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October 10, 2007

The Honorable Max Baucus
Chairman
Senate Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Charles Grassley
Ranking Minority Leader
Senate Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Charles B. Rangel
Chairman
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Jim McCrery
Ranking Minority Leader
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Expatriation Legislation

Dear Chairman Baucus, Chairman Rangel, Senator Grassley, Representative McCrery:

The enclosed comments concerning the current legislative proposals to change the tax treatment of individuals who relinquish U.S. citizenship or long-term residency are offered by members of a subcommittee of the International Estate Planning Committee of the American College of Trust and Estate Counsel, acting as individuals and not as representatives of the College.

The American College of Trust and Estates Counsel is a professional association of approximately 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities. The College offers technical comments about the law and its effective administration. It does not take positions on matters of tax policy.

The enclosed comments have not yet been submitted to the Board of Regents of the College for its approval and therefore should not be construed as representing the position of the College.

The individuals who were principally responsible for the preparation of this report are Ellen Harrison, chair of the subcommittee, and Henry Christensen, Virginia Coleman, Robert Lawrence, Carlyn McCaffrey, and Gideon Rothschild. Anne O'Brien and Beth Tractenberg also participated. These comments were reviewed and approved by Duncan Osborne, chair of the International Estate Planning Committee. The individuals who prepared and reviewed this report have substantial experience advising clients on the Federal tax issues relevant to moving into and out of the United States.

Although the individuals who prepared these comments have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such individual (or the firm or organization to which such individual belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of these comments.

We welcome the opportunity to meet with you to discuss our recommendations in more detail and answer any questions you may have.

Sincerely,

Ellen Harrison

Ellen K. Harrison

Enclosure

cc: John Buckley
Chris Javens
Kase Jubboori
Allen Littman
Joshua Odintz

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COMMENTS ON EXPATRIATION PROPOSALS

October, 2007

Several bills have been introduced in the current session of Congress that would revise the tax treatment of certain persons who relinquish citizenship or long-term residency ("covered expatriates"). Among them are Section 205 of the Small Business and Work Opportunity Act of 2007 (S. 349) and Section 12 of the Defenders of Freedom Tax Relief Act of 2007 (S. 1593). These bills are referred to as "the Senate bill." A somewhat different proposal for taxing covered expatriates is in Section 5 of the Tax Collection Responsibility Act of 2007 (H.R. 3056). This bill is referred to as "the House bill."

We offer our comments on the Senate and House bills to assist legislators in crafting a bill that better achieves the legislative objectives as articulated in House Report 110-281 accompanying the House bill and in Senate Report 110-1 accompanying S. 349 - tax-neutrality, administrability and effectiveness – and to point out some technical problems with the proposed legislation.

The purpose of the proposed law is to make expatriation "tax-neutral."

> The Committee recognizes that citizens and residents of the United States have a right not only physically to leave the United States to live elsewhere, but also to relinquish their citizenship or terminate their residency. The Committee does not believe that the Internal Revenue Code should be used to stop U.S. citizens and residents from relinquishing citizenship or terminating residency; however, the Committee also does not believe that the Code should provide a tax incentive for doing so. In other words, to the extent possible, an individual's decision to relinquish citizenship or terminate residency should be tax-neutral.
>
> The Committee recognizes that the American Jobs Creation Act of 2004 altered prior law regarding expatriation in a number of respects, including the replacement of the subjective "principal purpose of tax avoidance test" with objective rules.

Notwithstanding these changes, the Committee remains concerned that the present-law expatriation tax rules (as modified in 2004) are difficult to administer and could be made more effective. In addition, the Committee is concerned that the alternative method of taxation under Section 877 can be avoided by postponing the realization of U.S.-source income for 10 years.

Consequently, the Committee believes that the present-law expatriation tax rules should be replaced with a new tax regime applicable to former citizens and residents. Because U.S. citizens and residents who retain their citizenship or residency generally are subject to income tax on accrued appreciation when they dispose of their assets, as well as estate tax on the full value of assets that are held until death, the Committee believes it fair to tax individuals on the appreciation in their assets when they relinquish their citizenship or terminate their residency. The Committee believes that an exception from such tax should be provided for individuals with a relatively modest amount of [income and net worth, or] appreciated assets. The Committee also believes that, where U.S. estate or gift taxes are avoided with respect to a transfer of property to a U.S. person by reason of the expatriation of the donor, it is appropriate for the recipient to be subject to [an income tax based on the value of the property] *a transfer tax similar to the avoided transfer taxes.*[1]

The Senate report also contains the following explanation:

The Committee also believes that the present-law immigration rules applicable to former citizens are ineffective. The Committee believes that the rules should be modified to eliminate the requirement of proof of a tax avoidance purpose,

[1] The bracketed words appear only in the House report and the italicized language appears only in the Senate report.

and to coordinate the application of those rules with the tax rules provided under the new regime.

Our comments begin with a brief summary of current law and a description of the provisions of the Senate and House bills and then address ways in which the legislative proposals could be amended to better achieve the purpose of making expatriation tax-neutral; suggest ways in which the proposals could be amended in order to avoid certain administrative problems; recommend expanded exemptions that would avoid unfairness and double taxation; and propose limits on the extension of taxing jurisdiction to non U.S. persons. In particular, our comments will discuss the elections to defer the exit tax, ways to minimize double tax caused by mismatching of the timing of income for U.S. and foreign tax purposes, special rules for retirement plans and trusts, appropriate exemptions for individuals and property, the new proposed tax on gifts and bequests from covered expatriates, and problems of administration. Each section of the paper concludes with some recommendations. In conclusion, we recommend an alternative method of preventing avoidance of gift and estate taxes by expatriation which we think is fairer and easier to administer.

Current law applicable to expatriates

Currently, Code Sections 877, 2107 and 2501(a)(3) impose a special tax regime on covered expatriates for the ten years following termination of citizenship or long term residency ("expatriation"). A person is a "covered expatriate" under current law if prior to expatriation he or she was a U.S. citizen or long-term permanent resident and either had a five-year average annual income tax liability of as much as $124,000 (indexed to $136,000 for 2007) or a net worth of $2 million or fails to certify that he or she is tax compliant. A long-term permanent resident is a person who has held a permanent resident visa (a "green card") for at least 8 out of the preceding 15 years. Limited exceptions apply for persons who were dual residents at birth and for persons who expatriate before age 18 ½.

In general, under this special tax regime, a covered expatriate is subject to U.S. Federal income tax under an expanded definition of U.S. source income, gifts of U.S. securities and debt obligations of U.S. issuers are subject to U.S. Federal gift tax, and the U.S. Federal gift and estate taxes apply to transfers of stock of certain closely held foreign corporations that own U.S. assets. In addition, a covered expatriate is considered a resident of the United States for all U.S.

Federal tax purposes if the covered expatriate spends as little as 30 days in the United States in any calendar year during the 10 years following expatriation.

A person is treated as a citizen or permanent resident until the individual gives notice of an expatriating act or termination of residence to the Secretary of State or Secretary of Homeland Security and files Form 8854 with the Internal Revenue Service (the "IRS"). Form 8854 is required to be filed each year for the ten year period that the special tax regime applies, whether or not any tax is due.

After the ten-year period following expatriation, a covered expatriate is subject to U.S. Federal taxation only under rules applicable to other nonresident aliens.

Description of the Senate bill

Under the Senate bill, covered expatriates would no longer be subject to the existing tax regime described above. Instead, new Code Section 877A would impose an "exit tax" or "mark-to-market tax." Covered expatriates would be treated as selling all assets on the day before expatriation. A tentative tax would be due 90 days after expatriation, calculated as if the expatriate's tax year ended on the date of expatriation.

All expatriates would be covered regardless of his or her motive for expatriation and regardless of his or her income and net worth, but the first $600,000 of gain deemed realized upon expatriation would not be taxed. The only expatriates excepted from tax on expatriation would be (i) persons who became dual citizens at birth who had not been resident in the United States for the 5 years before expatriating and (ii) persons expatriating before attaining age 18 ½ who had spent less than 5 years in the United States.

U.S. real property would be excepted from taxation upon expatriation. The Secretary would have authority to allow additional exemptions.

Interests in both U.S. and foreign retirement plans would be taxed as if the present value of the person's accrued benefit were distributed to the covered expatriate on the date of expatriation and then recontributed to the plan. The Secretary would be given authority to write regulations covering the extent to which foreign retirement plans are taxable under these rules.

Tax attributable to gain on a covered expatriate's beneficial interest in a foreign trust would be taxable upon expatriation, but tax on gain attributable to an expatriate's beneficial interest in a U.S. trust would be deferred and taxed as distributions were made, either when the trust becomes a non-U.S. trust or upon the death of the covered expatriate.

The new rules would allow two deferral elections. A covered expatriate could elect (i) to continue to be taxed as a citizen with respect to all assets owned on the date of his or her expatriation or (ii) to defer tax on selected assets until he or she disposed of the asset or died. However, both elections would require that security be posted and any benefits under a tax treaty be waived. In addition, interest would accrue on deferred tax at a rate 2% higher than the underpayment rate.

The Senate bill would amend Code Section 102 to provide that gifts and bequests from covered expatriates to U.S. persons are taxable as ordinary income.

The obligation under Code Section 6039G to file Forms 8854 would continue to apply to covered expatriates.

Immigration rules would be amended to deny former citizens reentry to the United States if the individual were determined not to be compliant with his or her U.S. Federal tax obligations, and for this purpose, the IRS would be allowed to disclose tax return information to immigration authorities.

Description of the House bill

Like the Senate bill, the House bill would impose an “exit tax” or “mark-to-market tax.” Covered expatriates would be treated as selling all assets on the date before expatriation. However, unlike the Senate bill, the House bill also would continue current law subjecting expatriates to a special tax regime for the ten years immediately following expatriation even if the expatriate had paid the exit tax.

Like the Senate bill, the House bill would exclude the first $600,000 of gain realized, and this amount would be adjusted for inflation. The basis of assets deemed sold would be adjusted to fair market value, and in the House bill (unlike the Senate bill), this adjustment to basis applies even to the first $600,000 of gain exempted from tax.

The Senate bill requires payment of the exit tax within 90 days of expatriation, whereas the House bill does not specify a due date and, presumably, the exit tax would be due with the covered expatriate’s regular income tax return for the year of expatriation.

The term “covered expatriate” is defined differently in the Senate and House bills. There is no income tax or net worth test in the Senate bill, but the House bill applies the current law definition of covered expatriate in Code Section 877 to the new exit tax. Thus, a person would be subject to the mark-to-market rules if he or she were also subject to the Code Section 877 rules based on his or her five-year average income tax, net worth or failure to certify tax compliance. However, the exceptions for dual citizens and minors in the House bill are changed to allow such persons to have been U.S. residents for up to ten years, rather than five years, before becoming ineligible for the exceptions. The House bill retains the same test for long-term permanent residents – the 8 out of 15 year test.

The Senate bill exempts U.S. real property from the exit tax and gives the Secretary authority to issue regulations exempting other categories of assets from the exit tax. The House bill contains no similar exemptions.

While the Senate bill allows two deferral elections – one is an election to continue to be taxed as a U.S. citizen with respect to all property that otherwise would be subject to the exit tax and the other is an election to defer payment of the exit tax on selected assets - the House bill only allows the latter election, namely the election to defer payment of the exit tax on an asset by asset basis. Both bills require the covered expatriate to post security for the deferred tax. However, the House bill allows the IRS to accept not only a bond as security, but also other forms of security (including a letter of credit). In addition, the House bill imposes interest on the deferred tax at the usual deficiency rate, whereas the Senate bill adds two percentage points to such interest rate. Both bills require the covered expatriate who makes a deferral election to waive treaty benefits which would preclude the assessment or collection of the deferred exit tax.

The House bill, like the Senate bill, has special rules for retirement plans and trusts, but the rules are quite different.

