S. HRG. 104–381

TAXATION OF INDIVIDUALS WHO RENOUNCE THEIR U.S. CITIZENSHIP

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

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TAXATION OF INDIVIDUALS WHO RENOUNCE THEIR U.S. CITIZENSHIP

TUESDAY, MARCH 21, 1995

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:33 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the subcommittee) presiding.*

Also present: Senators Grassley, D'Amato, Moynihan, Bradley, and Graham.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN OF THE SUBCOMMITTEE

Senator HATCH. We are happy to call this to order. A good morning to my colleagues and our witnesses this morning. Today's hearing is on the Clinton Administration's revenue proposal to assess a capital gains tax on the unrealized gain of the property of U.S. citizens who renounce their citizenship.

The Treasury Department first announced the details of this proposal on February 6, 1995, as part of the administration's revenue proposals for the budget for fiscal year 1996.

Treasury has estimated that the proposal would result in $6.9 billion in additional revenue between 1995 and the year 2005. Apparently the provision would affect no more than a handful of very wealthy taxpayers.

The issue became more prominent last Wednesday when the Finance Committee adopted a modified version of the proposal on the bill to extend the health insurance deduction for self-employed taxpayers, H.R. 831.

The idea that super-rich Americans would, in effect, "sell" their citizenship by expatriating away from the long arm of the Internal Revenue Service is reprehensible to most of us. That is why this proposal has strong appeal, at least at first glance. However, there are usually more considerations to issues than first meet the eye, and I think that that is the case here.

There have been a number of concerns raised about this proposal on constitutional grounds, on human rights grounds, and on tax policy grounds. Because of the urgency of bringing H.R. 831 to the

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*The Joint Committee on Taxation prepared a document for this hearing entitled "Background and Issues Relating To Taxation of U.S. Citizens Who Relinquish Citizenship," and is included in the appendix.

Senate floor in time to pass the health insurance deduction measure as soon as possible before the final due date for 1994 tax returns on April 17th, we announced this hearing on very short notice.

So, I sincerely apologize that we had to do that on such short notice and I sincerely appreciate that our witnesses had to put their testimonies together over the weekend. I want to thank them, on behalf of our committee, for being willing to be with us today. We want to especially thank those witnesses who had to travel to be here.

As we hear testimony from the two panels of witnesses, I hope that at least three general issues are addressed. First, does this proposal impinge on the fundamental human right to emigrate? Second, will the enactment of this provision have a detrimental effect on the attractiveness of this country to foreign investment? And, finally—I know my colleagues are just as interested in finding ways to shut down tax avoidance schemes as I am—is there another and better way to achieve this goal than through this provision?

So we look forward to the comments of our witnesses this morning, and we will turn now to our Ranking Member on the committee.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I just very much would associate myself with your comments. We are looking forward to Secretary Samuels, Ms. Borek, and the other panelists. There are legitimate questions and they will need to be answered. I will see how they do.

Senator HATCH. Well, thank you, Senator Moynihan.

We will now turn to our first panel, which consists of Ms. Jamison Borek, who is Deputy Legal Advisor at the State Department. We are happy to have you with us.

And Mr. Leslie Samuels, Assistant Treasury Secretary for Tax Policy, and we are real happy to have you with us as well. We welcome the both of you and we would just turn to you at this time.

STATEMENT OF LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary SAMUELS. Mr. Chairman, I would ask that our written statement be placed in the record, and I would like to briefly summarize it for you this morning.

Senator HATCH. Without objection.

Secretary SAMUELS. I appreciate the opportunity to testify in support of the administration's and the Finance Committee's modified proposal designed to prevent a relatively few very wealthy Americans from avoiding U.S. tax on millions of dollars of gains by renouncing their United States citizenship.

Next month, millions of Americans will settle up with their government and finalize their tax obligations. Recent reports in Forbes Magazine and other media have described how a very small num-

ber of Americans avoid their U.S. tax obligations by giving up their U.S. citizenship.

We believe that when a U.S. citizen who is subject to tax on his worldwide income changes his status to that of an alien who is exempt from most U.S. tax, it is appropriate and fair to tax him on those gains on which tax has not previously been paid.

These expatriots should not obtain an unfair advantage over those U.S. citizens who continue to meet their tax obligations to our government. Other countries, such as Canada, Australia, and Germany, impose similar taxes. Each country crafts its proposal to deal with its own basic tax structure and other fiscal considerations.

Opponents of this proposal infer that this tax is designed to prevent free emigration or deny other important human rights. The proposal approved by this committee does not in any way—does not in any way—restrict Americans from leaving or entering this country. As a matter of fact, many expatriating former Americans choose to spend a significant amount of time in the United States, often with family members who have not renounced their citizenship.

My views are strongly buttressed by others much more learned in this field than I. First, the Deputy Legal Advisor of the State Department will address this issue when I complete my statement.

Also, I would like to place in the record a letter I received yesterday from a distinguished international lawyer and Treasury consultant on Eastern European tax programs, Professor Paul B. Stephan, III, of the University of Virginia, as well as a letter from the Acting Legal Advisor of the State Department.

Senator HATCH. Without objection, it will be placed in the record.

[The letter appears in the appendix with Secretary Samuels prepared statement.]

Secretary SAMUELS. An argument has also been made that the provision is somehow unconstitutional on the grounds that no taxable gain has been realized by the former American.

This argument is, in our view, completely without merit. There are similar taxing regimes already in the Internal Revenue Code whose constitutionality has been upheld against similar challenges.

For example, the Foreign Personal Holding Company Rules, applicable to both corporate and individual stockholders, and the Controlled Foreign Corporation Regime that also applies to corporate and individual shareholders, have both been upheld by the courts against challenges that it was unconstitutional to tax unrealized income.

Finally, we must remember that we are not writing here on a clean slate. The proposal is an amplification, an improvement, of Section 877 of the Internal Revenue Code, which was enacted almost 30 years ago.

Unfortunately, Section 877 has proven ineffective in addressing the abuses at which it was targeted. Old Section 877 taxed expatriating Americans for 10 years, but only on certain gains and in a manner that raised administrative and extraterritoriality problems.

Section 5 of H.R. 831 is designed to avoid the problems of existing law. With its exemption of up to $1.2 million of gain for a mar-

ried couple, the provision eliminates from its coverage all but the wealthiest.

Although the taxes imposed on gains at the time the American renounces citizenship, there are provisions permitting deferral of payment of the tax for 10 years if adequate security is provided.

U.S. pension plan benefits are excluded from coverage, as well as up to $500,000 of foreign pension benefits. U.S. real estate is exempt from this proposal.

Finally, citizenship will be deemed lost on the date of renunciation before a U.S. Government official, or on the happening of certain other events, whichever occurs first.

Enactment of this legislation will help assure continued respect for the fairness and equity of our voluntary income tax system. With the revenue held in trust for deficit reduction, Section 5 of H.R. 831 sends an important signal of our continuing intent to reduce our fiscal deficit.

Mr. Chairman, this concludes my statement. I will be available to answer any questions that the subcommittee may have.

Senator HATCH. Thank you.

Ms. Borek, do you have a statement?

STATEMENT OF JAMISON S. BOREK, DEPUTY LEGAL ADVISOR, DEPARTMENT OF STATE, WASHINGTON, DC

Ms. BOREK. Yes. Thank you, Mr. Chairman, members of the committee. With your permission, I also will give a brief statement and hope that you will accept the written statement for the record.

Senator HATCH. That will be fine. Without objection, we will put it in the record.

Ms. BOREK. Thank you.

[The prepared statement of Ms. Borek appears in the appendix.]

Ms. BOREK. I am here today to address the question of whether Section 5 of H.R. 831, as reported by the committee, raises legal questions concerning international human rights.

This proposal, as you know, would effectively require payment of taxes, taking into account gains if there are gains, upon the renunciation of citizenship by treating this as equivalent to a sale. The proposal would apply only to gains in excess of $600,000. It would not apply to U.S. real property owned directly, nor to certain pension plans.

It has been suggested by some that this proposal would violate the right to leave the territory of a State or the right to change one's citizenship, as recognized in international human rights law. In our view, however, this tax proposal does not conflict with these, or any other, international human rights.

I would note, first of all, that the Covenant on Civil and Political Rights, which has been cited, does not refer to the right to emigrate or change one's nationality, it is simply to the right to travel, the right to leave any country, including one's own.

This proposal does not in any way affect the right to travel. It is not an exit tax, it does not apply when you travel, it is wholly unrelated to travel. Rather, it applies at the time that an individual renounces citizenship.

Based on the past experience of the Department, this is most likely to affect U.S. citizens who have already departed from the

United States, since it is our experience that most renunciation of citizenship occurs at that time. But, in any event, whether the individual is in or out of the United States or whether they travel is not affected by this proposal.

It is, nonetheless, well-established that a State could impose certain economic controls in connection with departure as long as such controls do not result in a de facto denial of the individual's right to emigrate.

Similarly, a claim of violation of the right to renounce citizenship could only be made where the right is effectively precluded. There is no international law right to avoid taxes by changing citizenship.

Section 5 would impose taxes which are comparable to those which U.S. citizens would have to pay were they in the United States. It is a bona fide means of collecting taxes on gains which have already accrued. It is not a pretext to keep people from leaving; it is not so burdensome as to effectively preclude change of nationality or travel. It applies only to gains, and only when these gains are in excess of $600,000.

Therefore, while it may mean that there are certain consequences of change of citizenship and they may be expensive, it in no way stands in the way or makes it impossible for individuals to actually change their citizenship if they choose to do so. It does not impose a burden on anyone which they could not afford to pay and, thus, preclude the right.

In short, it is the view of the Department of State that this proposal does not raise any significant question of interference with international human rights. I hope this information is helpful to the committee. Thank you.

Senator HATCH. Thank you very much.

Mr. Samuels, as I understand it, U.S. law already includes a system that is designed to prevent U.S. citizens and residents from expatriating in order to avoid U.S. taxes. Now, is that correct?

Secretary SAMUELS. Mr. Chairman, that is correct. Section 877 of the Internal Revenue Code was adopted by Congress in 1966.

Senator HATCH. What, specifically, are the problems with that system?

Secretary SAMUELS. Mr. Chairman, we see several problems. First, Section 877 only applies to those citizens who renounce with a principal purpose of avoiding U.S. tax. It has been very difficult for the Internal Revenue Service to determine whether a person has a principal purpose of avoiding U.S. tax.

Obviously, the people who are leaving with significant wealth all claim that they do not have that purpose, so it is very difficult for us to determine those who should be subject to the section and those who are not.

Second, the provision only applies to tax U.S.-source gain realized by the expatriating person for a 10-year period after the expatriation. This provision raises two separate issues.

First, it is only U.S.-source gain, U.S. citizens, under longstanding U.S. tax principles that go back to the beginning of the income tax or tax on their worldwide income, both U.S.-source and foreign-source. This only looks at one part of their gain, not all of it. So that is an issue from a tax policy perspective that we have seen.

Second, the existing section taxes the expatriot on appreciation that occurs after the person has actually renounced his citizenship. So, if you leave with stock that is worth $100 that you bought for $50 and you sell it 5 years from now and are subject to this section at $150, you are taxed on the whole $100 of gain, not just the $50 of gain that accrued while you were a citizen.

We think that that raises some extraterritoriality issues and, from a policy perspective, it would be better to tax just a gain that accrued while the person was a citizen of the United States.

Third, as a practical matter, because we look to sales after someone has expatriated and the expatriates say that they did not leave for tax purposes, it is hard for the IRS to administer the provision.

So, those are the problems that we looked at when we were examining that section and led us to making the proposal in the President's budget that was adopted in modified form at the Senate Finance Committee last week.

Senator HATCH. In preparing the proposal did the administration look at the practices of other developed nations in capturing the revenues from those who seek to avoid taxation through voluntary expatriation?

Secretary SAMUELS. Mr. Chairman, we did. There are two types, one which is in the category that is really the one that the proposal adopts, is subjecting gain to tax when the person expatriates. In that category, in some form, everyone has a slightly different provision, Canada, Australia and Germany.

Then you have a group of other countries that follow our existing Section 877 which look to periods after expatriation and continue to tax their residents. For example, the Scandinavian countries tend to follow that practice.

I would say, in looking at this and comparing us to foreign jurisdictions, one difference is that the United States is, in some ways, quite unusual, in that we tax our citizens on the basis of citizenship, not residence.

The United States has always attached a great deal of importance to citizenship and other countries tax their citizens on the basis of residence. So, it is a kind of a different philosophy and that plays into the different systems that people have adopted.

Senator HATCH. All right.

Ms. Borek, let me just ask one question to you. Have the countries mentioned by Mr. Samuels signed on to the International Covenant on Civil and Political Rights? And, of those that have, how do they reconcile their commitment to guaranteeing the right to emigrate with their practice of capturing revenues from those who would deliberately seek to avoid taxation by surrendering their citizenships?

Ms. BOREK. They do belong. As I noted previously, if you look at——

Senator HATCH. Do all of them belong?

Ms. BOREK. I would be 99 percent confident that they all belong. The Scandinavian countries, Canada, Australia, and Germany are all parties.

Senator HATCH. Now, how do they reconcile that?

Ms. BOREK. Well, the Covenant itself provides only a right to travel, which is not affected by this. What you would have to look

to, to make an argument that there is a human rights problem, is customary international law, which is reflected in the practice of States.

I think it is clear from the practice of these States that there is not a prohibition on this in customary international law because it is not something which is generally recognized as a violation of human rights. The Covenant itself does not pick up the provision on change of nationality, it has only the provision on travel, the right to leave.

Senator HATCH. All right. Thank you.

Senator Moynihan?

Senator MOYNIHAN. Thank you, Mr. Chairman.

If I could address myself to Ms. Borek, I believe this is the first occasion you have testified before the Finance Committee.

Ms. BOREK. Before this committee, Senator, yes.

Senator MOYNIHAN. Welcome. I take it that the gist of the administration position is that we are treating this particular class of citizens in no way differently from citizens at large, in a sense. They are being expected to pay the same taxes that other Americans would pay, those who did not leave the country.

Ms. BOREK. That is certainly part of it. Even more strongly, I think one could say there is not a prohibition in this area. You would have to have a measure which was much more burdensome so as to really make it impossible for people realistically to change their nationality to even have a question. If you had that question, then I think it would be very significant that we were treating people just as we were treating everyone else.

Senator MOYNIHAN. Could I ask you, you speak of international human rights law. Now, what is that?

Ms. BOREK. Well, in the case of travel, there is the treaty, the International Covenant on Civil and Political Rights, which we are a party to.

Senator MOYNIHAN. Which we ratified in 1992.

Ms. BOREK. Which we ratified.

Senator MOYNIHAN. Yes. But you also spoke of customary international law. Are individuals subjects of customary international law?

Ms. BOREK. We do recognize that there are some principles of customary international human rights law. The United States——

Senator MOYNIHAN. Customary human rights law.

Ms. BOREK. Yes.

Senator MOYNIHAN. Where does one find that?

Ms. BOREK. Customary law depends primarily on the practice of States, to show in their practice that they believe there is a prohibition in international law, so it is more difficult to prove.

It is not as clear and it is not as large a body of law as the treaty law. For example, we have taken the view that torture is prohibited by customary international human rights law, even if you do not happen to belong to a treaty that prohibits torture.

Senator MOYNIHAN. Yes. Are there other practices which we hold to be violations of customary international human rights law?

Ms. BOREK. Well, we have recognized, as relevant to this, that there is some degree of right to change nationality, or ought to be, under customary law.

Senator MOYNIHAN. Now, wait. Is there or is there not? Ought to be is not exactly a category.

Ms. BOREK. Well, if you are going to establish customary international law you really have to show that every other country agrees with you, or most other countries agree with you.

In the area of, perhaps, change of nationality, that is less clear than in the area of torture, but I think the United States is a Nation composed of many people who have changed their nationality, and has taken a clearer view on change of nationality.

Senator MOYNIHAN. We do have a large interest in such a principle, the right to change nationality. But you do not feel that this tax treatment in any way impinges on a prior and higher right, which is that of changing nationality?

Ms. BOREK. No. People remain entirely free to change their nationality. There is only a consequence in a case where there is an extremely high amount of capital gain, that certain taxes are due, and that is not standing in the way of changing nationality.

Senator MOYNIHAN. Thank you, Ms. Borek. Thank you, Mr. Chairman.

Senator HATCH. Thank you.

Senator D'Amato?

Senator D'AMATO. I noticed that one of the witnesses in their statement seemed to raise a question as to why it is that the proposal seems to have changed as it relates to citizens only, not to long-term resident aliens. Are you aware of that?

Secretary SAMUELS. Senator D'Amato, Section 5 of H.R. 831 that this committee passed last week and was based on Senator Moynihan's amendment only dealt with citizens, not with long-term resident aliens who held green cards, who were part of the administration's proposal.

Senator D'AMATO. Well, I want to ask, what is your feeling as it relates to the resident aliens, should they not be included in that provision? Why did the administration initially have that provision? The argument put forth, I think by Mr. Marshall Langer, what do you think about that?

Secretary SAMUELS. Senator D'Amato, that was discussed at the hearing. Senator Graham actually asked me about how we felt about it, and I will be happy to repeat it here. Our original proposal was based on the concept that someone who had a green card which enables that person to have permanent residence in the United States for a significant length of time, at some point one could decide as a policy matter that that person had the benefits of the protections afforded by the government, that it would be appropriate to tax that person if that person gave up his or her green card. We picked 10 out of the last 15 years.

In the context of what the committee passed, we said we understood that that provision was not in there. It was a policy judgment we made, it was a policy judgment that we could understand how the committee might decide not to include resident aliens who were green card holders. From our point of view, we looked at that and supported Section 5 of the bill as passed by the committee.

If one wanted to come back and revisit that——

Senator D'AMATO. Well, that is what I am doing.

Secretary SAMUELS. All right.

Senator D'AMATO. So, just for point of information, as it relates to the testimony put in by Mr. Langer, if you look at it you raise that question. He raises the question, so I am raising it with you.

How much revenue would be derived, or do you have a number in terms of revenue that would be derived, if you were to use the administration's initial proposal as it relates to long-term resident aliens, do we have a number?

