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IS THE NATION OF IMMIGRANTS PUNISHING ITS EMIGRANTS: A CRITICAL REVIEW OF THE EXPATRIATION RULES REVISED BY THE AMERICAN JOBS CREATION ACT OF 2004

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I. INTRODUCTION. 7
II. NORMATIVE PRINCIPLES: COHERENCE AND DISTRIBUTIVE JUSTICE. .. 9
A. Nonresident Aliens. 9
1.U.S. Income Taxation. 9
2. U.S. Estate and Gift Taxation. 10
B. U.S. Persons. 11
1. U.S. Income Taxation. 11
2. U.S. Estate and Gift Taxation. 19
C. Summary. 20
III. AN ALTERNATIVE METHOD OF TAXATION – TAXATION OF EXPATRIATES 20
A. Background 20
B. Expatriation Provisions Under FITA 21
C. Expatriation Provisions Under HIPAA. 23
1. Individuals Subject to the Alternative Method of Taxation. 23
2. Exceptions to Treatment as an Expatriate 25
3. The Alternative Method of Taxation 27
4. Coordination with Immigration Rules 29
5. Procedural Rules and Requirements. 29
6. Need for Change?. 30
7. Summary. 30
IV. EXPATRIATION PROVISIONS UNDER THE JOBS ACT 31
A. Individuals Subject to the Alternative Method of Taxation. 31
B. Exceptions to Treatment as an Expatriate. 32
C. The Alternative Method of Taxation. 36
D. Tax Rules for Determining Citizenship and Residency Termination. 37
E. Procedural Rules. 38

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F. Coordination with Immigration Provisions. 38
G. Summary. 38
V. A FAIR SYSTEM OF TAXATION FOR EXPATRIATES............................... 39
A. Mark-to-Market Regime Would End Expatriation for the Purpose of Tax Avoidance. 40
B. Mark-to-Market Regime Would be applied on the Basis of the Expatriate's Ability to Pay. 40
C. Mark-to-Market Regime Would Reduce Economic Inefficiency. 40
D. Mark-to-Market Regime Would Reduce Unequal Treatment of Expatriates. 41
E. Mark-to-Market Regime Would be Easier to Manage. 41
F. Mark-to-Market Regime Would Eliminate the Need for Alternative Estate and Gift Tax Provisions. 42
G. Additional Considerations. 42
VI. CONCLUSION. 42

I. INTRODUCTION

The thesis of this article is that the revised U.S. tax expatriation provisions fail to correct the most important defects of the prior U.S. tax expatriation regimes. Under the new rules, expatriating[1] U.S. citizens and resident aliens subject to the U.S. tax expatriation rules can still avoid U.S. tax on items properly taxable by the U.S. On the other hand, they remain subject to U.S. tax on income that should fall outside of U.S. tax jurisdiction.

During the last forty years, the U.S. has undertaken several attempts to capture what it sees as its rightful share of the income and gain of tax-motivated expatriates. In carrying out this policy, Congress developed a set of alternative U.S. tax rules applicable only to tax-motivated expatriates, subjecting them to an alternative method of U.S. taxation. From the perspective of the U.S., the necessity for an alternative method of taxation arises because of the bifurcated structure of the U.S. tax system, applying one set of rules to U.S. persons and another, generally more favorable set of rules to nonresident aliens. The U.S. imposes residence-based taxation on U.S. persons, subjecting them to U.S. income tax on their worldwide income, to U.S. estate tax on their worldwide estates, and to U.S. gift tax on their worldwide gifts.[2] On the other hand, the U.S. imposes source-based and business-based taxation on nonresident aliens, subjecting them to U.S. income tax on U.S.-source passive and business income, and to U.S. estate and gift tax on U.S. situs property.[3] In both situations, income is subject to U.S. tax only upon the occurrence of a recognition event. The divergence in the scope of the two tax regimes creates a situation in which the U.S. tax liability of an individual calculated under one tax regime could be markedly different from the individual's U.S. tax liability determined under the other tax regime, with nonresident alien status generally rendering the less "taxing" result. The financial benefits of nonresident alien tax status may encourage wealthy U.S. persons to expatriate and be taxed by the U.S. as nonresident aliens. The challenge posed by expatriation is especially acute because it involves moving from residence-based taxation to source-based taxation, potentially causing some unrealized gain to escape U.S. tax as certain gains are not subject to U.S. tax under source-based taxation.

Such tax-motivated expatriation is what Congress has been trying to prevent, first with the enactment of the Foreign Investors Tax Act of 1966

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1. For the purposes of this article, "to expatriate" means to renounce U.S. citizenship or to terminate U.S. resident alien status.

2. See IRC § 1(covering U.S. income taxes); IRC § 2001(covering U.S. estate taxes); IRC § 2501(covering U.S. gift taxes).

3. See IRC § 871(covering U.S. income taxes); IRC § 2101(covering U.S. estate taxes); IRC § 2501(covering U.S. gift taxes).

("FITA"),[4] followed by the changes introduced in the Health Insurance Portability and Accountability Act of 1996 ("HIPAA").[5] Pursuant to the alternative tax regime established by FITA, U.S. citizens who renounced their U.S. citizenship remained subject to U.S. income tax on U.S.-source income, as defined for that purpose, and to U.S. estate and gift tax on transfers of U.S. situs property, for a period of ten years if their expatriation was motivated in part by the avoidance of U.S. taxes. HIPAA extended the alternative method of taxation to certain U.S. resident aliens who terminated their U.S. residency with a purpose of such tax avoidance. Both the FITA and HIPAA rules provided some relevant exceptions from the application of the alternative regime. The American Jobs Creation Act of 2004 ("Jobs Act"),[6] signed into law on October 22, 2004, introduced four key changes to the expatriation provisions that affect all U.S. persons contemplating expatriation but does not completely eliminate the potential for tax-motivated expatriation.

Under the revised tax expatriation rules, an expatriate's actual motivation for termination of residency or renunciation of citizenship is no longer relevant and the alternative method applies if one of three bright-line tests is met. One of the three tests is independent of the expatriate's income or tax liability, thus completely eliminating the presumption of tax avoidance. In addition, the Jobs Act removed practically all meaningful exceptions from the application of the alternative method, in fact limiting the exceptions to a narrow group of U.S. citizens. The Jobs Act also adopted tax-based rules for determining whether, for U.S. tax purposes, an individual has in fact expatriated. Last but not least, the alternative tax regime no longer applies to an expatriate otherwise subject to the alternative regime who, in any given year within the ten-year period following expatriation, spends more than thirty days in the U.S. Instead, the Jobs Act subjects such returning U.S. persons to full U.S. taxation.

In this Article, I argue that the revised rules do not fully eradicate the potential for tax avoidance through tax-motivated expatriation. Instead, the amended rules create new problems. The abandonment of the tax avoidance motive, the elimination of the ruling request procedure, the addition of a bright-line test, and the use of tax rules for determining whether one has expatriated may be viewed as positive developments. These changes reduce the potential for subjective judgment calls, lessen the administrative burden on the Internal Revenue Service ("IRS"), and broaden the taxpayer base subject to the alternative method. However, the revised provisions still

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4. Pub. L. No. 89-809, 80 Stat. 1539 (1966) (codified as amended in scattered section of 26 U.S.C.).

5. Pub. L. No. 104-191, 110 Stat. 1936 (1996) (codified as amended in scattered section of 26 U.S.C.).

6. Pub. L. No. 108-357, 118 Stat. 1418 (2004) (codified as amended in scattered section of 26 U.S.C.).

subject expatriates to U.S. tax on certain gains that should be free of U.S. tax. In addition, expatriates can still avoid U.S. tax on accrued gain by holding on to property with accrued gain for the ten-year period during which the alternative method applies. This also creates unequal tax treatment among similarly situated expatriates. Moreover, the revised rules treat U.S. citizens and resident aliens unequally, allowing some exceptions to U.S. citizens that technically cannot be extended to U.S. resident aliens. Last but not least, the expatriation provisions are out of step with international norms, in particular by taxing former U.S. citizens and resident aliens subject to the alternative regime as U.S. persons in any one year during the ten-year period in which they return to the U.S. for as little as thirty-one days a year.

Part II of this article provides a brief overview of the U.S. taxation of U.S. persons and nonresident aliens and highlights the areas relevant in triggering tax-motivated expatriation. Part III examines the alternative method of taxation developed in response to tax-motivated expatriation and compares the FITA and HIPAA expatriation provisions. Part III also examines the problems that plagued the FITA and HIPAA expatriation provisions and ultimately triggered reform. Part IV analyzes the expatriation provisions of the Jobs Act by detailing the U.S. tax effects on expatriating individuals and by highlighting areas in need of reform. Part V argues that Congress should consider adopting a mark-to-market approach for taxing expatriates because such an approach would eliminate the potential for tax avoidance, prevent the U.S. taxation of income accrued after expatriation, eliminate economic inefficiencies caused by the dissimilar tax treatment of U.S.-source and foreign-source income, and would conform to international tax norms. Part VI provides a summary of the key characteristics of the current expatriation regime and briefly outlines the most compelling reasons for the adoption of a mark-to-market regime.

II. Taxation of Individuals

The U.S. has developed two distinct systems of taxation, one applicable to U.S. persons and the other to nonresident aliens. Therefore, the first step that must be taken in resolving whether and to what extent a certain person is subject to U.S. tax is determining whether she is a U.S. person or a nonresident alien.

A. Nonresident Aliens

1. U.S. Income Taxation – A nonresident alien is a non-U.S. citizen individual who does not qualify as a U.S. resident alien under the residency rules.[7] In general, the extent to which a nonresident alien is subject to U.S.

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7. IRC § 7701(b)(1)(B).

tax depends on the source and the type of the income. Nonresident aliens are generally subject to U.S. income tax at a flat rate of 30% on U.S.-source fixed or determinable annual or periodical income that is not effectively connected with a U.S. trade or business.[8] Nonresident aliens are also subject to a 30% U.S. tax on capital gain, but only if they are present in the U.S. in a given year for a period aggregating 183 days or more.[9] The 30% tax is based on the gross amount of income and is generally collected through withholding under section 1441 of the Code.[10] In addition, nonresident aliens are subject to U.S. income tax, at graduated rates under section 1 of the Code, on income that is effectively connected with the conduct of a U.S. trade or business.[11] Effectively connected income includes gain on the sale of a U.S. real property interest.[12] Foreign-source income earned by nonresident aliens is generally not subject to U.S. income tax.

The U.S. income taxation of a nonresident alien may be modified by an applicable bilateral income tax treaty if the nonresident alien qualifies for benefits under the treaty. A nonresident alien generally qualifies for treaty benefits only if she is a bona fide tax resident of the U.S. treaty partner.[13]

2. U.S. Estate and Gift Taxation – Nonresident aliens are also subject to U.S. estate tax on U.S. situs property, which generally includes real property and tangible personal property located in the U.S., as well as stock

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8. IRC § 871(a)(1).