Like the Senate bill, the House bill taxes the covered expatriate’s accrued benefit in certain deferred compensation arrangements as if the amount were distributed to the expatriate upon expatriation and then recontributed to the plan. However, the House bill adopts a withholding regime for distributions from “eligible deferred compensation arrangements” to avoid immediate imposition of tax.

"Specified tax deferred accounts," which include IRAs, are treated as if distributed to the covered expatriate on the date of expatriation and taxed accordingly except that no early distribution tax applies. Thus, IRAs are not eligible for the withholding regime.

Unlike the Senate bill, which differentiates between U.S. and foreign trusts, the House bill does not apply the exit tax to an interest in a nongrantor trust, whether the trust is a U.S. trust or a non U.S. trust. Instead, the House bill provides that the trustee is required to withhold 30% of the "taxable portion" of a distribution to a covered expatriate. In addition, if appreciated property is distributed to a covered expatriate, the gain is recognized to the trust as if the appreciated property had been sold to the covered expatriate for fair market value. "Taxable portion" means the portion that would be included in the gross income of a U.S. person. The House bill provides that the expatriate "shall be treated as having waived any right to claim any reduction under any treaty."

The House bill allows an expatriate who immigrated to the United States to calculate the exit tax based upon his or her basis at the time he or she first became a U.S. resident. There is no comparable provision in the Senate bill.

The House bill imposes a new tax on gifts and bequests from covered expatriates. In the Senate bill the new tax is an income tax and in the House bill the new tax is imposed by subtitle 15 of Title B, indicating that it is a succession tax, although no name is given to the tax. The tax in the House bill is imposed at the highest rate of U.S. gift and estate taxes at the time the gift or bequest is received by a U.S. person (either an individual or a U.S. trust) or at the time the distribution is made to a U.S. person from a foreign trust that is "attributable to" a gift or bequest from a covered expatriate. Under the House bill, the tax would apply regardless of when the expatriation had occurred.

The House bill repeals Code Section 7701(n) which defers the effective date for loss of citizenship to the time that notice is given to the Secretary of State and any statement that may be required by Code Section 6039G (Form 8854) is filed. The Senate bill does not repeal Code Section 7701(n). However, both bills would enact a new Code Section 7701(a)(50) which provides that an individual shall not cease to be treated as a U.S. citizen before the date on which citizenship is treated as relinquished under new Code Section 877A (which does not require filing Form 8854). Under both bills, the Secretary would be authorized to issue regulations allowing an earlier effective date of termination of citizenship for persons who became at birth dual citizens of the United States and another country. In addition, the House bill amends Code Section 7701(b)(6) to provide that a long term lawful permanent resident who elects to be treated as nonresident under the provisions of a treaty must notify the IRS of the commencement of such treatment.

The House bill does not include any immigration provisions comparable to those in the Senate bill, or any provisions concerning sharing of tax return information with the U.S. immigration authorities.

I. Deferral elections

Instead of paying the exit tax at the time of expatriation, the Senate bill allows an expatriate to make an irrevocable election to be taxed as a U.S. citizen with respect to all property that otherwise would be covered by the exit tax. An electing 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. Federal gift, estate, and generation-skipping transfer taxes. The election to continue to be taxed as a U.S. citizen would not be available unless the individual were to (i) provide security to ensure payment of the tax under this election in such form and manner, and in such amount, as the Secretary of the Treasury (the "Secretary") requires, (ii) waive future rights under treaties that would otherwise protect such individual from paying the U.S. tax, and (iii) comply with such other requirements as the Secretary may prescribe. The amount of the exit tax that would have been owed but for this election (including any interest, penalties and certain other items) would be a lien in favor of the United States on all U.S.-situated property owned by the individual until (i) the tax liability was satisfied, (ii) the tax liability became unenforceable by reason of lapse of time, or (iii) the Secretary was satisfied that no further tax liability could arise. The House bill does not include this election.

Both the Senate and House bills allow a covered expatriate to elect to defer payment of the exit tax with respect to particular property on an asset by asset basis. The election would be irrevocable. However, an individual who elected to defer payment of the tax would be charged interest for the period the tax was deferred. Under the Senate bill, the interest rate would be two percentage points higher than the rate normally applicable to individual underpayments. Under the House bill, the interest rate would be the usual rate on underpayments. Under the election, the deferred tax attributable to a particular asset would be due on the due date of the return for the taxable year in which the asset was disposed of (or, if the asset is disposed of in a transaction in which gain was not recognized in whole or in part, at such other time as the Secretary might prescribe). In order to elect deferral of the exit tax, an individual would be required to provide security. Under the Senate bill, a bond in the amount of the deferred tax would be required except if an individual established to the satisfaction of the Secretary that another security arrangement was adequate. Under the House bill, the security could be a bond meeting the requirements of Code Section 6324 or another form of security for payment (including letters of credit) that met requirements prescribed by the IRS. The individual also would be required to waive rights under treaties that would otherwise protect such individual from paying the applicable U.S. Federal tax. Under the Senate bill (but not the House bill) the deferred tax amount (including any interest, penalties and certain other items) would be a lien in favor of the United States on all U.S.-situated property owned by the covered expatriate until (i) the tax liability was satisfied, (ii) the tax liability became unenforceable by reason of lapse of time, or (iii) the Secretary was satisfied that no further tax liability could arise.

The proposed security arrangements would be costly and, under some circumstances, would unduly burden an individual's right to expatriate. If an individual did not have sufficient transferable assets to satisfy the security requirement, he or she could not satisfy the tax obligations imposed by the exit tax either by paying the tax or by providing security to defer the payment of tax. For example, the exit tax might be attributable in large part to a beneficial interest in a trust, an accrued benefit in a retirement plan, nonvested deferred compensation arrangement, or an interest in a closely held business that was subject to transfer restrictions, none of which could be sold or assigned as security for a loan or a bond. The security arrangements would impose an undue hardship on such an individual, who neither had nor had access to liquidity.

We recommend that the security requirement not apply to the extent the covered expatriate lacked the financial resources to provide it. Instead, the final bill should include a limitation on the amount of security required based upon the covered expatriate's assignable assets. Such a limitation would minimize the burden on an individual's right to expatriate in situations in which the covered expatriate owned little property in his or her own name but was treated as owning property under the provisions of the bill.

The Senate bill specifically lists only one type of security arrangement (a bond) and fails to address what standard the IRS might use to determine whether an alternate security arrangement would be "adequate." Historically, under Code Section 6166, bonding requirements have been onerous, considering the expense and length of time for which bonds are required. We recommend that the final bill specifically identify other acceptable security arrangements, including: (i) an irrevocable letter of credit from (1) a U.S. financial institution, (2) the U.S. branch of a foreign bank, or (3) a foreign bank and confirmed by a bank described in Code Section 581; (ii) a withholding arrangement with a U.S. brokerage firm; or (iii) a taxpayer-established U.S. trust with security provisions similar to those available for qualified domestic trusts under Code Section 2056A and Regs. Section 20.2056A-2(d). The proposed alternate security arrangements should be coordinated with the lien imposed on the U.S. property owned by the covered expatriate. We also recommend that clarification be provided in the case of the election to continue to be taxed as a U.S. citizen, with respect to whether the amount of security would have to be increased if the value of the property that would trigger the tax increased after expatriation.

The Senate and House bills would require payment of the exit tax based on values at the time of expatriation, whether or not the expatriate ever realized gain on the actual disposition of the property held at the time of expatriation. The bills fail to take into consideration the possible decline in the value of the property following expatriation, which could be particularly severe in the case of stock options. Moreover, the interest that would be charged under the deferral election under the Senate bill is extremely high and when added to the tax could exceed the value of the property when sold. Although we agree with the concept of deferring payment of the exit tax until the disposition of the underlying assets, we recommend that the bill limit the amount of the exit tax payable under the deferral provision to the lesser of (i) the unrealized gain at the time of expatriation plus interest, and (ii) the amount realized at the time the individual disposes of the property reduced by foreign taxes paid as a result of such disposition. The amount in clause (i) should be reduced by gain subject to the deferred tax in prior dispositions.

For example, suppose that the aggregate deferred gain on four assets was $2 million, $500,000 each. Suppose that two years after expatriating, the covered expatriate sold one of the assets and realized a gain of $600,000. Under our proposal, all of that gain would be realized and taxed in the year of the actual sale, rather than only the $500,000 of gain attributable to that asset on the date of expatriation (as under the Senate and House bills.) However, only $1.4 million of accrued gain would remain to be recovered upon further dispositions of assets by the covered expatriate. This rule would accelerate the collection of tax because the amount due on the sale of a particular asset would not be limited to the portion of gain attributable to such property on the date of expatriation. However, this rule also would insure that a tax payment obligation would not be created in an amount that exceeded a person's ability to pay.

Alternatively, the election to continue to be subject to U.S. tax could be allowed on an asset by asset basis, so that the U.S. tax would be based on the amount actually realized whether it was greater or less than the unrealized gain at the time of expatriation. This proposal likewise would avoid the problem of having a tax calculated on a hypothetical gain which may bear no relationship to the actual gain, if any. It could also potentially subject those covered expatriates who deferred payment of the exit tax to a greater amount of tax than would have been imposed without the deferral election.

For example, assume that the unrealized gain on four assets was $500,000 each on the date of expatriation and an election was made to treat three of those assets – representing unrealized gain of $1.5 million - as subject to U.S. tax after expatriation. If one asset becomes worthless but the other two assets were sold at a gain of $1,000,000 apiece, the gain subject to U.S. tax would be $2 million, an amount $500,000 more than the aggregate gain on expatriation. However, if the gain ultimately realized on the sale of the three assets was less than $1.5 million, only the amount of gain realized would be subject to the deferred exit tax.

The deferred exit tax should not apply to any asset which is included in the covered expatriate's estate for U.S. federal estate tax purposes at death, assuming that under then applicable U.S. law the asset is entitled to a basis step-up under Code Section 1014. To impose the deferred tax in these circumstances would be contrary to the stated goal of tax neutrality. If the exit tax has been paid prior to death of a covered expatriate (e.g. because payment of the exit tax was not deferred) and the same asset later is subject to U.S. Federal estate tax, an adjustment for the exit tax paid on that asset should be allowed against the U.S. Federal estate tax attributable to that asset.

Similarly, if an asset on which payment of the exit tax has been deferred later is subject to the U.S. Federal gift tax, an adjustment should be made to the exit tax to reflect the adjustment to basis allowed under Code Section 1015. If the exit tax has been paid before the gift is made, an adjustment for the exit tax should be allowed against U.S. Federal gift tax attributable to that asset.

The Senate and House bills provide that the payment of the exit tax may be deferred until the due date of the return for the taxable year in which the covered expatriate disposes of such property, or, in the case of property disposed of in a transaction in which gain is not recognized in whole or in part, "until such other date as the Secretary may prescribe." In order to eliminate uncertainty regarding the due date for payment of deferred tax, we suggest that the Secretary's authority to prescribe alternate dates for payment of the exit tax be removed from the bill and that the date for all payments be the due date of the return for the taxable year in which the individual either transfers the property in a taxable or nontaxable transaction, including a gift.

Recommendations

Limit security requirements where the covered expatriate lacks the resources to secure the deferred tax;

Allow alternative security arrangements;

Limit interest accruals on deferred tax to the deficiency rate;

Limit the deferred tax due on the disposition of an asset on which tax has been deferred to the net amount realized on disposition;

Allow an election to subject an asset to continuing U.S. tax jurisdiction on an asset-by-asset basis;

Provide an adjustment for the exit tax where an asset is subject to the U.S. Federal gift or estate tax following expatriation; and

Clarify the due date for payment of any deferred tax.

