THE TAX REGIME FOR INDIVIDUAL EXPATRIATES: WHOM TO IMPRESS?

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I. INTRODUCTION

The American Jobs Creation Act of 2004 (the "2004 Act")[1] includes provisions to amend the tax regime for individual expatriates. This salvo is the latest in a politically charged exchange about the taxation of expatriates that ignited in the mid-1990s.[2] Proposals to replace the current expatriate tax regime with an "exit tax" and treat expatriation as a realization event have been reintroduced a number of times in the Senate and were included in the 2004 Senate Bill that was rejected in Conference.[3]

While the term "expatriation" is often used interchangeably to mean both the act of relinquishing legal status as a U.S. national and the act of abandoning United States domicile, it is important to distinguish between the two concepts. For most countries, which tax based on residence rather than nationality, it is not a change in legal nationality status, but rather the act of emigrating that alters an individual's tax status as a person generally subject to the country's taxing jurisdiction. The U.S. international tax regime for individuals turns on nationality status rather than domicile, as discussed below. Under the U.S. system, it is the loss of legal U.S. nationality that causes an alteration of general U.S. taxing jurisdiction. Of course, emigration is a necessary condition of expatriation, but it is not a sufficient condition, and, frequently, the two acts do not occur contemporaneously.

Legislative attention was drawn to expatriation by the wide publicity accorded a few egregious tax-motivated expatriations.[4] The expatriates involved were citizens and life-long U.S. residents who had enjoyed the privileges of U.S.

[1]American Jobs Creation Act of 2004, H.R. 4520, 108th Congress, 2d Sess., §804 (2004). Substantially identical provisions were included in the TREASURY DEPT., GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2005 REVENUE PROPOSALS (February 2005), *reprinted in* 2004 TAX NOTES TODAY 22-20 (Feb. 3, 2004) [hereinafter Administration's Proposal] and have been included in a number of House bills, for example, the Chairman's mark of the American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. § 2005 (2003).

[2]For a general discussion of the political battle over the taxation of expatriates during the 1990s, see Nancy Loube, *Expatriate Games: Politics Obscures Technical Issues*, 67 TAX NOTES (TA) 158 (Apr. 10, 1995); Martin A. Sullivan, *Democrats Revisit Expatriate Tax: With Neutrality and Justice for All?*, 85 TAX NOTES (TA) 407 (Oct. 25, 1999).

[3]Jumpstart Our Business Strength Act, S. 1637, 108th Cong. (2004) [hereinafter Senate JOBS Act]. Provisions to this effect have been a perennial revenue raiser, including, for example, the recent Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2004, S. 1072, 108th Cong. § 5652 (2004). *See also* STAFF OF JOINT COMM. TAXATION, 108TH CONG., DESCRIPTION OF THE HIGHWAY REAUTHORIZATION AND EXCISE TAX SIMPLIFICATION ACT OF 2004 (Comm. Print 2004). The exit tax was first proposed by the Clinton Administration in its Fiscal Year 1995 Budget Proposal, described in U.S. DEPT. OF TREASURY, GENERAL EXPLANATION OF REVENUE PROPOSALS IN CLINTON ADMINISTRATION'S FY 1996 BUDGET REQUEST (February 1995). A revised exit tax regime was then proposed by late Senator Moynihan, S. 700, 104th Cong. (1995) [hereinafter Moynihan Exit Tax Proposal].

[4]*See, e.g.*, Laurie P. Cohen, *Kenneth Dart Forsakes U.S. for Belize*, WALL ST. J., Mar. 28, 1994, at C1; Robert Lenzner & Philippe Mao, *The New Refugees: Americans Who Give Up Citizenship to Save on Taxes*, FORBES MAGAZINE, Nov. 21, 1994, at 131; Karen de Witt, *Some of the Rich Find a Passport Lost is a Fortune Gained*, N.Y. TIMES, Apr. 12, 1995, at A1.

nationality and residence, including the opportunity to accumulate vast wealth. They then expatriated to sunny tax-havens, presumably to avoid U.S. taxes, while maintaining significant continuing contacts with the United States. Faced with facts like these, a legislator's reaction to fulminate then legislate is understandable. Nevertheless, while this may be the situation at which the current expatriate tax regime is primarily aimed, it does not describe the situation of many, perhaps most, potential expatriates.

While few have much sympathy for the tax motivated expatriates described above, the current expatriate tax regime captures many other individuals whose situation is more sympathetic. Increasing international mobility has led, particularly in the case of wealthy families, to significant diversity of citizenship and nationality among family members. It is common for a wealthy family to include members who, by reason of birth in the United States, marriage, or otherwise, are U.S. citizens or green-card holders and stand to inherit a significant portion of the family's wealth. In its origins, the family's wealth may have had little or no relation to the United States. The actual contacts of U.S. citizen family members with the United States may range widely, from the individual who has chosen to make the United States his or her home, to the individual who takes advantage of his or her status to study or to reside temporarily in the United States, to the individual who maintains little or no actual contact with the United States but retains U.S. citizenship or a green card primarily to ensure access to a stable safe haven in the event of political instability at home. Yet all are fully taxed by the United States on their worldwide income on the basis of their nationality status. The appropriate tax regime for individuals who expatriate in these circumstances may be far less intuitive.

The United States was among the first countries to recognize expatriation as an important right. At common law, sovereign allegiance was immutable. The common law doctrine of "perpetual allegiance" denied a subject the right to sever his allegiance to the place of his birth.[5] The rule was widely recognized, initially even in the United States. However, American attitudes to the doctrine soured when the British vigorously asserted the doctrine to justify impressing captured British-born, U.S.-naturalized sailors into service in the British navy. American outrage led ultimately to the War of 1812.[6]

While U.S. citizens today enjoy a statutory right to expatriate,[7] these former citizens navigate treacherous international tax waters. Which expatriates are the United States able to capture in the extra-territorial exercise of its taxing power?

[5]*See, e.g.*, Calvin's Case, 77 Eng. Rep. 377, 382 (K.B. 1608) ("ligeance or obedience of the subject to the Sovereign is due by the law of nature."). *See generally* Peter J. Spiro, *Dual Nationality and the Meaning of Citizenship*, 46 EMORY L.J. 1411 (1997).

[6]*See* Charles Gordon, *The Citizen and the State: Power of Congress to Expatriate American Citizens*, 53 GEO. L.J. 315, 319 (1965). *See also* 3 JOHN BASSETT MOORE, A DIGEST OF INTERNATIONAL LAW § 439 (1906) (discussing the U.S. furor in 1866-67 over the refusal of Great Britain to recognize the right of native British subjects to divest themselves of allegiance by naturalization in the United States, in the context of their participation in the Fenian movement).

[7]*See* Immigration and Nationality Act, 8 U.S.C. § 1481 (2004).

Which captured expatriates should it impress? Should the expatriate tax regime satisfy domestic tax policy norms, conflicting international tax norms, or serve merely to impress upon the electorate that their elected representatives share their distaste for wealthy taxpayers who seek to escape their fair tax burden?

Part I of this Article compares the U.S. tax regime for citizens and permanent legal residents to that for nonresident aliens and explains the income tax and wealth transfer tax advantages of expatriation. Part II summarizes the current law regime applicable to expatriates, primarily under section 877 of the Code prior to the changes made by the 2004 Act. Part III summarizes the changes adopted in the 2004 Act and the competing Senate proposal to adopt an exit tax imposed on a mark-to-market basis. Part IV summarizes constitutional law, international law, and tax policy concerns that should inform the design of the expatriate tax regime and evaluates how successfully these are addressed by prior law, the law as amended by the 2004 Act, and the competing proposal. Finally, Part V tentatively suggests an alternative and more rational regime. Under this regime, to avoid a full departure tax (based on estate tax principles) on property owned at the time of expatriation, the expatriate would be required to transfer the property to a custodian who agrees to act in that capacity. The custodian would generally be required to withhold taxes imposed on income from the custodial property. This income would continue to be taxed as income of a citizen up to the point at which the aggregate tax imposed is equal to a tentative tax amount computed based on mark-to-market principles at the time of expatriation. A substitute wealth transfer tax would apply to assets transferred to the custodian, based on estate tax principles but at a rate discounted to reflect the actuarial likelihood of death for someone of the expatriate's age.

II. WHY EXPATRIATE? THE U.S. INTERNATIONAL TAX REGIME FOR INDIVIDUALS

While there are other reasons an individual may choose to expatriate, wealthy individuals often see reducing their U.S. tax burden as a predominant consideration. Expatriating may avoid or reduce U.S. income taxes and wealth transfer taxes.

A. *The Income Tax*

Like most countries, the United States has an international tax system that distinguishes between those individuals generally subject to its taxing jurisdiction who are taxed on worldwide net income by reason of their affiliation with the United States ("residence-based taxation") and foreign individuals who are not subject to the general taxing jurisdiction of the United States and are taxed only on income derived from U.S. sources, generally on a gross basis collected by withholding ("source-based taxation").[8]

[8]For a general overview of the history and policies underlying U.S. taxation of international income, see Michael J. Graetz et al., *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997).

The United States asserts its general jurisdiction to tax individuals more expansively than almost any other country. United States citizens[9] and green card holders[10] are taxed on their worldwide income whether or not they are actually domiciled or resident in the United States. Referring to the U.S. regime as "residence based" is, however, a misnomer. The U.S. system is a nationality-based tax regime.

The articulated rationale for founding jurisdiction to tax on an individual's nationality rather than their domicile is that nonresident citizens have the valuable right to avail themselves of the legal protection of the United States, enjoy the opportunity to enter and leave the territorial jurisdiction of the United States at any time, and may participate fully in the democratic institutions of the United States.[11] Somewhat less plausibly, taxation of green card holders, even if they are not within the United States in a particular year, is justified by their opportunity freely to enter and depart the United States, engage in employment within its borders, and acquire citizenship status with relative ease.

The United States nationality-based approach is markedly at odds with international norms. With the exceptions of the Philippines and Eritrea, other countries generally assert jurisdiction to tax individuals under a residence-based regime only if they are actually resident or domiciled in the country.[12]

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[9]An individual acquires U.S. citizenship by (1) birth within the geographic boundaries of the United States; (2) birth outside the United States to at least one United States resident parent (as long as that parent has previously been resident in the United States for a requisite period of time); or (3) voluntarily, by naturalization. Except where citizenship is acquired fraudulently or through misstating material facts during the naturalization process, an individual citizen generally may not be involuntarily deprived of his or her citizenship. *See* Afroyim v. Rusk, 387 U.S. 253, 266 (1967). Acts that can result in loss of citizenship are (1) naturalization in a foreign state after the age of 18; (2) taking an oath of allegiance to a foreign state or its subdivision after the age of 18; (3) serving in the armed forces of a foreign state, under certain circumstances; (4) taking a government job with another country, under certain circumstances; (5) renouncing nationality in the prescribed form before a U.S. diplomatic or consular officer abroad; (6) renouncing in time of war, upon approval of the Attorney General; and (7) committing an act of treason or other seditious act specified in the statute.

[10]An individual acquires permanent legal resident ("green card") status by application if certain conditions (such as marriage to a U.S. national) are met. A green card can be relinquished merely by mailing the card to the immigration authorities. A green card holder can be involuntarily deported through a judicial or administrative decision for various reasons, and green card status may be forfeited if the holder leaves the United States for an uninterrupted period of more than one year (although the holder may apply for reinstatement). Other aliens may be temporarily resident in the United States under the visa program. Such temporary residents may be taxed as residents as long as they qualify as resident aliens based on the "substantial presence test" under section 7701(b). For convenience, citizens and permanent residents subject to tax on this basis are together referred to as U.S. tax nationals.

[11]See the discussion below of *Cook v. Tait*, 265 U.S. 47 (1924).

[12]*See* STAFF OF JOINT COMM. TAXATION, 104TH CONG., ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION B-1 (Comm. Print 1995) [hereinafter JCT Expatriation Report]. *See also* STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., REVIEW OF THE PRESENT LAW TAX AND IMMIGRATION TREATMENT OF RELINQUISHMENT OF CITIZENSHIP AND TERMINATION OF LONG-TERM RESIDENCY (Comm. Print 2003) [hereinafter JCT 2003 Expatriation Report].

The United States also defines its international income tax base more broadly than many countries. U.S. tax nationals are subject to net income tax on their worldwide income.[13] The United States affords a foreign tax credit for income taxes of other countries incurred on income derived from foreign sources.[14] However, although the foreign tax credit effectively cedes primary taxing jurisdiction to the country of source, it reserves to the United States a residual claim to tax that income to the extent U.S. tax rates exceed the rate of tax imposed by the source country. By contrast, a number of countries adopt "territorial" or "exemption" systems that exclude foreign source income, at least to the extent it is not remitted.[15]

The expansive reach of U.S. taxing jurisdiction is compounded by complex and often overlapping anti-deferral regimes that apply to income earned by certain foreign corporations owned or controlled by U.S. tax nationals.[16] These regimes are intended to limit inappropriate deferral of income but may in some situations be punitive.[17] Even countries that do not have a territorial tax system generally have less intrusive anti-deferral regimes than the United States and may not tax income earned through companies located in offshore jurisdictions.

Some relief from this expansive nationality-based tax regime is provided to U.S. citizens who are resident in a county with which the United States has concluded a bilateral income tax treaty. The focus of income tax treaties is generally to apportion jurisdiction to tax between the country from which income is sourced and the country in which the taxpayer is resident. However, treaties do address to some extent conflicting claims to tax income based on a general affiliation to the taxing jurisdiction. Income tax treaties contain so-called "tie-breaker" rules that, in the case of dual residence, cede taxing jurisdiction to the country in which the individual has his permanent home or "center of vital interests." However, tax treaties entered into by the United States invariably contain a "savings clause" under which the United States reserves the right to tax its citizens and, in some cases, legal residents to the same extent as if the

[13]A limited exclusion of up to $80,000 of certain foreign earned income is provided by section 911.

[14]I.R.C. §§ 901-904.

[15]The taxing jurisdiction of Hong Kong exempts foreign source income entirely. *See generally* Michael Olesnicky & Steven Siker, *Business Operations in Hong Kong*, 964-2ND TAX MNGT. PORT. (BNA) A-17 (2004). Certain countries like the United Kingdom tax individuals who are resident but not domiciled in the country on a remittance basis, *i.e.*, only to the extent that foreign income or gain is remitted to the United Kingdom. Similar remittance-based tax systems apply in Ireland and Malaysia. Other countries generally tax residents on their worldwide income but may exempt capital gains or tax such gains at significantly reduced rates. *Id.*

[16]The controlled foreign corporation regime (sections 951 to 962) and the elective qualified electing fund (or QEF) regime (sections 1293 to 1295) that applies to passive foreign investment companies may require a U.S. tax national who owns shares in such a foreign corporation, directly or indirectly, to include in current income his or her share of all, or certain classes of, the underlying corporate income whether or not distributed.