Secretary SAMUELS. Senator D'Amato, when we prepared our revenue estimate we looked at all the available information and our revenue estimate was based on estimates of revenue that would be attributable to U.S. citizens who renounced their citizenship and it is my recollection it did not include any revenue from green card holders who gave up their green cards. We did not have enough information to make that estimate, so it was not included in our revenue estimate.

Senator D'AMATO. All right. Have you ever asked for that estimate or looked at what that estimate would be as it related to, if you had included long-term resident aliens? At some point in time the administration had a proposal. In that proposal it included long-term resident aliens. Is that correct?

Secretary SAMUELS. That is correct, Senator.

Senator D'AMATO. Did you make a revenue estimate as it relates to what the revenue would be that would be produced by this tax as it relates to long-time resident aliens? I see my colleague maybe has a question, since he has pursued this before. Maybe he wants to expand on it. Senator Graham?

Senator GRAHAM. Well, I think Mr. Samuels might want to answer the question, then I could refer to the data that we have been provided on that.

Senator D'AMATO. Mr. Samuels, could you tell me?

Secretary SAMUELS. Senator D'Amato, when we prepared the revenue estimate for the administration's proposal, which included the proposal for long-term resident aliens, at that point we looked at that and our revenue estimators did not have data that would provide them with reasonable certainty to include the amount in the revenue estimate. So, yes, we looked at it and our revenue estimate did not include any amount for the green card holder part of the provision because we did not have the data.

Senator D'AMATO. Well, let me ask you. How difficult would that be to obtain that? Do you not think that that would be something worthwhile to look at?

Secretary SAMUELS. Absolutely. We ask our revenue estimators on a regular basis to try to have the best available data, and they are continually trying to do that. It is just, at the time they made their estimate they did not have it.

Senator D'AMATO. I do not mean to be beating a dead horse, but would it be appropriate to ask you or ask the Chair whether or not we could get some estimates? It seems to me that you could make them, for example, at a 10-year period of time, residents who have been here 10 years, or whatever period of time, and get some estimates.

I think at least that might be instructive to us. It would seem to me that possibly that amount of money may be considerably more than this legislation as it applies to citizens. I do not know,

but I think at least I would like to have that, and I mention that to the Chair.

Senator GRAHAM. Mr. Chairman.

Senator HATCH. Senator Graham.

Senator GRAHAM. If I could just comment that the original revenue estimate from the administration on their proposal, which contained both citizens and non-citizens, was $1.7 billion over the 5-year period.

The Joint Committee on Taxation, estimating for only citizens, gave a number of $1.359 billion, which would indicate that there is a $341 billion gap between those two numbers, which could be a difference in estimating technique, some other factor, or it could be in part, or substantial part, the difference between citizens and non-citizens.

Senator MOYNIHAN. Could I say to my friend from Florida that I believe the Joint Tax Committee indicated that limiting the application to U.S. citizens would cost $137 million?

Senator HATCH. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I would like to pursue the questions that Senator D'Amato has been pursuing. For the State Department, if the tax is only applied to citizens who are renouncing their citizenship, what affect do you think that will have on such issues as the inclination of aliens to seek citizenship as distinct from staying in a long-term alien status?

Ms. BOREK. Thank you, Senator. I am not sure that I, personally, am competent to answer this question. Let me just check if someone is here from the Consular Affairs Bureau.

[Pause]

Ms. BOREK. Our initial view is that it is very difficult to predict, given the number of factors that would come into play. If you would like I could try to get you a more considered view for the record.

Senator GRAHAM. Good. Thank you.

Still, for State, what numbers do you have to estimate the number of individuals who meet the definition of a long-term resident as proposed in the administration's recommendation, that is, a lawful permanent resident for at least 10 of the last 15 years?

Ms. BOREK. I think it may be that the Treasury Department has numbers on that for you. I think we could try also to get you numbers for the record. One of the questions, of course, which affected, I think, the initial estimates, is that it is much more speculative in the case of the permanent resident.

Senator GRAHAM. I would like to move to a second area of inquiry, and that has to do with the current law and what might be done to make the current law more enforceable. The response that we have received informally to that question is, the administration's proposal of this legislation represents its best assessment of what should be done. But assume we pass the change in policy as it relates to citizens, but continued to treat the long-term non-resident aliens as today. Are there any steps that you would recommend that we could take to enhance enforcement?

Secretary SAMUELS. Senator Graham, if I could just repeat the question to make sure I understand, we are talking about increas-

ing enforcement with respect to those citizens who renounce their citizenship.

Senator GRAHAM. There are a couple of options. If we pass, as it left this committee, H.R. 831, we will have a change in policy as it relates to renouncing citizens, but we will continue to have the current policy as it relates to long-term residents. So the question is, do you have any recommendations of what we might do to increase the enforcement capabilities of the current law as it will continue to apply to long-term residents?

Secretary SAMUELS. Senator Graham, just for clarification, let me mention that the current law does not apply at all to long-term residents, it only applies to citizens who renounce their citizenship. So, a long-term resident who leaves the United States, gives back the green card, can exit the country and if that person has accumulated gains while that person was resident, they can leave the country and not be subject to tax with respect to those gains. So that group of individuals just are not covered under current law.

We thought about, as part of the proposal that we made, to deal with long-term resident aliens who have green cards about how that system might work, and I think that the one area which we have thought about where one could consider trying to make some changes is, right now when someone comes into the country and they have appreciated assets they are not subject to any mark to market kind of regime with respect to those assets. There has been suggestions, for example, the Canadian system has a so-called mark to market kind of approach.

Right now, as a matter of practice there is kind of a self-help mark to market regime where people, before they get here, if they know they have significant unrealized gains, will actually do something to realize them before they get here, so there is kind of a self-help system.

Actually, it works against the government because they obviously do not realize losses before they get here, they will kind of keep those ready to use if they decide to sell the property with a loss once they get here. So we think that if you want to look at green card holders, that this would be an area to explore, is how to deal with determining tax bases when someone comes into the country.

Senator GRAHAM. I wonder, Mr. Chairman, if we might ask the Treasury to submit in writing a further proposal relative to enforcement on long-term, non-citizen residents.

Senator HATCH. That would be fine. Can Treasury do that for us? Will you be able to do that for us?

Secretary SAMUELS. Yes, we will.

Senator HATCH. That will be fine. If you would do that right away, because we are really pressured on this.

Secretary SAMUELS. Right.

Senator HATCH. Let us go to Senator Grassley.

Senator GRASSLEY. Yes. Mr. Samuels, notwithstanding the discussion you just had with Senator Graham about current law, how enforceable is this provision to tax expatriots, and will there have to be any new processes set up to carry it out to see that the job is done?

Secretary SAMUELS. Senator Grassley, I think that the proposal can be administered. Let me just, in the context of discussing that,

give some background. First, we think the revenue estimate is associated with a very small number of individuals.

Part of the revenue estimate is based on individuals who will decide not to leave, they will just decide to stay here and continue to pay their taxes like you and I do, and they will not leave. That is part of the revenue estimate. They have paid their taxes, they will continue to pay their taxes.

We think people who leave and decide that it is economic for them to pay their taxes just make that decision, and we think some people will do that. We think that they will settle up when they leave.

If you look at the types of people who have engaged in this type of behavior as reported in the press, they tend to like to come back here and visit. Some of them have their businesses here, some of them maintain their homes here, some of them have their families here that they come and visit. And you can come back into the country, under current law, effectively, 120 days a year and not be subject to additional U.S. tax.

So the group is not kind of going off and we will never see them again, so we think that when you look at the types of individuals, and we expect that people will pay the taxes they owe, that, looking at the overall situation, we should not have any significant problem.

Senator GRASSLEY. Really no problem and not a particularly overwhelming job. It is based on their willingness to be law abiding citizens; is that basically what you are saying?

Secretary SAMUELS. Well, that is part of it. In addition, I believe that in the future when citizens that renounce their citizenship, I think the State Department may give the Treasury Department the names of those individuals and then we can make sure that they have complied with their tax obligations.

Senator GRASSLEY. All right. I want to turn to something now that a witness, Mr. Rosenbloom, who is on the next panel, raises. He raises the issue of denying a stepped up basis in property that is inherited from a person who has renounced citizenship. So my question is, why should this not be considered also, and has Treasury done any revenue estimates on this?

Secretary SAMUELS. Senator Grassley, when we looked at this proposal we made a policy judgment that this proposal should just apply to the income tax, not any transfer tax such as the gift tax or the estate tax. We thought that it was fair to ask a person to pay tax on their unrealized gains when they leave the country.

It is kind of like paying your last month's rent when you are asked to leave. In that context, we decided, as a policy matter, that that was adequate and we did not want to get into the gift and estate tax area, and we have not.

So I think that would be something we would look at, but it was an issue that we considered in designing the overall proposal, and at that time thought that it was best just to keep this targeted to the income tax.

Senator GRASSLEY. This provision is limited just to capital assets, is that correct?

Secretary SAMUELS. Yes. When someone leaves, if they have income, they are supposed to pay tax on their income up to the date

they leave. And with respect to gains, what this change is, we are asking them to pay tax on all their unrealized appreciation in excess of the $600,000, and without regard to U.S. real estate. So we targeted this in a way to deal with what we thought were the abusive situations.

As I said, it is a very small number of people who produce this, in our view, significant amount of money. I am sure you will recall when the committee reported this out last week, it was agreed that this was to go to deficit reduction, which we support.

Senator GRASSLEY. Well, if it is limited to just capital assets, have you given any thought about expanding it to all assets? I am just getting at the thought process you went through. I am not questioning your judgment.

Secretary SAMUELS. I think that we felt that the capital assets were what was really important. I guess someone, if they had a sole proprietorship, could have inventory here, but unless they took it out of the country to sell it, because it was not a capital asset, they would normally be taxed when they sold the inventory. So we think that that is really the focus of the proposal. We would obviously consider other options. I think that when we looked at this we did not think that that was necessary.

Senator MOYNIHAN. Urgent dispatch from rear.

Senator GRASSLEY. Mr. Chairman, thank you.

Senator HATCH. Well, thank you. As I understand it, those who renounce U.S. citizenship are going to have to pay income taxes for 10 years under current law after they leave. Am I wrong on that?

Secretary SAMUELS. Mr. Chairman, under current law, once you leave you are only required to pay tax on U.S.-source capital gains.

Senator HATCH. Right. But that is kept track of for, what, 10 years?

Secretary SAMUELS. For 10 years. Yes, sir.

Senator HATCH. All right. Unless there are other questions, why do we not move to our second panel. I want to thank you for appearing and we appreciate your testimony.

Now we will turn to our second panel consisting of Ellen K. Harrison, a partner of Morgan, Lewis & Bockius of Washington, DC; Marshall J. Langer, Of Counsel, Shutts & Bowen, London, England; R. David Rosenbloom, Member, Caplin & Drysdale, Chartered, here in Washington, DC; and Robert F. Turner, Charles H. Stockton Professor of International Law at the U.S. Naval War College in Newport, Rhode Island.

So Ms. Harrison, we will start with you, first. If you could keep your remarks for 5 minutes; we are pressed for time. If you could summarize in 5 minutes we would appreciate it. We will take all statements as part of the full record here.

Ms. Harrison, we will turn to you.

STATEMENT OF ELLEN K. HARRISON, PARTNER, MORGAN, LEWIS & BOCKIUS, WASHINGTON, DC

Ms. HARRISON. Thank you, Senator Hatch. Thank you to members of the committee for inviting me to come.

I would like to begin by saying that I generally endorse the principle of preventing evasion of U.S. tax obligations through expatria-

tion, but I do not believe that this bill should pass because I think it is seriously flawed.

I would like to go through a number of my tax policy objections to the legislation.

First of all, the exit tax purports to be an income tax but dispenses with the requirement for an income realization event. Apart from the issue of whether this is constitutionally required, I think it is bad tax policy because we have a serious measurement problem. We have heard the example of the mark to market rules, the sub-Part F rules, the Foreign Personal Holding Company Rules, and so on, but they are really inapposite because in all of those cases—well, in the Holding Company cases—income is realized, it is just realized through an entity that the taxpayer controls, so you can clearly measure the taxpayer's share of income. It is much more difficult to measure what someone's unrealized income is.

In the mark-to-market case, we have inventory that consists of readily tradeable securities for which market quotations are readily available, so we do not have a measurement problem.

We also have a liquidity problem if we do away with the realization event, and this is a very serious problem and makes this tax proposal sound like a penalty for expatriation, which I think is unattractive, to say the least.

Foreign personal residences should be exempt to prevent a forced sale of a foreign residence. Foreign pension plans should be exempt without the $500,000 cap and without implementing regulations because typically in a retirement plan a person has no immediate right to recover those assets. More than 5 years should be allowed to pay a tax on closely-held business interests.

The exit tax would apply to all property includable in a person's estate. While it is true that the estate tax applies to property that is outside the taxpayer's control, the estate tax laws, unlike the income tax laws, provide a mechanism for collection of the tax. Section 220.7 of the Code makes the tax liability recoverable from property held in trust that is outside the taxpayer's control. We have nothing similar here. It raises a question in my mind whether this tax would be unenforceable.

We also have a very serious mismatching problem. We all know that from the beginning of the income tax we have allowed credit for taxes paid to foreign jurisdictions on the same income. We will not have that here. If the taxpayer who is expatriating pays a U.S. income tax, he is not going to get a stepped up basis for, say, U.K. tax purposes. Many years later, if he sells the same property, he will owe U.K. tax. There probably will be no credit allowed. This is inequitable.

For this reason I think that the exit tax should be postponed until a realization event occurs, which is available, by the way, to people in Australia and Canada, which purports to be the model. In those countries an election can be made to pay the tax when a later realization event occurs. If the bill is amended to so provide, I would not have an objection to it.

The most egregious aspect of this proposed bill is the tax on discretionary beneficial interests held through a trust. A beneficiary has no control over that asset, may never receive that asset, has no right to that asset. There are people around who have a sub-

stantial portion of their so-called net worth in these discretionary trusts and this tax would make them insolvent. They would effectively be unable to comply with the tax laws, which is obviously undesirable.

The exemptions that you provide, I think, should be expanded. Just as you have exempted U.S. real property interests, I suggest you exempt other property interests held by an expatriate which continue to be subject to U.S. tax jurisdiction, such as U.S. trades or businesses.

I also suggest that you seriously consider, or reconsider, the fairness of this proposal to U.S. citizens who have lived and worked abroad for many years and who have developed their wealth in another country. This person is in a very different position from the Mr. Greenbacks in the President's press release, who is described as growing a retail business in the United States and benefitting from U.S. labor and U.S. markets. There are citizens of the United States who have lived abroad and who have developed wealth outside the United States.

The better alternative, as Senator Hatch asked, is, I think, to tighten the existing rules—sections 877, 2107, and 2501. I think that those rules could be made workable. Also, it is questionable whether this switch of policy to impose a capital gains tax on exit will actually raise more revenue.

If you impose tax on all of someone's unrealized gains, that is probably the last dollar the U.S. will collect. If you, instead, tighten the existing rules you may be able to continue to collect tax for many years to come.

But, if you are going to impose an exit tax, follow the Canadian and Australian examples of allowing deferral of tax, perhaps with a security mechanism, as we did in TAMRA when the marital deduction was repealed for non-citizen surviving spouses. We have qualified domestic trust rules that allow people to post, in effect, security through a trust mechanism for later payment of the tax when it would be due if the person were a U.S. citizen.

I think that it is also a serious change of policy to try to tax unrealized gains that may have accrued while you are a citizen versus a non-citizen. If we are going to change policy, we should allow a step-up in basis for people who come into the United States and not tax their gains at all for U.S. tax purposes.

Senator HATCH. Thank you so much.

[The prepared statement of Ms. Harrison appears in the appendix.]

Senator HATCH. Mr. Langer.

STATEMENT OF MARSHALL J. LANGER, COUNSEL, SHUTTS & BOWEN, LONDON, ENGLAND

Mr. LANGER. Thank you, Mr. Chairman.

First, I would like to second just about everything that Ms. Harrison just said. I would agree with that as a starting point. Fewer than 1,000 Americans a year give up their citizenship. Americans do not relinquish their citizenship to escape the capital gains tax, so imposing a capital gains tax on them is not going to keep them from going.

Those who leave do so because they perceive a deteriorating quality of life in this country, coupled with an escalating tax burden, and what they sometimes consider to be a confiscatory estate tax that will deprive their children and grandchildren of most or all of what they have been able to build up during their life.

Instead of looking at the reasons why these people are going, the administration wants to lock them in by making it economically impossible for them to leave. That is exactly the opposite of what we should be doing.

Thirty years ago the Soviet Union imposed a departure tax to prevent its best-educated and brightest people from leaving. During the 1960's, practically everyone in Congress attacked the Soviet departure tax as an unjust violation of human rights.

Some within the United States applaud the administration proposal as a way of keeping the super-rich from escaping tax obligations. Outside the country, however, the proposal is having some serious repercussions. Some wealthy foreigners are considering disinvestment. They do not want to invest in a country that erects a wall around its citizens to keep them from leaving.

It does not matter whether that wall is built of bricks and mortar, like the Berlin Wall, or is an economic wall in the form of a departure tax. The proposed departure tax sends the wrong message to aliens already in the United States and to those who may be coming to the United States in the future.

It tells them to make as much money as they can here as fast as they can and to leave, but not to ever consider becoming an American citizen because then they will get trapped by this tax.

The proposal also sends the wrong message to wealthy Americans who have not yet left. It seems to tell them that if they ever plan to leave they had better go now before the cost of doing so becomes even higher.

Congress could tell all taxpayers that leaving the system will not relieve them of their obligation to pay capital gains tax when they eventually sell their assets. We do that now with respect to real estate in the United States, and we could do that by beefing up the existing law so that when someone left they would either have to lock their assets into some form of a trust, like the Qualified Domestic Trust, or pay a tax now, something that Ms. Harrison has just suggested.

That is what the anti-expatriation rules are supposed to do, but probably do not. I suspect that the main reason why they do not is that in the 29 years that those anti-expatriation rules have been on the books, the IRS has never even bothered to issue regulations under them to try to enforce them, nor have they seriously come back to Congress and said, here are a couple of loopholes that need to be closed, and here is how we suggest that be done.

Mr. Chairman and members of the committee, I think that the best feature of this proposed departure tax, and its one redeeming feature, is that it has got a positive revenue estimate of about $2.2 billion over the next six years, all of which is to be paid for by people for whom the American people have very little sympathy.

