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

[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 107^{th} 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.

B. Potential Purposes for a Tax Regime for Former Citizens and Former Long-Term Residents

In analyzing a special tax regime applicable to individuals who relinquish citizenship or terminate residency, it is necessary to consider the purposes intended to be served by such a regime. A regime could be designed to serve one or more of a variety of purposes, including: (1) expressing official disapproval of tax-motivated citizenship relinquishment or residency termination; (2) deterring or punishing tax-motivated citizenship relinquishment or residency termination; (3) removing unintended tax incentives for relinquishing citizenship or terminating residency, thereby achieving tax neutrality in the decision to take such actions; (4) taxing appreciation and asset value that accrues while a person is a U.S. citizen or resident; (5) ensuring that individuals cannot enjoy any tax benefits that may arise from relinquishing citizenship or terminating residency while still maintaining significant ties to the country; and (6) combinations of and variations on these purposes. Although the present-law alternative tax regime may serve several purposes, the legislative history to the enactment of the alternative tax regime in 1966 and its modifications, particularly the 1996 amendments, as discussed below, indicates that Congress primarily intended the alternative tax regime to serve the purpose of eliminating unintended tax incentives for citizenship relinquishment or residency termination.

C. Legislative History: Congressional Purpose for the Alternative Tax Regime

1. Foreign Investors Tax Act of 1966

The present-law alternative tax regime was first enacted as part of the Foreign Investors Tax Act of 1966[300] (the "1966 Act"). However, unlike present law, the original alternative tax regime did not contain objective thresholds to treat an individual's citizenship relinquishment as having a principal purpose of tax avoidance. Under the 1966 rules, an individual who relinquished U.S. citizenship was subject to the alternative tax regime only upon proof of a tax avoidance purpose. If it was reasonable to believe that the former citizen's loss of citizenship would result in a substantial reduction in U.S. tax based on the former citizen's income for the taxable year, then the former citizen had the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes.

The intent underlying the enactment of the alternative tax regime can be more fully understood in the context of broader revisions to the U.S. tax treatment of nonresident noncitizens and foreign corporations that were part of the 1966 Act. The 1966 Act eliminated progressive taxation of nonresident noncitizens for income that was not effectively connected with the conduct of a U.S. trade or business. Congress was concerned that such a change would encourage some individuals to surrender their U.S. citizenship and move abroad. By doing so, a former citizen could avoid the graduated tax rates on U.S. investment income.[301]

In addition, the 1966 Act reduced the estate tax rates applicable to nonresident noncitizens to more closely equate them with the taxation of estates of U.S. citizens.[302] Although Congress believed that it was doubtful that many citizens would relinquish citizenship for these reasons, in enacting the alternative tax regime, Congress clearly believed that removal of any such incentive was desirable.[303] Congress expressed a view that the wealth of a former citizen that generally would have been accumulated in the United States was properly subject to the regular U.S. estate tax rates.[304]

Similar reasoning applied in the gift tax context. Under pre-1966 law, a gift of intangible property having a U.S. situs by a nonresident noncitizen who was engaged in a U.S. trade or business was subject to U.S. gift tax. This rule proved impossible to enforce, so the 1966 Act provided that gifts of intangible property by nonresident noncitizens are not subject to the U.S. gift tax. To prevent the new rule from becoming a means of tax avoidance by U.S. citizens, the

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[300] Pub. L. No. 89-809.

[301] *See* H.R. Rep. No. 1450, at 22-23 (1966).

[302] *See* H.R. Rep. No. 1450, at 42 (1966).

[303] *See* H.R. Rep. No. 1450, at 46-50 (1966); S. Rep. No. 1707, 28-29, 54, 57 (1966).

[304] *See* S. Rep. No. 1707, at 54 (1966).

1966 Act provided that this new rule did not apply to gifts by individuals who renounced citizenship for tax avoidance purposes.[305]

The following statement of Senator Russell Long from the Senate floor debate on the 1966 Act captures the intent of Congress with respect to the enactment of the alternative tax regime:

> Your committee agrees with the House that such an amendment is necessary since–although there are undoubtedly few Americans who would avail themselves of such a maneuver–but for this provision, the bill does make such a scheme more advantageous. Therefore, we wish to foreclose the possibility that this bill would serve as an encouragement to such people.[306]

For these reasons, Congress designed a regime to apply special tax rules for those persons who relinquish citizenship with a principal purpose of avoiding U.S. income, estate, or gift taxes.

