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tax notes international
Volume 41, Number 10 ■ March 13, 2006

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Reprinted from *Tax Notes Int'l*, March 13, 2006, p. 867

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Viewpoints

The Exit Tax — A Perfectly Bad Idea

by Charles M. Bruce, Lewis Saret, Stéphane Lagonico, and Steve Trow

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All statutory references herein are to the U.S. Internal Revenue Code, unless otherwise stated. The views presented are those of the authors and do not necessarily represent the views of any other person or group.

The US $56 billion to $70 billion tax reconciliation bill (H.R. 4297), which is currently in front of a conference committee of House and Senate members, contains provisions that would impose an exit tax (or mark-to-market tax) on some U.S. citizens and long-term residents.[1] (For H.R. 4297 as amended and passed by the U.S. Senate, see *2006 WTD 28-10* or *Doc 2006-2562*.) Different versions of an exit tax have been proposed several times over the last six to seven years and, in fact, the Senate has passed an exit tax on three previous occasions. While conventional wisdom is that those proposals, which have been voted down in the past, will again be dropped by the conference committee, many people have a queasy feeling this time.

The exit tax is a bad idea for policy and technical reasons. It has been considered in the past and rejected. The Joint Committee on Taxation, in its comprehensive February 2003 study, did not embrace the approach.[2] Not only should it not be enacted into law, but it should also be dropped once and for all. (For the JCT report, see *2003 WTD 31-18* or *Doc 2003-3954*.)

This discussion is summary in nature. Renunciation of citizenship or relinquishment of permanent residency status (both commonly referred to as expatriation) is a very serious step and should only be undertaken after the most careful consideration of all the legal and personal consequences.[3] It is unfortunate that individuals and families must worry about developments like this. They should not have to arrange their lives on short notice around U.S. tax legislative proposals.

Where Do Things Stand?

The exit tax provisions are in the Senate-passed version of H.R. 4297. In the form of S. 2020, they

[1]These are figures for the five fiscal years beginning October 2006 and ending in 2010.

[2]"Review of the Present-Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency," Joint Committee on Taxation, JCS-2-03 (Feb. 2003).

[3]Portions of this article are drawn from congressional materials prepared by the JCT or one of the two taxwriting committees, whose authorship is respectfully acknowledged.

were approved on November 18, 2005. They were added to H.R. 4297 when that bill was taken up and approved by the Senate on February 14. (The bill was labeled the Tax Relief Extension Reconciliation Act of 2005 when it passed the House; the name was changed to the Tax Relief Act of 2005 when it was amended and approved by the Senate.) A conference committee will decide in the coming weeks whether those provisions stay in the bill or are cut out.

There is some chance that the bill, even though reported out by the conference committee, will not become law because the committee's handiwork could be rejected by either or both houses, which would be highly unlikely, or could be vetoed by the president, which again would be highly unlikely. With the Republican Party controlling both houses of Congress and the White House, it is hard to imagine the conference committee's version of the bill not becoming law.

The exit tax is a bad idea for policy and technical reasons. Not only should it not be enacted into law, but it should also be dropped once and for all.

The bill is approximately 400 pages in length and contains roughly 150-200 provisions. The exit tax provisions are included alongside a number of other "revenue offset provisions," meaning provisions that pick up rather than lose revenue. The total revenue raised by the exit tax is estimated to be US $251 million over five years, a pittance in the scheme of things. If something is enacted, this will be the third time in the last decade that Congress has rewritten the rules in the antiexpatriation area.[4]

Who Cares?

That subject is of interest to U.S. nationals (citizens) that may wish to renounce their U.S. citizenship and to U.S. long-term residents (individuals that are lawful permanent residents — typically "green card" holders — in 8 out of the most recent 15 years) that may wish to terminate their permanent residence status. It is also of interest to companies and individuals that are interested in attracting highly skilled immigrants to work in the United States, "accidental Americans" that happen to be U.S. citizens by virtue of birth in the country or birth to a U.S. parent, and immigrants who possess a green card but who might one day want to return, say, to their country of birth.

The provisions affect more than just wealthy Americans that want to stop paying tax in the United States, which is a very small group consisting of perhaps two dozen millionaires per year. Those provisions also affect tens of thousands of individuals who are dual nationals — that is, of U.S. and some other nationality — because they were born in the United States or were born to a U.S. parent.[5] Many of those individuals live outside the United States. Also, those provisions also affect many thousands of long-term residents (that is, individuals who came to the United States and ended up staying for one reason or another). Surprisingly, there are large numbers of green card holders living in places like London, Paris, Geneva, Hong Kong, and Taipei.