9. IRC § 871(a)(2).

10. IRC § 1441.

11. IRC § 871(b). A detailed examination of what constitutes income that is effectively connected with the conduct of a U.S. trade or business is beyond the scope of this article. Courts generally hold that profit-oriented activities in the U.S. will be considered to constitute a trade or business only if such activities are regular, substantial, and continuous. See Comm'r v. Spermacet Whaling & Shipping Co., 281 F.2d 646 (6th Cir. 1960) (a foreign corporate taxpayer engaged in a whaling expedition off the coast of South America for the purpose of obtaining sperm oil and selling it to a U.S. refinery for resale was not engaged in a U.S. trade or business because the activity was not regular, substantial, and continuous).

12. IRC § 897(a). Before the enactment of the Foreign Investment in Real Property Tax Act of 1980, nonresident aliens investing in U.S. real estate often paid no tax on gain derived from the disposition of U.S. real property held for investment or personal use as such gain did not qualify as fixed or determinable annual or periodical income or gain, or as income effectively connected with the conduct of a U.S. trade or business.

13. Pursuant to Article 4 of the U.S. Model Income Tax Convention, only those persons will be considered residents of a state who, under the laws of that state, are liable to tax therein on her worldwide income by reason of domicile, residence, place of incorporation, place of management or any other criterion of a similar nature. See U.S. Model Income Tax Convention, art. 4 (1996).

in a U.S. corporation.[14] To prevent nonresident aliens from escaping U.S. estate taxes by simply giving away during their lifetime all of their assets otherwise subject to U.S. estate tax, the U.S. subjects nonresident aliens to U.S. gift tax on transfers of real or tangible personal property located in the U.S.[15] Of course, these U.S. estate and gift tax rules are also subject to bilateral estate and gift tax treaty modifications, which may provide some significant benefits to residents of certain treaty countries.[16]

The limited U.S. taxation of nonresident aliens reflects sound tax policy. As a general rule, nonresident aliens have an insubstantial connection to the U.S. and their worldwide income should not be subject to U.S. taxation. On the other hand, imposing U.S. tax on U.S.-source income and on income connected with a U.S. trade or business makes sense because the U.S. provided the particular benefit, e.g., the sales that generated the income.[17]

B. U.S. Persons

1. U.S. Income Taxation – On the other hand, the U.S. subjects all U.S. persons to U.S. income tax on their worldwide income, regardless of the source of the income. Accordingly, all of the income that a U.S. citizen or U.S. resident alien earns generally is subject to U.S. individual income tax at graduated rates under section 1 of the Code, even if the individual does not reside or spend time in the U.S. and the income is entirely from foreign sources.[18] Most countries tax their residents, including resident citizens, on their worldwide income, but the U.S. may be the only country that taxes all of its citizens, including those residing in other countries, on their worldwide

14. IRC §§ 2101, 2106.

15. IRC § 2501.

16. Pursuant to Article 5 of the U.S.-German Estate Tax Treaty, immovable property that forms part of the estate of a U.S. domiciliary but is located in Germany generally will be subject only to German estate tax instead of both U.S. and German estate taxes. See Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, June 27, 1986, art. 5, T.I.A.S. 11082.

17. As a practical matter, the U.S. refrains from taxing all U.S.-source income so as to encourage foreign investment in the U.S. For example, pursuant to IRC § 871(i)(2)(A), nonresident aliens are generally exempt from U.S. tax on interest from deposits not effectively connected with the conduct of a U.S. trade or business. Similarly, IRC § 871(h) exempts from U.S. tax portfolio interest paid to nonresident aliens.

18. IRC § 61. Gross income is defined as income from all sources. Thus, foreign-source items of income are subject to U.S. income tax unless specifically excluded by another section of the Code.

income.[19] The Supreme Court held in Cook v. Tait that the U.S. taxation of a U.S. citizen's worldwide income is in fact constitutional and is in compliance with international law.[20]

The worldwide taxation of U.S. persons is often viewed as necessary because an individual's total income, wherever earned or sourced, affects her ability to pay U.S. taxes.[21] In addition, if in the hands of U.S. persons foreign-source income were exempt from U.S. tax or were taxed at a lower rate than U.S. source income, it would encourage the shifting of capital abroad and potentially reduce investment in the U.S. On the other hand, taxing foreign-source income at a higher rate than U.S.-source income would be detrimental to the free flow of capital and would have a negative effect on free trade.

Although U.S. persons are subject to U.S. tax on their worldwide income, U.S. tax on their income is deferred because the U.S. taxes income only upon the occurrence of a recognition event. For example, a U.S. shareholder of a U.S. corporation is not taxed on the income of the corporation until the corporation makes a distribution of income to the shareholder in the form of a dividend.[22] Similarly, a U.S. shareholder of a U.S. corporation is not taxed on the appreciation in the value of her stock in that corporation until she disposes of the stock.[23] Consequently, U.S. persons with such accrued but unrecognized gain could avoid U.S. tax through the use of various tax planning techniques, including transfers of appreciated property to a foreign corporation that could sell the appreciated property free of U.S. tax. To prevent such abuses and protect residence-based taxation, Congress has enacted various provisions to ensure that income and gain attributable to U.S. shareholders are in fact taxed to U.S. shareholders.[24]

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19. See generally Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates, and Gifts, § 65.1. (5th Ed. 1999) (providing a comprehensive overview of the U.S. taxation of U.S. citizens and resident aliens).

20. 265 U.S. 47 (1924).

21. See Jeffrey M. Colon, Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy, 34 San Diego L. Rev. 1, 10 (1997) (analyzing the bases for the worldwide taxation of U.S. citizens and resident aliens).

22. IRC § 61(a)(7).

23. IRC § 1001.

24. See IRC § 367 (transfer of property from the U.S.); IRC § 551-558 (foreign personal holding company regime, repealed by the Jobs Act); IRC § 951-964 (controlled foreign corporation regime); IRC § 1291-1298 (passive foreign investment company regime). A detailed discussion or these provisions is beyond the scope of this article. For in-depth analysis, see Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation, ¶ B2 (1991).

a) Tests for U.S. Residency

As the term U.S. person includes U.S. resident aliens, the U.S. income taxation of a non-U.S. citizen individual depends on whether she is considered a U.S. resident alien or a nonresident alien for U.S. tax purposes. A non-U.S. citizen may be considered a U.S. resident alien for U.S. tax purposes, but remain a nonresident alien for immigration purposes. For example, a non-U.S. citizen holding a nonimmigrant "H" visa and working in the U.S. on a full-time basis is a nonresident alien under U.S. immigration law but is likely to be considered a U.S. resident alien under U.S. tax law. If a non-U.S. citizen is a nonresident alien for U.S. tax purposes, the rules detailed in the previous section of this article will apply.

On the other hand, if a non-U.S. citizen meets the definition of a U.S. resident alien, she will be taxed in the same manner as a U.S. citizen. The Code provides that a non-U.S. citizen will be treated as a U.S. resident alien for U.S. income tax purposes if she fall into one of three categories.[25]

(1) U.S. Permanent Resident Test

First, a non-U.S. citizen will be considered a U.S. resident alien for tax purposes if she has been lawfully admitted to the U.S. for permanent residence.[26] A person lawfully admitted to the U.S. for permanent residence is a U.S. resident alien for both U.S. income tax and U.S. immigration purposes. This test for U.S. permanent residence is sometimes referred to as the "green card test." Consequently, if a non-U.S. citizen is treated as a U.S. landed resident for U.S. immigration purposes, she will be treated as a U.S. resident alien for U.S. tax purposes.[27]

(2) Substantial Presence Test

In addition, a non-U.S. citizen will be considered a U.S. resident alien for U.S. tax purposes if she is physically present in the U.S. for at least thirty-one days during the current calendar year and has been present in the U.S. for at least 183 days during the three-year testing period, including the current year, using weighted counting.[28] Under this method, each day of presence in the U.S. in the current year is treated as a full day, each day of presence in the U.S. in the immediately preceding year is treated as one-third of a day, and each day of presence in the U.S. in the second preceding year is

25. IRC § 7701(b)(1)(A).

26. IRC § 7701(b)(1)(A)(i), Regs. § 301.7701(b)-1(b)(1).

27. A U.S. resident who meets the green card test may be able to claim nonresident alien status pursuant to the tie-breaker provisions of a bilateral U.S. income tax treaty.

28. IRC § 7701(b)(3)(A); Regs. § 301.7701(b)-1(c).

treated as one-sixth of a day.[29] If the individual is not present in the U.S. in the current year for at least thirty-one days, she will not be considered a U.S. resident alien under this test, even if she otherwise satisfies the 183-day average.[30] Generally, if a nonresident alien is never present in the U.S. for more than 120 days in any one year, she will be able to avoid U.S. resident alien status under the weighted counting method.[31] This test is designed to capture nonresident aliens who establish solid connections to the U.S. warranting their taxation as U.S. persons.

For the purpose of applying the substantial presence test, an individual is considered to be present in the U.S. if she is present during any part of the day.[32] However, certain days of presence in the U.S. are ignored for this purpose. First, the days of presence of an individual in the U.S. as a result of a medical condition that arose while such individual was present in the U.S. will not count as days of presence.[33] Similarly, days of presence in the U.S. by Mexican and Canadian residents as regular commuters[34] from those countries will not count as days of presence for the purpose of this test, and neither will days of presence in the U.S. by a nonresident alien for less than twenty-four hours, provided that their presence in the U.S. is merely incidental to their travels between two foreign points.[35] There are also certain categories of individuals who are considered exempt and none of their days of presence in the U.S. count for the purpose of the substantial presence test. Exempt individuals include employees of foreign governments,[36] employees

29. IRC § 7701(b)(3)(A)(ii).

30. IRC § 7701(b)(3)(A)(i).

31. If a nonresident alien is present in the U.S. for exactly 120 days every year, she will not be considered a U.S. resident alien under the substantial presence test because her physical presence in the U.S. will not reach 183 days: she is deemed to be physically in the U.S. on 120 days in the current year, forty days (one-third of 120) in the immediately preceding year, and twenty days (one-sixth of 120) in the second preceding year, totaling 180 days over the three-year testing period.

32. IRC § 7701(b)(7)(A).

33. Regs. § 301.7701(b)-3(c). If a nonresident alien travels to the U.S. for the purpose of receiving medical treatment, none of the days spent in the U.S. for that purpose is exempt.

34. IRC § 7701(b)(7)(B), Regs. § 301.7701(b)-3(e).

35. IRC § 7701(b)(7)(C), Regs. § 301.7701(b)-3(d). Pursuant to this exception, if a nonresident alien comes to the U.S. for the purpose of conducting business at an airport while traveling to another foreign point, an argument can be made that she is present in the U.S. on that day for the purpose of the substantial presence test because her presence in the U.S. is not merely incidental to travels between two foreign points.

