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

[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.

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

B. Income Tax Rules

1. Scope of section 877

Present-law section 877 applies only to certain U.S.-source income (albeit a broad definition of U.S.-source income) of a former citizen or former long-term resident that is earned or realized within the 10-year period following citizenship relinquishment or residency termination. Foreign-source income of the former citizen or former long-term resident generally is not taxed. Income earned or realized after the 10-year period is not taxed. As a result, if the goal of a special tax regime for former citizens and former long-term residents is to remove tax incentives for an individual to relinquish citizenship or terminate residency, the current scope of section 877 is too narrow to accomplish that goal. A U.S. citizen or long-term U.S. resident, who would otherwise be taxed on worldwide income, would be able to avoid U.S. tax on his or her foreign-source income and, after 10 years, on all of his or her income, by relinquishing citizenship or terminating residency. From a tax perspective, the individual would still be better off relinquishing citizenship or terminating residency as opposed to continuing to be taxed on his or her worldwide income, notwithstanding section 877 (even assuming effective enforcement and full compliance with section 877).

(a) Foreign-source income not affected

A U.S. citizen or resident who owns assets located abroad or assets that produce foreign-source income may have an incentive, under present law, to relinquish citizenship or terminate residency because the alternative tax regime does not tax foreign-source income, and generally does not tax foreign-situs property for estate and gift tax purposes. Similarly, to the extent that individuals restructure their activities to convert U.S.-source assets to foreign-source assets, considerable incentives for citizenship relinquishment or residency termination continue to exist.[389]

Several rules limit the ability of a U.S. taxpayer to convert U.S.-source assets to foreign-source assets. For example, if a person transfers U.S. property to a foreign corporation, prior to citizenship relinquishment or residency termination, recognition of any gain generally will be required.[390] If an individual relinquishes citizenship or terminates residency and then converts U.S.-source assets into foreign-source assets this provision will not apply. However, section 877 contains several provisions aimed at addressing such conversions.

[389] This incentive, of course, is limited by foreign tax consequences. That is, if the former citizen or former long-term resident has a foreign tax burden on his or her foreign-source income that equals or exceeds the U.S. tax burden, then there may be no incentive to relinquish citizenship or terminate residency. To the extent that the former citizen or former long-term resident can choose where to reside, however, the individual could take up residence in a low tax jurisdiction and the U.S. tax incentive to relinquish citizenship or terminate residency would remain.

[390] Sec. 367.

A former citizen or former long-term resident who is subject to the alternative tax regime and who within the 10-year period beginning on the date of citizenship relinquishment or residency termination exchanges property that produces U.S.-source income for property that produces foreign-source income is required to recognize immediately as U.S.-source income any gain on the exchange.[391] In the alternative, such a former citizen or former long-term resident can enter into an agreement with the Secretary of the Treasury specifying that any income or gains derived from the property received in the exchange during the 10-year period after citizenship relinquishment or residency termination would be treated as U.S.-source income. The Secretary of the Treasury is authorized to issue regulations providing similar treatment for nonrecognition transactions that occur within five years immediately prior to the date of citizenship relinquishment or residency termination. Under Notice 97-19, the period is extended to cover the five years prior to citizenship relinquishment or residency termination as well as the 10 years subsequent to citizenship relinquishment or residency termination. As a result, a former citizen or former long-term resident cannot avoid section 877 by, for example, exchanging U.S. assets for stock in a foreign corporation, and then selling such stock in the foreign corporation, which otherwise would give rise to foreign-source income outside of the scope of section 877.

Similarly, the Secretary of the Treasury is authorized to issue regulations to treat removal of tangible personal property from the United States, and other circumstances that result in a conversion of U.S.-source income to foreign-source income without recognition of any unrealized gain, as exchanges for purposes of computing gain subject to section 877. Under Notice 97-19, the removal from the United States of appreciated tangible personal property having an aggregate fair market value in excess of $250,000 within the 15-year period beginning five years prior to the citizenship relinquishment or residency termination will be treated as an "exchange" subject to these rules. Thus, for example, a former citizen who removes appreciated artwork from the United States could be subject to immediate tax on the appreciation (or have to enter into a gain recognition agreement with respect to such property) under this provision.[392]

Preventing a nonrecognition exchange of U.S.-source assets for foreign-source assets accomplishes little, however, if former citizens and former long-term residents could achieve the same ends indirectly through entering into a gain recognition agreement with respect to the exchange of U.S.-source assets for stock in a foreign corporation, but then effecting the conversion of the U.S.-source assets to foreign-source assets within the corporation (thereby, for example, escaping U.S. estate tax because all assets held are foreign-source). Under present law, if a former citizen or former long-term resident who is subject to the alternative tax regime contributes property that would produce U.S.-source income to a controlled foreign corporation within the 10-year period after citizenship relinquishment or residency termination, any income or gain on the contributed property (or other property which has a basis determined by reference to the basis of such contributed property) received or accrued by the corporation is treated as

[391] Sec. 877(d)(2) (as added by the 1996 Act.).

[392] On the other hand, under Notice 97-19, any gain from the removal of tangible personal property worth $250,000 or less will not be subject to tax under section 877. In such circumstances, an incentive to relinquish citizenship or terminate residency would remain; however, it may not be worth the administrative burdens to remove such an incentive.

received or accrued directly by the former citizen or former long-term resident and, therefore, treated as U.S.-source income that is subject to U.S. tax.[393] If the former citizen or former long-term resident disposes of the stock of the foreign corporation, the individual is subject to U.S. tax on the gain that would have been recognized if the corporation had sold such property immediately before the disposition. As in the case of nonrecognition transactions, individuals are required under Notice 97-19 to apply this contribution to a controlled foreign corporation rule for the 15-year period beginning five years prior to the citizenship relinquishment or residency termination.

A similar rule applies in the estate tax context. A decedent's estate includes the proportion of the decedent's stock in a foreign corporation that the fair market value of the U.S.-situs assets owned by the corporation bears to the total assets of the corporation.[394] This rule applies in situations in which (1) the decedent owned, directly, at death 10 percent or more of the combined voting power of all voting stock of the corporation and (2) the decedent owned, directly or indirectly, at death more than 50 percent of the total voting stock of the corporation or more than 50 percent of the total value of all stock of the corporation.[395]

Although the 1996 changes to the alternative tax regime were intended to restrict a former citizen's or former long-term resident's ability to convert U.S.-source assets to foreign-source assets, it is difficult to evaluate the effectiveness of the restrictions. Nothing prevents an individual from investing in foreign-source assets over time. In fact, the more time an individual spends abroad, the more likely that is to occur. Further, if there is no built-in gain with respect to an asset (or the asset is cash), there is no cost to converting it from U.S.-source to foreign-source because no gain recognition would be required. Consider a U.S. citizen who just inherited a sizeable amount of assets. Those assets would have a basis in that citizen's hands equal to their fair market value.[396] That individual could convert those assets to foreign-source with no tax cost and then relinquish citizenship, thereby (1) eliminating U.S. income tax on any gain or income subsequently generated, and (2) eliminating any potential future U.S. estate or gift tax. In addition, even if conversion cannot be accomplished without tax consequences, it may still be desirable to convert assets, particularly capital assets to which the lower capital gains tax rate would apply, to foreign-source and pay the corresponding income tax in order to avoid the estate

[393] Sec. 877(d)(4). For section 877(d)(4) to apply, the individual must own, directly or indirectly, 10 percent or more (by vote) of the stock of the foreign corporation. Also, it will only apply if the foreign corporation would be a CFC if the individual were a U.S. citizen.

[394] Sec. 2107(b).

[395] Both the section 877 and section 2107 controlled foreign corporation look-through rules could be avoided if the individual owns 50 percent or less of the vote and value of the corporation. In addition, as discussed below, there is no analog to the controlled foreign corporation look-through rules in the gift tax area.

[396] Sec. 1014. This example assumes that the decedent does not die during 2010, when estate tax repeal and a carryover-basis regime are in effect under present law. Sec. 1014(f).

tax, which is considerably higher (leaving aside the one-year repeal of that tax for 2010 under present law).