Dual nationals and long-term residents must be concerned because the existing rules for taxation of expatriating individuals would be changed by the exit tax provisions. If they were to renounce or relinquish their residency status after the effective date of the new law, they would be penalized. The effective date, as drafted now, is the date of enactment — that is, the date the president signs the bill into law.

The effective date is anyone's guess; it could be March 15 or April 15 or any other date in the not-too-distant future. Indeed, it is entirely possible that those new rules will not be enacted during this Congress.

Obviously, the dilemma for individuals who might be affected is: Should I do something now? Complicating the matter is the fact that it is very difficult to complete a renunciation in less than several weeks, and that period can be significantly longer if it is necessary to "catch up" with past due filings. A renunciation will not be effective for U.S. income tax purposes until the individual can attest that he or she is fully compliant with all tax filings. Relinquishment of a green card can proceed much quicker.

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[4]Added by P.L. 89-809 (Foreign Investors Tax Act of 1966, P.L. 89-809, 89th Cong., 2d Sess. (1966)). Amended by P.L. 109-135 (technical correction), P.L. 108-357, P.L. 105-34, P.L. 104-191, P.L. 104-188, P.L. 102-318, P.L. 99-514, P.L. 96-222, P.L. 95-600, P.L. 94-455 (Deadwood Act), and P.L. 93-406. The rules were overhauled in 1996 in the Health Insurance Portability and Accountability Act and again in 2004 in the American Jobs Creation Act of 2004 (P.L. 108-357).

[5]These individuals might be born in the United States of a non-U.S. parent who was a foreign worker, student, exchange visitor, business visitor, or tourist that came to the country with a spouse or partner. Many of those individuals are not current in their U.S. income tax and in reporting the filing of forms, which includes Treasury Department Form 90-22.1, Report of Foreign Bank and Financial Accounts.

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What Are the Rules Now?

General Rules

U.S. citizens and residents are generally subject to U.S. income tax on their worldwide income, regardless of source, residence, or location, and to U.S. estate tax on their "deathtime" transfers and to gift tax on their "lifetime" transfers, regardless of where their property is located.

Also, while often overlooked, U.S. citizens and residents must file annual Foreign Bank Account Reports (FBAR), reporting all non-U.S. bank, brokerage, and other financial accounts that they own or control. That is a nontax, Bank Secrecy Act law with USA Patriot Act undertones. It is a subject unto itself, which will not be dealt with here.[6]

1995-2004 Tax Rules

For individuals who expatriated between February 6, 1995, and June 3, 2004, for a 10-year period after a U.S. citizen renounced his United States citizenship or a long-term resident terminated his U.S. residency with a "principal purpose of avoiding U.S. taxes," those individuals became subject to an alternative method of income taxation, rather than that generally applicable to nonresident aliens.

Those individuals generally were made subject to income tax only on U.S.-source income at the rates then applicable to U.S. citizens.

Individuals who relinquished citizenship or terminated residency were treated as having done so — that is, presumed to have done so — with a principal purpose of tax avoidance and, therefore, were generally subject to the alternative tax regime if: (a) their average annual U.S. federal income tax liability for the five tax years preceding citizenship relinquishment or residency termination exceeded US $100,000; or (b) their net worth on the date of relinquishment or termination equaled or exceeded US $500,000. Those amounts were adjusted annually for inflation.

Some categories of individuals (for example, dual residents) could avoid being deemed to have had a tax avoidance purpose by obtaining a ruling from the IRS in some circumstances.

Antiabuse rules were provided to prevent the circumvention of the alternative tax regime. Special estate and gift tax rules similarly applied. The estate tax rules applied to tax transfers of U.S.-situs, but not foreign-situs, property, including the decedent's pro rata share of the U.S. property held by a foreign corporation.

U.S. citizens who renounced citizenship and long-term residents who terminated residency generally were required to provide information about their assets held at the time of expatriation. However, that information was required only once.

The Reed Amendment

Apart from tax rules, in 1996 Congress enacted amendments to the immigration law prohibiting individuals who renounce U.S. citizenship for purposes of avoiding taxation from entering the United States — the so-called Reed amendment.