36. Regs. § 301.7701(b)-3(b)(2). This means that an ambassador or an employee of a consulate or embassy can remain in the U.S. for an unlimited period of time without ever becoming a U.S. resident.

of international organizations,[37] teachers and trainees,[38] students,[39] as well as professional athletes who are temporarily present in the U.S. in order to compete in charitable sports events.[40] Crewmembers of foreign vessels are also exempt, provided they do not conduct any other trade or business in the U.S. during their presence.[41] Individuals falling into the exempt categories are treated as being temporarily present in the U.S., as evidenced by their nonimmigrant visa status, and their temporary presence does not warrant residence-based U.S. taxation.

(3) First Year Election

A non-U.S. citizen can make an affirmative election to be treated as a U.S. resident alien for U.S. tax purposes. Eligibility for making this election is limited to any non-U.S. citizen who is a nonresident alien in the current year and in the preceding year, but is a U.S. resident alien under the substantial presence test during the following year. In addition, a non-U.S. citizen making this election must be present in the U.S. for at least thirty-one consecutive days in the year for which she is making the election and must be present in the U.S. for a period that includes 75 or more of the days starting with the first day of the thirty-one day period and ending with the last day of the year.[42] This test is also referred to as the "first-year election" because the nonresident alien would be considered a U.S. resident alien in the following year in any case, subjecting her to U.S. tax on her worldwide income. This election affords a nonresident alien the opportunity to be treated as a U.S. resident alien sooner and take advantage of any applicable deductions or credits not available to person subject to U.S. taxation as nonresident aliens.

b) Exceptions to Treatment as a U.S. Tax Resident

Two of the three tests for treatment as a U.S. resident alien for U.S. tax purposes require an affirmative election by the non-U.S. citizen. On the other hand, under the substantial presence test, U.S. residency is "forced" on a person who, for U.S. immigration purposes, is a nonresident alien.

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37. Id.

38. Regs. § 301.7701(b)-3(b)(3). However, the regulations limit the number of years for which the exemption may be claimed by teachers and trainees. Regs. § 301.7701(b)-3(b)(7).

39. Regs. § 301.7701(b)-3(b)(3). However, the regulations limit the number of years for which the exemption may be claimed by students. Regs. § 301.7701(b)-3(b)(7).

40. Regs. § 301.7701(b)-3(b)(5).

41. IRC § 7701(b)(7)(D).

42. IRC § 7701(b)(4).

Nonetheless, an individual who meets the substantial presence test may still be able to avoid U.S. residency in one of two ways.

(1) Closer Connection Exception

Under the so-called closer connection exception, a nonresident alien who is a U.S. tax resident under the substantial presence test can avoid U.S. resident alien status if she can establish that she was present in the U.S. for less than 183 days during the current calendar year and has a "tax home"[43] in a country to which she has a "closer connection"[44] than to the U.S.[45] An individual's tax home is located at her regular or principal place of business, or, if she is not engaged in any business or occupation, her tax home will be her regular place of abode. An individual can establish that she has a closer connection to such a tax home by demonstrating that she has maintained "more significant contacts" with that country, including the location of her permanent home, family, personal belongings, personal bank accounts and similar criteria.[46] The closer connection exception can be especially useful for individuals who do not qualify for income tax treaty benefits and cannot claim nonresident status under the treaty tie-breaker rules. However, the exception is not available for any nonresident alien who applies for U.S. permanent resident status during a given taxable year as an application for permanent residency clearly negates the person's closer connection to the foreign country.[47]

An individual who is deemed a U.S. resident alien by virtue of the substantial presence test and who wants to claim nonresident alien status pursuant to the closer connection exception must claim such status on Form 8840 (Closer Connection Exception Statement for Aliens) and attach it to her Form 1040NR tax return for the year.[48]

(2) Treaty Tie-Breakers

Similarly, if an individual is considered a U.S. resident alien under one of the three residency tests and she is also considered a tax resident of another country under that country's internal laws, she can utilize the tie-breaker rules of the applicable income tax treaty to determine her country of residence for income tax purposes. Accordingly, by applying the treaty tie-breaker rules, a dual resident can claim nonresident alien status for U.S. tax

43. IRC § 7701(b)(3)(B), Regs. § 301.7701(b)-2(c).
44. IRC § 7701(b)(3)(B), Regs. § 301.7701(b)-2(d).
45. IRC § 7701(b)(3)(B), Regs. §§ 301.7701(b)-2(c), (d).
46. Regs. § 301.7701(b)-2(d).
47. IRC § 7701(b)(3)(C).
48. Regs. § 301.7701(b)-8.

purposes.[49] The tie-breaker rules generally determine a person's residence by first determining the permanent home of the individual. "Permanent home" generally means a dwelling that is continuously available to the individual if her stay at the home is intended to be permanent. If the individual has a permanent home in both states, her "center of vital interests" determines her residency status. A center of vital interests takes into account the location of the individual's family, employment, friends, personal possessions, political and cultural activities, and other similar criteria. If the individual's center of vital interests cannot be determined, the state in which she has a habitual abode will be determinative in assigning residency for this purpose. "Habitual abode" is the place where the individual stays more frequently. If the habitual abode element of the test also fails to render a clear result, the citizenship of the individual is the next factor. Should that fail as well, the authorities of both states can make a mutual determination as to the person's residence.[50] However, in most cases, it should be fairly easy to determine the location of a person's permanent home or, if she has more than one permanent home, the location of her center of vital interests.

If a "dual-resident" U.S. resident alien takes the position that she is, in fact, a nonresident alien of the U.S. pursuant to a treaty tie-breaker provision and is a resident of the treaty partner, she must file Form 8833 (Treaty-based Return Position Disclosure under sections 6114 or 7701(b)) with her Form 1040NR nonresident alien income tax return.[51] However, such a dual resident who is treated as a nonresident alien pursuant to a tie-breaker provision will still be considered a U.S. resident alien for all purposes of the Code, other than the calculation of her U.S. income tax liability.[52] For example, a dual resident tie-breaker in favor of a treaty partner will continue to be treated as a U.S. tax resident for the purpose of determining whether a certain foreign corporation is a controlled foreign corporation ("CFC") for the purpose of applying the CFC rules.[53]

(3) Effects of the Exceptions

Both exceptions will allow a bona fide resident of another country to avoid U.S. resident alien status for U.S. income tax purposes. On the other hand, the exceptions will not help a wealthy individual avoid full U.S. income taxation if she cannot satisfy either exception because she spends a limited amount of time in various countries for the purpose of avoiding full

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49. Regs. § 301.7701(b)-7.

50. See, e.g., Income Tax Treaty, July 19, 2002, U.S.-U.K., Volume 4 art. 4(5), Tax Treaties (CCH) ¶ 10,901.04.

51. Regs. § 301.7701(b)-7(b)-(c).

52. Regs. § 301.7701(b)-7(a)(3).

53. Id.

taxation in any one country and, as a result, does not have a closer connection to or a center of vital interests in any other country.

The "center of vital interests" element of the tie-breaker provisions resembles the "closer connection exception" to the substantial presence test. Such similarity makes sense as both tests are used to determine a dual-resident individual's tax status. As previously noted, the closer connection test is generally relied upon only if a person cannot benefit from a treaty and, therefore, cannot rely on the treaty tie-breaker rules to claim non-U.S. resident status. Reliance on an income tax treaty is more advantageous because it carries certain other benefits. For example, under the German-U.S. Income Tax Treaty, German-source interest derived and beneficially owned by a resident of the U.S. is generally taxable in the U.S. only.[54] Without reliance on the treaty, the interest income could be taxed in both countries and the individual would have to rely on foreign taxation credits to avoid double tax on this income.[55]

Although an individual who is considered a U.S. resident alien under domestic tax law may rely on the tie-breaker provision of a tax treaty to claim non-U.S. status, the U.S. reserves the right to tax its residents on their worldwide income. Most bilateral tax treaties contain a "saving clause" providing that the U.S. reserves the right to tax its citizens and residents, as residence is determined by the treaty, on their worldwide income.[56] It is unclear what purpose the reference to U.S. residents serves in treaties with this type of saving clause because if the individual tie-breaks in favor of the treaty partner, she will be considered a nonresident alien of the U.S. under the tie-breaker provision and, therefore, under the saving clause as well.[57] U.S. citizens, of course, are always "fair game" and generally will be subject to U.S. tax on their worldwide income regardless of whether or not they reside in the U.S.[58] The definition of U.S. citizens, for this purpose, also includes former citizens subject to U.S. taxation under section 877. However,

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54. Income Tax Treaty, August 21, 1991, U.S. – FRG, Vol. 2 art. 11(1), Tax Treaties (CCH) ¶ 3203.23.

55. IRC § 904(a). Foreign tax credits provide limited relief only, as the amount of foreign taxes paid that can be used to reduce U.S. tax is limited to an amount equal to the pre-credit U.S. tax on the individual's foreign source income.

56. See generally Income Tax Treaty, July 19, 2002, U.S.-U.K., Vol. 4 art. 1(4), Tax Treaties (CCH) ¶ 10,900; see also Income Tax Treaty, August 21, 1991, U.S. – FRG, Vol. 2 Protocol art. 1(a), Tax Treaties (CCH) ¶ 3210.

57. Income Tax Treaty art. 1(4), July 19, 2002, U.S.-U.K., Tax Treaties (CCH) ¶ 10,901.1. Most treaties contain a savings clause that defines U.S. resident with reference to the treaty definition of U.S. resident.

58. See e.g., Priebe v. Comm'r, 51 T.C.M. (CCH) 907 (T.C. 1986) (a U.S. citizen residing and working in Canada as a minister was subject to U.S. self-employment tax on income earned in Canada by operation of the saving clause of the U.S.-Canada Income Tax Treaty).

as a practical matter, other treaty provisions often limit the reach of treaty saving clauses.[59]

2. U.S. Estate and Gift Taxation – U.S. citizens and U.S. resident aliens are also subject to U.S. gift tax on transfers of property by gift,[60] regardless of where the property is actually located, and to U.S. estate tax on the value of their taxable estate at the time of their death, regardless of where the property is situated.[61] The definition of U.S. resident alien for U.S. estate and gift tax purposes differs from the definition of U.S. resident alien for U.S. income tax purposes. For U.S. estate tax purposes, a U.S. resident alien is a decedent who, at the time of her death, had her "domicile" in the U.S. Domicile means a place where the individual lives, for even a brief period of time, with no definite present intention of later moving from such location. Residence without the "requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal."[62] The definition of U.S. resident alien for U.S. gift tax purposes is the same as for U.S. estate tax purposes, except that the domicile of the person is tested at the time of the making of the gift.

If a decedent or donor is considered a domiciliary of the U.S. under U.S. law and the domiciliary of another country under that country's internal laws, the tie-breaker rules of an applicable estate and gift tax treaty may be utilized to determine the residence of the decedent or donor. Estate and gift tax treaty tie-breaker provisions are similar to the tie-breaker provisions of income tax treaties.[63] Bilateral estate tax and gift tax treaties provide specific rules for the taxation of certain types of properties owned by decedents and donors.

