TAX REVIEW

NO. 154

PROPOSED EXPATRIATION RULES

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April 12, 1995

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Jurisdictional Framework/Background

U.S. citizens and aliens considered to be resident in the United States for income tax purposes[1] are subject to U.S. Federal income tax on their worldwide income.[2] Furthermore, such individuals may be subject to tax on all or a portion of the income of certain non-U.S. corporations under the controlled foreign corporation ("CFC") rules or[3] the foreign personal holding company ("FPHC") rules,[4] or by making an election under the passive foreign investment company ("PFIC") rules.[5]

In addition, the estate of a U.S. citizen or an alien domiciliary of the United States is subject to U.S. Federal estate tax on the value of all worldwide assets owned, or considered to be owned, on the date of death of the decedent.[6] Similarly, an inter-vivos gift of any property, regardless of where situated, made by a U.S. citizen or an alien domiciliary of

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1 IRC section 7701(b).

2 IRC section 1. However, certain bona-fide residents of Puerto Rico are not subject to U.S. Federal income tax on Puerto Rican source income. IRC section 933.

3 IRC section 951 et. seq.

4 IRC section 551 et. seq.

5 IRC sections 1293 and 1295.

6 IRC section 2001.

the United States is subject to a gift tax which is creditable against the estate tax.[7]

By contrast, the United States exercises only limited income taxing jurisdiction over aliens who are not considered to be resident for U.S. income tax purposes, and only limited gift and estate tax jurisdiction over inter-vivos gifts and the estates of aliens who are not U.S. domiciliaries. Thus, for example, an alien who is not a resident of the United States for income tax purposes (a nonresident alien) is subject to U.S. Federal income tax at the same rates applicable to U.S. persons only on income which is, or is considered to be, effectively connected with the conduct of a U.S. trade or business, and is subject to U.S. federal income tax at a 30 percent rate on certain categories of non-effectively connected U.S. source fixed or determinable income,[8] with the tax on the latter category of income usually collected by withholding at source.[9] A nonresident alien is not subject to U.S. Federal income tax on non-U.S. source income unless such income is considered to be effectively connected with the conduct of a U.S. trade or business;[10] and non-U.S. source income can be considered to be

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[7] IRC sections 2501 and 2012.

[8] IRC sections 861, 862, 863 and 871.

[9] IRC section 1441 et. seq.

[10] IRC section 871.

effectively connected with the conduct of a U.S. trade or business in only limited circumstances.[11] Thus, for example, a nonresident alien will not be subject to U.S. Federal income tax on non-U.S. source compensation, and ordinarily will not be subject to U.S. Federal income tax on capital gain,[12] or non-U.S. source interest or dividends.

The estate of an alien who was not domiciled in the United States upon his death is subject to estate tax only on the value of U.S. situs property owned at death.[13] Thus, an alien who is not a U.S. domiciliary may shield his U.S. situs assets from estate tax by holding such assets through a foreign corporation.[14] Since shares of a foreign corporation would generally not constitute U.S. situs property, ownership of shares of a foreign corporation at death would not ordinarily attract a U.S. estate tax. Moreover, an alien who is not domiciled in the United States is ordinarily not subject to gift tax with respect

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[11] IRC section 864(c)(4).

[12] But *Cf*. IRC section 897 (relating to FIRPTA), and IRC section 871(a)(2). *See* also IRC section 865.

[13] IRC sections 2103, 2104 and 2105.

[14] Whether such ownership would be cost effective after taking into account the present value of the excess of the corporate tax rate over the individual tax rate is another matter.

to intangible property, wherever situated, and other non-U.S. situs property.[15]

Income, estate and gift tax treaties to which the United States is a party modify certain of the rules described above. However, U.S. tax treaties generally do not confer benefits with respect to U.S. taxes, on U.S. citizens,[16] and in certain cases former citizens.[17]

As a result of the limited tax jurisdiction asserted by the United States over the income and assets of individuals who are non-U.S. persons, there was a concern that a U.S. citizen might wish to change his status to a non-U.S. person (by relinquishing U.S. citizenship). Out of this concern, the present expatriate provisions were enacted as part of the Foreign Investment Tax Act of 1966.[18]

The Current Expatriate Provisions

As noted above, the tax jurisdiction which the United States exerts over a nonresident alien is substantially narrower than that exerted over a U.S. citizen or resident. Anticipating that certain U.S. individuals might be inclined to consider taking advantage of the more limited tax jurisdiction imposed on

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15 IRC sections 2501(a)(2) and 2511(a).

16 *See*, e.g., U.S.-Japan Income Tax Treaty, Art. 4(3).

17 *See*, e.g., U.S.-Netherlands Income Tax Treaty, Art. 24(1).

18 IRC sections 877, 2107 and 2501(a)(3).

nonresident aliens by changing their status from U.S. citizens to aliens, three provisions were added to the Code, the so-called expatriate provisions, the objectives of which were to make it more difficult for such badly motivated persons to obtain the full benefit of the narrower tax jurisdiction exerted over nonresident aliens.