> ***If dual nationals and long-term residents were to renounce or relinquish their residency status after the effective date of the new law, they would be penalized.***

Under that provision, any alien who is a former citizen of the U.S. who officially renounced U.S. citizenship and who is determined by the U.S. attorney general to have renounced citizenship for the purpose of avoiding taxation by the United States is inadmissible; that is, he can be prevented from entering the country. If the individual flunked one of the two monetary thresholds in the tax provisions (see above), he automatically — at least on the face of things — fell within the reach of that very punitive immigration rule. The tax rules treated the individual as having expatriated for tax avoidance purposes, and therefore the immigration authority needed only, in effect, to adopt that finding for purposes of applying the immigration rule.

The Reed amendment has never been officially applied to exclude (refuse entry to) any individual because, among other reasons, the attorney general has never been authorized to obtain the necessary tax returns and other tax information.[7]

Today's Rules

In 2004, effective for expatriations (relinquishments or renunciations) after June 3, 2004, more objective and somewhat simplified rules came into existence. Those rules are the ones in effect today, and they will remain in effect until amended:

- *Objective Standards for Determining Whether Former Citizens or Former Long-Term Residents Are Subject to the Alternative Tax Regime*. The 2004 Jobs Act replaced the subjective determination of tax avoidance as a principal

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[6]For an explanation of these rules, see Bruce and Saret, "Foreign Bank Account Report (TD F 90-22.1): Tricky Turns Dangerous" (BNA, June 9, 2003).

[7]The authors believe that some consular officers in American embassies have unofficially, and improperly, applied the rule to refuse to grant a visa to a former U.S. citizen.

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purpose for renunciation of citizenship or relinquishment of permanent residency status with objective rules. A former citizen or former long-term resident will be subject to the alternative tax regime for a 10-year period following renunciation or relinquishment, unless, in general, he: (1) establishes that his average annual net income tax liability for the five preceding years does not exceed US $124,000 (adjusted for inflation after 2004) and that his net worth does not exceed US $2 million; and (2) certifies that he has complied with all U.S. federal tax obligations for the preceding five years and provides such evidence of compliance as may be required. If a former citizen exceeds either or both of the monetary thresholds set forth immediately above, that person can still be excluded (excused) from the alternative tax regime under extraordinary circumstances, which are defined in detail. Interests in trusts are taken into account. IRS Notice 97-19, issued under a prior set of provisions, provides detailed information and examples on point.

- *Tax-Based (Instead of Immigration-Based) Rules for Determining When an Individual Is No Longer a U.S. Citizen or Long-Term Resident for U.S. Federal Tax Purposes.* An individual continues to be treated as a U.S. citizen or long-term resident for U.S. federal tax purposes until he: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the secretary of state or the secretary of homeland security, respectively; and (2) provides a statement in accordance with the reporting rules in section 6039G. Form 8854, "Initial and Annual Expatriation Information Statement," as revised in May 2005, must be filed. Existing practice in an oath of renunciation procedure is to file one original with the consular officer at the embassy and a second with the IRS service center in Philadelphia.

- *Imposition of Full U.S. Taxation for Individuals Who Are Subject to the Alternative Tax Regime and Who Return to the United States for Extended Periods (the 30-Day Rule).* The alternative tax regime does not apply to any individual for any tax year during the 10-year period following citizenship relinquishment or residency termination if that individual is present in the United States for more than 30 days in the calendar year ending in that tax year. (In limited circumstances, that 30-day figure can be increased to 60 days.) Instead, that individual is treated as a U.S. citizen or resident for that tax year and thus is taxed on his worldwide income. That rule does not apply to those individuals who are deemed not to have renounced or relinquished for tax purposes because they do not meet the monetary thresholds. It is not clear what happens if a person flunks in one year and passes in the next; there are, however, anti-"in-and-out" rules in section 7701(b)(10) (coordination with section 877).

- *Imposition of U.S. Gift Tax on Gifts of Stock of Some Closely Held Foreign Corporations That Hold U.S.-Situated Property.* Special antiabuse rules were added to apply the U.S. gift tax to some types of gifts. In those instances, the taxpayer is the donor/former U.S. citizen or resident alien.

- *An Annual Return Filing Requirement for Individuals Who Are Subject to the Alternative Tax Regime, for Each of the 10 Years Following Citizenship Relinquishment or Residency Termination*. Former citizens and former long-term residents that are subject to the alternative tax regime are required to file an annual return for each year following renunciation or relinquishment or residency. The annual return is required even if no U.S. federal income tax is due. The annual return requires specific information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. The penalty for failure to file or failure to correctly include all required information is generally US $5,000. It is not clear whether an individual subject to this return filing requirement must file the nontax FBAR forms.

The Treasury secretary, in addition, is required to publish in the *Federal Register* the names of all former citizens that have in one way or another renounced or otherwise lost U.S. citizenship.

