I. EXECUTIVE SUMMARY

Overview of tax law

In general

U.S. citizens and noncitizens who are U.S. residents generally are subject to U.S. tax on a worldwide basis for U.S. Federal income, estate, and gift tax purposes.[2] On the other hand, noncitizens who are nonresidents generally are subject to U.S. tax only on income from U.S. sources and income effectively connected with the conduct of a trade or business within the United States. In addition, noncitizens who are nonresidents generally are subject to U.S. estate and gift tax only with respect to U.S.-situated property. Bilateral tax treaties may modify the treatment under these general tax rules.

Alternative tax regime for certain former citizens and former long-term residents

Since 1966, special tax rules have applied to a U.S. citizen who relinquishes U.S. citizenship with a principal purpose of avoiding U.S. taxes. These rules are referred to as the "alternative tax regime." Under the alternative tax regime enacted in 1966,[3] a former citizen is subject to an alternative method of income taxation for 10 years following citizenship relinquishment. The alternative tax regime is a hybrid of the tax treatment of a U.S. citizen and a noncitizen who is a nonresident. For the 10-year period following citizenship relinquishment, the former citizen is subject to tax only on U.S.-source income at the rates applicable to U.S. citizens, rather than the rates applicable to noncitizens who are nonresidents. However, for this purpose, U.S.-source income has a broader scope than it does for normal U.S. Federal tax purposes and includes, for example, gain from the sale of U.S. corporate stock or debt obligations. The alternative tax regime applies only if it results in a higher U.S. tax liability than the liability that would result if the individual were taxed as a noncitizen who is a nonresident.

In addition, since 1966, the alternative tax regime has included special estate and gift tax rules. Under these rules, if a former citizen who is subject to the alternative tax regime dies within 10 years of citizenship relinquishment, his or her estate includes the value of certain closely-held foreign stock to the extent that the foreign corporation owns U.S.-situated property. In addition, under the alternative tax regime, the former citizen is subject to gift tax on gifts of U.S.-situated intangibles, such as U.S. stock, made during the 10 years following citizenship relinquishment.

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[2] The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") repealed the estate tax for estates of decedents dying after December 31, 2009. However, the Act included a "sunset" provision, pursuant to which EGTRRA's provisions, including estate tax repeal, do not apply to estates of decedents dying after December 31, 2010.

[3] The present-law alternative tax regime was first enacted as part of the Foreign Investors Tax Act of 1966, Pub. L. No. 89-809.

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In 1996, several significant changes were made to the alternative tax regime.[4] These amendments followed press reports and Congressional hearings indicating that a small number of very wealthy individuals had relinquished their U.S. citizenship to avoid U.S. income, estate, and gift taxes, while nevertheless maintaining significant contacts with the United States.

First, the 1996 amendments extended the application of the alternative tax regime to certain long-term residents who terminate their U.S. residency. Thus, under the 1996 amendments, the alternative tax regime applies both to U.S. citizens who relinquish citizenship and long-term residents who terminate residency with a principal purpose of avoiding U.S. taxes.

Under the 1996 amendments, a U.S. citizen who relinquishes citizenship or a long-term resident who terminates residency is treated as having done so with a principal purpose of tax avoidance (and, thus, generally is subject to the alternative tax regime) if: (1) the individual's average annual U.S. Federal income tax liability for the five taxable years preceding citizenship relinquishment or residency termination exceeds $100,000; or (2) the individual's net worth on the date of citizenship relinquishment or residency termination equals or exceeds $500,000. These amounts are adjusted annually for inflation.[5] Certain categories of individuals can avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the Internal Revenue Service ("IRS") regarding whether the individual relinquished citizenship or terminated residency principally for tax reasons. This ruling practice is detailed in Notice 97-19 and was modified in Notice 98-34.[6]

The 1996 amendments provide for certain anti-abuse rules to prevent circumvention of the alternative tax regime through conversion of U.S.-source income or property to foreign-source income or property. In addition, the 1996 amendments extend the scope of the alternative tax regime by including foreign property acquired in nonrecognition transactions, taxing amounts earned by former citizens and former long-term residents through controlled foreign corporations, and suspending the 10-year liability period during any time at which a former citizen's or former long-term resident's risk of loss with respect to property subject to the alternative tax regime is substantially diminished, among other measures.