Thus, it would seem that the only way to remove completely the tax incentive for a U.S. citizen or long-term U.S. resident to relinquish citizenship or terminate residency is to continue to tax that person on worldwide income even after citizenship relinquishment or residency termination.[397] Indefinitely taxing a nonresident noncitizen on his or her worldwide income would seem to exceed U.S. taxing jurisdiction and could be viewed as inconsistent with principles of international taxation, as well as U.S. treaties.[398] Such a tax also would seem to create a barrier to citizenship relinquishment or residency termination and raise international human rights and constitutional issues.[399] Moreover, with the person, property, and income outside of the United States, effective administration of such a rule may be impossible.

(b) The 10-year period

Timing recognition of gains and losses to circumvent the 10-year period

The alternative tax regime applies for a 10-year period from the date on which an individual relinquishes citizenship or terminates residency. As such, there remain tax incentives for citizenship relinquishment or residency termination for those who can delay their asset disposition (or who have a life expectancy of greater than 10 years in the case of the estate tax). A person can relinquish citizenship or terminate residency, wait 10 years, and then dispose of assets at a gain without U.S. tax consequences, transfer intangible property to relatives and

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[397] Other purposes could be accomplished through other means. For example, if it was decided that removing the incentive for citizenship relinquishment or residency termination is futile and that a better policy objective would be to capture tax appreciation that accrued while assets were held by a person subject to the U.S. taxing jurisdiction upon such person's departure from the U.S. taxing jurisdiction, a deemed-realization approach could be better suited to accomplish such an objective (albeit this approach would also present issues). In fact, the deemed-realization approach is not unlike the policy behind present-law section 367.

[398] Customary principles of international law generally call for the exercise of taxing jurisdiction to be based on one or more of several factors such as (1) nationality, (2) domicile or residence, (3) presence or doing business within the country, and (4) location within the country of property or transactions from which income is derived. Charles H. Gustafson and Richard C. Pugh, *Taxation of International Transactions*, par. 2007 (1991).

[399] For a discussion of international human rights and constitutional issues, see the 1995 Joint Committee staff study, supra note 315. Notwithstanding that, in general, the U.S. taxing jurisdiction would most likely not extend to the taxation of worldwide income of nonresident individuals who are not citizens of the United States. According to the CRS, it appears that reasonable evidentiary standards can be required to determine whether loss of citizenship has occurred. *See* A-53 (May 10, 2000, Memorandum I from the CRS). To the extent that loss of citizenship is not accomplished, it would seem that the U.S. taxing jurisdiction could extend to the worldwide income of such a person.

others in the United States without gift tax consequences, or convert the U.S.-source assets to foreign-source assets in order to avoid the estate tax.

Thus, it is unclear whether the 10-year period is sufficiently long to be an effective disincentive for tax-motivated citizenship relinquishment or residency termination. The 10-year period may be essentially meaningless to the extent that a former citizen or former long-term resident can effectively monetize a position with respect to appreciated assets or otherwise preserve the appreciation (through hedging the position or otherwise substantially diminishing the risk of loss with respect to the position) without triggering a taxable event during the 10-year period. For example, assume Ms. D lost her citizenship on January 1, 2002, and is subject to section 877. On that date Ms. D owns 10,000 shares of stock of a U.S. corporation ("USCo"), with a value of $10 million and a basis of $1 million. On the next day, Ms. D enters into a short sale of the stock (i.e., a short sale "against the box"). Ms. D closes the short sale 10 years later by delivering the stock.

By entering into the short sale, Ms. D hedges her position in the USCo stock so that the risk of loss on the stock is substantially (if not completely) diminished and monetizes the stock (including the appreciation). Under pre-1996 law, entering into the short sale could have accomplished a hedge and monetization of Ms. D's position without tax consequences.[400] Upon closing the short sale, $9 million of gain would be realized on the USCo stock, but the closing of the short sale would occur beyond the 10-year period covered by section 877. Accordingly, the alternative tax regime would no longer apply to Ms. D and, as a nonresident noncitizen, she would not be subject to U.S. tax on that gain.

Present law limits a taxpayer's ability to accomplish such a strategy in certain respects.[401] Under present law, the 10-year period is suspended for gains derived from a particular property during any period in which the individual's risk of loss with respect to such property is substantially diminished by (1) the holding of a put option with respect to such property (or similar property), (2) the holding by another person of a right to acquire the property, or (3) a short sale or any other similar transaction. Thus, in the above example, when the short sale is

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[400] Prior to the enactment of the section 1259 constructive sales rules in 1997, the recognition of gain or loss from a short sale "against the box" was deferred under the "open transaction" doctrine until the short sale was closed through delivery of the underlying property. Section 1259 now limits the ability of taxpayers to monetize or hedge financial assets that have appreciated in value by requiring the recognition of gain upon entering into a short sale (as well as other types of specifically defined "constructive sales") with respect to an appreciated financial position. However, section 1259 only applies if the taxpayer has substantially eliminated both the risk of loss and the opportunity for gain with respect to an appreciated financial position. Thus, section 1259 generally does not apply to transactions that reduce only the risk of loss or opportunity for gain, such as the purchase of a put option or the sale of a call option. Because of this and other similar limitations on its scope, section 1259 itself does not entirely eliminate the availability of certain techniques to monetize or preserve the appreciation in financial assets for the purpose of circumventing the 10-year period under section 877.

[401] Sec. 877(d)(3).

closed, Ms. D would continue to be subject to the alternative tax regime and the $9 million would be taxable U.S.-source income to Ms. D.

Notwithstanding this provision, however, a taxpayer generally still can monetize a position in U.S.-source assets (albeit at a cost) by borrowing against such assets until the 10-year period expires. For example, assume instead of entering into a short sale, Ms. D in the above example borrowed $10 million for a 10-year period, pledging her USCo stock as security. Ms. D would have the use of the funds for the 10 years (with interest and other costs). After 10 years, assuming the value of USCo did not decline, she could sell the USCo stock and use the proceeds to satisfy the obligation. There would be no U.S. income tax on the sale of the stock because the sale would occur beyond the 10-year period. Further assume that Ms. D used the proceeds from the borrowing to invest in foreign-source assets and that such assets and her USCo stock were her only assets. If Ms. D died during the 10-year period, her taxable estate would be reduced by a portion of the debt for U.S. estate tax purposes.[402] Ms. D's estate for estate tax purposes would include $10 million of U.S.-situated assets (the USCo stock). The foreign assets would not be included as part of her U.S. estate. The value of the U.S. estate would be reduced by half of the debt secured by the stock (the proportion treated as a deduction from the gross estate), or $5 million.[403] Ms. D has reduced her estate tax liability with respect to the $10 million of U.S.-situated assets by half. The heirs would inherit the stock and the foreign investment with a stepped-up basis, [404] and could sell either one without tax consequences and retire the debt. If the heirs chose to retain the foreign investment and sell the stock, a conversion of U.S. assets to foreign assets would have been achieved, and the heirs themselves could relinquish citizenship or terminate residency without U.S. tax being collected with respect to the appreciation in the U.S. assets, the proceeds of which effectively have been reinvested in the foreign assets. Thus, the ability to borrow against U.S.-source assets to circumvent the 10-year period provides a continuing opportunity for tax-motivated citizenship relinquishment or residency termination.

Similarly, if the taxpayer can defer receipt of payment (and corresponding tax consequences) until after the 10-year period through use of an installment sale, the alternative tax regime can be avoided, at least in part if not completely. The effectiveness of the 10-year period could be improved by (1) tolling the 10-year period during any time in which the former citizen or former long-term resident incurs a debt obligation that is directly or indirectly secured by

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[402] This example assumes that Ms. D does not die during 2010, when estate tax repeal and a carryover-basis regime are in effect under present law.

[403] A portion of the $10 million debt secured by the U.S. property is deductible under section 2106. This portion is based on the value of that portion of the decedent's gross estate situated in the United States at the time of death bears to the value of the decedent's entire gross estate wherever situated. Treas. Reg. sec. 20.2106-2(a)(2). In this simplified example, the decedent's U.S. estate consisted of $10 million of U.S. stock, $10 million of foreign stock, and $10 million of debt secured by the U.S. stock. The portion of the debt treated as a reduction in the value of the estate equals $5 million ($10 million debt multiplied by $10 million value of U.S. property in the estate over $20 million total value of the gross estate).

[404] Sec. 1014.

U.S.-source assets while that debt obligation remains outstanding and (2) extending the 10-year period to cover years in which proceeds of an installment sale of a U.S. asset made during the 10-year period are received after the expiration of the 10-year period. However, administrative and enforcement concerns, as described below, may militate against any further extensions of the 10-year period.