Several things should be noted about the rules that exist today:

- Those new rules are far clearer and easier to work with than the predecessor rules. For individuals whose recent average tax liability and current net worth do not exceed the US $124,000 and US $2 million levels, after expatriating there is no further obligation to report or pay taxes.
- If the expatriate is subject to the alternative tax regime for the 10-year period, only U.S.-source income is subject to tax. Income from salary or consulting fees earned outside the United States is not taxed. Also, income from the sale of non-U.S. securities is not taxed.
- The 30-day rule can be a problem. However, it does not apply to individuals falling below the monetary threshold. Others will simply have to live with the rule.

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- Many people, including the spouse of the principal “bread winner” or a child, ordinarily will be able to renounce or relinquish without exceeding the monetary thresholds.
- The issue often is not imposition of the tax rules but imposition of the immigration-based sanctions. Persons that are determined to have relinquished U.S. citizenship for tax purposes can be excluded, under the Reed amendment, discussed above, from entering the country by the U.S. Citizenship and Immigration Services (which is now part of the Department of Homeland Security). Regulations under the Reed amendment have not been promulgated, and that power has never officially been invoked.
- The tax rules enacted in 2004 have been stripped of any tax motivation; that is, they operate without any regard to tax motivation. It can no longer be said, therefore, that a person who is “caught” by the tax rules has expatriated with a principal purpose of tax avoidance. Developments regarding those immigration rules should nonetheless be carefully watched.

Tomorrow’s Rules — Will They Include an Exit Tax?

What might be enacted in the coming weeks is a form of exit tax. (Congress and the Treasury Department prefer calling it a mark-to-market tax.)

That approach was proposed by the Clinton administration in February 2000. Several members of Congress, including Rep. Charles B. Rangel, D-New York, who is a conferee on the conference committee on H.R. 4297, offered proposals along the same lines in 1999 and 2002. In 2002 the Senate approved an amendment to a House-passed bill that looked very similar to the proposal that was approved by the Senate last November. There are subtle differences in all those proposals. We will focus only on the version currently being considered.

Those provisions arose as part of the version of the tax bill proposed by Senate Finance Committee Chair Chuck Grassley, R-Iowa, when it came through his committee. It is believed that Grassley, assisted by the Senate Finance Committee staff, simply reached for proposals that previously had been adopted by the committee or the Senate as a whole but not enacted into law. In other words, they pulled old proposals off the shelf.[8]

In General

The Senate bill subjects some U.S. citizens who relinquish their citizenship and long-term U.S. residents who terminate their residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the relinquishment or termination.

Gain from the deemed sale will be taken into account at that time without regard to other tax code provisions; any loss from the deemed sale generally will be taken into account to the extent otherwise provided in the code. Presumably the gain will be ordinary income or capital gains as provided under normal rules.

Any net gain on the deemed sale is recognized to the extent it exceeds US $600,000 (US $1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The US $600,000 amount is increased by a cost-of-living adjustment factor for calendar years after 2005.

Individuals Covered

The exit tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term resident if he was a lawful permanent resident for at least 8 out of the 15 tax years ending with the year in which the residency termination occurs. A number of details and a few highly circumscribed exceptions can apply.

Election to Be Treated as a U.S. Citizen. An individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen regarding all property that otherwise is covered by the expatriation tax. That election is an “all-or-nothing” election; an individual cannot pick and choose properties to which it will be applied.

The individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. Also, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes.

To make that election, the individual is required to waive any treaty rights that would preclude the collection of the tax. The individual also would be required to provide security to ensure payment of

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[8]Because unusually no committee report accompanied the bill when reported by the Senate Finance Committee, we have had to rely on the statutory language of the bill and on the Senate Finance Committee tax staff’s 21-page memorandum entitled “Summary of Tax Relief Act of 2005,” dated November 18, 2005. The memorandum is available at http://finance.senate.gov/sitepages/leg/111805legbill.pdf. *See also*, “Review of the Present-Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency,” Joint Committee on Taxation, JCS-2-03 (Feb. 2003), describing prior versions of the exit tax.

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the tax. The amount of tax that would have been owed but for this election (including any interest, penalties, and some other items) will constitute a lien in favor of the U.S. government on all U.S.-situs property owned by the individual.