The 1996 amendments require individuals to provide certain tax information, including tax identification numbers, upon relinquishment of citizenship or termination of residency. The penalty for failure to provide the required tax information is the greater of $1,000 or five percent of the tax imposed under the alternative tax regime for the year. In addition, the U.S. Department of State ("Department of State") and other governmental agencies are required to provide this information to the IRS.

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[4] Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191.

[5] The inflation-adjusted amounts are $122,000 and $608,000, respectively, for 2003. Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

[6] 1997-1 C.B. 394 and 1998-2 C.B. 29. *See* A-166 and A-193.

Overview of immigration law

In general

For immigration purposes, a noncitizen seeking to enter the United States generally is required to present valid documentation, usually a visa and a passport. The Department of State and the Immigration and Naturalization Service (the "INS") form a "double check" system for entry into the United States. The Department of State grants visas, and the INS inspects persons upon arrival at a port of entry and determines whether they will be admitted into the country. There are many grounds on which a person can be denied entry or reentry, some of which can be waived. Even if such grounds cannot be waived, a person may be "paroled" (granted temporary admission) into the United States for emergency or humanitarian reasons.

Special immigration rule for U.S. citizens who renounce citizenship for tax reasons

In 1996, the Congress enacted a special immigration provision applicable to individuals who renounce their U.S. citizenship with the purpose of avoiding taxation.[7] Under this provision, a former citizen is to be denied reentry into the United States if the Attorney General determines that the individual renounced his or her citizenship for the purpose of avoiding U.S. tax.[8] The Attorney General has the authority to waive this prohibition with respect to non-immigrants (*i.e.,* individuals who do not want to establish permanent residence in the United States). This special provision does not apply to former long-term residents who terminate residence for tax reasons.

Overview of Joint Committee staff review

The Joint Committee staff conducted an extensive review of the present-law alternative tax regime for certain former citizens and former long-term residents and the related immigration laws. This included a review of the relevant statutes and their legislative history, discussions with the Federal agencies responsible for enforcing these laws, research of articles and commentaries written on the subject of citizenship relinquishment or residency termination, an examination of individual tax return information, and discussions with practitioners who advise individuals wishing to relinquish citizenship or terminate residency.[9]

To assist in this review, the Joint Committee staff requested that the General Accounting Office ("GAO") review the administrative practices of the U.S. Department of the Treasury ("Department of Treasury"), the IRS, the Department of State, and the INS in connection with the collection and processing of information about former citizens and former long-term

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[7] Illegal Immigration Reform and Immigrant Responsibility Act, Pub. L. No. 104-208, Division C, sec. 352(a), 110 Stat. 3009-641 (1996).

[8] *Id.*

[9] For a description of the Joint Committee staff methodology for this review, *see* Part III. below.

residents. The Joint Committee staff also requested that the GAO review the enforcement of the various requirements set forth in the alternative tax regime and related immigration rules. The GAO completed its review and issued a report in May 2000.[10]

The Joint Committee staff spent extensive time during 1999 and 2000 conducting its review. Chairman William Archer, who originally requested the Joint Committee staff review, retired at the end of the 106th Congress in 2000. At that time, the Joint Committee staff had not completed its review. Due to more pressing work, the project was set aside. In 2002 and early 2003, based on renewed interest in the topic expressed by several Members of Congress, the Joint Committee staff spent extensive time to update and complete its review, including updating prior work to take into account changes in law and administrative practices since 2000. This process included reviewing numerous private letter rulings issued to former citizens and former long-term residents since 2000, analyzing the potential effects of changes in law, such as the changes to the estate tax provisions as part of EGTRRA, as well as other developments, such as reorganizations within the IRS that could affect the administration of the alternative tax regime.

Summary of Joint Committee staff findings

Based on the GAO and Joint Committee staff review of the various Federal agencies' administrative procedures, the Joint Committee staff concludes that there is little or no enforcement of the special tax and immigration rules applicable to tax-motivated citizenship relinquishment and residency termination. The GAO stated in their 2000 report that the IRS does not yet have a systematic compliance effort in place to enforce the present-law alternative tax regime. Since that time the IRS generally has ceased all compliance efforts directly relating to the income, estate, and gift tax obligations of former citizens and former long-term residents under the alternative tax regime, other than compiling a Certificate of Loss of Nationality ("CLN") database for such individuals and publishing their names in the *Federal Register* as required by section 6039G.[11] In addition, the INS and the Department of State have not denied reentry into the United States to a single former citizen under the 1996 special immigration rule. While the Joint Committee staff is aware that the INS has begun drafting guidelines to implement the immigration provision, it is unclear whether the guidelines will have any significant effect on enforcement.