Section 877

Section 877 provides that an individual who relinquishes his U.S. citizenship with a principal purpose of avoiding U.S. taxes[19] will for a ten-year period immediately preceding the close of the taxable year preceding the loss of citizenship be subject to U.S. tax at the higher of (a) the tax that would be imposed generally on nonresident aliens under

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[19] It should be noted that the IRS must first establish that it is reasonable to believe that the expatriation would, but for the application of section 877, have the effect of a substantial reduction in worldwide taxes. Once that is established, the taxpayer has the burden of proving that his expatriation did not have the proscribed principal purpose. IRC section 877(e). In most instances, where considerable income arises shortly after the expatriation which would be taxed more favorably under the tax regime for nonresident aliens, it appears the IRS will be able to meet its burden, and the taxpayer will not be able to meet his burden. *See Max Kronenberg*, 64 TC 428 (1975); *Di Portonova v. U.S.*, 82-2 USTC ¶9598 (Ct. Cl. 1982). Indeed, there appears to be only one reported case where the taxpayer was able to convince a court that the expatriation did not have the proscribed principal purpose. *See Cecil B. Furstenberg*, 83 TC 755 (1984). However, it is less than clear that the IRS could successfully demonstrate that there was a proscribed principal purpose where the substantial reduction in taxes arose from events not in existence at the time of expatriation.

section 871, or (b) a tax at the regular rate applicable to U.S. citizens on "U.S. source income" and other income which is effectively connected with the conduct of a U.S. trade or business. For purposes of this provision, section 877(c) deems certain income to be from U.S. sources, including gains from the sale or exchange of property located in the United States, gains from the sale or exchange of stock of a domestic corporation or debt obligation of a U.S. person, and gain from the sale or exchange of any other property which has a basis determined in whole or in part by reference to property the gain from the sale of which would be deemed U.S. source income under the above rules.[20]

It is clearly the intention of section 877 that a former U.S. citizen who is a nonresident alien and who is subject to section 877 (hereafter a "section 877 taxpayer") would be subject to U.S. tax on the gain derived, within the statutory ten-year period, from the sale of shares of a U.S. corporation, since under section 877(c) such gain would be considered U.S. source income.[21] It further appears[22] to be the intention of

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20 IRC section 877(c).

21 It should be noted that IRC section 865(a), a later-enacted provision, provides that except as provided in section 865, the source of gain from the sale of personal property depends on the residence of the seller. Section 865(g) defines the term "resident" in part by reference to citizenship, not former citizenship. *Cf.* IRC § 865(j)(3); *Tedd N. Crow* 85 TC 376 (1985); but *Cf.* Rev. Rul. 79-152, (continued...)

section 877 that gain derived from the sale or exchange of shares in a non-U.S. corporation would also be considered to be U.S. source gain to the extent the basis of the shares of such foreign corporation were determined in whole or in part by reference to the basis of property, such as U.S. shares, contributed to such corporation in, for example, a section 351 exchange.[23] However, if the foreign corporation were, in an unrelated transaction,[24] later to sell the shares of the domestic corporation, it would not likely be subject to U.S. tax on any gain derived

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[21](...continued)
1979-1 C.B. 237. Accordingly, it may be possible to argue that the expanded source rule of section 877(c), insofar as it pertains to gain from the sale of personal property, has been pre-empted by section 865, although there does not appear to be any evidence that such a pre-emption was intended.

[22] No regulations have been promulgated under section 877.

[23] Were a U.S. person to exchange shares of a U.S. corporation for shares of a non-U.S. corporation, any applicable nonrecognition rule would, except in very limited circumstances, be overridden by section 367(a). The term "U.S. person" as used in section 367(a) does not encompass nonresident aliens who are former U.S. citizens. *See* Reg. § 1.367(a)-1T(d)(1). Accordingly, an expatriate subject to section 877 may, subject to section 367(b), transfer shares in a U.S. corporation to a non-U.S. corporation in an otherwise applicable non-recognition transaction without triggering the recognition of gain which arguably would be U.S. source under section 877(c). Furthermore, the regulations promulgated under section 367(b) do not appear to catch within their sweep transfers made by nonresident aliens who are former citizens.

[24] *Cf. Kaspare Cohn Co. Ltd.* 35 B.T.A. 646 (1937).

therefrom;[25] a foreign corporation cannot be a section 877 taxpayer. Moreover, any such gains derived by such foreign corporation in a year subsequent to the year of relinquishment of U.S. citizenship and residence[26] would not likely be attributed to the section 877 taxpayer. Furthermore, provided such foreign corporation did not reinvest in U.S. situs property, it is likely that the value transferred to the foreign corporation would not be subject to U.S. estate tax.[27]

Accordingly, it appears that with proper planning, it may be possible for a section 877 taxpayer to avoid U.S. tax on gain derived from the sale of U.S. assets notwithstanding section 877. While section 877 catches within its sweep other forms of U.S. source income, such as interest, dividends, royalties, and compensation, apart from compensation similar maneuvering may avoid a tax resulting from the operation of section 877 with respect to such income. A section 877 taxpayer is unlikely to avoid U.S. tax on U.S. source compensation.[28] However, in view of section 864(c)(6) (which treats deferred U.S. source

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25 IRC sections 881, 882, 864 and 865.

26 A portion of the gain derived in the year of relinquishment of U.S. citizenship may be attributed under the CFC or FPHC rules. See IRC sections 951(a)(1) and (2)(A), 551(b).

27 IRC section 2107(b).

28 See *William N. Dillin*, 56 T.C. 228 (1971).

compensation as effectively-connected income), section 877 may not be needed for that result.