Date of Citizenship Relinquishment. The bill sets forth rules for establishing the date of relinquishment. In the most common case, that will be the date the individual swears or affirms his oath of renunciation in front of a consular officer and witnesses. For U.S. State Department purposes, the process is not complete until the individual receives a Certificate of Loss of Nationality (CLN) signed by the State Department in Washington, but he or she is treated as having "renounced" as of the date of the taking of the oath of renunciation. It can take several months for a CLN to be issued.

Deemed Sale of Property on Expatriation. The deemed sale rule generally applies to all property interests held by the individual on the date of citizenship renunciation or residency termination. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax under the existing Foreign Investment in Real Property Tax Act, generally are excepted from the tax.

Tax is due on the 90th day after the date of expatriation (renunciation or termination).

Retirement Plans and Similar Arrangements. Special rules apply to employer-sponsored retirement plans or deferred compensation arrangements, as well as interests in an individual retirement account or annuity.

Deferral of Payment of Tax. An individual can elect to defer payment of the mark-to-market tax, in which case interest will be charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments (currently 5 percent rather than 3 percent).

Detailed rules spell out how that deferral is effected and how the government is secured. Death of the individual abruptly ends the deferral.

Interests in Trusts. Trusts pose special problems. Detailed rules apply to trust interests held by an individual at the time of citizenship relinquishment or residency termination. The treatment of trust interests depends on whether the trust is a qualified trust.

A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust. (This coincides with the definition of domestic trust in section 7701(a)(30).)

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying those provisions.

Also, an individual who holds (or who is treated as holding) a trust interest at the time of expatriation is required to disclose on his or her tax return the method used to determine his or her interest in the trust and whether that individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the exit tax due regarding that trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to that interest. That separate trust is treated as having sold its net assets as of the date of citizenship relinquishment or residency termination and having distributed the assets to the individual, who then is treated as having recontributed the assets to the nonqualified trust.

The rules of section 6324A(d)(1), (3), and (4) (regarding liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under that provision. The individual is subject to the exit tax regarding any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the exit tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments (currently this figure would be 9 percent).

A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and the historical pattern of trust distributions.

If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of citizenship relinquishment or residency termination. In determining that amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (that is, the individual is allocated the maximum amount that he or she could receive).

The exit tax imposed on such gains is collected when the individual receives distributions from the trust or, if earlier, upon the individual's death. Interest is charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments.

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If an individual has an interest in a qualified trust, the individual is subject to the exit tax upon the receipt of distributions from the trust. Those distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual expatriates, the exit tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event, mercifully, will the tax imposed exceed the deferred tax amount regarding the trust interest.

For this purpose, the deferred tax amount is equal to: the tax calculated regarding the unrealized gain allocable to the trust interest at the time of citizenship relinquishment or residency termination, increased by interest thereon, and reduced by any exit tax imposed on prior trust distributions to the individual.

If any individual's interest in a trust is vested as of the citizenship relinquishment or residency termination date (for example, if the individual's interest in the trust is noncontingent and nondiscretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the citizenship relinquishment or residency termination date (for example, if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined, not so mercifully, by resolving all contingencies and discretionary powers in the individual's favor.

In the case in which more than one trust beneficiary is subject to the exit tax regarding trust interests that are not vested, the rules are intended to apply so that the same unrealized gain regarding assets in the trust is not taxed to more than one individual.

The exit tax becomes due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of exit tax equals the lesser of: (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event; or (2) the deferred tax amount regarding the trust interest as of such date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax regarding those distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against that individual regarding the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies. The creation of liability for the trustee is especially noteworthy.

Coordination With Present-Law Alternative Tax Regime. The existing expatriation income tax rules in section 877 and the accompanying expatriation estate and gift tax rules will not continue to apply to a former citizen or former long-term resident whose expatriation occurs on or after the date of enactment of the new provisions. A conforming amendment at section 422(e) of the Senate version of the bill, adding new section 877(h), states, "This section shall not apply to an expatriate (as defined in section 877A(e)) whose expatriation date (as so defined) occurs on or after the date of the enactment of this subsection."

Treatment of Gifts and Inheritances From a Former Citizen or Former Long-Term Resident. The exclusion from income for the value of property acquired by gift or inheritance (section 102) generally will not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (that is, an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to some exceptions regarding dual citizens and minors.

Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of that gift or inheritance in gross income and is subject to U.S. tax on that amount. Having included the value of the property in income, the recipient would then take a basis in the property equal to that value.

The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or to property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules).