II. Double Taxation

Code Section 877A would impose an exit tax on U.S. citizens and long-term permanent residents who renounce their citizenship or relinquish their rights as U.S. permanent residents. [2] The sale is deemed to occur on the day before expatriation, when citizens and residents are still subject to the full scope of U.S. tax law. The timing avoids potential treaty conflicts since under treaty savings clauses, the United States retains the right to tax its own citizens and long-term residents.[3] The ultimate effect of such timing for most expatriates, however, is to set up a virtual guarantee of double taxation on income when the same asset is subsequently sold. For most expatriates, a foreign tax credit will be of little use because the exit tax will be imposed *before* the citizen or long-term resident expatriates. Consequently, most countries to which an expatriate might relocate would not provide a credit against the tax later imposed by such other country when the same asset is sold.[4]

Where an *actual* sale of assets owned by a covered expatriate on date of expatriation would have generated a foreign tax credit to reduce U.S. income tax, a *deemed* sale should also allow the same foreign tax credit even though the foreign tax is not payable at that time. For example, if a covered expatriate owns real estate in another country, in the event of an actual sale, the United States would allow a foreign tax credit to reduce the U.S. Federal income tax. However, there is no foreign tax actually paid on the deemed sale that occurs upon expatriation and therefore no foreign tax credit to reduce the U.S. Federal income tax. Thus, with respect to foreign real property, the tax on a deemed sale violates the neutrality principle because it exceeds the tax that would be due on an actual sale. It seems appropriate to allow the exit tax to be reduced by the amount of foreign tax credit that would have been allowable in the event of an actual sale because expatriation does not reduce the covered expatriate's U.S. tax exposure in such cases. Although it is possible that the foreign tax actually paid on a later disposition may be less, a deemed sale should not incur higher tax than an actual sale would have incurred at the time of expatriation.

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[2] Notably, while the U.S. has been contemplating enactment of an exit tax, the European Court of Justice has found one member country's exit tax counter to European Union law. Du Saillant, EJC, C-9/02 (2004).

[3] E.g. Paragraph 4 of Article 1 of the United States-United Kingdom Income Tax Treaty. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, July 19, 2002, U.S-U.K., (see Rhoades & Langer, U.S. International Taxation and Tax Treaties, UNIK § 1.01 (Matthew Bender)).

[4] See Sanford H. Goldberg, *Taxation Caused by or After a Change in Residents*, Tax Notes Int'l (August 7, 2000).

The Senate bill attempts to mitigate the financial impact of the exit tax through two deferral provisions. As discussed above, a covered expatriate would be able to make an irrevocable election to be taxed as a U.S. citizen or permanent resident on all property to which the exit tax would apply until the covered expatriate disposes of the property. Alternatively, a covered expatriate would be allowed to defer payment of the exit tax on particular assets. While electing to be taxed as a U.S. citizen or resident and/or to defer payment of the tax on certain property may reduce the initial tax burden, in the long run, the elections could increase the possibility that a covered expatriate will be subject to double taxation on gains.

Whether or not the exit tax is deferred, it is not clear whether the exit tax may be offset by a foreign tax credit for foreign taxes incurred when the asset on which the exit tax has been paid is sold in a subsequent year. However, where the exit tax is deferred, an additional question arises -- how the limitations on use of a foreign tax credit are to be applied. Finally, because the deferral elections require the expatriate to waive of treaty benefits, the tax ultimately paid by the expatriate may be higher.

Although the U.S. allows a taxpayer to credit foreign taxes against the U.S. Federal income tax to avoid double taxation, the credit mechanism may not work very well in the case of the exit tax. One reason is timing. Although a foreign tax credit is allowed even if the U.S. and foreign taxes are not incurred in the same year, under Code Section 904(c), the foreign tax paid in any year can be carried back only one year or forward up to ten years to offset U.S. Federal income tax. Because the exit tax increases the likelihood that tax on the same gain will be imposed in different years in the United States and another country, the crediting mechanisms should be expanded to prevent double tax.

In addition, unless the foreign tax is creditable against the exit tax, in most cases a covered expatriate would not benefit from a foreign tax credit because he or she is unlikely to satisfy the sourcing rules that limit the use of a foreign tax credit. Code Section 904 provides that the foreign tax credit allowed to a U.S. taxpayer shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's foreign source income bears to worldwide income. Code Section 906 allows a foreign tax credit to a nonresident alien only for foreign tax paid on his or her income effectively connected with a trade or business within the United States.

It is not clear how these source limitations on the use of a foreign tax credit would apply in the case of the exit tax, particularly where the tax is deferred. The amount and character of the covered expatriate's U.S. and foreign source income may be different in the year of expatriation and the year in which an asset subject to deferred exit tax is sold.

For example, gains realized on the disposition of personal property generally are sourced in the country of the seller's residence under Code Section 865(a) as well as under the tax laws of most other countries. If a covered expatriate ceases to be a U.S. resident on the date of expatriation and becomes a resident of a foreign country, gains realized when the covered expatriate is living abroad should be considered foreign source income. However, if the covered expatriate was living in the United States at the time of expatriation, the gain imposed on expatriation would be U.S. source income. Under these circumstances, will the foreign tax be creditable against the exit tax? The foreign country of residence is unlikely to allow U.S. tax to be credited against its tax when a resident of the foreign country sells personal property that has no nexus with the United States, other than that it was owned when the taxpayer ceased to be a citizen or resident of the United States. None of the double tax treaties would require the foreign country to allow a credit for the U.S. exit tax. Unless the U.S. foreign tax credit rules are changed to allow foreign taxes to be credited against the exit tax under expanded sourcing and timing rules, double tax is likely. Following expatriation, a covered expatriate rarely would have any U.S. tax on U.S. source income that could be offset with foreign tax credits.[5]

Double tax would be avoided if the new country of residence allowed its residents an adjustment to basis upon immigration. There is precedent for this. A recently approved protocol to the United States-Canada treaty, if ratified, would allow persons moving from Canada to the United States, and who owed an exit tax in Canada upon departure, to obtain a fair market value basis for U.S. tax purposes.[6] If Congress enacts an exit tax, a solution to the double tax problem

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[5] Although the taxpayer theoretically can deduct foreign taxes in lieu of taking a credit, unless he or she has effectively connected income, the deduction is not available.

[6] Article 8 of a Protocol Amending the Convention between Canada and the United States with Respect to Taxes on Income and on Capital, adopted on September 21, 2007, would amend paragraph 7 of Article XII (Gains) on the Convention to provide as follows: "Where at any time an individual is treated for the purposes of taxation by a Contracting State as having alienated a property and is taxed in that State by reason thereof, the individual may elect to be treated for the purposes of taxation in the other Contracting State, in the year that includes that time and all subsequent years, as if the individual had, immediately before that time, sold and repurchased the property for an amount equal to its fair market value at that time."

is to negotiate similar treaty protection for U.S. persons who expatriate and become taxable as residents of other countries.

A U.S. citizen who expatriates while living abroad has a better prospect of benefiting from a foreign tax credit. The deemed sale of personal property as a result of the imposition of the exit tax in this case should generate foreign source income. However, a long-term resident would not have the same opportunity because the exit tax, by definition, would be imposed while he or she was a U.S. resident. If he or she elected to continue to be taxed as a U.S. citizen and sold assets after becoming a nonresident, then the foreign tax credit should operate properly.

There is precedent under existing law for expanding the allowance of foreign tax credits to mitigate the special taxes imposed on expatriates. Under Code Section 877, the potential for double taxation of income, estate and gift taxes is reduced during the ten-year alternative tax period by offsetting foreign tax credits for taxes paid to the expatriate's new country of residence. A covered expatriate will pay tax on the expanded category of U.S. source income but the timing of income generally is not changed, so that if he or she must also pay tax on this income in his or her new country of residence, he or she may be entitled receive a foreign tax credit offsetting U.S. taxes owed under the alternative tax regime.[7] Also, Code Section 877(a) specifically allows a foreign tax credit for any U.S. tax imposed solely by reason of that Section. Similarly, Code Sections 2107(c)(2) and 2501(a)(3)(B) allow credits for foreign estate and gift taxes imposed on transfers subject to the expatriation tax rules. Proposed Code Section 877A also should expand foreign tax credit rules, but fails to do this.

The deferral elections require a waiver of treaty benefits. Despite the "savings clauses" under double tax treaties, which preserve the right of the United States to tax its citizens and residents on worldwide income, such treaties do provide limited tax relief to U.S. citizens and residents. For example, under Article 18 of the OECD Model Treaty, pension income may only be taxed in the country of residence. Covered expatriates should not be required to waive benefits under a treaty that would have been available to them had they not expatriated because this violates the principle of tax neutrality.

[7] Under Code § 901(b)(3), receipt of this foreign tax credit by citizens or residents of another country is dependent upon the foreign country applying a similar credit for taxes paid to the United States.

As discussed above, a covered expatriate may be subject to U.S. Federal estate or gift taxes on the same property that was subject to the exit tax. For example, if a covered expatriate were to pay the exit tax on a U.S. situs asset and a later gift or bequest of such asset were subject to a U.S. Federal gift or estate tax, the total taxes with respect to the asset would be higher than those that would be imposed on a U.S. citizen or resident, who would only have paid a U.S. Federal gift or estate tax and not the exit tax. We have therefore suggested that adjustments should be made in order to preserve tax neutrality in this situation. In addition, the same assets on which the exit tax has been paid may be subjected to the new tax imposed on gifts or bequests received by a U.S. person in a later year. Adjustment to the U.S. Federal gift or estate tax imposed on the same property that was subject to the exit tax is appropriate to preserve tax neutrality.

The consequences of Code Section 877A may be particularly unjust to long-term residents or naturalized citizens who may have acquired the property prior to immigrating to the United States and received no step-up in basis upon arrival. The exit tax applies to the entire gain upon deemed disposal, including appreciation that accrued before becoming a U.S. resident.[8] The House bill ameliorates the problem by recognizing a new basis to persons who immigrate to the United States. If the exit tax is enacted, a basis adjustment, as provided by the House bill, upon immigration to the United States should be adopted.

U.S. real property is exempt only under the Senate bill. Because U.S. capital gains tax would be due when the U.S. real property is sold, there is no reason to tax the property upon expatriation. Also, upon sale, a foreign tax credit for the U.S. tax would offset tax imposed by the expatriate's new country and double taxation would be avoided. However, under the House bill, unless the new country of residence allows a new basis upon immigration, tax relief may not be available when the property is sold.

<u>Recommendations</u>

Allow immigrants to elect to adjust the basis of assets to fair market value upon immigration to the United States;

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[8] <u>Id</u>. (noting that many other countries would provide a step-up in basis under these circumstances). Australia, one of a handful of countries with an exit tax, provides for a step-up in basis upon immigration.

Negotiate treaty protection allowing a similar basis adjustment election to U.S. expatriates for purposes of calculating gain subject to tax in the new country of residence;

Do not require the waiver of treaty benefits that are otherwise available to a U.S. citizen;

Allow a U.S. foreign tax credit to offset the exit tax without regard to timing or sourcing rules, or, in the alternative, allow a credit against the exit tax for foreign tax that would have been paid had an actual sale of assets occurred on the date of expatriation;

Allow an adjustment to deferred exit tax if property later is subject to U.S. Federal gift or estate tax; and

Allow an adjustment against U.S. Federal gift, estate or chapter 15 tax on assets that were subject to the exit tax.

III. Expatriation rules applied to trusts

Under current law, a person who is a grantor of a trust may be subject to tax upon expatriation under some circumstances. For example, if the trust is foreign and the grantor ceased to be treated as the owner of the trust upon expatriation, Code Section 684 may impose gain as if the assets in the trust were sold. Gains are deemed realized, but losses are not deemed realized and do not offset gains. If a U.S. trust became a foreign nongrantor trust as a result of a person's expatriation, gain may be realized under Code Section 684. Except as provided in Code Section 684, however, expatriation would not change the taxation of trust income, and income distributed to a covered expatriate would be taxed to the same extent as if received directly and not through the trust.

The rules for trusts are significantly different in the Senate and House bills.