Senator Long used to say, "Don't tax you, don't tax me, tax the guy behind the tree." The proposed departure tax certainly meets

that criteria, but it fails every other criteria of sound tax policy and, in my opinion, it should be relegated to the garbage can.

Give Americans back the quality of life they used to have and stop trying to grab the last nickel from those people who are going. If you put them into a position where they are forced to eventually pay the tax when they sell these assets, most of them will comply, as Secretary Samuels said a few minutes ago. Others will fight to stay, and thousands of others will come from all over the world to join them in this country.

Thank you, Mr. Chairman.

Senator HATCH. Thank you, Mr. Langer. I presume from listening to you that you do not like this tax.

Mr. LANGER. You are right.

[The prepared statement of Mr. Langer appears in the appendix.]

Senator HATCH. Mr. Rosenbloom.

STATEMENT OF H. DAVID ROSENBLOOM, MEMBER, CAPLIN & DRYSDALE, CHARTERED, WASHINGTON, DC

Mr. ROSENBLOOM. Mr. Chairman and members of the subcommittee, thank you for inviting me to testify in regard to the administration's proposal.

I have prepared a statement to submit and I hope the Chair will allow it to be submitted for the record. I will try to summarize it as briefly as I can. I will refer consistently to the administration's proposal, although what is, I take it, on the table is, in fact, Section 5 of H.R. 831, as reported by the Senate Finance Committee.

I am a tax practitioner and a lecturer in taxation at Harvard Law School. I was the International Tax Counsel in the Treasury Department from 1978 to 1981. I have worked in the international tax area for more than 20 years, and I have worked specifically with Section 877 and its counterpart provisions in the estate and gift tax area.

The administration has proposed, quite simply, that property held by an individual who renounces citizenship would be marked to market upon such renunciation of citizenship.

As I read the legislative materials, that applies to all property and not simply to capital assets. That means the gain or loss would be calculated based on fair market value at the time of renunciation and recognized for income tax purposes. That would apply to all citizens, whether they are resident in the United States or abroad, and it would apply to all property, whether the property is in the United States or abroad. There are a limited number of exceptions, which I will not summarize. On the whole, I think this is a reasonable and sensible proposal. I support it, and I think you should, too.

To understand the administration's proposal you have to appreciate the context in which it is made. We, the United States, stand virtually alone in the world in imposing taxation on the basis of citizenship. We have done this since the first income tax in 1913.

That means that we impose taxes on citizens who are resident in the United States and citizens who are resident in Mexico, Brazil, Australia, wherever. It also means that we impose tax on citizens no matter where their income is earned, whether it is earned in the United States or earned in Brazil or Australia.

U.S. policy in this regard is certainly open to doubt and controversy. Many other countries regard the policy as overreaching, unadministrable, or otherwise ill-advised. But the policy is entrenched in our law and there have never been any serious efforts to abandon it.

At bottom, our insistence on taxing citizens says something about how we, Congress and the American people, view U.S. citizenship as compared with mere presence or residence in this country. Our law says, in effect, that citizenship is not only an incalculable privilege of Americans, but a source of obligations as well.

On a somewhat less abstract level it may also be observed that taxes are paid in order to fund government and that governmental responsibilities of the United States are worldwide.

The U.S. citizen in Brazil derives ample benefit from programs and policies of the U.S. Government which must, of course, be paid for. There is a perfectly sound economic reason why such a person should be asked to defray, in part, the cost of these policies and programs.

About 40 years ago Congress determined that our policy of taxing on a citizenship basis holds implications for persons who renounce citizenship. In the Foreign Investors Tax Act of 1966, Congress enacted Section 877 of the Internal Revenue Code, along with its companion provisions in the estate tax and the gift tax.

These provisions attach certain tax strings to certain expatriations for a 10-year period thereafter. Congress did this because it was concerned that individuals might seek to escape their U.S. obligations by renouncing citizenship.

Section 877 does not work. Moreover, it cannot be made to work by interpretation. I know. I was involved in trying to interpret it. As the level of tax sophistication in this country has risen in recent years, and increasingly greater intellectual resources have been trained upon the tax laws, many Code provisions have been tested. Section 877 was one of the earliest to be found wanting. Avoiding it is truly child's play. Administering it in a fair way is impossible. It cannot be saved by interpretation.

Thus, the administration's proposal raises a straightforward issue of tax policy. Should Congress fix a provision of law that has long been seen as having a justifiable purpose and that is irrevocably broken? I think an affirmative answer to that question is required.

In the first place, tolerating an ineffective provision like Section 877 breeds disrespect for the tax laws in general. This is not a good thing for a country that depends on a high level of tax compliance, and that will depend upon tax measures to finance its government needs for as long as we have a United States.

In the second place, the administration's proposal is a clear improvement over present law. It is simple. It is administrable. And it is fair, not only to those individuals who choose to surrender citizenship, but to those who are left behind to shoulder the burden.

Foregoing tax on expatriates by leaving present law in place or by eliminating Section 877, which is just about the same thing, really represents a tax increase on other taxpayers, other U.S. citizens, and also U.S. residents who must continue to finance govern-

ment through taxes, inflation, a weaker dollar, and other involuntary exactions.

The administration's proposal is fair because it would impose tax on accretions to wealth that are attributable to the period of citizenship. It would include only net gains accruing prior to the time when the taxpayer ceases to be a U.S. citizen.

Persons wishing to surrender are free to seek their fortune under other flags, and we would impose no further tax except to the extent that we would on persons who never were U.S. citizens. In this respect, the administration's proposal cuts back on the reach of Section 877, which extends to gains that accrue long after citizenship has been abandoned.

Now, in my statement I have said that this is not the only way to change present law, that there may be other ways. But this is a good way, on its own merits. It makes a lot of sense, and I think the committee should support it.

Further, if the committee would wish, I am prepared to address myself to the constitutional objections to this provision which I regard, like the Second Circuit, as bordering on the frivolous. Thank you very much.

Senator HATCH. Thank you. We will be happy to take those written suggestions.

[The information and the prepared statement of Mr. Rosenbloom appear in the appendix.]

Senator HATCH. Mr. Turner, you will be our final witness here today.

STATEMENT OF ROBERT F. TURNER, CHARLES H. STOCKTON PROFESSOR OF INTERNATIONAL LAW, U.S. NAVAL WAR COLLEGE, NEWPORT, RI

Mr. TURNER. Thank you very much, Mr. Chairman. It is a great pleasure to be here to discuss these important issues. It is a particular pleasure to be here also in the presence of Senator Moynihan, who is such a distinguished expert on international human rights and international law. I have a prepared statement which I would submit for the record, as suggested.

Before turning to the merits of the issue, I would like to make three quick caveats. One, is I am appearing here today in my personal capacity and not on behalf of the Naval War College or the University of Virginia, and my views are entirely my own.

Second, which may be important, I know almost nothing about tax law, and to the extent we get into the tax law issues, I am going to have to defer on those.

Finally, having been invited in the early evening last Friday, and having had to travel from the War College in Rhode Island to Charlottesville in order to do research in the law library on Sunday, I was up all night Sunday night writing my testimony. I literally have not read it.

I therefore apologize for the condition it is in. The nice way to characterize it may be "wishy-washy." It is written by someone who really was not quite sure what he thought about this. After about seven hours sleep last night, as I drove up here early this morning, I got my thoughts together; and I am now much more troubled by this bill than my prepared testimony may indicate.

What I would like to do, and I think my primary contribution, if any, is going to be to discuss the relevant rules of international law which ought to be considered. I want to focus on two of them.

First of all, the International Covenant on Civil and Political Rights, and second, a part of American domestic law, but a part very much based upon a perception of international law, and a part which certainly contributed to the development of customary international law, and that is, of course, the Jackson-Vanik Amendment to the 1974 Trade Act.

On the 2nd of April of 1992, the Senate consented to the ratification of the International Covenant on Civil and Political Rights. The President ratified the covenant and, in so doing, the United States joined more than 100 other States in assuming solemn international legal obligations.

I would note that the unanimous report of the Foreign Relations Committee on this treaty categorized the rights enumerated in the covenant as being "the cornerstones of a democratic society."

Of possible relevance to the issue now before this subcommittee, Article 12 of the covenant provides, in pertinent part, "Everyone shall be free to leave any country, including his own. The above-mentioned rights shall not be subject to any restrictions except those which are provided by law and are necessary to protect national security, public order..., public health or morals, or the rights and freedoms of others, and are consistent with the other rights recognized in the present convention."

Before I listened to Ms. Borek this morning, who is a very distinguished lawyer, I had some doubts. Having heard her, I am more convinced than before that she is mistaken. As I read her testimony, it strikes me as the work of a very good lawyer trying to rationalize a policy she wants to support, a policy that the administration supports. But the argument she makes, saying that this provision does not apply to the act of emigration, it only applies to renunciation of citizenship, that just does not pass the straight face test to me, honestly.

The renunciation of citizenship is a part of the act of emigration. Saying that the covenant only protects the right to travel, implicitly it does not protect the right to emigrate, I think is simply error as a matter of law.

Saying that because these people are super-rich the provision is not so burdensome as to effectively preclude change of nationality or emigration, that, too, is not the standard. The standard is, you cannot restrict that right, except for certain purposes.

Indeed, the 1972 Soviet "Diploma Tax," which imposed a $5-25,000 tax on educated Soviet citizens who wished to leave and go to Israel or other countries, could be justified on exactly the same grounds.

All they were doing is collecting a duty owed the State for their free education. The United States Senate unanimously said that was wrong under international law. I do not see how you can reconcile what you are doing today, or what you are considering today, with that provision.

Now, Article 12 of the covenant is a fundamental right, but not an absolute right. There are exceptions. For example, it is permissible to keep someone convicted of, or on trial for, serious crimes

from leaving, and it also is clearly permissible to require a person who wishes to expatriate to pay their normal tax obligations to the State.

The issue is, can you require them to pay a tax obligation that would not be imposed upon a similarly situated American citizen who is not expatriating? And I think the answer to that has to be no.

Indeed, during the drafting of Article 12, one of the proposals that was made was to allow constraint on the act of emigration for the "general welfare" or "economic and social well-being" of the State, and those proposed exceptions were rejected in that process.

Let me turn quickly to the Jackson-Vanik Amendment, which was supported by every member of this committee who is still here. It had 78 co-sponsors in the Senate, and passed the Senate unanimously. The provisions of the Jackson-Vanik Amendment prohibited Most Favored Nation status to any non-market economy country that "denies its citizens the right or opportunity to emigrate" or, two, "imposes more than a nominal tax."

In that regard, my quick calculations here suggest—I am told that about two dozen people are involved in this and they are expecting to bring in over $1 billion—this tax would cost something like $40 million per qualifying person. Even for a rich person, that is more than a "nominal" constraint, I would think.

"Imposes more than a nominal tax on emigration or on the visas or other documents required for emigration for any purpose or cause whatsoever." This was said by the unanimous Senate to be a requirement of international law.

The first issue to me here is, does this provision impose a significant burden on people because they wish to expatriate that they would not otherwise incur in the same circumstances?

The second issue is, does it comply with the Jackson-Vanik Amendment that is still part of the law of the land? You can obviously overturn it, just as under our dualist system you can overturn our commitment to the international covenant under domestic law. That is, if you pass a law that violates the covenant, American courts will uphold it. The question is, should you?

Senator MOYNIHAN. The United States would be a lawbreaker.

Mr. TURNER. The United States would be a lawbreaker under international law. Exactly, Senator.

I believe that would be a sad mistake, given the relatively small sum of money we are discussing here. It may be that the integrity of this institution and our belief in human rights is sacrificeable for hundreds of billions of dollars, but for a $1 billion gain it strikes me this needs to be carefully considered.

Mr. Chairman, that concludes my oral statement. I will be happy to take questions.

[The prepared statement of Mr. Turner appears in the appendix:]

Senator HATCH. Thank you. You can submit a different statement if you care to.

Mr. TURNER. I appreciate that. I would like to at least clean it up some.

Senator MOYNIHAN. He said he would like to revamp it a little bit, so he certainly can.

Mr. TURNER. When I read it I may well want to make several changes to it.

Senator HATCH. Thank you.

We will turn to Senator Moynihan, first, here.

Senator MOYNIHAN. Mr. Chairman——

Senator HATCH. Go ahead.

Senator MOYNIHAN. Then I would just say we have heard remarkably cogent testimony. It makes me glad I am not a judge. I have been persuaded by each of the witnesses in succession.

I would ask Mr. Turner, and first of all say that when you got seven hours sleep driving up from Virginia, were you driving? [Laughter.]

Mr. TURNER. I'm sorry. What I meant to say was that, after seven hours' sleep, I drove up early this morning.

Senator MOYNIHAN. I see.

Mr. TURNER. But I had several hours in the car. I caught the early stages of rush hour traffic and it gave me a chance to ponder this issue some more.

Candidly, Senator, one of my concerns is, the most important time to protect the rights of individuals are when those individuals belong to small, unpopular groups and lack political power. Anyone who comes under this provision will have already in that process given up even their right to vote. These people are not popular with the American voters.

I was thinking about this. In some respects you can compare them to the Soviet Jews. They were a well-educated, probably wealthier-than-average group, and a group that did not apparently have a great deal of allegiance to the government in power, to the State at the time.

The people whose rights need most to be protected are precisely the people that do not have the ability to do it themselves. I hate to say it, but for years in this country we said that the poor people deserve rights as well as the rich.

Well, the converse is also true. Even if we may not like them, and may not be able to identify with them, the Constitution and the international human rights constitution, such as the covenant, ought to protect the rights of all people, irrespective of their economic circumstances.

Senator MOYNIHAN. Very forcefully stated. But could I ask you, sir, in that context, would you consider that the existing law that a U.S. citizen who relinquishes citizenship for the principal purpose to avoid Federal tax may be subjected to an alternative taxing method for 10 years, would you think that object the same——

Mr. TURNER. Senator, that is an important, interesting question. I have not looked at that. As I say, I am not a tax expert at all. I could probably give you a more coherent answer if you would let me answer that one for the record. I would like to look at the actual language of the statute.

[The following was subsequently received by the committee:]

Answer. Although, again, I am not a tax lawyer, I can see any of a number of possible difficulties with the existing law—primarily having to do with such things as extraterritoriality or jurisdiction over foreign nationals. But, addressing the issue from the standpoint only of international human rights law, two observations can be made: (1) a citizen who wishes to renounce his or her citizenship and emigrate to another country may be required to pay any "normal" tax obligation (that is to

say, to pay any tax that applies equally to all similarly situated citizens and is not "triggered" by some act or occurrence associated with emigration or expatriation); and (2) conversely, a substantial tax that is tied expressly to the decision or act of emigration/expatriation is inherently suspect. From the standpoint only of international human rights law, therefore, the current statutory scheme is in my view preferable to this proposal now before the Congress.

Mr. TURNER. The key test, though, ought to be, does someone by the act of expatriation incur a substantial financial obligation that would be greater than that person would incur had they chosen not to become an expatriate? At least it strikes me that ought to be the test. I suspect that anyone here could apply that test as well as I could.

Senator MOYNIHAN. Well, I do thank you very much. I would like to say, it is not every day that we get testimony which starts out with what it was Socrates said to Plato 2,500 years ago.

Could I ask Ms. Harrison, your remarks were circulated on the American Bar Association letterhead. Does that indicate you are representing the views of the ABA?

Ms. HARRISON. I am not here representing the views of the ABA.

Senator MOYNIHAN. You are not.

Ms. HARRISON. But my name was associated with the ABA comments.

Senator MOYNIHAN. We have a problem. Thank goodness you are the Chairman. But thank you very much all. I would like to hear your questions.

Senator HATCH. Well, thank you. We are glad to have you all here with us, and I think it has been an extremely interesting hearing. I thought it was going to be a fairly boring one when I came over, but it has been a lot more than that.

Let me go to you, Ms. Harrison. Please expand on the ways in which you think we could prevent expatriots from avoiding taxes by improving current statutes.

Ms. HARRISON. Yes, I would like to address that. I think we could start by eliminating the intent test in Section. 877 and either just eliminate it entirely or create a strong presumption that people who expatriate do so to avoid tax. I think we could consider extending the 10-year period.

Very important would be to amend Section 367 to prevent the use of intermediate entities, such as foreign corporations, foreign partnerships, and the like, as devices to avoid the tax that is supposed to be imposed. I think we could also benefit from the IRS issuing some regulations, putting teeth into the statute.

I think if we want to pursue the idea of an exit tax we should provide an election, as Canada does, which defers the incidence of tax to the time a realization event occurs and use some kind of security mechanism to ensure the collection of that tax. That should be explored.

Senator HATCH. Thank you.

Senator MOYNIHAN. Mr. Chairman, could I ask a question?

Senator HATCH. Sure.

Senator MOYNIHAN. Would an exit tax not violate the covenant?

Mr. TURNER. I believe it would, Senator.

Senator HATCH. A very interesting question. Let me go to you, Mr. Langer.

Mr. TURNER. A serious exit tax. A nominal tax would not, but a tax, if you are talking about $40 million, certainly would.

Senator HATCH. Yes. I may have a question for you.

Mr. Langer, is this proposal going to solve the problem of wealthy individuals avoiding U.S. taxes? If not, how best can we amend current law, either in the income tax area or the estate tax area, to close this loophole?

Mr. LANGER. I think one of the answers to that is what Ms. Harrison just said. She suggested doing something to amend Section 367. In one of my books I describe what I think is done today and what I think that she has just alluded to. That is, people who leave the United States take their assets and transfer them into foreign corporations and they do so by exchanging their assets for the shares of the foreign corporation.

Now, if a citizen or resident does that he is trapped under Section 367, but a former citizen doing it who is no longer a resident is not so trapped, so he gets a tax-free exchange when he sets up that foreign corporation.

I think that the Congress tried to address that back in about 1988 when it started to block tax-free exchanges of U.S. property for foreign property, but I think it was done in a defective manner at that time. The result of the way it works when a former citizen transfers his assets into a foreign corporation in exchange for the shares of that foreign corporation is that the foreign corporation itself can then sell the property; the corporation that has been formed remains tainted for 10 years, but the underlying assets in the foreign corporation are not tainted at all. That is something that could be cured.

Senator HATCH. That is interesting.

Mr. Rosenbloom, you mentioned amending Section 1014. Could you elaborate on a proposal to deny a stepped-up basis in property inherited from a person who has renounced their citizenship?