A review of the applicable U.S. estate tax rates demonstrates why a wealthy U.S. citizen or resident alien might want to avoid paying U.S. tax on her worldwide estate.[64] At present, U.S. citizens and resident aliens are

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59. For example, Article 1(5) of the U.K.-U.S. Income Tax Treaty provides that the right to tax residents and citizens on their worldwide income does not affect Article 24, which provides relief from double taxation. See Income Tax Treaty, July 19, 2002, U.S.-U.K., Tax Treaties (CCH) ¶ 10,901.1.

60. IRC § 2501(a).

61. IRC §§ 2001, 2031.

62. Regs. § 20.0-1(b)(1).

63. See, e.g., Estate Tax Treaty, June 27, 1986, U.S.-FRG, Vol. 2 art. 4(5), Tax Treaties (CCH) ¶ 3259.05.

64. See Richard A. Westin, Expatriation and Return: An Examination of Taxdriven Expatriation by United States Citizens, and Reform Proposals, 20 Va. Tax. Rev. 75, 80-85 (2000) (analyzing the driving forces behind expatriation, including U.S. estate tax).

subject to a 47% U.S. estate tax, with a $1,500,000 exclusion amount.[65] Although this rate is less than it has been in the past,[66] citizens and residents of certain other countries pay significantly less in estate taxes. Switzerland, for example, has no federal estate tax, providing a financial incentive to wealthy U.S. persons to become Swiss residents or citizens and be subject to U.S. estate taxes only on their U.S. situs property.[67]

C. Summary

The U.S. taxes its citizens and resident aliens on their worldwide income, estates, and gifts, whereas nonresident aliens are subject to limited U.S. taxation only. Consequently, an individual's classification as a U.S. person or as a nonresident alien for U.S. tax purposes can have a significant effect on the individual's U.S. tax liability. Such differences in U.S. tax liability may motivate some wealthy U.S. persons to expatriate and be taxed as nonresident aliens. To prevent tax-motivated expatriation that results in the avoidance of U.S. taxes, the U.S. has developed an alternative method of taxation applicable only to expatriates who meet certain criteria. This alternative method of taxation is examined in the next part of this article.

III. AN ALTERNATIVE METHOD OF TAXATION – TAXATION OF EXPATRIATES

A. Background

The alternative method of taxation developed as a result of the immense differences between the U.S. income, estate and gift taxation of U.S. citizens and resident aliens and the U.S. income, estate, and gift taxation of nonresident aliens, as explained above.

The need for a special method of taxation became pressing in 1966, when FITA eliminated the progressive income tax rates on the U.S.-source income of nonresident aliens that was not effectively connected with a U.S. trade or business and, thus, made nonresident alien tax status more attractive.[68] U.S. individual income and estate tax rates under the 1954 Code

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65. IRC § 2001(c).

66. Id. For example, for estates of decedents dying in 2003, the applicable estate tax rate was 49%.

67. See, Official Swiss Ministry resources, at http://www.ch.ch. Swiss cantons impose estate tax, but rates are very low compared to rates imposed by other countries and states.

68. Pub. L. No. 89-809, 80 Stat. 1541 (1966). Prior to 1966, nonresident aliens engaged in a U.S. trade or business were subject to U.S. income tax at graduated rates on all income derived from U.S. sources, including dividends, interest and other fixed or determinable, annual or periodical income. Nonresident aliens were also subject to

were quite high – an individual with $200,000 in annual income was subject to U.S. income tax at a rate of approximately 90%.[69] Similarly, a U.S. decedent leaving an estate of $2 million was subject to U.S. estate tax at a rate of approximately 50%.[70]

Without the existence of a "special" method of taxation, wealthy U.S. citizens could potentially renounce their citizenship and U.S. resident aliens could terminate their U.S. residency, transfer their assets accumulated in the U.S. to their new home country, potentially without recognizing any of the accrued gain, and later return to the U.S. for up to 120 days a year and be subject to U.S. taxation as nonresident aliens only. These tax-motivated expatriates could leave all of their non-U.S.-source income and assets outside of the taxing power of the U.S., and yet continue to spend a significant amount of their time in the U.S. with family and friends and enjoy the benefits offered by their former home country. Consequently, to avoid such perceived abuses, an alternative method of taxation was developed to apply for a limited time period to those U.S. citizens who renounce their U.S. citizenship and to those U.S. resident aliens who terminate their U.S. residency (and meet certain other requirements), with the purpose of avoiding U.S. taxes.

B. Expatriation provisions under FITA

FITA introduced the expatriation provisions in section 877, subjecting former U.S. citizens to U.S. income tax on U.S.-source income and on income effectively connected with a U.S. trade or business for a period of ten years following termination of U.S. citizenship if such termination had as one of its principal purposes the avoidance of U.S. taxes.[71] Gains from the sale or exchange of property (other than stock or debt obligations) located in the U.S. and gains from the sale or exchange of stock of a U.S. corporation or a debt obligation of a U.S. person were considered U.S. sources for the purpose of the expatriation provisions.

In addition, FITA added ection 2107 to the expatriation provisions, discouraging U.S. citizens from renouncing their U.S. citizenship to become nonresident aliens for U.S. estate tax purposes. Congress felt that it was "doubtful that many citizens would expatriate for this reason," but noted that

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U.S. estate tax on U.S. situs property (real or intangible), and to U.S. gift tax on U.S. situs tangible property. However, nonresident aliens were not subject to U.S. tax on any foreign-source income, even if such income was earned by a U.S. business. See H.R. Rep. No. 89-1450, pt. 4, at 22-23 (1966), reprinted in 1966 U.S.C.C.A.N. 965, 999-1000.

69. IRC § 1 (1954). The 1954 Code, as amended, was in effect in 1966.

70. IRC § 2001 (1954).

71. IRC § 877 (1966).

the removal of such incentive is desirable nonetheless.[72] Consequently, section 2107 imposed U.S. estate tax on the gross estate, comprised of U.S. situs property, of every former U.S. citizen who renounced her U.S. citizenship with a principal purpose of avoiding U.S. estate taxes and provided for a look-through rule to expand U.S. estate taxes on U.S. situs assets held by the expatriate through a CFC.[73] With respect to U.S. gift tax, FITA added section 2501(a)(3), which provided that the intangibles exception ordinarily available to nonresident aliens under section 2501(a)(2) was not applicable to those former U.S. citizens who terminated their U.S. citizenship with a principal purpose of avoiding U.S. taxes.[74]

These new income, estate, and gift tax provisions reflected Congress's desire to prevent the loss of U.S. tax revenues caused by switching from residence-based taxation to source-based taxation. However, the expatriation regime suffered from a basic design flaw from its inception. The source-conversion rules treated as U.S.-source income certain income and gain that accrued following expatriation and should have been free of U.S. tax. On the other hand, the ten-year rule created a potential for tax avoidance by encouraging expatriates to postpone recognition events until the expiration of the ten-year period. These two features are irreconcilable. Although the goal of the expatriation provisions is justified, the means is not suited for achieving that goal.

These design flaws created the numerous problems that afflicted the FITA expatriation provisions. The broad application of the alternative method and its dependence on the facts and circumstances of each case of expatriation made the regime difficult to administer. Similarly, the presumption rules were relaxed, placing the burden on the government to establish that it is reasonable to believe that a person's loss of citizenship would result in the substantial reduction of their U.S. income tax liability.[75] Only after the government met this burden was the burden shifted to the expatriate to show that the purpose of expatriation was not the avoidance of U.S. taxes.[76] The presumption rules were not properly coordinated and a tax avoidance motive established for U.S. income tax purposes did not necessarily establish a tax avoidance motive for U.S. estate or gift tax purposes. The burden again rested with the government to show that the loss of an individual's U.S. citizenship resulted in a substantial reduction of her U.S. estate taxes.[77] Similarly, the existence of a tax avoidance motive for U.S. income or estate tax purposes did not automatically establish tax

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72. H.R. Rep. No. 89-1450, supra note 66, at 22-23, reprinted in 1993 U.S.C.C.A.N. at 999-1000.

73. IRC § 2107 (1966).

74. IRC § 2501(a)(2)-(3) (1966).

75. IRC § 877(e) (1966).

76. See id.

77. IRC § 2107(e) (1966).

avoidance for U.S. gift tax purposes and the burden rested with the government to show that the loss of an individual's U.S. citizenship resulted in a substantial reduction of her U.S. gift taxes.[78]

In addition, U.S.-source income could be converted to non-U.S. source income with relative ease.[79] As a result of residing outside of the U.S., most of the income and gain of expatriates is expected to be foreign source. Since only U.S.-source income was subject to U.S. income tax under the alternative tax regime, most of the income of an expatriate fell outside the taxing power of the U.S.[80] However, with the use of certain tax planning techniques, an expatriate's U.S. tax burden could have been minimized even on U.S.-source income, which, for this purpose, included gain on the sale or exchange of property located in the U.S. and gain on the sale or exchange of U.S. stock or U.S. debt obligations.[81] For example, an expatriate who purchased stock in a U.S. corporation while still a U.S. citizen and continued to own such stock following her expatriation was subject to U.S. income tax on the gain resulting from the sale of the U.S. stock during the ten-year period. However, if the expatriate contributed the stock to a foreign corporation not engaged in a U.S. trade or business, the gain escaped U.S. income tax and the foreign corporation was able to sell the stock free of U.S. income tax and pay foreign-source dividends to the expatriate.[82] Thus, the expatriate completely avoided U.S. tax on the gain that accrued while she was a U.S. citizen.

The glitches and problems of the FITA regime spurred reform, but the amended HIPAA expatriation provisions suffered from the same faulty construction that did not allow the right amount of U.S. tax to be captured.

C. Expatriation Provisions under HIPAA

1. Individuals subject to the alternative method of taxation – The HIPAA version of section 877 continued to subject to U.S. income tax on U.S.-source income for the ten-year period those U.S. citizens who terminated their citizenship with a principal purpose of U.S. tax avoidance.[83]

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78. IRC § 2501(a)(4) (1966).

79. Colon, supra note 21, at 53-54.

80. IRC § 877(c) (1966).

81. Id.

82. See, e.g., David S. Zimble, Expatriate Games: The U.S. Taxation of Former Citizens, 93 TNT 226-165 (Nov. 1, 1993) (highlighting the tax planning techniques that allowed U.S. persons to achieve significant tax saving despite the application of the alternative tax regime).

83. IRC § 877(a)(1).

It also extended the same tax treatment to those U.S. resident aliens who were considered long-term U.S. resident aliens.[84]

The addition of section 877(e) was a major amendment to section 877, extending the expatriation rules to a group of U.S. resident aliens who were previously free to terminate their U.S. residency and return to their country of citizenship without any adverse U.S. tax consequences.