Post-departure enforcement

As discussed above, the present-law alternative tax regime, which applies for a 10-year period after citizenship relinquishment or residency termination, presents significant enforcement challenges. The initial enforcement challenge is that the IRS must make a determination as to whether a former citizen or former long-term resident is subject to section 877 and, therefore, should be monitored. The IRS may not, however, have the necessary information to make this determination.

Once this threshold-level determination has been made, the IRS has the continuing enforcement challenge of monitoring the former citizen or former long-term resident who is determined (or deemed) to be tax-motivated for the 10 year period. Such former citizens and former long-term residents generally are required to file a Form 1040NR for each of those 10 years if the former citizen or former long-term resident is liable for U.S. tax. The former citizen or former long-term resident is required to attach to the Form 1040NR a statement setting forth (generally by category) all items of U.S.- and foreign-source gross income. It may be difficult for the IRS to verify the completeness and accuracy of the return filed by the former citizen or former long-term resident, particularly for items that are not subject to U.S. information reporting. Similar difficulties exist for the IRS in determining whether a former citizen or former long-term resident who did not file a tax return is in fact required to do so and what the correct amount of income is.

As detailed in Part VII, above, prior to the reorganization of the IRS in the fall of 2000, the IRS had established guidelines under which the IRS, using the CLN database, would monitor certain individuals in the database for filing compliance during the 10-year period after citizenship relinquishment or residency termination and if required initiate audits or other compliance actions. Based on discussions with IRS staff, the Joint Committee staff understands that attempts at monitoring or compliance based upon the CLN database ceased upon the reorganization of the IRS in the fall of 2000.

There are several aspects to this continuing enforcement challenge with respect to information reporting. One is to keep track of items of income that come from or flow through third parties, such as interest and dividends. Because the Code has long required information reporting by U.S. payors of these items of income, the IRS can carry this out without much difficulty. However, it is possible for a former citizen or former long-term resident who is subject to the alternative tax regime to so structure his or her financial affairs prior to citizenship relinquishment or residency termination such that this information reporting is not done after citizenship relinquishment or residency termination.[405] Absent information reporting, it can be

[405] There are ways that the former citizen or former long-term resident can avoid entirely U.S. tax on some of these items. If, for example, the interest-generating cash deposits were

significantly more difficult for the IRS to reconstruct the taxpayer's income. Restructuring his or her financial affairs to avoid information reporting may, however, precipitate other consequences that the former citizen or former long-term resident may determine to be undesirable.[406]

Another aspect of this continuing enforcement challenge for the IRS with respect to information reporting is that it must keep track of the disposition of assets that will generate income (generally, capital gains). Again, the Code requires information reporting by persons such as brokers who sell assets, such as stock, on behalf of individuals, so in general the IRS is made aware that a sale transaction has occurred.[407] Information reporting is not required, however, on transfers of custody of such property (such as from one broker to another) that do not involve sales of the property. Accordingly, it would be possible for the former citizen or former long-term resident who is subject to the alternative tax regime to structure his or her financial affairs (by transferring the custody of the assets to a custodian who is not subject to U.S. information-reporting requirements) so that this information reporting does not occur. Again, this restructuring may precipitate other consequences that the former citizen or former long-term resident may determine to be undesirable.

Overlaying all of these considerations is the degree of cooperation with the IRS that is exercised by the former citizen or former long-term resident who is subject to the alternative tax regime. In general, the U.S. tax system relies to a very significant extent on the cooperation of taxpayers to fulfill all reporting obligations. The IRS is able to undertake enforcement actions against taxpayers who do not cooperate voluntarily, but the level of resources requisite to doing so increases substantially for items outside the general information reporting system. As a practical matter, it may be difficult to enforce such reporting obligations with respect to a taxpayer who no longer resides in the United States and who may not be otherwise subject to U.S. law. Any rule that requires monitoring and enforcement for a period of years after citizenship relinquishment or residency termination is likely to encounter the same challenges.

2. Proof of tax avoidance purpose

Under present law, the alternative tax regime applies to an individual who relinquishes citizenship or terminates residency, unless such relinquishment or termination did not have as a principal purpose the avoidance of tax. As a result of changes made by the 1996 Act, certain rules are provided that affect the burden of proving whether the relinquishment of citizenship or termination of residency had as a principal purpose the avoidance of tax. To understand these

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moved to a financial institution that is not subject to U.S. information-reporting requirements, the interest generated generally would not be considered U.S.-source income and, therefore, would not be subject to section 877.

[406] For example, reporting may be required on the exporting of monetary instruments pursuant to 31 U.S.C. 5316.

[407] Sec. 6045. Because this provision requires the reporting of gross proceeds but not the basis of the property, the IRS is not aware of the amount (if any) of taxable gain generated by the transaction.

changes, it is important to consider the establishment of a tax avoidance purpose under section 877 prior to the 1996 legislative changes.

(a) Proof of tax avoidance purpose under pre-1996 law

Prior to the changes to section 877 made in the 1996 Act, a two-level inquiry was required with respect to the determination of whether an individual's relinquishment of citizenship was tax-motivated, such that the alternative tax regime under section 877 applied. First, it was incumbent on the Department of the Treasury to establish that it was reasonable to believe that the individual's loss of citizenship would result in a substantial reduction in U.S. tax based on the individual's probable income for the taxable year. Once that was established, then the individual 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. In other words, under pre-1996 law, once the burden of proof shifted to the former citizen, it would not be sufficient for the individual to establish that he or she had substantial non-tax reasons for relinquishing citizenship so long as one of the principal purposes was the avoidance of U.S. tax (and the taxpayer did not foreclose such possibility). No regulations were ever promulgated by the Department of the Treasury to interpret this provision and the Secretary of the Treasury infrequently applied the rule. As a result, it would seem that the burden on the taxpayer under such a rule was extremely high and, as a practical matter, the rule was difficult to administer.

(b) Proof of tax avoidance purpose after 1996 changes

In 1996, the Congress was concerned that the alternative tax regime was difficult to administer because the regime applied unless an individual could prove a lack of a tax-avoidance purpose for relinquishing citizenship.[408] The 1996 changes in the law, therefore, were intended generally to "subject certain former citizens to the citizenship relinquishment tax provisions without inquiry as to their motive for losing their U.S. citizenship."[409] At the same time, the amendments permitted such individuals to request a ruling from the Secretary of the Treasury as to whether the loss of citizenship had a principal purpose of tax avoidance.

Thus, under present law, U.S. citizens who relinquish their citizenship and long-term residents who terminate their residency generally are treated as having relinquished citizenship or terminated residency with a principal purpose of the avoidance of taxes if either: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years ending before the date of such relinquishment or termination is greater than $100,000, or (2) the individual's net worth as of the date of such relinquishment or termination is $500,000 or more (i.e., the monetary thresholds).[410] The monetary thresholds contained in the tax liability test and the net worth test are indexed for inflation in the case of a loss of citizenship or termination of

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

[409] *Id.*

[410] Sec. 877(a)(2).

residency occurring in any calendar year after 1996. For calendar year 2003, the monetary thresholds for the tax liability test and the net worth test are $122,000 and $608,000, respectively.[411] This effectively creates two categories of individuals: those former citizens and former long-term residents who fall below the monetary thresholds and those former citizens and former long-term residents who fall above one of the monetary thresholds.

Former citizens and former long-term residents falling below the monetary thresholds

A former citizen or former long-term resident who falls below the monetary thresholds is not automatically treated as having a principal purpose of tax avoidance. Such an individual is subject to the alternative tax regime if the individual's relinquishment of citizenship or termination of residency had as one of its principal purposes the avoidance of tax. Factors taken into account in making a determination as to the presence of a principal purpose of tax avoidance include the substantiality of a former citizen's ties to the United States (including ownership of U.S. assets) prior to citizenship relinquishment, the retention of U.S. citizenship by a former citizen's spouse, and the extent to which a former citizen resides in a country that imposes little or no tax.[412] As was the case with the law prior to the 1996 Act, if the Secretary of the Treasury establishes a reasonable belief that a relinquishment of U.S. citizenship or termination of U.S. residency would likely result in a substantial tax reduction for the year of citizenship relinquishment or residency termination, the former citizen or former long-term resident bears the burden of proof that his or her relinquishment of citizenship or termination of residency did not have a principal purpose of tax avoidance.[413] It is unclear when this burden would be invoked, and unclear what evidence the individual could introduce to overcome this burden (i.e., to establish that the relinquishment of citizenship or termination of residency did not have as one of its principal purposes the avoidance of tax). The burden of proof for making this determination is the same as that for pre-1996 law. In other words, the same types of administrative complexities and difficulties inherent in determining an individual's subjective purpose for citizenship relinquishment or residency termination apply with respect to these cases.