Assume that in the illustration referred to above, some time after the sale of the U.S. situs property, the foreign corporation were to be liquidated at a time when it owned no U.S. property. Literally, the gain derived by the section 877(b) taxpayer on such liquidation would be considered to be U.S. source income, since the basis of the shares in the foreign corporation to such shareholder was determined in whole or in part by reference to the basis of U.S. property contributed to such corporation. The question may arise, however, as to whether the exertion of U.S. tax jurisdiction over a former citizen with respect to gains derived from the liquidation of a non-U.S. corporation owning no U.S. assets is permissible. In Di Portonova v. United States,[29] it was argued that the application of section 877 was unconstitutional since it had the effect of imposing personal (on the basis of former citizenship) rather than source jurisdiction over a non-U.S. citizen. The court had little difficulty rejecting the argument in that case (which involved U.S. mineral royalty interests) because, in its view, section 877 operated to tax only U.S. source income, and source-based taxation is permissible. While it is difficult to argue with the proposition that the U.S. may impose source-based

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29 *See* 82-2 U.S.T.C. ¶ 9598 (Ct. Cl. 1982).

taxation on what is conceded to be U.S. source income, it may be more difficult to justify the exercise of source based taxation on income which under international standards would not be considered as derived from the United States.

Sections 2107 and 2501(a)(3)

Section 2107 is the parallel to section 877 in the estate tax area. It provides that the estate of a decedent who had relinquished his or her citizenship with the proscribed principal purpose[30] within ten years of his or her death will be subject to U.S. estate tax on U.S. situs property owned directly, or through certain foreign corporations.[31] While this provision attempts to catch U.S. situs assets which have been shifted to foreign corporate solution,[32] as noted above, such assets may be sold with the proceeds reinvested in non-U.S. situs assets, thereby frustrating the provision. Moreover, an alien who is not domiciled in the United States may make a gift of shares in a foreign corporation without triggering a U.S. gift tax even if such person is a section 877 taxpayer.[33] This is because sections 2501(a)(3) and 2511, the expatriate provisions in the

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30 To be established as under section 877. IRC section 2107(e).

31 IRC sections 2107(b) and 2103.

32 As noted previously, this best can be accomplished after expatriation.

33 *Cf.* IRC section 2511(b).

gift tax area, do not convert shares of a foreign corporation into U.S. situs assets regardless of the composition of the assets owned by such corporation.[34]

Section 7701(b)(10)

While the provisions discussed above deal with losses of U.S. citizenship coupled with a bad purpose, the avoidance of tax may also be effected through avoidance of U.S. residence, regardless of purpose. An individual who had been considered a resident under section 7701(b) for a period of three consecutive years, thereafter ceases to be so considered for a year or more, and then within three years of the cessation of residence is again considered a resident under section 7701(b), will be subject to tax during the intervening period of nonresidence under the rules of section 877. Thus, such taxpayer will be subject to tax on U.S. source income, determined in accordance with section 877(c).[35]

Effect of Tax Treaties

All of our tax treaties have a so-called savings clause under which the United States may impose its tax on its citizens without regard to the treaty. In Tedd N. Crow,[36] the taxpayer successfully argued that unless it expressly states otherwise, a

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[34] *See* IRC sections 2501(a)(2) and (3), and 2511(a) and (b). *Compare* IRC section 2107(b).

[35] IRC section 7701(b)(10).

[36] 85 T.C. 376 (1985).

treaty savings clause does not apply to former citizens. The IRS, of course, had taken a contrary position.[37] Most newer treaties to which the United States is a party now expressly include former citizens within the savings clause.[38] Accordingly, the issue of a conflict between a treaty provision and section 877 is less likely to arise. Curiously enough, thus far no one has seen fit to broaden the definition of U.S. person found in various statutory and regulation provisions referred to above to include former citizens, a simpler solution to the problem of enforceability of section 877 than the current proposal.

In the succeeding sections of this paper, I will outline the proposed section 877A provisions. Thereafter, I will discuss the hysteria which appears to surround the provision.

Is There a Need to Change the Expatriate Provisions?

As previously noted, the underlying premise of the expatriate provisions is that absent such provisions, a U.S. citizen motivated principally by a tax avoidance purpose may avoid tax "simply" by expatriating and thereafter realizing U.S. source income or gains upon which a nonresident alien would not be subject to tax. Section 877 was intended to preserve the U.S.

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[37] See Rev. Rul. 79-152, 1979-1 C.B. 237.

[38] See, e.g., U.S.-Mexico Income Tax Treaty, Article 1(3); U.S.-German Income Tax Treaty, Protocol ¶1(a); U.S.-Spain Income Tax Treaty, Protocol ¶1.

tax base with respect to U.S. income or gains of tax-motivated individuals, not necessarily gains on income which had accrued during a period of U.S. citizenship. It was not intended to widen the U.S. tax base to include as subject to tax non-U.S. source income regardless of whether such income had been earned or realized prior to or after expatriation.[39] Indeed, as previously discussed, it is not at all clear that section 877 would pass muster on constitutional grounds were it to be perceived as other than a source-based tax.[40]

Accepting for the moment its limited purpose, the question has arisen as to whether the current expatriate provisions are effective, or can be made to be effective, in achieving their purpose. In this regard, certain serious concerns have been raised regarding the effectiveness of such provision. First, it has been argued that the requirement of showing that an expatriation was motivated principally by a tax avoidance purpose creates an enforcement problem, since it is difficult to prove principal purpose. However, this argument is not very convincing. Under section 877(e), all the IRS need show is that it is reasonable to believe that taxes were a principal motivating factor, and that can be established by showing that the tax after expatriation will be substantially less than the

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[39] *Cf.* IRC section 7701(b)(10).