<u>The Senate bill</u>

The Senate bill exposes a covered expatriate to a exit tax on account of his or her status as a beneficiary of a trust if it is determined that he or she "holds" an interest in a trust on the day before his or her expatriation date. Despite the significance of the holding requirement, the proposal contains no clear method by which to determine whether or not a covered expatriate actually holds an interest in a trust. Proposed Code Section 877A(f)(3)(A) provides that a covered expatriate's "interest in a trust shall be based upon all relevant facts and circumstances, including the terms of the trust instrument and any letter of wishes or similar document, historical patterns of trust distributions, and the existence of any functions performed by a trust protector or any similar advisor." At best, these factors are nothing more than indications as to what the covered expatriate might expect to receive from a trust rather than any actual property interest in the trust. Except when an individual's trust interest can be actuarially valued, as is the case with an interest such as the right to receive trust income for a term, it is impossible to predict how these factors can be used to measure an individual's interest in a trust. We are, therefore, very concerned that the proposed Code Section 877A will give rise to substantial inequities.

A not unusual, simple example will illustrate our concern. Suppose that P created a discretionary trust 10 years ago for the benefit of all of his or her descendants. C, a covered expatriate, is one of three living children of P, but has never received any distributions from the trust. At the time of C's expatriation, P had three living grandchildren as well as three living children. In fact, no distributions have ever been made from the trust. P's letter of wishes to the trustee indicated that P viewed the trust as a financial safety net for her children and that she would prefer that the trustee accumulate income and maintain principal unless a child or more remote descendant was in need of funds for educational or medical expenses or other support related needs. What facts should determine whether C holds an interest in the trust? Should he or she be able to show that he or she holds no interest because it is unlikely that he or she would ever receive a distribution. Or, would he or she be treated as holding a 1/6th interest because there are six beneficiaries. If the latter approach is followed, C risks paying a substantial tax on values he or she is likely never to receive.

Once it is determined that a covered expatriate holds an interest in a trust, proposed Code Section 877A(f) creates two different regimes for the tax treatment of these interests - one for interests in Qualified Trusts, defined as trusts that are United States Persons within the meaning of Code 7701(a)(30)(E), and one for interests in all other trusts, referred to in this section as "Foreign Trusts."

Treatment of Covered Expatriates Holding Interests in Foreign Trusts

If a covered expatriate holds an interest in a Foreign Trust, he or she will not be treated as having sold the interest. Instead, his or her interest is to be treated as a separate share in the trust, the share is to be treated as a separate trust consisting of the trust assets allocable to the share, and the separate trust is to be treated as having sold all of its assets on the day before the expatriation of the covered expatriate and as having distributed all its assets to the covered expatriate. The covered expatriate then pays the tax he or she would have paid if his or her deemed separate trust had actually distributed the sale proceeds to him or her and is treated as having recontributed the assets he or she received back to the trust.

We assume that the object of the proposal is to require the covered expatriate to include in his or her gross income any gain deemed to have been recognized on the deemed sale as well as any previously undistributed income earned in the year of expatriation prior to the expatriation event and the trust's undistributed income from prior years. This result interacts uneasily with the various existing methods for taxing trusts and their beneficiaries and creates a number of anomalies and unanswered questions, including:

1. What happens to the trust's undistributed net income when the separate trust is constituted? If the covered expatriate is deemed to have an interest consisting of a 20% vertical slice of all of the trust's assets, does his or her trust have 20% of the trust's undistributed net income? Will the deemed distribution be treated as a distribution of some portion of that undistributed income potentially exposing the covered expatriate to heavy interest penalties?[9]

2. When a covered expatriate's interest in a trust consists only of the right to receive income, either absolutely or in the discretion of a trustee, how should his or her interest in the trust be established? Suppose, for example, that the covered expatriate had a right to receive all of the income from the trust for life and that the actuarial value of his or her right to income was equal to 20% of the value of the trust? Should his or her share consist of a vertical slice of all of the trust's assets? Suppose the trust consisted of $50 million worth of shares of U.S. stock with a basis of $10 million. Should he or she be treated as having capital gain income of 20% of $40 million despite the fact that, if he or she had not expatriated, he or she would never have paid any tax on the capital gains generated by the trust? Going forward, he or she will continue to be taxed by the United States on the dividends he or she receives from the trust. Should there be a

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[9] See Code Section 665 et seq. subjecting distributions from a trust that are deemed to consist of income accumulated in the trust in prior years to a "throwback tax," which includes an interest component.

mechanism that would permit him or her to offset future U. S. Federal taxes on dividend income by the tax he or she paid on expatriation?

3. Will the assets deemed to have been recontributed to the trust by the covered expatriate have a new basis equal to fair market value on the deemed sale upon expatriation?

4. Will the covered expatriate who receives future distributions from the trust be treated as having received them from the portion he or she recontributed so that the tax advantage, if any, of the new basis will inure to his or her benefit?

5. Will the covered expatriate's share of the trust be treated as a separate trust with respect to which he or she is a grantor so that, if consistent with Code Section 672(f), he or she would be treated as the owner of that portion of the trust?

6. In the case of an interest in a charitable remainder trust, how is the distribution to be allocated among the various categories of accumulated income? Will the covered expatriate receive a charitable deduction for the deemed recontribution of assets back to the trust? Will a charitable remainder annuity trust lose its status as a charitable remainder trust because of the deemed contribution by its expatriating beneficiary? Charitable remainder trusts are not permitted to accept additions and are not permitted to make distributions in excess of the amounts originally provided for in the trust instrument.

7. In the case of an interest in a pooled income fund within the meaning of Code Section 642(c) and in the case of a charitable lead trust, will the covered expatriate receive a charitable deduction for the deemed recontribution of assets back to the trust?

8. When one of the assets in the trust is a United States Real Property interest (as defined in Code Section 897(c)(1)), should that asset be excluded from the deemed sale with respect to the covered expatriate's separate trust to give the covered expatriate the same protection he or she would have received under proposed Code Section 877A(d)(1)(A) if he or she had owned such property directly?

Treatment of Covered Expatriates Holding Interests in Qualified Trusts

If a covered expatriate holds an interest in a Qualified Trust, he or she will not immediately be subject to the exit tax regime imposed by proposed Code Section 877A(a).

Instead, a system that permits deferral of tax, but in many cases will result in double taxation of the same unrealized amounts, is imposed.

The amount of exit tax that would have been imposed on the covered expatriate's allocable expatriation gain is to be calculated and used to establish a "deferred tax account." This account, with various adjustments, will be used to calculate the amount of future tax to be paid by the covered expatriate. The calculation of this amount starts with the determination of the interest that the covered expatriate holds in the trust, a calculation that is subject to the same uncertainties discussed above, with the addition of one other factor. Proposed Code Section 877A(f)(2)(D) introduces the concept of "vested and unvested" interests in the trust. A covered expatriate's allocable expatriation gain is to be determined only with respect to his or her vested and unvested interests. An "unvested interest" is to be determined by "assuming the maximum exercise of discretion in favor of the beneficiary and the occurrence of all contingencies in favor of the beneficiary." This concept limits the amount of exit tax that will be imposed on a later distribution to an expatriate. For example, an addition to the trust made after expatriation or appreciation accruing after expatriation are shielded from tax.

After expatriation, when the covered expatriate receives a distribution from the trust, he or she will be subject to the taxes on such distribution that a nonresident alien would ordinarily pay on distributions from a trust that is a United States person, (i.e., a 30% tax on dividends received from United States corporations), and will be subject to an additional tax equal to the lesser of (i) the amount of the distribution multiplied by the highest tax rate imposed by Code Section 1(e) for the taxable year which includes the day before the expatriation date and (ii) the amount in the deferred tax account. The additional tax is to be withheld by the trustees.

As discussed above, the deferred tax account is calculated as of the expatriation date. Thereafter it is increased by interest determined at a rate 2% in excess of the rate of interest on underpayments of tax under Code Section 6621, producing a current interest accrual of 10%, compounded daily. It is decreased by the taxes imposed on the covered expatriate under proposed Code Section 877A, and, if the covered expatriate's interest is unvested, to the extent provided in regulations, by the amount of tax imposed by proposed Code Section 877A on distributions with respect to unvested interests not held by the covered expatriate. Thus, distributions with respect to a covered expatriate's unvested interest that are made to any other beneficiary who is not also a covered expatriate would not reduce the covered expatriate's deferred tax account. An adjustment to the covered expatriate's deferred tax account should be made in order to avoid overstating his or her share of the trust's unrealized gain at the time of expatriation.

If the covered expatriate disposes of his or her interest in the trust, if the trust ceases to be a Qualified Trust, or if the covered expatriate dies while there is a positive balance in his or her deferred tax account, a tax is to be imposed on the trust equal to the lesser of (i) the amount in the deferred tax account or (ii) the amount of tax the covered expatriate would have paid with respect to the interest he or she held in the trust if she had expatriated on the date of the disposition, cessation, or death. If the covered expatriate only owned a lifetime interest in a trust, presumably his or her interest at death is zero and no exit tax would be owed. However, this point should be clarified. Curiously, proposed Code Section 877A(f)(2)(F) appears to give other trust beneficiaries the right to recover this tax from the covered expatriate or from his or her estate. It is unclear how or in what jurisdiction this right of recovery could be pursued successfully.

An illustration will show how far this approach strays from the goal of tax neutrality that proposed Code Section 877A is intended to achieve for covered expatriates. Suppose that C, a covered expatriate, is determined to hold a 50% interest in a trust that consists of $50 million worth of shares of U.S. stock with a basis of $10 million all of which had been held for more than one year, and that expatriation occurred in a year in which the tax on long term capital gains was 15%. C's initial deferred tax account will consist of $3 million. ($50 million minus $10 million multiplied by 50% and again multiplied by 15%.) For the next 5 years after expatriation, C receives no distributions from the trust. In the meantime, the trust sells all of its stock and pays total U.S. taxes of $6 million, and reinvests the proceeds in new securities with respect to which there is now $8 million of unrealized appreciation. By the end of 5 years, C's deferred tax account will have grown to approximately $4.9 million (assuming a continuing interest rate of 10%). In year 6, the covered expatriate receives a distribution of $1 million worth of dividend income generated by the trust's investment in stocks of U.S. corporations. The trustee withholds tax of $300,000, calculated at the 30% rate applicable to nonresident aliens as it is required to do under Code Section 1441. In addition, the trustee will be required to withhold an additional $350,000 (35% of $1 million) under proposed Code Section 877A. C will be subject to total taxes of $650,000 on C's $1 million distribution, notwithstanding that the trust has already paid the taxes on C's portion of the unrealized capital gains that existed at the time of C's expatriation. And C's deferred tax account continues to hold about $4.55 million ($4.9 million - $350,000), exposing C to future taxes up to this amount (plus accumulated interest thereon).

It is not clear from the Senate bill whether additional tax would be due upon C's death. If C's beneficial interest terminates at death, no further tax should be due because C would not have benefited from the assets remaining in the trust. C's beneficial interest at that point is zero. However, if this is not the intended rule and additional tax is due upon C's death, in the above example, the trust will pay a tax equal to the lesser of the amount in C's deferred tax account or the amount of tax C would have owed with respect to C's beneficial interest in the trust had C expatriated on the date of C's death, assuming that the trust were not then a qualified trust. Total taxes imposed on C and the trust as to C's interest, would then amount to at least almost $4 million and possibly more than $8 million:

- $300,000 withheld tax on dividends actually paid to C
- $350,000 withheld tax imposed by Code Section 877A on distributions to C
- $3,000,0000 tax paid by the trust on C's 50% share of assets sold by the trust
- Either $600,000 tax paid by the trust on C's 50% share of unrealized gains at the time of C's death (or the $4,550,000 balance of C's deferred tax account, depending upon how the law is applied in this context).

If C had not expatriated, total taxes imposed on C and the trust as to C's interest would have been only $3,150,000, consisting of $3,000,000 of capital gain tax paid by the trust and $150,000 on $1,000,000 of dividends received and distributed to C.

