

REPORT #831

TAX SECTION

New York State Bar Association

Proposed Legislation Relating to the
Taxation of Expatriation

Table of Contents

Cover Letter: i
A. General Considerations..... iii
B. Technical Comments on Certain Trust Issues..... viii

TAX SECTION

1995-1996 Executive Committee

CAROLYN JOY LEE

Chair
Worldwide Plaza
825 Eighth Avenue
New York City 10019
212/903-8761

RICHARD L. REINHOLD

First Vice-Chair
212/701-3672

RICHARD O. LOENGARD, JR.

Second Vice-Chair
212/820-8260

STEVEN C. TODRYS

Secretary
212/715-9331

COMMITTEE CHAIRS

BankruptcyJoel Scharfstein
Linda Z. Swartz**Basis, Gains & Losses**Stephen B. Land
Robert H. Scarborough**CLE and Pro Bono**Damian M. Hovancik
Deborah H. Schenk**Compliance, Practice & Procedure**Robert S. Fink
Arnold Y. Kapiloff**Consolidated Returns**Ann-Elizabeth Purintun
Dennis E. Ross**Corporations**Katherine M. Bristol
Deborah L. Paul**Cost Recovery**Geoffrey R.S. Brown
Elliot Pisem**Estate and Trusts**Carlyn S. McCaffrey
Georgiana J. Slade**Financial Instruments**David P. Hariton
Bruce Kayle**Financial Intermediaries**Richard C. Blake
Thomas A. Humphreys**Foreign Activities of U.S. Taxpayers**Reuven S. Avi-Yonah
Philip R. West**Individuals**Victor F. Keen
Sherry S. Kraus**Multistate Tax Issues**Robert E. Brown
Paul R. Comeau**Net Operating Losses**Stuart J. Goldring
Robert A. Jacobs**New York City Taxes**Robert J. Levinsohn
Robert Plautz**New York State Franchise and****Income Taxes**James A. Locke
Arthur R. Rosen**New York State Sales and Misc.**Maria T. Jones
Joanne M. Wilson**Nonqualified Employee Benefits**Stuart N. Alperin
Kenneth C. Edgar, Jr**Partnership**Andrew N. Berg
William B. Brannan**Pass-Through Entities**Roger J. Baneman
Stephen L. Millman**Qualified Plans**Stephen T. Lindo
Loran T. Thompson**Real Property**Alan J. Tan
Lary S. Wolf**Reorganizations**Patrick C. Gallagher
Mary Kate Wold**Tax Accounting**Erika W. Nijenhuis
Jodi J. Schwartz**Tax Exempt Bonds**Linda D'Onofrio
Patti T. Wu**Tax Exempt Entities**Michelle P. Scott
Jonathan A. Small**Tax Policy**David H. Brockway
Peter V. Cobb**U.S. Activities of Foreign Taxpayers**Michael Hirschfeld
Charles M. Morgan, III**TAX SECTION****New York State Bar Association****MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE**M. Bernard Aidinoff
Dickson G. Brown
E. Parker Brown, IIScott F. Cristman
Harold R. Handler
Walter HellersteinSherwin Kamin
Charles I. Kingson
Richard M. LederYaron Z. Reich
Stanley I. Rubenfeld
David R. SicularEsta E. Stecher
Eugene L. Vogel
David E. Watts

March 27, 1995

**MEMORANDUM TO THE MEMBERS OF THE HOUSE
WAYS & MEANS SUBCOMMITTEE ON OVERSIGHT***Re: H.R. 831 -- Proposed Legislation
Relating to the
Taxation of Expatriation

This memorandum comments on portions of the legislation included in the President's fiscal 1996 budget and introduced in the House as H.R. 981 and in the Senate as S. 453. The comments relate to the portion of the bills concerning the taxation of U.S. citizens and residents who relinquish their citizenship or residency (the "Expatriation Proposal"). This portion of the bill has, with some modifications discussed below, been passed by the Senate as an amendment to H.R. 831, a bill extending the health insurance deduction for the self-employed. The Expatriation Proposal is the subject of a March 27, 1995 hearing before the Subcommittee on Oversight.