[40] *See Di Portonova, supra.*

tax would have been had there been no expatriation.[41] Once that is established, the taxpayer has the burden of proving that tax avoidance was not a principal purpose of the expatriation, a burden which is not easy to meet. Indeed, there appears to be only one reported case where a taxpayer has been able to meet her burden of proof.[42] However, if there is a serious concern that enforcement of section 877 is hampered by the difficulty of overriding a taxpayer's proof concerning his motivation, a simple legislative solution would be to amend section 877 to provide for its application without regard to whether an expatriation had a bad tax purpose.[43]

A second problem identified with present section 877 is that the U.S. gain on income subject to tax as a result of section 877 may not have accrued during the section 877 taxpayer's citizenship. Rather, U.S. gains accruing after loss of citizenship are caught by section 877 if there were to be a sale within ten years of expatriation. As noted previously, there is no evidence that the intent of section 877 was to limit its application to income or gains accrued at the time of expatriation or even to limit its application to gains realized only with respect to U.S. assets at the time of the expatriation

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[41] *See Max Kronenberg*, 64 T.C. 428 (1975); *Di Portonova, supra*.

[42] *Cecil B. Furstenberg, supra*.

[43] *Cf.* IRC section 7701(b)(10).

event. Indeed, apart from closed transactions, it is not easy to determine when a gain has accrued. Nor does it appear credible that a principal purpose of the proposed changes described below is to reduce, rather than enlarge, the amount of tax that will be payable as a result of the provision.

A third problem with the present provision is that it requires an individual who has "expatriated" to continue, for a ten-year period, to report his U.S. income (as determined under section 877(c)). It is argued that once an individual has "gone over the citizenship wall," he is not inclined to report his U.S. income as being subject to tax.[44] But this may well be because most taxpayers who expatriate do so for a number of reasons, only one of which may be tax motivated. Such taxpayers may well feel, however erroneously, that they can establish that their principal purpose was not tax avoidance. If a per se rule were adopted, it may well be that there would be increased reporting.

A more convincing reason to effect a change is that, as described previously, the effect of the current provisions may be avoided because, apart from savings clauses under our new tax treaties, the term "U.S. person" does not include a former U.S. citizen. It is because of this limitation that expatriates may adjust their holdings after expatriation to avoid a tax under section 877. This problem, however, could more easily be dealt

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[44] As will be seen below, proposed section 877A may not solve this problem.

with by simple amendments to sections 367 and 1491 (and perhaps section 865).[45] Were such amendments to be made, and assuming a per se rule were adopted, it would appear that section 877 would accomplish its original purpose of taxing at the regular U.S. tax rates the U.S. source income realized by expatriates for a ten-year period.

As will be seen below, it is not clear that accomplishing the original limited purpose of section 877 is all that is currently intended. Rather, the proponents of proposed section 877A appear to intend to effect a broadening of personal U.S. tax jurisdiction (i.e., taxation on worldwide income) to former citizens with respect to assets owned or considered owned by them upon expatriation.

The Operation of Proposed Section 877A

There are at least three versions of proposed section 877A. The first version was introduced on February 6, 1995 as section 201 of the Administration's Tax Compliance Act of 1995.[46] The second version, which modified the Administration's Proposal, was approved by the Senate Finance Committee on March 21, 1995.[47] On April 6, 1995, the most recent version was

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45 *Cf*. Rev. Rul. 79-152, 1979-1 C.B. 237.

46 S.453, S.Rept. No. _____ 104th Cong., 1st Sess (hereafter the "Administration Proposal").

47 It is incorporated in Section 5, H.R. 831, S. Rept. No. 104-16, 104th Cong., 1st Sess. (the "Finance Proposal").

introduced by Senators Moynihan, Bradley, Conrad and Graham as S.700 and is currently pending (the "New Version").[48] Each of these versions has as its common thread that upon an expatriation event occurring on or after February 6, 1995, an expatriate shall, regardless of his motive for expatriating, be treated as having sold for fair market value, immediately prior to such expatriation event property held by such person, and shall, with certain exceptions, recognize gain or loss with respect to such deemed sales in excess of $600,000[49] notwithstanding any other provision of the Code.[50]

Unlike either the Administration Proposal or the Finance Proposal, the New Version provides that the application of proposed section 877A may be avoided for any property with respect to which an irrevocable election to continue to be taxed as a citizen is in effect (referred to here as a "personal jurisdiction election").[51] In the event a personal jurisdiction election were to be in effect for any property, such property shall continue to be taxed in the same manner as if it were held by a U.S. citizen. Thus, for example, gain derived from the sale of such property would be subject to U.S. income tax even if such

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[48] S.700, S.Rept. No. _____, 104th Cong., 1st Sess.

[49] Prop. section 877A(b).

[50] Prop. section 877A(b).

[51] Prop. section 877A(a)(3), New Version.

gain were to be realized more than ten years after the expatriation event. Moreover, property which is subject to the personal jurisdiction election remains subject to excise taxes, as well as gift and estate taxes imposed on U.S. citizens.[52] Significantly, however, the amount of gift, estate or transfer taxes that could be imposed with respect to property for which a personal jurisdiction election were in effect cannot exceed the amount of income taxes that could be imposed if the property had been sold for fair market value immediately prior to such transfer.[53] As a result, the estate of an expatriate who has made a personal jurisdiction election with resect to an item of property and who has died owning such property will be liable to pay tax equal only to the income tax that would have been incurred if such property had been sold immediately prior to death.

By contrast, if a personal jurisdiction election were not to be made with respect to an item of property which remained subject to U.S. estate tax by reason of such property being owned at death by the decedent and constituting U.S. situs property (for example shares of a U.S. corporation), in addition to the tax imposed by reason of the general rule of section 877A, an

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[52] *See* Explanation of Revision to H.R. 831 _____ (the "Explanation").