Also, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, when no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

The practical considerations attached to a wholly discretionary foreign trust when the class of beneficiaries can be expanded or contracted are formidable. There will also be problems for a beneficiary needing to obtain information about a trust. For

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example, the beneficiary may not be entitled to information concerning a letter of wishes or distributions to other beneficiaries. Also, how a recipient of a gift or bequest is supposed to know about the citizenship or residency of the donor or deceased is not explained.

Information Reporting. The Senate-passed provisions provide that some information reporting requirements under present law applicable to former citizens and former long-term residents also apply for purposes of those provisions.

Immigration Rules. The immigration rules that deny tax-motivated expatriates reentry into the United States would be modified to remove the requirement that the citizenship relinquishment be tax-motivated, and instead former citizens would be denied reentry if the individual is determined not to be in compliance with his tax obligations (regardless of the subjective motive for expatriating).

For that purpose, the amendment permits the IRS to disclose some items of return information of an individual, upon written request of the attorney general or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act.

Specifically, the amendment would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether that taxpayer is in compliance with section 877A and to identify the items of noncompliance.

It is worth noting that the provision in effect creates a truly draconian penalty for failure to file proper returns; one loses his ability to ever enter the country.

Effective Date. The provisions as approved by the Senate generally are effective for U.S. citizens who relinquish their citizenship or long-term residents who terminate their residency on or after the date of enactment, whenever that is. Date of enactment, of course, is the date that the legislation is signed into law by the president.

The provisions regarding gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after the date of enactment, whose citizenship relinquishment or residency termination occurs on or after that date; therefore, individuals that expatriated in the past, and their children, can heave a sigh of relief.

The provisions of the bill regarding former citizens under U.S. immigration laws likewise are effective on or after the date of enactment.

Some significant points to note are:

- The new rules do not sit on top of the existing rules. The existing provisions of the code do not apply to individuals that are subject to new section 877A. That means, among other things, that the monetary thresholds in section 877 will have no application. The alternative tax regime for taxing U.S.-source income for a 10-year period will not apply. The physical presence rules intended to penalize expatriates that return to the United States for extended periods of time (typically 30 days) will be irrelevant.
- The provision taxing gifts and bequests from tax expatriates goes beyond the bounds of enforceability and sets a dangerous precedent. As noted, how will a recipient know whether her uncle renounced U.S. citizenship after such-and-such date? Will the IRS maintain a database for all to access? The existing rules for reporting, but not paying tax on, large foreign gifts and bequests do not require disclosure of the donor or deceased. Will that form be changed? The size of payments from the United States to persons in other countries is very large; a significant number of those payments come from individuals who have emigrated from another country to the United States, losing their former citizenship in the process. Will the tax authorities of those other countries want to follow suit and tax recipients of gifts and bequests in the same way?
- The provisions targeted at individuals with interests in domestic and other trusts break new ground in draftsmanship and may be almost unenforceable.
- Those provisions, as unique as they are, are estimated to pick up only US $251 million over five years — a relatively small amount when viewed in the context of a US $56 billion to $70 billion act. Of course, these estimates do not include offsetting estimates for losses in revenues from highly talented individuals or well-capitalized entrepreneurs who may be dissuaded from establishing U.S. residency or citizenship.

What Is the Likelihood of Enactment?

No one knows. As unsatisfactory an answer as that is, that is the case.

The provisions are buried in a large piece of legislation. They have not received much attention. There apparently are no interested parties speaking out. The administration has not stated its position on the subject. The provisions may slide by simply because the revenue pickup is needed to meet a target figure, without regard to any other considerations.

When Might Those Provisions Come Into Existence?

Again, it is impossible to say. They may never be enacted.

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If enacted, they probably — no guarantee — would become law in the next 30 to 45 days. The conference committee, it is thought, will begin work soon. To become law, the exit tax provisions have to be approved by the conference committee, the conference committee's report has to be adopted by both the House and the Senate, and the president has to sign the bill into law. As drafted, those provisions would not become effective until the president signs the bill.

Practical Considerations

Here are some important practical considerations. Some will militate in favor of acting quickly. Others may lead the individual to want to wait until the new rules are in place. As can be seen, the landscape is strewn with tricky technical and judgmental issues.

A. If one were considering expatriating at some time and had property with large amounts of built-in gain, he probably should think about doing that before enactment of this bill in order to avoid the exit tax. The provisions for taxing U.S. beneficiaries of gifts and bequests in many cases also will be a significant detriment. Also, in particular cases, the provisions targeted at beneficiaries of a trust can create serious problems and invite tortuous audits.