The Code did not provide tax-based rules for determining when a U.S. citizen was considered to have relinquished her citizenship or a long-term U.S. resident terminated her long-term U.S. residency for U.S. tax purposes. In the absence of tax-based rules, the Code relied on the Immigration and Nationality Act ("INA")[85] to determine whether, for the purpose of the expatriation provisions, a U.S. citizen relinquished her U.S. citizenship or a long-term U.S. resident alien terminated her U.S. residency. The INA provides that a U.S. citizen can relinquish her citizenship by performing one of the following acts with the intention of relinquishing U.S. nationality: (1) obtain naturalization in a foreign state upon reaching age 18; (2) take an oath of allegiance to a foreign state upon reaching age 18; (3) enter or serve in the armed forces of a foreign state if that foreign state is in conflict with the U.S.; (4) accept employment with a foreign government; (5) formally renounce U.S. citizenship before a U.S. diplomatic or consular officer in a foreign state; (6) formally renounce in writing U.S. citizenship in the U.S. in a form prescribed by the Attorney General; or (7) commit an act of treason.[86] On the other hand, a long-term U.S. resident alien's U.S. residency is terminated if she ceases to be a lawful permanent resident of the U.S.[87] or commences to be treated as a resident of a foreign country under the provisions of a bilateral income tax treaty between the U.S. and the foreign country and does not waive the benefits of that treaty.[88]

If an individual performed an act of expatriation, the new presumption rules of section 877(a)(2) determined whether the person did so with a principal purpose of avoiding U.S. taxes.[89] An individual was deemed to have expatriated with a principal purpose of avoiding U.S. taxes if (1) her average annual U.S. federal income tax liability for the five taxable years

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84. IRC § 877(e). A long-term U.S. resident alien is a person who is a lawful permanent resident of the U.S. in at least eight years of the 15-year period ending at the time of residency termination. However, a person is not considered a long-term U.S. resident for those years in which such person is treated as a resident of a foreign country under the provisions of a tax treaty between that foreign country and the U.S.

85. 8 U.S.C. 1101.

86. 8 U.S.C. 1481.

87. IRC § 877(e)(1)(A). IRC § 877(e)(1)(A) references IRC § 7701(b)(6), which incorporates U.S. immigration laws for determining a person's status as a U.S. resident alien for U.S. tax purposes.

88. IRC § 877(e)(1)(B).

89. IRC § 877(a)(2).

ending before the date of loss of U.S. citizenship or termination of U.S. residency was greater than $ 100,000 (the "tax liability test"), or (2) her net worth as of the date of such loss or termination was $ 500,000 or more (the "net worth test").[90] This provision supplied many of the "teeth" that were missing under the FITA version, which included no automatic presumption rules and placed the initial burden of proof on the government. It also underscored the purpose of the expatriation rules, focusing on individuals with the potential for tax-motivated expatriation.

Under HIPAA provisions, U.S. citizens and long-term U.S. residents subject to section 877 were unable to fully benefit from bilateral tax treaties even if they were considered bona fide residents of the treaty partner. As noted in Part II of this Article, saving clauses in most, if not all, U.S. bilateral income tax treaties provide that persons subject to U.S. taxation under section 877 are subject to U.S. taxation for a period of ten years as if the treaty had not come into effect.

2. Exceptions to Treatment as an Expatriate – By adding the automatic presumption rules, the HIPAA expatriation provisions allowed less affluent individuals to completely avoid the application of the alternative tax regime upon expatriation. In addition, certain individuals who were considered to have expatriated with a principal purpose of tax avoidance by meeting the tax liability or net worth tests had the opportunity to overcome this presumption by submitting a complete and good faith ruling request to the IRS within one year of expatriation for a determination by the IRS that the loss of U.S. citizenship was not motivated by tax avoidance.[91] Before the enactment of HIPAA, only a limited exception was available to certain dual residents, with no option of filing a ruling request.[92] As previously noted, the existence of such exceptions allowed some expatriates to avoid U.S. tax on income accrued during the period of U.S. citizenship or residency.

Under HIPAA, a former U.S. citizen was qualified to submit a request for a ruling if the person was (1) an individual born with dual citizenship who remained a citizen of the other country, (2) an individual who became a citizen of the country of birth, spouse's birth or parents' birth, within a reasonable time following loss of citizenship, (3) an individual who was not present in the U.S. for more than thirty days each year in the ten-year period immediately preceding the date of loss of citizenship, (4) an individual who relinquished her citizenship before reaching the age of 18 ½, or (5) an individual that fell into any other category of individuals designated

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90. IRC § 877(a)(2). After 1996, the numbers were adjusted for inflation.

91. IRC § 877(c).

92. IRC § 877(d) (1966). Pursuant to § 877(d), the alternative method of taxation did not apply to a nonresident alien who acquired dual citizenship at birth and resided in the country of her other citizenship.

by the Treasury Regulations.[93] While these categories contemplated a close connection to the country to which the individual was moving, lessening the chance that the move was indeed motivated by tax avoidance, they did not require an insubstantial link to the U.S. Despite the limited categories of eligible individuals, the documentation required to be submitted as part of the ruling request was quite extensive and included statements such as the individual's reasons for termination of residency or loss of citizenship, foreign countries where the individual is a resident or intends to be a resident, a balance sheet setting forth the individuals assets, and many additional items. The requirements were set out in detail in Notice 97-19,[94] with some modifications provided in Notice 98-34.[95]

While section 877(e) subjected long-term U.S. resident aliens to the alternative method of taxation, it did not provide such long-term U.S. resident aliens with the opportunity to submit a ruling request to show that their termination of U.S. residency was not motivated by tax avoidance. Consequently, to grant fair treatment to similarly situated long-term U.S. resident aliens who, as a group, were no more likely than U.S. citizens to expatriate for the purpose of avoiding U.S. taxes, the IRS extended virtually the same exceptions to long-term U.S. resident aliens. Under Notice 97-19, as modified by Notice 98-34, a long-term U.S. resident was eligible to submit a ruling request if the resident (1) became, within a reasonable period following expatriation, a resident fully liable to income tax in the country in which the individual was born, in the country where the individual's spouse was born, or in the country where either of the individual's parents were born,[96] (2) was not present in the U.S. for more than thirty days each year in the ten-year period immediately preceding the date of residency termination, or (3) prior to reaching age 18 ½, ceased to be taxed as a lawful permanent resident, or commenced to be treated as a resident of another country under an income tax treaty and did not waive the benefits of such treaty. The submission of such a complete and good faith ruling request was sufficient to overcome the presumption of tax avoidance, but the IRS was always free to subsequently make a substantive determination based on the individual's U.S. income, estate or gift tax returns that the principal purpose of expatriation was, in fact, the avoidance of U.S. taxes.

If the IRS determined that the request was complete and in good faith, the alternative method of taxation did not apply and the individual was considered a nonresident alien following the individual's expatriation. As a nonresident alien, the individual could benefit from a bilateral income tax

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93. IRC § 877(c)(2)(A)-(D).

94. I.R.S. Notice 97-19, 1997-1 C.B. 394.

95. I.R.S. Notice 98-34, 1998-2 C.B. 29.

96. Prior to the modifications of Notice 98-34, Notice 97-19 required that a long-term resident become a citizen of the country to which she expatriated. See Notice 97-19, 1997-1 C.B. 394.

treaty between the U.S. and another country and from all of the generally applicable U.S. tax rules without any "source conversions." If a bilateral income tax treaty applied, the nonresident alien was subject to U.S. tax in accordance with that treaty, which generally meant that she was subject to U.S. tax on the sale of U.S. real estate, on the sale of shares in a U.S. real estate holding company, on income derived from U.S. real property, on dividends received from a U.S. company, and on profits earned by an enterprise if the enterprise was engaged in a U.S. trade or business through a permanent establishment in the U.S., such as an office.

Thus, the HIPAA exceptions perpetuated an existing problem by allowing wealthy U.S. persons to avoid U.S. taxes by expatriating to an "approved" country.

3. The Alternative Method of Taxation – The method of taxation was significantly changed by HIPAA. If a former U.S. citizen or long-term U.S. resident alien was determined to have expatriated with a principal purpose of tax avoidance, the alternative method of taxation applied for the ten-year period following expatriation. For U.S. tax purposes, the expatriate was neither a U.S. citizen nor a U.S. resident alien. Pursuant to the alternative regime, the expatriate was subject to U.S. tax on her U.S.-source income at the rates applicable to U.S. persons rather than at the rates applicable to other nonresident aliens. However, unlike in the case of a U.S. person, the expatriate was not taxed on her foreign-source income and she was allowed to take deductions only to the extent such deductions were connected with the gross income taxable under section 877, except that no capital loss carryover was allowed.[97] This limitation imposing U.S. tax only on U.S.-source income at first blush may appear to be benign, but, in fact, the range of income items treated as U.S.-source for the purpose of section 877[98] was, and still remains, more expansive than the range of items generally considered U.S.-source income under the Code.[99] Section 877(d)(1) contains the so-called "source conversion" rules and provides that the following items of gross income will be treated as income from sources within the U.S.: gains on sale or exchange of property (other than stock or debt obligations) located in the United States; gains on sale or exchange of stock issued by a domestic corporation or debt obligation of a U.S. person, the U.S., or a State; and income or gain derived from controlled foreign corporation if certain ownership tests are met. In the case of nonresident aliens, these items of income are generally not subject to U.S. tax, but section 877(d)(1) treats these items as U.S.-source and, within the context of section 877, they are taxed to nonresident aliens. In addition, pursuant to section 877(d)(2),

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97. IRC § 877(b)(1)-(2).
98. IRC § 861(a).
99. IRC § 877(d)(1).

individuals subject to section 877 were taxed on exchanges of property that generated U.S.-source income for property that would have generated foreign source income.[100] Similarly, under section 877(d)(4), as modified by Notice 97-19,[101] income or gain from property contributed to a foreign corporation by an expatriate during the 15-year period commencing five years prior to expatriation was treated as U.S.-source, and the expatriate was taxed on such income or gain as though she continued to own such property. This subsection applied if the corporation would have been a controlled foreign corporation at the time of the contribution and the taxpayer would have been a U.S. shareholder, ignoring the fact of the expatriation.

In addition, the taxable estate of a decedent who expatriated with a principal purpose of avoiding U.S. taxes was subject to U.S. estate tax if the decedent lost her U.S. citizenship or terminated her long-term U.S. resident alien status within the ten-year period immediately preceding her death.[102] The taxable estate of an expatriate subject to the alternative tax regime included her U.S. situs assets,[103] plus stock of certain controlled foreign corporations. More specifically, the U.S. estate of a tax-motivated expatriate included a percentage of the fair market value of the stock of a foreign corporation of which the expatriate owned, at the time of her death, 10% or more of the combined voting power and owned (directly, indirectly, or constructively) more than 50% of the combined voting power or value of the stock of that foreign corporation.[104] However, the expatriate could benefit from limited U.S. foreign tax credits for estate, inheritance, or legacy taxes paid to a foreign country with respect to stock in such controlled foreign corporations.[105] Similarly, under section 2501(a)(3)(A), the transfer of intangible property by a nonresident alien was not exempt from U.S. gift tax if, within the ten-year period immediately preceding date of a transfer, the nonresident lost her U.S. citizenship or terminated her U.S. resident alien status, but section 2501(a)(3)(D) provided that U.S. gift tax imposed under this section could be credited with the amount of gift tax that was paid to a foreign country with respect to that gift.[106]

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100. IRC § 877(d)(2). This subsection provides that on an exchange during the ten-year period beginning on the date of expatriation, exchanged property will be treated as sold for its fair market value on the date of exchange if generally, on such exchange gain would not be recognized, income derived from the property was from U.S. sources, and income derived from the property so acquired would be from non-U.S. sources. An exception was available to individuals who entered into an agreement with the IRS.