[53] Prop. section 877A(a)(3)(B), New Version.

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estate tax would be due.[54] However, if the property were subject to estate tax by reason of section 2107 (i.e., such property constitutes shares in a controlled foreign corporation), the income tax resulting from the application of section 877A would be creditable against the estate tax.[55] Accordingly, it would seem prudent to transfer to a foreign corporation any property for which a personal jurisdiction election is not in effect.

In order to make a personal jurisdiction election, security must be provided for the ultimate payment of tax on the property which is the subject of the election,[56] and there must be a waiver of treaty benefits.[57]

Similar to the Administration Proposal, but unlike the Finance Proposal, the New Version would also apply to "long-term residents," who cease to be so considered. A long-term resident is an individual who has been a green card holder in at least 8 years of the 15 year period ending on the last day of the year of

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[54] Prop. section 877A(i), New Version.

[55] Prop. section 877(i).

[56] According to the Explanation, adequate security includes placing property subject to the election in a U.S. resident trust. However, providing security may present a problem with respect to property which, while not owned by the expatriate, would be includible in his estate, and therefore is subject to proposed section 877A.

[57] Prop. section 877A(3)(c), New Version.

expatriation.[58] However, unlike the Administration Proposal, an individual who is a long-term resident and who relinquishes his green card would appear to be subject to the application of proposed section 877A notwithstanding that such individual may continue to be considered to be a resident under the substantial presence test of IRC section 7701(b). However, such individual may make the personal jurisdiction election. Finally, it should be noted that the New Version of proposed section 877A exempts from the application of section 877A an individual who expatriates before reaching the age of 18-1/2 years, but only if such individual has not met the substantial presence test of section 7701(b) for five or more years before the date of expatriation.[59]

Under all three versions, any gain derived from a deemed sale is to be recognized notwithstanding any potential nonrecognition provision which might apply.[60] Furthermore, any period during which recognition of gain or time for payment of the tax may be deferred terminates on expatriation.[61] Thus, for

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58 Prop. section 877A(e), New Version; *Compare* Proposed section 877A(e)(2), Administration Proposal (10 of 15 years).

59 Prop. section 877A(e)(1).

60 See Joint Committee on Taxation, Background and Issues Relating to Taxation of U.S. Citizens who Relinquish Citizenship (JCX-14-95), March 20, 1995 (hereafter "JCX Report") at 5.

61 Prop. section 877A(g).

example, section 1034 could not apply to a sale of a principal home made before expatriation if a replacement principal home had not been acquired prior to expatriation. However, if a U.S. principal home were owned at the time of expatriation, it would not appear to be caught by section 877A, since it would constitute a U.S. real property interest.[62]

It is also apparently the intention that proposed section 877A would require inclusion in gross income notwithstanding section 933.[63] Thus, for example, a U.S. citizen who is a bona-fide resident of Puerto Rico and who, at the time of his expatriation, owned real property in Puerto Rico, would be subject to U.S. tax on any built-in appreciation thereon (subject to the $600,000 floor) notwithstanding that such deemed gain might be considered Puerto Rican source income which would be exempt from U.S. tax under section 933.

Under all three versions, certain property owned by an expatriate is expressly exempted from the application of the provision. The exempted property includes interests in a qualified retirement plan. Also exempt are interests in a foreign pension plan but only to the extent the value thereof does not exceed $500,000.[64] In addition, any U.S. real property

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62 *See infra.*

63 JCX Report at 5.

64 E.g., prop. section 877A(d)(2), Finance Proposal.

interest other than an interest in a domestic corporation which at the time of the expatriation did not qualify as a real property holding corporation is also exempted.[65] The latter exemption appears sensible as far as it goes, but it is unclear that it goes far enough or that it accomplishes its purpose. It is certainly sensible to exempt from the application of the deemed sale provision property the gain on which would be subject to tax on a sale by a nonresident alien. Accordingly, it is sensible to exempt from the application of section 877A U.S. real property interests, since nonresident aliens are subject to tax on gain derived therefrom.[66] It appears less sensible to exclude from such exemption an interest in a former domestic real property holding corporation which at the time of expatriation is still a U.S. real property interest. However, if the concern is that such interest would lose its status as a U.S. real property interest over time, the same could be said for domestic real property holding corporations, and indeed the "problem" already exists under FIRPTA. By the same token, it would appear sensible to also exempt from the application of the provision other property the gains derived from the sale of which would subject a nonresident alien to tax, such as, for example, property used in

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65 Prop. section 877A(d)(1); IRC sections 897(c)(1) and (2).

66 *See* IRC section 864(c)(7).

a trade or business,[67] since such property retains its character as business property, the gain from the sale of which would be effectively connected for a ten-year period.

Conspicuously absent from the list of exempt property are shares or debt obligations of non-U.S. issuers. Accordingly, built-in gain on such property would be subject to gain recognition under the provisions even though the gain that would have been derived from an ultimate sale would likely have been foreign source. The exclusion from the exempt category for shares or debt obligations of a foreign issuer is consistent with the apparent intention of proposed section 877A to extend personal tax jurisdiction to persons who expatriate but with respect only to property owned at the time of expatriation.[68]

Having noted what is not included, it is worth noting what is included: not only all property (other than property which is exempt) owned at the time of expatriation, but also property which although not owned at the time of expatriation, would have been included in the expatriate's estate had he died on the date of his expatriation.[69]

In addition, under both the Finance Proposal and the New Version, upon an expatriation event, the expatriate shall be

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[67] *See* IRC section 864(c)(7).