In addition to these general purposes for enacting an alternative tax regime, Congress enacted provisions with more specific purposes. Congress expressed concern with respect to avoiding the alternative tax regime through the transfer of assets abroad (and out of U.S. taxing jurisdiction) in connection with taking the steps to relinquish citizenship. Therefore, the 1966 Act provided that if certain stock ownership tests are met, the value of the former citizen's gross U.S. estate is to include the same proportion of the value of the stock holdings of the former citizen in the foreign corporation as its property having a U.S. situs bears to all its property. The purpose of this rule was to expand the U.S. estate tax base of former citizen decedents to prevent them from avoiding U.S. tax on the estate by transferring assets with a U.S. situs to a foreign corporation in exchange for its stock. Such a transfer would reduce the portion of the former citizen's gross estate having a U.S. situs subject to estate tax because the stock of a foreign corporation has a foreign situs even though the assets of the foreign corporation are situated in the United States.[307] Similar concerns, related to inappropriately avoiding the alternative tax regime, led Congress to modify the source rules with respect to certain other property, including bonds issued by U.S. persons.[308]

2. Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984[309] provided a more objective definition of residence for income tax purposes.[310] In connection with this change, Congress extended the alternative

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[305] *See* H.R. Rep. No. 1450, at 50.

[306] Congressional Record, Oct. 12, 1966, at 25337.

[307] *See* H.R. Rep. No. 1450, at 47; S. Rep. No. 1707, at 54.

[308] *See* H.R. Rep. No. 1450, at 50; S. Rep. No. 1707, at 57.

[309] Pub. L. No. 98-369.

tax regime to certain residents who leave the United States and later return. In enacting this change, Congress intended that under the mechanical tests for residency, U.S. residents should not be able to leave the United States for a short period, dispose of assets free of U.S. tax, and then resume U.S. residence. Congress also expressed concern with the alternative tax regime to the extent the rules allow for the subsequent disposition of foreign assets held during U.S. citizenship or residence free of U.S. tax.[311]

3. Tax Reform Act of 1986

The concern with the conversion of U.S. assets into foreign assets as a means of avoiding the alternative tax regime, first expressed in 1966, resurfaced in connection with the Tax Reform Act of 1986[312] (the "1986 Act"). Congress sought to prevent former citizens who were subject to the alternative tax regime from avoiding the rules by making tax-free exchanges of U.S. property for foreign property. Under the 1986 Act, such converted property would retain its U.S.-source. Congress believed that former citizens should not be able to accomplish indirectly that which they are prohibited from doing directly.[313] Such changes were consistent with the purposes of the 1966 Act of removing tax incentives for expatriation. These changes were also consistent with the view that gains accrued while property was within the U.S. jurisdiction should be taxed in the United States.

4. 1995 Joint Committee staff study

Legislation enacted in 1995 directed the Joint Committee staff to conduct a study of issues presented by certain proposals to modify the tax treatment of expatriation.[314] The Joint Committee staff study was released on June 1, 1995, and contained several findings and conclusions relating to the prior-law alternative tax regime (i.e., pre-1996 law) as well as other proposals to modify significantly the alternative tax regime.[315] The Joint Committee staff

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[310] An individual who has been treated as a U.S. resident for at least three consecutive years, and who becomes a nonresident and then regains residency status within a three-year period is subject to U.S. tax for all intermediate years under the section 877 income tax rules. Sec. 7701(b)(10).

[311] *See* Joint Committee on Taxation, *General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984*, 465, JCS-41-84 (Dec. 31, 1984).

[312] Pub. L. No. 99-514.

[313] *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 1050, JCS-10-87 (May 4, 1987).

[314] *See* the Self-Employed Person's Health Care Reduction Extension Act of 1995, Pub. L. No. 104-7, sec. 6 (1995).