* This memorandum was prepared by Carolyn Joy Lee, Chair of the Tax Section, with substantial assistance and commentary from Henry Christensen, III, John A. Corry, Michael I. Frankel, Sanford H. Goldberg, Robert Lawrence, Richard O. Loengard, Carlyn S. McCaffrey, Elliot Pisem, Richard L. Reinhold, Michael L. Schler, Philip R. West and Reuven Avi-Yonah. The views expressed herein are not necessarily shared by all of the individuals who commented on this memorandum.

FORMER CHAIRS OF SECTIONHoward O. Colgan
Charles L. Kades
Samuel Brodsky
Thomas C. Plowden-Wardlaw
Edwin M. Jones
Hon. Hugh R. Jones
Peter Miller
John W. FagerJohn E. Morrissey Jr.
Charles E. Heming
Richard H. Appert
Ralph O. Winger
Hewitt A. Conway
Martin D. Ginsburg
Peter L. Faber
Hon. Renato BegheAlfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. CohenDonald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Corry
Peter C. Canellos
Michael L. Schler

The haste with which the Expatriation Proposal is being brought before the Congress has made it impossible to prepare a full Tax Section report on the Expatriation Proposal, or to present the issues discussed herein to our Executive Committee, prior to the Oversight Subcommittee hearing. This memorandum does not therefore set forth the views of the Tax Section, but instead reflects preliminary comments of individuals who are in the process of preparing a full report for Executive Committee consideration. While the Tax Section generally avoids such preliminary commentary, in view of the time constraints it appears in this case that this may be the only opportunity to comment.

The Expatriation Proposal raises some very basic questions of tax policy. We express no view at this point as to the tax policy considerations that underlie the proposal to increase the taxation of expatriates. We do, however, agree that under current law it is quite easy to escape U.S. taxation by expatriating, and that the existing provisions of the Code that were designed to address this are essentially ineffective.

The Expatriation Proposal also raises numerous difficult technical issues. These issues do not seem to have been fully thought through; certainly in its current form the Expatriation Proposal is technically deficient in important respects, most notably its treatment of trusts. We believe that enactment of the Expatriation Proposal in its current form would be ill advised. It will likely require considerable technical amendments, and will leave many important and basic questions unanswered.

Since a February 6, 1995, effective date has already been announced, it seems unnecessary to proceed at this pace with such technically underdeveloped legislation. A somewhat longer period between the announced effective date and enactment of the Expatriation Proposal would be neither unfair to the taxpayers affected by the proposal nor detrimental to the fisc. We therefore urge that

the time be taken to draft a proposal that better addresses the substantive and technical tax issues.

Turning to the substance of the Expatriation Proposal in its current form, our comments fall into two groups -- comments on the general approach of the proposal, and certain technical comments on the treatment of trusts.

A. General Considerations.

The essential feature of the Expatriation Proposal is the imposition of an income tax at the time an individual expatriates. In this respect the Expatriation Proposal does represent a major tax policy change. Instead of taxing U.S. citizens and residents on their world-wide income as it is realized, the Expatriation Proposal seeks to tax them on the appreciation that accrued during the period they were citizens or residents, without requiring a realization event. In doing so, the Expatriation Proposal goes beyond existing deemed sale rules in the Code (e.g., Code §367) and treats the relinquishment of one's citizenship as a taxable event, essentially requiring the expatriating individual to mark his or her assets to market. Compare Code §475.

This approach has both merits and flaws. On the positive side, the imposition of tax at the time of expatriation could be said to be the theoretically correct approach, since the time of expatriation marks the termination of the traditional personal taxing jurisdiction of the U.S. over its citizens. Furthermore, the Expatriation Proposal is fairly simple to administer; a regime that deferred the imposition of tax on expatriates would be more complex, and may give rise to over- and under-taxation, relative to the results under the Expatriation Proposal.

There are, however, some drawbacks to and technical flaws in the Expatriation Proposal. It requires the valuation of assets at the time of expatriation, which often is a less reliable measure of gain than a tax imposed on an actual disposition. It also imposes tax at a

time when the expatriate has not actually disposed of assets, and is still living. In this respect the tax on expatriates is different from, and arguably more burdensome than, the tax on U.S. citizens. The approach of the Expatriation Proposal raises liquidity problems, which are recognized to some extent by the proposed application of Code §6161 to permit deferred payments of the expatriation tax. Query, however, whether that kind of deferral, which is discretionary with the Commissioner, will sufficiently address the liquidity concerns. Some may also find the imposition of interest, currently at 9% compounded daily, burdensome.

