C. Estate and Gift Tax Rules

1. In general

Individuals who contemplate relinquishing citizenship or terminating residency for tax purposes generally consider three main U.S. taxes: the income tax, the estate tax, and the gift tax. For wealthy taxpayers, the estate and gift tax, the rates of which reach 49 percent (for 2003), may serve as the motivating factor in the decision to relinquish citizenship or terminate residency.[433] For these individuals, avoidance of U.S. estate and gift taxes, alone, could be the reason for citizenship relinquishment or residency termination, even if there may be income tax consequences associated with these acts. While the future of the estate tax is uncertain, the tax continues to apply at high rates to those estates that are subject to it, and relinquishing citizenship or terminating residency remains an effective way for many taxpayers to reduce or eliminate the burden of the tax.

As discussed in more detail below, the estate and gift tax rules under the alternative tax regime are not effective deterrents to relinquishing citizenship or terminating residency to avoid U.S. estate and gift tax. These rules merely expand the property that is considered U.S.-situated property for purposes of U.S. estate and gift taxes. Former citizens and former long-term residents may be able to avoid application of these rules by making certain that they do not own any such U.S.-situated property after citizenship relinquishment or residency termination. This can be achieved by either investing outside the United States or converting U.S.-situated property to foreign-situated property.

The income tax rules under the alternative tax regime may provide some deterrent to estate and gift tax-motivated citizenship relinquishment or residency termination. Some individuals may be unwilling or unable to pay an income tax on the conversion of U.S. property to foreign property or on the transfer of property to foreign corporations, trusts, or estates. However, individuals whose primary goal is avoidance of the U.S. estate and gift tax may be relatively unconcerned with the imposition of an income tax. For these individuals, the income tax rules under the alternative tax regime serve little deterrent effect.

2. History of the estate and gift tax rules of the alternative tax regime

In 1966, when the estate and gift tax rules under the alternative tax regime were first enacted, nonresident noncitizens were subject to lower estate and gift tax rates than were U.S. citizens. The rules then provided that former citizens who were subject to the alternative tax regime would not be able to take advantage of the lower estate and gift tax rates. In addition to lower estate and gift tax rates for nonresident noncitizens, the estate and gift tax rules were not unified in 1966.[434]

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[433] *See* Part VI, above.

[434] The estate and gift tax regime became unified in 1976. Pub. L. No. 94-455, Sec. 2001.

Two estate and gift tax rules (originally enacted in 1966) apply to individuals who are subject to the alternative tax regime. One rule is an estate tax rule that prevents former citizens and former long-term residents from sheltering property from U.S. estate tax by transferring U.S.-situated property to foreign corporations. Under this rule, the former citizen or former long-term resident is required to include in his or her U.S. estate the value of certain closely-held foreign stock to the extent the foreign corporation owns U.S.-situated assets.[435]

The second rule is a gift tax rule. Prior to 1966, U.S. citizens and nonresident noncitizens, alike, generally were subject to gift tax on the transfer of U.S. intangibles, such as U.S. stock and securities. Due to enforcement problems with these rules when applied to nonresidents, the gift tax rules were amended in 1966 to provide generally that nonresident noncitizens are not subject to U.S. gift tax on the transfer of intangibles. However, this intangible exclusion was not extended to individuals subject to the alternative tax regime, such that former citizens and former long-term residents who are subject to the alternative tax regime continue to remain subject to U.S. gift tax on transfers of U.S. intangible property.[436]

In 1988, the lower estate and gift tax rates that applied to nonresident noncitizens were repealed.[437] As a result, nonresident noncitizens, including former citizens and former long-term residents who are subject to the alternative tax regime, are now subject to the same rate bracket to which U.S. citizens and residents are subject.

3. Scope of the estate and gift tax rules of the alternative regime

The special estate and gift tax rules apply only to the transfer of certain U.S.-situated assets of certain former citizens and former long-term residents during the 10 years after citizenship relinquishment or residency termination. This includes a transfer during the former citizen's or former long-term resident's life (for gift tax purposes) or a transfer at a former citizen's or former long-term resident's death (for estate tax purposes) during this 10-year period. Foreign-situated assets generally are not subject to either U.S. estate or gift tax regardless of whether the nonresident noncitizen was an individual who relinquished citizenship or terminated residency for tax reasons. Thus, if an alternative tax regime is designed to remove estate and gift tax incentives for individuals to relinquish citizenship or terminate residency the present law provisions are insufficient deterrents. A wealthy U.S. citizen or resident who is otherwise subject to U.S. tax on his or her worldwide estate or on lifetime gifts of worldwide property would be able to avoid U.S. estate and gift tax by (1) surviving for 10 years after citizenship relinquishment or residency termination (or waiting 10 years to make a lifetime gift),[438] (2)

[435] Sec. 2107(b).

[436] Sec. 2501(a)(3).

[437] Pub. L. No. 100-647, sec. 5032(a).