[315] *See* Joint Committee on Taxation, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation*, (JCS-17-95), June 1, 1995 (hereinafter referred to as the "1995 Joint Committee staff study").

identified certain problems with the prior-law provisions, including the use of certain legal methods to avoid some or all taxation under section 877 through tax planning, the relocation of individuals to certain treaty countries that did not permit the United States to impose tax under section 877 on former citizens, the relocation of assets outside of the scope of section 877 (which only applied to U.S.-source income producing assets), and administrative difficulties associated with demonstrating that tax avoidance was the principal purpose for the individual's expatriation.

5. Health Insurance Portability and Accountability Act of 1996

Through press reports and hearings, Congress became informed that a small number of very wealthy individuals each year relinquish their U.S. citizenship for the purpose of avoiding U.S. income, estate, and gift tax in spite of section 877.[316] As a result, several significant changes were made to the alternative tax regime in 1996 as part of the Health Insurance and Portability and Accountability Act of 1996[317] (the "1996 Act"). Congress revisited the alternative tax regime and made several amendments to strengthen the regime, consistent with the purposes of the 1966 Act. In amending the alternative tax regime, Congress continued to recognize that U.S. citizens have a basic right under both U.S. and international law not only to leave the United States and live elsewhere, but also to relinquish their U.S. citizenship. Accordingly, Congress did not believe that the Internal Revenue Code should be used to stop U.S. citizens or residents from expatriating or terminating residency. Punishment or deterrence, therefore, does not seem to be the intended purpose of the alternative tax regime. At the same time, however, Congress believed that the Code should not provide an incentive for citizenship relinquishment or residency termination.[318] Thus, similar to the purposes underlying the enactment of the alternative tax regime in 1966, the 1996 amendments reflect the view of Congress that tax incentives for citizenship relinquishment or residency termination should be eliminated and tax neutrality should be the goal.[319]

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[316] *See* Robert Lenzner and Philippe Mao, "The New Refuges," *Forbes*, Nov. 21, 1994; United States Senate Committee on Finance, Subcommittee on Taxation and IRS Oversight, *Hearing on the Administration's Proposal to Impose a Tax on Individuals Who Renounce Their U.S. Citizenship,* Mar. 21, 1995; United States House of Representatives Committee on Ways and Means, Subcommittee on Oversight, *Hearing to Examine the Administration's Proposal Relating to the Tax Treatment of Americans Who Renounce Citizenship*, Mar. 27, 1995.

[317] Pub. L. No. 104-191. The 1996 legislative changes to the alternative tax regime generally followed the provisions of H.R. 3103, as passed by the House on March 28, 1996, with certain modifications.

[318] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*, 378, JCS-12-96 (Dec. 18, 1996).

[319] Notwithstanding that Congress expressed a purpose of removing tax incentives for citizenship relinquishment or residency termination as the reason for the 1996 amendments to the alternative tax regime, the Illegal Immigration Reform and Immigrant Responsibility Act of 1996 prohibited persons who renounce U.S. citizenship for the purposes of avoiding taxation from entering the United States. The apparent intent of this rule was that the United States

The 1996 Act extended the alternative tax regime to apply not only to U.S. citizens who lose their citizenship but also to certain long-term residents of the United States whose U.S. residency is terminated.

Second, the 1996 Act provided special rules for purposes of determining whether a former citizen or former long-term resident relinquished citizenship or terminated residency with a principal purpose of tax avoidance. Under these rules, an individual is deemed to have relinquished citizenship or terminated residency with a principal purpose of tax avoidance if (1) the individual's average annual U.S. Federal income tax liability for the five taxable years prior to citizenship relinquishment or residency termination exceeds $100,000, or (2) the individual's net worth on the date of citizenship relinquishment or residency termination is $500,000 or more, as adjusted for inflation. Certain categories of individuals can avoid being deemed to have a principal purpose of tax avoidance for expatriating or terminating residency under these special rules if such individuals submit a ruling request to the IRS regarding whether they relinquished citizenship or terminated residency principally for tax reasons.

Third, the 1996 Act expanded the categories of income and gains that are treated as U.S.-source (and, therefore, subject to U.S. income tax under section 877) if earned by an individual who is subject to the alternative tax regime, and included certain provisions to eliminate the ability to engage in certain transactions that under prior law (i.e., the law in effect before the 1996 changes) partially or completely circumvented the 10-year reach of section 877. These included transactions in which income is derived through controlled foreign corporations, certain foreign property is acquired in nonrecognition transactions, and U.S. property is contributed to foreign corporations.