Furthermore, the introduction of a new taxable event requires that a number of other technical changes be made in order to avoid duplicative taxation. For example, to avoid duplicative taxation of gain on assets on which the U.S. can impose tax even following expatriation, an expatriate's basis in the assets deemed disposed of must be adjusted to equal fair market value at the time of expatriation. Similarly, if an expatriate pays income tax on a deemed asset sale upon expatriation, it would be inappropriate, given the basic structure of the U.S. income and estate taxes, to impose U.S. gift tax or estate tax on that same asset, without allowing a credit for the income tax paid on the deemed sale.

In addition, the foreign income tax credit mechanisms currently provided in the Code do not work properly under a deemed sale regime, for the foreign country income tax is likely to be imposed in a later year, when an actual sale occurs, rather than in the expatriation year. If the Expatriation Proposal is enacted, the foreign tax credit rules, including the source rules, must be analyzed and revised, so that any duplicative imposition of U.S. tax on a deemed sale and foreign tax on an actual sale can, to the extent inconsistent with the intended effects of the Expatriation Proposal, be avoided. While some remedies could be achieved through amendments to our tax treaties, that would be a long process, would require the

cooperation of our many treaty partners, and would provide only piecemeal relief. We therefore believe these problems must be addressed as part of any legislation implementing the Expatriation Proposal.

The deemed sale approach also raises technical issues in applying general provisions of the Code to the deemed sale. These include, for example, determining an expatriate's holding period following the deemed sale; applying the wash sale rules of §1091; deciding whether the deemed sale can cause a partnership termination under §708; and determining whether the deemed sale is a disposition sufficient to trigger suspended passive losses under §469. The extent to which losses on the deemed sale (for example on personal and capital assets) are allowable in computing the gain subject to tax presumably should be determined under general tax rules, but this could be said more clearly. These kinds of technical issues are not insurmountable, and in most cases the "correct" answer is intuitively clear, but in terms of the technical application of specific Code sections it is not at all clear that the Expatriation Proposal in its current form adequately addresses these questions.

There are alternative approaches to the taxation of expatriates that would solve some of the foregoing problems, but create others, chiefly in the form of greater complexity. We believe such alternatives should be given fuller consideration, either as replacements for the proposed regime, or as options a taxpayer might elect, either in whole or in part, in lieu of the proposed regime.

One alternative is to measure the taxable gain at the time of expatriation, but postpone the payment of tax until the later gift, sale or other disposition of the asset, or the death of the expatriate. This approach would "capture" for the U.S. the tax on gain attributable to the individual's period of citizenship, but otherwise leave the

expatriate individual on a par with U.S. individuals in terms of liquidity issues and the burden of paying the tax. It could be structured to resolve most of the timing mismatches, and resolve various other technical problems, although this could become rather complex. Furthermore, if the U.S. neither participates in post-expatriation income and gain nor derives interest on the "postponed" expatriate tax, this approach would not be equivalent, on a revenue basis, to the Expatriation Proposal. It also could present collection problems (although, as discussed below, these might be solved through other mechanisms).

Another alternative would be to both measure and impose tax on an expatriate at the time his or her assets (or at least U.S. assets) are disposed of, or when the expatriate dies. This approach would essentially hold the treatment of the expatriate open, and apply the income and estate taxes as if the expatriate were still a citizen.

A mechanism like this currently exists in the U.S. estate tax. Under Code §§2056 and 2056A of the estate tax, a marital deduction is not available with respect to assets passing to a non-citizen spouse. The concern is that the non-citizen spouse will leave the U.S. and such assets will therefore not be taxed when the spouse dies. If, however, the assets are placed in a "Qualified Domestic Trust" ("QDOT") and thus retained in the U.S. for taxation on the death of the noncitizen spouse, a marital deduction is allowed.