The Joint Committee staff believes that a key reason for inadequate enforcement of the alternative tax regime is the inability to obtain necessary information from individuals: (1) at the time of citizenship relinquishment or residency termination; and (2) during the 10-year period following citizenship relinquishment or residency termination, for those individuals who are subject to the alternative tax regime. These enforcement difficulties begin at the time individuals notify the Department of State of their intent to relinquish citizenship.

For the period 1995 through 1999, only one-third of individuals relinquishing citizenship provided information statements that contained a social security number. For 2000 and 2001,

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[10] *See* the General Accounting Office Report ("GAO Report") at A-256.

[11] *See* A-141 (September 20, 2002, letter from the IRS) (relevant material redacted).

there was significant improvement in the number of information statements provided by individuals relinquishing citizenship, but the Joint Committee staff was unable to obtain specific information as to how many of these statements were fully completed and included social security numbers.[12] Without a social security number, the IRS cannot attempt to match the former citizen or former long-term resident to other IRS databases without a labor-intensive manual search.

For the period 1995 through 1999, 182 former citizens identified themselves as exceeding the thresholds provided under the alternative tax regime for being treated as having relinquished their citizenship for tax avoidance purposes.[13] For 2000 and 2001, 76 former citizens who provided information statements identified themselves as meeting one or more of the monetary thresholds or included a social security number.[14] Except for these individuals, the IRS does not appear to have sufficient information (e.g., social security numbers) for these periods to identify other individuals who might be subject to the alternative tax regime. Furthermore, with respect to those individuals who have been identified, the IRS currently makes no attempt to monitor and enforce the 10-year income tax return filing requirement for those individuals subject to the alternative tax regime.

The Joint Committee staff recognizes that monitoring the activities of individuals who no longer reside in the United States is inherently difficult, and that the need to do so poses serious challenges in enforcing these rules. At a minimum, an effective system for collecting and processing timely information relating to individuals who relinquish citizenship or terminate residency is a prerequisite to enforcing the rules. Enforcement of the immigration provision also is hindered by several factors, specifically lack of access by the Attorney General to the IRS records to identify former citizens who renounce citizenship for tax reasons, lack of access by the IRS to INS databases, differing interpretations between the INS and the Department of State as to what it means to officially renounce U.S. citizenship, and the lack of coordination between the tax rules and the immigration rules relating to individuals who relinquish citizenship or terminate their residency.

The Joint Committee staff also believes that inadequate enforcement of the alternative tax regime and the related immigration rules may be due in part to a low priority assigned to the enforcement of these rules by the Federal agencies involved. As indicated above, in 2000, the IRS generally ceased compliance efforts directed at former citizens and former long-term residents under the alternative tax regime. The IRS, therefore, cannot determine whether such individuals are meeting their tax return filing requirements under the alternative tax regime. Moreover, the GAO stated in its 2000 report that the IRS has never pursued an audit or otherwise

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[12] For a more detailed discussion, *see* Part VII.B. below.

[13] *See* the GAO Report at A-256.

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

examined those former citizens or former long-term residents who were determined in the ruling process to have a principal purpose of tax avoidance.[15]

Other factors also have contributed to enforcement problems. For example, the present-law alternative tax regime requires in many instances an inquiry into the subjective intent of the former citizen or former long-term resident -- i.e., whether one of the principal purposes for expatriating or terminating residency was the avoidance of tax. The IRS has limited resources that it must allocate to their best uses, and investigating the subjective reasons behind an individual's desire to relinquish citizenship or terminate residency requires a significant investment of those resources. If no such inquiry is made under the present-law rules, there is uncertainty as to whether a former citizen or former long-term resident is subject to the alternative tax regime.

