIC stocks if the gain is an excessive distribution. Neither the Code nor the Treasury Regulations provide any definition of the term "***disposition***" for purposes of Code Section 1291(a)(1). Assuming a renouncer is not a covered expatriate under Code Section 877A (g) (1) who is subject to mark-to-market capital gain reporting under Code Section 877A (a), the question for such a non-covered expatriate taxpayer is whether renouncing his or her U.S. citizenship will trigger a deemed disposition of PFIC stocks for Code Section 1291(a) income inclusion and Code Section 1298(f) information reporting purposes. To date there is no guidance from the IRS or Treasury on this issue. However, Proposed Treasury Regulation Section 1.1291-3, published on April 1992 states that:

> (1). Any transaction or event that constitutes an actual or deemed transfer of property for any purpose of the Code and the regulations thereunder, including (but not limited to) a sale, exchange, gift, or transfer at death, an exchange pursuant to a liquidation or Code Section 302(a) redemption, or a distribution described in Code Sections 311, 336, 337, 355(c) or 361(c).
>
> (2). **Change of U.S. residence or citizenship**. If a shareholder of a Code Section 1291 fund becomes a nonresident alien for U.S. tax purposes, the shareholder **will be treated as having disposed of the shareholder's stock** in the Code Section 1291 fund for purposes of Code Section 1291 on the last day that the shareholder is a U.S. person. Termination of an election under Code Section 6013(g) is treated as a change of residence (within the meaning of this paragraph (b) (2)) of the spouse who was a resident solely by reason of the Code Section 6013(g) election.

Code Section 1298(g) authorizes the Secretary to prescribe regulations as necessary or appropriate to carry out the purposes of this part. However, since the regulations referenced above are still in the proposed form, they do not control the determination of whether a deemed disposition of PFIC stock is triggered by a U.S. person who renounces his citizenship for PFIC

> income tax reporting purposes. Treasury should finalize the Proposed Treasury Regulations under Code Section 1.1291-3 to provide clarity and foster uniformity of application.

(Italics and bold font added for emphasis). In light of the considerable uncertainty regarding the impact of renunciation these matters, the Service may wish to consider providing further guidance regarding the provisions under Proposed Treasury Regulations Section 1.1291-3 (2) with respect to (i) the PFIC income inclusion for the U.S. shareholder's Final Stub Period Return and (ii) how these rules interact with the *per se* disregarded transactions under Notice 2018-26 vis-à-vis the Transition Tax, if any.

CONCLUSION

In light of the above discussion of tax issues encountered with respect to the filing and preparation of a renouncing U.S. Shareholder's Final Stub Period Return, for purposes of determining Subpart F income inclusion under Code Sections 951, 1291 and deferred income inclusion under Section 965, we would recommend that Treasury finalize or withdraw the Proposed Regulations under Code Sections 951 and 1291 such that U.S. shareholders who renounce can either properly calculate and report their pro rata share of Subpart F income and PFIC income inclusion on their Final Stub Period Return, or have a firm position to not report them at all. We would also recommend that the Service consider issuing new administrative guidance on the impact of renunciation for purposes of determining a renouncer's Subpart F, PFIC and Transition Tax liability, as applicable.

If the Treasury Department or Service promulgates regulations under Code Sections 877A(g), 951(a), 898(c), 965(a) and 1291(a) to clarify the determination and treatment of Subpart F income inclusion, deferred foreign income inclusion to Subpart F for Transition Tax purposes and PFIC deemed disposition income amounts recognized by a renouncing U.S. shareholder, it will promote consistency and uniformity in the tax return reporting and filing positions of renouncers, which may increase tax liabilities and ultimately generate tax revenues for the U.S. government.

Our proposal should have minimal impact on other tax laws because it will apply in limited circumstances to situations involving a U.S. shareholder who renounces his or her citizenship. Further, there are Proposed Treasury Regulations pending for decades that may provide approaches to the issues identified in our paper. Lastly, we believe our proposal is feasible and relatively easy to accomplish because there are already Proposed Treasury Regulations under Code Sections 898 and 1291 that may be utilized to provide approaches to resolving the issues identified in our paper. Furthermore, since Treasury and the Service are still in the process of developing regulations to interpret newly-enacted Code Section 965, this proposal presents relevant and important tax issues that should be taken into consideration in the process of drafting regulations and administrative guidance on the Transition Tax liability of U.S. shareholders who renounced in 2017.