[17]The "excess distribution" regime for U.S. shareholders in passive foreign investment companies who do not elect QEF treatment (section 1291) imposes a potentially punitive and uneconomic rate of tax on income or gain whose taxable receipt is deferred.

treaty were not in effect. A U.S. tax national who is resident in another country must therefore confront the specter of concurrent full taxation by both jurisdictions, either because the country has not entered into an income tax treaty with the United States, or because the United States preserves its claim to impose nationality-based tax under the savings clause of the applicable treaty and provides inadequate relief from double taxation under the treaty.

The extent to which the United States actually exercises the right to tax income reserved to it under a savings clause varies substantially because of disparities in the "Relief from Double Taxation" provisions of its income tax treaties. As a domestic law matter, the United States effectively allows a credit for income taxes imposed by the residence country on income sourced in the residence country or third countries,[18] because it does not impose a "per country" limitation on use of foreign tax credits.[19] Accordingly, concurrent full taxation by both countries potentially will arise only with respect to U.S.-sourced income. Generally, under treaty Relief from Double Taxation provisions, each country agrees to provide a credit for taxes imposed by the other on income from sources in that other country.[20] Most treaties do not, however, require the other country to credit U.S. taxes imposed solely by reason of the savings clause (*i.e.*, imposed on a citizen who is a resident of the other country under the residence tie-breaker provisions), and many treaties, therefore, do not require the other country to provide relief for U.S. nationality-based tax that is imposed on U.S.-sourced income of a U.S. citizen at a higher rate than would otherwise have applied to nonresident aliens.[21] The relief the United States provides in that

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[18]I.R.C. §§ 901-904.

[19]The foreign tax credit rules have long imposed an "overall limitation" on use of the foreign tax credit, *i.e.*, the amount of foreign tax credit available is limited to a proportion of the taxpayer's overall U.S. tax liability equal to the proportion of the taxpayer's global income derived from foreign sources. Beginning in 1932, taxpayers were required to use the lesser of an overall or "per-country limitation," which limited the credit for taxes of a foreign country based on the ratio which income from the particular foreign country bore to worldwide income. *See* Revenue Act of 1932, ch. 209, 47 Stat. 169, 211. In 1954, the overall limitation was repealed, leaving only a per-country limitation. *See* Internal Revenue Code Act of 1954, ch. 736, 68A Stat. 3, 287-88. In 1960, taxpayers were given the option of using an overall or per country limitation. *See* Act of Sept. 14, 1960, Pub. L. No. 86-780, § (a)(1), 74 Stat. 1010, 1010. In 1976, the per-country limitation was repealed. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 1031, 90 Stat. 1610, 1620-24.

[20]The credit is typically limited to that proportion of U.S. tax for the year which the income from the other country bears to worldwide income. Certain treaty partners instead provide an exemption in lieu of a credit. The exemption may be a complete exemption or progressive exemption (*i.e.*, exemption of the income for purposes of imposing tax but not for purposes of computing the marginal rate of tax to which the taxpayer is subject). *See, e.g.*, Convention for the Avoidance of Double Taxation, Dec. 30, 1995, U.S.-Fr., art. 24, para. 2; Convention for the Avoidance of Double Taxation, Dec. 26, 1975, U.S.-Ice., art. V, para. 2, 26 U.S.T. 2004; Convention for the Avoidance of Double Taxation, Dec. 19, 1997, U.S.-Switz. Treaty, Art. 23.

[21]The treaty with Russia permits a credit against Russian tax for U.S.-sourced income subject to U.S. nationality-based taxation even if the rate of tax exceeds the rate that would have applied to a nonresident alien. *See* Convention for the Avoidance of Double Taxation, Dec. 16, 1993, U.S.-Russ. Fed'n, art. 22; Treasury Dep't Technical Explanation of art. 22. This approach is not typical of more recent treaties, however. *See, e.g.*, United States income tax treaties with Australia, Czech Republic, Germany, Israel, Mexico, and the Netherlands. *See generally* RICHARD E. ANDERSEN & PETER H. BLESSING, INCOME TAX TREATIES OF THE UNITED STATES ¶ 19.02[2][b][ii] (Warren et al. eds. 2004).

circumstance is not uniform. In certain treaties, the United States effectively provides a credit for the other country's tax imposed on the U.S. source income after taking into account any credit for U.S. tax at source afforded by the other country.[22]

The result of the United States nationality-based tax on worldwide income is that most U.S. tax nationals could, absent a special regime for expatriates, substantially lower their United States income taxes by expatriating. Expatriating to a country that imposes no income tax (*i.e.*, a "tax haven") obviously affords the greatest opportunity to minimize income tax in aggregate. But expatriating to a country that imposes income tax at relatively high marginal rates but entirely exempts foreign source income (*i.e.*, a "tax refuge") may provide similar benefits. Tax refuge countries generally have the further advantage over tax havens of a broad tax treaty network which may help to minimize source country taxes imposed by third countries from which the individual derives income, and typically are also more congenial domiciles.

B. *Wealth Transfer Taxes*

While the potential for income tax avoidance has received much of the attention in the debate about tax-motivated expatriation, avoiding U.S. wealth transfer taxes is often a more important objective of tax-motivated expatriates.[23] The United States imposes an estate tax (currently, at rates of up to 47%) on property includible in the estate of a decedent.[24] As in the case of the income tax, the regime applies differently to U.S. tax nationals than to nonresident aliens. Assets of a decedent who is a U.S. tax national generally are subject to the U.S. estate tax regardless of the situs of the assets (*i.e.*, it is a tax on worldwide assets).[25] By contrast, a nonresident alien decedent is subject to estate tax only on property

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[22]*See, e.g.*, Tax Convention with The Netherlands, Dec. 18, 1992, U.S.-Neth., art. 25(6), S. TREATY DOC. No. 103-6.

[23]*See* Richard A. Westin, *Expatriation and Return: An Examination of Tax-Driven Expatriation by United States Citizens, and Reform Proposals*, 20 VA. TAX REV. 75 (2000).

[24]The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, repealed the estate tax and replaced it with a carryover basis regime effective for estates of decedents dying after December 31, 2009. The Act also repealed the generation-skipping transfer tax, but not the gift tax, for transfers made after December 31, 2009. However, all provisions and amendments made by the Act, including the repeal of estate and generation-skipping transfer taxes, do not apply after December 31, 2010. In effect, absent further legislative action, the repeal applies only to decedents dying and transfers made until 2010. Accordingly, the discussion below assumes the application of estate, gift, and generation-skipping transfer tax. The Economic Growth and Tax Relief Reconciliation Act replaced the 53% and 55% maximum estate and gift tax rate, beginning for decedents dying and gifts made after December 31, 2001, with a lower rate that is to decline yearly.

[25]Strictly, individuals who are not U.S. citizens will be treated as a tax nationals for estate tax purposes only if they are "domiciled" in the United States. *See* Reg. § 20.0-1(b)(1). In contrast to the income tax laws, which establish a relatively objective test of residence, the notion of domicile is inherently less certain. *See generally* Robert J. Misey, Jr., *Simplifying International Jurisdiction for United States Transfer Taxes: Retain Citizenship and Replace Domicile with the Green Card Test*, 76 MARQ. L. REV. 73 (1992). It is therefore possible that an expatriate will successfully cease to be a resident for income tax purposes while remaining domiciled for wealth transfer tax purposes. In the interests of brevity, this Article largely ignores this distinction, but it is often critically important in practice.

situated within the United States. For this purpose, stock of domestic corporations and obligations of domestic obligors (other than debt the interest on which qualifies for the portfolio interest exemption, certain bank deposits, and insurance policies) are treated as U.S.-situs property. Because shares of a foreign corporation generally are not treated as U.S.-situs property, it is fairly easy for a well-advised nonresident alien to avoid U.S. estate tax by holding assets through a non-U.S. corporation. Accordingly, absent a special estate tax regime for expatriates, a U.S. tax national could significantly reduce U.S. estate tax by expatriating.

The United States indirectly provides some relief to U.S. nationals subject to the concurrent imposition of a death tax by the country in which the individual is actually resident. Section 2014 affords a unilateral foreign tax credit in the case of certain death taxes paid to a foreign country with respect to foreign situs assets.[26] This credit, however, is primarily aimed at concurrent taxation of foreign situs property owned by U.S. nationals who are resident in the United States rather than simultaneous assertions of wealth transfer taxes based on conflicting notions of domicile.

The United States also provides relief from double taxation under bilateral estate and death tax treaties. The network of estate and death tax treaties is more limited than the U.S. income tax treaty network.[27] The treaties address double taxation that may arise (1) from the inconsistent treatment of the situs of particular property for purposes of wealth transfer tax (*i.e.*, where both countries assert the right to tax the property based on its assumed situs in that country) and (2) from inconsistent domestic law rules defining persons generally subject to tax based on their affiliation with the taxing jurisdiction. Most older treaties apportion the right to impose wealth transfer taxes based on the situs of particular assets and adopt bilaterally agreed rules for assigning situs to particular assets.[28] More recent treaties address concurrent taxation by apportioning the right to tax based on domicile.[29] Domicile-type treaties avoid the major complication of situs-type treaties—the need to determine a situs for each asset in the estate—by allocating exclusive taxing jurisdiction to the country of domicile. Because treaty country rules defining domicile may differ, domicile-type treaties prescribe tie-breaker rules to settle on a single fiscal domicile. As under income tax treaties, the United States generally reserves the right to tax its nationals without regard to these tie-breaker rules but provides a credit for foreign estate or death taxes

[26]The credit is limited proportionally by the ratio of the value of assets subject to the foreign tax included in the gross estate to the entire value of the gross estate. I.R.C. § 2014(b).

[27]The following 20 countries presently have estate or death tax treaties in force with the United States: Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Portugal, South Africa, Spain, Sweden, Switzerland, and the United Kingdom.

[28]The estate tax treaties between the United States and the following countries fall into this category: Australia, Finland, Greece, Ireland, Italy, Japan, Norway, Switzerland, and South Africa.

[29]Countries that have domicile-based estate tax treaties with the United States include Austria, Denmark, France, Germany, the Netherlands, Sweden, and the United Kingdom.

imposed on the same property by the country of domicile.[30]

The U.S. estate tax is backstopped by the generation-skipping transfer tax[31] and gift tax,[32] which are imposed primarily to prevent transfers that would avoid the imposition of the estate tax. Generation-skipping transfer tax applies to prevent wealth transfers that skip generations, thereby avoiding estate tax on intervening generational transfers. If the donor is a nonresident alien, the same rules apply except that only transfers of property situated in the United States are subject to generation-skipping transfer tax. Gift tax generally applies to gifts of property by U.S. citizens or residents, subject to certain domestic law exemptions. In the case of an individual who is not a U.S. tax national, gift tax generally applies only to gifts of U.S.-situs tangible personal property or real property. Intangible assets of a nonresident alien, such as stock, generally are not subject to the tax.

Again, the more preferential treatment accorded nonresident aliens may create tax incentives to expatriate.

III. THE PRIOR TAX LAW REGIME FOR U.S. EXPATRIATES

Given the potentially significant tax advantages of expatriating, since 1966 the tax law has included provisions intended to deter tax-motivated expatriation.[33] The statutory regime has focused particularly on income tax avoidance, although avoidance of estate and gift tax is also addressed.

A. *Income Tax—Section 877 Prior to Its Amendment*

Section 877, previously amended by the Health Insurance Portability and Accountability Act of 1996 (HIPA),[34] governs the income tax treatment of expatriates.[35] Under section 877 (as in effect prior to the 2004 Act, "prior section 877"), an individual who loses U.S. citizenship within a ten year period preceding the close of the taxable year is subject to tax on income realized during this "taint" period in the manner described below unless the loss of citizenship did not have as one of its principal purposes the avoidance of taxes. An individual who loses permanent legal resident status is similarly taxed.[36] Individuals who

[30]*See, e.g.*, Treasury Dept. Model Estate & Gift Tax Treaty, Nov. 20, 1980, arts. 1(3), 9(1); Estate & Gift Tax Treaty, Oct. 19, 1978, U.S.-U.K., arts. 5(1)(b), 9(1)(b), TAX TREATIES (CCH) ¶ 10,970.

[31]I.R.C. §§ 2601-2663.

[32]I.R.C. §§ 2501-2524.

[33]The original expatriate tax regime was enacted as part of the Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539.

[34]The amendments were adopted by the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936 [hereinafter HIPA].

[35]No regulations have issued under section 877, although the Service has offered some guidance in two Notices: Notice 97-19, 1997-1 C.B. 394, *modified in part by* Notice 98-34, 1998-2 C.B. 29 (providing background regarding the general application of sections 877, 2107, and 2501).

[36]*See* I.R.C. § 877(e). The regime also applies in modified form to certain aliens treated as resident aliens for tax purposes even if they are not permanent residents. Section 7701(b)(10) applies the rules of section 877 to persons who have residence status under the "substantial presence" test for three consecutive years, cease to satisfy the test, but then regain this residence status based on substantial presence within three years thereafter. Section 877 applies to income earned during the "gap" period.

are deemed to have the requisite tax avoidance purpose are referred to below as "tax-motivated expatriates."

A tax-motivated expatriate is subject to a special tax on specified classes of income earned during the ten-year period following expatriation. During this ten-year period, income deemed to be from sources within the United States or effectively connected to the conduct of a U.S. trade or business is subject to the net income tax applicable to U.S. tax nationals to the extent this tax exceeds any U.S. income or withholding tax that would otherwise apply to the income. In effect, section 877 imposes a form of alternative minimum tax for expatriates on U.S.-sourced income and effectively connected income.

Generally applicable source rules are somewhat modified for this purpose. The following items, ordinarily foreign-sourced, are treated as U.S. source income or gain: (1) gains from property (other than stock or debt) located in the United States, (2) gains from the sale or exchange of stock or debt obligations of U.S. issuers, and (3) income or gain derived from stock of certain controlled foreign corporations to the extent of the expatriate's proportionate interest in untaxed earnings and profits accumulated by the controlled foreign corporation prior to the individual's expatriation.[37] These modified source rules under section 877 may be viewed as a limited attempt to reach gains that have a United States nexus but generally are sourced by the residence of the seller of property as a matter of administrative latitude, probably because the tax would be difficult to collect by withholding.

To prevent circumvention of these rules, otherwise nontaxable exchanges of property may be taxable if the exchange effectively converts U.S.-source income into foreign source income unless the expatriate enters into a gain recognition agreement to treat the future gain as U.S. source.[38] Property that generates U.S. source income that is transferred on a tax-free basis to a controlled foreign corporation continues to be taxed directly to the tax-motivated expatriate.[39] The running of the ten-year period may be suspended for appreciated property as to which the expatriate has entered into a transaction that hedges the risk of loss on the property.[40]

To avoid double taxation of expatriates who are or become resident in a country that imposes taxes on the same income, the tax-motivated expatriate may reduce the alternative tax by the amount of any income, war profits, or excess profits tax on the income against the additional tax imposed under section 877.[41] This effective credit is not subject to limitations generally applicable to

[37] I.R.C. § 877(d).