The Senate bill should be modified to produce a more reasonable result. The deferred tax account should be reduced by taxes actually paid by the trust attributable to the covered expatriate's share of unrealized gain at the time of expatriation. In the above example, the tax attributable to C's share of unrealized gain at the time of C's expatriation was $3 million. If the trust realizes the gain five years later and pays U.S. tax on that gain, there is no justification for taxing the same gain to C when distributions are made. If the gain has been taxed to C under Code Section 877A before the trust realizes the gain, the trust should be allowed a credit for the tax withheld from C. As discussed below, a much simpler rule is possible without loss of revenue.

Code Section 877A should impose a tax only on principal distributions that reduce the U.S. tax base. As a general rule, capital gains realized by a U.S. trust are going to be taxed in the United States regardless of the citizenship or residency of the beneficiary. Distributions of trust principal do not reduce the U.S. tax base in such cases because capital gains are not included in distributable net income of a U.S. trust and remain taxable to the trust, a U.S. taxpayer, despite the level of distributions. Therefore, no protections are necessary to preserve U.S. taxing jurisdiction because of a beneficiary's expatriation except in cases where capital gain would be included in distributable net income or distributions of appreciated property are made to a beneficiary. In general, capital gain is not included in distributable net income except where it is required to be distributed and a distribution of appreciated property to a beneficiary carries out income only to the extent of basis, which becomes the basis of the property in the hands of the beneficiary. In the case of a distribution of property to a covered expatriate, this rule would allow avoidance of U.S. tax if the gain realized by the beneficiary upon a later sale of the property would not be U.S. source income. Therefore, distributions of property (other than U.S. real property) to beneficiary who is a covered expatriate should be considered a gain recognition event. These cases are limited and the tax imposed by Code Section 877A should be restricted to cases where a distribution erodes the U.S. tax base.

It is particularly inappropriate to impose tax on a covered expatriate based on his or her share of unrealized gains of a trust where the covered expatriate has only an income interest in a trust. In such a case, the covered expatriate has no right to such gains. More importantly, as explained above, imposition of tax on unrealized gains is not necessary to preserve U.S. taxing jurisdiction in the case of a U.S. trust.

Finally, the bill should be clarified to provide that there is no tax due upon the death of the covered expatriate with respect to his or her beneficial interest in a trust if his or her interest is extinguished at death.

The House bill

The House bill contains special rules for nongrantor trusts. Presumably no special rule is necessary for a grantor trust because the expatriate is treated as owning, and therefore as selling, the portion of the grantor trust that he or she is deemed to own under the grantor trust rules on the date of expatriation.

For both foreign and U.S. nongrantor trusts, the House bill imposes a 30% tax withholding requirement on distributions to covered expatriates. Also, a nongrantor trust is deemed to have sold appreciated assets distributed to a covered expatriate beneficiary. No enforcement mechanism is provided with respect to foreign trusts. As a result, as a practical matter it may be difficult to enforce the withholding regime on a foreign trust that has no U.S. beneficiary.

The most significant feature of the House bill's treatment of nongrantor trusts is that the amount subject to withholding is not capped by the covered expatriate's share of the amount of unrealized gain on trust assets on the date of expatriation. In addition, the covered expatriate is not given the benefit of the lower tax rates normally applicable to certain kinds of income such as long term capital gains. Finally, the withholding obligation appears to be applicable to trusts created by the covered expatriate after expatriation. These rules unreasonably extend U.S. Federal taxing jurisdiction beyond the traditional norms of international taxation. Consistent with these norms, the amount subject to U.S. Federal tax and withholding should be capped by the expatriate's share of unrealized income and gain as of the date of expatriation. This can be accomplished by using the concept of a deferred tax account like the one proposed in the Senate bill, with the adjustments recommended above.

Recommendations

Adopt the withholding rules used in the House bill for nongrantor trusts but cap the amount withheld at the amount in a deferred tax account similar to that in the Senate bill (adjusted as stated below), except that the amount in the deferred tax account should not increase by more than the deficiency rate;

The deferred tax account should be reduced by U.S. taxes paid by the trust that are attributable to a covered expatriate's share of pre-expatriation gain;

The deferred tax account should be adjusted if distributions with respect to a covered expatriate's unvested interest in a trust are made to another beneficiary (whether or not the other beneficiary also is a covered expatriate);

Tax should be imposed under new Code Section 877A on principal distributions from U.S. trusts to covered expatriates *only* where (i) the distribution is made in kind with appreciated assets (other than U.S. real property); (ii) the distribution is included in distributable net income of the trust and therefore reduces the trust's taxable income; or (iii) the distribution is from a charitable remainder trust;

When applicable, lower rates on long term capital gains or other tax advantaged income should be available to a covered expatriate;

The exit tax should not apply to an expatriate who has only an income interest in a trust;

Do not impose the exit tax at the death of the covered expatriate attributable to his or her beneficial interest in a trust if the interest expires at death; and

Exempt charitable split interest trusts.

IV. Expatriation rules applied to retirement plans

Current Law

Code Section 877 contains no special rules for the taxation of retirement plan distributions received by an expatriate subject to that Section. Accordingly, an expatriate is taxed on such distributions in the same way as any other nonresident alien. The Code contains no sourcing rule for retirement plan distributions, and the rules that have been developed in this regard by the Internal Revenue Service, in the absence of an applicable treaty, are complex and murky. [10]

Employer contributions to a pension plan are treated as compensation. Therefore, to the extent attributable to employer contributions made while the employee was performing services in the U.S., distributions from a qualified retirement plan are U. S. source income.[11] Such income with respect to contributions for services performed through 1986 is taxed as fixed or determinable annual or periodic ("FDAP") income at a 30% (or lesser treaty) rate and subject to withholding under Code Section 1441. It is unclear whether in the view of the Service income with respect to contributions for services performed after 1986 is likewise FDAP income or is

[10] There are two limited statutory exceptions to the rules described below. These are found in Code secs. 402(e)(2), applicable to Civil Service annuities and other retirement benefits paid by the United States, and 871(f), applicable to certain retirement benefits received for services performed outside the United States.

[11] Rev. Rul. 79-388, 1979-2 C.B. 270.

instead effectively connected income. Such income would appear to be effectively connected income under Code Section 864(c)(6), effective for tax years after 1986, which provides that the determination of whether deferred compensation income received by a nonresident alien is effectively connected or not will be made as if the income had been received in the year the services were performed and without regard to whether the taxpayer was engaged in a U.S. trade or business during the current year. In at least one private letter ruling,[12] the Service has in fact taken this position, holding that Code Section 864(c)(6) applied to distributions from a qualified (401(k)) plan attributable to post-1986 employer contributions, with the result that such distributions were taxed as effectively connected income and subject to withholding under Code Section 3405 rather than 1441 (unless the participant elected out of Code Section 3405 withholding in which case 1441 withholding would apply). However, in Rev Proc. 2004-37, 2004-1 C.B. 1099, in which the Service set out a methodology for determining how much of a distribution from a defined benefit plan to a nonresident alien was U.S. source and non-U.S. source income where it was attributable to contributions with respect to services performed within and without the United States, no mention is made of effectively connected income. Instead, it is stated flatly that to the extent a distribution is U.S. source income, it is subject to withholding under Code Section 1441.

To the extent a distribution is attributable to employer contributions made while the employee was performing services outside the U.S., distributions are foreign source income and thus not subject to U.S. tax.[13] To the extent attributable to the income or appreciation on employer contributions, regardless of where the services were performed, retirement plan distributions are U.S. source FDAP income based on the situs of the trust as a U.S. trust.[14] Putting all this together, it is possible that a single distribution could be subject to three different tax regimes: FDAP income, effectively connected income, and foreign source income not subject to U.S. tax at all.

There appears to be no authority on the U.S. taxation of distributions from an IRA to a nonresident alien. Distributions from an IRA other than a rollover IRA should be taxed entirely as U.S. source income (except to the extent attributable to after-tax contributions) by analogy to

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[12] PLR 9041041.

[13] Rev. Rul. 72-149, 1972-1 C.B. 218.

[14] Rev. Rul. 79-388, supra; Clayton v. U.S., 33 Fed. Cl. 628 (1995).

the rule for qualified retirement plans. Distributions attributable to contributions to the IRA, all of which reduced compensation income that would otherwise have been fully subject to U.S. tax in the year earned, would be U.S. source compensation income, and perhaps effectively connected income under Code Section 864(c)(6). Distributions attributable to the earnings and appreciation on the contributions would be U.S. source income under the situs rule.

Distributions from a rollover IRA would likewise be taxed entirely as U.S. source income except if the character of the distributions were traced back to the qualified plan from which the rollover was made, and some portion of the distribution attributed to employer contributions while the employee was outside the U.S.

<u>The Senate bill</u>

The general mark-to-market rule applicable to other assets does not apply to any interest in a qualified retirement plan described in Code Section 401(a), 403(a) or (b), an individual retirement account or annuity, a 457 plan of a state or local government or exempt organization, or, to the extent provided in regulations, a foreign pension plan or similar retirement arrangement. Instead, an amount equal to "the present value of the expatriate's nonforfeitable accrued benefit" is treated as having been received by the individual on the day before the expatriation date as a distribution from the plan. The amount otherwise includable in income with respect to subsequent actual distributions from the plan would be reduced by the amount previously taken into income on expatriation (and not already applied against prior taxable distributions).

The imposition of tax on a phantom distribution from a qualified retirement plan or 457 plan will create obvious hardship for a plan participant who under the terms of the plan is not eligible to receive distributions at the time of expatriation. A lesser hardship will be imposed on an IRA owner under age 59 1/2 at the time of expatriation, who could take a distribution to cover the tax but would have to pay a 10% penalty tax on it. Thus, any such distribution would have to be grossed up not only for the ordinary income tax it would generate but also for the penalty tax. Both results seem unduly harsh.

The deemed distribution will in many if not most instances give rise to double taxation in the U.S. and in the new country of residence. In the year of expatriation there will be no tax in the new country of residence against which the U.S. income tax on the plan or IRA, triggered by the expatriation, could be credited. However, actual distributions from the plan or IRA will presumably be taxed as they occur in the new country of residence, and again there will be no credit for the U.S. tax because it will have been paid in a prior year.

In its present form, the proposed legislation would appear to deny the covered expatriate the benefit of treaty protections that he or she would have been entitled to had he or she remained a U.S. citizen. For instance, under Article 17 of the U.S.-U.K. income tax treaty, pension income payable to a resident of the U.K. may be taxed only by the U.K., and this provision is excepted from the savings clause applicable to U.S. citizens under Article 1. A pension benefit of an expatriate resident in the U.K., however, would apparently be subject to the exit tax upon expatriation regardless. Such a result seems inconsistent with the stated goal of tax neutrality.

As further discussed below, we recommend a different approach entirely to the taxation of retirement plan distributions. If the approach in the proposed legislation is to be retained, however, at a minimum clarification of the following points is needed:

1) The concept of the "present value of the nonforfeitable accrued benefit" for a defined benefit plan.[15] This is a crucial concept because it is the measure of what will be taxed on expatriation, but it is not defined at all in the proposed legislation. The Description of the bill prepared by the Joint Committee Staff says only the following:

> "It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e))."

We feel this concept is far too important to be left to regulations, which could leave taxpayers affected by the bill in limbo for a substantial period of time. Nor are we convinced that Code Section 417(e), which provides a method for determining the present value of a qualified joint and survivor annuity or qualified preretirement survivor annuity for purposes of determining whether the plan may distribute it as a lump sum, may be readily extrapolated into

[15] For a defined contribution plan or IRA the vested accrued benefit would presumably be the value of the employee's account under the plan or of the IRA.

this quite different context. Even if it can be, the complexity of Code Section 417(e) makes it clear that the taxpayer would need professional help and very likely the cooperation of the plan administrator, which might or might not be forthcoming, to actually do the present value calculation.[16]

2) The consequence of the expatriate's death before the full amount of tax paid on expatriation is recovered. The only fair result in this circumstance would be for the beneficiary, regardless of his or her U.S. tax status, to have the benefit of the outstanding balance against U.S. tax payable by the beneficiary in determining the U.S. tax on distributions received after the expatriate's death. This would appear to be the intent of the bill, since it refers in Code Section 877A (d)(2)(B) to any distribution after expatriation "to *or on behalf of* the covered expatriate." However, this intent, if it is the intent, should be more explicitly stated. In addition, attention should be given to the logistics of how this would work; in many instances it might be difficult or impossible for the beneficiary to access the necessary information.