101. Notice 97-19, 1997-1 C.B. 394, at 401.

102. IRC § 2107(a)(1). The estate tax provisions affecting expatriates remain the same under the Jobs Act.

103. IRC §§ 2103, 2106.

104. IRC § 2107(b).

105. IRC § 2107(c)(2).

106. IRC § 2501(a)(3).

These HIPAA amendments to the source rules were quite significant because under the FITA version of section 877, only gains from the sale or exchange of property located in the U.S. (other than stock and debt obligations) and gains from the sale or exchange of stock in a U.S. corporation or debt obligations of U.S. persons were treated as U.S.-source. The new "source conversion" rules ensured that former U.S citizens and long-term U.S. residents no longer escaped U.S. tax on certain other U.S.-source items that had accrued but unrecognized gain at the time of expatriation. The fact that under these rules, income accrued on U.S.-source items following expatriation remained subject to U.S. tax was not addressed. The source conversion rules also encouraged investment in foreign assets and assets producing foreign-source income and, thus, fostered economic inefficiency.

4. Coordination with Immigration Rules – Section 1182(a) of the Immigration and Nationality Act ("INA"), which is effective as of September 30, 1996, also increased the drawbacks of expatriation, at least for U.S. citizens.[107] Section 1182(a)(10)(E)[108] of the INA provides that a former U.S. citizen who officially renounced her U.S. citizenship in order to avoid U.S. taxation and who is determined by the Attorney General to have expatriated with the purpose of avoiding U.S. taxes, would not be allowed to re-enter the U.S. Pursuant to section 1481 of the INA,[109] official renunciation appears to encompass only the making of a formal written renunciation in the U.S. using a method designated by the Attorney General, or a formal renunciation in a foreign state before a U.S. diplomatic or consular officer. Consequently, a former U.S. citizen treated as an expatriate pursuant to the alternative method was subject not only to U.S. income, estate, and gift taxes, but was also unable to re-enter the U.S. if her expatriation was "formal" in nature. The language of the INA suggests that a former U.S. citizen who merely obtained naturalization in a foreign country and, thus, did not formally renounce her U.S. citizenship, could be allowed to-reenter the U.S. under U.S. immigration rules. The definition of tax avoidance for U.S. immigration purposes was not coordinated with the principal purpose test established for U.S. tax purposes. As a result, even though the tax avoidance standard has been eliminated from the revised section 877, a tax avoidance standard is still in effect for U.S. immigration purposes and there is no indication at present of any change in these immigration rules.

5. Procedural Rules and Requirements – A U.S. citizen who renounced her U.S. citizenship pursuant to the INA provisions was required

107. 8 U.S.C. § 1182 (1995).
108. Id.
109. 8 U.S.C. § 1481 (1995).

to file an information statement under section 6039G of the Code. A long-term U.S. resident alien who terminated her U.S. residency was also required to provide this information. The information statement filing requirement was satisfied by the filing of Form 8854 (Expatriation Initial Information Statement). In addition, former U.S. citizens and former long-term U.S. resident aliens subject to section 877(b) were also required to annually file U.S. individual income tax returns on Form 1040NR.[110]

6. Need for Change? – The HIPAA rules contained the same basic design flaw as the initial expatriation provisions, perpetuating the shortcomings of the existing regime. The possibility of tax-motivated expatriation persisted. For example, an expatriating U.S. citizen determined to avoid full U.S. taxation could have done so by marrying a nonresident alien, submitting a ruling request to the IRS indicating the intention to renounce her U.S. citizenship, and moving to the country of the spouse's birth. The underlying difficulty is obvious as it is impossible to know an individual's true motives beyond assessing that individual's financial and family circumstances. Likewise, an expatriate was able to avoid the alternative regime by holding on to property with accrued gain until the expiration of the ten-year period. These tactics prolonged inequality among similarly situated expatriates as some expatriates would sell their U.S. property within the ten-year period and pay the applicable U.S. tax, while others would wait and dispose of their U.S. property without paying any U.S. tax. The IRS also continued to assess the subjective intent of the expatriating individual and was also burdened by the ruling request process. These persistent problems prompted Congress to consider several proposals to revise the expatriation provisions.

7. Summary – For over forty years, Congress has been trying to develop an alternative tax regime applicable to expatriates whose change in status is motivated by the avoidance of U.S. taxes. The initial expatriation provisions established the basic structure of the alternative tax system pursuant to which tax-motivated U.S. citizen expatriates were subject to U.S. income tax on U.S.-source income and to U.S. estate and gift tax on transfers of U.S. situs property for a period of ten years following expatriation. However, the laxness of the presumption rules and the simplicity with which U.S.-source income could be converted to foreign-source income made the initial provisions ineffective.

The HIPAA amendments introduced the "source-conversion" rules of section 877(d), subjecting a wider range of items to U.S. taxation. The amended rules also increased the pool of potential expatriates by extending the application of the expatriation provisions to long-term U.S. resident

110. Notice 97-19, 1997-1 C.B. 394, at 403-04.

aliens and by providing automatic presumption rules. On the other hand, the monetary thresholds and the ruling request process provided exceptions for persons who may have been less likely to expatriate for tax reasons. Although the revised expatriation provisions improved some aspects of the initial expatriation rules, they retained the flawed design of the original rules. Both the FITA and the HIPAA regimes subjected to U.S. tax U.S.-source income accrued following the renunciation of citizenship or termination of long-term residency. Yet the amended provisions failed to eliminate the potential for tax avoidance. Expatriates could refrain from selling their U.S. assets during the application of the alternative regime. Likewise, U.S. tax could be avoided by filing a ruling request and moving to a country to which the expatriate had the requisite connections.

IV. EXPATRIATION PROVISIONS UNDER THE JOBS ACT

Congress considered various alternatives in amending the expatriation provisions, including the mark-to-market exit tax system proposed by Senators Grassley and Baucus in 2003.[111] In 2004, Congress again rejected the mark-to-market approach to the taxation of expatriates. However, the mark-to-market regime resurfaced in the current Congress.[112]

The expatriation provisions of the Jobs Act follow the overall structure of the HIPAA expatriation provisions and subject expatriates to U.S. income, estate, and gift taxes for a period of ten years following expatriation. However, the new rules introduced some drastic changes without completely eliminating the potential for tax avoidance through expatriation.

A. Individuals Subject to the Alternative Method of Taxation

Revised section 877(a)(2) replaces the subjective determination of tax avoidance with three bright-line tests.[113] Under the revised rules, a former U.S. citizen or long-term U.S. resident alien is subject to the alternative method of taxation under section 877 for a period of ten years if (i) her average annual net income tax liability for the five years preceding

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111. See Jumpstart Our Business Strengths Act, S. 1637, 108th Cong. § 442 (2003). This mark-to-market exit tax system was another option that had been considered in the revision of the expatriation provisions. Pursuant to a mark-to-market system, expatriates would be subject to U.S. tax on the net unrealized gain in their property as if such property were sold for its fair market value the day before expatriation. Certain properties, such as U.S. real property interests, would be exempt because such interests are subject to U.S. tax in the hands of nonresident aliens as well.

112. Highway Reauthorization and Excise Tax Simplification Act of 2005. H.R. 3, 109th Cong. (2005).

113. IRC § 877(a)(2).

expatriation exceeds $124,000,[114] (ii) her net worth is $2 million or more on the date of expatriation, or (iii) she fails to certify under penalties of perjury that she complied with all of her U.S. tax obligations for the five preceding years or fails to provide evidence of such compliance if requested by the Secretary of Treasury. These three tests are now used to conclusively determine whether an expatriate is subject to the alternative method of taxation. The individual's motivation for expatriation is no longer relevant – if an expatriate falls within this group and does not satisfy any of the exceptions, she will be subject to U.S. taxation pursuant to section 877.

The third test for applying the alternative method of taxation is a new test that underscores the complete elimination of the tax avoidance motive from section 877. Pursuant to this test, a former U.S. citizen who earns $40,000 per year and has no independent source of income or wealth can be subject to the alternative method of taxation if she fails to fulfill the certification obligation or provide evidence of such compliance, even if requested following the expatriation. Although this requirement appears relatively easy to meet, it may be burdensome for a naturalized U.S. citizen or resident alien who lacks English language skills or the funds necessary to afford professional tax advice.

The new rules for subjecting an expatriate to the alternative tax regime are clear and objective, reducing the potential for tax avoidance by subjecting all expatriates to section 877(a). However, U.S. taxes may still be avoided if the former U.S. citizen or resident alien does not sell her U.S. source property within the ten-year period following expatriation.

B. Exceptions to Treatment as an Expatriate

The ruling request system for obtaining an exception has been eliminated and the alternative method of taxation can be avoided only if certain objective criteria are satisfied. First, an expatriate will avoid being taxed under section 877 if she falls below the $2 million net worth and $124,000 U.S. income tax liability thresholds and certifies that she has complied with all U.S. tax obligations for the five-year period preceding the expatriation and provides evidence thereof (if requested).[115]

Second, even if an expatriate meets at least one of the monetary thresholds, she can avoid the application of the alternative tax regime if she falls into one of two very narrowly defined categories of individuals. A former U.S. citizen can avoid the application of the alternative tax regime if (i) the individual was born a U.S. citizen and a citizen of another country and remained a citizen of that other country and (ii) had no "substantial contacts"

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114. IRC § 877(a). This amount is adjusted for inflation after 2004.
115. IRC § 877(a).

with the U.S.[116] A person will be deemed as having no "substantial contacts" with the U.S. if she was never a resident of the U.S.,[117] never held a U.S. passport,[118] and was not present in the U.S. for more than thirty days during any calendar year in the ten-year period preceding her loss of U.S. citizenship.[119] Alternatively, a former U.S. citizen can avoid the application of the alternative tax regime if (i) she was born a U.S. citizen, (ii) neither of the parents was a U.S. citizen at the time of birth, (iii) she lost her U.S. citizenship before reaching 18 ½ years of age, and (iv) was not present in the U.S. for more than thirty days during any calendar year in the ten-year period preceding the loss of citizenship.[120] In the case of either exception, the expatriate must certify under penalties of perjury that she has complied with all of the U.S. tax obligations for the five-year period preceding the expatriation.

If an expatriate can satisfy one of these exceptions, she will be subject to U.S. tax as a nonresident alien and will be able to benefit from an applicable U.S. bilateral income tax treaty.

