VI. PURPOSES OF A SPECIAL TAX REGIME FOR CITIZENSHIP RELINQUISHMENT AND RESIDENCY TERMINATION

A. Background: The Tax Incentive to Relinquish Citizenship or Terminate Residency

In order to assess the purposes of a special tax regime for former citizens and former long-term residents, it is instructive to begin with a rough illustration of how U.S. tax savings can become a significant factor in a U.S. citizen's or resident's decision to relinquish citizenship or terminate residency. Assume a U.S. citizen owns appreciated U.S. stock in XYZ company with a $10 million basis and a $110 million fair market value. All appreciation accrued while the individual owned the stock as a U.S. citizen. If the individual sells that stock, the individual will realize a $100 million gain and will be subject to $20 million in taxes (assuming a 20-percent rate on long-term capital gains). When that individual dies (assuming for simplicity that the proceeds of the sale have not been consumed or reinvested prior to death), the $90 million of after-tax sales proceeds would be subject to estate taxes in the approximate range of $40 million to $50 million under present law, depending on the year of death (and assuming the estate includes other property sufficient to exhaust the unified credit and the lower estate tax rates).[297] The combined taxes thus would likely be in the approximate range of $60 million to $70 million. If the individual dies before the stock is sold, there would be no capital gains tax, and the estate tax owed with respect to the $110 million of stock would be in the approximate range of $50 million to $60 million, depending on the year of death (and subject to the various assumptions stated above).

If the United States did not have any special tax regime for former citizens and former long-term residents (as was the case before 1966), U.S. citizens and long-term residents in some instances would have a substantial tax incentive to relinquish citizenship or terminate residency and thereby become subject to U.S. tax only as a nonresident noncitizen.[298] In the above example, the sale of the stock by the former citizen generally would not be taxable in the United States.[299] In addition, the proceeds from the sale could be held in foreign accounts that would not be taxable in the United States. If the former citizen desired to continue holding the stock, it could be held indirectly through a foreign corporation in order to avoid the estate tax that might

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[297] If the individual dies in 2010, then no estate tax would be imposed under present law. Under present law, with the exception of 2010, the estate tax applies with a maximum rate ranging from a low of 45 percent (2007, 2008, 2009) to a high of 55 percent (2011 and later). The rate is 49 percent for 2003.

[298] There could be foreign tax consequences to consider. To the extent that income of the former citizen or former long-term resident is subject to foreign taxes, and assets of the former citizen or former long-term resident are subject to foreign estate taxes, the tax incentive for citizenship relinquishment or residency termination would be less compelling.

[299] Gains on the sale of stocks or securities issued by U.S. persons generally are not taxable to nonresident noncitizens because such gains are considered to be foreign-source income. Sec. 865(a).

otherwise be applicable. In addition, without special immigration rules, the former citizen could return to the United States for significant lengths of time (up to 182 days in any given year, and up to about four months per year on a sustained basis) without jeopardizing his or her status as a nonresident noncitizen. In sum, under the generally applicable tax rules, there are several tax-related benefits that might motivate an individual to consider relinquishing citizenship or terminating residency, and which might be addressed through a special tax regime for former citizens and former long-term residents.

The example above also illustrates that an analysis of taxpayer incentives to relinquish citizenship or terminate residency is complicated by uncertainty regarding the estate tax. EGTRRA provided incremental estate and gift tax rate reductions and unified credit increases from 2002 to 2009, among other changes, and repealed the estate tax for estates of decedents dying after December 31, 2009. However, EGTRRA also included a "sunset" provision, pursuant to which the EGTRRA provisions, including estate tax repeal, do not apply after December 31, 2010. Thus, under present law, the estate tax phases down from 2002 to 2009, is repealed for 2010, and then returns in 2011 without the rate reductions and unified credit increases that were phased in prior to repeal (i.e., the law in effect prior to 2002 applies). In the 107th Congress, several bills were introduced that would make estate tax repeal permanent (e.g., H.R. 586, H.R. 2143, H.R. 2316, H.R. 2327, and H.R. 2599) and one bill was introduced to accelerate estate tax repeal (S.3). The House passed H.R. 586 and H.R. 2143. In addition, the Senate passed, as Senate Amendment 2850 to S. 1731 (an agriculture reauthorization bill), a provision expressing the Sense of the Senate that estate tax repeal should be made permanent. The House also passed a similar measure (H. Res. 524). The Senate did not pass a bill making estate tax repeal permanent.

It is possible that the combination of the phasing down of the estate tax, its repeal for 2010, and an expectation on the part of taxpayers that this repeal may be made permanent could reduce the estate-tax incentives to relinquish citizenship or terminate residency. On the other hand, the delay prior to repeal for 2010, combined with the possibility that this repeal may not be made permanent, or may not be allowed to take effect in the first place, could suggest that the estate-tax incentives to relinquish citizenship or terminate residency are not significantly reduced as a result of EGTRRA. While the impact of the estate tax provisions of EGTRRA on incentives to relinquish citizenship or terminate residency thus cannot be precisely quantified, the example above illustrates that these incentives persist under present law, as substantial estate tax liabilities are still imposed, and may still be avoided in whole or in part by relinquishing citizenship or terminating residency, subject to the operation of the alternative tax regime.