We note also that there are circumstances in which the bill in its present form would require a tax to be paid on expatriation on a benefit which ultimately was not received at all, by either the employee or a beneficiary. This could occur in the case of a defined benefit plan which paid out a qualified preretirement survivor annuity as the only form of death benefit for an employee who died prior to his annuity starting date. An employee might well have a "nonforfeitable accrued benefit" at expatriation, but if he died unmarried prior to commencement of benefits no death benefit would be payable. In such circumstances, a refund of the tax paid on expatriation should be available, payable to the beneficiary's estate.

3) Status of Roth IRAs. Presumably there is no intention to impose any tax on expatriation on Roth IRAs to the extent they would not be taxed if the expatriate remained in this country. This needs clarification, however. Roth IRAs are clearly not covered by the special rules for retirement plans. They are not, however, exempted from the general mark-to-market rule, which by its terms applies to "all property of a covered expatriate."

One questions the need to have any tax on U.S. qualified retirement plans and IRAs triggered upon expatriation. Under Code Section 401(a) a qualified retirement plan by law must

[16] We note that the calculation of the present value under Code Section 417(e) has been changed effective in 2008, and that a transition rule is provided for distributions in 2008 through 2011.

be "a trust created or organized in the United States;" under Code Section 408 an IRA must be a trust created or organized in the United States or a custodial account, with a bank as trustee or custodian "or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust [or account] will be consistent with the requirements of this Section." A 403(a) plan, 403(b) annuity, or 457 plan may be established only by a tax exempt (501(c)(3)) or governmental employer and thus will of necessity be a U.S. construct. In other words, qualified retirement plans and IRAs, unlike the expatriate's assets held outside these arrangements, will not be leaving the country with the expatriate. There is therefore not the need to collect the tax upon departure or run the risk of not being able to collect it at all.

The Senate bill recognizes this fact in the case of interests in U.S. trusts (called "qualified trusts"), which are exempted from the general mark-to-market rule but distributions from which to the expatriate are subject to tax when made. Although we feel the rules proposed for U.S. trusts are flawed,[17] the fundamental concept of taxing distributions when made, where the distributing entity remains subject to U.S. jurisdiction and the tax can be enforced by withholding, is a sound one.

Beyond that, in the case of qualified retirement plans and IRAs, it would appear that no new rule is necessary at all to impose a tax on post-expatriation distributions attributable to contributions made during the period that the expatriate was a U.S. citizen and subsequent appreciation thereon, because such distributions would be fully subject to tax as U.S. source income in any event. The rule that excludes from tax distributions attributable to services performed outside the U.S. is premised on the taxpayer being a nonresident alien during the year the services were performed; by hypothesis it would have no application if the taxpayer was in fact a U.S. citizen at the time.[18] Thus, the entire distribution from an IRA post-expatriation, and any distribution from a qualified retirement plan except to the extent of post-expatriation employer contributions for services performed outside the U.S., would be subject to U.S. tax either as effectively connected or FDAP income.

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[17] See in this connection the discussion above beginning at page 23.

[18] See Rev. Rul. 79-389, 1979-2 C.B. 281, dealing with the extent to which distributions to a U.S. citizen from a pension plan attributable to contributions made for services performed abroad is income from sources without the U.S. for purposes of the foreign tax credit.

There is no reason, however, to perpetuate in this context the uncertainty under existing law as to whether retirement plan distributions taxable to a nonresident alien are treated entirely as FDAP income or in part as effectively connected income. We would strongly recommend that the proposed legislation adopt a simple rule that all distributions from U.S. qualified plans or IRAs received by a covered expatriate be treated as FDAP income, subject only to any treaty benefit which would have been applicable had the individual not expatriated.

For foreign retirement plans, we would recommend the approach adopted in the House bill, under which, if certain requirements designed to ensure collection of the tax are met, a withholding regime will likewise apply.

<u>The House Bill</u>

The House bill comes much closer to the model we suggest above in that it establishes a category of deferred compensation arrangements, called “eligible deferred compensation items,” for which there is no immediate exit tax. Instead, the payor of eligible deferred compensation items is required to withhold and pay a tax of 30% from any “taxable payment,” meaning a payment that would be taxable if the payee were subject to U.S. income tax.

A “deferred compensation item” is broadly defined to include qualified and nonqualified deferred compensation arrangements, foreign or domestic, and “any property or right to property which the individual is entitled to receive in connection with the performance of services to the extent not previously taken into account under §83.” Inexplicably, however, it does not include most IRAs, which would be subject to an immediate realization rule applicable to “specified tax deferred accounts”.[19] The latter rule is comparable to that in the Senate bill for retirement arrangements generally.

An "eligible deferred compensation item" is a deferred compensation item which satisfies two requirements. First it must be a payment obligation that is either owed by a U.S. payor or owed by a foreign person who elects to be treated as a U.S. person for purposes of the withholding tax obligation, provided that such non-U.S. person satisfies rules to be adopted by

[19] A "deferred compensation item" is defined in relevant part as any interest in a plan or arrangement described in Section 219(g)(5). Section 219(g)(5) encompasses §401(a), §403(a), governmental, and §403(b) plans and arrangements as well as SEP IRAs (408(k)) and SRAs (408(p)). The definition of "specified tax deferred accounts", by contrast, specifically includes an individual retirement account or annuity described in §408(a) or (b) other than a SEP IRA or an SRA.

the IRS to assure that the obligation will be met. Second, the expatriate must agree to notify the payor of his expatriate status and to waive treaty benefits that otherwise might reduce the rate of tax withholding. Amounts “attributable” to compensation for services rendered outside the United States while the covered expatriate was not a U.S. citizen or resident are not taxable.

This regime affords the opportunity for covered expatriates not to have to pay tax immediately on their retirement benefits so long as the requirements for eligible deferred compensation status are met, and by and large these requirements appear reasonable. In addition, by imposing the withholding tax at 30%, it in essence treats these payments as FDAP income, as recommended in the discussion of the Senate bill's treatment of retirement benefits.

There is one notable gap, however, alluded to above: IRAs would not be eligible for this treatment because they are not treated as deferred compensation items at all. Instead IRAs are lumped with Coverdell accounts, 529 plans, health savings accounts and Archer MSAs as a "specified tax deferred account" and made subject to an immediate exit tax.[20] Many IRAs are rollovers from qualified plans, and all IRAs are subject to the same distribution requirements and constraints as qualified plans. The primary purpose of IRAs, as the name suggests, is the same as that of a qualified plan: to provide for retirement. By contrast, one is hard pressed to think of any resemblance between IRAs and the other arrangements comprising the category of “specified tax deferred accounts” other than that it is tax deferred and an individual arrangement. IRAs should therefore be included in the definition of a deferred compensation item and as such eligible for the withholding regime if the stated additional requirements are met.

There are also certain ambiguities in the treatment of deferred compensation arrangements which should be clarified and other, less significant changes we would recommend.

1) Roth IRAs do not appear to be covered as either a deferred compensation item or a specified tax deferred account. Like IRAs, they should be included in the definition of a deferred compensation item. In that case, so long as the Roth met the requirements for an

[20] "Specified tax deferred accounts," a category which has no counterpart in the Senate bill, are not dealt with as such in these comments. The accounts falling under this category, apart from IRAs which do not belong there, tend to be small and, with the exception of §529 tuition plans, infrequently encountered. We suggest that the administrative complexities of imposing an exit tax on these accounts exceed any revenue gain. At a minimum, if this category is to be retained, it should be classified whether the "interest" in a §529 plan which would be taxed is that of the account owner or the beneficiary.

"eligible" deferred compensation item, nontaxable distributions would automatically be exempt from tax to an expatriate.

2) It is unclear whether the treaty waiver which is required for an eligible deferred compensation item applies also to the plan beneficiary.

3) The covered expatriate should have the benefit of treaty provisions which would have been allowed had he or she not expatriated. See the discussion at pages 16 and 30 above.

4) It is unclear how distributions "attributable" to services performed outside the U.S. while the expatriate was not a U.S. citizen or resident are to be determined.

5) The requirements which must be met for a foreign arrangement to be eligible for the withholding regime should be stated in the legislation rather than left to regulations, which could be some time in coming.

6) In those circumstances in which the House bill would result in the imposition of an exit tax (*i.e.* the arrangement is not an eligible deferred compensation item), many of the comments made above about the Senate bill's provisions applicable to retirement benefits would apply as well.

<u>Recommendations</u>

Adopt the basic withholding regime of the House bill but include IRAs as a "deferred compensation item";

Allow expatriates to benefit from treaty exemptions that apply to U.S. citizens;

Include in the legislation the requirements that must be met in order for a deferred compensation arrangement of a foreign payor to be eligible for the withholding regime; and

In the (presumably few) circumstances in which the mark to market tax will apply, clarify the measure of the tax and the consequence of the expatriate's death before recovery of the tax, with and without a death benefit under the arrangement.

V. Appropriate exemptions

Under current law, a person who relinquishes U.S. citizenship is subject to expatriation tax rules if he or she has either a five-year average annual income tax liability of as much as $124,000 (indexed to $136,000 for 2007) or a net worth of at least $2 million, or if he or she fails to certify that he or she is tax compliant. A long-term permanent resident is subject to the same rules. A long-term permanent resident is a person who has held a permanent resident visa (a "green card") for at least eight out of the fifteen years preceding expatriation.

Limited exceptions apply for persons who were dual citizens at birth and persons who expatriate before attaining age 18 ½. A dual citizen is not subject to the expatriation rules if he or she was a dual citizen at birth, never was a resident of the United States, never held a U.S. passport, spent no more than thirty days in the United States during any of the ten years prior to expatriation, and continues to be a citizen of the other country of which he or she was a citizen at birth.

A person who expatriates before attaining age 18 ½ is excepted from the expatriation rules if he or she became a citizen at birth, neither parent was a U.S. citizen and he or she was not present in the United States for more than thirty days during any of the ten years prior to expatriation.

Current law exposes an expatriate to U.S. Federal tax on an expanded definition of U.S. source income and U.S. situs assets, but does not expose all assets to U.S. Federal tax. Under the current law the expatriation tax rules expire ten years after expatriation.

The Senate bill

The Senate bill covers expatriates regardless of the level of his or her taxable income or net worth. Instead of applying these thresholds, the Senate bill exempts the first $600,000 of gain from the exit tax.

The Senate bill continues and liberalizes the exceptions under current law for certain dual citizens and minors. Under the Senate bill, a dual citizen may qualify for an exception to the exit tax if he or she was a dual citizen at birth, continues to be a citizen of and taxed as a resident of such other country and has not been a resident of the United Sates for the five year period ending with the date of expatriation. A person who expatiates before attaining age 18 ½ is not subject to the exit tax if he or she spent less than five years in the United States before expatriating.

The Senate bill provides an exception to the exit tax for "exempt property." Exempt property includes a US. real property interest as defined in Code Section 897(c)(1) other than stock of a U.S. real property holding company which does not on the day before the applicable expatriation date meet the requirements of Code Section 897(c)(2). The Senate bill also authorizes the Secretary to create other classes of exempt property.

The House bill

The House bill continues to apply the taxable income and net worth tests under current law. In addition, the House bill exempts the first $600,000 of gain. The House bill contains the same exemptions for dual citizens except that a dual citizen may have been a resident of the United States for up to ten years during the fifteen year period ending with the year of expatriation. Similarly, the House bill raises from five to ten years the period of time a minor may have resided in the United States and still qualify for the exception to the exit tax for persons who expatriate before attaining age 18 ½. The House bill does not similarly raise the residency test for long-term permanent residents.