It is difficult if not impossible to renounce U.S. citizenship on short notice. It normally requires several weeks. State Department forms need to be filled out and presented in advance. An appointment with a consular officer must be made. The tax form (Form 8854) must be completed. Of course, a renunciant must have a satisfactory "other" nationality.

Also, if the expatriate is not current with his tax filings, those have to be brought up to date. An individual renouncing citizenship or terminating long-term residency must certify that he has complied with all U.S. federal tax obligations for the preceding five years and must provide such evidence of compliance as may be required. Otherwise, he will be treated for tax purposes as not having renounced; in other words, he will be a U.S. taxpayer even though he is for immigration purposes an alien. Terminating permanent residency status can be accomplished relatively quickly.

B. If one did not have property with built-in gain in excess of the US $600,000 exemption level — for example, if he had mainly cash and cash equivalents — he might prefer to be under the new rules. That individual would not have to face the provisions taxing future U.S.-source income, and he would not have to worry about the 30-day rule. If that individual was not too concerned about the taxing of U.S. recipients of gifts and bequests, that would act as further encouragement to wait to expatriate.

The Conference Committee Should Not Agree to an Exit Tax

The conference committee should reject the provisions. No one is particularly worried about wealthy individuals renouncing their U.S. citizenship. Those individuals can bring their U.S. income tax burden down to an acceptable level in a dozen ways. The capital gains rates, which are addressed elsewhere in the bill, are a major factor, as are tax-exempt bonds and pension arrangements. Also, death taxes are steadily being reduced or eliminated. In any event, the existing rules provide an effective deterrent. The focus when considering an exit tax should be on dual residents, especially accidental Americans and long-term residents (immigrants).

Aspects of the exit tax, as a practical matter, are frankly unenforceable.

Imposition of an exit tax will discourage highly skilled immigrants from coming to and staying in the United States.[9]

An exit tax will cause people wanting to work in the United States to avoid applying for a green card. The avenue of choice will become one of the nonimmigrant visas. Those include specialty workers (H-1B), intracompany transferees (L-1), treaty traders and investors (E-1/E-2), persons of extraordinary ability (O-1), artists and entertainers (P-1/-2/-3), religious workers (R-1), and North American Free Trade Agreement treaty professionals (TN). The system will become more problematic and more arbitrary. The H-1B category is already overrun. The treaty trader/treaty investor (E-1/E-2) category is only available to nationals of a country that has a Treaty of Friendship, Commerce, or Navigation or equivalent treaty with the United States.[10]

Aspects of the exit tax, as a practical matter, are frankly unenforceable. Since the tax is not actually

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[9]A recent book, *Flight Capital*: *The Alarming Exodus of America's Best and Brightest*, by David Heenan, argues that America should guard against losing the best and the brightest of its immigrants. Large numbers of physicists, computer scientists, mathematicians, and other highly skilled contributors to the U.S. economy are vital to America's prosperity. It is hard to imagine a measure better calculated to do exactly the opposite than an exit tax.

[10]For an excellent discussion of U.S. nonimmigrant rules and statistics, see "Temporary Migration to the United States: Nonimmigrant Admissions Under U.S. Immigration Law," Research and Evaluation Division, U.S. Citizenship and Immigration Services, Office of Policy and Strategy (January 2006).

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collected before or at the time of expatriation, if it is not paid, it will in all likelihood have to be collected from an individual living outside the United States with assets outside the country. There is no mechanism for doing that. A U.S. individual receiving a bequest from her aunt in Germany has no way of knowing reliably that her aunt resided years ago in the United States as a legal resident for eight or more years before leaving. How can the IRS realistically hope to catch transfers that pass from the aunt to someone else, from that person to a third person, and from that person to the U.S. recipient? Those cases involve individuals and families, not big companies with audit committees and armies of accountants and attorneys, all subject to the Sarbanes-Oxley rules. Also, since the exit tax creates a deemed sale, often it will engender difficult valuation problems.

The tax on gifts and bequests to U.S. persons is remarkable in its application and sets a very bad precedent.

The tax on gifts and bequests to U.S. persons is remarkable in its application and sets a very bad precedent. It is unclear whether the provisions apply to property acquired outside the United States after expatriating. If it applies only to property existing at the time of expatriation, which would be one way of interpreting the cross-referencing in the provision, then expatriates and their executors will need to trace the origins of gifts and bequests, which again raises practicality issues.