[438] Issues with respect to the 10-year period after citizenship relinquishment or residency termination as it relates to the estate and gift tax provisions are similar to those discussed above in connection with the income tax provisions. *See* Part VIII.B.1.b, above. An important distinction exists, however, in that it is much more difficult to plan survival for a 10-year period

investing in foreign situated-assets either prior to or after citizenship relinquishment or residency termination, and/or (3) converting U.S.-situated assets to foreign-situated assets, thereby removing such assets from the former citizen's or former long-term resident's U.S. estate or gift tax base. To limit these incentives, present law expands the class of property that is considered U.S.-situated.[439] These rules, however, are narrow in scope and, as a result, may not be effective at achieving their desired purpose.

(a) Foreign-situated assets not affected

The estate and gift tax rules under the alternative tax regime generally attempt to limit avoidance of the U.S. estate and gift tax by former citizens and former long-term residents through expanding the U.S. estate and gift tax base. The alternative tax regime expands the estate tax base by including the value of closely-held foreign stock of a former citizen or former long-term resident in the U.S. estate to the extent the foreign corporation owns U.S.-situated assets, if the former citizen or former long-term resident died within 10 years of citizenship relinquishment or residency termination.[440] For gift tax purposes, the alternative tax regime expands the U.S. gift tax base by subjecting to gift tax transfers of U.S.-situated intangibles (e.g., U.S. stocks and bonds) made within 10 years of citizenship relinquishment or residency termination.[441] These special estate and gift tax rules are designed to expand the definition of U.S.-situated property for estate and gift tax purposes. The estate and gift tax rules, however, have no application to foreign-situated property. Indeed, to the extent a former citizen or former long-term resident owns foreign-situated property or converts U.S. property to foreign property, the estate and gift tax rules under the alternative tax regime have no effect. Thus, the present-law alternative tax regime provides an incentive for former citizens and former long-term residents either to invest in property located outside the United States or to convert U.S.-situated property to foreign-situated property in a transfer or exchange.

To the extent that a U.S. citizen or long-term resident invests in foreign-situated assets over time, there is a U.S. estate and gift tax incentive for citizenship relinquishment or residency termination. Had that person made a gift or died while he or she was a U.S. citizen or long-term resident, the gross value of the foreign-situated asset would have been subject to U.S. estate or gift tax. The tax on such assets can be avoided by relinquishing citizenship or terminating residency, notwithstanding the present-law alternative tax regime.

(in order to avoid the estate tax) as opposed to postponement of realization for a 10-year period (in order to avoid the income tax) or postponement of a gift for a 10-year period (in order to avoid the gift tax).

[439] Secs. 2107 and 2501.

[440] Sec. 2107(b).

[441] Sec. 2501(a)(3). There is no foreign stock look-through rule for gift tax purposes that is analogous to section 2107(b).

In addition to individuals who have invested in foreign-situated property, there is an estate and gift tax incentive for citizenship relinquishment or residency termination for those who are able to "re-situate" their U.S. property outside the United States. If this conversion from U.S.-situated to foreign-situated property can be accomplished through a transfer or exchange without income tax consequences, the incentive may be considerable. As discussed below, however, even if income tax consequences exist, there still may be tax incentives for citizenship relinquishment or residency termination.[442]

Under the income tax rules, there are several provisions that limit the ability of a taxpayer to convert U.S.-situated property into foreign-situated property by providing for an income tax on certain transactions by U.S. citizens or residents or former citizens or former long-term residents.

An income tax is imposed on a U.S. person on the gain realized on transferring U.S. property to a foreign corporation.[443] If a U.S. person transfers property to a foreign corporation, such transfer generally is treated as a sale or exchange for an amount equal to the property's fair market value. For example, if a U.S. person contributes appreciated property to a foreign corporation, a tax would be imposed on the gain at the income tax rates.

An income tax is also imposed on the transfer by a U.S. person to a foreign trust or foreign estate.[444] Thus, if a U.S. person transfers appreciated property to a foreign trust, for example, a tax would be imposed on the inherent gain with respect to such property at the income tax rates.

For the five-year period prior to and the 10-year period after citizenship relinquishment or residency termination, individuals subject to the alternative tax regime generally are subject to U.S. income tax on the exchange of property that gives rise to U.S.-source income for property that gives rise to foreign-source income.[445] Such former citizens and former long-term residents who exchange U.S.-source income producing property for foreign-source income producing property generally are subject to income tax as if such U.S. property were sold for its fair market value on the date of such exchange. For example, if the former citizen or former long-term resident exchanges appreciated U.S. property, such as U.S. stock, for foreign stock, such individual generally must recognize gain to the extent of the gain inherent in the U.S. stock if the transaction occurs within five years prior to or 10 years after citizenship relinquishment or residency termination.

These income tax rules, however, may not be not sufficient to remove the estate and gift tax incentives for citizenship relinquishment or residency termination. First, the income tax

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[442] Secs. 367, 684, and 877.