Mr. ROSENBLOOM. Well, yes. That provision, which was advanced by the Bar of the City of New York, fits in with certain other sections of Section 1014. Normally, of course, under our tax laws there is a stepped-up basis at death.

One way of escaping tax on appreciation is by dying, and then assets go on to the next generation at the then value, which may be considerably higher than cost. All the appreciation-value escapes tax. Enormous amounts escape tax.

There is nothing in our law that prevents a stepped-up basis for a person who expatriates now. So, therefore, if somebody chooses to renounce citizenship, leave citizenship, they can pass on property to the next generation with the stepped-up basis and that generation, presumably, if it so chooses, can come back into the United States.

It seems to me that it is fitting and in accordance with other things that we have done in Section 1014 to deny a stepped-up basis here. We do not give a step-up in basis to stock for foreign personal holding companies or in passive foreign investment companies, which are two of the exotica that inhabit the international tax world. It seems to me this fits right in there and it would be a sensible thing to do, but it is not a substitute for what the administration has proposed.

Senator HATCH. You see it as an alternative to what they propose.

Mr. ROSENBLOOM. I do not see it as an alternative because it is really addressed principally to the estate and gift tax problem. I do believe—and I think in this regard I may differ somewhat from the Treasury—that the appropriate thing for Congress to do is to fix not only Section 877, which is an income tax provision, but also the estate and gift tax provisions.

Because on one point, and one point only, I do agree with my old friend, Mr. Langer, which is that I believe that most people, in expatriating, are looking principally to the estate tax. I think the estate tax is a bigger concern than the income tax. I am not saying the income tax is not also a concern, but the estate tax, I think, cannot be avoided so easily.

Senator HATCH. I see.

Mr. Turner, just one last question to you. You specifically said in the 1974 Jackson-Vanik Amendment is the law that embodies the fundamental right to emigrate, guaranteed by the Universal Declaration of Human Rights adopted in December of 1948.

As you know, the opponents of that provision have focused on this famous amendment, or on this provision, or the opponents of this particular approach have focused on Jackson Vanik, which, of course, declares our commitment to the right to emigrate.

Yet, as you know, there are fundamental differences in the situations which Jackson Vanik was, and is, directed and the situation we are discussing here today, specifically. Jackson Vanik refers to "non-market economies."

At the time, the Soviet Union, which had, (A) a fundamentally different approach to human rights, if it can be called that, than nations of the west, and (B) highly restrictive policies—some would call them extortion, or some did call them extortion at the time—aimed at preventing the emigration of Soviet Jews. This proposal is not geared toward any such countries, but rather to citizens of our own country.

Let me just say this. Specifically, if one of the main conditions of Jackson-Vanik was the imposition of more than a nominal tax, how exactly do you compare the Soviet practice with the administration's proposed rate of 35 percent? Does the problem we face in addressing this issue hang on the definition of nominal, and if so, how do we reconcile that?

Mr. TURNER. You asked several questions, Senator.

Senator HATCH. There were a lot of questions in there.

Mr. TURNER. The non-market economy caveat, it is true, was part of the Jackson-Vanik Amendment, but it certainly was not part of international law. That is, international law did not require a higher standard of totalitarian states than it did of democracies. Senator Jackson put that in because he was focusing it particularly at the Soviet Union and East European states.

Indeed, one can argue that the customary international law standard applicable to the Soviets in 1974 was less than the U.S. standard today, in the sense that the Soviets had abstained on voting on the universal declaration and, in fact, had opposed the inclusion of Article 13, the article in the Universal Declaration that dealt with this issue.

And even after the Jackson-Vanik Amendment was passed, in the Helsinki negotiations, although the Helsinki Final Act did incorporate, by reference, the Universal Declaration, the Soviets effectively resisted putting any specific reference to the right of emigration in the baskets to the Final Act of the Helsinki conference.

Historically all of international law was based on the consent of states. We now have a concept of jus cogens that says there are certain fundamental principles, "preemptory norms," we call them, that all States have an obligation to follow; but in most areas to be bound a State must consent either by ratifying a treaty or international agreement, or by carrying out a consistent practice that is regarded as a legally binding rule.

The United States, particularly through things like the Jackson Amendment, has clearly said that we view this right to be customary international law. That pretty much locks us in. The Soviets, on the other hand, objected as this law was being formed, and a persistent objector can avoid a normal requirement of customary law.

Now, it is clear to me that the Russians today, and the Soviets a few years ago, were, in fact, bound. I believe this is an important norm. I believe the Universal Declaration represented customary law. It clearly was not intended to be a legally-binding document. The U.S. position at the time was, this was not a legal obligation, but rather a political document.

Senator MOYNIHAN. It was aspirational, I think.

Mr. TURNER. It was an aspirational document. That was the word I was reaching for. And because it was unanimously approved, or it was approved without negative votes by the General Assembly——

Senator MOYNIHAN. May I just say, it is not the word you are reaching for, it is the word in your testimony. You really were up late, were you not?

Mr. TURNER. Thank you, Senator. I appreciate that.

If I understood your question, Mr. Chairman, you said there is a difference in how the law applied. For the Soviets to pass a law saying that people who got a free education cannot leave the Soviet Union without paying the state back for that obligation, for that expenditure, it strikes me there is a direct parallel between that and our saying that people who have money, have great wealth, and wish to give up their American citizenship and flee to another country cannot do so without paying something more than a nominal tax.

Again, it is very clear. Under the covenant, under international law you can require people who wish to expatriate to pay their lawful normal tax obligations. The problem arises when you try to impose a different, and substantially more burdensome, tax obligation on them because they make the decision to emigrate. Again, the State Department's effort to draw a distinction between renunciation of citizenship and the process of emigration suggests to me that somebody was really straining to try to make this thing look legitimate. It does not in my view pass the straight-face test, as much as I respect the State Department. I think the State Department legal staff is as good as any law firm in the country, but I think in this case they were trying to defend their client's case and

not—I should not characterize their testimony, but let me just say I do not share that view. I really think there is a serious problem here. You tax lawyers, you experts in this, may find a way to reconcile it.

But the fact that as a non-tax lawyer I am troubled by it suggests there may be a serious perception that we are not following the Jackson-Vanik principle and the rule of international law, and it not only will come back to haunt us when the Saddam Hussein's of the world respond to our criticism by saying "you guys also violate the covenant," it also may come back to haunt us when we try to impose Jackson-Vanik on the PRC, or elsewhere. I think it will weaken the moral authority of the U.S. Senate and the U.S. Government in the pursuit of human rights values, and that troubles me.

Senator HATCH. This has been an interesting hearing.

Do you have any other questions you care to ask?

Senator MOYNIHAN. I do not, Mr. Chairman. But I wonder if we might include in the record a letter from Prof. Paul Stephan III, to Secretary Samuels. You all travel a lot. You met each other in an airport in Pittsburgh.

Mr. TURNER. Did Paul mention that, or did I mention it?

[The letter appears in the appendix with Secretary Samuel's prepared statement.]

Senator MOYNIHAN. He said, "I ran into my former student, Bob Turner, who informed me of his intention to testify before the Senate Finance Committee to the effect that the proposal did raise problems under international law. As I told him at the time, I found his arguments unconvincing. However, I am responsible only for Bob's education in Soviet law, not in international tax law."

Mr. TURNER. Certainly, my testimony is not on tax law at all. I know nothing about international tax law, it is purely on human rights law. I did run into Paul. We sat on a plane. He was coming back from Moscow and I was coming back from the War College. He is not the only one who took that position.

I also called Professor Lou Heiken, who, as I am sure you know, is at Columbia University, and who is a distinguished expert on human rights law and international law, and a former president of the American Society of International Law. He said he saw no problem with this either, and both of their comments were among the reasons that led me to be very equivocal in my written testimony. I wanted to support this bill.

But, as I looked at it and kept thinking about it, the more troubled I became. It sure looks to me, just as the Soviets said you have got to pay your legitimate debt for your free education before you can leave, we seem to be imposing an impediment on emigration, and that troubles me.

Senator HATCH. Well, I think you have raised some interesting human rights concerns. There are a number of us who are concerned. I do not see the constitutional concerns that some do. I think this can probably be done. The question is, should we? You raised some concerns that I think we ought to take under consideration.

I think each of you has been an excellent witness.

Senator MOYNIHAN. Yes.

Senator HATCH. I think this has been a particularly stunning panel. So, we want to thank you for being here, we want to thank you for helping us with this. We will just have to take a real good, careful look at it and see where we come out. Thank you very much.

With that, we will recess until further notice.

[Whereupon, at 12:03 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF JAMISON S. BOREK

Thank you, Mr. Chairman and Members of the Committee. I am here today to address the question whether Section 5 of H.R. 831 as reported by the Senate Committee on Finance raises legal questions concerning international human rights.

The proposal in Section 5 would effectively require payment of taxes by U.S. citizens on gains, if they have such gains, if they elect to renounce U.S. citizenship, by treating this as equivalent to a realization of gains (or losses) by sale. The proposal would only apply to gains in excess of $600,000; it would not apply to U.S. real property owned directly, nor to certain pension plans.

It has been suggested by some that this proposal would violate international human rights law. However, based on information provided to us by the Department of the Treasury that persons affected would have the means to pay the tax and that such taxes would not be more burdensome than those they would pay if they were to remain U.S. citizens, it is our view that this tax proposal is consistent with international human rights law.

As described more fully below, closing a loophole that allows extremely wealthy people to evade U.S. taxes through renunciation of their American citizenship does not violate any internationally recognized right to leave one's country. It is inaccurate on legal and policy grounds to suggest that the Administration's proposal is analogous to efforts by totalitarian regimes to erect financial and other barriers to prevent their citizens from leaving. The former Soviet Union, for example, sought to impose such barriers only on people who wanted to leave, and not on those who stayed. In contrast, Section 5 seeks to equalize the tax burden born by all U.S. citizens by ensuring that all pay taxes on gains above $600,000 that accrue during the period of their citizenship. Unlike the Soviet effort to discriminate against people who sought to leave, we understand from Treasury that Section 5 does not treat those who renounce their U.S. citizenship less favorably than those who remain U.S. citizens.

International law recognizes the right of all persons to leave any country, including their own, subject to certain limited restrictions. Article 12(2) of the International Covenant on Civil and Political Rights provides that: "Everyone shall be free to leave any country, including his own." Article 12(3) states that the right "shall not be subject to any restrictions except those which are provided by law, are

necessary to protect national security, public order (*ordre public*), public health or morals or the rights and freedoms of others, and are consistent with the other rights recognized in the present Covenant."

Section 5 does not affect a person's right to leave the United States. Any tax obligations incurred under Section 5 would be triggered by the act of renunciation of U.S. citizenship, and not by the act of leaving the United States. In addition, since during peacetime U.S. citizens must be outside the United States to renounce their citizenship (*see* 8 U.S.C. §§1481(a)(5),1483(a)) the persons affected by Section 5 would have already left the United States. Renunciation does not preclude them from returning to the United States as aliens and subsequently leaving U.S. territory. Accordingly, Section 5 does not affect a person's right or ability to leave the United States.

Inherent in the right to leave a country is the ability to leave permanently, *i.e.*, to emigrate to another country willing to accept the person. The proposed tax is as unconnected to emigration as it is to the right to leave the United States on a temporary basis. It is not the act of emigration that triggers tax liability under Section 5, but the act of renunciation of citizenship. These two acts are not synonymous and should not be confused with one another. Because the United States allows its citizens to maintain dual nationality, U.S citizens may emigrate to another country and retain their U.S. citizenship. Hence, the act of emigration itself does not generate tax liability under Section 5. Indeed, we understand from the Department of the Treasury that some of the people potentially affected by Section 5 already maintain several residences abroad and hold foreign citizenship. Moreover, in stark contrast to most emigrants, particularly those fleeing totalitarian regimes, it is reported that some continue to spend up to 120 days each year in the United States after they have renounced their citizenship.

While emigration from the United States should not be confused with renunciation of U.S. citizenship, it should nonetheless be noted that it is well established that a State can impose economic controls in connection with departure so long as such controls do not result in a *de facto* denial of emigration. As Professor Hurst Hannum notes in commenting on the restrictions on the right to leave set forth in Article 12 of the Covenant:

> "Economic controls (currency restrictions, taxes, and deposits to guarantee repatriation) should not result in the *de facto* denial of an individual's right to leave . . . If such taxes are to be permissible, they must be applied in a non-discriminatory manner and must not serve merely as a pretext for denying the right to leave to all or a segment of the population (for example, by requiring that a very high 'education tax' be paid in hard currency in a country in which possession of hard currency is illegal)."1/

A wealthy individual who is free to travel and live anywhere in the world, irrespective of nationality, is in no way comparable to that of a persecuted individual seeking freedom who is not even allowed to leave his or her country for a day. In U.S. law, the Jackson-Vanik amendment to the Trade Act of 1974 (19 U.S.C. §2432) is aimed at this latter case and applies to physical departure, not change of nationality. Examples of States' practices that have been considered to interfere with the ability of communist country citizens to emigrate include imposing prohibitively high taxes specifically applied to the act of emigration with no relation to an individual's ability to pay, or disguised as "education taxes" to recoup the State's expenses in educating those seeking to depart permanently. Such practices also include punitive actions, intimidation or reprisals against those seeking to emigrate (e.g., firing the person from his or her job merely for applying for an exit visa). It is these offensive practices that the Jackson-Vanik amendment is designed to eliminate and thereby ensure that the citizens of these countries can exercise their right to leave. (See Tab A for further analysis of the Jackson-Vanik amendment.)

The only international human rights issue that is relevant to analysis of Section 5 is whether an internationally recognized right to change citizenship exists and, if so, whether Section 5 is consistent with it. The Universal Declaration of Human Rights, which is in many respects considered reflective of customary international law, provides in Article 15(2) that: "No one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality" (emphasis added).2/ Although many provisions of the Universal Declaration have been incorporated into international law, for example in the International Covenant on Civil and Political Rights, Article 15(2) is not. Accordingly, the question arises whether this provision could be considered to be customary international law.

States' views on this question and practices do vary. Many countries have laws governing the renunciation of citizenship, but renunciation is not guaranteed because they have also established preconditions and restrictions, or otherwise subject the request to scrutiny.3/ Professor Ian Brownlie has commented on Article 15(2) in the context of expatriation that: "In the light of existing practice, however, the individual does not have this right, although the provision in the Universal Declaration may influence the interpretation of internal laws and treaty rules."4/ Others agree with this position. (See Restatement of the Foreign Relations Law of the United States, §211, Reporters' Note 4). Nonetheless, the United States believes that individuals do have a right to change their nationality. The U.S. Congress took the view in 1868 that the "right of expatriation is a natural and inherent right of all people" in order to rebut claims from European powers that "such American citizens, with their descendants, are subjects of foreign states, owing allegiance to the governments thereof . . . ." (Rev. Stat. §1999).

It is evident, however, that States do not recognize an unqualified right to change nationality. It is generally accepted, for example, that a State can require that a person seeking to change nationality fulfill obligations owed to the State, such as pay taxes due or perform required military service.5/ This is especially true where the requirement is by its nature proportional to the means to pay, and thus does not present a financial barrier, which we understand from Treasury is the case here.

The consistency between Section 5 and international human rights law is further demonstrated by the practice of countries that are strong supporters of international human rights and that have adopted similar tax policies. According to the Report prepared by the Staff of the Joint Committee on Taxation, Germany imposes an "extended tax liability" on German citizens who emigrate to a tax-haven country or do not assume residence in any country and who maintain substantial economic ties to Germany. Australia imposes a tax when an Australian resident leaves the country; such person is treated as having sold all of his or her non-Australian assets at fair market value at the time of departure. To provide another example, Canada considers a taxpayer to have disposed of all capital gain property at its fair market value upon the occurrence of certain events, including relinquishment of residency.

Accordingly, to the extent that Section 5 imposes taxes on persons who have the ability to pay and that are no more burdensome than those they would pay if they remained U.S. citizens, it would not raise human rights concerns with respect to change of citizenship for two reasons. First, U.S. citizens would remain free to choose to change their citizenship. This proposal does not in any way preclude such choice, even indirectly. We understand from Treasury that any tax owed, by its nature, applies only to gains and thus should not exceed an individual's ability to pay. Second, international law would not proscribe reasonable consequences of relinquishment, such as liability for U.S. taxes that accrue during the period of citizenship. We understand from the Department of the Treasury that the imposition of taxes under Section 5 would be equitable, reasonable and consistent with overall U.S. tax policy because the provision applies only to gains that accrued during the period of citizenship in excess of $600,000; the tax rate is consistent with other tax rates; and affected persons would have the financial means to pay the tax, either immediately or on a deferred basis. Obviously, there is no international right to avoid paying taxes by changing one's citizenship.

In conclusion, based on the information described above, it is the view of the Department of State that this proposal does not raise any significant question of interference with international human rights.

I hope that this information is helpful to the Committee.

FOOTNOTES

1. H. Hannum, The Right to Leave and Return in International Law and Practice 39-40 (1987).

2. Article XIX of the American Declaration on the Rights and Duties of Man provides that: "Every person has the right to the nationality to which he is entitled by law and to change it, if he so wishes, for the nationality of any other country that is willing to grant it to him." The American Declaration is not a legally binding document.

3. See Coumas v. Superior Court in and for San Joaquin County (People, Intervenor), 192 P.2d 449, 451 (Sup. Ct. Calif. 1948). When confronted with Greek refusal to consent to an expatriation, the Supreme Court of California stated: ". . . The so-called American doctrine of 'voluntary expatriation' as a matter of absolute right cannot postulate loss of original nationality on naturalization in this country as a principle of international law, for that would be tantamount to interference with the exclusive jurisdiction of a nation within its own domain."

4. I. Brownlie, Principles of International Law (4th ed.) 557 (1990). Professor Lillich comments that "the right protected in [Article 15] has received very little subsequent support from states and thus can be regarded as one of the weaker rights . . . ." "Civil Rights," in T. Meron, Human Rights in International Law at 153-54 (1988).

5. A State should not, for example, withhold discharge from nationality if, inter alia, acquisition of the new nationality has been sought by the person concerned in good faith and the discharge would not result in failure to perform specific obligations owed to the State. P. Weis, Nationality and Statelessness in International Law (2nd ed.) 133 (1979). In Coumas, supra note 3, the Supreme Court of California observed that Greece qualified the right of expatriation on fulfillment of military duties and procurement of consent of the Government.