The rules set a bad precedent and risk upsetting the international norm applicable to the taxation of remittances. Most countries do not tax the receipt of an intrafamily gift or bequest. Certainly the United States does not. If the United States chooses to tax, say, a family member who remains in the country on remittances from a father who has moved back to his native country, why shouldn't countries that currently do not tax remittances from citizens that have emigrated from that country to the United States change their rules? The tax treatment of remittances is an enormously important subject, and changes should be approached with great care.[11]

The rules for taxing the act of expatriation have changed three times over the last 10 years. The IRS tax rules sit alongside USCIS (immigration), State Department, and Social Security Administration rules. Everyone, including the consular officers that oversee the renunciation process, needs a breathing spell. Enacting a set of exit tax rules that increases the complexity of this part of the code exponentially would not be welcome, we suspect, in any quarter.

The application of the exit tax, in fact, can be quite arbitrary. Not "hit" — that is, not treated as a "covered expatriate" — is an individual who became at birth a citizen both of the United States and another country, who as of the date of renunciation continues to be a citizen of and is taxed as a resident of the other country, and who has not been a resident of the United States during the most recent five years. Thus, if A was born in the United States of German parents and at the time of renunciation continues to reside in and pay taxes in Germany, and has not resided in the United States at any time during the last five years, he is not taxed. If the same facts apply, but the country is Saudi Arabia rather than Germany, the individual apparently is taxed; Saudi Arabia does not have an income tax. The same problem would arise regarding Bermuda. Also, A would be taxed if instead of living in Germany, he took advantage of the European Union rules for free movement of people to work in the United Kingdom. (Perhaps he could move back to Germany for a few months, but it seems odd to make that a requirement.)

Also not hit is a young person who renounces before attaining age 18½, but only if he or she has resided in the United States for not more than five years before renunciation. Therefore, not even all minors will be exempted. Of course, there probably will not be many wealthy minors that will actually incur the tax; if such a person exists, presumably the family can send them away from the United States before crossing over the five-year line, but again it is peculiar to be forcing families to perform such maneuvers.[12]

The exit tax affects long-term residents in especially perverse ways. The counting of the years — 8 out of the most recent 15 — picks up years before the effective date of the bill. For example, B obtained a green card in 1998. If he returns to his native country, say, Italy, in 2007, he will be taxed as a relinquishing long-term resident. There is no relaxation or transition rule.

There will be problems with the timing of a long-term resident's relinquishment. Normally, it will be the date he hands in his green card.[13] There

[11]*See* http://migration.ucdavis.edu/mn/data/remittances/remittances.html.

[12]Oddly, there are immigration law problems for parents who would like to renounce the citizenship of a child; this is very difficult to accomplish. The easiest way is to wait until the child is 18 and then have the child go through the process.

[13]This step is best done by meeting with a consular officer at one of the American Embassies, handing the officer the

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are, however, a large number of green card holders that have abused the system by, in fact, residing outside the United States and not paying U.S. taxes. If caught, their green card will probably be taken away by an immigration inspector and they may well be treated for immigration purposes as having relinquished the green card at some point in the past; yet they will not have relinquished for tax purposes because they are not current with their U.S. taxes and they have not filed the necessary tax form.[14] That leaves the whole matter in a very messy state. Simply leaving the United States without handing in the green card but not paying U.S. tax and not filing FBAR reports is obviously a bad idea. That person is not entitled to permanent residency status any longer and yet is subject to all the U.S. tax and related rules. If the new US-VISIT procedures for tracking entries and exits are extended to green card holders, that will make it difficult for people simply to fade into the background. Also, while not in place today, the day will come when the enforcement of the various day-counting and other rules is greatly improved by information sharing between the immigration authorities and the IRS.[15]

Conclusion

The conferees should discard the exit tax proposal. In doing so, they should make clear that this type of proposal would not simply be put back on the shelf but retired for all time. Even the cloud of an exit tax will discourage talented and well-to-do immigrants from coming to the United States. It is a perfectly bad idea. ◆

green card, getting a receipt, and, at the same time, giving the officer a copy of Form 8854. The original form should be mailed to the IRS service center in Philadelphia. Simply handing the green card to a USCIS official at a port of debarkation will not accomplish relinquishment for tax purposes.

[14]Form 8854 (Rev. May 2005), "Initial and Annual Expatriation Information Statement."

[15]"As House taxwriters on February 16 explored loosening some of the IRS's disclosure restrictions, a Homeland Security Department official revealed that the White House is working on a legislative proposal to use confidential tax information for immigration law enforcement and antiterrorism." Allen Kenney, "White House Plans to Roll Out Disclosure Modifications, Security Official Says," *2006 TNT 33-1* or *Doc 2006-3233* (Feb. 17, 2006).

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