D. General Issues Raised by Proposals

Income tax rules

Issues common to present law and proposals

Mark-to-market proposals would impose an income tax on unrealized gains when an individual relinquishes citizenship or terminates residency, regardless of the taxpayer's subjective motivation for citizenship relinquishment or residency termination. The mark-to-market proposals thus would eliminate the necessity to examine the former citizen's or former long-term resident's subjective intent in order for the deemed sale rules to apply. The taxation of unrealized gains under the mark-to-market proposals, however, is a departure from the normative U.S. income tax system, which generally imposes tax only on realized gains.

The mark-to-market proposals have been justified on certain grounds. First, some argue that it is appropriate to collect U.S. tax with respect to those individuals who have enjoyed the benefits of U.S. citizenship or residency or with respect to U.S. citizens and long-term residents whose assets have enjoyed the protection of being within U.S. borders.[559] That is, income taxes are one of the costs of citizenship, one of the mechanisms by which the Federal Government finances the benefits that U.S. citizens and long-term residents receive. Under this view, it may be unfair to tax a U.S. citizen who has had no meaningful contacts with the United States and who arguably has not exercised the benefits of citizenship. For example, this rationale would not seem to support imposition of a mark-to-market tax on a U.S. citizen who was born outside the United States and who never lived in nor held assets in the United States. In addition, it may be unfair to tax assets of long-term U.S. residents that were acquired outside the United States and were never brought into the United States. The mark-to-market proposals, however, would impose tax on former citizens and former long-term residents regardless of the level of the individual's U.S. benefits, regardless of any taxes the individual previously has paid, and regardless of the fact that the assets had no relationship with the United States. On the other hand, the individual's worldwide assets, including those assets that have no relationship with the United States, would remain subject to U.S. tax if the individual remains a U.S. citizen or long-term U.S. resident.

Second, some argue that it is appropriate to collect U.S. tax from certain U.S. citizens who relinquish U.S. citizenship but maintain a significant continuing relationship with the United States, including spending significant periods of time in the United States. It is argued that such individuals are not really relinquishing their ties to the United States and, thus, should continue to be taxed as U.S. citizens or residents. Under this view, the tax imposed under the mark-to-market proposals is a proxy for the tax that would have been owed had the individual continued to be a U.S. citizen or resident. If a mark-to-market tax were justified on the basis that the

---

[559] Some assert that benefits of U.S. citizenship include being able to travel on a U.S. passport and to enjoy the protection of a U.S. embassy outside the United States. Others assert that the benefits of U.S. citizenship relate primarily to beneficial services (such as advances in health care, technology, and modern public works) that are enjoyed by those living in the United States.

individual did not really sever ties with the United States, then it may not be appropriate to impose tax on individuals who clearly maintain no ongoing ties. For example, it may be inappropriate to tax an individual who acquired U.S. citizenship by birth and who has never lived in the United States. The mark-to-market proposals could affect former citizens who have lived abroad their entire lives and who have very tenuous ties to the United States. The mark-to-market proposals also would affect former citizens and former long-term residents who sever all ties with the United States. The proposals addresses this concern to some degree, although they do not completely eliminate the concerns.[560]

Third, proponents of the mark-to-market proposals argue that such proposals would simplify the taxation of former citizens and former long-term residents by eliminating the subjective inquiry into the intent of the former citizen or former long-term resident. Because there is no intent requirement under these proposals, the IRS would not have to delve into specific factual details for each individual's citizenship relinquishment or residency termination to determine if the individual had a tax avoidance motive. Instead, in order to assess the mark-to-market tax, the IRS would simply be required to show that an individual relinquished citizenship or terminated residency. Removing the intent requirement might also lead to increased voluntary compliance, because individuals would no longer be able to rationalize that they are not subject to the tax because they had other reasons for relinquishing citizenship or terminating residency.

These first three issues with respect to the mark-to-market proposals (i.e., collecting tax with respect to those who have enjoyed the benefits of citizenship, collecting tax from those who have not meaningfully severed ties with the United States, and eliminating inquiries into subjective intent) are not unique to the mark-to-market proposals, but rather are common issues with respect to the scope of any tax regime applicable to former citizens and former long-term residents. In fact, these same issues relate to the effectiveness of the present-law alternative tax regime. Some of the recommendations made by the Joint Committee staff with respect to present law address these issues and could also be applicable with respect to the mark-to-market proposals. The arguments discussed below, on the other hand, are more specific to the mark-to-market proposals.