The use of objective thresholds such as income tax liability and net worth assumes that it is more likely that persons above these monetary thresholds have tax avoidance as one of their principal purposes for relinquishing citizenship or terminating residency. At the same time, by retaining pre-1996 law with respect to individuals falling below the monetary thresholds, the statute (and in particular section 877(f)) contemplates that an individual who falls below the monetary thresholds still could have tax avoidance as one of their principal purposes for relinquishing citizenship or terminating residency. Thus, with respect to individuals falling below the monetary thresholds, the 1996 amendments did not accomplish an easing of administrative difficulties.

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[411] Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

[412] H.R. Conf. Rep. No. 104-736, at 325 (1996).

[413] Sec. 877(f).

To the extent that more objective tests could be adopted in order to ease administrative difficulties in determining an individual's intent for relinquishing citizenship or terminating residency, it can be argued that the alternative tax regime simply should not apply to individuals who fall below the monetary thresholds. With respect to this class of individuals, the rules are difficult to administer and are not enforced. As a result, the rules themselves do not encourage compliance. It certainly would seem that some individuals below some monetary thresholds (whatever those thresholds are or should be) could relinquish citizenship or terminate residency for tax avoidance reasons. Excepting such persons from the alternative tax regime, however, can be viewed as part of the cost of a more administrable and more objective regime.

Former citizens and former long-term residents exceeding the monetary thresholds

A former citizen or former long-term resident who exceeds one or both of the monetary thresholds is treated as having a principal purpose of tax avoidance. As a result, such an individual generally will be subject to the alternative tax regime. Such a person will nevertheless not automatically be treated as having a principal purpose of tax avoidance if the individual (1) falls within certain categories of persons described below and (2) submits a ruling request for the Treasury Secretary's determination as to whether the individual's relinquishment of citizenship or termination of residency had for one of its principal purposes the avoidance of taxes. The individual must submit the ruling request within the one-year period beginning on the date of relinquishment of citizenship or termination of residency.

Former citizens are eligible to submit a ruling request (and therefore are not automatically subject to the alternative tax regime) if: (1) the individual was born with dual citizenship and retains only the non-U.S. citizenship; (2) the individual becomes, within a reasonable period after citizenship relinquishment, a citizen of the country in which the individual, the individual's spouse, or one of the individual's parents, was born; (3) the individual was present in the United States for no more than 30 days during each year in the 10-year period immediately preceding the date of his or her relinquishment of citizenship; (4) the individual relinquishes his or her U.S. citizenship before reaching age 18 and a half; or (5) the individual falls under any other category that may be prescribed by Treasury regulations.[414] Former long-term residents are eligible to submit a ruling request if: (1) the individual becomes, within a reasonable period after residency termination, a resident fully liable for income tax in the country in which he or she was born, his or her spouse (if married) was born, or his or her parents were born; (2) the individual was present in the United States for 30 days or less during each year of the 10-year period prior to residency termination; or (3) the individual ceases to be taxed as a lawful permanent resident, or commences to be treated as a resident of another country under an income tax treaty and does not waive the benefits of such treaty applicable to residents of the foreign country, before the individual reaches age 18½ .

If a former citizen or former long-term resident exceeds one of the monetary thresholds and (1) is eligible to submit a ruling request but does not submit such a request, or (2) is not eligible to submit a ruling request because such individual is not described in one of the specified categories, then such person is treated as having a principal purpose to avoid taxes and, therefore,

[414] Sec. 877(c)(1)(A) and (c)(2).

is subject to the alternative tax regime. For this class of individuals, the rules are very objective and straightforward – the alternative tax regime applies. The rules in this regard should be relatively simple to administer because they do not suffer from the administrative difficulties of pre-1996 law in trying to evaluate the intent of such individuals. Although the rules are easier to administer with respect to this class of individuals, that benefit is not without a cost: it is certainly possible that there are individuals within this class who relinquish citizenship or terminate residency for reasons wholly independent from tax avoidance, yet such individuals would nonetheless be subject to the alternative tax regime.

(c) Ruling process

Although the 1996 changes to the alternative tax regime provided certain objective monetary thresholds to simplify the inquiry into tax motivation, the changes preserved a ruling process for certain classes of former citizens and former long-term residents who exceeded one of the monetary thresholds and, therefore, would otherwise be treated as tax-motivated. Because the alternative tax regime automatically applies to a former citizen or former long-term resident exceeding one of the monetary thresholds absent the ruling process, there is great pressure on both (1) the categories of individuals eligible to request a ruling and (2) the ruling process itself. Individuals above one of the monetary thresholds, therefore, have an incentive to submit a ruling request provided that they fall (at least arguably) within one of the designated categories of eligible persons.

The procedures for obtaining a ruling with respect to whether an individual's relinquishment of citizenship or termination of residency is tax-motivated are detailed in Notice 97-19, as revised by Notice 98-34. Under Notice 98-34, if a former citizen's or former long-term resident's tax liability or net worth exceeds the monetary thresholds, the individual will not be automatically treated as having a principal purpose of tax avoidance if he or she (1) is eligible to submit a ruling request that his or her relinquishment of citizenship or termination of residency did not have for one of its principal purposes the avoidance of U.S. taxes (because the person satisfies the requirements of one of the categories described above), (2) submits such a request in a timely manner, and (3) provides the IRS with a complete and good faith ruling request. The IRS determines whether a submission was complete and provided in good faith. If the ruling request constitutes a complete and good faith submission, the IRS may also, depending on the information submitted, provide a substantive ruling as to whether the individual's relinquishment of citizenship or termination of residency had as one of its principal purposes the avoidance of U.S. taxes.

Thus, under Notice 98-34, the IRS has three basic alternatives for a ruling under section 877:

(1) The IRS could provide a substantive ruling that the individual's citizenship relinquishment or residency termination did not have for one of its principal purposes the avoidance of U.S. taxes in those cases in which the information submitted clearly establishes the lack of such a principal purpose;

(2) The IRS could provide a substantive ruling that the individual's citizenship relinquishment or residency termination did have as one of its principal purposes

the avoidance of U.S. taxes in those cases in which the information submitted clearly establishes the existence of such a principal purpose; or

(3) The IRS could express no opinion as to whether the individual's citizenship relinquishment or residency termination had one of its principal purposes the avoidance of U.S. taxes in those cases in which, although there is a complete and good faith submission, the information submitted does not clearly establish the existence or lack of such a principal purpose. [415]

If the IRS rules favorably with respect to the former citizen or former long-term resident (i.e., the information submitted clearly established that the individual did not have tax avoidance as one of his or her principal purposes for the citizenship relinquishment or residency termination), then the individual generally would not be treated as having relinquished citizenship or terminated residency for tax avoidance purposes and would not be subject to the alternative tax regime.[416] If the IRS rules adversely with respect to the reasons for the citizenship relinquishment or residency termination (i.e., the information submitted clearly established that one of the individual's principal purposes for relinquishing citizenship or terminating residency was tax avoidance), then the individual can challenge the ruling in court.[417] Very few of the published rulings, however, involved determinations that were adverse to the taxpayer.[418]

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[415] Although not explicitly discussed in Notice 98-34, the IRS presumably also could rule that the submission was not complete and in good faith, in which case the individual would be in the same position as if no submission were made -- that is, the individual would be treated as tax-motivated. Of course, as a practical matter, a former citizen or former long-term resident could withdraw such a request prior to the IRS so ruling. The withdrawal would have the same effect.

[416] It is possible that the IRS could later challenge the taxpayer on audit and, for example, contend that the ruling was based on factual misrepresentations. As a practical matter, however, if a taxpayer receives a favorable ruling, the taxpayer generally will be expected from the alternative tax regime.