[68] *Cf. Di Portonova, supra.*

[69] Prop. section 877(c)(1).

considered to have received a distribution in respect of a beneficial interest he had, directly or indirectly through intervening entities, in a trust and such trust, to the extent of such interest, shall be considered to have sold all of its assets. Furthermore, the assets shall be deemed to have been recontributed to the trust.[70] For this purpose, a beneficiary's interest in a trust shall be determined taking into account precatory letters, and patterns of distribution. In the Finance Proposal, if a beneficiary's interest could not be determined under the above rules, such interest would be determined on the basis of the person who is most closely related to the grantor.[71] Under the New Version, an interest in a trust is considered owned first by a grantor who is also a beneficiary. Any remaining interest is considered owned under the priority that would obtain in intestacy.[72] Thus, for example, in the case of a discretionary trust settled by a parent for the benefit of two children of the grantor, barring any precatory letters or patterns of distribution which might indicate otherwise, each such child would be deemed to have a one-half interest. If instead, the class of potential beneficiaries of a discretionary trust consisted entirely of two corporations, and each of two

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[70] Prop. section 877A(f)(2).

[71] Prop. section 877A(f)(1), Finance Proposal.

[72] Prop. section 877A(f)(B), New Version.

children of the grantor owned all of the shares of one of the two corporations, beneficial interest could not be determined on the basis of the degree of kinship unless one were to look through the corporations which were the actual beneficiaries. Finally, it should be noted that at least according to the Joint Committee, it is intended that the beneficiary of a grantor trust will not be considered a beneficiary for this purpose, but rather the grantor would be considered to own the trust property directly.[73]

The New Version introduces a novel fresh-start rule under which generally the bases of assets owned at the time an individual first becomes a citizen or resident is stepped up (or down) to the fair market value of such assets on the date which is the earlier of the date such individual first became a U.S. citizen or resident, or the date the particular asset was first used in a U.S. trade or business, or first became a U.S. real property interest.[74] Thus, for example, if an alien were to first become a resident on January 1, 1996 at a time when he owned property with a basis of $100 and a fair market value of $1000, his basis in such property would be $1000. However, if

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73 JCX Report at 3. Prop. section 877A(8)(1)(B) appears consistent with this.

74 Prop. section 1061(c)(4). However, the basis for depreciation purposes is not affected. Prop. section 1061(b).

such property had earlier been used in a U.S. trade or business, the fresh-start would apply to the first date it was so used.

Significantly, the fresh-start rule appears to apply retroactively to aliens who first became residents under the substantial presence rules of section 7701(b) before the effective date of proposed section 877A, with regard to dispositions of property occurring on or after the effective date of proposed section 877A.[75] However, the fresh start does not apply to any individual who at the time he first becomes a U.S. resident under section 7701(b) is a dual resident entitled to treaty benefits under a treaty fiscal domicile article.[76]

Procedurally, under the various versions, for purposes of imposing the tax on any net gain in excess of $600,000 deemed to have been derived on the deemed sales of an expatriate's property, such expatriate's tax year is deemed to end on the date of his expatriation.[77] Furthermore, the expatriate would be required to file a tax return for the short period ending on the date of his expatriation, and pay the tax due as a result of the deemed gain by the 90th day after the date of expatriation. However, only the net gain required to be included as a result of proposed section 877A need be reported on such short year return.

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75 Section 2(c), S.700.

76 Prop. section 1061(c)(2).

77 Prop. section 877A(h)(1).

Notwithstanding the filing of such short year return, the expatriate will continue to be obligated to file a return for the entire year of expatriation.[78] Furthermore, any tax paid with the short year return will be credited as a tax payment for the year. In addition, any tax imposed as a result of section 877A may be deferred under section 6161 principles.[79]

Section 877A Debate

There appears to be a number of concerns which thus far have been raised against the enactment of the Administration and Financial Proposals. First, a concern has been raised that to the extent the proposal requires a tax on unrealized gains to which there is no entitlement at the time of expatriation, it is not constitutionally permissible. Second, a concern has been raised that even if permissible its application would not make for good tax policy since the tax imposed on unrealized gains may never materialize and even if it were to later materialize may result in double taxation unless the new country of residence for the expatriate itself had a fresh-start rule (as Canada does) or would give a credit for the tax that would be imposed under proposed section 877A (which appears to be unlikely). Third, a concern has been raised that taxing an expatriate who is a contingent beneficiary of a discretionary trust on a portion of

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[78] JCX Report at 4.

[79] Prop. section 877A(h)(2).

the appreciation of the trusts's assets because of his degree of kinship to the settlor may result in taxing an individual on what he may never receive. Finally, and perhaps most significantly, it has forcefully been argued that proposed section 877A is nothing more than an exit tax which may well put an undue burden on an individual's right to expatriate, may be suspect under our international agreements, and may violate our own standards concerning human rights.[80]

With respect to the first issue, it appears that it may be difficult to mount a successful constitutional attack on a tax imposed on unrealized gains. Eisner v. Macomber,[81] which is generally cited for the proposition that income must be realized for it to be taxed, appears to have been decided in the context of the statutory provisions then in effect. It does not appear that Eisner v. Macomber stands for the proposition that the Code cannot impose a tax on unrealized gains.[82] Indeed, in a number

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80 The international law experts cannot agree whether the proscription is against burdening expatriation, or emigration. *See* and *compare* Turner, The "Exit Tax" and International Law: Does Section 203 of the Tax Compliance Act of 1995 Violate International Human Rights Law Protecting the Right of Emigration/Expatriation, Statement before Subcommittee on Oversight, Comm. Ways & Means, House of Representatives, March 27, 1995 (hereinafter "Oversight Hearings"), with Stephan, Oversight Hearings Statement.

