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).