SECTION 201 OF THE TAX COMPLIANCE ACT OF 1995: CONSISTENCY WITH INTERNATIONAL HUMAN RIGHTS LAW

The Department of State believes that Section 201 of the proposed Tax Compliance Act of 1995 is consistent with international human rights law. As described below, closing a loophole that allows extremely wealthy people to evade U.S. taxes through renunciation of their American citizenship does not violate any internationally recognized right to leave one's country. It is inaccurate on legal and policy grounds to suggest that the Administration's proposal is analogous to efforts by totalitarian regimes to erect financial and other barriers to prevent their citizens from leaving. The former Soviet Union, for example, sought to impose such barriers only on people who wanted to leave, and not on those who stayed. In contrast, Section 201 seeks to equalize the tax burden born by all U.S. citizens by ensuring that all pay taxes on gains above $600,000 that accrue during the period of their citizenship. Unlike the Soviet effort to discriminate against people who sought to leave, the purpose of Section 201 is to treat those who renounce their U.S. citizenship on the same basis as those who remain U.S. citizens.

Section 201 would require payment of taxes by U.S. citizens and long-term residents on gains above $600,000 that accrue immediately prior to renunciation of their U.S. citizenship or long-term residency status. These tax requirements are similar to those that they would face if they remained U.S. citizens or long-term residents at the time they realized their gains or at death. While U.S. tax policy generally allows taxpayers to defer gains until they are realized or included in an estate, we understand from the Department of the Treasury that Section 201 treats renunciation as a taxable event because such act effectively removes the underlying assets from U.S. taxing jurisdiction.

International law recognizes the right of all persons to leave any country, including their own, subject to certain limited restrictions. Article 12(2) of the International Covenant on Civil and Political Rights provides that: "Everyone shall be free to leave any country, including his own." Article 12(3) states that the right "shall not be subject to any restrictions except those which are provided by law, are necessary to protect national security, public order (*ordre public*), public health or morals or the rights and freedoms of others, and are consistent with the other rights recognized in the present Covenant."

Section 201 does not affect a person's right to leave the United States. Any tax obligations incurred under Section 201

would be triggered by the act of renunciation of U.S. citizenship, and not by the act of leaving the United States. In addition, since during peacetime U.S. citizens must be outside the United States to renounce their citizenship (see 8 U.S.C. Secs. 1481(a)(5),1483(a)) the persons affected by Section 201 would have already left the United States. Renunciation does not preclude them from returning to the United States as aliens and subsequently leaving U.S. territory. Accordingly, Section 201 does not affect a person's right or ability to leave the United States.

Inherent in the right to leave a country is the ability to leave permanently, i.e., to emigrate to another country willing to accept the person. The proposed tax is as unconnected to emigration as it is to the right to leave the United States on a temporary basis. It is not the act of emigration that triggers tax liability under Section 201, but the act of renunciation of citizenship. These two acts are not synonymous and should not be confused with one another. Because the United States allows its citizens to maintain dual nationality, U.S citizens may emigrate to another country and retain their U.S. citizenship. Hence, the act of emigration itself does not generate tax liability under Section 201. Indeed, we understand from the Department of the Treasury that some of the people potentially affected by Section 201 already maintain several residences abroad and hold foreign citizenship. Moreover, in stark contrast to most emigrants, particularly those fleeing totalitarian regimes, some continue to spend up to 120 days each year in the United States after they have renounced their U.S. citizenship.

While emigration from the United States should not be confused with renunciation of U.S. citizenship, it should nonetheless be noted that it is well established that a State can impose economic controls in connection with departure so long as such controls do not result in a de facto denial of emigration. As Professor Hurst Hannum notes in commenting on the restrictions on the right to leave set forth in Article 12 of the Covenant:

> "Economic controls (currency restrictions, taxes, and deposits to guarantee repatriation) should not result in the de facto denial of an individual's right to leave . . . If such taxes are to be permissible, they must be applied in a non-discriminatory manner and must not serve merely as a pretext for denying the right to leave to all or a segment of the population (for example, by requiring that a very high 'education tax' be paid in hard currency in a country in which possession of hard currency is illegal)."1/

A wealthy individual who is free to travel and live anywhere in the world, irrespective of nationality, is in no way comparable to that of a persecuted individual seeking freedom who is not even allowed to leave his or her country for a day. In U.S. law, the Jackson-Vanik amendment to the Trade Act of 1974 (19 U.S.C. Sec. 2432) is aimed at this latter case

and applies to physical departure, not change of nationality. Examples of States' practices that have been considered to interfere with the ability of communist country citizens to emigrate include imposing prohibitively high taxes specifically applied to the act of emigration with no relation to an individual's ability to pay, or disguised as "education taxes" to recoup the State's expenses in educating those seeking to depart permanently. Such practices also include punitive actions, intimidation or reprisals against those seeking to emigrate (e.g., firing the person from his or her job merely for applying for an exit visa). It is these offensive practices that the Jackson-Vanik amendment is designed to eliminate and thereby ensure that the citizens of all countries can exercise their right to leave. (See Tab A for further analysis of the Jackson-Vanik amendment.)

The only international human rights issue that is relevant to analysis of Section 201 is whether an internationally recognized right to change citizenship exists and, if so, whether Section 201 is consistent with it. The Universal Declaration of Human Rights, which is in many respects considered reflective of customary international law, provides in Article 15(2) that: "No one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality" (emphasis added).2/ Although many provisions of the Universal Declaration have been incorporated into international law, for example in the International Covenant on Civil and Political Rights, Article 15(2) is not. Accordingly, the question arises whether this provision could be considered to be customary international law.

States' views on this question and practices do vary. Many countries have laws governing the renunciation of citizenship, but renunciation is not guaranteed because they have also established preconditions and restrictions, or otherwise subject the request to scrutiny.3/ Professor Ian Brownlie has commented on Article 15(2) in the context of expatriation that: "In the light of existing practice, however, the individual does not have this right, although the provision in the Universal Declaration may influence the interpretation of internal laws and treaty rules."4/ Others agree with this position. (See Restatement of the Foreign Relations Law of the United States, Sec. 211, Reporters' Note 4). Nonetheless, the United States believes that individuals do have a right to change their nationality. The U.S. Congress took the view in 1868 that the "right of expatriation is a natural and inherent right of all people" in order to rebut claims from European powers that "such American citizens, with their descendants, are subjects of foreign states, owing allegiance to the governments thereof . . . ." (Rev. Stat. Sec. 1999).

It is evident, however, that States do not recognize an unqualified right to change nationality. It is generally accepted, for example, that a State can require that a person seeking to change nationality fulfill obligations owed to the State, such as pay taxes due or perform required military

service.5/ This is especially true where -- as here -- the requirement is by its nature proportional to the means to pay, and thus does not present a financial barrier.

The consistency between Section 201 and international human rights law is further demonstrated by the practice of countries that are strong supporters of international human rights and that have adopted similar tax policies. According to the Report prepared by the Staff of the Joint Committee on Taxation, Germany imposes an "extended tax liability" on German citizens who emigrate to a tax-haven country or do not assume residence in any country and who maintain substantial economic ties to Germany. Australia imposes a tax when an Australian resident leaves the country; such person is treated as having sold all of his or her non-Australian assets at fair market value at the time of departure. To provide another example, Canada considers a taxpayer to have disposed of all capital gain property at its fair market value upon the occurrence of certain events, including relinquishment of residency.

Accordingly, Section 201 would not raise concerns with respect to change of citizenship for two reasons. First, U.S. citizens would remain free to choose to change their citizenship. This proposal does not in any way preclude such choice, even indirectly. Any tax owed, by its nature, applies only to gains and thus should not exceed an individual's ability to pay. Second, international law would not proscribe reasonable consequences of relinquishment, such as liability for U.S. taxes that accrue during the period of citizenship. We understand from the Department of the Treasury that the imposition of taxes under Section 201 would be equitable, reasonable and consistent with overall U.S. tax policy. We are aware of no evidence that would suggest otherwise. The tax, as we understand it, applies only to gains that accrued during the period of citizenship in excess of $600,000; the tax rate is consistent with other tax rates; and affected persons have the financial means to pay the tax. Indeed, were these persons to choose to retain their U.S. citizenship, they would have to pay similar taxes upon realization of their gains or upon death. Obviously, there is no international right to avoid paying taxes by changing one's citizenship.

In conclusion, it is the view of the Department of State that Section 201 does not violate international human rights law. Accordingly, the debate on the merits of Section 201 should focus solely on domestic tax policies and priorities.

TAB A

Section 5 of the proposed Tax Compliance Act of 1995 does not conflict with the Jackson-Vanik amendment to the Trade Act of 1974 (19 U.S.C. §2432). That amendment restricts granting most-favored-nation treatment and certain trade related credits and guarantees to a limited number of nonmarket economies that unduly restrict the emigration of their nationals. Specifically, it applies to any nonmarket economy which:

"(1) denies its citizens the right or opportunity to emigrate;

(2) imposes more than a nominal tax on emigration or on the visas or other documents required for emigration, for any purpose or cause whatsoever; or

(3) imposes more than a nominal tax, levy, fine, fee or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice . . . ."

This provision, according to the Senate Finance Committee, was "intended to encourage free emigration of all peoples from all communist countries (and not be restricted to any particular ethnic, racial, or religious group from any one country)." (1974 U.S.C.C.A.N. 7338.) These countries were expected to "provide reasonable assurances that freedom of emigration will be a realizable goal" if they were to enter into bilateral trade agreements with the United States. (Id.)

The amendment does not apply to emigration from the United States or to the renunciation of U.S. citizenship. It has been suggested, however, that Section 5 would somehow conflict with the "spirit" or the "principles" of the Jackson-Vanik amendment. The Department of State does not agree with such proposition.

Generally, in implementing this statute, the President makes determinations concerning a nonmarket economy's compliance with freedom of emigration principles contained in the amendment. Such determinations take into account the country's statutes and regulations, and how they are implemented day to day, as well as their net effect on the ability of that country's citizens to emigrate freely. The President may, by Executive Order, waive the prohibitions of the Jackson-Vanik amendment if he reports to Congress that a waiver will "substantially promote" the amendment's freedom of emigration objectives, and that he has received assurances from the country concerned that its emigration practices "will henceforth lead substantively to the achievement" of those objectives. (19 U.S.C. §2431(c).)

Several types of State practices have been considered by the United States to interfere with the ability of communist country citizens to emigrate, such as:

- prohibitively high taxes specifically applied to the act of emigration with no relation on an individual's ability to pay or disguised as "education taxes" seeking to recoup the state's expenses in educating those who are seeking to permanently depart;
- punitive actions, intimidation or reprisals by the State against those seeking to emigrate (e.g., firing a person from his or her job merely for applying for an exit visa);
- unreasonable impediments, such as requiring adult applicants for emigration visas to obtain permission from their parents or adult relatives;
- unreasonable prohibitions of emigration based on claims that the individual possesses knowledge about state secrets or national security; and
- unreasonable delays in processing applications for emigration permits or visas, interference with travel or communications necessary to complete applications, withholding of necessary documentation, or processing applications in a discriminatory manner such as to target identifiable individuals or groups for persecution (e.g., political dissidents, members of religious or racial groups, etc.).

Examples of these practices in the context of the former Soviet Union are described in an exchange of letters between Secretary of State Kissinger and Senator Jackson of October 18, 1974, discussing freedom of emigration from the Soviet Union and Senator Jackson's proposed amendment to the Trade Act, now known as the Jackson-Vanik amendment. (Reprinted in 1974 U.S.C.C.A.N. 7335-38.)

As explained in the accompanying memorandum, Section 5 does not deny anyone the right or ability to emigrate, and does not impose a tax on any decision to emigrate. Neither does the proposed tax raise questions of disparate standards applicable to the United States as against the nonmarket economies subject to Jackson-Vanik restrictions.

The emigration practices of those countries which have been the target of Jackson-Vanik restrictions have typically involved individuals or groups that have been persecuted by the State (e.g., dissidents), precluded family reunification, applied across the board to all citizens by a totalitarian State in order to preclude massive exodus, or have otherwise

been so restrictive as to effectively prevent the exercise of the international right to leave any country including one's own (as recognized in Article 12(2) of the International Covenant on Civil and Political Rights and further described in the accompanying memorandum). Furthermore, the primary objectives of those seeking to emigrate from those countries have been to avoid further persecution or to be reunified with their relatives, and to leave permanently. It was the act of leaving for any period of time that the State sought to block. None of these conditions are comparable to the exercise of taxing authority by the United States under Section 5 or to the status of the individuals who would be subject to that tax.

As stated in the accompanying memorandum, Section 5 would not interfere with the right of an individual to physically depart from the United States, whether temporarily or permanently.

RESPONSE BY DEPARTMENT OF STATE
TO QUESTION POSED BY SENATOR GRAHAM

Hearing of March 21, 1995
Subcommittee on Taxation and Internal Revenue Oversight
Committee on Finance
United States Senate

Question:

Can you advise how many legal permanent resident aliens might be subject to the provisions of this legislation if it is extended to long-term alien residents of the United States?

Answer:

The State Department does not maintain records relating to long-term resident aliens in the United States. Such records are kept by the Immigration and Naturalization Service which has advised that there are approximately ten million legal permanent resident aliens in the United States.

RESPONSE BY DEPARTMENT OF STATE
TO QUESTION POSED BY SENATOR GRAHAM

Hearing of March 21, 1995 Before
Subcommittee on Taxation and Internal Revenue Oversight
Committee on Finance
United States Senate

Question:

Would the enactment of the tax changes embodied in Sec. 5 of H.R. 831 have the effect of discouraging legal permanent residents in the United States from becoming U.S. citizens and does the State Department have any idea of the number of persons who might come within this category?

Answer:

While no precise numbers are available, it is possible that a very small number of persons eligible to become U.S. citizens for whom tax motivations are primary would refrain from naturalizing in light of the provisions of H.R. 831 applicable to persons who abandon or renounce U.S. citizenship. It seems likely, however, that a person concerned primarily about tax consequences would not choose to become a citizen in the first place and, thus, would have little concern about the tax consequences of ceasing to be a U.S. citizen. Of course, the great majority of persons eligible for U.S. citizenship are motivated by the many beneficial aspects of becoming a U.S. citizen rather than by tax considerations.

PREPARED STATEMENT OF ELLEN K. HARRISON

Thank you for extending me the honor of participating in this panel.

I endorse the goal of preventing evasion of U.S. tax obligations by expatriation. Those who have enjoyed the privileges and protections of U.S. citizenship should not be permitted to avoid paying tax on wealth accumulated from U.S. sources. However, the Administration's proposed exit tax goes too far.

The Senate Finance Committee's amendments of March 15 improve the proposal by:

1. proposing a fairer effective date for loss of citizenship;

2. exempting from the exit tax lawful permanent residents who relinquish residency status;

3. endorsing the principle that a person who pays the exit tax is entitled to a basis adjustment for U. S. tax purposes; and

4. recognizing the need for clarification of the tax treatment of deemed sales of beneficial interests in trusts deemed owned by expatriating citizens.

However, these amendments do not eliminate many serious problems with the exit tax proposal.

Although the proposed exit tax raises important constitutional and human rights, as well as tax policy, issues, I confine my remarks to tax policy issues. Here are my concerns:

1. <u>An income tax should be imposed only upon a sale or other disposition of an asset</u>.

a. The exit tax purports to be an income tax; an income realization event has not occurred.

b. Taxing unrealized gains presents a liquidity problem. For this reason, foreign personal residences and foreign pension plans should be exempt. More than 5 years should be allowed to pay tax attributable to business interests.

c. Taxing unrealized gains mismatches the timing of U.S. and foreign income tax so that foreign tax credits will not be effective to prevent double tax.

d. Basis adjustments for U.S. tax purposes should be provided for in the statute without the need for

implementing regulations, which may not be forthcoming for many years.

e. The exit tax should not apply to discretionary beneficial interests in trusts unless such trusts were established by the expatriate as a tax avoidance device. Beneficiaries have no right to receive distribution of such assets. They may be unable to pay the exit tax on trust assets. The March 15, 1995 amendment suggests that beneficiaries may not only owe tax on deemed gain, but also may be treated as receiving an accumulation ("throwback") distribution. In the case of foreign trusts, this would involve penalty interest. It is too draconian.

2. Exemptions are too limited.

a. Exemptions from the tax should extend to all property that remains subject to U.S. tax jurisdiction -- such as U.S. businesses.

b. The fairness of the exit tax as applied to U.S. citizens who live and work abroad should be reconsidered. Mr. Greenbacks, the example in the President's press release, benefitted from the "dynamic US economy and a workforce that was educated in the United States." This hypothetical case is quite different from the case of a person who built a successful business outside the U.S. Non-U.S. situs assets of persons who have lived and worked abroad for many years should be exempt.

3. The better alternative to fight tax avoidance is to expand, enforce and tighten §§ 877, 2107 and 2501(a)(3).

Consider the Mr. Greenbacks illustration. If the exit tax is enacted, Mr. Greenbacks will owe capital gains on his unrealized appreciation. He will likely immediately convert his assets to non-U.S. situs assets. The U.S. will not collect any more tax of any kind from Mr. Greenbacks or his estate. If, instead, no exit tax is imposed, Mr. Greenbacks will continue to pay U.S. tax on at least a portion of his salary and his dividend stream from his U.S. business interest. Also, his estate will owe estate tax on the value of his U.S. business interests. The U.S. ultimately may collect more tax from the Greenbacks. Arrangements that may be used to avoid §§ 877, 2107 and 2501(a)(3) should be proscribed so that Mr. Greenbacks will owe U.S. income tax when he sells his U.S. business, U.S. gift tax if he gives interests in his U.S. business, or U.S. estate tax if he dies owning such business.

4. If the exit tax is imposed on unrealized appreciation, the following provisions should be adopted.

a. Deferral of payment should be permitted, without interest. Precedent for deferral is found in the qualified domestic trust rules of § 2056A. Canada permits deferred payment of its departure tax.

b. Heretofore, jurisdiction to tax was based on citizenship or residency at the time a realization event occurs. If this principle is to be abandoned and gains that accrue during the period of U.S. citizenship are to be taxed in the U.S. without regard to citizenship or residency at the time of sale, gains that accrued to persons prior to becoming U.S. citizens similarly should be exempt from any U.S. income tax.