The lack of exceptions for long-term U.S. resident aliens is striking, but not unusual. The former version of section 877 did not include an exception for long-term U.S. resident aliens either, although the IRS extended the exception to long-term U.S. resident aliens using the same tests applicable to U.S. citizens. With the current structure of section 877, such extension seems difficult without deviating from apparent Congressional intent. The current exceptions to the alternative tax regime are available only to "accidental" U.S. citizens who did not seek out a close connection to the U.S. It could be challenging to apply this standard to long-term U.S. resident aliens because long term U.S. resident aliens, by definition, sought out a close connection to the U.S. by applying for a green card and remained in the U.S. long enough to be considered long-term U.S. resident aliens. An argument may be made that persons who chose to accept the benefits of U.S. residency should not be allowed to retract and leave the U.S. without "paying

116. IRC § 877(c)(2).

117. IRC § 877(c)(2)(B)(i). A U.S. citizen will not be deemed a U.S. resident pursuant to the substantial presence test if she never spent more than 120 days in the U.S. in any given year. See IRC § 7701(b)(3)(A).

118. IRC § 877(c)(2)(B)(ii).

119. IRC § 877(c)(2)(B)(iii).

120. IRC § 877(c)(3). Pursuant to 8 U.S.C. § 1481(a), a native born or naturalized citizen of the U.S. must be at least 18 years of age when renouncing U.S. citizenship. However, a minor over the age of 14 may be able to renounce her U.S. citizenship before a U.S. consular officer but only if she is able to persuade the U.S. consular officer that she fully understands the nature and the consequences of renunciation and is voluntarily seeking to renounce her U.S. citizenship. Parents are not authorized by these provisions to renounce their minor children's U.S. citizenship. See 8 U.S.C. § 1481(a).

for" any of the benefits resulting from their stay in the U.S. However, there is no sound reason for treating U.S. resident aliens differently from U.S. citizens. This discrepancy places a heavy burden on many potential immigrants who now will have to seriously contemplate their long-term future and determine whether they want to remain in the U.S. permanently or at some point return to their home country. Tax advisors should take great care in explaining to their nonresident alien clients the ramifications of becoming a U.S. resident alien.

Although section 877(c) provides two exceptions for U.S. citizens, these exceptions are extremely limited. In practice, only those U.S. citizens who were born to one U.S. parent or to two non-U.S. parents and resided almost exclusively outside of the U.S., can be exempt from the alternative method of taxation following the loss of U.S. citizenship.[121] A U.S. citizen who is a dual citizen and chose to accept the advantages offered by the country of her other citizenship seems to lack the requisite connection to the U.S.[122]

The revised exceptions are an improvement over the HIPAA exceptions in that they eliminate significant administrative burdens present under the ruling request system and reduce the potential for granting exceptions to persons who have the intention of avoiding U.S. taxes. However, the revised exceptions subject similarly situated U.S. citizens and resident aliens to different standards for no apparent reason. A minor renouncing her U.S. citizenship before the age of 18 ½ could have resided in the U.S. for up to eight years and still qualify for the exception, whereas a long-term U.S. resident residing in the U.S. for eight years would not qualify for the exception.

To further complicate the expatriation provisions, new section 877(g) subjects those expatriates subject to the alternative method of taxation who return to the U.S. and remain here for more than thirty days in any given calendar year to full U.S. taxation for that year.[123] Up to thirty days spent in the U.S. for employment purposes by (1) an expatriate who becomes a citizen or resident of a country in which such person, her spouse or either of her parents was born, provided that the person is fully liable for income in that county, or by (2) a person who was present in the U.S. for no more than thirty days during each year in the ten-year period ending on the date of citizenship relinquishment or residency termination, will not be counted for

121. IRC § 877(c)(2). Under the dual citizen exception, a U.S. citizen with two U.S. citizen parents who have not resided in the U.S. can technically qualify if all the other requirements are met. IRC § 877(c)(2).

122. See IRC § 877(c)(2).

123. IRC § 877(g).

determining the individual's physical presence.[124] This is a dramatic change from the prior rules, which generally followed the substantial presence test for subjecting an expatriate to full U.S. taxation. Subjecting former U.S. citizens and long-term U.S. resident aliens to U.S. tax on their worldwide income is fundamentally unfair. Most, if not all, former U.S. citizens and long-term U.S. resident aliens will be bona fide tax residents of their chosen countries of residence and will be subject to full taxation in that country. Subjecting them to full U.S. taxation on the basis of such limited presence in the U.S. will strongly discourage former U.S. persons from returning to visit friends or family or to conduct business. This provision in particular cannot be viewed as comporting with international tax policy standards. In fact, the existence of an expatriation regime in itself breaks with international tax standards.[125] The U.S. taxation of an expatriate's worldwide income is also likely to result in double taxation, although some limited U.S. tax credits are available to remedy the double-tax effect.[126]

Section 877(g) has the potential to be a true revenue raiser. The threshold for triggering U.S. taxation as a U.S. person is so low that it will be practically impossible for any former U.S. citizen with family, friends, or business connection in the U.S. to avoid. The language of section 877(g) makes it clear that those expatriates who are subject to section 877 only as a result of their failure to certify that they have met their U.S. tax obligations for the five years preceding expatriation will also be taxed as U.S. resident aliens in any calendar year in which they spend more than thirty days in the U.S. during the ten-year period following expatriation.[127]

There is one practical way a long-term U.S. resident alien contemplating the termination of her U.S. residency may be able to avoid

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124. Id. For the purpose of this provision, days an individual spends in the U.S. as a result of a medical condition that arose while such individual was present in the U.S. will not be counted. This exception is similar to the exception allowed under the substantial presence test.

125. Most countries do not have an expatriation tax regime, allowing their citizens and residents to expatriate without a tax cost. Germany has a limited expatriation regime pursuant to which those German citizens who were German tax residents for at least five years during the ten-year period preceding expatriation and who emigrate to a tax haven or fail to take up tax residence in another country while retaining strong economic ties with Germany will be subject to German tax on income that is considered German source income. See Aussensteuergesetz, v. 20.12.2001 (BGBl. I S. 3858). Spain has a limited expatriation regime as well, pursuant to which Spanish citizens who emigrate to a tax haven, as specifically defined for this purpose, will be taxed as Spanish residents for the year in which the emigration taxes place and for the following four years. See Art. 9.3, Ley del Impuesto sobre la Renta de Personas Fisicas.

126. IRC § 877(b) (credit for income tax); IRC § 2107(c)(2) (credit for foreign estate tax); IRC § 2501(a)(3)(B) (credit for foreign gift tax).

127. IRC § 877(g)(1).

treatment as an expatriate under revised section 877. If a long-term U.S. resident alien files as a nonresident alien for the 2004 taxable year under an applicable treaty tie-breaker provision and does not waive the benefits of the treaty, she will be treated as a nonresident alien for all of 2004, as she will be considered to have terminated her U.S. residency on January 2004, avoiding the application of the new rules with the June 3, 2004 effective date.[128] Consequently, she would be subject to the prior section 877 rules and presumably would be able to submit a ruling request pursuant to the rules in effect under the HIPAA version of section 877. Some commentators suggest that in some cases long-term U.S. resident aliens may be able to avoid the application of the new rules even by filing amended returns for open years to claim foreign residence under a treaty.[129] In addition, it is also possible that late filing will not at all deprive a nonresident alien of her ability to claim nonresident status pursuant to a treaty tie-breaker as the regulations under sections 6114 and 7701 do not suggest that late filing will result in loss of ability to claim nonresident status.

C. The Alternative Method of Taxation

The revised rules generally retain the same income tax rules in effect under the HIPAA expatriation provisions. In addition, the modified provisions also preserve the alternative estate and gift taxation rules, with some minor changes. For example, U.S. gift tax will be imposed on a gift made by an expatriate subject to the alternative method of taxation at the time of making the gift, with a credit for foreign gift taxes paid.[130] In addition, a gift of stock of a foreign corporation made by an expatriate subject to the alternative method will be subject to U.S. gift tax if the gift is made during the ten-year period.[131] This rule mirrors U.S. estate tax section 2710(b) and applies only if the expatriate, prior to making the gift, owned, directly or indirectly, 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation and if they are also considered to own, under the attribution rules, in excess of 50% of either the total combined voting power of all classes of stock entitled to vote in the foreign corporation or of the total value of the stock of the corporation.[132] If

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128. An individual's tax status is determined on a calendar year basis. IRC § 7701(b)(1)(A)(i) provides that a nonresident alien will be considered a U.S. resident with respect to any calendar year if she was admitted as a permanent resident at any time during the calendar year. See IRC 7701(b)(1)(A)(i); see also Regs. § 301.6114-1(a)(1)(ii).

129. See generally Marco Blanco & John Kaufmann, The Noose Tightens: the New Expatriation Provisions, 2005 TNT 2-36, (Jan. 4, 2005).

130. IRC § 2501(a)(3).

131. IRC § 2501(a)(5).

132. Id.

the gift is taxable under these tests, the taxable gift includes that portion of the fair market value of the stock transferred which the fair market value of any asset owned by that corporation and situated in the U.S. bears to the total fair market value of all assets owned by the foreign corporation.[133] It is irrelevant whether the stock is situated in or outside of the U.S.[134]

The revised expatriation provisions continue to subject to U.S. income tax U.S.-source income accrued after the expatriation. There is no sound reason for subjecting former U.S. citizens and long-term U.S. resident aliens to U.S. tax on gain resulting from the sale of U.S. stock or other property generally sourced under section 865 if they purchased such property following their expatriation and all of the gain accrued while they were nonresident aliens. In such situations, expatriates should be taxed in the same manner as other nonresident aliens because there is no actual U.S. tax avoidance. Taxing only the gain that accrued during the period of U.S. citizenship or residence could be a significant administrative burden on the taxpayer and the IRS in situations where the expatriate holds on to the property following expatriation. This problem could have been solved only by adopting a mark-to-market system, but such proposals have been rejected by Congress.[135]

D. Tax Rules for Determining Citizenship and Residency Termination

The revised provisions define the termination of U.S. citizenship or long-term U.S. residency for U.S. tax purposes. In effect, under new section 7701(n), a U.S. citizen or long-term U.S. resident alien who otherwise performs an act of expatriation will retain her U.S. status for U.S. income tax purposes until she gives notice to the Secretary of State or to the Secretary of Homeland Security of the act of expatriation and provides a statement in accordance with section 6039G.[136] This section abandons the use of immigration-based residency rules and instead requires the use of tax-based rules for determining a U.S. citizen's or long-term U.S. resident alien's tax status. The IRS published Notice 2005-36 to clarify the reporting requirements.[137] The Notice provides that Form 8854 has been revised so that expatriates can use it to satisfy both the notice requirement of new section 7701(n) and the reporting requirement under section 6039G. Consequently, following an act of expatriation, an expatriate not subject to the alternative regime must file Form 8854 only once, whereas an expatriate subject to the

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133. IRC § 2501(a)(5)(C).
134. IRC § 2501(a)(5)(A)(i).
135. See, e.g., S. 1637, 108th Cong. § 4422 (2003).
136. IRC § 7701(n).
137. IRS Notice 2005-36, 2005-19 I.R.B. 1007.

alternative regime must file Form 8854 each year during the ten-year period the alternative regime applies.