Issues specific to mark-to-market proposals

Some argue that it is appropriate to tax unrealized gains that accrue during the period that an individual was subject to U.S. taxation on a worldwide basis. Under this view, a former citizen or former long-term resident with foreign income or assets should not be permitted to avoid U.S. tax on such income or assets that economically accrued while the individual was a

[560] For example, the House bill provides for an exception to the mark-to-market tax for individuals born with citizenship both in the United States and in another country; provided that, among other things, the individual was a resident of the United States for no more than eight out of the 15 taxable years ending with the year of citizenship relinquishment. The Senate amendment would exclude a dual citizen from birth from the mark-to-market rules if the individual was not a resident of the United States for the five years prior to citizenship relinquishment.

U.S. citizen or U.S. resident. A fundamental general principle of the U.S. Federal income tax system is that it taxes only realized gains. In part, this rule can be viewed as one of administrative convenience: the realization principle addresses liquidity concerns and income measurement valuation problems and costs. Nonetheless, income and gain accrue over time. As a result, the United States arguably has the right to tax the income or gain that accrues while an asset is held by a person who is a U.S. citizen or long-term resident subject to U.S. taxing jurisdiction. In this regard, citizenship relinquishment or residency termination could be viewed as a deemed realization event.[561] Consistent with this rationale, some would argue that an exit tax based on a mark-to-market regime would be more appropriately considered in the context of a broader policy initiative that would mark to market both items that are entering as well as items that are exiting the U.S. taxing jurisdiction.[562] Under such a regime, emphasis would be on measuring and taxing gains and income that accrue while (and only while) a person is a citizen or resident of the United States.

Proponents of the mark-to-market proposals argue that a special tax is more appropriately collected at the time of citizenship relinquishment or residency termination, as compared to collection of a tax over a 10-year period following an individual's citizenship relinquishment or residency termination (as under present law), when the individual may be outside the United States and collection of such taxes may be more difficult. To the extent that an individual does not intend to return to the United States, however, the IRS would likely have many of the same enforcement problems that exist under present law with respect to monitoring and investigating individuals who have physically departed the United States, and identifying individuals subject to the rules.[563] This problem of administration, however, generally is limited to the time of

---

[561] Certain provisions under present law depart from the realization requirement, including the mark-to-market regime for securities dealers under section 475, the mark-to-market taxation of certain regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options under section 1256, and the rules for taxing original issue discount under sections 1271-1275.

[562] For related proposals in this regard, see the Clinton Administration's Fiscal Year 2001 Budget Proposals regarding modifying the treatment of built-in losses and other attribute trafficking and simplifying the taxation of property that no longer produces income effectively connected with a U.S. trade or business.

[563] The mark-to-market proposals also present serious administrability concerns with respect to their application to green-card holders. Unlike the procedures for relinquishing citizenship, there are no formal procedures when a noncitizen terminates U.S. residency by which such an individual is required to relinquish a green card, nor is there any incentive for an individual to actually turn in a green card upon leaving the United States. If such individuals were made aware that a special tax would be imposed upon the relinquishment of a green card, it may be even more likely that these individuals would simply leave the United States without ever notifying the authorities of their departure. Thus, it may be difficult for the IRS to determine the identity of long-term residents who terminate their residency absent any voluntary compliance by these individuals. An additional difficulty arises in the context of green-card holders in that some individuals who would otherwise obtain green-cards could instead obtain

citizenship relinquishment or residency termination. The proposals would ease the overall administrative burdens by not requiring monitoring of transactions over a 10-year period as under present law.[564]

Enforcement issues

Enforcement of the mark-to-market proposals would depend (as under present law) upon the extent to which former citizens and former long-term residents supply the necessary information for the IRS to determine that the requirements for imposing the tax apply. To the extent that the necessary information is not supplied by former citizens, former long-term residents, or appropriate agencies involved in the citizenship relinquishment or residency termination process (as has been the case under present law), enforcement of the tax may not be successful. Under both present law and the mark-to-market proposals, the IRS may not learn about the citizenship relinquishment or residency termination until the individual has physically left the country. In addition, physical separation from the United States may hinder the ability of the IRS to collect any tax owed (as under present law). With notification, the IRS can attempt to determine whether a former citizen or former long-term resident possesses any assets within the United States that could be seized to satisfy the tax liability. Seizure of assets for failure to pay taxes is permitted under present law.[565] The Senate amendment would grant the IRS the authority to impose a lien on U.S.-situs property for taxes that are deferred under that proposal. In addition, the Clinton Budget proposal and the Senate amendment would seek to encourage enforcement of the mark-to-market tax by denying former citizens reentry into the United States (regardless of their subjective motive for expatriating) if the former citizen did not comply with their tax obligations under the proposal.