Fourth, the 1996 Act provided relief from double taxation in circumstances in which another country imposes tax on items that would be subject to U.S. tax under the alternative tax regime. This change addressed the concern that amounts taxed under the alternative tax regime could be subject to double taxation. For example, under pre-1996 law, items could be taxed by both the United States and the country of residence of a former citizen.

Fifth, the 1996 Act contained provisions to enhance compliance with the alternative tax regime, and to assist the IRS in identifying former citizens and former long-term residents who are subject to the alternative tax regime. The 1996 Act imposed information reporting obligations on U.S. citizens who lose their citizenship and long-term residents whose U.S. residency is terminated at the time of citizenship relinquishment or residency termination, and required the Department of State and other governmental agencies to share certain information with the IRS with respect to such individuals.

The 1996 legislative changes to the alternative tax regime were effective for any individual who lost U.S. citizenship, and any long-term resident whose U.S. residency was terminated, on or after February 5, 1995. A special transition rule applied to individuals who committed an expatriating act within one year prior to February 6, 1995, but had not applied for

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should not allow individuals who renounce citizenship for tax purposes the continued enjoyment of some of the privileges of residency in the United States. *See* Part V.D.1, above.

a CLN as of such date. Such an individual was subject to the alternative tax regime, as modified in 1996, as of the date of application for the CLN, but was not retroactively liable for U.S. income taxes on his or her worldwide income. In the case of any former citizen, a request for a ruling that such individual did not have tax avoidance as a principal purpose for the individual's citizenship relinquishment was due not earlier than 90 days after August 21, 1996 (the date of enactment of the 1996 Act).[320]

The 1996 Act also directed the Department of Treasury to undertake a study on the tax compliance of U.S. citizens and green-card holders residing outside the United States and to make recommendations regarding the improvement of such compliance. The findings of such study and recommendations were required to be reported to the House Committee on Ways and Means and the Senate Committee on Finance within 90 days after August 21, 1996 (the date of enactment of the 1996 Act). In May 1998, the Department of Treasury issued its study on the income tax compliance by U.S. citizens and U.S. lawful permanent residents residing outside the United States.[321] The Department of Treasury noted that compliance and enforcement may be extremely difficult with respect to individuals whose connection with the United States was or will be minimal. For example, if an individual no longer has investments in the United States, the IRS may not receive information from third party payers with respect to that individual. Thus, the IRS may not be able to determine whether such individual should have filed a U.S. income tax return. The report also noted that information from the Department of State and the INS often lack the former citizen's or former permanent resident's social security number. Since IRS systems are based on such numbers, the report noted that the IRS has difficulty matching the information it receives from these agencies with other IRS data. In addition, the report pointed out that the date a CLN is issued does not correspond with the date of the expatriating act. The report noted that the 10-year period under section 877 potentially could expire between the date of the expatriating act and the issuance of the CLN by the Department of State. Finally, the Department of Treasury noted that the information provided by the INS with respect to former green card holders was not sufficient to identify which green card holders were former long-term residents for purposes of the alternative tax regime (i.e., a resident for eight out of the last 15 years).

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[320] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress*, 387, JCS-12-96 (December 18, 1996). Similarly, the required information statements were not due earlier than 90 days after August 21, 1996. *Id.* Under Notice 96-60, 1996-2 C.B. 227, the IRS announced that it intended to issue detailed guidance with respect to the ruling request and information reporting rules, and stated that ruling requests and information statements are not due earlier than 60 days after the issuance of such guidance. The due dates for the information statements are described in Notice 97-19. See discussion in Part IV.B.5. above.

[321] *See Department of Treasury, Income Tax Compliance by U.S. Citizens and U.S. Lawful Permanent Residents Residing Outside of the United States and Related Issues*, Rep. No. 3108 (May 15, 1998).

D. Summary

There are several potential purposes that a tax regime for former citizens and former long-term residents could serve. The design of the taxing regime and evaluation of the effectiveness of the regime depends on one's view of the appropriate purpose for the regime. Congress has indicated that the present-law alternative tax regime is intended to serve the purpose of removing the tax incentives for citizenship relinquishment or residency termination. The scope of this review, therefore, is limited to analyzing the present-law rules to determine whether they are effective in achieving that purpose.