[38] I.R.C. § 877(d)(2). This revised source rule is intended to prevent transactions commonly employed by tax-motivated expatriates to avoid the effect of the regime. Prior to the enactment of these rules, by contributing assets to a foreign corporation in a qualified reorganization or section 351 transaction, an expatriate could rather easily convert U.S. source income into non-taxed foreign source income.

[39] I.R.C. § 877(d)(4).

[40] I.R.C. § 877(d)(3).

[41] I.R.C. § 877(b)(2).

foreign tax credits, for example under section 904. However, it may only reduce the alternative tax imposed under section 877 and not income taxes for which the individual is liable without regard to section 877.

Long-term residents who lose their U.S. nationality status may, for purposes of computing tax under section 877, irrevocably elect to adjust the basis of their property to its fair market value on the original date the long-term resident attained green card status. No comparable relief is afforded U.S. citizens and no basis step up is available for assets owned indirectly.[42]

The application of the alternative tax under prior section 877 is conditioned upon the existence of a tax avoidance purpose for expatriating. Determining whether expatriation is tax-motivated has proven to be a challenging undertaking and the statutory law has evolved in response to the difficulties experienced by the Service in administering the motive-based statutory regime.

Before 1996, the burden was on the government to demonstrate in all cases that an expatriate was tax-motivated, seldom an easy task.[43] Following the 1996 amendments to prior section 877 by HIPA, the statute applied a hybrid approach which adopted both an objective test and subjective test of motivation. A former citizen was presumed to have expatriated with a principal purpose of avoiding tax if: (1) the individual's average annual U.S. income tax for the five taxable years prior to expatriation was greater than $100,000 (indexed for inflation) or (2) the individual's net worth on the date of expatriation was $500,000 or more (indexed for inflation).

Even if an expatriate did meet the tax liability test or net worth test, the expatriate could overcome the presumption of tax motivation by submitting a request for a ruling to the Service within one year following the loss of citizenship and demonstrating to the Service the absence of such a principal tax avoidance purpose for expatriating.[44] To be eligible to request a ruling, however, the

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[42]This limited basis step up does not preclude substantial unfairness. For example, a U.S. tax national who inherits shares in a group of family companies engaged in managing the family investments is likely subject to the passive foreign investment company regime. *See supra* notes 16 and 17 and accompanying text. Her basis in shares of the parent company will, if inherited from a nonresident alien, be their fair market value at death, but basis in lower tier companies is not adjusted. Sale of parent company shares is arguably an "indirect disposition" of the lower-tier passive foreign investment companies resulting in recognition of underlying gain, which is taxed at ordinary income rates. While basis in intervening companies and the parent company is increased to reflect gain recognized, this may result in a capital loss on disposition of the parent company shares. The passive foreign investment company rules also make it challenging to reorganize companies on a nontaxable basis to eliminate such basis disparities after the fact. *See generally* Prop. Reg. §§ 1.1291-3, -6, 69 Fed. Reg. 31,154 (2004).

[43]*See, e.g.*, Furstenburg v. Commissioner, 83 T.C. 755 (1984) (an Exxon heiress successfully argued that her expatriation upon marriage to an Austrian aristocrat was motivated by her husband's insistence that his wife hold Austrian citizenship). Other taxpayers who failed to cover their tracks as carefully have been less successful. *See, e.g.*, Kronenburg v. Commissioner, 64 T.C. 428 (1975).

[44]The burden of proof is on the person seeking a ruling, and only a person who obtains a favorable ruling will not be subject to tax liability on his U.S. source income. Because the Service experienced significant difficulty in reaching a conclusion as to motivation in certain cases given the inherently factual nature of the inquiry, as a matter of ruling practice, if a good faith, complete ruling request is submitted, and the Service declines to rule that the expatriation either was or was not tax-motivated,

individual had to be within one of the following categories: He or she (1) became at birth a citizen of the United States and another country and continued to be a citizen of the other country; (2) became (within a reasonable period after expatriation) a citizen of the country in which the individual, a parent or spouse was born; (3) was present in the United States for no more than 30 days during each year of the 10 years preceding expatriation;[45] (4) lost U.S. citizenship before reaching the age of 18½; or (5) was otherwise in a category specified by regulations. Despite its regulatory authority to provide relief in other situations, the Service had not done so but was willing to entertain a ruling where an individual narrowly failed to satisfy the criteria of an enumerated category.[46]

The motivation of an expatriate who did not meet the tax liability or net worth tests and, therefore, was not presumed to be tax-motivated was, in practice, usually irrelevant. Prior section 877 technically applied to a tax-motivated expatriate who does not meet either the tax liability or net worth test. Moreover, if the Service could establish that it is reasonable to believe that expatriating will reduce the taxes on an individual's probable income for the year, the burden was on the individual to demonstrate an absence of tax motivation.[47] However, because such an expatriate would seldom be avoiding significant taxes, to challenge expatriation in these circumstances would have been a questionable allocation of scarce administrative resources.

In its practical application, therefore, prior section 877 was a hybrid. For expatriates who did not fall within the defined classes of individuals entitled to seek ruling relief, the test was objective and largely turned on taxable income and net worth. The presumption regarding tax motivation was effectively irrebuttable and the objective tests were determinative.

Limiting the ability to rebut this presumption to persons in particular categories had some appeal as a means to limit the administrative burden on the Service of motive-based examinations. However, the design of these statutory categories was fundamentally incoherent. Generally, the categories appeared calculated to allow the presumption of tax motivation to be overcome only by individuals whose significant contacts with another country, and lack of significant contacts with the United States, suggested that they were likely to have legitimate nontax reasons for expatriating. The categories generally described persons who (1) had not been physically present within the United States for the preceding ten years, (2) had a pre-existing or contemporaneous nationality affiliation (by birth or through a parent or spouse) with the country whose citizenship they adopt, or (3) were under 18½ years of age.

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it will rule that the ruling request is complete and submitted in good faith and will treat this as overcoming the presumption of tax motivation. The expatriate nevertheless may be subject on audit to a determination that the expatriation was tax-motivated but will, at least, not be subject to an adverse presumption regarding motivation. Notice 98-34, 1998-2 C.B. 29.

[45]For this purpose, presence due to a medical condition is ignored, but presence for other reasons that typically would not count towards the substantial presence test under section 7701(b) appear to count adversely towards the 30 days.

[46]Notice 97-19, 1997-1 C.B. 394.

[47]I.R.C. § 877(f).

The latter category made some sense in that it is practically difficult to renounce citizenship prior to age 18.[48] Accordingly, an individual's U.S. nationality status before attaining that age is in some sense involuntary. It may be unfair to tax an individual as a national on income accrued during a period in which her allegiance to the United States could not have been relinquished. If that is the rationale for the category, however, it is difficult to understand why expatriates so described were required to run the gauntlet of the ruling process and also demonstrate an absence of tax motivation. Logic would instead suggest that they be permitted to avoid the involuntary tax burden. Conversely, if the category is intended to serve as a filter designed to identify those expatriates less likely than the average expatriate to be tax-motivated, it served this function poorly. There is no reason to think that younger expatriates are less likely to be tax-motivated. Younger individuals are arguably more likely to have legitimate nontax reasons for emigrating, but as discussed above, emigration is an issue distinct from expatriation. They are less likely to have significant income or accumulated wealth than older expatriates. But individuals who lack significant income or wealth were already effectively exempted from the alternative tax under prior section 877 by the tax liability and net worth tests. So individuals who sought ruling relief under this category by definition were wealthy enough to be presumed to have expatriated for tax reasons.

The category for persons with limited recent presence in the United States was probably intended to provide an avenue of relief for persons who are taxed based solely on their U.S. nationality rather than actual residence in the United States. If the tax burden on nonresident U.S. citizens is viewed as excessive relative to the benefits they derive from their nationality status, it may seem unfair to penalize their decision to relinquish U.S. nationality in order to reduce that tax burden. Again, however, if that was the rationale for the category, it is difficult to understand why expatriates so described were required to demonstrate an absence of tax motivation. The test for significant U.S. presence also seems unduly restrictive. A single ill-advised month-long vacation in the United States during the preceding ten years precluded relief. This category, also, made limited sense if it intended to filter into the ruling process persons less likely than average to have a tax motivation for relinquishing U.S. nationality status. Such an individual presumably would have been, for at least ten years, a U.S. national resident in the foreign country. Clearly, nationality status had not prevented such individual's living and working abroad. One can question why such an individual then sought to renounce U.S. nationality, if not for tax reasons.

The category for dual nationals was similarly flawed in conception. First, it did not appropriately identify individuals most likely to have been subjected to a

[48]Because a person who renounces citizenship must do so voluntarily, and persons renouncing who are under the age of 18 may in any event reacquire citizenship at age 18, immigration authorities are very reluctant to recognize a renunciation of U.S. citizenship by a person younger than 14 and may, in practice, require that the person seeking to renounce their citizenship be at least 18.

double tax burden. The overwhelming majority of other countries impose personal income tax based on residence, not nationality. So the category excluded many nonresident U.S. citizens subjected to double tax as a result of their U.S. nationality. Second, because an individual's acquisition of nationality status (as distinct from residence) in another country is largely immaterial to his tax treatment by that other country, there is no reason to believe that subsequent decision to relinquish U.S. nationality status was not motivated by U.S. tax avoidance. Perhaps the category assumed that an individual who sought to acquire the nationality of another country would be required to forfeit their U.S. nationality and therefore it was reasonable to assume that this was the reason for relinquishing the individual's U.S. citizenship. However, a number of countries permit dual nationality. Whether the laws of the country whose citizenship is acquired required the expatriate to surrender U.S. citizenship would have been a more rational demarcation than whether the country happened to be the country in which the expatriate, a spouse, or parent a was born.

B. *Estate Tax—Prior Law Section 2107*

Section 2107 governs the estate tax treatment of expatriates. Under section 2107(a) (prior to amendment by the 2004 Act, "prior section 2107"), a former citizen who lost his or her U.S. citizen status within the ten year period preceding death was subject to a revised estate tax regime, described below, unless the loss of citizenship did not have as one of its principal purposes avoidance of tax (either income or estate tax). Expatriation was presumed to be tax-motivated for this purpose if so treated under prior section 877(a)(2) (*i.e.*, the tax liability or net worth tests were met and ruling relief was not available or granted). Comparable rules applied to green card holders who expatriated for tax reasons.[49]

A tax-motivated expatriate generally continued to be subject to the estate tax only on the type of U.S.-situs assets generally included in the gross estate of a nonresident. However, prior section 2107 expanded the class of includible property to reach U.S.-situs assets held through certain controlled foreign corporations in which the expatriate decedent owned at death more than ten percent of the voting power.[50] The expatriate decedent's gross estate was required to include that portion of the total value of the decedent's shares in the controlled foreign corporation which the value of the corporation's U.S.-situs assets bore to the value of all the corporation's assets.

[49]I.R.C. § 877(e).

[50]A foreign corporation is a controlled foreign corporation for this purpose if the decedent owns or is considered to own (applying the attribution rules of section 958(a) or 958(b) which generally attribute shares owned by his family members, and related corporations, partnerships, and trusts, directly or indirectly) more than 50% of the voting power or value of the foreign corporation. A decedent is treated as continuing to own shares as to which he has made an inter vivos transfer if the shares would be includable under sections 2035 through 2038.

Section 2107(c) affords a credit for any death tax paid to any foreign country on foreign shares included in the decedent's U.S. estate solely by reason of section 2107.[51]

Prior section 2107 did not eliminate the estate tax benefits of expatriating because many foreign-situs assets that would be includable in the estate of a U.S.-citizen decedent could escape tax despite section 2107. Further, expanding the class of U.S.-situs property to include stock of controlled foreign corporations may not in practice capture estate tax on these assets. The former citizen need only survive the ten-year taint period. Indeed, for the citizen whose actuarial risk of dying within ten years is not high, the contingent risk of a tax under section 2107 could typically be hedged by purchasing life insurance. Prior section 2107, therefore, operated to deter only the old and infirm.

C. *Gift and Generation-Skipping Transfer Tax*

Section 2501(a)(3) governs the gift tax treatment of expatriates. As discussed above, gift tax generally does not apply to transfers by a nonresident alien of intangible property (including shares). By interaction with section 2511(b), section 2501(a)(3) (prior to amendment by the 2004 Act, "prior section 2501") expanded the class of taxable gifts by a nonresident that are subject to gift tax to include transfers of shares of a domestic corporation or obligations of a domestic issuer by a person who has lost her citizenship with a principal purpose of tax avoidance during the preceding ten year period. Comparable rules applied to green card holders who expatriated for tax reasons.[52] A credit was afforded for any foreign gift taxes that apply to a transfer which is subject to U.S. gift tax solely because of prior section 2501(a)(3).

The interaction of the expatriate regime and the generation-skipping transfer tax was, and remains, somewhat unclear. There are no special expatriate generation-skipping transfer tax rules. Treasury regulations provide that a nonresident alien transferor will be subject to the generation-skipping transfer tax if he or she would be subject to the tax under chapter 11 (the estate tax) or chapter 12 (the gift tax).[53] Because a nonresident is subject to the generation-skipping transfer tax if the initial transfer would have been subject to estate or gift tax, at issue is whether the regular or expatriate estate and gift tax rules apply for this purpose. Arguably, for tax-motivated expatriates, in determining whether an initial transfer would be subject to estate or gift taxes, the question is whether the expatriate estate and gift tax rules would have applied to the transfer. The statutory language, however, did not clearly support this conclusion. For example, section 2511(b) treats stock as U.S.-situs "for purpose of [chapter 11]." The generation-skipping

[51]The credit is limited to the lesser of: (1) the portion of the tax paid to such foreign country that the amount included in the U.S. gross estate by reason of ownership of such shares bears to the value of all property subject to the foreign tax, or (2) the portion of the U.S. tax attributable to the amount includable by reason of ownership of the foreign shares, which is the U.S. tax multiplied by a fraction, the numerator of which is the amount includable as to the foreign shares and the denominator of which is the value of all property included in U.S. gross estate. I.R.C. § 2107(c).

[52]I.R.C. § 877(e).

[53]Reg. § 26.2663-2.

transfer tax is not found in chapter 11, but rather in chapter 13.

