VIII. EFFECTIVENESS OF PRESENT-LAW TREATMENT OF CITIZENSHIP RELINQUISHMENT AND RESIDENCY TERMINATION

A. Summary

The 1996 legislative changes to the alternative tax regime made improvements in the effectiveness of the provisions relating to citizenship relinquishment and residency termination. However, there are several areas in which the present tax law continues to provide tax incentives for citizenship relinquishment or residency termination. This section describes certain effectiveness problems with respect to both the alternative tax regime for former citizens and former long-term residents and related immigration laws.

Income tax rules

With respect to the income tax rules under the alternative tax regime, the following problem areas exist with respect to the rules that may hinder their effectiveness in removing tax incentives for citizenship relinquishment or residency termination. First, the alternative tax regime generally does not apply to foreign-source income or gain, such that an individual with significant foreign income or assets generally would be better off from a tax standpoint by relinquishing citizenship or terminating residency than by continuing to be taxed on his or her worldwide income.

Second, the 10-year period following citizenship relinquishment or residency termination during which a former citizen or former long-term resident is subject to the alternative tax regime can easily be avoided. For example, a former citizen or former long-term resident could wait for the 10-year period to expire before disposing of assets otherwise subject to the special rules, or borrow against U.S.-source assets during the 10-year period.

Third, significant challenges remain with respect to monitoring and enforcement during the 10-year period with respect to former citizens and former long-term residents who may otherwise not be subject to U.S. law. No effective system is in place for collecting and processing timely information relating to these individuals. Moreover, these individuals might not be physically present in the country at any time, and their assets may not be situated in the country or under the control of any U.S. person.

Fourth, the alternative tax regime continues to depend, in large part, on the subjective intent of the former citizen or former long-term resident, which has been acknowledged by both the Congress and the IRS as making the provisions difficult to administer. In this regard, significant administrative difficulties have arisen in this area as a result of the IRS ruling process for determining whether certain categories of individuals should not be treated as having a principal purpose of tax avoidance, including difficulties associated with the modified ruling procedures under Notice 98-34.[386] Of the 255 rulings issued under Notice 98-34 through July 1,

[386] 1998-2 C.B. 29. *See* A-193.

2002, 127 were "fully submit" rulings, which express no opinion regarding whether such individuals' citizenship relinquishment or residency termination was tax-motivated.[387]

Fifth, the penalties for failure to comply with the rules do not appear to be sufficient disincentives to encourage former citizens and former long-term residents to provide the critical information necessary for the Department of Treasury and the IRS to enforce the rules.

Estate and gift tax rules

Several features of the special estate and gift tax rules under the alternative tax regime hinder the effectiveness of these rules in removing the tax incentives for citizenship relinquishment or residency termination.

First, the alternative tax regime generally does not apply to foreign-situated property. Thus, to the extent that an individual owns foreign-situated property, such individual would be better off from a tax standpoint by relinquishing citizenship or terminating residency rather than continuing to be subject to U.S. estate tax on their worldwide estate. Moreover, former citizens and former long-term residents can avoid U.S. estate and gift taxes by investing in assets located outside the United States or converting U.S.-situated property to foreign-situated property after (or even before) citizenship relinquishment or residency termination, in order to remove their assets from the U.S. estate and gift tax base. This may be advantageous even if there are income tax consequences associated with transferring assets out of the U.S. taxable estate.

Second, enforcing U.S. estate and gift taxes against individuals who no longer reside in the United States presents special difficulties. For example, the IRS may have difficulty determining whether a former citizen or former long-term resident (or other nonresident noncitizen) who died outside the United States owned U.S.-situated property that is subject to U.S. estate tax.

Tax treaties

Even if the present-law alternative tax regime were modified to improve its effectiveness, the regime could still have little or no effect in many instances. Under relevant legislative history to the 1996 expatriation tax legislation and related administrative guidance, the alternative tax regime applies regardless of conflicting treaty provisions that may otherwise prevent the application of the alternative tax regime, for the 10-year period following the enactment of the 1996 expatriation legislation (i.e., August 21, 1996). After that 10-year period ends (i.e., beginning August 21, 2006), any conflicting treaty provisions that are still in force will take precedence over the alternative tax regime. Thus, for periods after that date, the alternative tax regime may have little or no effect with respect to individuals who relocate to certain countries with which the United States has a tax treaty, to the extent that the treaty does not

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[387] *See* Table 3 in Part VII.

permit the United States to impose a tax on former citizens or former long-term residents who reside in such other countries.[388]

Immigration rules

Since its enactment in 1996, the INS and the Department of State have not enforced the immigration provision with respect to former citizens. The Joint Committee staff has been advised that the INS, in conjunction with the Department of Justice, the Department of Treasury, the Department of State, and the IRS, are in the process of developing guidelines to implement the immigration provision. In the absence of such guidelines, this review cannot assess whether such guidelines will improve the effectiveness of the immigration provisions.

[388] *See* Part VIII, D., below.