The House bill does not create a category of exempt property.

A minimum net worth and taxable income test is advisable to ease the administrative burden of the exit tax. In addition, the exemption of $600,000 of gain may be too low. This number was the amount exempt from U.S. Federal gift and estate tax at the time the exit tax was originally proposed. These exemptions have increased. Currently the amount exempt from the U.S. Federal gift tax is $1 million and the amount exempt from the U.S. Federal estate tax is $2 million for 2007 and will be increasing to $3.5 million in 2009. It would be appropriate to use either the applicable gift or estate tax exemption to achieve the stated objective of neutrality.[21]

A problem with the expatriation tax under both current law and the proposed legislation is the failure to recognize the distinction between the residency tests for U.S. Federal income tax purposes (a visa and physical presence test) and U.S. Federal gift and estate tax purposes (domicile). A long-term permanent resident within the meaning of Code Section 877 and proposed Code Section 877A may not be domiciled in the United States. Such a person is not subject to gift and estate tax except with respect to U.S. situs assets, and it is inappropriate for the relinquishment of a green card to increase the person's exposure to the U.S. Federal gift and estate tax. Nevertheless, that is the result under current law.

[21] Code Sections 2010 and 2505 refer to these exemptions as the "applicable exclusion amount" and as the "applicable credit amount."

The likelihood that a long-term permanent resident would not be domiciled in the United States is far from a remote possibility. A person who is on assignment to the United States for purposes of employment but who retains significant contacts with his or her home country, such as a permanent home and family ties, probably is not domiciled in the United States despite having a green card. In such cases, since expatriation does not affect the expatriate's exposure to the U.S. Federal gift and estate tax, the act of expatriation should not increase such a person's exposure to such taxes. Accordingly, any new tax on gifts or bequests which may be enacted, as discussed below, should not apply to gifts or bequests from former long-term residents who were not U.S. domiciliaries.

Under the House bill, the exception for dual citizens applies if a person was not a U.S. resident for more than ten out of the fifteen years preceding expatriation. However, the test for long-term permanent residents is less – eight out of fifteen years. The residency test for long-term permanent residents should be increased. As a U.S. citizen has a preferred status and more comprehensive rights under the Constitution than a long-term resident, it is unfair to subject a former long-term resident, one who has not had such status for a substantial period of time, to the same rules as a former U.S. citizen.[22] Consideration should be given to substituting "17 out of 20 years"[23] (or other long period) for "8 out of the last 15 years" to provide more equity and to encourage talented individuals to remain in and contribute to the United States, as well as to prevent an exodus of well-qualified professionals.

The exception for minors who expatriate should be at least as broad as in the House bill. Because a minor has no choice whether to live in the United States or abroad, a minor should not be penalized under the tax laws for having been a resident in the United States.

Exceptions should apply for assets that remain subject to the U.S. taxing jurisdiction following expatriation. The administrative difficulty of measuring and collecting tax on a phantom realization event should be avoided if adequate enforcement mechanisms are available for collection of the tax when a realization event occurs. U.S. real property is a good example of such an asset. Purchasers of U.S. real property interests are required to withhold a portion of the

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[22] *See generally,* Andrew Walker, *The Tax Regime for Individual Expatriates: Whom to Impress?, The Tax Club,* March 29, 2004 at pp 42-43.

[23] A person is deemed to be domiciled in the United Kingdom for certain purposes if he or she had been a resident of the United Kingdom for 17 out of the last 20 years.

purchase price of property acquired from a nonresident alien seller. Payment of tax in other contexts also can be assured through the use of a withholding arrangement. As discussed elsewhere, U.S. trustees, IRA custodians, qualified plan administrators and U.S. employers can be held responsible for collecting the tax. Foreign payors who meet certification requirements (like "qualified intermediaries") should be allowed to elect into a withholding arrangement.

Additional categories of assets should either be exempted from the exit tax or subject to an alternative withholding arrangement. Such categories would include insurance, annuities, alimony and other rights to receive future income.

Recommendations

- Continue the net worth and U.S. Federal income tax thresholds;
- Link the net worth test to the U.S. Federal estate tax applicable exclusion amount;
- Limit any tax on gifts and bequests by covered expatriates to those who were citizens or domiciliaries of the United States;
- Increase the residency test for long-term lawful permanent residents to ten years or preferably to 17 out of 20 years;
- Broaden the exception for minors;
- Provide an exemption for U.S. real property interests and other classes of assets for which collection on actual disposition can be assured; and
- Substitute a withholding arrangement for immediate imposition of the exit tax wherever possible without jeopardizing collection.

VI. New tax on gifts and bequests

Under current law, there is no tax on amounts received as gifts or bequests from covered expatriates. Both the Senate bill and the House bill introduce an entirely new tax regime on such items. In the Senate bill the new tax regime is an income tax and in the House bill the new tax regime is a succession tax.

The Senate bill

The Senate bill proposes to amend Code Section 102 to provide that the exclusion from gross income for the value of property acquired by gift, bequest, devise or inheritance will not apply to the value of any property acquired by gift, bequest, devise or inheritance from a covered expatriate after the expatriation date unless certain exceptions apply. Accordingly, a U.S. person who receives gifts, bequests, devises or inheritances from a covered expatriate would be subject to U.S. Federal income tax on such amounts. Notwithstanding Code Sections 1015 and 1022, the basis of any property described in proposed Code Section 102(d)(1)(A) in the hands of the donee or the person acquiring such property from the decedent or donor would be equal to the fair market value of the property at the time of the gift, bequest, devise or inheritance.

The proposed income inclusion rule under Code Section 102(d)(1)(A) would not apply if either:

1. the gift, bequest, devise or inheritance is shown on a timely filed return of tax imposed by chapter 12 as a taxable gift by the covered expatriate or included in the gross estate of the covered expatriate for purposes of chapter 11 and shown on a timely filed return of tax imposed by chapter 11 of the estate of the covered expatriate, or

2. no such return was timely filed, but no such return would have been required to be filed even if the covered expatriate had been a citizen or long-term resident of the United States.

The proposed income inclusion rule for gifts and inheritances is a new method to tax the transfer of wealth and sets a dangerous precedent. In effect, it introduces a fourth type of U.S. Federal tax applicable to the transfer of property, namely, an inheritance (or succession) tax in the form of an income tax, in addition to the gift, estate, and generation-skipping transfer taxes. If transfers are subject to both foreign gift or estate tax and U.S. income tax, there will be no crediting mechanism to avoid double taxation as none of the existing double tax treaties will apply. If the legislatures of other countries from which U.S. persons have emigrated adopt the same or similar rules to tax remittances of wealth from such U.S. emigrees to residents of their former countries, the impact would be significant as the aggregate amount of such remittances, and the corresponding taxes, could be substantial.[24]

The scope of the income inclusion rule is unfair because it treats the value of all property transferred by a covered expatriate as income, thereby exposing wealth acquired by a covered expatriate after his or her expatriation date, as well as, in the case of a former long-term lawful resident, wealth accumulated before entry into the United States, to potential U.S. Federal income taxation. This is contrary to the comments in the Committee reports that the decision to expatriate should be tax neutral. Consistent with the exit tax under proposed Section 877A of the Code, which is imposed generally only with respect to the unrealized gain of a covered expatriate as of the expatriation date, the property subject to the income inclusion rule under proposed Code Section 102(d) should be capped at an amount equal to the covered expatriate's net worth as of his or expatriation date. Additionally, to avoid double taxation, the covered expatriate's net worth should be reduced further by the exit tax payable. Finally, the tax should not apply to the receipt of income from a trust that received a gift of corpus from a covered expatriate because that amount would already be subject to income tax. There is no valid reason to tax the income twice.

To avoid the complication of administering a "cap" on the amount subject to tax, consideration should be given to a sliding scale of rates that reduces the tax rate over time. For example, the tax imposed on transfers within two years of expatriation could be subject to tax at the full rate, but the tax rate thereafter could diminish periodically so that eventually the tax rate would be zero. This proposal is discussed at greater length at the end of this paper.

The caption of Code Section 205(b) of S.349 - - "Inclusion in Income of Gifts and Bequests Received by *United States Citizens and Residents* from Expatriates" *(emphasis added)* is not part of the text of the bill and is not reflected in the proposed amendment of Code Section 102, which applies to *any* person, and *not just U.S. citizens and residents*. For example, proposed Code Section 102(d)(1)(A) is appropriately broader than the caption and would apply to receipts of property by U.S. trusts. It should be clarified that this "deemed income" is not taxable when the recipient is a nonresident alien individual or a foreign nongrantor trust as such

[24] *See* Charles M. Bruce, *Anti-Expatriation Legislation Aimed at Individuals: Is Congress going to Enact an "Exit Tax"*, Tax Mgmt. Int'l J. (February 10, 2006) at p. 6.

deemed income does not fall within the categories of income taxable under Section 871 of the Code. However, such gifts presumably would enter into the calculation of the foreign trust's net income, which could affect the tax treatment of distributions by such trusts that are made to U.S. beneficiaries.

Under proposed Code Section 102(d)(1)(B), a basis adjustment to fair market value applies to property that is included in income notwithstanding Code Section 1015 or 1022, which generally do not permit such adjustments for transfers under such Sections. Proposed Code Section 102(d)(1)(B) does not refer to Code Section 1014, which limits the adjustment of the cost basis of property acquired from a decedent only to certain specified transfers. Therefore, proposed Code Section 102(d)(1)(B) should be revised to clarify that there will be an adjustment in basis notwithstanding any contrary rule under Code Section 1014.

Proposed Code Section 102(d)(2)(A) provides an exception to the income inclusion rules if the gift, bequest, devise, or inheritance is reported on a timely filed U.S. Federal gift tax return as a taxable gift or included in the covered expatriate's gross estate in a timely filed U.S. Federal estate tax return. A further exception to the income inclusion rule is provided under proposed Code Section 102(d)(2)(B) even where estate or gift tax returns were not timely filed if "no such return would have been required to be filed even if the covered expatriate were a citizen or *long-term resident* of the United States."(*emphasis added*) The reference to a long-term resident should be deleted because, as noted above, a long-term resident might not have been a domiciliary, in which case he or she would not have been subject to U.S. transfer tax on a world wide basis. Accordingly, this new tax should not apply at all except to amounts received from former citizens or domiciliaries. Even with this change the proposed exception would be administratively unworkable, as discussed below.

1. <u>Requirement to file a U.S. Federal estate tax return (Form 706)</u>

   For decedents dying in 2007, Form 706 must be filed by the executor of every decedent who was a citizen or domiciliary of the United States whose gross estate plus adjusted taxable gifts is more than $2,000,000. It will be impossible in many cases for a U.S. recipient of property at death to know whether the decedent's estate met the filing threshold.

2. Requirement to File a U.S. Federal Gift Tax Return (Form 709)

A citizen or resident of the United States is generally required to file a U.S. Federal gift tax return to report transfers exceeding the annual exclusion amount (currently $12,000) to any person other than his or her spouse, regardless of whether a gift tax is payable. This suggests that there would be income inclusion for gifts exceeding $12,000 to any person as a U.S. Federal gift tax return would have been required to be filed for such gifts. The proposed legislation should be amended to provide that there is no income inclusion until the aggregate gifts to U.S. persons from a covered expatriate exceeds the Federal gift tax exemption amount, currently $1,000,000.

The proposed legislation would place a tremendous burden on U.S. recipients of gifts and inheritances from a foreign person, presumably relatives. The U.S. recipient would be required to determine if the foreign relative was a covered expatriate, and if so, whether the transfer was reported on a U.S. Federal estate or gift tax return, and if not, whether such a return would have been required to be filed if the foreign relative had been a U.S. citizen. A U.S. recipient would therefore be required to maintain records of the aggregate amounts of transfers made by the foreign relative to any possible number of transferees to determine whether the relevant threshold amounts for filing a return have been met. It is also unclear who, among the many transferees, would have the benefit of the U. S. Federal estate and gift tax exemptions.