81 252 U.S. 189 (1920); *See Guttentag, Oversight Hearings Statement; Shay, Oversight Hearings Statement*; JCX Report at 13.

82 *See* IRC sections 475, 1256.

of instances where there has been a change in form of ownership and nothing more, the Code deems gain to be realized.[83] However, where there has been no change in form, the issue is somewhat less clear. Indeed, the one court which had occasion to deal with the taxation of unrealized gains under section 1256 refused to decide the broader issue of whether it was in Congress' power to tax gains inherent in capital assets prior to realization or constructive receipt[84] in circumstances other than one before it.[85] Requiring realization without a change in either form or substance may run afoul of other precedents as well.[86]

As previously noted, the New Version does not necessarily require there to be a tax on unrealized appreciation. Rather, the taxpayer may elect to avoid such tax by agreeing to personal jurisdiction with respect to a particular asset. Furthermore, the New Version limits the unrealized appreciation

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83 *See*, e.g., IRC sections 336(a) and 1491.

84 Because the taxpayer was entitled to receive the unrealized appreciation.

85 *Murphy v. U.S*, 93-1 U.S.T.C. ¶50,220 at 88,032. But *see* Prop. Reg. § 1.1291-3(b)(2) (which would provide upon a shareholder of a PFIC becoming a nonresident alien, he or she would have been deemed to have disposed of his or her shares in the PFIC). *See* also Prop. Reg. § 1.1291-6(c)(2)(iii) (which would provide for gain recognition on death in certain limited circumstances).

86 *See Cottage Savings Association v. Commissioner*, 91-1 U.S.T.C. ¶50,187 (S.Ct. 1991); *Cf.* Rev. Rul. 57-535, 1957-2 C.B. 513.

which would be subject to tax, to appreciation accruing after the date the alien first became a U.S. citizen or resident. As a result, the possibility of double taxation either will be eliminated or reduced.[87] For the same reason, the personal jurisdiction election should eliminate any concern that a contingent beneficiary would be taxable on amounts to which such person would never become entitled. If the election were made, no tax would result unless such person received a distribution.

The more difficult question is whether the New Version adequately deals with the concern that the provision unduly restricts an individual from choosing to separate from the United States. If, as has been suggested, the provision's objective is to dissuade a citizen or lawful permanent resident from expatriating by imposing a substantial economic burden on expatriation, it may well run afoul of international standards. Obviously, the personal jurisdiction election is intended as the way around this problem. If the taxpayer elects, he is free to go (provided the security remains.) An issue for which there may be no simple answer is whether the conditions exacted for the personal jurisdiction election, i.e. the agreement to pay taxes on income or gain generated from assets owned (or considered

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87 Double taxation should be avoided in principle if the gain ultimately realized with respect to property which is subject to a personal jurisdiction election is considered to be foreign source income. Under section 865, such gain may or may not be considered foreign source income depending on a number of factors. *See* IRC section 865(a) and (g).

owned) at the time of expatriation whenever realized and the requirement to provide security therefor, nevertheless may be viewed by some in the international community as an undue burden the United States imposes on expatriation in violation of its own principles.

NEW YORK TIMES
WEDNESDAY, APRIL 12, 1995

One Way to Save a Fortune: Become a Former American

By KAREN DE WITT

WASHINGTON, April 11 — Each had a reason for giving up American citizenship, and each says it had nothing to do with taxes.

One man wanted to be a citizen of Israel, the land of his birth. Another was a global marketer who could live anywhere and now calls Belize his home. Still another so loved the balmy Bahamas that he preferred a Bahamian passport to an American one.

But each of these expatriate Americans also avoided paying millions of dollars in United States taxes.

A loophole in the tax law, one that Congressional Democrats have been trying to close, allows non-citizens to avoid taxes on capital gains and estates. That, critics point out, has permitted a handful of very wealthy Americans who have renounced their citizenship to save millions — some say billions — in taxes.

Reached in Nassau, Michael D. Dingman, chairman of Abex, a New Hampshire-based maker of aerospace and industrial products, said his expatriation had nothing to do with taxes.

"I decided to become a Bahamian, and you can't be a Bahamian and a U.S. citizen at the same time," Mr. Dingman said. "It's an honor to be a Bahamian citizen. They have to want you. You can't buy your way in. This is not St. Kitts. The change had nothing to do with taxes."

A half-dozen or so of the super-rich, including Mr. Dingman, have been identified over the last six months by The Wall Street Journal and Forbes magazine as among the tax expatriates: Ted Arison, founder of Carnival Cruise Lines, who now lives in Israel; John Dorrance 3d, Campbell Soup heir, who has Irish citizenship; Kenneth Dart, president of the foam cup company Dart Container, now a citizen of Belize; J. Mark Mobius, a leading international money manager, who has German citizenship and lives in Hong Kong and Singapore; Frederick Krieble, a director and former treasurer of the Hartford-based Loctite Corporation, a maker of sealants, who has moved on to the Caribbean, taking up residence in the Turks and Caicos Islands.