IV. AN OVERVIEW OF EXPATRIATION PROVISIONS IN THE 2004 ACT AND COMPETING EXPATRIATION PROPOSALS

A. *The 2004 Act*

The 2004 Act alters the prior section 877 regime in one significant respect, by eliminating subjective motivation as a condition for application of the regime. The 2004 Act also tightens the prior law regime in certain other respects. The changes are effective for individuals losing U.S. tax nationality after June 3, 2004. Under the 2004 Act, an individual losing U.S. citizenship or green card status is subject to the alternative tax under section 877, without regard to his motivation, if the individual's average annual net income tax liability for the five taxable years preceding expatriation exceeds $124,000 (indexed for inflation), the individual's net worth on the date of expatriation exceeds $2 million (indexed for inflation), or if the individual fails to certify under penalty of perjury that she complied with her U.S. tax liabilities for the five taxable years preceding expatriation. Exceptions would apply (without regard to motivation) to certain dual citizens and certain U.S. citizens who relinquish citizenship prior to age $18^{1}/_{2}$. This change eliminates the administratively burdensome inquiry into motivation required under prior law and the associated Service ruling process, and frees the Service to devote its resources to more constructive pursuits.

First, exempting individuals in certain categories from the regime without regard to motivation is a distinct improvement over prior law. As discussed above, exempting dual citizens and individuals who expatriate at a young age makes some sense in identifying individuals who arguably are overtaxed based on their nationality but makes little sense as a filter designed to identify those individuals who are less likely to be tax-motivated. Removing the inquiry as to motivation therefore adds a certain rationality to the scheme. Nevertheless, the scheme remains flawed insofar as it exempts individuals based on their particular foreign nationality status rather than their domicile. Exposure to concurrent foreign income tax is almost always more closely related to foreign residence than nationality.

Second, as amended by the 2004 Act, section 877 taxes more aggressively purported expatriates whose contacts with the United States continue to be significant. Except to the extent provided in regulations, an individual who is generally subject to section 877 and who is physically present in the United States for more than 30 days in a calendar year during the ten-year taint period generally will be subject to U.S. tax on his worldwide income as though he were a U.S. citizen or resident for that taxable year.[54] Such taxable year citizens are

[54]The U.S. would, in any event, potentially tax an individual as a resident on the basis of "substantial presence" if he were present for at least 31 days in the year and more than 183 days during that and the preceding two years (discounting days of presence in the prior year by one third and days of presence in the year before that by one sixth). *See* I.R.C. § 7701(b). In its effect, therefore, this change simply creates a more expansive substantial presence test for certain former citizens and green card holders.

also fully subject to estate and gift tax on transfers at death or by gift during that year.

Third, the 2004 Act tightens the gift tax rules for expatriates. Certain gifts of stock of closely held foreign corporations by a former citizen or former long-term resident are be subject to U.S. gift tax. Prior section 2501 applied only to gifts of domestic stock or obligations.

Fourth, an individual who expatriates will continue to be taxed as a U.S. tax national until the individual gives notice of an expatriating act or termination of residency to the Secretary of State or the Secretary of Homeland Security and provides the statement required by section 6039G (information on individuals losing U.S. citizenship). This provision is intended to address difficulties in determining exactly when an individual has expatriated and prevent whipsaws of the government.[55]

Finally, annual reporting would be required for individuals subject to the alternative tax regime, even if they have no U.S. tax liability that year.

B. *The Exit Tax Proposal*

An alternative to the approach adopted under the 2004 Act and prior section 877, reflected most recently in the Senate JOBS Act but rejected at Conference,[56] would instead tax all expatriates on a mark-to-market basis (with certain narrow exceptions) thereby requiring expatriates to recognize unrealized gain or loss on all property owned at the time of expatriation. Variations of this approach have been proposed on a number of occasions in the past.[57] While not identical, the proposals are sufficiently similar that this Article describes only the "Exit Tax Proposal" reflected in the Senate JOBS Act, but notes certain key differences to other versions of the exit tax.

Under the Exit Tax Proposal, covered expatriates generally would be taxed on unrealized gain inherent in their assets as if the assets had been sold for their fair market value on the day preceding the day United States citizenship or green card status terminates. The resulting net gain would be taxed to the extent it exceeds $600,000 ($1.2 million for joint filers who both expatriate) indexed for inflation (the "Exit Tax").[58] The expatriate could elect to defer payment of the

[55]Relinquishment of citizenship must be deliberate and voluntary. Not only must the citizen intend the expatriating act but also must intend that the act have the effect of terminating U.S. nationality. *See* Afroyim v. Rusk, 387 U.S. 253, 261-68 (1967). Under the Department of State's official policy, if a U.S. citizen (1) is naturalized in a foreign country, (2) takes a routine oath of allegiance, or (3) accepts nonpolicy level employment with a foreign government, the intent to retain U.S. citizenship at the time of the act will be presumed, in the absence of a statement or other evidence to the contrary. When such a case comes to the attention of a U.S. consular officer, the person is asked by questionnaire whether he or she intended by the act to give up U.S. citizenship. On learning there was no such intent, the consul so certifies to the Department. Because the time at which U.S. nationality status is relinquished may therefore be ambiguous, this provides opportunities to whip-saw the government.

[56]*See supra* note 3.

[57]*Id.*

[58]The $600,000 exclusion presumably is intended to provide relief somewhat comparable to the unified credit against wealth transfer taxes.

Exit Tax subject to an interest charge (at a rate two percentage points higher than the regular underpayment rate under section 6621(a)(2)) if adequate security for payment is provided.

Covered expatriates would include citizens who relinquish their citizenship, and former green card holders who have been resident in the United States for 8 of the 15 taxable years prior to and including the year of expatriation. A green card holder is treated as expatriating when she ceases to be a lawful permanent resident (*i.e.*, lose her green card status) or is treated as a resident of another country under an applicable income tax treaty and does not waive the benefit of the treaty. Exceptions would apply in two situations: (1) in the case of a person who was at birth a dual citizen and as of the expatriation date, continues to be a citizen of, and taxed as a resident of the second country, provided he or she has not been resident in the United States for the five taxable years preceding expatriation; and (2) in the case of a person who expatriates prior to reaching $18^1/_2$ years of age, if he or she has not been a resident of the United States for more than five taxable years.

Real estate subject to tax under the FIRPTA regime would be exempt from the Exit Tax and the Treasury would be authorized to exempt other classes of property (perhaps, for example, property that generates income otherwise subject to net income tax because it is effectively connected to a U.S. trade or business).

Covered expatriates would not be subject to estate or gift tax on the property subject to the mark-to-market regime. However, the exclusion of gifts and inheritances from income under section 102 would not apply to any gift or inheritance received by a U.S. taxpayer from a covered expatriate unless such property had been reflected on a timely filed gift or estate tax return of the covered expatriate or no estate or gift tax return would have been required to have been filed for the property even if the transferor had not expatriated. In effect, this provision adopts what amounts to a special inheritance tax on U.S. taxpayers who receive property by gift or bequest from a covered expatriate.

In lieu of incurring the mark-to-market Exit Tax, a covered expatriate could elect irrevocably to be treated as a U.S. citizen with respect to all property subject to the Exit Tax (and any substitute basis property). Estate, gift, and generation-skipping transfer tax also would continue to apply to this property to the same extent as if the expatriate were a citizen. The expatriate would have to provide adequate security for payment of tax on this property, including a lien on all U.S.-situs property of the expatriate. The expatriate would be required to waive any treaty rights that would preclude assertion of the tax.

The Moynihan version of the Exit Tax Proposal allowed this election to be made on a property-by-property basis rather than for all affected property.[59] The likely purpose for this property-by-property election was to address the arguable unfairness of imposing a mark-to-market tax on appreciated property which in

[59]Moynihan Exit Tax Proposal, *supra* note 3.

the hands of a citizen might have enjoyed the benefit of a step up in basis at death.[60] A property-by-property election permits an expatriate to weigh the costs of wealth transfer taxes on the property as to which he elects perpetual U.S. nationality-based tax against the cost of immediate mark-to-market recognition of gain. However, a property-by-property election is arguably unduly generous. Presumably, the taxpayer will elect mark-to-market treatment of high basis foreign situs assets which will then largely escape wealth transfer tax. Low basis foreign assets, and U.S.-situs assets that will remain subject to U.S. wealth transfer taxes, may be more favorably treated if the alternative treatment is elected. The more recent Senate Exit Tax Proposals did not include this feature.

The Moynihan Exit Tax Proposal also would have allowed an expatriate to adjust the basis of property to its fair market value on the date U.S. nationality status was acquired. The recent Senate Exit Tax Proposal did not include this feature. Its omission would result in excessive tax on expatriates whose nationality status was acquired only after the expatriate had accumulated significant appreciated property. The absence of an inbound mark-to-market adjustment to basis allows the United States to tax income that accrued economically before U.S. nationality status was acquired. This is inherently inconsistent with the asserted rationale for the Exit Tax. One can argue that failing to afford a mark-to-market basis for assets entering U.S. taxing jurisdiction is an inherent flaw in its international tax regime which adversely affects all immigrants. Arguably, there is no particular reason to favor expatriates in this regard. Further, determining the historic value of property at the time U.S. nationality status was acquired may be difficult. However, as the Exit Tax scheme adopts a mark-to-market regime with all its complexities for property leaving U.S. taxing jurisdiction and accelerates the time at which the expatriate realizes the income compared to other similarly situated taxpayers, the arguments against adopting a comparable inbound mark-to-market are not compelling.

The Exit Tax Proposal contains special rules for trusts. Trusts present particular problems in applying a mark-to-market regime because the amount of income to which the beneficiary is entitled (and therefore the value of the beneficial interest) may depend on the exercise of discretion by a fiduciary or other contingencies. Taxing only the value of rights to income that are legally vested and determinable avoids the imposition of an excessive tax on discretionary income but creates opportunities for abuse. However, particularly in the case of a U.S. beneficiary who is a member of a non-U.S. family, discretionary trusts in which he or she has beneficial interests may have been established for reasons entirely unrelated to U.S. tax avoidance. The uneasy choice under a mark-to-market regime is therefore between accepting a risk of tax avoidance planning and overtaxing the innocent. Unsurprisingly, the Exit Tax Proposal errs on the side of overinclusion. Under the Exit Tax Proposal, different rules apply depending on whether the trust is a "qualified trust." A trust is a qualified trust if it is subject to the primary

[60]*See* I.R.C. § 1014.

supervision of U.S. courts and U.S. persons control all of the substantial trust decisions.[61] The expatriate's interest in a qualified trust is determined at the time of expatriation by assuming that all contingencies and discretionary interests are resolved in the individual's favor (*i.e.*, the "maximal allocation presumption": the individual would receive the maximum amount permitted under the trust). Tax is only imposed, however, as the individual receives distributions from the trust or, if earlier, upon death, and an interest charge is imposed on the assumed deferral of the tax at a rate two percentage points higher than the usual rate for underpayments. The trustee of a qualified trust must withhold the tax and, unless the expatriate agrees to waive any treaty rights that would preclude collection of the tax, the tax is imposed on the trust; the trustee is personally liable for the tax and the other beneficiaries will have a right of contribution.

In the case of a nonqualified trust, the expatriate's interest (*i.e.*, assets allocable to the expatriate) is treated as a separate trust that disposed of these assets and distributed the proceeds to the individual who then recontributed the assets to the trust. The expatriate is taxed on the deemed distribution.[62] If the expatriate's interest is vested, gain is determined based on the assets allocable to the interest. If the interest is not vested, gain is determined based on the assets allocable to the interest using the maximal allocation presumption.

C. *Essential Features of Prior Law and the Proposed Alternatives*

To summarize, three distinct models for an expatriate tax regime are described above; prior section 877, the law as amended by the 2004 Act, and the Exit Tax.

Prior law adopted a regime that was, somewhat uneasily, an anti-avoidance regime insofar as it applied only to those expatriates who had the requisite tax avoidance motive. The regime admittedly was a hybrid because it adopted what amounted to an irrebuttable presumption of avoidance for individuals who met the tax liability or net worth tests and were not within the categories of persons entitled to seek ruling relief. Nevertheless, prior section 877 did not purport to be a tax regime of general applicability to individuals whose U.S. nationality status terminates. Expatriates were not denied the tax benefits of expatriation as long as their hearts were pure. Those of impure heart, or who were not permitted to rebut the presumption created by the tax liability and net worth tests, were subject under prior section 877 to a unique transitional regime for a limited ten-

[61] *Cf.* I.R.C. § 7701(a)(30)(E). The distinction appears intended to take into account the greater ability of the United States to reach the fiduciary of, and assets held in, a "qualified trust" following expatriation.

[62] There are numerous unresolved technical issues with these trust provisions on which this Article will not dwell. *See, e.g.*, New York State Bar Association Tax Section, *Report on Proposed Legislation on Expatriates and Foreign Trusts*, *reprinted in* 95 TAX NOTES INT'L (TA) 118-13 (Jun. 20, 1995); CHARLES M. BRUCE, AMERICAN BAR ASSOCIATION, COMMENTS CONCERNING TITLE II OF THE TAX COMPLIANCE ACT OF 1995 (H.R. 981 AND S. 453) (Mar. 10, 1995), *reprinted in* 95 TAX NOTES INT'L (TA) 59-12 (Mar. 28, 1995) [hereinafter ABA Report].

year period. The transitional regime that was imposed resembled a territorial or exemption system in that it exempted from the alternative tax most income from foreign sources, but the regime went further by providing a credit for any foreign taxes imposed on U.S. source income. The regime also permitted most expatriates largely to avoid wealth transfer taxes that would apply to U.S. tax nationals.

Section 877, as amended by the 2004 Act, instead adopts a tax regime of general applicability to individuals whose U.S. nationality status terminates, and it eliminates remaining vestiges of the motive-based, anti-avoidance approach. Like prior law, the 2004 Act adopts a transitional rule unique to expatriates for a limited ten-year period. That 2004 Act change similarly resembles a territorial or exemption system in that it exempts from the alternative tax most income from foreign sources. The new law also permits expatriates largely to avoid wealth transfer taxes that would apply to U.S. nationals, although it makes avoidance of gift tax slightly less easy.

The Exit Tax is also of general applicability to individuals whose U.S. nationality status terminates. However, it eschews adopting a transitional approach unique to expatriates. Conceptually, the Exit Tax proposal would terminate U.S. taxing jurisdiction upon expatriation and attempt to capture all income accrued economically prior to expatriation and purports to tax that income under the same regime that applies to all U.S. nationals. Like the other approaches, the Exit Tax Proposal allows an expatriate largely to avoid wealth transfer taxes, but adopts a special inheritance tax for U.S. nationals who acquire property from an expatriate by gift or bequest. As the price of avoiding the Exit Tax, the expatriate can elect what amounts to perpetual status as a U.S. tax national with respect to property owned at the time he or she expatriates.

The next Part of this Article evaluates these models from the perspective of applicable legal limits imposed by the Constitution, international law and U.S. treaty obligations, and from a tax policy viewpoint.