The mark-to-market proposals would reduce a taxpayer's ability to avoid taxation through tax planning, because a more comprehensive tax base would be utilized. Thus, it would be more difficult to structure one's holdings in a manner designed to avoid the mark-to-market tax.

Critics of the mark-to-market proposals argue that the proposals present enforceability issues that do not exist under present law. Because such proposals would impose a tax on unrealized gains (and, thus, market price for the assets may not be readily available), there may be significant valuation disputes between taxpayers and the IRS. These valuation disputes are likely to be even more problematic in the case of interests in trusts, because beneficiaries who relinquish citizenship or terminate residency would be subject to a tax liability determined by

---

certain types of nonimmigrant visas if the proposal was enacted and, thus, escape taxation under the proposal. Similar difficulties may exist, however, with respect to the administration of present law in connection with green-card holders.

[564] The strength of the proposals in easing administrative burdens is lessened to some extent by permitting the tax to be paid over a 10-year period. The requirement of posting a bond is helpful in this regard.

[565] Sec. 6331.

reference to the unrealized appreciation in the value of the trust's assets notwithstanding the fact that the beneficiary has no access to the assets of the trust.[566] The proposals also raise liquidity issues because the assets held at the time of citizenship relinquishment or residency termination may not be liquid and, thus, the individual may not have sufficient resources with which to pay the tax upon citizenship relinquishment or residency termination. These liquidity concerns are alleviated to some degree by the ability to defer payment of the mark-to-market tax if certain conditions are met (albeit, as described above, at the cost of lessening the ability to ease administrative burdens).

The mark-to-market proposals may create an incentive to relinquish citizenship or terminate residency that does not exist under present law for individuals who either have recently inherited wealth or who expect to inherit wealth in the near future, because the basis of inherited assets is stepped up to fair market value on the date of the decedent's death. Thus, there would be little or no mark-to-market tax imposed on such assets.

Double taxation issues

The proposals could give rise to potential double taxation issues. For U.S. tax purposes, the proposals would provide for a step up in basis for any gain recognized upon the deemed sale of assets upon citizenship relinquishment or residency termination, so that double taxation of that same gain generally would not occur for U.S. income tax purposes. However, as described below, such a regime could lead to double taxation if a former citizen or former long-term resident is subject to U.S. gift or estate tax on the same property. In addition, double taxation could occur if the foreign country to which the former citizen or former long-term resident became a resident also taxed the same gain upon a later disposition of the asset.[567] In this regard, many countries do not exempt from local tax gains that accrued prior to the time an individual became a resident of that country.[568] Consequently, double taxation will occur if a former citizen or former long-term resident is subject to the mark-to-market tax on the deemed sale of an asset, becomes a resident of another country that includes pre-immigration gains in its tax base, and subsequently sells that asset.[569] In addition, the House bill does not have special coordination

---

[566] For a discussion of valuation and other problems associated with marking to market interests in trusts under prior mark-to-market proposals, see the 1995 Joint Committee staff study, supra note 315.

[567] Furthermore, the jurisdiction in which the asset is located may also levy its tax on the gain realized.

[568] See Part IX., above. Australia, Canada, Denmark, and Israel are exceptions to the general rule of most countries that tax gains that have accrued prior to the individual's immigration to such country.

[569] Such an individual generally would not be eligible for specific relief from double taxation under a tax treaty. It is uncertain whether double taxation relief could be obtained under a mutual agreement procedure article of an income tax treaty. These articles of U.S. tax treaties generally grant the competent authorities of the treaty countries to consult and resolve double taxation issues regardless of whether they are specifically covered by the treaty. A potential

rules with the present-law alternative tax regime. Thus, it is unclear how the House bill would interact with the present-law alternative tax regime, and, if they both apply, how potential double taxation would be addressed.