A comparable regime could be applied to expatriates, postponing the tax on the expatriate's assets provided that those assets continue to be subject to U.S. taxation and within the reach of U.S. tax authorities. The trade-off for avoiding the immediate imposition of tax on such assets would be that, when income or estate tax is eventually triggered, it would be measured by the then gain or value of the assets, not the gain or

value at the time of expatriation; as an adjunct to deferral it also would seem appropriate to consider imposing tax on the income earned from the asset after expatriation.

The application of this kind of regime to expatriates would eliminate many of the difficult issues of liquidity and double taxation presented by the Expatriation Proposal. It would entail greater complexity, however, and raise other questions. If the QDOT approach is taken it would be necessary to devise and apply an adequate trust mechanism for expatriates' assets. In addition, some decisions need to be made concerning various technical and practical aspects of taxing the expatriate on income from the assets during the period between expatriation and the event (i.e., disposition or death) that triggers payment of the tax. Moreover, the treatment of expatriates' foreign assets would need to be considered further, balancing against concerns for protecting the revenue the need to avoid undue hardship.

Whatever the approach to taxing expatriation, the introduction of a tax on gain of expatriates raises questions as to how the U.S. should treat assets that are brought into the U.S., either upon the naturalization of a foreigner, or as gifts received by U.S. persons from foreigners. If every country imposed a regime like that of the Expatriation Proposal, there would be duplicative taxation any time an individual changed his or her nationality. To avoid this, the Expatriation Proposal should, as suggested in the Joint Committee Pamphlet,** include a provision that treats an individual as having a basis in his or her property equal to the fair market value of each asset at the time the individual enters the country or, in the case of property gifted by a foreigner, at the time the

** Background and Issues relating to Taxation of U.S. Citizens Who Relinquish Citizenship and Longer-Term Resident Aliens Who Relinquish Their U.S. Residency", March 23, 1995, p. 11.

individual receives the gift. The bill does not yet reflect this, however. Furthermore, while according a fair market value basis for expatriation tax purposes is necessary to avoid the imposition of U.S. expatriation tax on gain accrued before the person or asset came to the U.S., query whether the theoretical underpinnings of the Expatriation Proposal do not also require such a basis adjustment for all purposes of the Code, including the measure of gain on a disposition of such assets by a U.S. person.

Any tax on expatriation also requires consideration of the causes of expatriation, and whether it is appropriate to impose an expatriate tax in each case. For example, if a child born abroad to U.S. parents cannot renounce his or her citizenship until reaching the age of eighteen, but does so promptly thereafter, is it appropriate to impose U.S. tax on the gain that accrued while the child was a minor and incapable of expatriating?

B. Technical Comments on Certain Trust Issues.

In considering our commentary on the Expatriation Proposal we have identified a number of technical questions and problems, the most severe of which are in the proposal's treatment of interests in trusts. There are complex technical questions involving the interaction of the income taxation of trusts, the estate tax rules, and the generation skipping tax with a new expatriate tax. But perhaps the most fundamental issue is the imposition of a tax on beneficiaries based upon their imputed share of trust assets.

In considering the treatment of trusts it may be helpful to distinguish between (i) trusts established by third parties for the benefit of the expatriate, and (ii) trusts established by the expatriate; the latter category might be further subdivided between (x) trusts established by the expatriate before February 6, 1995, and (y) trusts established by the expatriate

thereafter. It also is important to bear in mind that in the usual case there are constraints on a beneficiary's ability currently to receive any particular share of the trust. Most future interests in a trust, and many current interests, are contingent and are affected, for example, by survival, by trustee discretion in making and allocating distributions, by powers of appointment, and so on.

Moreover, even if an interest in a trust can be valued, "spendthrift" clauses included in trusts frequently limit a beneficiary's ability to sell or otherwise realize the value of his or her interest in a trust. Furthermore, with any testamentary or irrevocable trust it is generally impossible to change the terms of the trust. Thus, while a beneficial interest in a trust can have real value that value also can be contingent, as well as impossible currently to realize.

The Expatriation Proposal is designed to tax expatriates on gain in "their" assets at the time of expatriation. The Expatriation Proposal provides that an expatriate's interest in a trust is to be identified "based upon all relevant facts and circumstances including the terms of the trust instrument and any letter of wishes or similar document, historical patterns of trust distributions, and the existence of and functions performed by a trust protector or any similar advisor." Where this analysis does not produce a clear answer, trust shares are allocated based on "degrees of kinship." Expatriation Proposal, §877A (f)(1). The Expatriation Proposal thus seeks to impose a current tax on the expatriate's imputed share of trust assets.