V. LEGAL LIMITS ON THE IMPOSITION OF A SPECIAL TAX ON EXPATRIATES

A. *Constitutional Limits*

Certain commentators suggest that the United States Constitution may limit the ability of the United States to impose a special tax on expatriates.[63]

Broad legislative language provides some support for the notion that expatriation is a fundamental right.[64] No right of expatriation is to be found in

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[63]*See id.*

[64]In granting a right of expatriation, the Expatriation Act of 1868, ch. 249, 15 Stat. 223, proclaimed: "[w]hereas the right of expatriation is a natural and inherent right of all people, indispensable to the enjoyment of the rights of life, liberty, and the pursuit of happiness; . . . [Therefore] any declaration, instruction, opinion, order, or decision of any officer of the United States which denies, restricts, impairs, or questions the right of expatriation, is declared inconsistent with the fundamental principles of the Republic."

the Constitution, however.[65] Accordingly, a tax imposed in connection with expatriation should not, as a general matter, violate the Constitution even if it significantly burdens expatriation, because it is very doubtful that the right to expatriate itself enjoys any specific constitutional protection.

The right to expatriate (*i.e.*, voluntarily relinquish U.S. nationality status) is to be distinguished from the right to travel internationally (*i.e.*, to physically leave the United States) which may enjoy some measure of constitutional protection.[66] This arguably is a more fundamental personal liberty that may logically encompass a right to emigrate. To the extent a constitutionally protected right to emigrate exists, taxing expatriates may have the indirect effect of burdening that right of emigration. As a matter of customary international law, the state to which the expatriate emigrates is entitled to tax the worldwide income of the expatriate. Concurrent taxation by the United States may impose, in effect, a confiscatory tax on emigrants. Given the number of tax haven countries that do not impose any income tax and other countries that exempt foreign sourced income, at worst, concurrent U.S. taxation could be said to burden immigration to particular foreign countries rather than emigration generally. Even if there is a constitutional right to depart the United States, it is far less clear that any constitutional right exists to emigrate to the particular foreign country of one's choice.[67] Moreover, this reasoning would suggest that the tax treatment of nonresident nationals who do not relinquish their U.S. nationality is similarly infirm as a constitutional matter, when constitutional jurisprudence is to the contrary.[68] In any event, affording a full credit for foreign residence-based taxes imposed on the expatriate should insulate any expatriate tax regime from constitutional objections of this nature.

Constitutional challenges to an expatriate tax regime must therefore be founded on general constitutional limits on the power to tax. These limits are few and

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[65] *See* Shanks v. Dupont, 28 U.S. (3. Pet.) 242, 246 (1830) (no persons can, without government consent, put off their allegiance and become aliens). *See generally* Richard W. Flournoy, Jr., *Naturalization and Expatriation*, 31 YALE L.J. 702, 709 (1922). *But see* Michelle L. Carter, *Giving Taxpatriates the Boot—Permanently?: The Reed Amendment Unconstitutionally Infringes on the Fundamental Right to Expatriate*, 36 GA. L. REV. 835, 838 (2002) (arguing that expatriation has achieved status as a fundamental right entitled to substantive due process protections under the Fifth Amendment).

[66] *See, e.g.*, Zemel v. Rusk, 381 U.S. 1, 14 (1965); Aptheker v. Secretary of State, 378 U.S. 500, 505-06 (1964); Kent v. Dulles, 357 U.S. 116, 125 (1958). The United States Supreme Court first recognized the essential nature of the right to travel in *Kent v. Dulles*, holding that "the right to travel is a part of the 'liberty' of which the citizen cannot be deprived without due process of law under the Fifth Amendment." 357 U.S. at 125. However, the court noted in *Zemel v. Rusk*, a case involving restrictions on travel to Cuba, that although a citizen may not be deprived of the right to travel without due process, this does not mean that the right can under no circumstances be inhibited. *See* 381 U.S. at 14; *see also* Haig v. Agee, 453 U.S. 280, 307 (1981).

[67] *See, e.g.*, Califano v. Aznavorian, 439 U.S. 170, 177-78 (1978) (upholding denial of social security benefits during extended period of absence); *Zemel*, 381 U.S. at 19-20 (upholding denial of passport approval for travel to Cuba); Berrigan v. Sigler, 499 F.2d 514 (D.C. Cir. 1974) (upholding refusal of the United States Board of Parole to grant permission to travel to North Vietnam).

[68] *See* Cook v. Tait, 265 U.S. 47, 56 (1924).

weak, particularly as applied to the federal government rather than state governments.[69] The due process clause of the Fifth Amendment protects against deprivation of property without due process of law. To constitute a violation of substantive due process under the Fifth Amendment, however, a taxing statute must likely be so arbitrary as to amount to a confiscation of property.[70] The imposition of tax by the United States based solely on an individual's U.S. nationality has passed constitutional muster.[71] If that is not arbitrary or confiscatory, the Federal government presumably enjoys wide latitude in this arena. A tax on expatriates, to the extent it does no more than preserve the power to tax income that has accrued economically during the period an expatriate held U.S. nationality, would therefore almost certainly survive constitutional scrutiny. A regime that taxes an expatriate less favorably than other nonresidents on income accrued economically after the individual has expatriated is somewhat less constitutionally robust. Nevertheless, this likely is constitutionally permissible if it is reasonably calculated to prevent tax avoidance.[72]

Accordingly, the regime proposed under prior law and as amended by the 2004 Act is almost certainly constitutionally permissible. It applies for a limited ten-year period, captures only U.S.-sourced income otherwise subject to U.S. taxing jurisdiction, and permits a full credit for any foreign taxes imposed on the same income. Accordingly, it would almost certainly be viewed as a revenue-raising regime which merely denies excessive tax benefits to expatriates and does not unduly burden the right of emigration.

The constitutionality of an Exit Tax is somewhat less certain. One could argue that it burdens emigration to a greater extent than the 2004 Act, because it taxes, on an accelerated basis, income or gain that may also be subject to residence-based tax by the country to which the expatriate emigrates, but provides no credit for that tax. On the other hand, the taxpayer may elect to be taxed as a citizen on the income, thereby achieving relief from concurrent foreign taxes.

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[69]In contrast to the Fourteenth Amendment, which limits state power to tax, the Fifth Amendment contains no equal protection clause, although it has been held to embody equal protection principles. *Cf.* Regan v. Taxation Without Representation of Washington, 461 U.S. 540 (1983). Nevertheless, this does not mean that the limits of state power to tax are coterminous with limits on the federal government. *See* Burnet v. Brooks, 288 U.S. 378, 405 (1933) ("[T]he criterion of state taxing power by virtue of the relation of the States to each other under the Constitution is not the criterion of the taxing power of the United States by virtue of its sovereignty in relation to the property of nonresidents."); *see also* Frick v. Pennsylvania, 268 U.S. 473 (1925); United States v. Bennett, 232 U.S. 299, 306 (1914).

[70]*See* Steward Mach. Co. v. Davis, 301 U.S. 548, 584-85 (1937); Heiner v. Donnan, 285 U.S. 312, 336 (1932) (Stone J., dissenting); Brushhaber v. Union Pac. R.R., 240 U.S. 1, 24-25 (1916); Randolph v. Commissioner, 74 T.C. 284, 289-90 (1980).

[71]*Cook*, 265 U.S. at 56; *see also* Lord Forres v. Commissioner, 25 B.T.A. 154, 160-61 (1932) (upholding U.S. tax on dividends paid by a foreign corporation to a nonresident alien).

[72]*See* Helvering v. City Bank Farmers Trust Co., 296 U.S. 85, 90 (1935) ("A legislative declaration that a status of the taxpayer's creation shall, in the application of the tax, be deemed the equivalent of another status falling normally within the scope of the taxing power, if reasonably requisite to prevent evasion, does not take property without due process.").

That this relief comes at the price of electing perpetual U.S. taxpayer status with respect to the expatriate's property could be viewed as an unpalatable condition. On balance, however, the intent of the regime appears to be to protect the fisc in a reasonable manner and it would therefore likely survive any challenge on due process grounds. By taxing unrealized gains, the Senate Proposal also implicates the Sixteenth Amendment.[73] However, despite provocative contrary views, it is fairly settled that realization is not a constitutionally mandated requirement.[74]

B. *Limitations Imposed by International Human Rights Law*

Similar limits on the imposition of a special tax on expatriates are imposed by international human rights law.

The rights to emigrate and expatriate are recognized at international law. Article 12 of the International Covenant on Civil and Political Rights recognizes the right to emigrate.[75] The Universal Declaration of Human Rights,[76] adopted by the United Nations General Assembly on December 10, 1948, recognizes both a right physically to leave (emigration) and a right to change one's nationality (expatriation).[77] The United States also recognizes both of these rights.[78]

For reasons similar to those outlined above, however, it is doubtful that a tax imposed in connection with expatriation violates international human rights law even if it incidentally burdens expatriation.[79] Human rights law recognizes the legitimacy of reasonable restrictions on the right to emigrate. For example, the

[73]Eisner v. Macomber, 252 U.S. 189, 205-06 (1920) (suggesting that the realization requirement is constitutionally mandated).

[74]*See, e.g.*, MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION § 5.01 (8th ed. 1999) ("[r]ealization is strictly an administrative rule and not a constitutional, much less an economic, requirement of 'income.'"); JOSEPH T. SNEED, THE CONFIGURATIONS OF GROSS INCOME 65-72 (1967) (discussing the Court's erosion of the constitutional requirement of realization); Boris I. Bittker, *Charitable Gifts of Income and the Internal Revenue Code: Another View*, 65 HARV. L. REV. 1375, 1380 (1952) (expressing no doubt that realization is not constitutionally required); Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725, 741 n.69 (1992) (citing both judicial and academic authority for proposition that realization requirement is not constitutionally mandated); Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779, 791 (1941) (stating that most commentators agree that realization is not constitutionally mandated). *But see* Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution,* Macomber *and Mark to Market*, 13 VA. TAX. REV. 156 (1993) (arguing that realization is still required by Sixteenth Amendment).

[75]Mar. 23, 1966, 999 U.N.T.S. 171.

[76]U.N. GAOR, 3d Sess., Supp. No. 3, at 71, U.N. Doc. A/810 (1948).

[77]*See* JCT Expatriation Report, *supra* note 12, at 90.

[78]*Id.* at 90-91. *But see* Detlev F. Vagts, *The Proposed Expatriation Tax—A Human Rights Violation?*, 89 AM. J. INT'L L. 578 (1995) (asserting that international law does not protect right to expatriate).

[79]*See Taxing Expatriates: Hearing on H.R. 831 Before the House Comm. on Ways and Means*, 104th Cong. (1995) (statement of Paul B. Stephan III, Professor, University of Virginia Law School), *reprinted in* 95 TAX NOTES INT'L (TA) 60-61 (Mar. 29, 1995); Renee Judith Sobel, *United States Taxation of Its Citizens Abroad: Incentive or Equity*, 38 VAND. L REV. 101 (1985). *But see* Vagts, *supra* note 78, at 578 (suggesting there is no international law right of expatriation as distinct from the right of emigration).

International Covenant on Civil and Political Rights provides in Article 12(3) that "the above-mentioned rights shall not be subject to any restrictions except those which are provided by law, are necessary to protect national security, public order (order public), public health or morals or the rights and freedoms of others, and are consistent with the other rights recognized in the present Covenant." Many countries impose some form of special tax regime on former residents.[80]

Comparisons drawn by some commentators[81] to the Soviet taxes on Jewish emigrants that engendered international condemnation and motivated the Jackson-Vanik Amendment are therefore misplaced.[82] Those taxes were imposed on emigration (*i.e.*, on the right to depart the geographic boundaries of the Soviet Union rather than on a change in nationality status) and moreover, were in the nature of a poll tax assessed without regard to the emigrant's ability to pay. The taxes were therefore clearly calculated to impede the free movement of persons. The right to expatriate under international law should preclude a tax regime for expatriates only to the extent that tax regime is similarly calculated to impede personal movement.

C. *Limitations Imposed by Treaty Obligations*

A more significant obstacle to the imposition of a special tax on expatriates arises because of rights created under U.S. bilateral income tax treaties. An expatriate who becomes resident in a country that has concluded an income tax treaty or wealth transfer tax treaty with the United States generally is entitled to claim the protection of that treaty against U.S. taxes.

Although the United States has, in the past, taken the position that treaty savings clauses generally preserve the right of the United States to tax its former citizens, the Tax Court in *Crow v. Commissioner*[83] rejected this assertion. Following *Crow*, the United States likely may tax an expatriate who is a treaty country resident on income or property that the treaty generally reserves to the country of residence only if the treaty specifically reserves to the United States

[80]Australia, Canada, France and the Netherlands each impose some form of departure tax on resident individuals whose residence status terminates. The countries offer differing exceptions, opportunities to defer the tax, and, in some cases, may waive the tax if no actual disposition occurs within a certain period following departure. Germany imposes a limited departure tax on substantial interests in German resident companies and a trailing tax on former residents who expatriate to tax haven countries for some period after departure. JCT Expatriation Report, *supra* note 12, at app. B; *see generally* Sanford H. Goldberg et al., *Taxation Caused by or After a Change in Residence*, 21 TAX NOTES INT'L (TA) 643 (Aug. 7, 2000). However, international law in this area continues to evolve. The European Court of Justice recently held in *de Lasteyrie du Saillant* (case C-9/02) that the French exit tax is not compatible with the freedom of establishment in Article 43 of the E.C. Treaty (reported in a European Court of Justice press release dated March 11, 2004, and reprinted in 2004 WORLD TAX DAILY 49-17 (Mar. 12, 2004)).

[81]*See, e.g.*, ABA Report, *supra* note 62.

[82]*See* Jackson-Vanik Amendment, Pub. L. No. 93-618, 88 Stat. 1978 (imposing sanctions on nonmarket economies that impose a more than nominal tax on acts related to emigration).

[83]85 T.C. 376, 379-80 (1985).

the right to tax the expatriate in the relevant circumstances, or if Congress has evinced a specific intent to override conflicting treaty provisions.

Treaties have the same effect as federal law and a court will generally construe them to avoid a conflict. In the case of unavoidable conflict, the later legislative enactment prevails.[84] Congress certainly has the power to override contrary treaty provisions as a matter of U.S. domestic law. However, treaty overrides are a violation of international law and therefore this is a power to be exercised sparingly.[85]

Treaty partners react unfavorably to unilateral abrogation of U.S. obligations. While it could be argued that the number of expatriates and amount of revenue at issue is too small to elicit significant objections by treaty partners, this ignores the varying contexts in which conflict might arise. Wealthy foreigners can lobby their local legislators too. Treaty partners are unlikely to object vigorously to U.S. expatriation taxes imposed on resident citizens whose wealth has clearly been accumulated during the period of U.S. residence and whose expatriation is tax-motivated. One can certainly imagine more adverse reaction when the person taxed is a U.S. citizen who has never lived in the United States and relinquishes U.S. nationality status in order to acquire citizenship of the country in which the individual in fact resides.