International law issues

Some have argued that under certain circumstances a mark-to-market tax upon citizenship relinquishment or residency termination might conflict with rights to emigrate or expatriate recognized by U.S. and international law.[570] In addition, potential constitutional issues have been raised with respect to such a tax.[571] The Joint Committee staff requested the CRS to review the constitutionality of the Clinton Budget proposal and the Rangel-Matsui bill (H.R. 3099), and whether these proposals comport with international law. As a general matter, according to the CRS, the possible application of a mark-to-market regime to those retroactively

---

determination is made on a case-by-case basis that is based on the particular facts and circumstances. A former citizen generally would request competent authority assistance from the competent authority of his or her country of residence. The competent authorities may not reach agreement or even if agreement could be reached, the process can be time consuming (and, thus, costly) for the taxpayer. If the gain is attributable to U.S. sources, the foreign country may give a credit against its local tax for the U.S. tax paid.

[570] For a discussion of these issues, see the 1995 Joint Committee staff study, supra note 315. The 1995 Joint Committee staff study pointed out that some observers have labeled prior mark-to-market proposals as "exit taxes" that may conflict with rights to emigrate or expatriate recognized under international law. The 1995 Joint Committee staff study stated that it is difficult to conclude that such proposals would be an arbitrary infringement under international law if the mark-to-market proposals are viewed as an attempt to neutralize the tax consequences that flow under U.S. tax laws from the decision to retain or renounce U.S. citizenship.

[571] *Id.* The 1995 Joint Committee staff study described certain potential constitutional issues raised by prior mark-to-market proposals, such as whether the proposals violate the Constitution on the ground that the Sixteenth Amendment contains an implicit requirement that gains be realized before Federal income taxes are imposed, and whether other aspects of such proposals conflict with constitutional principles such as the due process clause of the Fifth Amendment. The 1995 Joint Committee staff study noted that judicial decisions and legal commentary represent a substantial line of authority for the position that the concept of realization is not constitutionally mandated, and that prior mark-to-market tax proposals generally would not appear to lead to a colorable constitutional challenge under the due process clause of the Fifth Amendment. However, it was also pointed out that there may be due process challenges as applied to particular factual settings, such as the case in which a beneficiary of a trust who has merely a contingent interest in the trust is deemed to have income under a mark-to-market proposal. The study also describes other potential due process challenges that may arise under such proposals, such as the retroactive application of mark-to-market taxes on individuals who have long since relinquished their citizenship under law in effect prior to the enactment of such a regime.

continued as U.S. citizens is an issue that is vulnerable to constitutional challenge.[572] In addressing these issues, the CRS stated the following:

> [W]e believe that the [Clinton] Administration proposal calls for replacing existing IRC § 877 with an exit tax effective for all those relinquishing citizenship on or after the date of first committee action. Generally, limited retroactivity for the period of time it takes to get legislation through the legislative process does not raise due process concerns. In some expatriates' cases, this trade off between 10 years of additional U.S. tax liability and a one-time exit tax may result in lower costs. For others, the opposite would be true. Existing law does not tax those who are not expatriating for tax avoidance purposes, while the [Clinton] Administration proposal would tax everyone expatriating who possesses over $600,000 in assets. The expatriates lacking a tax avoidance purpose have a stronger expectation of no change in the law than do those potentially subject to current IRC § 877. In addition, those who think they lost citizenship years ago and are not expatriating for tax avoidance purposes may be less likely to be well advised (and therefore be on notice of possible tax law changes).[573] Careful consideration should be given to whether it is fair to impose such a tax retroactively on the non-avoiders.
>
> We believe that the exit tax in the House proposal is supposed to be on top of the tax in IRC § 877. If this is correct, the House proposal would impose a new exit tax on everyone expatriating while continuing the existing regime for those who expatriate with tax avoidance purposes. The same objections that might be raised against the [Clinton] Administration proposal might be raised against the House proposal as well. In addition, the arguments that the House exit tax is a new tax, and the arguments that it is not fair to impose a new tax retroactively, seem stronger. This is not to say that imposing such a tax retroactively for a limited period would necessarily be found unconstitutional, but it raises more questions about the fairness of retroactive imposition than does the [Clinton] Administration proposal.[574]

With respect to international law considerations, the CRS stated that a non-confiscatory exit tax would not raise insurmountable international law concerns. However, the CRS concluded that to the extent that the mark-to-market tax is in addition to the present-law alternative tax regime (which may be the case with the House bill), the U.S. assertion of taxing jurisdiction will be seen as that much more outside international norms.[575]

---

[572] *See* A-63 (May 10, 2000, memorandum II from the CRS).