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21 March 1995

Senator Orrin G. Hatch, Chairman
Subcommittee on Taxation and IRS Oversight
Committee on Finance
United States Senate
Washington, DC 20510, U.S.A.

Re: Administration Proposal to Tax Americans Who Expatriate

Dear Mr. Chairman:

I would like to begin by repeating the first two paragraphs of a letter that I sent to Chairman Bill Archer and Congressman Sam Gibbons of the House Ways and Means Committee on February 28, 1995:

> The Administration has proposed the imposition of a departure tax designed to prevent a handful of wealthy tax-motivated expatriates from leaving the United States without first paying their "fair share" of taxes. The popular media thinks this is great. I think it may be one of the worst tax proposals in recent history.
>
> The obvious aim of the proposal is to prevent a handful of super-rich individuals from escaping the payment of U.S. income taxes by leaving the United States and relinquishing their citizenship (if they are citizens), or relinquishing their green cards (if they are long-term permanent residents). *This is a legitimate aim,* and it is perfectly correct for Congress to enact a provision to carry it out. It probably should have done so years ago. The pending provision, however, seeks to carry out this legitimate aim in a flawed manner. The proposal should seek to trap U.S. assets so that U.S. income tax must be paid when the gain is realized regardless of the status of the

> individual at that time. Legislation doing that with U.S. real estate interests has been on the books for 15 years. The law should not seek to trap the individual by telling him he can't go without paying a toll charge for the privilege of doing so.

A copy of that letter is attached. I want to reiterate everything contained in that letter and to add several points based on subsequent developments.

At a meeting in London about three weeks ago attended by senior IRS officials, I criticized the way in which the draft proposal could unfairly hurt some long-term holders of green cards who really didn't live in the United States. I did so as an example to illustrate how poorly conceived the proposal was. To my amazement, I now find that this potential glitch is to be cured by applying the departure tax *only to citizens*, not to long-term residents. Mr. Chairman, this is exactly the opposite of what the legislation should do. If there is any possible justification for imposing a departure tax it has to be because someone has lived in the United States for many years and has made his unrealized gains from his U.S. business while he was resident. The fact that he is or was a U.S. citizen is and should be irrelevant.

The amendment doesn't improve the proposed legislation; it makes it much worse. Now that it targets only citizens, it is probably unconstitutional and a clear violation of human rights. The Administration justifies its proposed departure tax by noting that Canada has such a tax. There is a big difference. Canada's tax is imposed on the abandonment of *residence*, not citizenship. In addition, Canada is perceived to treat its taxpayers fairly by giving all new immigrants a full step-up in basis for all of their foreign assets when they arrive in Canada. As revised, the Administration proposal would completely ignore those individuals who remain in the country for many years just as long as they avoid becoming U.S. citizens. Mr. Chairman, I find it hard to conceive of a more stupid policy for this country to have than one which would discourage its successful immigrants from ever becoming U.S. citizens.

If we must have a departure tax, it should be based on long-term residence -- not on citizenship. It should apply to those who are residents because they have green cards and to those who are residents because they meet the substantial presence test, whether they are citizens or not. Moreover, there is much greater justification for applying such a tax to unrealized gains from U.S. sources than to those from foreign sources.

In my prior letter, I suggested that there were some unexplained delays in the issuance of certificates of loss of nationality. I understand that an amendment may change the effective date of expatriation so that those who tried to leave last year should no longer be caught. After writing my earlier letter, I was

informed by someone who had expatriated last year that he has now received his certificate. After what he considered to be a long delay, it was approved by the State Department on February 8, 1995, two days after the original effective date of the Administration's proposal. Upon inquiry, an employee of the American Consulate in London told him that his certificate was one of 30 long-delayed certificates that the London Consulate had received bearing the same date. The relevant date should remain the date of expatriation as determined by the State Department. If the date of expatriation is to be changed it should be done by amending the Immigration and Nationality Act, not the Internal Revenue Code.

An estimated three million American citizens reside outside the United States. An American citizen who lives and works abroad is more likely than one residing in the U.S. to have a legitimate non-tax reason for changing his citizenship. For example, his job may require him to become a local citizen and his new country may prohibit dual citizenship. Yet, he would be treated less fairly by the Administration proposal than an American who lives in the United States. An American citizen who leaves California would not be deemed to sell his California house or his other U.S. real estate. An American citizen who lives in Europe and finds it necessary to expatriate would be deemed to have sold his house and his other European real estate. At the very least, the proposal should exempt the principal residence of a citizen who has been a bona fide resident of a foreign country.

I will now discuss some of the policy reasons that make it essential that this Committee reject the departure tax proposal.

Fewer than 1,000 Americans a year give up their citizenship. Americans do not relinquish their citizenship to escape the capital gains tax. Thus, imposing a capital gains tax is not going to keep them from going. They leave because they perceive a deteriorating quality of life in this country coupled with an escalating tax burden and a confiscatory estate tax that will deprive their children and grandchildren of most or all of what they have been able to build up during their life.

Instead of looking at the reasons why these people are going, the Administration wants to lock them in by making it economically impossible for them to leave. That is exactly the opposite of what we should be doing. Thirty years ago, the Soviet Union imposed a departure tax to prevent its best-educated and brightest people from leaving. During the 1960s, practically everyone in Congress attacked the Soviet departure tax as an unjust violation of human rights.

Some within the U.S. applaud the Administration proposal as a way of keeping the super-rich from escaping their tax obligations. Outside the country, however, the proposal is already having serious repercussions. Some wealthy foreigners are considering disinvestment. They don't want to invest in a country that erects a wall around its citizens to keep them from leaving. It doesn't matter whether that wall is built of bricks and mortar like the Berlin Wall or is an economic wall in the form of a departure tax.

The proposed departure tax sends the wrong message to aliens already in the U.S. and to those who hope to come in the future. It tells them to make money as fast as they can and then leave, but not to ever become American citizens.

The proposal also sends the wrong message to wealthy Americans who have not yet left. It seems to tell them that if they ever plan to leave, they had better go now before the cost of doing so becomes even higher.

In 1986, the Reagan Administration and Congress made a tax deal with the American people. They got rid of tax shelters and most deductions in exchange for a maximum 28 percent federal income tax. The people accepted that deal but subsequent administrations and Congresses have not.

A wealthy American now pays about 40 percent more in federal income taxes than he would have paid under the 1986 law. He also pays a much higher medicare tax, higher state and local taxes, and he can look forward to paying a confiscatory 55 percent estate tax on all his assets when he dies. If he tries to by-pass his children in favor of his grandchildren, his taxes at death will take 80 percent of his estate. There may also be state death taxes and there will almost certainly be arguments with the IRS over the valuation of his assets since the IRS often overvalues assets for estate tax purposes.

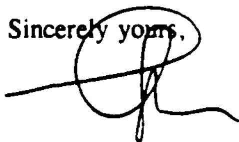
Those who plan estates or sell life insurance will hate me for saying so, but the federal death tax system does much more harm to American society than good. Each year, about two million Americans die but only about 27,000 of them have taxable estates. Our death tax policy is to soak only the rich. The others all get a free ride in the form of a tax-free step-up in basis at death.

We should get rid of the estate tax and substitute a capital gains tax at death, with an exemption for small gains and all transfers to surviving spouses. This would raise more money than the existing estate tax system and no one will even think of leaving America. As an added benefit, it would attract thousands of successful entrepreneurs from other countries. They will fight to move to America, set up new businesses here, and create thousands of new jobs.

Mr. Chairman, the Administration's departure tax proposal has only one redeeming feature. It comes with a positive revenue estimate of $2.2 billion over the next six years, all of which is to be paid by people for whom the American people have very little sympathy. Senator Long used to say: "Don't tax you. Don't tax me. Tax the guy behind the tree." The proposed departure tax meets that criteria but it fails every other criteria of sound tax policy and it should be relegated to the garbage can.

Give Americans back the quality of life they used to have and stop trying to soak the rich. They will all fight to stay and thousands of other successful entrepreneurs from all over the world will fight to join them in this country.

Sincerely yours,



Marshall J. Langer

Marshall J. Langer is an American lawyer from Florida, now living and working in London. He was previously a partner in Miami's oldest law firm, SHUTTS & BOWEN, and is now *of counsel* to the firm, based at its London office.

Langer is a graduate of the **Wharton School of Finance and Commerce** of the **University of Pennsylvania**. At the **University of Miami**, he became the first *summa cum laude* graduate in the history of the law school. He practiced law in Miami for over 30 years before moving to Europe ten years ago. He has written extensively on subjects relating to international tax law, and is especially known for his writings on the use of tax havens and tax treaties.

His first book, HOW TO USE FOREIGN TAX HAVENS, was published by the **Practising Law Institute (PLI)**, New York, in 1975. The third edition, published by **PLI** in 1985, has a more conservative title, **PRACTICAL INTERNATIONAL TAX PLANNING.** It is in looseleaf format and **Langer** updates it every year. He and a colleague have begun work on an expanded fourth edition which will be published later this year.

In 1980, **Langer** became coauthor (with **Rufus Rhoades** of California) of a set published by **Matthew Bender**, called **RHOADES & LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS.** **Langer** and his coauthor update this five-volume looseleaf set four times each year. **Langer** writes all of the material relating to tax treaties.

Since moving to England, Langer has also written two books that are published in the United Kingdom by Scope International. One is called **THE SWISS REPORT.** The other is **THE TAX EXILE REPORT**, the fourth edition of which has just been published.

Langer taught for many years at the **University of Miami** law school, serving as an Adjunct Professor until 1985. He has chaired and spoken at numerous tax institutes and seminars throughout the United States and Europe, as well as in Canada, Japan, Hong Kong, Malaysia, Australia, and the Caribbean. He has also given several seminars at Oxford.

In 1990, **Langer** was selected as *Outstanding Tax Attorney of the Year* by the **Tax Section** of **The Florida Bar.** He continues to consult with private clients on matters relating to migration from one country to another, citizenship and passports, residency, domicile, wealth preservation, international tax planning, and the use of tax treaties.

Senate Committee on Finance
Subcommittee on Taxation and
Internal Revenue Service Oversight
March 21, 1995

Testimony of H. David Rosenbloom

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me to testify today in regard to the Administration's proposal to change the income tax rules applicable to individuals who renounce U.S citizenship. More specifically, I intend to address myself to section 5 of H.R. 831 as reported by the Senate Committee on Finance. I will, however, refer to that section as "the Administration's proposal."

I am a tax practitioner and a law school lecturer in taxation. I was International Tax Counsel in the Treasury Department from 1978 to 1981, and I have worked in the area of international taxation for more than twenty years.

The Administration has proposed that property held by an individual who renounces citizenship would be marked to market upon such renunciation. This means that gain or loss would be calculated based on fair market value at the time of the renunciation, and the gain or loss would be recognized for income tax purposes. The rule would apply to all U.S. citizens, irrespective of their country of residence and irrespective of the geographic situs of their property: Both U.S. and foreign residents and U.S. and foreign property are covered. There are a limited number of exceptions justified either by continuing U.S. tax jurisdiction (in the case of U S. real property interests), or by administrative difficulties (in the case of qualified pension plans), or by the conclusion that tax should not apply below some threshold (witness the exemption of the first $600,000 in gain).

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On the whole, this is a reasonable and sensible proposal. I support it, and I think you should too.

To understand the Administration's proposal it is necessary to appreciate the context in which it is made. The United States stands virtually alone in the world in imposing taxation on the basis of citizenship. We have done this since the first income tax in 1913. This means that we impose taxes on resident and nonresident U.S. citizens alike, irrespective of the geographic source of their income.

U.S. policy in regard to citizens is certainly not free from doubt or controversy. Many other countries regard this policy as overreaching, unadministrable, or otherwise ill advised. But the policy is entrenched in our law, and there have not been any serious efforts to abandon it. At bottom, the U.S. insistence on taxing citizens says something about how we — the Congress and the American people — value United States citizenship, as compared with mere presence, or residence, in this country. Our tax law says, in effect, that citizenship is not only an incalculable privilege but a source of certain obligations as well.

On a somewhat less abstract level it may also be observed that taxes pay for government, and that the governmental responsibilities of the United States are worldwide. The U.S. citizen in Brazil derives ample benefit from programs and policies of the U.S. government, which must of course be paid for. There is a perfectly good economic reason why such a person should be asked to defray in part the cost of these policies and programs.

About thirty years ago Congress determined that our policy of taxing on a citizenship basis holds implications for persons who renounce citizenship. In the Foreign

Investors Tax Act of 1966 Congress enacted section 877 of the Internal Revenue Code. which attaches certain tax strings to certain expatriations for a certain period thereafter Congress was concerned that individuals might seek to escape their U.S tax obligations by renouncing citizenship

Section 877 does not work. Moreover, it cannot be made to work through interpretation. As the level of tax sophistication has risen in recent years, and increasingly greater intellectual resources have been trained upon the tax laws, many Code provisions have been tested. Section 877 was one of the earliest to be found wanting Avoiding it is child's play. Administering it in a fair way is impossible

Thus the Administration's proposal raises a straightforward issue of tax policy Should Congress fix a provision of law that has long been seen as having a justifiable purpose and that is demonstrably broken?

I think an affirmative answer to this question is required. In the first place, tolerating an ineffective provision like section 877 breeds disrespect for the tax laws in general That is not a good thing for a country that depends upon a high level of tax compliance and that will depend upon tax measures to finance its government needs for as long as there is a United States.

In the second place, the Administration's proposal is a clear improvement over present law It is simple. It is administrable. And it is fair — not only to those individuals who choose to surrender their citizenship but to those of us who stay behind to shoulder the burden. Foregoing tax on the expatriates by leaving present law in place — or by abandoning section 877 altogether, which is tantamount to the same thing — really represents

a tax increase on other U.S. taxpayers, residents and citizens, who must continue to finance government through taxes, inflation, a weaker dollar, and other involuntary exactions

The Administration's proposal is fair because it would impose tax on accretions to wealth that are attributable to the period of citizenship. The tax would include only net gains accruing prior to the time when the taxpayer ceases to be a U S citizen Persons wishing to surrender citizenship are free to seek their fortune under other flags, with no further assertion of U.S. tax jurisdiction other than what would apply to persons who never were U.S. citizens. In this respect, the Administration's proposal cuts back on the reach of present law, which extends to gains accruing long after citizenship has been surrendered.

The Administration's proposal may not be the only rational way to change section 877 Other changes might make sense as well — perhaps in addition to the one that the Administration advocates. I note, for example, that the Association of the Bar of the City of New York suggested, in 1991, that section 1014 of the Code be amended to deny a stepped-up basis in property inherited from a person who has renounced citizenship. That seems like another sensible suggestion — particularly since the Administration's proposal would do nothing to prevent expatriates from escaping U.S. estate tax. The provisions of section 2107 (estate tax) and section 2503(a)(3) (gift tax) are just as flawed as section 877.

In any event, the Administration's proposals would give reality to the policies expressed by Congress in 1966, which in turn were built upon policies dating from 1913. Alternatives or additions could be considered, but the Administration's proposal is worth doing on its own merits.

The issue presented by the proposal may not be simple — nothing about the U.S tax system is simple — but it is straightforward: Is it better to have a clear, unambiguous, workable rule for persons who abandon citizenship or should we prefer instead the complex, unfair, and unadministrable statute that we presently have?

This is an issue of tax policy — indeed, of uniquely U.S. tax policy. It is not an issue of constitutional law. The constitutional objections to this proposal rest entirely upon an alleged constitutional requirement of "realization" deriving from Eisner v. Macomber, a 75-year old, 5-4 decision of the Supreme Court. The requirement is not found in the words of the Sixteenth Amendment or elsewhere in the Constitution, and the Court explicitly referred to realization four years ago as founded on "administrative convenience." Most commentators, including commentators cited approvingly by the Court, consider the constitutional basis of realization to have been abandoned. So do the various lower courts that have considered the issue on the merits. The Second Circuit referred to the realization issue as "bordering on the frivolous." Moreover, if the Administration's proposal is unconstitutional, so are whole chunks of the Internal Revenue Code which suffer from the same or similar infirmities — starting with the foreign personal holding company rules of 1937, the 1962 provisions of subpart F, the 1981 commodities rules, the repeal of the General Utilities doctrine in 1986, and the new mark-to-market regime for securities dealers enacted in 1993.

Other objections to the proposal are equally meretricious. The issue here is one of tax policy — and not an especially new tax policy at that.

FOR RELEASE UPON DELIVERY
Expected at 10:30 a.m. EDT
March 21, 1995

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON TAXATION
AND INTERNAL REVENUE OVERSIGHT
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and members of the Subcommittee, I am pleased today to testify in support of section 5 of H.R. 831 as reported by the Committee on Finance. This proposal is similar to an Administration proposal contained in the President's fiscal year 1996 budget. This proposal is somewhat more limited than the Administration's proposal, since it does not apply to certain lawful permanent residents[1] and it does not include the companion provisions on taxation of certain trusts. My testimony today is limited to section 5 of H.R. 831 as adopted by the Committee.

Under the Committee's bill, if a U.S. citizen relinquishes his or her citizenship, property held by that person would be treated as sold at fair market value immediately before such expatriation. For this purpose, property that would be treated as sold would include all items of property that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of deemed sale. In addition, certain trust interests would be subject to the new rules. In this regard, the bill provides that a beneficiary's interest in a trust is determined based on all the facts and circumstances.

The Committee's bill contains several important exceptions. First, gains up to $600,000 would be exempt from tax. Second, United States real estate and interests in certain retirement plans would not be treated as sold. With IRS approval and appropriate security, taxpayers could defer the payment of tax for up to ten years. The bill would be effective for relinquishments of citizenship occurring after February 6, 1995. For this purpose a person is considered to relinquish his citizenship on the first date on which the individual gives notice to a U.S. official.

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[1] The President's budget proposal applied the tax on expatriation to "long-term residents" who cease to be subject to tax as residents of the United States. The budget proposal defined a long-term resident as an individual who had been a lawful permanent resident of the United States (i.e., a green card holder), other than an individual who was taxed as a resident by another country under a treaty tie-breaker rule, in at least ten of the prior fifteen taxable years.

Because of the exceptions described above, Treasury estimates that approximately two dozen very wealthy taxpayers per year with substantial unrealized gains would be subject to the proposed rules. The revenue from section 5 of H.R. 831 is dedicated to deficit reduction.