[417] *See* H.R. Conf. Rep. No. 736, 104th Cong., 2d Sess. 325 (1996). In such cases, it would be the IRS's position that the alternative tax regime automatically applies to such taxpayer, and that the taxpayer would have to challenge an adverse ruling in a refund suit to recover any taxes paid by reason of section 877. Notice 97-19. The taxpayer presumably could challenge that position by arguing that a ruling should have been granted (that is, by demonstrating that one of the principal purposes for the citizenship relinquishment or residency termination was not the avoidance of U.S. tax).

[418] *See*, Part VII.B.2, above, Table 3: Private Letter Rulings Issued to Former Citizens and Former Long-Term Residents Under Notice 97-19 and Notice 98-34 during the Period from January 1, 1997 through July 1, 2002.

Almost half of the rulings issued under Notice 98-34 fall within the "fully submit" category.[419] The monetary thresholds hold little meaning for this category of former citizens and former long-term residents. The position of an individual who receives a fully submit ruling is the same as (1) an individual who falls below the monetary thresholds or (2) an individual subject to the pre-1996 law. In each of these cases, the determination of the individual's purpose for citizenship relinquishment or residency termination is to be made if, and at the time, that the individual is selected for audit. The burden of proof provided by section 877(f) would apply. That is, once the Secretary of the Treasury establishes it is reasonable to believe the relinquishment of citizenship or termination of residency would result in a reduction of taxes, the burden of proving that the relinquishment of citizenship or termination of residency did not have for one of its principal purposes the avoidance of taxes is on the individual. Thus, the ruling process does little to assist with the determination of tax avoidance in cases in which the individual's intent is not entirely clear. If the taxpayer can clearly establish intent, the ruling process seems to work, although one might question whether a ruling process is necessary with respect to such cases. Thus, the fully submit category of ruling does not appear to be serving the legislative purpose of the alternative tax regime.

In addition, there is no clear, discernable pattern for the published private letter rulings under section 877. For the favorable rulings, one common factor is that the former citizen or former long-term resident would be subject to tax in his or her new country of citizenship or residence on worldwide income at a rate comparable to the U.S. income tax rate. That factor alone, however, does not appear to be dispositive. Hence, in many cases, the ruling process under present law does not appear to be accomplishing a clear delineation of who might be subject to the alternative tax regime.

(d) Conclusions

The present-law alternative tax regime depends, in large part, on a subjective inquiry as to the intent of the former citizen or former long-term resident – namely, whether one of the principal purposes of citizenship relinquishment or residency termination was the avoidance of U.S. taxes. The burden on former citizens and former long-term residents to establish that one of the principal purposes is not tax avoidance (i.e., to prove the negative) is extremely high. The difficulty in administering this subjective test has been acknowledged by both Congress and the IRS.[420] The 1996 amendments to section 877 made this inquiry more objective in certain respects: for former citizens and former long-term residents above the monetary thresholds who do not fall within one of the categories of persons eligible to submit a ruling request or who do not submit a timely ruling request, the alternative tax regime automatically applies without further inquiry. For all other classes of former citizens and former long-term residents, the uncertainties and administrative complexities associated with this subjective inquiry continue.

Because of the difficulties in administering subjective intent tests (both in connection with the ruling process and outside of the ruling process for taxpayers who either fall below the

[419] *Id.*

[420] *See* H.R. Rep. No. 104-96, at 148 (1996); Notice 98-34.

monetary thresholds or who receive fully submit rulings), consideration should be given to eliminating the ruling process, and replacing present law with an entirely objective test. Under such a test, objective, demonstrable monetary thresholds would be considered as a proxy for a determination that one of an individual's principal purposes for relinquishing citizenship or terminating residency is avoidance of U.S. taxes. The alternative tax regime would automatically apply to former citizens and former long-term residents who exceed certain monetary thresholds. For those who fall below the monetary thresholds, the alternative tax regime would not apply. No further showing would be required of such individuals; there would be no subsequent audit exposure involving inquiry into their intent.

Use of an objective standard such as monetary thresholds involves certain trade-offs. There likely will be some individuals who fall below these monetary thresholds who relinquish citizenship or terminate residency for tax-motivated reasons. They would benefit from such a rule because their audit exposure would be eliminated. As a practical matter, given the enforcement weaknesses of present law, the cost of relieving such persons of obligations under the alternative tax regime are small (from both a revenue and policy perspective) as compared to the simplicity the rule would provide.

At the same time, there also are likely to be some former citizens and former long-term residents who exceed the thresholds who have no tax motivation for relinquishing citizenship or terminating residency. A question of fairness arises because such people would be subject to the alternative tax regime without opportunity for rebuttal (other than, perhaps, challenging whether they really exceed the thresholds). This issue exists under present law with respect to former citizens and former long-term residents who exceed the monetary thresholds and who are not eligible to submit a ruling request. The present-law ruling process, however, serves to mitigate the rigidity of the rule, at least with respect to those individuals who fall within one of the categories eligible to submit a ruling request. Thus, there are persons who could be worse off under a fully objective rule without an exception. The cost to such persons is compliance with the alternative tax regime. Some would argue that such a cost is not significant: the former citizen or former long-term resident generally would be taxed on U.S.-source income as a nonresident noncitizen in any event; the alternative tax regime expands the concept of U.S.-source income in this regard for a fixed, 10-year period of time. This cost should be weighed against the benefit of eliminating the subjective inquiry which, in connection with other measures to improve information collection, would result in a simpler rule to administer and a more effective regime. Because an objective standard is more rigid than present law, to the extent such a standard is adopted, consideration also should be given to raising the threshold to cover individuals with a higher net worth because the argument that there is correlation between monetary thresholds and intent generally would seem to be stronger in the case of higher net-worth individuals. As discussed in more detail below, much of the incentive to relinquish citizenship or terminate residency may be linked to avoidance of the U.S. estate and gift tax. Tax thresholds (such as the unified credit amount) under the estate and gift tax rules may serve as a useful reference in this regard.

To the extent that it is desirable to retain some opportunity for relief for taxpayers who exceed the objective monetary thresholds but who are not relinquishing citizenship or terminating residency for tax avoidance purposes, narrow, objective exceptions to the rule should be established in lieu of the ruling process. This would produce a general benefit of moving away from the subjective inquiry of intent that is required in the ruling process as well as a specific benefit of eliminating the fully submit category of rulings, which appears to have an effect that is inconsistent with the intent of the 1996 amendments to the alternative tax regime. The exceptions should be limited in scope because such persons (notwithstanding that they exceed the monetary thresholds) would be out of the alternative tax regime without further inquiry. In this regard, it may seem fair to except from the alternative tax regime those individuals who relinquish their citizenship, but who never have had substantial contacts with the United States -- notwithstanding that such individuals may exceed the monetary thresholds.

For example, a person who has been a dual citizen since birth (because, for example, he or she was born in a foreign country but has one U.S. parent), but who never has been a resident of the United States and who has not utilized the benefits of his or her U.S. citizenship (as evidenced for example, by only visiting the United States, if at all, for short periods of time and by not traveling on a U.S. passport), might be viewed as having such insubstantial contacts with the United States as to warrant an exception from the alternative tax regime if that person decided to forgo his or her U.S. citizenship. Similarly, a minor who became a U.S. citizen by being born in the United States while his or her parents (who are foreign) were temporarily in the United States, but who gives up U.S. citizenship by age 18 and a half, might be excepted from the alternative tax regime if the person was not present in the United States for any significant period of time (e.g., less than 30 days) during a certain period (such as a 10-year period). In any case, such exceptions should be narrow, limited, clear, and objectively verifiable so as to avoid the difficulties raised by the present-law subjective intent test and ruling process.

In addition, no exceptions from the alternative tax regime should be permitted (regardless of whether a person is above or below the monetary thresholds) unless the former citizen or former long-term resident can establish that he or she has complied with all of his or her prior U.S. Federal tax obligations.[421] If a person has not complied with his or her tax obligations prior to citizenship relinquishment or residency termination, it seems fair to assume that tax avoidance is one of the principal purposes of the citizenship relinquishment or residency termination. If the person has not complied, the person should be required to take the necessary steps to become current with respect to those obligations. Once the person relinquishes citizenship or terminates residency, as a practical matter it likely will be more difficult for the IRS to enforce those obligations. Hence, it is in the interest of administration of the tax system to treat an individual's citizenship relinquishment or residency termination as tax-motivated unless he or she is current with respect to his or her U.S. tax obligations up to the point of citizenship relinquishment or residency termination.