E. Procedural Rules

U.S. citizens and long-term U.S. resident aliens subject to section 877 must file annual returns for each of the ten years during which the alternative method applies, even if no U.S. federal income tax is due for any of those years.[138] The information to be provided under section 6039G remains essentially the same as under the prior rules, with the exception that expatriates must indicate the number of days spent in the U.S. in a given taxable year. The penalty for failure to file a statement under section 6039G is increased to $10,000, unless the individual can show that the failure is due to reasonable cause and not to willful neglect.

F. Coordination with Immigration Provisions

The Jobs Act expatriation provisions fail to address the discrepancies between the U.S. immigration and tax rules applicable to expatriates. Such failure perpetuates opposing preferences between former U.S. citizens and former long-term U.S. resident aliens. Under U.S. tax law, only U.S. citizens may be able to avoid the application of the alternative regime, provided they satisfy the requirements of section 877(c). Under U.S. immigration law, only former long-term U.S. resident aliens can freely return to the U.S. following expatriation because former U.S. citizens who are determined to have renounced their U.S. citizenship for tax avoidance purposes (as determined under immigration rules) can be excluded from the U.S. This discrepancy between U.S. immigration and U.S. tax rules needs to be addressed as it creates an apparent discrepancy in the treatment of U.S. citizen and long-term U.S. resident alien expatriates, with the tax rules favoring former U.S. citizens and the immigration rules favoring former long-term U.S. resident aliens.

G. Summary

The expatriation provisions of the Jobs Act introduced some vital changes to the existing expatriation provisions of the Code, affecting expatriating U.S. citizens and long-term U.S. resident aliens in four principal ways. First, the motivation for expatriation is now inconsequential and any expatriate who meets any one of the three bright-line tests, but none of the limited exceptions, is subject to the alternative method of taxation for the ten-year period following expatriation. Second, the exceptions from the

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138. IRC § 6039G(a).

application of the alternative tax regime are very limited and are available to certain dual citizens only. Third, the termination of U.S. residency or the renunciation of U.S. citizenship is insufficient to terminate such status for U.S. tax purposes and additional steps must be taken to finalize tax expatriation. Fourth, former U.S. citizens and long-term U.S. resident aliens returning to the U.S. for more than thirty days in any given year are treated as U.S. persons for that year and are subject to full U.S. taxation.

The revised rules are an improvement over the existing rules in that they lessen the administrative burden on the IRS by eliminating the ruling request procedure and by lessening the potential for tax avoidance. However, U.S. citizens and long-term U.S. resident aliens may still be able to avoid U.S. tax on certain items by refraining from any sale or exchange during the ten-year period for which the alternative method of taxation applies. This potential for tax avoidance also creates inequality in the treatment of similarly situated expatriates, as some will pay U.S. tax on the gain resulting from the sale of U.S.-assets while others will wait for the expiration of the ten-year period and pay no U.S. tax on such gain. In addition, the imposition of U.S. income tax on U.S.-source income accrued after the expatriation results in economic inefficiency. Moreover, U.S. citizens and long-term U.S. resident aliens are not treated equally because long-term U.S. resident aliens do not have any exceptions from the application of the alternative regime. Last but not least, the imposition of full U.S. taxation on expatriates returning to the U.S. for as few as thirty-one days a year in any one of the ten years to which the alternative method applies is out of step with international norms.

V. A FAIR SYSTEM OF TAXATION FOR EXPATRIATES?

As the history of the expatriation provisions demonstrates, the taxation of former U.S. citizens and long-term U.S. resident aliens is a considerable challenge to the U.S. tax system. On the one hand, the U.S. has the right to tax accrued but unrealized gain that would otherwise be taxable to the expatriate upon realization if she remained a U.S. person. On the other hand, the U.S. should refrain from taxing gain that accrues during a period when the expatriate is a nonresident alien for all practical purposes and, as such, would not be subject to U.S. tax on those gains.

In creating a better expatriation tax regime, Congress should reconsider a mark-to-market expatriation regime.[139] Under a mark-to-market system, expatriates would be subject to U.S. tax on the net unrealized gain in their property as if such property were sold for its fair market value the day

139. Colon, supra note 21, at 30-33 (providing an in-depth analysis of the benefits of a mark-to-market expatriation tax regime).

before expatriation.[140] Such a system would apply to all of the property owned by the expatriate, with the exception of U.S. real property interests, which would be subject to U.S. tax on disposition.[141] Some mark-to-market expatriation proposals rejected by Congress in the past subjected such gain to U.S. tax only to the extent the gain exceeded a threshold.[142]

A. Mark-to-Market Regime Would End Expatriation for the Purpose of Tax Avoidance

Under the expatriation rules currently in effect, tax avoidance is still possible by holding on to property with accrued but unrealized gain for the ten year period during which the alternative tax regime applies. Although market forces may make it unrealistic for many expatriates to wait that long to dispose of properties that would otherwise be subject to U.S. tax, in many cases it may be an option and in those situations it may deprive the U.S. of a significant amount of revenue to which it is entitled. Under a mark-to-market regime, all unrealized gain would be subject to U.S. tax, with the exception of unrealized gain in U.S. real property interests, which are subject to U.S. tax in any event.

B. Mark-to-Market Regime Would Be Applied on the Basis of the Expatriate's Ability to Pay

Under the current expatriation structure, expatriates face ten years of U.S. tax on a variety of income the U.S. unilaterally deems U.S.-source income. Such income is likely subject to tax in the expatriate's country of citizenship or residence as well, subjecting such income to the burden of double taxation, with some limited tax credits. A mark-to-market regime would subject the expatriate to a one-time U.S. tax on gain that has already accrued and income that has already been earned, at tax rates that would generally apply to the expatriate if she remained a U.S. person. This system would preclude double taxation of gain or income in the future.

C. Mark-to-Market Regime Would Reduce Economic Inefficiency

The current rules encourage expatriates to invest in foreign assets or in assets that generate foreign-source income because such assets and income are free from U.S. tax. This distorts the free flow of capital and hampers the decision making process by forcing expatriates to make investment decisions based purely on tax considerations and not on economic efficiency. A mark-

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140. See, e.g., S. 1637, 108th Cong. § 442 (2003).
141. Id.
142. Id.

to-market system would encourage investments based on economic efficiency and sound business judgment. The expatriate would be subject to U.S. tax at the time of expatriation on gain that accrued while the individual was a U.S. person. Following expatriation, the individual would be able to make investment decisions based on market factors and would be free to invest in U.S. assets or assets producing U.S.-source income because she would be subject to U.S. tax on any such income or gain in the same manner as other nonresident aliens.

D. Mark-to-Market Regime Would Reduce Unequal Treatment of Expatriates

Under the current system, similarly situated expatriates may be subject to unequal treatment. For example, an expatriate holding stock of a U.S. corporation with substantial accrued but unrealized gain will be subject to U.S. tax if she sells the stock during the ten year period the alternative tax regime applies. On the other hand, a similarly situated expatriate holding stock of a U.S. corporation with the same amount of accrued but unrealized gain will not be subject to U.S. tax if she holds the stock until the expiration of the ten year period. Under the mark-to-market system, both expatriates will be subject to the same amount of tax on the deemed sale of the U.S. stock at the time of expatriation. This method is not perfect as it may be difficult for some expatriates to procure the amount of liquid assets needed to cover their U.S. tax liability on the deemed disposition, but it would be a more equitable way to impose the expatriate tax.

E. Mark-to-Market Regime Would be Easier to Manage

The current expatriation regime requires the U.S. to closely follow the "taxable" activities of expatriates for ten years following their expatriation. This involves tracking the transfer of real, tangible, and intangible property by sale, gift, or other disposition, reviewing U.S. tax returns, and conducting audits if necessary, all of which increase the administrative burden placed on the IRS. It may be impossible to track every relevant activity that could have a tax effect as the expatriate and, presumable, most of her property, will be located in her new home country. In addition, extensive and close cooperation with foreign tax authorities may be required for the sake of efficiency and effectiveness. The mark-to-market regime would allow a one-time accounting with respect to all the property owned by the expatriate, with the exception of U.S. real property interests.

F. Mark-to-Market Regime Would Eliminate the Need for Alternative Estate and Gift Tax Provisions

The current structure of the expatriation provisions requires a set of tax rules governing the U.S. income taxation of U.S.-source property and a separate set of tax rules regulating the U.S. estate and gift taxation of expatriates. Under a mark-to-market system, this multi-tiered approach would be replaced with a one-time accounting at the time of expatriation and would eliminate the need for a separate set of U.S. estate and gift tax expatriation rules.

G. Additional Considerations

Although a recent bill includes provisions for the mark-to-market taxation of expatriates, Congress is unlikely to change the current rule.[143] Congress should at least address the inequality caused by the section 877(c) exceptions being available only for U.S. citizens and either completely eliminate the exceptions or make them available to similarly situated long-term U.S. resident aliens. In addition, Congress should repeal section 877(g), which drastically subjects to full U.S. taxation any expatriate for any calendar year in the ten-year period in which the expatriate spends more than thirty-one days in the U.S. A former U.S. citizen or long-term U.S. resident alien who spends thirty-one days in the U.S. lacks the requisite connection to the U.S. that would warrant U.S. taxation of their worldwide income and assets.

VI. CONCLUSION

Congress should re-evaluate the approach it has taken to the U.S. taxation of expatriates and should reconsider other possibilities, including the mark-to-market approach it has repeatedly rejected.

The current expatriation regime perpetuates the potential for tax avoidance, as expatriates are subject to the alternative U.S. tax system only for a period of ten years following expatriation and, thus, have the potential to avoid U.S. taxes by postponing the realization event triggering U.S. tax. The ten-year period of application also causes similarly situated expatriates to be taxed and, therefore, treated unequally, depending on whether the expatriate decides to sell her U.S. assets during the ten year period or whether she decides to hold on to the U.S. assets until the expiration of the ten year period. In addition, the current rules impose U.S. tax on gain that accrued after expatriation and, as a result, should not be subject to U.S. tax.

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143. Highway Reauthorization and Excise Tax Simplification Act of 2005. H.R. 3, 109th Cong. (2005).

In fact, the present regime taxes gain that should be free from U.S. tax but allows gain that should be subject to U.S. tax to escape. The expatriation provisions also treat U.S. citizens and long-term U.S. resident aliens unequally, allowing some exceptions to U.S. citizens that cannot be extended to similarly situated long-term U.S. resident aliens. Moreover, the expatriation provisions are out of step with international norms, in particular by taxing former U.S. citizens and long-term U.S. resident aliens as U.S. persons if they return to the U.S. for as little as thirty-one days a year.

The mark-to-market approach would be preferable to the current system as it would terminate the potential for tax avoidance through expatriation, treat similarly situated expatriates equally, subject to U.S. tax the right amount of gain, reduce economic inefficiency, eliminate the need for separate estate and gift tax expatriation provisions, and it would be easier to administer. It would be a system that could actually work.