Nor is renegotiation of treaty obligations a costless solution to potential conflicts with treaty partners. As in any contractual renegotiation, the treaty partner is likely to extract concessions in other areas in return for a willingness to concede the taxation of former citizens (whether or not they strongly object in principle to this perceived expansion of U.S. taxing jurisdiction).[86] Indeed, this concern was sufficiently significant that Treasury objected strongly to the enactment of the HIPA revisions to section 877 as an unwarranted destabilization of the treaty process.[87]

Thus, section 877 may violate the majority of treaties, which either do not reserve the right to tax former citizens or reserve the right to tax only former citizens whose expatriation was tax-motivated. Congress expressed its belief (likely, mistakenly) in enacting the 1996 HIPA amendments that the broad provision granting a credit against the alternative tax for any foreign income or similar taxes was sufficient to avoid such a conflict.[88] However, to the extent the statute was found to conflict with particular treaties, Congress intended section 877 to override the treaty. In a novel departure, however, Congress expressed its

[84]*See* Chae Chan Ping v. United States, 130 U.S. 581, 600 (1889); Whitney v. Robertson, 124 U.S. 190, 195 (1888).

[85]Vienna Convention on the Law of Treaties, May 23, 1969, art. 26, U.N. Doc. A/CONF. 39/27, 8 I.L.M. 679, 690. *See* Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT'L L. REV. 71, 82 (1995).

[86]*See* JCT Expatriation Report, *supra* note 12, at 118-21.

[87]Letter from Leslie Samuels, Assistant Treasury Secretary for Tax Policy, to The Honorable Bill Archer, Chairman, House Committee on Ways & Means (Sept. 14, 1995), *reprinted in* 95 TAX NOTES INT'L (TA) 180-18 (Sept. 18, 1995).

[88]STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., REPORT ON GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS 321-90 (Comm. Print 1996).

intent that this treaty override would apply for a limited period only.[89]

Section 877 as amended by the 2004 Act is not inherently more violative of U.S. treaty obligation than prior section 877, but in practice may result in more frequent conflicts, because many expatriates who are eligible to seek ruling relief under current law will now be taxed regardless of motivation.

The Exit Tax proposal is arguably preferable to the other models from this perspective because the tax is imposed at the time the expatriate is still a citizen. Accordingly, imposition of the tax is clearly within the right reserved to the United States under treaty savings clauses. However, it may violate the spirit if not the letter of "Relief from Double Taxation Provisions" that require the United States to credit foreign taxes on this income, as discussed more fully below.

VI. TAX POLICY PARAMETERS

Given the limits imposed on the adoption of a special tax on expatriates described above, in particular the need to renegotiate U.S. obligations under its income tax treaties, and the relatively limited revenue that will be raised by the proposals,[90] one may ask why adopting a new regime makes any policy sense.[91] Questions of allocative efficiency and the effect of legislation on international capital flows, typically a major international tax policy concern, likely do not loom as large in this context.[92] Making the regime more administrable is a worthy goal but presumes that an expatriate tax regime is worth having.

[89] *Id.*

[90] The Joint Committee on Taxation estimated the ten year revenue impact of the individual expatriation provisions of the 2004 Act to be $377 million. *See* JOINT COMMITTEE ON TAXATION, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 4520, THE AMERICAN JOBS CREATION ACT OF 2004, JCX-69-04 (October 7, 2004). By contrast, estimated revenue impact of provisions to shut down abusive leasing transactions was $26.56 billion. *Id.* The ten-year revenue estimate for the Senate version of the Exit Tax was $665 million. *See* JOINT COMMITTEE ON TAXATION, COMPARISON OF THE ESTIMATED BUDGET EFFECTS OF H.R. 4520, THE AMERICAN JOBS CREATION ACT OF 2004, AS PASSED BY THE HOUSE OF REPRESENTATIVES AND H.R. 4520 THE JUMPSTART OUR BUSINESS STRENGTH ACT, AS AMDENDED BY THE SENATE, JCX-53-04 (July 23, 2004).

[91] For a comprehensive discussion of tax policy considerations relevant to the expatriate tax regime, see Jeffrey M. Colón, *Changing U.S. Tax Jurisdiction: Expatriates, Immigrants and the Need for a Coherent Tax Policy*, 34 SAN DIEGO L. REV. 1 (1997).

[92] *See* JCT 2003 Expatriation Report, *supra* note 12, at 101-07. Nevertheless, an expatriate tax regime does raise marginal efficiency concerns to the extent the regime favors certain classes of income earned by an expatriate and thereby distorts investment decisions. The prior section 877 and section 877 as amended favor investment in foreign source assets because the income from these assets will not be subject to the alternative tax during the ten year taint period. This violates the capital export neutrality principle by favoring foreign investment. The Exit Tax, in contrast, may distort investment decisions in the opposite direction. By accelerating tax on income that may also be subject to foreign tax at a later date but providing no mechanism to credit the subsequent foreign tax, the regime in theory creates incentives for a prospective expatriate to acquire, prior to expatriation, assets that generate U.S. source income or foreign assets that generate income that will not be subject to significant foreign tax. However, because the tax is imposed at the time of expatriation (or the expatriate must elect to be taxed as a U.S. national with respect the affected assets in perpetuity), no post-expatriation planning is possible after the fact. To the extent the gain has already accrued (and the expectancy of future income subject to foreign tax already exists), limited planning opportunities exist to avoid the problem. It would be a very farsighted individual who arranged his or her portfolio many years in advance with a view to future expatriation; so one suspects this effect would be limited to a few unusual cases.

Nor is deterring expatriation a legitimate goal of the expatriate tax regime. A change in the longstanding protections afforded to expatriation would, at least, be contrary to customary international norms, long-standing practice in the United States, and would likely violate intuitions about personal liberty shared by many Americans.[93] Even if the United States were to adopt a policy of deterring expatriation (as distinct from tax avoidance expatriation), the tax system is not the appropriate means by which to achieve this deterrence. While tax penalty provisions succeed in increasing the after-tax cost of the activity, they fail to increase the cost in a manner sufficiently related to the harm caused by the activity, and little proportionality exists between the penalty and the severity of the offense. Put simply, an expatriate tax regime can only legislate patriotism by the wealthy. If expatriation really is inherently objectionable, without regard to opportunities it presents for tax avoidance, it should be regulated by other means.[94]

The rationale for the expatriate tax regime must lie primarily in its symbolic function.[95] An important objective of any tax legislation is to promote among taxpayers a perception that obedience to the tax laws, as well as punishment for violation of the tax laws, is enforced equitably. Perceived equality in application and enforcement of the tax laws is essential to the system. Precisely because the taxation of wealthy expatriates is so intertwined with notions of citizenship, patriotism and liberty, and is so politically charged, an expatriate tax regime is a significant symbol of legislative determination to ensure equitable compliance and enforcement of the tax laws. This suggests, however, that relative neutrality and fundamental fairness should be a significant objective of the regime.

A. *Tax Neutrality*

Making the decision to expatriate tax neutral, which has been suggested as a goal of the Exit Tax,[96] is a laudable ideal but is impossible to achieve without violating other policy objectives. The basic design of the U.S. international tax regime for individuals is inherently less favorable to U.S. nationals. True tax neutrality would therefore require adopting a system under which nationals are perpetually subject to U.S. taxing jurisdiction. However, the asserted justification for pure nationality-based taxation (the assumed right of access to legal protections and benefits) evaporates once the individual relinquishes these vestigial rights upon expatriating. Because their nationality provides the basic equitable justification for their tax burden, they are necessarily more unfairly taxed if their tax status is not appropriately adjusted upon their relinquishing U.S. nationality status. A regime which entirely eliminates tax incentives to expatriate

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[93] *See* Alice G. Abreu, *Taxing Exits*, 29 U.C. DAVIS L. REV. 1087, 1129 (1996) (arguing that a punitive regime would violate international law).

[94] *See generally* Eric M. Zolt, *Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 343-45 (1989).

[95] Abreu, *supra* note 93, at 1140.

[96] *See* JCT 2003 Expatriation Report, *supra* note 12.

therefore would violate fundamental fairness, as discussed below. At best, a fair expatriate tax regime can attempt to limit tax avoidance that is viewed as disproportionate to the individual's new status (*i.e.*, provide a clean break from U.S. taxing jurisdiction).

Neither prior section 877 nor section 877 as amended satisfy even this more limited articulation of tax neutrality. Foreign source income that has accrued economically prior to expatriation escapes the U.S. tax that would have applied if the income had been realized by a U.S. taxpayer. The expatriate also may significantly reduce the wealth transfer taxes that would otherwise have applied. Accordingly, under both regimes, significant tax incentives to expatriate persist.

The Exit Tax satisfies the tax neutrality principle somewhat better. In general, it taxes worldwide income that has economically accrued prior to expatriation and would otherwise have been taxable to a citizen. This does not achieve true neutrality as income accrued post-expatriation may still be more favorably taxed, but it is a reasonable accommodation. Nevertheless, the Exit Tax to some degree disfavors expatriates as compared to other U.S. nationals. The regime taxes this income on an accelerated basis and in violation of the realization principles that would generally have applied. Tax deferral is valuable and acceleration of the tax penalizes expatriates. Indeed, the gains that are taxed on an accelerated basis may have escaped tax entirely in the hands of a U.S. national due to the step up in tax basis available at death.[97] So the disparity is not necessarily merely a timing disparity. On the other hand, the approach permits expatriates to elect to be subject to tax on the same basis as would have been the case had they not expatriated. On the whole, therefore, the Exit Tax better satisfies the neutrality principles than do prior section 877 or section 877 as amended, although it may violate other important policy goals discussed below.

B. *Equity and Fairness Considerations*

That a tax regime for expatriates should meet standards of fundamental fairness and equity is so true as to be trite. But establishing the appropriate standard of fairness in this context is not easy.[98] Income tax policy literature generally posits fairness in terms of horizontal equity. Horizontal equity is achieved to the extent similarly situated taxpayers are similarly taxed.[99] In a purely domestic context, there is reasonable consensus that horizontal equity is satisfied by a tax based upon an individual's ability to pay, that is, by reference to the economic

[97] *See* I.R.C. § 1014.

[98] *See generally* J. Clifton Fleming et al., *Fairness in International Taxation: The Ability to Pay Case for Taxing Worldwide Income*, 5 FLA. TAX. REV. 299 (2001); Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL'Y INT'L BUS. 145 (1998).

[99] In contrast, vertical equity is satisfied to the extent the differential taxation of dissimilar taxpayers is appropriate in relation to the difference. However, vertical equity, incorporating as it does notions of distributive justice, is considerably more controversial and this Article will not join that debate.

income of the taxpayer.[100] Competing notions of horizontal equity consider benefits actually derived from government, rather than ability to pay, to better measure horizontal equity.[101] But it is generally impossible in practice accurately to measure the benefits provided to particular taxpayers. Even if governmental benefits in principle justify tax burdens, economic income arguably is a reasonable proxy for the benefits actually derived. Whatever the general merits of ability to pay as a proxy for horizontal equity in the domestic context, however, it is inherently more problematic in the international context.

Even if the United States could practically impose tax on individuals without regard to their nationality, this would violate other fundamental norms of justice, in particular, that individuals subject to the tax be afforded the right to participate in the democratic institutions that determine their tax burden and that each country and its citizens have the right to determine for themselves the notions of tax fairness that should apply to them. Horizontal equity in the international context therefore is typically restated in more limited terms: all U.S. taxpayers should be taxed on their worldwide income at the same rate (or under the same rate schedule) and permitted to deduct or credit foreign taxes appropriately imposed on the same income.[102] Even this more limited articulation, however, begs the question of which individuals are appropriately to be treated as U.S. taxpayers. Most commentators attempting to apply notions of inter-individual equity in the international context have side-stepped the vexing question of whether individuals are appropriately included in this class merely because of their nationality.[103] When they offer any justification, commentators argue that U.S. tax jurisdiction may be overreaching as applied to the limited class of nonresident nationals, but that this is an insignificant and marginal problem given the small number of persons involved. Unfortunately for present purposes, individuals who are taxed despite their limited U.S. nexus based on their nationality may represent only a small subset of all U.S. taxpayers, but they represent a very large subset of potential expatriates.

Jurisdiction to tax based solely upon an individual's nationality rather than actual residence accords quite poorly with notions of horizontal equity. A nonresident national and a long-term resident national are not similarly situated, and taxing them as if they were can perhaps be rationalized by administrative necessity but cannot be justified on equitable grounds. Justifying an equal tax burden based upon ability to pay obfuscates this inherent dissimilarity.

An individual whose only relationship to United States is her nationality status, has at best enjoyed an option, never exercised, on the more comprehensive rights of United States citizenship and benefits of residence in the United

[100]*See generally* Fleming, *supra* note 98.
[101]Kaufman, *supra* note 98, at 152-53; *see also* Fleming, *supra* note 98, at 333-35.
[102]Fleming, *supra* note 98, at 303-06.
[103]*E.g.*, *id.* at 309-10.

States and some attenuated direct benefit in the form of international protection afforded by the United States to its citizens. While this more remote nexus may justify some level of taxation, as the constitutional jurisprudence argues,[104] taxing such a person identically to a person who has enjoyed the full panoply of rights and benefits of U.S. residence violates the basic premise of horizontal equity. Such nonresident nationals are overtaxed from the perspective of horizontal equity under the current nationality-based system and arguably do no more than relieve themselves of an excessive burden when they choose to depart U.S. taxing jurisdiction.

Permanent legal residents also arguably are overtaxed under the current system. From the standpoint of residence-based taxation, their burden is appropriate. But when the power to tax is purportedly justified by the legal privileges and protections afforded to nationals, legal residents are overtaxed. They do not, for example, have the ability to participate in the democratic institutions that determine their tax obligations. Nor do they enjoy the protection of the United States abroad, except to a very limited extent. Perhaps more importantly, unlike citizens, their status is not constitutionally protected to the same degree. Put differently, if legal protections and rights afforded nonresident citizens alone are sufficiently valuable to justify the substantial burden of a tax on their worldwide income, legal residents should be entitled to a steep discount. One can argue that, in practice, green card holders have an option to acquire the full panoply of benefits, as they generally become entitled to apply to become naturalized citizens with the passage of time (typically after five years). Once that period has elapsed, that such an individual enjoys reduced rights and protections compared to a full citizen is arguably a matter of choice. Further, imposing a reduced tax burden on legal residents would discourage conversion to full citizenship, violating important immigration policy goals. On the other hand, when the permanent resident chooses to let this option on citizenship lapse, one can also question whether it is fair to tax him to the same extent as a person who has always enjoyed the full panoply of rights and benefits.