This approach would simplify present law considerably and make it much more administrable. Former citizens and former long-term residents falling below the monetary thresholds would not be subject to the alternative tax regime. Former citizens and former long-term residents exceeding the monetary thresholds would be subject to the alternative tax regime unless they satisfy the requirements of limited, objective exceptions. For those who satisfy the

[421] Because of concerns of administrability, the showing of compliance with tax obligations could be limited to a discrete period of time, such as five years.

requirements of these exceptions, they would also not be subject to the alternative tax regime, without further inquiry into intent.[422] At the same time, although the use of an objective standard for determining whether an individual is subject to the alternative tax regime would improve present law, that alone is not sufficient. As discussed below, steps should be taken to improve the ability of the IRS to obtain necessary information with respect to the former citizen or former long-term resident, and more stringent enforcement measures need to be adopted.

3. Information gathering with respect to former citizens and former long-term residents

Under the Code, a U.S. citizen who loses his or her citizenship is required to provide an information statement to the Department of State (or other designated government entity). With the following information: (1) the individual's social security number, (2) the mailing address of the individual's principal foreign residence, (3) the new country of residence, (4) the new country of citizenship, (5) information concerning the individual's assets and liabilities if the tax liability threshold or the net worth threshold under section 877(a)(2) is met, and (6) such other information as the Treasury Secretary prescribes. A similar information statement is required for long-term residents who terminate their residency. Individuals can provide this information on IRS Form 8854.[423] A copy of Form 8854 is in the Appendix at A-204.

An individual who fails to provide the required information statement is subject to a penalty for each year (of a 10-year period beginning on the date of loss of citizenship or termination of residency) during which the failure to provide the statement continues. The penalty is equal to the greater of five percent of the tax required to be paid under section 877 for that year or $1,000.

Several factors influence an assessment of the sufficiency of the penalties for failure to provide the required information statement. The overall rate of compliance may at first appear to be low. Fifty-seven percent of the 2,735 former citizens published in the *Federal Register* for 1995 through 1999 did not provide the required tax information statements when they relinquished citizenship.[424] Relatively recent changes, however, appear to have markedly improved compliance. The Department of State issued guidance to its consular posts as of November 1996, calling for them to obtain the required tax information statements from any person who loses citizenship. Based on a random sampling of 200 out of the 2,735 former citizens, the GAO estimates that after November 1996, 84 percent included expatriation tax information statements.[425] In addition, for 2000 and 2001, 87 percent of the 792 former citizens

[422] The IRS could, of course, audit such individuals to verify that the requirements had been satisfied.

[423] There is, however, no statutory requirement that individuals provide the required information on the official IRS form. Some Department of State consular offices will accept the information in alternate formats.

[424] *See* GAO Report at A-256.

[425] *See* GAO Report at A-256. The GAO estimates the standard of error of this estimate as plus or minus eight percentage points.

who received CLNs provided a tax information statement.[426] This substantial increase in the compliance rate may be largely attributable to the Department of State issuance of guidance rather than to the possibility of the IRS imposing the penalty.

Another relatively recent change that may have improved compliance is the issuance by the IRS of Form 8854 in January 1999. This form is designed to obtain all of the information required to be reported by section 6039G. Although there is no statutory requirement that individuals utilize this form, many consular offices provide it to individuals who wish to renounce their U.S. citizenship. The absence of an official IRS form may have had an impact on the rate of noncompliance (and the quality of the information obtained) prior to January 1999.

The ability of the IRS to assess a monetary penalty against a former citizen or former long-term resident who refuses to provide the required tax information statement is dependent upon the nature and location of the taxpayer's assets. In general, the IRS has the power to collect the penalty if assets remain in the United States and can be found, but if the assets are in a foreign jurisdiction, the power of the IRS to collect is generally limited to whatever authority (if any) is provided pursuant to a tax treaty with the foreign jurisdiction. Because of these restrictions, it may not be possible to design a penalty that is effective against an uncooperative former citizen or former long-term resident. These restrictions may explain (in part) why the IRS has not assessed the penalty for not filing the required tax information statement.[427]

At the same time, however, it is important to recognize that the filing of a tax information statement by a former citizen or former long-term resident is critical for the IRS to enforce the alternative tax regime. At a minimum, the IRS must be able to obtain the individual's social security number, if the individual has a social security number, in order to utilize IRS records to verify compliance. To the extent that the information is not provided to the IRS, significant difficulties exist in effectively administering the alternative tax regime. As stated above, the present-law penalty does not appear to be an effective means of obtaining the necessary information. Rules should be adopted that provide adequate incentives for a former citizen or former long-term resident to provide such information.

As an alternative to monetary penalties as an incentive for providing the required information, consideration should be given to continuing to treat an individual as a U.S. citizen or resident (i.e., subject to tax on worldwide income) until such point when the individual satisfies the requirements of section 6039G (i.e., when the individual fully and accurately completes the IRS Form 8854.)[428] As a result, an individual who is relinquishing citizenship or terminating residency to avoid taxation on worldwide income or assets would have a meaningful incentive to complete Form 8854.

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[426] *See* A-123 (August 14, 2002 letter from the IRS).

[427] *Id.*

[428] As discussed below, modification of immigration rules in this regard to limit the admissibility of individuals who relinquish citizenship or terminate residency and do not comply with the information reporting requirements would be helpful.

Some may question whether requiring the completion of a tax form as a prerequisite to a loss of citizenship or permanent residence status for U.S. tax purposes raises constitutional issues or issues under principles of international law. The requirement to provide certain information as a prerequisite to relinquishment of tax citizenship can, however, be viewed as a requirement of proof of "intent" to relinquish tax citizenship. According to the CRS, it is generally acceptable under U.S. constitutional law for Congress to require reasonable evidentiary standards, such as the filing of an IRS form, as a requirement for loss of citizenship.[429] The CRS has indicated that there is some precedent for the divergence of the tax and nationality definitions of citizenship. Under principles of international law, the CRS has indicated that such limits on the right to relinquish citizenship cannot be arbitrary. It would not seem arbitrary, however, that individuals continue to be treated as citizens for U.S. tax purposes until such time when they provide appropriate notice to the government of their intention to relinquish their tax citizenship in a manner that will enable the government to reasonably enforce its tax laws.[430] In other words, as long as the limitation is reasonable and the underlying motive is to protect the integrity of the tax system rather than to penalize or prohibit the right to emigrate or expatriate, such requirement should not violate international norms.[431]

A related issue involves the potential lag in time between citizenship relinquishment, which occurs upon the individual's completion of an expatriating act with the requisite intent to relinquish citizenship, and the date upon which the Department of State receives notice of the citizenship relinquishment. Generally, the Department of State may not be aware of an individual's citizenship relinquishment until the individual provides notice such as through applying for a CLN. As discussed above, the date upon which the CLN is approved is not the effective date for loss of tax citizenship under present law; the loss of citizenship dates back to the date of the expatriating act. Thus, under present law, even if a former citizen provides the appropriate information on a Form 8854 upon applying for a CLN, that person could be treated as having relinquished citizenship several years prior to the application for that CLN by reason of an expatriating act in a prior year, such as naturalizing in a foreign country. The 10-year period will have started to run before the IRS has had any opportunity to learn of the citizenship relinquishment.

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[429] *See* A-53, Memorandum I from the CRS dated May 10, 2000.

[430] *Id.*

[431] *See* also the 1995 Joint Committee staff study, supra note 315. Although the requirement of filing an IRS form may (under principles of constitutional law and international law) be a reasonable prerequisite to giving up U.S. tax citizenship, concerns may be raised if this change in the law had a retroactive effect and caused persons who relinquished citizenship before its effective date to continue to be treated as citizens for U.S. tax purposes. Accordingly, it would seem appropriate for any such change in law to apply prospectively to expatriating acts occurring after the date of enactment.

In addition, according to the INS, no records are kept regarding the movement of permanent residents into or out of the United States.[432] Unless a former permanent resident tries to reenter the United States after a prolonged absence (e.g., more than one year) without the proper documentation, or voluntarily turns in his or her green card, the INS generally would not be aware that an individual has relinquished permanent residency status.

These absences or delays in notification of an expatriating act or termination of residency can preclude the IRS from properly enforcing the alternative tax regime. A rule that would conform the loss of citizenship or termination of residency for U.S. tax purposes to the date that the required information was provided to the IRS would serve an additional benefit of eliminating the problems created by this delay.