The Joint Committee staff concludes that the problems with enforcement are significant enough that it is not possible to fully assess the potential effectiveness of the present-law alternative tax regime and related immigration rules. The Joint Committee staff believes that the enforcement problems (specifically the lack of information about former citizens and former long-term residents) must be addressed before the effectiveness of these rules can be fully evaluated. In this regard, the Joint Committee staff makes several recommendations designed to improve the administration and enforcement of the alternative tax regime and the related immigration rules.

Summary of Joint Committee staff recommendations

The Joint Committee staff recommends several changes to the present-law alternative tax regime and related immigration rules, with a view toward improving the administration and enforcement of these rules.

Consistent with its mandate in connection with this study, the Joint Committee staff has focused on potential improvements to the operation of the present-law rules. Thus, the staff's recommendations are designed to fit within the basic framework of the present-law alternative tax regime, and to make this regime work as well as possible. The Joint Committee staff does not take a position as to more fundamental changes that might be considered, such as replacing the present-law alternative tax regime with a mark-to-market exit-tax system, or eliminating altogether the tax regime specific to former citizens and former long-term residents.[16]

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[15] Recent information from the IRS indicates that the IRS has undertaken, or is in the process of undertaking, examinations of a small number of individuals who were determined to be subject to the alternative tax regime under the ruling process. However, the Joint Committee staff has been unable to determine, in all cases, the amount of tax collected from this small group of individuals. *See* A-132 (August 14, 2002, letter from the IRS); A-141 (September 16, 2002, letter from the IRS); A-141 (September 20, 2002, letter from the IRS) (relevant material redacted).

[16] *See* Part X, below, for a discussion of alternative approaches to the tax treatment of former citizens and former long-term residents.

While the Joint Committee staff believes that its recommendations would improve the effectiveness and administration of the present-law rules, it should be noted that, even if the Congress were to enact the Joint Committee staff recommendations, tax incentives for citizenship relinquishment and residency termination would remain. An alternative tax regime that is limited to U.S.-source income and, in the case of the estate and gift taxes, to U.S.-situated assets (albeit with expanded definitions of such income and assets) cannot eliminate the tax incentives to relinquish citizenship or terminate residency in cases in which an individual owns significant foreign-situated property. Similarly, an alternative tax regime that applies for a 10-year period following citizenship relinquishment or residency termination will not be effective with respect to individuals who are willing to wait the 10-year period prior to disposing of assets that would be subject to tax under the alternative tax regime. Perhaps most fundamentally, any tax regime applicable to individuals who are no longer physically present in the country, and whose assets may no longer be situated in the country or under the control of any U.S. person, inevitably faces serious challenges of enforcement as a practical matter. This enforcement effort requires significant resources to be devoted to the few individuals who are subject to the alternative tax regime. Accordingly, the Joint Committee staff believes that careful consideration should be given as to whether the alternative tax regime and related immigration rules, even as modified by the recommendations set forth below, can fully achieve the goals that the Congress intends to accomplish.[17]

The Joint Committee staff recommendations are summarized immediately below and are discussed in detail in Part XI, below.

A. Tax Recommendations

1. Provide objective rules for the alternative tax regime

The Joint Committee staff recommends that objective rules replace the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law. Under the proposed objective rules, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident:

> (a) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $122,000 (adjusted for inflation after 2003) and his or her net worth does not exceed $2 million, or alternatively satisfies limited exceptions for dual citizens and minors who have had no substantial contact with the United States, and
>
> (b) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the five preceding years and provides such evidence of compliance as the Secretary of the Treasury may require.

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[17] *See* Part VI, below, for background on the purposes of a special tax regime for former citizens and former long-term residents.

This recommendation, like present law, retains an income tax liability test and a net worth test, but it departs from the present-law approach in two significant respects. First, the objective monetary thresholds would become the general rule for conclusively determining whether a former citizen or former long-term resident would be subject to the alternative tax regime. The monetary thresholds would serve as a proxy for tax motivation and, unlike present law, no subsequent inquiry into the taxpayer's intent would be required or permitted in any case. The ruling process of present law would be eliminated. Second, because this objective monetary standard would be less flexible than present law, the present-law amount for the net-worth threshold would be increased.