Under Code Section 2107(c)(2) and Code Section 2501(a)(3)(B), a U.S. foreign tax credit is allowed for foreign gift and death taxes paid in respect of transfers subject to the U.S. Federal estate or gift tax under the existing expatriation regime. Apparently, a U.S. foreign tax credit would not be allowed under either of those Sections or Code Section 901 for any foreign gift or death taxes on property that was treated as income under proposed Code Section 102(d). As a policy matter, a credit should be allowed in order to avoid double taxation. Absent a credit, if the donee is liable to pay a foreign tax (e.g., a inheritance tax), only the value of the property in excess of the foreign tax should be includible in the gross income of the U.S. recipient under proposed Code Section 102(d).

The House bill

The House bill imposes a succession tax (at the highest rate applicable for the U.S. Federal gift and estate tax) on gifts and bequests acquired directly or indirectly from a person who was a "covered expatriate" at the time of such acquisition. All of the same concerns expressed about the Senate bill apply to the House bill. However, the House bill is far more objectionable. Unlike the Senate bill, the House bill would impose the tax regardless of when the donor expatriated, and therefore has retroactive effect.

Like the Senate bill, the House bill does not limit the succession tax to the amount of property owned by a covered expatriate at the time of expatriation. For example, suppose that a college student expatriates and subsequently earns a large fortune. Upon his or her death sixty years later, bequests to U.S. heirs would be subject to the succession tax. As is the case with the Senate bill, the amount subject to this tax should be limited to the expatriate's net worth on date of expatriation, reduced by the exit tax imposed. If the tax is to be neutral, the expatriate's net worth should be further reduced by the gift or estate tax applicable exclusion amount, since this amount would not have been subject to transfer tax had he or she not expatriated. In the alternative, as discussed below, a sliding scale of diminishing rates of tax could be used to avoid the administrative complexity of imposing a cap.

The House bill exempts $10,000 per year received by any person. The exemption should be tied to the annual exclusion, which has been adjusted for inflation to $12,000. Similarly, gifts to U.S. charities and to spouses who are US citizens should be exempt. In the interest of tax neutrality, for the same reason, the covered expatriate's U.S. beneficiaries and donees should be allowed the benefit of the previously unused applicable exclusion amount to reduce the applicable U.S. Federal gift and estate tax, but determining what that was and how the applicable exclusion amount should be allocated as among multiple beneficiaries would be difficult or impossible in any given case.

The proposed succession tax is reduced by any gift or estate tax paid to a foreign country. This should be expanded to include any form of inheritance, succession, and/or capital gains taxes at death imposed by foreign countries in lieu of an estate tax. It also should be expanded to include gift or estate taxes paid to the United States. Even though gifts and bequests included on a timely filed U.S. Federal gift or estate taxes return are not subject to the tax, gift or estate taxes paid with a late-filed return should be creditable.

The proposed succession tax applies if the donor was a covered expatriate at the time of "such acquisition of the property." It is not clear how this applies to a gift to a foreign trust that later makes a distribution to a U.S. person. Is the status of the expatriate relevant at the time of the transfer to the foreign trust or at the time of the distribution to the U.S. person? The donor may be a covered expatriate at the time of the transfer to the trust but not at the time of the distribution or vice versa.

The tax imposed by Chapter 15 would be deductible under Code Section 164 in computing the U.S. person's income tax on the receipt of a distribution from a foreign trust. The deduction would be a "below the line" deduction, and thus would be limited by Code Section 67(e). Consistent with the rule applicable to income in respect of a decedent (which also is subject to both estate tax and income tax), the income tax deduction for the succession tax paid should be an "above the line deduction."

Recommendations

Limit the succession tax to the covered expatriate's net worth on date of expatriation reduced by exit tax paid and the applicable exclusion amount;

As an alternative to a "cap" described above, use a sliding scale of declining rates based on the period of time between expatriation and the gift or bequest to a U.S. person;

The tax should not apply to persons who expatriated prior to date of enactment;

The annual gift tax exclusion should apply;

Gifts and bequests that qualify for the marital or charitable deduction should be exempted;

Allow a foreign tax credit for foreign taxes of any classification imposed on the same transfer (and not just gift and estate taxes);

Allow the credit for US tax paid in connection with untimely filed gift or estate tax returns;

Allow an "above the line" income tax deduction for succession tax paid on transfers that also are includable income;

Exempt long term permanent residents who are not domiciled in the U.S.;

Clarify how the tax applies to gifts indirectly made through a foreign trust; and

Clarify how to calculate the basis of assets received from a covered expatriate which have been subject to this tax.

VII. Retaining Code Section 877

The Senate bill repeals Code Section 877 if proposed Code Section 877A is passed. However, the House version continues both Code Sections 877 and 877A. Once a person has paid the exit tax, tax policy should not discourage covered expatriates from investing in U.S. markets. Exposing the covered expatriate to tax under Code Section 877 will discourage such investment. Moreover, once the U.S. has collected the appropriate tax from an expatriate, there does not seem to be a good reason to impose special rules on the covered expatriate that are more onerous than those rules that are applicable to other nonresident aliens.

Recommendation

Code Section 877 should not apply to an expatriate who is subject to Code Section 877A.

VIII. Problems of Administration

Under the Senate bill, the exit tax is due 90 days from the effective date of expatriation. The effective date of expatriation is the earliest of (i) the date the expatriate renounces nationality before a diplomatic or consular officer (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (ii) the date the expatriate furnishes to the State Department a signed statement of voluntary relinquishment of nationality confirming the performance of an expatriation act (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (iii) the date that the State Department issues a certificate of loss of nationality; or (iv) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization. Because the effective date of expatriation could be more than 90 days before the certificate of loss of nationality is issued, the tax due date should not be earlier than 90 days after the certificate is issued.

The House bill does not require a payment of tax earlier than the usual tax due date for the year of expatriation. Here also, a grace period of ninety days should be allowed for filing the return once a certificate of loss of nationality has been issued.

Both bills grant the Secretary authority to determine an earlier effective date of expatriation for persons who became at birth a citizen of the United States and another country. This authority also should extend to persons who expatriate prior to attaining age 18 ½. It is not clear how the exit tax is to be imposed in cases where the effective date of expatriation is retroactive.

Both bills continue the information reporting obligations under Code Section 6039G. These reporting rules apply to covered expatriates who are subject to U.S. Federal taxation under Code Section 877, which applies for only ten years after expatriation. If Code Section 877 is repealed, reporting rules should be revised. It is not necessary to require reporting for individuals who have satisfied their tax payment obligations.

The Senate bill allows the immigration authorities to deny entry to expatriates who have not complied with tax obligations. Some due process should be allowed for review of that determination. The House bill does not include this provision.

<u>Recommendations</u>

The exit tax should not be due before the date which is 90 days after the certificate of loss of nationality is issued; and

Some due process review is necessary to give expatriates the right to challenge an adverse determination that denies re-entry into the United States.

IX. Alternative Proposal

While we understand the wish of Congress to replace the current expatriation tax regime with a new approach, which is more capable of enforcement, we have doubts about the feasibility of enforcing the long post-expatriation provisions upon United States recipients of future donative transfers. We also think that such provisions, while understandably seeking fairness, are perhaps overzealous. It is for this reason that we have made the following alternative proposal for continuing, but reducing liability for, estate and gift taxes for 10 years following expatriation.

An alternative approach to the succession or income tax on gifts or bequests proposed in the Senate and House bills is to provide that a covered expatriate who was a U.S. citizen or domiciliary will be subject to U.S. Federal gift and estate tax on his or her worldwide assets with the applicable rate of tax declining on a sliding scale based on the time the individual has not been a U.S. citizen or domiciliary. We suggest that the reduction in the applicable rate be the same as provided for prior tax credits under Section 2013 of the Code. Thus, the applicable rate would be reduced by 20% for every two-year period the individual had not been a U.S. citizen or domiciliary; if he or she had not been a U.S. citizen or domiciliary for two years he or she would pay only 80% of the U.S. Federal gift or estate tax which otherwise would have been applicable and after ten years there would be no U.S. Federal gift or estate tax payable. Such an approach would be easier to administer than the one proposed and would eliminate the potential for a covered expatriate to give or bequeath property to a non-U.S. person who, in turn, would at some future time provide for the U.S. person, thus requiring the need for some form of intermediary rule which also might be difficult to administer.

If a covered expatriate's property is subject to a gift or estate tax (or other equivalent form of tax) in a jurisdiction other than the United States with which the United States has a treaty, the treaty should provide for the avoidance of double taxation. If there is no treaty, a credit for any such foreign tax should be provided against the U.S. Federal gift and estate tax.

X. Conclusion

We agree that enforcement of any tax imposed by reason of expatriation would be better served by an exit tax than it is by the current regime. However, we are troubled by many of the provisions of the proposed legislation.

In particular, we think that the proposed income or succession tax provisions applicable to gifts or bequests from covered expatriates, which applies regardless of the period of time between expatriation and the receipt of the gift or bequest, will be unenforceable and bad policy. It is for this reason that we make our alternative proposal for imposing gift and estates tax on an expatriate's worldwide estate, but at a tax rate that would decline over ten years to zero, as a regime more capable of enforcement.

We also believe that an expatriate should be subject either to Code Section 877 or 877A but not both. Once an expatriate has paid the exit tax, there is no reason to impose any additional taxes under Code Section 877, and doing so discourages U.S. investment.

We also are very concerned by an absence of appropriate protections from double taxation. In our experience, the vast majority of expatriates return to their countries of origin, most of which impose tax regimes at rates comparable to or even higher than rates imposed in the United States. Unless protection is afforded against double taxation, we believe that the new law may have the unintended consequence of fostering less rather than greater tax compliance.

For the same reason, we think that the new law must give greater attention to a person's ability to pay the tax. A person who is unable to pay the tax or post the security required for the privilege of deferring payment of the tax has no ability to expatriate *and* comply with his or her U.S. tax obligations. Apart from the point acknowledged by the Committee reports accompanying these bills that tax laws are not intended to prevent expatriation, it is not always the case that an individual has the option not to expatriate. Family and employment considerations may force expatriation, particularly for a long-term resident. A permanent resident visa may be revoked as well as relinquished.

An exit tax is likely to be complicated and expensive to administer. Therefore, we encourage the use of a withholding regime and deferral of imposition of the tax whenever the assets owned by an expatriate remain subject to U.S. tax jurisdiction and reasonable safeguards can be used to assure collection of the tax.

Finally, if expatriation is to be tax neutral, as we agree it should, the amount of U.S. tax imposed on an expatriate should not exceed the amount of U.S. tax he or she would have paid had he or she not expatriated. As explained above, the proposed bills do not achieve the neutrality objective. In many cases, the amount of tax imposed by the bills would greatly exceed the amount of tax the expatriate would have owed had he or she not expatriated.

Below are our recommendations:

- In lieu of the new tax proposed on gifts and bequests to U.S. persons from covered expatriates, which has the problems discussed in this report, subject a covered expatriate to gift and estate tax on his or her worldwide estate but at a declining rate of tax over time. If this recommendation is not followed, the new tax should be substantially revised in accordance with the recommendations set forth in this report.

- Except as provided above, once an expatriate has paid the exit tax, he or she should be treated like any other nonresident alien person.
- The exit tax should be not apply where assets owned by an expatriate remain subject to U.S. tax jurisdiction and appropriate mechanisms for collection of the U.S. tax are available.
- An expatriate should be given a reasonable and workable election to defer payment of the exit tax, and the amount of deferred tax due on disposition of an asset should not exceed the amount realized (or the value of an asset transferred, if gain is not required to be recognized).
- Appropriate adjustments to U.S. taxes should be allowed to avoid imposing more U.S. tax on an expatriate than he or she would have owed if he or she had not expatriated.
- Deductions and credits for taxes paid to foreign countries, and treaty protection for those entitled to it, must be allowed to offset the exit tax.