This has two basic problems. First, in any case where there are different "classes" of trust interests (e.g., income to wife for life, then remainder to the children), or where the trustee is given discretion in the distribution of trust income or principal, there is no way accurately to ascertain any beneficiary's share of the trust

assets. The imposition of tax on a share of the trust imputed to the beneficiary is therefore almost certain either to over- or understate the expatriate's actual share of trust assets.

Second, the imposition of tax at the beneficiary level can be a real hardship when the assets that are taxed remain in trust and are not distributed to the beneficiary. Treating the beneficiary as the owner of an imputed share of trust assets for purposes of the expatriation tax means that the tax is imposed on the individual, but the individual may very well not have access to the assets to pay the tax. Furthermore, the beneficiary is unlikely to be able to borrow against or sell his or her beneficial interest at anything close to the value of the imputed share of trust assets. Under the Expatriation Proposal, therefore, the beneficiary not only is subject to tax on a share of gain he or she may never realize, but also is required to pay that tax when he or she may not have access to the assets taxed.

The Expatriation Proposal also provides that the assets on which an expatriate is taxed include any interest that would be includible in the expatriate's estate had he or she died at the time of expatriation. In the context of trusts, this provision again gives rise to anomalies. For example, consider the simple and common case of a marital deduction trust, which provides for income to be payable to the decedent's wife for life, with the corpus then distributed to the decedent's son. Under the estate tax regime the full value of the trust assets is includible in the wife's estate at her death. If the wife expatriates, therefore, the Expatriation Proposal would subject the full value of the trust to tax. Under the provisions taxing beneficiaries' interests in trust, however, the Expatriation Proposal also would subject a portion of the value of the trust to tax if the son expatriates. If both wife and son expatriate, tax would be imposed twice on some portion of the trust assets.

This example illustrates another fundamental problem with the Expatriation Proposal's approach to measuring the assets to be subjected to the expatriation tax.

An alternative approach to the taxation of expatriates' interests in trusts would be to treat them similarly to the "open transaction" treatment described above for directly held assets. (This approach may be particularly appropriate for expatriates who are beneficiaries of trusts established by third persons, and for an expatriate's interests in a trust he or she established before February 6, 1995.) This alternative would postpone the imposition of the expatriate tax until the beneficiary receives a distribution from the trust (or, if the beneficiary has a power of appointment, until the beneficiary's death). Clearly, a tax imposed on the distribution would more accurately measure the expatriate's true share of the value of the trust assets; furthermore, this would defer the imposition of tax until the taxpayer had the beneficial enjoyment of the taxed assets.

This approach would require that tax be collected from an individual who has already expatriated. To some extent, while imposition of tax at the time of expatriation may effect some practical enhancement of collectibility, there is no assurance an expatriating individual will not have removed assets from the U.S. prior to expatriation. Any expatriation tax system will therefore have collection risks. Furthermore, the imposition of tax on a beneficiary with no directly held assets creates its own collection problems. The collection problems raised by the alternative should, therefore, be considered in context.

Moreover, with U.S. trusts, or trusts with U.S. trustees, withholding mechanisms might be an effective means to buttress collection of the tax. The QDOT approach, discussed above, could also be considered.

Withholding may not be as effective a collection mechanism with foreign trusts, and the imposition of a requirement to post security would be unworkable if the beneficiary does not have access to trust assets. However, given the imposition of tax under Code §1491 on the transfer of assets into a foreign trust, and the treatment of such trusts as grantor trusts, there are already some restraints on the abusive use of foreign trusts. Furthermore, the deferral could be limited to trusts settled by third parties and trusts created before February 6, 1995; in that case the avoidance exposure would be, for example, a situation in which a parent created a trust for the benefit of her children; the trust invested in assets, now appreciated, and made no sales during the mother's lifetime; and one of the children/beneficiaries now expatriates. We have not, however, had sufficient opportunity to study this problem to be able to propose a solution that both avoids undue hardship to beneficiaries of foreign trusts and protects the fisc. Again, this illustrates the need for further consideration of this area before legislation is enacted.