The alternative tax regime would not apply to a former citizen who is a dual citizen or a minor with no substantial contacts with the United States prior to relinquishing citizenship. These exceptions for dual citizens and minors would use the present-law definitions of such individuals,[18] but the exceptions would operate differently from the present-law rules, which require an inquiry into intent. Under the recommendation, even if a former citizen or former long-term resident exceeded the monetary thresholds, that person would be excluded from the alternative tax regime if he or she fell within one of the specified exceptions (provided that the requirement of certification and proof of compliance with Federal tax obligations is met). These exceptions would provide relief to individuals who have never had any substantial connections with the United States, as measured by certain objective criteria, and would eliminate IRS inquiries as to the subjective intent of such taxpayers.

2. Provide tax-based rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes

The Joint Committee staff recommends that an individual should continue to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes until:

(a) notification of an expatriating act or termination of residency is provided to the Department of State or the INS, respectively, and,

(b) a complete and accurate IRS Form 8854 (i.e., a tax information statement) is filed.

In addition, the Department of State (including U.S. consular offices) should be required to provide a uniform tax information statement (i.e., IRS Form 8854) to all individuals who relinquish citizenship.

This recommendation would improve present-law rules by denying taxpayers the tax benefits of citizenship relinquishment or residency termination unless and until they provide the information necessary for the IRS to enforce the alternative tax regime.

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[18] Secs. 877(c)(2)(A) and 877(c)(2)(C), respectively.

3. Provide a sanction for individuals subject to the alternative tax regime who return to the United States for extended periods

The Joint Committee staff recommends that a former citizen or former long-term resident who is subject to the alternative tax regime and who is present in the United States for more than 30 days in any calendar year during the 10-year period following citizenship relinquishment or residency termination should be treated as a U.S. resident for U.S. Federal tax purposes for that calendar year.

This recommendation would reduce the tax incentives to relinquish citizenship or terminate residency for individuals who desire to maintain significant ties to the United States.

4. Impose gift tax with respect to certain closely held foreign stock

The Joint Committee staff recommends that gifts of certain closely held stock of a foreign corporation by an individual subject to the alternative tax regime be subject to U.S. gift tax to the extent that the foreign corporation holds U.S.-situated assets.

This recommendation would create parity between the relevant estate and gift tax rules and would combat a well-known method of gift tax avoidance.

5. Impose annual return requirement

The Joint Committee staff recommends that former citizens and former long-term residents who are subject to the alternative tax regime be required to file an annual return that provides, among other things, information on the permanent home of the individual, the individual's country of residency, the number of days the individual was present in the United States, and detailed information about the individual's income and assets. The annual return would be required even if no U.S. tax is due.

This recommendation would enable the IRS to monitor more effectively both the income generated by assets as well as any dispositions of assets that may be subject to U.S. tax.

6. Transition issues

The Joint Committee staff recognizes that transition issues would have to be addressed in connection with implementing these recommendations. Any Joint Committee staff recommendations that are adopted should apply on a prospective basis.

The Joint Committee staff recommends an immediate moratorium on the issuance by the IRS of the "fully submit" category of rulings under Notice 98-34.

B. Immigration Recommendations

1. Conform present-law immigration provision to tax rules

The Joint Committee staff recommends that the present-law tax and immigration provisions be coordinated in terms of both coverage and administration. Accordingly, the

substantive standards governing whether a former citizen or former long-term resident is inadmissible into the United States under the special immigration provision should be tied to the tax law provisions, and the IRS should be the agency primarily responsible for applying these standards.

This recommendation would create consistency between the relevant tax and immigration provisions and would assign the responsibility for making tax-related determinations to the agency best-equipped to do so.

2. Eliminate discretionary exception from immigration provision

The Joint Committee staff recommends that no waivers of substantive inadmissibility be available for former citizens and former long-term residents who are inadmissible by reason of the special immigration provision relating to tax avoidance.

This recommendation would bolster the deterrent effect of the special immigration provision.

3. Promote interagency information sharing

The Joint Committee staff recommends that the INS's databases be made accessible to the IRS and other appropriate Federal agencies for purposes of administering the special immigration provision relating to tax avoidance. These databases also should be modified to include social security numbers, if available, among other modifications.

This recommendation would facilitate the interagency cooperation needed to enforce the special immigration provision.

4. Amend Code section 6103

The Joint Committee staff recommends that section 6103 be modified to enable the IRS to share with the appropriate agencies the minimum tax information necessary to implement the special immigration provision.

Like the previous recommendation, this recommendation would facilitate the interagency cooperation needed to enforce the special immigration provision.