The Administration supports the Committee's bill because we are concerned that all U.S. persons pay their fair share of U.S. tax. Our existing laws generally subject individuals to tax when assets are sold or when the individual dies. Certain wealthy people have found that they can completely avoid paying U.S. tax on their gains by renouncing their U.S. citizenship. Because of the costs of obtaining another nationality and other transaction costs, renouncing U.S. citizenship to avoid tax is generally only a viable option for the wealthiest Americans.

Although recent publicity has focused on recent expatriations by super-rich Americans, the problem of tax avoidance by renouncing citizenship is not new. The United States first enacted expatriation tax rules in 1966 as part of the Foreign Investors Tax Act. The 1966 Act was intended to spur foreign investment in the United States by reducing U.S. tax on activities of foreign investors. Section 877 was adopted as part of this overhaul because Congress was concerned that the new rules to encourage foreign investment might also encourage U.S. persons to save taxes by surrendering their citizenship. H.R. Rep. No. 1450, 89th Cong., 2nd Sess. 22 (1966).

Under current section 877, a special taxation regime applies to a U.S. citizen who renounces his or her citizenship unless the loss of citizenship did not have as one of its principal purposes the avoidance of tax. This special regime applies for 10 years after expatriation. It subjects certain assets that produce U.S. source income to tax at graduated U.S. rates as if the person were still a U.S. citizen. Thus, taxing U.S. persons who abandon their U.S. citizenship is an accepted part of our law.

The United States is not the only country in the world to enact rules to prevent expatriate tax avoidance. Other developed countries have enacted tax legislation to combat tax avoidance by expatriation. A brief summary follows. In 1971, Canada enacted a provision which treats a Canadian resident taxpayer as having sold all of his capital assets at their fair market value when he relinquishes his residence. In 1992, the Canadians reviewed this provision, and decided to expand it to apply to all assets (not just capital assets) that are owned by the departing resident. Australia also enacted a provision similar to the Canadian rule. In 1971, Germany enacted a rule which requires long-term residents of Germany who terminate their German residence to be deemed to have disposed of 25 percent ownership interests in German corporations. Other countries have enacted different approaches to deal with the same problem. Countries which continue to tax former residents under special rules include Denmark, Sweden, Norway, Finland, and Germany. Thus, it is accepted in the international community that a country may enact special antiabuse rules to address the problem of departing taxpayers.

The Treasury Department has recently taken a close look at this area and concluded that section 877 needs to be overhauled. As a result of this review, the President's fiscal year 1996 budget contains a proposal to revise section 877.

The need for changes are based on several considerations. First, under existing rules, U.S. tax is triggered only if the expatriate had a tax avoidance motive. This tax motivation requirement is subject to abuse because it is often difficult to determine whether someone had a principal purpose of tax avoidance. Consequently, in practice it has been difficult to sustain a determination that an individual should be subject to tax under section 877.

Second, existing law only applies to certain U.S. source income. This standard is subject to abuse because taxpayers may be able to convert U.S. source income subject to the tax under current section 877 to foreign source income that is not subject to the tax. In practice, we understand that practitioners advise their clients on ways to accomplish this conversion in a manner that purports to avoid section 877.

In addition, the U.S. source restriction of current law is inconsistent with the normal rule that U.S. citizens should be subject to tax on their worldwide income, whether from U.S. or foreign sources. However, existing section 877 allows former citizens to earn foreign source income with impunity.

Third, existing expatriation rules are extraterritorial in nature. Current expatriation rules do not merely tax gains accruing while the person was a citizen, but also tax gains accruing between expatriation and sale of the asset. Thus, if a tax-motivated expatriate purchased U.S. stock the year after he relinquished his citizenship and sold the stock eight years later, current rules would subject the entire gain from this sale to U.S. taxation. Arguably, these gains should not be caught in the U.S. tax net. The requirement of current law that the imposition of the tax must wait until the property is actually sold requires the IRS to monitor transactions that occur long after an individual relinquishes his citizenship.

The Committee's bill addresses the basic issued raised by existing section 877. The proposal taxes appreciation over $600,000 without regard to tax motivation. In addition, the tax applies to all gains, not just U.S. source gains. Finally, the tax would no longer be extraterritorial. Only gain accruing while the taxpayer was a U.S. citizen would be subject to United States tax.

We believe that the Congress has the ability to enact the Committee's bill. In 1920, the Supreme Court in *Eisner v. Macomber*, 252 U.S. 189 (1920), held unconstitutional an income tax imposed on stock dividends because the taxpayer had not yet realized this gain. However, the Supreme Court thereafter retreated from creating a constitutional requirement for realization. In 1940 the Court held in *Helvering v. Bruun*, 309 U.S. 461 (1940), that a landlord realized gain when he repossessed leased land on which the tenant had erected a building that added about $50,000 to the value of the property. A few months later, the Court ruled in *Helvering v. Horst*, 311 U.S. 112 (1940), that accrued interest on certain

negotiable interest coupons should be taxed to the person that gave the coupons away. In that case, the Court demoted the realization concept from a constitutional principal by describing it as a rule "founded on administrative convenience."

More recently, other provisions of the Internal Revenue Code that tax gain prior to realization have been held to be constitutionally valid. These provisions include the foreign personal holding company provisions, the subpart F provisions, and the mark-to-market rules of section 1256. The Second Circuit considered the foreign personal holding company rules in *Eder v. Commissioner*, 138 F.2d 27 (2nd Cir. 1943), and found that Congress intended to attack "incorporated pocketbooks", and that this purpose was valid and constitutionally permissible. In a later case upholding the Subpart F rules, the Second Circuit said that the constitutional argument "borders on the frivolous." *Garlock v. Commissioner*, 489 F. 2d 197, 202 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974). More recently, the Ninth Circuit upheld the validity of section 1256 rules stating "section 1256 is neither arbitrary, capricious, nor confiscatory and is a proper exercise of Congress' constitutional power to tax." *Murphy v. U.S.*, 992 F.2d 929, 931 (9th Cir. 1993).[2]

Finally, the constitutionality of existing section 877 has been upheld by the courts. *Di Portanova v. U.S.*, 690 F.2d 169 (Ct.Cl. 1982). In another case involving expatriation, the Tax Court held that "the taxing power of Congress... is exhaustive and embraces every conceivable power of taxation." *See Dillin v. Comm'r*, 56 T.C. 228, 241 (1971).

We believe that the power to tax income extends to the power to prevent taxpayers from rearranging their affairs to avoid tax on unrealized appreciation. See Bittker, Federal Taxation of Income, Estates and Gifts para. 5.2 at Id. at 5-20 (1989). A reasonable opportunity to impose and collect the tax on appreciated assets is when the U.S. citizen gives up his or her citizenship. Therefore, the tax imposed should be seen as neither arbitrary, capricious, nor confiscatory and as a proper exercise of the constitutional power to tax.

Let me next address the issue of whether the proposal is consistent with international human rights and the Jackson-Vanik amendments to the Trade Act of 1974. Attached is a letter from the Department of State addressing these issues. In brief, that letter states that the proposal "does not conflict with international human rights law concerning an individual's right to freely emigrate." The letter also states that "the proposal does not conflict with the Jackson-Vanik amendments to the Trade Act of 1974." Fundamentally, the right to emigrate is the right to leave physically the territory of a state. That right is not affected in any way by the proposal. The Committee's bill would not tax the physical departure from the United States, rather it would tax the renunciation of United States citizenship.

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[2] Although the court upheld the constitutionality of section 1256 on due process grounds, it explicitly declined to address the realization issue.

Finally, regarding our treaty obligations, section 5 of H.R. 831 is consistent with our tax treaties since the United States reserves the right to tax its citizens and certain former citizens.

We believe that Americans who avoid their tax responsibilities by expatriating should not be rewarded. Instead, they should be asked to pay tax that U.S. citizens will pay sooner or later. Consequently, we support section 5 of H.R. 831.

Mr. Chairman, this concludes my remarks. I would be pleased to answer any questions that the subcommittee may have.

UNIVERSITY OF VIRGINIA
SCHOOL OF LAW
March 20, 1995

PAUL B. STEPHAN III
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Leslie B. Samuels
Assistant Secretary of the Treasury for Tax Policy
U.S. Department of the Treasury

Dear Mr. Samuels.

I have been asked to offer an opinion as to whether the Administration's proposal to treat the renunciation of U.S. citizenship as a realization event with respect to wealthy taxpayers presents any problems under international law, particularly in light of the position the United States has taken in the past with respect to the freedom to emigrate. As I find myself in the unusual position of being a specialist in international law, U.S.-Soviet relations, and federal taxation, I am happy to do so.

The Jackson-Vanik Amendment to the Trade Act of 1974 and the 1975 Helsinki Accords both express a strong U.S. stand in favor of the freedom of people to emigrate free of more than "a nominal tax," 19 U.S.C. § 2432(a)(2), and there is substantial authority for the proposition that the international law of human rights incorporates the obligation to refrain from erecting such impediments to emigration. But it is critical to recognize the distinction between the right to travel, on the one hand, and the right to change one's citizenship status, on the other. Emigration necessarily involves the former, but not necessarily the latter The human rights concerns that dominated our encounters with the Soviet Union and other totalitarian regimes during the 1970s and 1980s were based on violations of the right to travel. Those governments treated their borders as the perimeter of a prison, and their citizens as prisoners. The so-called education tax that the Soviet Union threatened to impose on emigrants, which inspired the above cited language in the Jackson-Vanik Amendment, was triggered by a request to travel abroad, not by an attempt to renounce Soviet citizenship. Whether the communist regimes also made it difficult to surrender citizenship was a matter of indifference to us. Indeed, many authorities believed that the Soviet Union and other governments violated international law by making it too *easy* to lose one's citizenship, as they did when they imposed involuntary loss of citizenship as a form of punishment for political dissent (*e.g.*, the case of Aleksandr Solzhenitsyn).

The Administration's proposal, as I understand it, has absolutely no effect on the right of a citizen to travel abroad. It is triggered only by a change of citizenship status, not by the crossing of the country's borders. The reason for this distinction is clear when one considers how U.S. tax rules operate. Whether a citizen resides within or without the United States, the obligation to pay tax on appreciation of assets remains the same Any gain realized and recognized during life will result in an income tax. Any unrealized appreciation that remains at death will not be subject to an income tax, but instead will subject the decedent to the estate tax. To be sure, the federal estate tax is not an exact substitute for an income tax at death on unrealized appreciation, both because only wealthy persons (those with assets in excess of $ 600,000, assuming no taxable gifts during life) are subject to the estate tax, and

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because the taxable estate includes both realized and unrealized appreciation. But I am not alone in having pointed out that the estate and gift tax, in practice, serve as a reasonable approximation for the income tax that could be levied on unrealized appreciation at death.

All of the above turns on citizenship, not on residence A U S citizen who resides abroad will have to include in his tax base any gain realized from the disposition of an asset, *see Cook v. Tait*, 265 U.S. 47 (1924), will pay a federal gift tax on any taxable gift during his life, no matter where the asset is located, and will include all of his worldwide assets in his taxable estate at death. By contrast, a citizen who severs the bond of citizenship and does not continue to reside in the United States will pay neither income, gift, nor estate tax (except as U.S.-sourced income and, for the estate and gift tax, transfers of certain property sourced to the United States) The change of citizenship status, not of residence, is what matters for U.S. tax law Current law recognizes the significance of changes in citizenship by subjecting nonresident aliens who lose U.S citizenship for tax avoidance reasons to a special alternative income tax, *see* Internal Revenue Code Section 877. Section 2107 imposes a similar result with respect to the estate tax, and 2501(a)(3) with respect to the gift tax. What the Administration proposal would do, as I understand it, is replace the unworkable tax avoidance standard of Sections 877, 2107 and 2501(a)(3) with a *per se* rule that applies to any person with sufficient assets to make future estate taxation a probability. An analogous provision is Section 367 of the Code, which denies nonrecognition treatment in certain corporate reorganizations if the recipient of appreciated property is a foreign corporation. I never have heard the argument that the latter provision imposes an impermissible burden on the right of a domestic corporation to export its capital.

In summary, the international law of human rights is concerned with restrictions on the right to leave one's country, not those on the right to renounce one's citizenship. To the extent human rights law deals with citizenship status, it addresses involuntary denials of citizenship, not burdens triggered by the renunciation of citizenship Furthermore, the proposed measure is not a tax on the export of capital as such, but rather a logical part of a comprehensive scheme to ensure that all appreciation of capital owned by a U.S. citizen eventually will be subject to a U.S. tax, whether income, gift, or estate For these reasons, it is inconceivable to me that the Administration's proposal could be seen as violating international human rights law

To be sure, there are few positions with respect to customary international law that cannot obtain the support of at least some jurists Last Saturday, while passing through Pittsburgh's airport, I ran into my former student, Bob Turner, who informed me of his intention to testify before the Senate Finance Committee to the effect that the proposal did raise problems under international law. As I told him at the time, I found his arguments unconvincing. However, I am responsible only for Bob's education in Soviet law, not in international or tax law

I hope this letter is useful Please feel free to make whatever use of it you wish.

Sincerely,

Paul B Stephan III

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Andreas F. Lowenfeld
Herbert and Rose Rubin
Professor of International Law

March 27, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Secretary:

You have asked for my views on section 5 of H.R. 831 presently pending before the U.S. Senate, which as I understand it would impose a capital gains tax on United States citizens who renounce their U.S. citizenship, based on a hypothetical sale of all their property (subject to a deduction) immediately prior to renunciation. In particular, you have asked my view on whether such a tax would be inconsistent with applicable treaties or principles of international law.

Statement of Qualifications

I have been a professor of law at New York University since 1967, specializing in international law and international economic transactions. Prior to joining the faculty of New York University, I served for more than five years in the United States Department of State, as Special Assistant to the Legal Adviser for Economic Affairs, and Deputy Legal Adviser (1961-66). I was an Associate Reporter for the American Law Institutes's Restatement (Third) of the Foreign Relations Law of the United States (1979-87), and I served as consultant to the ALI Project on Income Tax Treaties (1988-92).

Conclusion

Without taking any position on the desirability of the proposed legislation, I am confident that neither adoption nor enforcement of the provision in question would violate any obligation of the United States or any applicable principles of international law.

<u>Analysis</u>

There is no doubt that international law today recognizes the right to emigrate, and the right to change one's nationality. Article 13(2) of the Universal Declaration of Human Rights (1948) states

> Everyone has the right to leave any country, including his own....

Article 15(2) states

> No one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality.

Without here debating the binding character of the Universal Declaration (see <u>Restatement (Third) of Foreign Relations Law</u>, introduction to Part VII, §701, and notes thereto), it is clear to me that the Congress should not be asked to adopt legislation that runs contrary to principles to which the United States has given and continues to give its support. I do not believe, however, that H.R. 831 is contrary either to the right to emigrate (i.e., change of one's residence) or to expatriate (i.e., change of one's nationality). No prohibition against performing either or both of these acts is contained in the proposed legislation, nor is the tax so burdensome as to be fairly regarded as penal or confiscatory.

Persons who wished to abandon their American Citizenship for reasons of political or religious belief would not be prevented from doing so by H.R. 831. Persons who were considering renunciation of their U.S. citizenship for purposes of reducing their tax liability -- whether on income or upon succession at death -- might be dissuaded by H.R. 831 from doing so, but I do not believe the effect of the proposed tax could be classified as an *arbitrary denial* of the right to change one's nationality within the meaning of the Universal Declaration.

I understand that the question has been raised whether H.R. 831 is inconsistent with §402 of the Trade Act of 1974, tr so-called Jackson-Vanik Amendment. I am very familiar with the amendment, having written about it in my book <u>Trade Controls for Political Ends</u> at pp. 166-190 (2d.ed 1983). I am clear that the amendment was addressed to a quite different purpose, i.e., inducement to Soviet authorities to abandon their restrictions on Jews and some other groups who desired to leave the Soviet Union to escape discrimination and persecution. It is true that one of the restrictions against which the Jackson-Vanik Amendment was directed was taxation; however (i) the Soviet tax was a relatively high tax based not on wealth or income but on the level of education; and (ii) the tax was imposed on *emigration*, not on change of citizenship or nationality. I have read the prepared statement of

Professor Robert F. Turner of March 21, 1995; I find his suggestion that H.R. 831 is somehow inconsistent with the ideals expressed in the Jackson-Vanik Amendment quite unpersuasive, as a matter of history, of purpose, and of law.

In sum, imposition of *unreasonable* conditions on emigration or change of nationality could be contrary to international law. H.R. 831 imposes no restrictions on emigration; it does impose some conditions on renunciation of United States citizenship, but these conditions are not unreasonable, and therefore not unlawful.

Respectfully submitted,

Andreas F. Lowenfeld
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of International Law

HARVARD LAW SCHOOL
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March 24, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury Washington, D.C. 20220
Fax: 202-622-0605

Dear Secretary Samuels,

Your office has requested my views as to international law implications of the proposed tax on expatriates that would be imposed by section 5 of H.R. 831. You will understand that this is my personal opinion and in no way purports to represent the views of the institution to which I belong. It is also compact in form due to the constraints of time imposed by your legislative schedule and my own impending travel.

The right of expatriation has always been highly valued by the United States, which has defended it against the claims of other nations that refused to let their citizens go. The right to make this choice is the counterpart of the right not to lose one's citizenship except by one's own voluntary choice, a right underlined by opinions of the Supreme Court. However, in my view, the proposed tax does not amount to such a burden upon the right of expatriation as to constitute a violation of either international law or American constitutional law. It merely equalizes over the long run certain tax burdens as between those who remain subject to U.S. tax when they realize upon certain gains and those who abandon their citizen while the property remains unsold.

Furthermore, the proposed tax does not except, in the most indirect way, burden the right to emigrate. It is the right to emigrate rather than the right to expatriate onesself which is the subject of various conventions and of customary international law. As stated in the preceding paragraph, it basically equalizes certain tax burdens. It is not comparable to the measures imposed by such countries as the former Soviet Union and German Democratic Republic which were obviously and intentionally burdens on the right to emigrate.

In arriving at these conclusions I have reviewed various materials such as your statement before the Subcommittee on Taxation and Internal Revenue Oversight, two opinions of the Office of the Legal Adviser, U.S. State Department, the views of Professors Paul Stephan III and Robert Turner and others.