Given these conceptual difficulties, it should not be surprising that the various expatriate tax regimes reach somewhat troubling results in some circumstances from the perspective of equity and fundamental fairness. Prior section 877 and section 877 as amended are arguably unduly generous to the expatriate who is a long-term resident. There is no reason why such an expatriate should escape tax on foreign-sourced income economically accrued during the period of residence when that income would be taxable to a similarly situated resident who does not expatriate. On the other hand, as applied to nonresident nationals, both are unduly harsh. These taxpayers have enjoyed only limited benefits and have arguably been overtaxed during the period of their nationality, and taxing them more harshly than other nonresident aliens after they relinquish their nationality rights, albeit only on U.S. source income, is not fundamentally fair. At best, it

[104]*See* Cook v. Tait, 265 U.S. 47, 56 (1924).

represents rough justice to the extent both regimes permit them largely to avoid wealth transfer taxes that would otherwise have applied and limit the income tax imposition to U.S. source income that would bear tax to a significant extent in the hands of a nonresident alien.

The Exit Tax Proposal, conversely, is largely fair as applied to former resident nationals and even more unfair to nonresident nationals. A resident expatriate is subject to tax on worldwide income that has accrued economically during the period she enjoyed the full benefits of residence and citizenship. Admittedly, the tax is accelerated and she is deprived of the benefits of deferral and possible step up in the basis of the assets at death. However, if the realization requirement is viewed as an exercise of administrative latitude rather than as fundamental to the definition of taxable income, this arguably is not unfair. Moreover, these individuals largely escape wealth transfer taxes that would otherwise have applied to their property, at least to the extent they do not later devise property on a U.S. taxpayer. As applied to a nonresident national, at best, one can argue that the Exit Tax does no more than perpetuate the unfairness of the general regime for nonresident U.S. tax nationals. But accelerating the imposition of tax in violation of realization norms compounds the unfairness. Offering an election instead to be taxed in perpetuity as a U.S. national with respect to property owned upon expatriating merely adds insult to injury.

C. *International Equity and International Comity*

An alternative focus is whether an expatriate regime fairly apportions jurisdiction to tax income among competing national taxing authorities (*i.e.*, achieves inter-nation equity).[105]

Because the United States affords, under domestic law and by treaty, a foreign tax credit for taxes imposed on foreign source income (without imposing a per country limitation), foreign taxes on foreign source income are generally creditable whether imposed by a particular source country or imposed by a foreign country in which the individual is resident. Accordingly, the United States to that extent cedes taxing jurisdiction over this income to the new country of residence.[106] Arguably, however, affording an unlimited foreign tax credit for residence country taxes does not fully address the international comity concerns. Presumably, the decision of the residence country to tax at a lower effective rate than the United States reflects a complex political and economic judgment by that country about the benefits of capturing this revenue rather than leaving it in

[105]*See generally* Kaufman, *supra* note 98, at 153-55; Peggy B. Musgrave, *Consumption Tax Proposals in the International Setting, in* TAX CONVERSATIONS: A GUIDE TO THE KEY ISSUES IN THE TAX REFORM DEBATE 447, 449-50 (Richard Krever ed., 1997); Peggy B. Musgrave, *International Tax Base Division and the Multi-National Corporation*, 27 PUB. FIN. 394 (1972).

[106]The United States may grant broader relief by treaty (for example, if source rules in the treaty are more generous in the definition of foreign source income than domestic law). Generally, the savings clause exempts from its application the Relief from Double Taxation provision so that an expatriate will be permitted this broader relief.

the hands of residents to be consumed or invested to the benefit of the local economy. The claim of the United States to this income may therefore be perceived as an arrogation by a jurisdiction with a tenuous claim to the income of that decision. If one accepts the premise that the jurisdiction in which the individual becomes resident and acquires nationality has a stronger claim to tax income of an individual than a country whose nexus to the individual is based on theoretical legal protections afforded to them under their former nationality status, a U.S. tax on foreign source income (even with a full credit) may violate inter-nation equity. Accordingly, an expatriate tax can be justified from the standpoint of inter-nation equity only if it is limited to income which accrued while the individual was a national of the United States. Even so limited, the tax remains troubling to the extent it is imposed on income accrued during the period the individual was also a tax resident of the other country. However, the latter concern is an inherent problem of the U.S. nationality-based regime and arguably must be addressed comprehensively rather than partially through the expatriate tax regime.

Also at issue is an expatriate tax imposed on U.S. source income to the extent the tax rate exceeds that which otherwise would have applied to U.S. source income earned by nonresidents. If the residence country generally provides a credit for this tax (assuming it does not exempt the income entirely under a territorial or exemption system), it may effectively cede the right to tax this income to the United States. Other countries may consider this somewhat objectionable as applied to a U.S. citizen who is resident in the other country, but they are likely to find it highly objectionable when the individual is no longer a U.S. citizen or resident. Again, this suggests that an expatriate tax can be justified from the standpoint of inter-nation equity if it is limited to income which accrued economically while the individual was a U.S. tax national.

Section 877 as amended will violate most treaties to which the United States is a party. Even those treaties that permit the United States to tax former citizens under the savings clause generally premise this concession on the current law regime and allow the United States to tax only tax-motivated expatriates.[107] Of course, prior secion 877 was similarly infirm insofar as it applied to expatriates who meet the tax liability or net worth tests and were not permitted to demonstrate an absence of tax motivation. But one can question whether compounding the error is sensible at a time when U.S. unilateralism and its perceived indifference to international law constraints are being widely criticized.

The Exit Tax is also problematic from an international comity perspective. Because it accelerates the time at which the income is realized, it may effectively tax income that will ultimately be subject to foreign taxes but provides no

[107]The only treaties that generally permit taxation of former citizens under the savings clause and do not limit this reservation to former citizens whose expatriation was tax-motivated are those with the Czech Republic, the Slovak Republic, Mexico, and Switzerland.

mechanism to credit the foreign taxes. This may or may not technically violate Relief from Double Taxation provisions of treaties under which the United States agrees to credit foreign taxes on foreign source income. However, it certainly has the same effect and may violate the intent of those provisions. The expatriate can of course elect to be taxed as a U.S. national in perpetuity with respect to the assets, which will ensure that a credit for foreign taxes is available. But this may be an unpalatable choice for the individual and is entirely outside the control of the other country. It could still be viewed as arrogating to the United States the other country's decision about the appropriate rate at which to tax income that accrues economically after expatriation.

D. *Administrability and Enforcement*

Issues of administrability and enforcement loom large in the design of an expatriate tax regime. Given the limited administrative and enforcement resources of the Service, the relatively small amount of revenue at issue, and the small number of affected individuals, an ideal expatriate tax regime should be based on clear and objective standards and be readily administrable.

Section 877, prior to its amendment in 2004, failed miserably from an administrability perspective. Both the amended version of section 877 and the Exit Tax are a significant improvement insofar as they eliminate tax motivation as a factor in applying the regime. The Exit Tax Proposal, however, replaces one administrative burden with another. A mark-to-market regime may be relatively easily administered if it applies only to highly liquid assets whose valuation is readily determinable. The Exit Tax Proposal is not so limited. Significant administrative resources are therefore likely to be consumed in challenging asserted valuations of illiquid assets.

Because the expatriate tax regimes purport to apply to individuals who frequently will not be found within the territorial jurisdiction of the United States and may or may not have assets the United States can reach, enforcement is also a significant challenge. International law significantly constrains the United States in its ability to enforce its expatriate tax regime extraterritorially. The broad theoretical assertion of its taxing jurisdiction by the United States may therefore exceed the practical ability of the United States to assess and collect the extraterritorial tax so imposed.[108]

As a matter of public international law, courts of one sovereign will not enforce the tax judgments of another under the "revenue rule."[109] Although

[108]*See generally* A. N. Sack, *(Non-)Enforcement of Foreign Revenue Laws, in International Law and Practice*, 81 U. PA. L. REV. 559 (1933) (discussing the reasons for nonenforcement due to the diversity among various economic systems).

[109]*See* Her Majesty the Queen ex. rel. British Columbia v. Gilbertson, 597 F.2d 1161, 1163 (9th Cir. 1979); Moore v. Mitchell, 30 F.2d 600, 604 (2d Cir. 1929) (Hand, J., concurring), *aff'd*, 281 U.S. 18 (1930); Planche v. Fletcher, 99 Eng. Rep. 164, 164 (1779); Holman v. Johnson, 98 Eng. Rep. 1120, 1121 (1775); RESTATEMENT (THIRD) FOREIGN RELATIONS LAW OF THE UNITED STATES § 483 (1987); *see generally* William J. Kovatch Jr., *Recognizing Foreign Tax Judgements: An Argument for Revocation of the Revenue Rule*, 22 HOUS. J. INT'L L. 265 (2000).

United States courts have read this rule narrowly to preclude enforcement of foreign tax judgments only where this would require them to determine the validity of the foreign tax law,[110] the relevant interpretation would be that of the courts of the foreign jurisdiction in which the U.S. seeks to collect the tax. The principle of the revenue rule is widely accepted internationally. Countries may depart from the revenue rule by bilateral treaty but the number of countries with which the United States has concluded such agreements is small. The United States has entered into only five income tax treaties under which the contracting parties have agreed to provide general assistance in collecting tax judgments.[111] With one exception, however, these provide only limited assistance as to collection of net income tax.[112] Accordingly, this represents a significant practical and jurisdictional impediment to the collection of the expatriate tax from persons who are not within the territorial jurisdiction of the United States and do not have assets that the United States can reach.

Further, the United States is constrained in its ability to extradite determined expatriates in the case of criminal tax evasion of expatriate taxes by nonresidents. Almost all countries from which the United States seeks extradition regulate extradition by statute. Foreign extradition statutes ordinarily establish the procedures by which extradition from such countries occurs. However, unlike U.S. extradition statutes, foreign extradition statutes normally have provisions that establish substantive rules governing extradition. Additionally, some foreign constitutions have provisions affecting extradition from those countries. Both the procedural and substantive extradition laws of a country from which the United States requests extradition can substantially limit the ability to obtain extradition in criminal tax cases.[113]

The prior section 877 and section 877 as amended undoubtedly raise enforcement difficulties, although these difficulties are no more pronounced than the difficulties generally inherent in taxing nationals who are not actually resident in the United States. Accordingly, these enforcement difficulties may be viewed as merely a special instance of the inherent enforcement challenges created by a nationality-based tax regime.[114] By imposing the section 877 alternative tax only on U.S. source income, the reach of these regimes is at least limited to income and assets that the United States may be able to reach even without personal jurisdiction over the taxpayer.

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[110]*See* United States v. Trapilo, 130 F.3d 547, 552-53 (2d Cir. 1997).

[111]The relevant treaties are those with Denmark, France, Sweden, the Netherlands, and Canada. However, the degree of assistance required to be provided is limited. *See* ANDERSEN, *supra* note 21, at ¶ 24.01[1][b][i]. The United States is a party to the Multilateral Mutual Assistance Convention but has entered reservations with respect to its collection provisions. *Id.*

[112]The most recent broadly drafted collection provision was adopted in the 1995 Protocol to the U.S.-Canada treaty. Revised Protocol Amending the 1980 Tax Convention with Canada, Mar. 28, 1984, U.S.-Can., 1980 U.S.T. 154. The mutual collection assistance provision provides broad assistance for a revenue claim that has been certified by the applicant state as "finally determined." *Id.*

[113]*See* Westin, *supra* note 23, at 133-34.

[114]*See generally* TREASURY DEPT., INCOME TAX COMPLIANCE BY U.S. CITIZENS AND LAWFUL PERMANENT RESIDENTS RESIDING OUTSIDE THE UNITED STATES AND RELATED ISSUES (1998).

An asserted benefit of the Exit Tax is its greater enforceability because it is imposed at the time of expatriation. Indeed, enforcement concerns are likely the primary justification for accelerating tax in violation of realization norms. The greater enforceability of the Exit Tax regime is, however, largely illusory. Its enhanced enforceability is premised on the questionable assumption that an individual is more likely to be found within the United States at the time nationality status is relinquished than thereafter. Yet, as discussed above, the acts that can result in loss of citizenship are (1) naturalization in a foreign state after the age of 18; (2) taking an oath of allegiance to a foreign state or subdivision after the age of 18; (3) serving in the armed forces of a foreign state, under certain circumstances; (4) taking a government job with another country, under certain circumstances; (5) renouncing nationality in the prescribed form before a U.S. diplomatic or consular officer abroad; (6) renouncing in time of war, upon approval of the Attorney General; and (7) committing an act of treason or other seditious act specified in the statute. Any of these acts may, or, indeed, must be taken while the individual is beyond the reach of the United States. The United States could, perhaps, refuse to recognize relinquishment of U.S. nationality for tax purposes unless the appropriate security for payment of taxes is provided. However, this would be a somewhat symbolic penalty. Determined evaders will likely simply continue to ignore their U.S. tax obligations whether theoretically imposed based on the individual's status as a U.S. national or as an expatriate. Alternatively, the United States could require all persons physically departing the United States to demonstrate that they are not emigrating or to provide adequate security for potential expatriate tax obligations. Such a "sailing permit" is already imposed in the case of permanent legal residents and it has proven to be less than effective.[115] Moreover, extending this requirement to citizens who travel outside the United States, at the least, would be politically unpopular and is likely to engender howls of outrage from civil libertarians. In the end, like the other expatriate tax regimes, the Exit Tax depends on voluntary compliance by the affected individuals. The Exit Tax compounds enforcement challenges by purporting to reach income from foreign sources which may be least accessible to the United States in the absence of personal jurisdiction over the expatriate.

E. *Estate and Gift Tax Policy Concerns*

Debate over the expatriate tax regime has focused on income tax avoidance and has largely ignored the fact that avoidance of wealth transfer taxes may be at least as important in motivating expatriates. Under any of these regimes, opportunities for significant wealth transfer tax avoidance will persist.

As discussed above, both prior section 877 and section 877 as amended largely allow an expatriate the more favorable estate and gift tax treatment afforded

[115]*See* I.R.C. § 6851(d). "Sailing permit" colloquially refers to Form 2063 (U.S. Departing Alien Income Tax Statement) or Form 1040-C (U.S. Departing Alien Income Tax Return) on which this information must be provided. For a discussion of compliance, see Westin, *supra* note 23, at 102.

nonresident aliens. The Exit Tax Proposal allows the expatriate to escape nationality-based wealth transfer taxes entirely, except to the extent the expatriate chooses to devise property on a U.S. tax national, in which case the heir will be subject to income tax on receipt of that property.[116]

The lack of attention to wealth transfer taxes may not be merely accidental. As argued above, one of the more important functions of the expatriate tax regime is likely its symbolic role in demonstrating to taxpayers that tax avoidance is precluded and thereby legitimating a tax system based on voluntary compliance. Given the wide degree to which the basic legitimacy of the estate and gift tax is under attack, symbolically protecting these taxes may not elicit the same concern.