[573] On the other hand, they can remain outside the tax system by never appearing before a government official to obtain a CLN.

[574] *See* A-63 (May 10, 2000, memorandum II from the CRS).

[575] *Id.*

Estate and gift tax rules

Under the mark-to-market proposals, the present-law estate and gift tax rules that apply generally to nonresident noncitizens would continue to apply. These individuals would continue to be subject to estate and gift tax on the transfer of U.S.-situated property. However, the Clinton Budget proposal and the Senate amendment would repeal the special estate and gift tax rules that apply to U.S. citizens and long-term residents who give up their U.S. citizenship or resident status with a principal purpose of avoiding U.S. tax.

In addition to imposing a mark-to-market tax upon citizenship relinquishment or residency termination, the mark-to-market proposals would impose a second "inheritance type" tax on the property of a former citizen or former long-term resident that is transferred back to a U.S. person. While the proposals are similar, there are differences in scope and application. Under the Clinton Budget proposal and the Senate amendment, the second tax would be imposed on the receipt of property by a U.S. person from a former U.S. citizen or former long-term resident. Under the Clinton Budget proposal, if a former citizen or former long-term resident subsequently makes a gift or bequest to a U.S. person, the value of the property would be treated as "gross income" to the U.S. recipient, taxable at the highest marginal rate applicable to estates and gifts. Under the Senate amendment, the U.S. recipient of the property would include in gross income the value of the property received from the former citizen or former long-term resident (subject to certain exceptions and with no special provision for taxing the recipient at the highest marginal transfer tax rates).

Under the House bill, the second tax would be imposed on the receipt of property by a U.S. person from any former U.S. citizen or former long-term resident that was subject to the mark-to-market regime upon citizenship relinquishment or residency termination. Under the proposal, if a former citizen or former long-term resident subsequently makes a gift or bequest to a U.S. person, the property would be subject to a new inheritance tax regime. Under this regime, the property received by a U.S. person would be subject to tax at the highest marginal rate applicable to estates and gifts.

Under the mark-to-market proposals, property could be taxed twice – once, based on gain upon citizenship relinquishment or residency termination, and again, based on value upon receipt by a U.S. person. Under present law, property also may be taxed multiple times. For example, property sold at a gain may be subject to income tax at one point and, subsequently, may be subject to estate or gift tax on its entire value. However, applying a similar regime to former U.S. citizens and former long-term residents would be a departure from the present-law alternative tax regime. In some instances, property that is subject to both income and estate and gift tax could be taxed at combined rates significantly higher under the mark-to-market proposals than under present law.

Enforcement of the present-law estate and gift tax rules for former citizens and former long-term residents during a 10-year period presents difficulties. However, the mark-to-market proposals, which would assess an estate and gift tax any time property flows back to a U.S. person from a former citizen or former long-term resident, would present enforcement problems of their own. For example, the new inheritance-type estate and gift tax would apply to property that flows back to a U.S. person at any time after citizenship relinquishment or residency

termination. Moreover, it may be difficult to track whether a former U.S. citizen or former long-term resident made a gift or bequest of property for the benefit of a U.S. person.

Immigration rules

The Clinton Budget proposal and the Senate amendment would make certain modifications to the immigration rules with respect to former citizens.[576] The proposals would eliminate the present-law requirement that the individual's citizenship relinquishment be tax-motivated before denying the former citizen reentry into the United States. The proposals also would coordinate the modified immigration provision with the new mark-to-market income tax rules described above and would deny former citizens reentry into the United States if they did not comply with their tax obligations under the mark-to-market regime.

Some argue that this type of coordination between the immigration and tax rules would enhance enforcement and collection of the mark-to-market tax. They argue that the ability of former citizens to reenter the United States should be conditioned on satisfaction of their obligations (including tax obligations) upon leaving the United States. On the other hand, the original purpose of the present-law immigration provision was to prevent tax-motivated former citizens from reentering the United States. Thus, some may question the appropriateness of applying such a provision across the board for all former citizens regardless of motive.

[576] These proposed modifications are not contained in the House bill.