To effectively enforce the alternative tax regime, the IRS must obtain the required information as completely and consistently as possible. Accordingly, individuals seeking to relinquish their citizenship should be required to complete IRS Form 8854 and the use of alternate mechanisms by consular offices should be discontinued immediately.

Finally, the point of citizenship relinquishment or residency termination is not the only point in time at which it is in the interest of the IRS to receive information from former citizens or former long-term residents who are subject to the alternative tax regime. Under present law, such former citizens and former long-term residents are required to file tax returns only if they owe tax. As part of these tax returns, the former citizen or former long-term resident must also provide to the IRS a statement setting forth (generally by category) all items of U.S.-source and foreign-source gross income. Requiring the annual filing of balance sheet information by all former citizens and former long-term residents who are subject to the alternative tax regime (regardless of whether tax is due) during the 10-year period after citizenship relinquishment or residency termination would serve to provide the IRS with more recent financial and address information, thereby improving their ability to effectively administer the law.

[432] The INS tracks the movements of nonimmigrants on its NIIS database. NIIS tracks admission and departure dates of nonimmigrants, as well as each nonimmigrant's stated destination in the United States. The arrival and departure records of permanent residents are not tracked by any INS system.

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)

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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

[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.

D. Tax Treaties

1. In general

The United States has entered into many tax treaties with other countries. These include income tax treaties, as well as estate, inheritance, and gift tax treaties. The traditional objectives of these tax treaties are to reduce or eliminate double taxation (e.g., income, estate, inheritance, or gift taxes), and to prevent avoidance or evasion of the taxes of the two countries. In the case of income tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In addition, treaties generally prevent the source country from taxing capital gains derived by a resident of the other country and other income not specifically mentioned in the treaty.

Estate and gift treaties generally cover issues such as determining whether an individual is a domiciliary of each of the signatory countries, what property may be included in the gross estate of the country that is not the decedent's country of domicile or citizenship (i.e., a country that is not the individual's primary taxing jurisdiction), the exemptions, deductions, and credits that may be granted by a country that is not the decedent's country of domicile or citizenship, and any available credits.

To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives. Treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

2. Saving clauses

U.S. tax treaties typically provide rules to specify the residence or domicile of an individual who may be subject to tax as a resident under the domestic laws of both countries. The United States typically includes in its tax treaties a "saving clause" in order to preserve its right to tax U.S. citizens or residents who are residents of treaty partners. By reason of this saving clause, unless otherwise provided in the treaty, the United States may continue to tax its citizens or residents as if the treaty was not in force. The scope of the saving clause, however, differs by treaty. Some saving clause provisions apply only to preserve U.S. taxing jurisdiction with respect to U.S. citizens or residents. Other saving clause provisions apply to U.S. citizens or residents and to former citizens, but not to former long-term residents. The broadest saving clause provisions apply to U.S. citizens or residents as well as both former citizens and former long-term residents.

Income tax treaties

There are currently 55 U.S. income tax treaties in force. Of these treaties, eight contain a provision under which the saving clause (and, therefore, the U.S. jurisdiction to tax) applies to a former citizen or former long-term resident whose loss of citizenship or resident status had as one of its principal purposes the avoidance of tax; such application is limited to the 10-year period following the loss of citizenship or resident status.[448] This approach is consistent with the alternative tax regime for former citizens and former long-term residents as described above.

Not all U.S. tax treaties in force, however, are fully consistent with the approach under the alternative tax regime. In this regard, there are 16 U.S. income tax treaties currently in force that do not permit the United States to tax its former citizens or former long-term residents under the applicable saving clause.[449] These treaties potentially conflict with the alternative tax regime with respect to both former citizens and former long-term residents.

In addition, there are 24 U.S. income tax treaties currently in force that contain saving clauses that permit the United States to tax its former citizens (for the 10 years following the loss of citizenship if such loss had as one of its principal purposes the avoidance of tax), but do not expressly mention former long-term residents.[450] Of these treaties, 21 potentially conflict with the alternative tax regime with respect to former long-term residents.[451] According to the Department of Treasury, an additional potential conflict exists with the U.S.-Netherlands income tax treaty, because that treaty provides that the saving clause does not apply to former U.S. citizens who are nationals of the Netherlands.

There are seven U.S. income tax treaties currently in force that contain saving clauses that permit the United States to tax its former citizens, regardless of the reason for the loss of citizenship, but do not expressly mention former long-term residents.[452] According to the

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[448] *See* Table 4 at A-6. The Senate also has given its advice and consent to ratification of a new U.S. income tax treaty with Italy that contains a similar saving clause provision. The treaty and protocol are awaiting ratification by the Italian government.

[449] *See* Table 1 at A-3.

[450] *See* Table 2 at A-4.

[451] The U.S. income tax treaties currently in force with Austria, Ireland, and Luxembourg contain a saving clause provision that applies to former citizens (for the 10 years following the loss of citizenship if such loss had as one of its principal purposes the avoidance of tax), but does not expressly mention former long-term residents. According to the Department of Treasury, because these three income tax treaties entered into force after the date of enactment of the 1996 amendments to the alternative tax regime, the 1996 alternative tax regime does not override these three treaties with respect to former long-term residents. *See* S. Rep. No. 105-8 (1997), Exec. Rep. No. 105-7; S. Rep. No. 105-8 (1997), Exec. Rep. 105-13.

[452] *See* Table 3 at A-5.

Department of Treasury, five of these treaties potentially conflict with the alternative tax regime with respect to former long-term residents.[453]

Thus, of the 55 U.S. income tax treaties in force, only eight are fully consistent with the alternative tax regime. The majority of the remaining income tax treaties potentially conflict with the present-law alternative tax regime -- either with respect to former citizens (which is the case in 16 U.S. income tax treaties), or with respect to former long-term residents (which is the case in 42 U.S. income tax treaties).[454]

<u>Estate and gift tax treaties</u>

There currently are 16 U.S. estate and gift tax treaties in force. Of these treaties, only one is fully consistent with the alternative tax regime.[455] Of these treaties, 12 do not expressly permit the United States to tax estates of, or gifts by, former citizens and former long-term residents.[456] These 12 treaties potentially conflict with the alternative tax regime with respect to both former citizens and former long-term residents.

In addition, three of the 16 estate and gift tax treaties contain a saving clause that expressly permits the United States to tax estates of, and gifts by, former citizens whose loss of citizenship was tax-motivated, but do not expressly mention former long-term residents.[457] These three treaties potentially conflict with the alternative tax regime with respect to former long-term residents.

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[453] According to the Department of Treasury, because the income tax treaty with Switzerland entered into force after the date of enactment of the 1996 amendments to the alternative tax regime, even though the treaty is inconsistent with the alternative tax regime with respect to former long-term residents, the alternative tax regime does not override the treaty. *See* S. Rep. No. 105-8 (1997), Exec. Rep. 105-10. For the same reason, the U.S.-Ukraine income tax treaty should not be overridden by the 1996 alternative tax regime.

[454] As described above in notes 451 and 453, according to the Department of Treasury, five U.S. income treaties do not conflict with the 1996 alternative tax regime with respect to former long-term residents because those treaties entered into force after the date of enactment of the 1996 amendments to the alternative tax regime (*i.e.,* the income tax treaties with Austria, Ireland, Luxembourg, Switzerland, and Ukraine).

[455] *See* Table 7 at A-9. The new U.S. estate tax protocol with Germany permits the United States to tax estates of, and gifts by, former citizens and former long-term residents whose loss of such status has as one of its principal purposes the avoidance of U.S. tax for 10 years following such loss of status. Thus, the protocol amends the treaty to conform to the present-law alternative tax regime.

[456] *See* Table 5 at A-7.

[457] *See* Table 6 at A-8.

3. Interaction of the alternative tax regime with tax treaties

Potential conflicts between the alternative tax regime and the saving clauses in U.S. tax treaties may occur if, for example, income or gains are derived by a former U.S. citizen or former long-term U.S. resident who resides in a country with which the United States has a tax treaty. If the saving clause (and therefore the U.S. jurisdiction to tax) does not apply to the former U.S. citizen or former long-term U.S. resident, such individual generally would benefit from the treaty as if the alternative tax regime did not exist. For example, such individuals would obtain the typical treaty benefits providing for reduced rates or exemptions from U.S. tax on U.S.-source passive income, and exemptions from U.S. tax on U.S.-source capital gains, certain U.S.-source business and services income, or other U.S.-source income not specifically mentioned in the treaty. This result would apply even though U.S. tax would otherwise be imposed under the alternative tax regime with respect to these items of income during the 10-year period after citizenship relinquishment or residency termination.