Because the underlying policy objectives of the estate and gift tax are disputed, it is also difficult to discern on a principled basis how these taxes should operate in the case of expatriates. Asserted justifications for the estate tax include (1) the additional progressivity it adds to the tax system in a nondistortionary way (assuming that individual behavior is less likely to be affected by a tax which will be imposed only after death); (2) its role as a backstop to the income tax, which fails to tax completely net accretions to wealth, as it is theoretically committed to doing; (3) its ability to break up large concentrations of wealth across generations; and (4) its promotion of equality of opportunity by ensuring that everyone begins the game of life on a level playing field, so as to ensure equality of opportunity.[117] There are quite compelling counter-arguments to each of these asserted policy rationales, which this Article will not restate.[118] However, there are few comprehensive discussions of these policies in the context of multi-jurisdictional assertions of the tax.[119]

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[116]Such a special purpose inheritance tax may spawn an anti-avoidance regime of its own. For example, if property is transferred to a nonresident alien family member who, in turn, subsequently bequeaths or gifts property to U.S. nationals, will there be a tracing rule? If property is bequeathed by trust giving a second-generation U.S. national heir solely a power of appointment but no right to trust income or assets, will they be taxed? If so, if the power of appointment is to a nonresident alien who then exercises it in favor of the next generation of U.S. national heirs, will this be viewed as a transfer by the expatriate or by the nonresident?

[117]*See generally* Michael J. Graetz, *To Praise the Estate Tax, Not To Bury It*, 93 YALE L. J. 259 (1983).

[118]*See, e.g.*, Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES (TA) 1413 (Sept. 16, 1991).

[119]A rare exception is Cynthia Blum, *U.S. Transfer Taxation of Nonresident Aliens: Too Much or Too Little?*, 14 U. PA. J. INT'L ECON. L. 469 (1994). The OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts (OECD Model Estate Tax Treaty) notes only that the "burden of taxation resulting from the simultaneous levy of the taxes imposed under the domestic laws of several countries is certainly prejudicial to the development of economic relations and in particular to movements of private capital between Member countries." Accepting the premise that multiple transfer taxes on the same wealth may impede the free flow of capital and that this is undesirable as a matter of efficiency and perhaps human rights, this still offers little by way of a principled answer as to how taxing jurisdiction should be apportioned. OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts (1982), *reprinted in* 1 FED. TAX TREATIES (P-H) ¶ 1018, at 1037.

Breaking up large concentrations of wealth and the desire to promote equality of opportunity presumably should not be a concern if the wealth permanently leaves the United States. That concentrated wealth may effect unfortunate results on the polity to which it moves is no concern of the United States. The fact that a nonresident somewhere starts or continues life with an unfair advantage similarly is not a proper United States concern. Legitimate concern arises only if the wealth is in turn inherited by persons within the United States. By that reasoning, however, a bequest to a nonresident should escape the estate tax entirely. Taken to its logical conclusion, therefore, this rationale advocates the adoption by the United States of an inheritance tax rather than an estate tax, a matter beyond the scope of the expatriate tax provisions.

If the estate tax serves as a backstop either to the tax base or the progressivity of the income tax, this would suggest that it should not be avoided by expatriation to any greater extent than the income escapes. The problem is that the estate tax achieves reasonable progressivity only because the burden is assumed to accrue over the entire lifetime of the individual. Accelerating the estate tax at the time income tax is accelerated under the Exit Tax, for example, could be viewed as achieving confiscation rather than progressivity. Absent a principled basis upon which to accrue the estate tax during the period of allegiance, the appropriate progressivity is difficult to achieve. Moreover, the assumption that the tax has less distortionary effect on behavior than an income tax, itself a dubious proposition, loses any currency when the tax is imposed on expatriates.

F. *Conclusions*

To summarize, the regime under prior section 877 was objectionable primarily because it was difficult to administer, which defeats the legitimizing function of the regime. It did not remove incentives to expatriate, in practice, because its enforcement was likely uneven and, in principle, because it failed to tax foreign source income that had accrued economically while the U.S. tax national held that status. It also allowed the expatriate largely to avoid U.S. wealth transfer taxes. From a fairness perspective, it treated resident U.S. tax nationals too favorably as compared to other U.S. resident taxpayers and perpetuated the unfairness inflicted on nonresident tax nationals.

As amended by the 2004 Act, section 877 is certainly an improvement from the standpoint of administrability. But what results from eliminating the vestiges of a tax motivation requirement is a unique territorial or exemption regime of general applicability to persons whose tax national status terminates. Whatever the merits of an exemption system as compared to a worldwide income tax, introducing such a system through the back door as part of an expatriation regime is not appropriate. What is objectionable about the current international approach to nonresident individuals is not that they are taxed on foreign source income but that they are, in violation of international norms, subject to U.S. net income tax at all. From the standpoint of horizontal equity, the expatriate tax framework should have addressed this anomaly first.

The Exit Tax has certain appeal insofar as it moves towards greater tax neutrality. But as argued above, this is ultimately a vain endeavor and necessarily results in unfairness given the inherent unfairness of the system for taxing nonresident U.S. tax nationals. Subjecting to tax the foreign source income and gains that have accrued during the period of nationality by residents is certainly an improvement. However, accelerating the time at which this income is realized detracts from the goal of treating similarly situated taxpayers similarly and appears to be premised on questionable assumptions about improved collection and enforcement. The Exit Tax also exchanges the administrative difficulties of an motive-based regime for the valuation difficulties inherent in marking potentially illiquid assets to market.

VII. A MORE RATIONAL REGIME

Given the competing domestic tax policy goals, international tax norms, and enforcement difficulties described above, is an expatriate tax regime that perfectly reconciles these concerns possible? The answer is, of course, no. Nevertheless, a more rational system than those that have been enacted or proposed is conceivable. The outlines of such a regime are tentatively suggested below.[120]

As certain commentators have recognized, expatriation, like death, represents a final departure from the U.S. tax system. It is, in this sense, a form of "tax death." As a default rule, therefore, a system which imposes an exit tax based on the estate tax ("Departure Wealth Tax") seems to serve the requisite symbolic function more appropriately.[121] Moreover, this would prevent expatriation by citizens who are long-term residents of the United States and have accumulated significant wealth but do not own low-basis assets. If the Departure Wealth Tax is collected, no income tax would be collected, which is functionally the equivalent of permitting the step up in the basis of assets that otherwise would have been available at death. Citizens who are less than 18½ years of age and permanent legal residents who held that status for less than six years, or are deprived of that status involuntarily by an administrative or judicial proceeding, would be exempt from the Departure Wealth Tax.

Imposition of a Departure Wealth Tax admittedly raises the concern, expressed above, that the result should not unduly deter expatriation given its importance as a personal liberty. For example, expatriates effectively would be deprived of a credit for foreign death taxes that might otherwise have been available in connection with the imposition of estate tax and available treaty

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[120]The notion of a regime that "quarantines" assets of expatriates and uses a mark-to-market approach only to measure the amount of accrued tax, rather than assess it, is not original. *See, e.g.*, New York State Bar Association, *Memorandum to the Members of the House Ways and Means Subcommittee on Oversight Re: H.R. 831* (1995), *reprinted in* 1995 Tax Notes Today 62-45 (Mar. 30, 1995). As the letter notes, such a regime resembles the estate tax "Qualified Domestic Trust" (QDOT) under sections 2056 and 2056A. Indeed, the Exit Tax contains the seeds of such a regime in its own qualified trust provisions, although it imposes an interest charge.

[121]Abreu, *supra* note 93, at 1155.

protections. However, the existence of the alternative elective tax described below largely addresses these concerns.[122]

As a condition to avoiding the imposition of the full Departure Wealth Tax, an expatriate would be required to transfer custody of property included in the gross estate to a custodian or fiduciary who agrees to act as a designated expatriate custodian (DEC) and to elect the application of the regime described below. As a condition to the applicability of the DEC approach, the expatriate would be required to waive any treaty protections to which he or she may be entitled with respect to income earned through the DEC.

To be eligible to act as a DEC, an institution or entity would be required to enter into an agreement with the Service, similar to the agreement required of qualified intermediaries.[123] Under the agreement, the DEC would be required to agree to provide information to the tax authorities and submit to an audit of its activities. DECs who so elect and agree with the Service ("Withholding DECs") would be responsible for withholding tax on property transferred to them, would be jointly liable for taxes they fail to withhold as required by law, and would be required to meet specified financial criteria or otherwise satisfy the Service that tax would be collected. Expatriates who transfer property to a Withholding DEC would not be required separately to provide security satisfactory to the Service for payment of the tax described below. Accordingly, security provided by the expatriate to a Withholding DEC would be a matter of private contractual negotiation. This would limit the role of the government in restricting the availability of the elective regime because of legitimate, but perhaps conservative concerns about adequate security for payment of tax. DECs who do not so elect ("Nonwithholding DECs") would be subject to information reporting requirements but the expatriate would be required to provide security satisfactory to the Service in its sole discretion adequate to secure liability for the taxes of the DEC, as under the Exit Tax.

To the extent legal title to property could not be transferred to the DEC, for example due to foreign law restrictions or under the terms of a particular trust instrument, a Withholding DEC would be permitted to treat property designated for inclusion in the arrangement as if it were actually held by the DEC if there are arrangements reasonably calculated to ensure that information about the value and ownership status of the property is available to the DEC. Because it would be directly liable for any tax that it fails to appropriately withhold, it would be in the Withholding DEC's interest to ensure that it has access to such information and adequate security for any such liability.

The DEC would calculate the amount of gain that has economically accrued with respect to the property as the taxpayer otherwise would have to do under

[122]Those who are deeply concerned about this, or object in principle to wealth transfer taxes like the estate tax, can instead assume a system under which the default position is an immediate mark-to-market tax like the Exit Tax.

[123]*Cf.* Reg. § 1.1441-1(e)(5)(ii) (defining a qualified intermediary).

the Exit Tax and compute the tax that would have been due if the property had been sold on the date of transfer (the "Accrued Tax Amount"). This tax would not be due, however, and no underpayment interest would accrue on this amount. Rather, this mark-to-market would serve only to measure the income and gains that have economically accrued prior to expatriation.

An expatriate would be permitted to exclude any gains economically accrued during any cumulative period of five years or more that the expatriate was treated as a resident or domiciliary of a foreign country for purposes of its tax laws and would not have been treated as a resident of the United States applying the "substantial presence" test of section 7701(b). An expatriate would be presumed to have been resident in the United States during the period that he or she is a U.S. citizen or permanent legal resident and could overcome the presumption only by demonstrating by clear and convincing evidence that this test was not met for a particular year. The DEC would be permitted to seek an advance ruling as to the period of nonresidence and the amount of income or gain appropriately excluded in computing the Accrued Tax Amount.

Income realized with respect to assets held by the DEC would be taxed as income of a U.S. citizen. However, the aggregate taxes required to be paid by the DEC would in no event exceed the Accrued Tax Amount and assets could be withdrawn from the DEC arrangement without penalty once the aggregate tax paid by the DEC was equal to the Accrued Tax Amount. The Accrued Tax Amount would be reduced by any foreign income or wealth transfer taxes imposed on the DEC's income or assets by the country in which the expatriate is domiciled or resident for purposes of its tax laws.

Withdrawal of an asset from the DEC prior to satisfaction of the Accrued Tax Amount would be permitted as a matter of law (although the custodian, of course, could impose contractual conditions on such a withdrawal) but would be treated as a taxable disposition. Any borrowing (using principles of section 956) secured by property held, or treated as held by the DEC would trigger an obligation to pay off a portion of the Accrued Tax Amount equal to the lesser of the principal amount of the borrowing or the value of the DEC property securing the borrowing.

The DEC arrangement generally would continue until the earlier of death (at which time any remaining Accrued Tax Amount would be due) or the date on which the Accrued Tax Amount has been fully satisfied.

Special rules would apply when the value of assets has been affected by a fiduciary's exercise of discretion. The DEC would be permitted to seek a valuation agreement with the Service. In the absence of an agreed valuation, these assets would, at the election of the expatriate, either (1) be valued using the maximal allocation presumption similar to the Exit Tax Proposal, or (2) be excluded in computing the Accrued Tax Amount and subject to tax as and when income is realized and recognized under general principles without regard to the Accrued Tax Amount limitation and be fully subject to U.S. estate, gift, and generation-skipping transfer tax.

As discussed above, an arguable flaw under prior section 877, section 877 as amended, and the Exit Tax is that assets largely escape wealth transfer tax. However, it is clearly inappropriate to impose the full estate tax on an accelerated basis at the time of expatriation. Even those who generally endorse the imposition of wealth transfer taxes should accept the idea that the United States should be entitled to capture no more than its expectancy of collecting the estate tax during the period the individual held U.S. nationality. By recourse to mortality tables, which are widely available and used for other purposes of the income and estate tax, it is possible to determine the probability of death by the age at which the individual expatriates. Discounting the estate tax that would have been imposed had the individual died upon expatriation by the probability of death at the relevant age, one can determine the estate tax that has in a notional sense accrued to the United States during the period the individual held U.S. nationality. Accordingly, for estate tax supporters, in lieu of full estate tax, the expatriate could owe a discounted amount on property transferred to the DEC equal to the estate tax discounted to reflect the probability of death prior to the age of expatriation based on actuarial principles ("Adjusted Departure Wealth Tax").[124] The amount of Adjusted Departure Wealth Tax imposed would be deductible in computing taxable income used to determine the Accrued Tax Amount, providing the functional (albeit imperfect) equivalent of a step up in basis to that extent.

The proposed DEC regime shares with the Exit Tax the advantage of reaching all income that has economically accrued prior to expatriation. Unlike the Exit Tax, however, it does not accelerate the time at which tax is imposed, which disadvantages expatriates relative to other U.S. tax nationals. Accordingly, the DEC scheme better satisfies horizontal equity and neutrality concerns. The proposed DEC vehicle would provide a full credit for any foreign taxes imposed on the income following expatriation without imposing, as a price of this relief, a tax on income accrued economically after expatriation. It therefore appropriately addresses international comity concerns. Also, unlike the Exit Tax Proposal, it provides relief to nonresident nationals for gains economically accrued during a substantial period of nonresidence. The DEC proposal is at least as likely to ensure collection of the tax as the Exit Tax. As with any of the regimes, however, a determined expatriate who is willing to flout her legal obligations may escape tax.

This suggestion is not perfect, but appears better calculated to reconcile competing notions of fairness, inter-nation equity, and administrability than the other expatriate tax systems that have been enacted or proposed. Of course, the question remains: whom to impress? Cynics may suspect, perhaps correctly, that the

[124]The approach is admittedly imperfect. For one thing, expected wealth subject to the estate tax over the individual's life is likely to be lower in earlier years than later years so that one could argue that an expatriate is still undertaxed under this method. For reasons of administrative simplicity, however, it seems sensible to ignore such refinements. Recognizing that this approach is imperfect, nonetheless it does in general reach intuitively appealing results. Young expatriates will incur little or no substitute estate tax while the estate tax on the wealthy, old, and infirm may be substantial.

debate over the expatriate tax regime has been intended primarily for the consumption of the domestic electorate rather than to satisfy tax policy objectives. Perhaps the changes to section 877 enacted by the 2004 Act represent the final word. But it is not hard to imagine a change in the political winds that will cause interest in the competing models to reignite.