"Expatriation is the ultimate estate plan," said William Zabel, senior partner at Schulte, Roth & Zabel of New York, who is one of the nation's foremost authorities on trusts and estates and is author of "The Rich Die Richer — And You Can, Too" (William Morrow, 1995). "It's not a complete solution. But if you structure it right, the very few people it affects can save a bundle."

Fewer than a thousand Americans a year give up their citizenship, most for reasons that have nothing to do with taxes. But a dozen or more of those who leave are multimillionaires. Aiming at them, President Clinton proposed an expatriation tax in his 1996 budget; the Congressional Joint Committee on Taxation estimates that the tax would raise $3.6 billion over the next decade.

But Republicans opposed the provision and succeeded in killing it before Congress began its spring recess last weekend. Now Democrats are eager to revive the issue, and one of them, Senator Daniel Patrick Moynihan of New York, introduced a revised version of the proposal last Thursday and vowed to work for its passage.

"A genuine abuse exists in this area," said Mr. Moynihan, who noted that some wealthy expatriates, while avoiding taxes, maintained families and homes in the United States by staying within a 120-day-a-year limit on vists here.

"If you've gotten your riches from America, you should pay your fair share of taxes," said Leslie B. Samuels, Assistant Secretary for tax policy at the Treasury Department. "These expatriates are really like economic Benedict Arnolds. They shouldn't have an unfair advantage over other citizens because they're super-rich."

Unlike other countries, which tax on the basis of residence, the United States taxes on the basis of citizenship. Thus, Americans are subject to United States taxation on their worldwide income. In addition, the estate of an American pays taxes at a marginal rate of up to 55 percent of the assets that the citizen owned at death.

> Congress will be taking another look at a tax loophole.

"If you have $50 million, you could certainly potentially save a lot of their estate taxes if you aren't U.S. citizens," said Rich Kohan, director of the personal financial services group of Price Waterhouse. "That's not small change when you're talking in the neighborhood of an estate tax of 55 percent."

But Mr. Kohan said that although he had received many queries about the tax benefits of expatriation, none of his clients had decided to divest themselves of their citizenship as a way of avoiding taxes.

"It's pretty dramatic to give up your citizenship," he said. "First you have to leave the country, and then there is pretty intensive questioning about the purpose of the expatria-

Andrew Aitkin for The New York Times

Michael D. Dingman, chairman of a United States corporation, is among a number of wealthy Americans who have renounced their citizenship.

tion."

Under current law, a citizen who is even suspected of expatriating for tax reasons can still be taxed for up to 10 years. But the law is like a sieve and has "proven largely ineffective, because departing taxpayers have found ways to restructure their activities to avoid those rules, and compliance is difficult to monitor," a recent Treasury report said.

"In my case," said Mr. Dingman, who gave up his citizenship last June to live in the Bahamas, "I've been living here in one form or the other since 1964, and that's a long, long time. This is a beautiful place, it doesn't have big social problems, and you don't have big taxes. My wife and I moved here to live a little bit over five years ago, because we wanted a gentle, thoughtful, pleasant place to raise our three children."

His wife and children retained their American citizenship, which allows Mr. Dingman to travel freely into and out of the United States.

While Mr. Dingman insisted that taxes had played no role in his decision, he said he was sympathetic to those opposed to an expatriation tax.

"I'm investing money in China and the Czech Republic now," he said. "Why would I want to pay U.S. taxes on money if I invest in China? Other countries don't do that. And when I die, America says if you die within 10 years of the date you give up citizenship, you have to pay estate taxes. Since I've already paid taxes to get that money, why should my heirs pay taxes on it again?"

Tim Gallagher, director of public relations for Carnival Cruise Lines, said its founder, Mr. Arison, had given up American citizenship because he had simply wanted to reestablish citizenship in Israel, where he was born. When it was pointed out that Israel allowed for dual citizenship, Mr. Gallagher could offer no particular reason why Mr. Arison had given up his American passport.

The expatriation tax would treat departees as if they had sold all their assets at fair market value just before renouncing citizenship. Only net gain in excess of $600,000 would be taxed, and so just one or two dozen people a year would be affected. Real estate and certain pension benefits would be exempted.

After intense and acrimonious debate, the proposal died this year in a House-Senate conference on a tax bill. The Senate had passed the expatriate tax but agreed to drop it at the insistence of the House tax-writers, led by Representative Bill Archer, the Texas Republican who heads the Ways and Means Committee.

Now the Joint Committee on Taxation will study the issue over the next two months. After it reports in June, the issue is likely to be revived by Congress in the context of hammering out a Federal budget for the next fiscal year.

Meanwhile, Democrats and Republicans have continued squabbling over it. Some Republicans compare the tax to the kind of exorbitant exit fees that the old Soviet Union imposed on departing Jews; Democrats accuse Republicans of looking out for the rich even as they slash benefits for the poor.

Proponents and critics of the measure marshaled a slew of legal experts to testify on it this winter. They raised issues as varied as constitutional concerns, conflicts with international treaties, double taxation and the question of Cuban-Americans who wished to return to Cuba once Fidel Castro was gone.

High-priced lawyers lobbied against the expatriate tax, including former Representaive Guy Vander Jagt, a longtime Republican member of the Ways and Means Committee, who was acting on behalf of an unidentified wealthy expatriate now living in England.

The State Department held that none of the concerns were enough to bar an expatriation tax, and the minority Democrats agreed.

"This proposal," said Representative Sam M. Gibbons of Florida, the ranking Democrat on the Ways and Means Committee, "taxes individuals who are not fleeing economic or political repression but are attempting to shed the normal obligations of citizenship in the developed world."