The legislative history of the 1996 changes to the alternative tax regime addressed the interaction of the alternative tax regime and tax treaties. The legislative history stated that the alternative tax regime generally is consistent with the underlying principles of tax treaties. However, the legislative history contemplated that treaty provisions might conflict with the alternative tax regime. In particular, the legislative history stated that:

> [t]he Department of Treasury is expected to review all outstanding treaties to determine whether the expatriation tax provisions, as revised, potentially conflict with treaty provisions and to eliminate any such potential conflicts through renegotiation of the affected treaties as necessary. Beginning on the tenth anniversary of the enactment of the [1996 amendments to the expatriation tax provisions], any conflicting treaty provisions that remain in force would take precedence over the expatriation tax provisions as revised.[458]

Thus, until August 21, 2006 (the tenth anniversary of the enactment of the 1996 amendments to the alternative tax regime), the alternative tax regime will apply regardless of any conflicting treaty provisions that might otherwise restrict the United States' ability to tax its former citizens or former long-term residents. This may be viewed as a temporary (10-year) override of applicable treaties.

The Department of Treasury has undertaken efforts as part of its renegotiation of treaties to resolve some of these potential conflicts. The Department of Treasury has included a saving clause provision in its 1996 U.S. model income tax treaty that allows the United States to tax for 10 years (as if the treaty did not come into effect) former citizens and former long-term residents whose loss of such citizenship or resident status had as one of its principal purposes the avoidance of tax. However, as described above, conflicts in several U.S. treaties remain. The Department of Treasury has stated the following problems in attempting to resolve these remaining conflicts:

[458] H.R. Conf. Rep. No. 104-736, at 329 (1996).

While the Treasury Department intends to advocate this expanded saving clause whenever it takes part in treaty negotiations, it would be extremely difficult to renegotiate all potentially conflicting treaties within the 10-year period referred to in the legislative history of the 1996 expatriation legislation. The renegotiation of a tax treaty requires a significant commitment of resources by both countries. Accordingly, the Treasury Department must prioritize its treaty negotiations according to a variety of factors, including the relative significance of the issues to be addressed with its various treaty partners and potential treaty partners. The potential conflict between an existing treaty and the 1996 expatriation tax legislation is one such issue.

Even if the Treasury Department sought to renegotiate a treaty to eliminate this potential conflict, numerous factors may limit its ability to do so.[459] For example, a country with which the United States has a tax treaty is likely to view an agreement to expand the saving clause as a concession by that country, because the provision would expand the United States' ability to impose tax on a resident of that country. That country, if it were willing to agree to the expansion, would probably expect a concession from the United States in return. This is particularly likely because the issue would arise as a result of a treaty override by the United States.[460] The concession expected from the United States may or may not be acceptable to the United States. In addition, the Conference Report to the 1996 legislation, which purports to withdraw the treaty override after 10 years following enactment of the legislation, could provide an incentive for treaty partners to delay negotiations on the issue until the override purportedly expires in 2006. Accordingly, even if the Treasury Department had the resources to renegotiate all of the income tax treaties that conflict or (potentially conflict) with the 1996 legislation, it is not certain that mutually acceptable agreements could be reached. [461]

To the extent that conflicting treaty provisions can be fully conformed with the alternative tax regime prior to August 21, 2006, the United States can preserve its taxing jurisdiction with respect to former citizens and former long-term residents who reside in such treaty jurisdictions. However, as described above, there may be significant practical difficulties in reaching that goal. To the extent that a conflicting treaty provision cannot be conformed

[459] The difficulties involved in the renegotiation of U.S. treaties as a result of the 1996 legislation's treaty override were discussed in detail in the Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Committee on Finance, United States Senate, dated July 11, 1995.

[460] In this regard, the United States is widely perceived as overriding its treaty obligations more frequently than its treaty partners, a perception that has the potential to make it more difficult to obtain concessions from treaty partners and potential treaty partners.

[461] *See* A-20 (April 7, 2000, letter from the Department of Treasury). The Department of Treasury stated similar concerns with respect to the renegotiation of estate and gift tax treaties.

before the temporary treaty override expires in 2006, the alternative tax regime could have limited or no effect (depending on the current treaty provision) with respect to individuals who reside (or choose to reside) in that treaty jurisdiction.[462]

[462] It is unknown how many former citizens or former long-term residents currently are residents of treaty countries that have treaty provisions that conflict with the alternative tax regime.

E. Immigration Rules

1. Substantive determinations of inadmissibility

The immigration rules require the Attorney General to determine whether an individual renounced his or her citizenship for the purpose of avoiding U.S. taxation. The statute does not give any standards to judge the citizen's intent in relinquishing his or her citizenship. As a result, the Attorney General has discretion in determining whether an individual's purpose in renouncing U.S. citizenship was to avoid taxation. The Attorney General, however, is not charged with the administration of the tax laws. That responsibility lies with the Department of Treasury. The Department of Treasury, however, is not charged with enforcing or assisting in the enforcement of the immigration provision. Thus, the statute requires an INS immigration officer at the border or Department of State consular officer abroad to make a tax determination in order to enforce the immigration laws. In theory, to enforce the statute, the INS immigration officer or consular officer (as representatives of the Attorney General) would have to consider the tax treatment of the individual as a U.S. citizen, and then compare it to the tax treatment of the individual in his or her new country and consider whether the individual had other reasons for relinquishing citizenship.

Because the exclusion is based on the subjective intent or motivation of the former citizen, it is inherently difficult to administer. This difficulty is exacerbated by the inability of the INS and the Department of State to obtain information from the IRS to make the required determination. Even if the IRS had concluded that an citizenship relinquishment was motivated by tax avoidance, that information could not be shared with the INS or Department of State in its determination of whether a citizenship relinquishment was for the purpose of tax avoidance. The lack of explicit disclosure authority to administer the immigration provision renders the bar ineffective. Given the lack of training in tax matters and the lack of access to tax records, it is not efficient for the INS or Department of State to make the required determination.[463]

In addition to the difficulty of administration, a disparity exists between the coverage of section 877 and the immigration provision. Under section 877, tax avoidance must be one of the principal purposes for citizenship relinquishment, thus allowing for other principal purposes. Under the immigration provision, tax avoidance must be the purpose for citizenship relinquishment. Consequently, the test is more inclusive under section 877 than under the immigration provision. Coverage also differs as to former green card holders. Under section 877, former long-term residents with a tax avoidance purpose, as well as former citizens, are subject to the 10-year tax. The immigration provision does not apply to these former long-term residents.

[463] As discussed in Part V, above, the Homeland Security Act transfers the functions of the INS and the immigration functions of both the Attorney General and the Department of State to the Department of Homeland Security.

2. Waivers

Present law provides for discretionary waiver of inadmissibility to the United States. This waiver neutralizes the effect of being deemed inadmissible under the immigration provision. For those individuals seeking to establish permanent residence in the United States, the immigration provision is a bar to entry. For those individuals seeking to visit the United States temporarily, however, this ground of inadmissibility can be waived.[464] Waiver is discretionary and applications are evaluated on a case-by-case basis. Factors considered in determining whether to approve a waiver include:

(1) The effect on U.S. public interests;

(2) The seriousness of actions or conditions causing inadmissibility; and

(3) The reasons for wishing to enter the United States. There is no need to show a compelling reason for the visit.[465]

Thus, under present law, an individual who renounces citizenship for tax reasons could be admitted to the United States to visit family or for vacation. Since the former citizen left the United States to avoid taxation, there is little likelihood that such individual would wish to re-establish permanent residency as an immigrant (i.e., and be subject to tax once again). More likely than not, such individuals would be making short, perhaps frequent, trips to the United States for business or pleasure. Given the discretionary nature of the waiver, such visits are not impeded by such individual being deemed inadmissible. Thus, the goal of the immigration provision -- to deny reentry into the United States for individuals who renounce citizenship for tax reasons -- is not achieved because such individual can continue to reenter the United States, even routinely, without establishing permanent residency.

[464] 8 U.S.C. sec. 1182(d)(3).

[465] Department of State, 9 Foreign Affairs Manual, sec. 40.301 n.3.