[443] Sec. 367.

[444] Sec. 684.

[445] Sec. 877(d)(2) and Notice 97-19.

provisions apply only to the extent that there is gain realized on the property that is transferred or converted. If the property in question is cash or other high-basis property with little or no inherent gain, then the income tax rules would not serve any deterrent effect because there would be no income tax assessed on the conversion transaction. For example, an individual who inherits U.S.-situated property with a basis that is stepped up to fair market value[446] could immediately convert that property to foreign-situated property without income tax consequences (because there is no gain to tax).[447] Such individual could then relinquish citizenship or terminate residency, and the assets would be outside of the scope of the estate and gift tax rules under the alternative tax regime.

In addition, even if the individual pays income tax on gain with respect to transactions that convert U.S.-situated property to foreign-situated property, there may be an incentive to engage in such transactions and pay the income tax in order to avoid the estate and gift tax. Once the property has been transferred to a foreign entity or converted to foreign-situated property, it no longer would be subject to estate and gift tax if held by a former citizen or former long-term resident. Because the income tax rates are lower than the estate and gift tax rates and apply only to gain inherent in the property, whereas the estate and gift tax rates apply to the entire value of the property (and not just the inherent gain), individuals may be willing to pay the income tax in order to ensure that their property ultimately will be outside the U.S. estate and gift tax base. In other words, paying the income tax may be a small hurdle in successfully moving property outside the United States for U.S. estate and gift tax purposes.

(b) Post-departure enforcement

Enforcement of U.S. estate and gift tax of nonresident noncitizens (including individuals who relinquish citizenship or terminate residency for tax reasons) involves determining whether the individual has made a lifetime gift or transfer at death of U.S.-situated property. This presents difficulties. For example, the property may be cash or personal property for which no records of their transfer are kept indicating that the property has been transferred. For real estate or stock, for which such records generally are kept, tracking lifetime gifts would require examining local real estate records or corporate records, and such an examination by the IRS is unlikely unless the IRS becomes aware of the transfer from an outside source. In the estate tax context, similar difficulties may exist as well. Because the estate of a former citizen or former long-term resident would be administered outside the United States, the IRS may have difficulty learning of the death of former citizens and former long-term residents and may have trouble determining the extent of such individual's U.S.-situated property.

Enforcement of the additional estate tax rule that applies to certain former citizens and former long-term residents (which applies for the 10-year period after citizenship relinquishment or residency termination) presents difficulties of its own. Under this rule, the gross estate includes all U.S.-situated property and foreign stock to the extent the foreign corporation holds

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446 Sec. 1014.

447 U.S. estate tax may have been paid, however, by the estate of the decedent from which the former citizen or former long-term resident received the property.

U.S.-situated assets, provided that the decedent generally owned more than 50 percent of the stock. Such holdings would need to be identified on at least two levels. First, the decedent's interest in the foreign stock must be identified. This can be particularly difficult, because it could potentially require examination of the corporate records of a foreign corporation, jurisdiction over which the United States presumably would not have. Second, to the extent such a foreign corporation owns U.S.-situated property, enforcement would require looking through such foreign corporations to determine what assets they hold.

Under the gift tax rule, certain former citizens and former long-term residents are subject to gift tax on the transfer of U.S.-situated intangible property, such as U.S. stocks and bonds (again, for the 10-year period after citizenship relinquishment or residency termination). To enforce this provision, the IRS would need to determine when such stocks and bonds have been transferred by a nonresident noncitizen. Because such stocks or bonds would have been issued by a U.S. person, it may be possible for the IRS to examine, for example, the corporate records of a U.S. corporation.

4. Conclusions

Avoidance of U.S. estate and gift tax may be the primary reason some individuals relinquish citizenship or terminate residency. There is one estate tax rule and one gift tax rule that apply exclusively to former citizens and former long-term residents who are subject to the alternative tax regime, but those rules are narrow in scope and do not apply to the extent that the former citizen or former long-term resident holds foreign-situated assets. To the extent that the income tax rules under the alternative tax regime apply to certain conversion or exchange transactions, they may not be sufficient to deter estate and gift tax avoidance, because the income tax applies at rates substantially lower than those under the estate and gift tax. Moreover, the income tax provisions apply to the extent there is gain, depending on the value and the basis of the property. The estate and gift tax applies to the value of a taxpayer's entire interest in property. Thus, the income tax rules may serve as an inadequate deterrent in many cases of individuals who seek to avoid U.S. estate and gift tax.

It may be appropriate to consider additional tax rules that would provide greater deterrence to estate and gift tax-motivated citizenship relinquishment or residency termination. For example, consideration should be given to applying the special estate tax rule for gift tax purposes in order to prevent former citizens and former long-term residents from making lifetime gifts of closely-held stock in foreign corporations that hold U.S.-situated assets.