Very truly yours,

Detlev F. Vagts
Bemis Professor of Law

Prepared Statement of

PROFESSOR ROBERT F. TURNER

MR. CHAIRMAN, it is an honor and a pleasure to appear before the subcommittee this morning to explore the human rights ramifications of the so-called "exit tax" contained in Title II of H.R. 981, the "Tax Compliance Act of 1995."[1]

Before turning to the merits of the issue, I would like to make three caveats in connection with my appearance here today.

First of all, I am testifying in my *personal* capacity as a scholar interested in the subject of International Law; and, although I currently occupy the Charles H. Stockton Chair of International Law at the Naval War College while on leave of absence from the University of Virginia's Center for National Security Law, my appearance is unconnected with either of those relationships. Any similarities between the views I express and those of the War College, the Navy, the University of Virginia, or any other institution or organization, are purely coincidental. When I was contacted by your staff about possibly

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[1] *Inter alia*, this provision would amend the Internal Revenue Code by adding this language:

> If any United States citizen relinquishes his citizenship during a taxable year, all property held by such citizen at the time immediately before such relinquishment shall be treated as sold at such time for its fair market value and any gain or loss shall be taken into account for such taxable year.

That the "exit tax" is designed to affect a relatively small portion of the population is clear from the fact that the first $600,000 of gross income is excluded from this provision. According to the State Department, 697 US citizens expatriated in 1993 and 858 the following year. "It is not yet known how many of these former citizens, if any, will be subjected to tax under section 877." JOINT COMMITTEE ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1996 BUDGET PROPOSAL 17 n.6 (Feb. 17, 1995). The fact that the Treasury Department anticipates more than $2 billion in additional revenues from this provision by FY 2000 suggests either that many expatriates will be covered or that the few covered will be hit with rather substantial additional tax bills under this provision. *See infra*, note 48.

taking part in these important proceedings, I emphasized that it was imperative that my views not be attributed to the War College, and I was assured that would not be a problem.

Secondly, I want to stress from the start that I have absolutely no expertise on the substantive issue of tax law. I will therefore have to pass on any questions you might wish to raise predicated upon such a knowledge; and I certainly don't rule out the possibility that a thorough understanding of tax law might produce a different conclusion than the one I have tentatively reached when the relevant rules of International Law are applied to the statutory language now under review.

Finally, since my invitation to testify was not extended until late Friday afternoon (less than four days ago)—and because of prior commitments and travel requirements, I had less than one day to work seriously on my testimony—my prepared statement is not as polished as I might otherwise have preferred. The basic human rights issue is, of course, not new to me—ironically, I believe I first looked at the "right of emigration" professionally more than two decades ago when the Jackson-Vanik Amendment[2] came before the Senate while I was on the staff of Senator Robert P. Griffin of Michigan—and I don't believe the pressures of time have prevented me from accurately setting forth the basic legal rules by which this statutory provision should be judged. I have not had a great deal of time for serious analysis, however; and while I will venture some very tentative conclusions, I suspect that each of you will be able to apply the legal rules to the proposed new statute at least as well as I have been able to do in the limited time available.

I do not appear before you this morning for the purpose of either supporting or opposing the so-called "exit tax" provision of the tax bill. I do believe that upholding the rule of law is important, and I do believe that this provision may raise a sufficiently serious question under International Law that it warrants additional consideration before making a final decision on Section 201. To that end, I commend you for scheduling this hearing.

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[2] 19 U.S.C. §§ 2192 *et seq.*

Even if in the end you conclude that the provision does not, in reality, violate the Nation's solemn human rights treaty commitments, if there is even a colorable claim to the contrary that might be raised to undermine future US efforts to enforce human rights laws, it might be wise to avoid even the appearance of violating these laws. In the end it may come down to balancing the importance of the tax code provision against the potential harm that might result if we are perceived as having violated these important rules of international human rights law.

The Growth of a Legal Right to Emigrate

Today the right of citizens to renounce their citizenship and leave their own country is almost universally recognized as a fundamental civil right, but its widespread recognition as creating international obligations among States is of relatively recent origin. The origin of the right of **emigration** (i.e., the right to depart from one's country with the intention of not returning) and **expatriation** (i.e., the renunciation of one's citizenship) as a matter of internal law can arguably be traced back nearly 2500 years, to the famous *Dialogues of Plato*, in which Socrates says to Crito:

> [H]aving brought you into the world, and nurtured and educated you, and given you and every other citizen a share in every good which we had to give, we further proclaim to any Athenian by the liberty which we allow him, that if he does not like us when he has become of age and has seen the ways of the city, and made our acquaintance, he may go where he pleases and take his goods with him. None of . . . [our] laws will forbid him or interfere with him. Any one who does not like us and the city, and who wants to emigrate to a colony or to any other city, may go where he likes, retaining his property.[3]

The 42nd paragraph of the original 1215 version of the *Magna Carta* issued by King John at Runnymede guaranteed the right of "any one to go out from our kingdom,

[3] THE DIALOGUES OF PLATO 217 (7 Britanica Great Books of the Western World, 1952). *See also*, Jeffrey Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. 381, 384 (1987).

and to return, safely and securely, by land and by water, saving their fidelity to us"; but this "right to travel" was omitted from the forty-six subsequent versions—including the one issued by Henry III in 1225 usually associated with the term "Magna Carta"—on the grounds that such a right seemed "weighty and doubtful."[4] Nor, for that matter, was it clear that the right to "travel" included a right to emigrate—a right far more easily sustained now that people have changed from "subjects" of the King to "citizens" of the State.

Mr. Jefferson and the Right of Expatriation

Mr. Chairman, I gather that the Office of the Legal Adviser to the Department of State, and some of my colleagues in the international law community are trying to distinguish the right to "travel" from the right to renounce one's U.S. citizenship. Apparently underlying this view is the assumption that there is no legal "right" of expatriation—that is to say, no right to renounce one's allegiance to one's native country.

I find it surprising to hear that argument advanced on this issue, as the claimed "right of expatriation" was at the very core of the intellectual justification for the American Revolution.[5] The first sentence of the Declaration of Independence asserted that "the laws of nature & of nature's god" entitled "one people to dissolve the political bands which have connected them with another"[6] by declaring their independence. I hesitate to contemplate

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[4] By coincidence, I discussed this issue in my prepared testimony before the Senate Judiciary Committee Subcommittee on the Constitution on 5 October 1994 (page 2-3 of original text), which has not yet, to my knowledge, been published.

[5] "Founded as it was on emigration from other countries, the United States has long taken the position that the right to alter one's status by expatriation is an 'inherent and fundamental right.'" Seth F. Kreimer, *"But Whoever Treasures Freedom . . ."*. 91 MICH. L. REV. 9-7, 938 n.73, *quoting* JAMES H. KETTNER, THE DEVELOPMENT OF AMERICAN CITIZENSHIP 1608-1870 at 267-70 (1978).

[6] "When in the course of human events it becomes necessary for one people to dissolve the political bands which have connected them with another, and to assume among the powers of the earth the separate and equal station to which the laws of nature & of nature's god entitle them, a decent respect for the opinions of mankind requires that they should declare the causes which impel them to the separation." DECLARATION OF INDEPENDENCE. *See, generally,* JAMES MUNVES, THOMAS JEFFERSON AND THE DECLARATION OF INDEPENDENCE: THE WRITING AND EDITING OF THE DOCUMENT THAT MARKED THE BIRTH OF THE UNITED STATES OF AMERICA (1978).

the potential consequences if it is really the view of the Department of State that Jefferson's understanding of this alleged "right" was mistaken.[7] Even before the Declaration of Independence was written, the great Virginia jurist St. George Tucker noted that his state had rejected the feudal doctrine of indefeasible allegiance and had by judicial decision recognized a "right of expatriation."[8]

MR. CHAIRMAN, it is no small irony that we are gathered here this morning on the 205 anniversary of the date that Thomas Jefferson took the oath of office as our Nation's first Secretary of Foreign Affairs (later redesignated "Secretary of State"). While I am not appearing here on behalf of the University of Virginia, it is difficult to be associated with that great institution without being impressed by the transcendental wisdom of its founder, Mr. Jefferson. And, as is true with so many subjects, his legacy of brilliant writings provides insight directly relevant to this issue.

As early as 1774, in his *A Summary View of the Rights of British Americans,* Jefferson reminded King George II that:

> [O]ur ancestors, before their emigration to America, were the free inhabitants of the British dominions in Europe, and possessed a right, which nature has given to all men, of departing from the country in which chance, not choice, has placed them, of going in quest of new habitations, and of there establishing new societies, under such laws and regulations as, to them, shall seem most likely to promote public happiness.

Jefferson noted that:

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[7] It should be kept in mind that Jefferson believed that a primary basis of International Law (then called "the Law of Nations") was "natural law." To that end, his extensive collection of treatises in this area was catalogued under the heading "Law of Nature and Nations." *See, e.g.*, 2 Catalogue of the Library of Thomas Jefferson 67-88 (1983).

[8] Craig Evan Klafter, *The Influence of Vocational Law Schools on the Origins of American Legal Thought, 1779-1829*, 37 AM. J. LEGAL HIST. 307, 320 (1993).

> Their Saxon ancestors had, under this universal law, in like manner, left their native wilds and woods in the North of Europe, had possessed themselves of the Island of Britain, then less charged with inhabitants, and had established there that system of laws which has so long been the glory and protection of that country. Nor was ever any claim of superiority or dependence asserted over them by that mother country from which they had migrated; and were such a claim made, it is believed his Majesty's subjects in Great Britain have too firm a feeling of the rights derived to them from their ancestors, to bow down the sovereignty of their State before such visionary pretensions.

Thus, Jefferson was clearly asserting a "natural right" not only to depart from one's native country (to emigrate) but to sever the legal relationship which creates legal duties and rights for citizens of their native State. It is perhaps worth noting that Jefferson's thesis drew support in 1791, when the French *Declaration of the Rights of Man* affirmed the right "to come and to go" from the State as a "natural" right.[9]

The proposal before you comes from the Department of the Treasury; and thus, it may be useful to recall Jefferson's June 1806 letter to Secretary of the Treasury Albert Gallatin—the individual who occupied that post longer than any person in history, and whose statute stands outside its walls—in which our third president wrote:

> I hold the right of expatriation to be inherent in every man by the laws of nature, and incapable of being rightfully taken from him even by the united will of every other person in the nation. If the laws have provided no

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[9] *Id.* at 4, and Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 384.

> particular mode by which the right of expatriation may be exercised, the individual may do it by any effectual and unequivocal act or declaration.

Addressing the power of the Federal Government to interfere with this right to renounce one's citizenship, Jefferson added:

> Congress may, by the Constitution, "establish an uniform rule of naturalization", that is, by what rule an alien may become a citizen; but they cannot take from a citizen his natural right of divesting himself of the character of a citizen by expatriation.

Jefferson addressed this issue again in his 1821 *Autobiography*, when in discussing his own theory of American independence he argued that "our emigration from England to this country gave her no more rights over us, than the emigrations of the Danes and Saxons gave to the present authorities of the mother country, over England." He reasoned that "expatriation being a natural right, and acted on as such, by all nations, in all ages," the colonists were legally free to dissolve their relationship with Great Britain.

Make no mistake about it—Jefferson was espousing upon what he viewed to be principles of International Law. He wrote that "[t]he law of nations . . . is composed of three branches. 1. The moral law of our nature [or 'natural law']. 2. The usages of nations [what we today call 'customary law'). 3. Their special conventions (e.g., 'treaties' or 'positive' law).[10]

In Jefferson's clearly expressed view, both the law of "nature" and the law of nations denied the United States Government the legal right to deny this fundamental "right of expatriation" to its citizens. To witness able attorneys on behalf of the Department of

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[10] 3 WRITINGS OF THOMAS JEFFERSON 228 (Mem. ed. 1904).

State—which Thomas Jefferson personally set up as our first Secretary of State—suggest that the right to "travel" is not accompanied by a clear legal right to renounce U.S. citizenship, saddens me. Having served in the Department of State myself, I understand the loyalty Executive branch employees often feel to defend the President's position. But in this case I doubt seriously that the President was even aware that a human rights issue existed when this tax was proposed and approved.

Nor was Jefferson alone in upholding the right of Americans to renounce their previous citizenship. As secretaries of state, John Marshall, Madison, and James Monroe embraced the same doctrine; and the early naturalization laws implicitly endorsed the view by requiring new citizens to renounce prior allegiances to former States.[11] Furthermore, the War of 1812 was fought in no small part for the principle that Great Britain lacked any authority over former British citizens who had renounced that relationship while accepting naturalized U.S. citizenship.

In 1859, Attorney General Black wrote:

> The natural right of every free person, who owes no debts and is not guilty of any crime, to leave the country of his birth in good faith and for an honest purpose, the privilege of throwing off his natural allegiance and substituting another allegiance in its place—the general right, in one word, of expatriation, is incontestable. . . . We take it from natural reason and justice, from writers or known wisdom, and from the practice of civilized nations. All these are opposed to the doctrine of perpetual allegiance.[12]

The view that there is a fundamental right of citizens to renounce their allegiance to one State and move to live elsewhere without punishment was embraced by Congress in 1868—during another of many controversies with Great Britain concerning the rights of

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[11] *See, e.g.*, Alan G. James, *Expatriation in the United States: Precept and Practice Today and Yesterday*, 27 SAN DIEGO L. REV. 853 (1990).
[12] *Quoted in id.*

naturalized U.S. citizens—by enactment of "An Act Concerning the Rights of American Citizens in Foreign States," which provided in part:

> Whereas the right of expatriation is a natural and inherent right of all people, indispensable to the enjoyment of the rights of life, liberty, and the pursuit of happiness; and whereas, in the recognition of this principle this government has freely received emigrants from all nations, and invested them with the rights of citizenship; and whereas it is claimed that such American citizens, with their descendants, are subjects of foreign states, owing allegiance to the governments thereof; and whereas it is necessary to the maintenance of public peace that this claim of foreign allegiance should be promptly and finally disavowed: Therefore, any declaration, instruction, opinion, order, or decision of any officers of this government which denies, restricts, impairs, or questions the right of expatriation, is declared inconsistent with the fundamental principles of this government.[13]

Finally, two years later, Great Britain abandoned its claim of "once an Englishman, always an Englishman," and enacted a statute which provided that British citizens who became naturalized in other countries would become aliens under British law.[14] In 1894, Secretary of State Gresham refused to issue a certificate to assure the Russian Government that the United States had no objections to the granting of Russian citizenship to an American citizen, on the grounds that such a document might undermine the important principle that—and here he quoted the 1868 statute—the "right of expatriation is a natural and inherent right of all people."[15]

More recently, Section 349(a) of the Immigration and Nationality Act recognizes a right of every citizen to relinquish US citizenship.[16] Just a decade ago, the US Court of Appeals for the Ninth Circuit observed that "expatriation has long been recognized as a *right* of United States citizens," and noted that "the Supreme Court [has] placed the right of voluntary expatriation solidly on a constitutional footing."[17]

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[13] Expatriation Act of 1868, 15 Stat. 223 (1868).
[14] James, *supra* note 11. XXXX
[15] *Id.*
[16] 8 U.S.C. § 1481, *quoted in* 87 AM. J. INT'L L. 601 (1993).
[17] *Richards v., Secretary of State*, 752 F.2d 1413 at 1422 (1985).

The proposed "exit tax," of course, does not expressly challenge this well-established right to emigrate/expatriate—it merely provides that a few dozen very wealthy citizens will be forced to pay a major tax on appreciated assets should they wish to exercise this constitutional and international human right. In one sense the proposal does not "tax" the decision to exercise the well-established right—it simply provides as a matter of law that the Government will *pretend* that anyone exercising that right (who in the subjective judgment of the Internal Revenue Service is thought to be motivated by a desire to avoid additional tax liability) has sold all of his property. In reality, there would be no factual issue as to whether the targets of this tax had actually sold their property. This tax would only apply to property that had *not* been sold. But the Treasury Department has figured out that if we can just pretend that they did sell it, while perhaps we can't actually keep them from leaving and renouncing their American citizenship, we can at least make sure that they leave behind another $40 million or so each to help offset the deficit. All in all, Treasury estimates that the two dozen or so U.S. citizens who are likely candidates for this proposed tax will bring in something in excess of $1 billion toward deficit reduction. And since these individuals will lose their right to vote simultaneously with incurring the tax obligation, I can certainly understand how this might be an attractive proposition to those of you who must come up with solutions to the deficit problem.

International Law and Constraints on the Right to Emigrate

Mr. Chairman, the issue you have invited me to address is whether such a tax would bring the United States into noncompliance with any binding rules of International Law. As I indicated at the start, I am not sufficiently versed on issues of tax law to answer that question with any real confidence; but perhaps I can be of assistance by at least

summarizing the existing international law binding upon the United States concerning the human right to emigrate.

Let me began by briefly setting forth the status of the right to emigrate under International Law. I will first consider the relevant conventional (treaty) law binding upon the United States, followed by a look at some "non-binding" international documents which may shed light on these issues, and finally I will discuss the very important area of customary international law (which, under the Statute of the International Court of Justice, is considered as equal in authority to conventional law[18]).

Conventional International Law

The effort to codify international human rights law is of quite recent origin, essentially coming in the wake of World War II and the establishment of the United Nations. Article 55 of the UN Charter establishes as a goal the promotion of "universal respect for, and observance of, human rights and fundamental freedoms for all without distinction as to race, sex, language, or religion." In Article 56, "All Members pledge[d] themselves to take joint and separate action in co-operation with the Organization for the achievement of the purposes set forth in Article 55."

An important first step was the unanimous adoption (with eight abstentions, including the Soviet Union and several other Communist States) on 10 November 1948 of the "Universal Declaration of Human Rights" as a UN General Assembly Resolution.

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[18] STATUTE OF THE INTERNATIONAL COURT OF JUSTICE, Art. 38. While customary law may over time replace a rule established by treaty, and the general goal is to ascertain the most recent expression of the consent of the parties (thus a more recent customary practice accepted as law (*opinio juris*) may prevail over a prior treaty), it is probably accurate to observe that, where a relevant treaty exists between the parties to a dispute, the terms of the treaty will provide at least the starting point for resolution of the dispute. However, the principle that "the specific prevails over the general" (*lex specialis derogat generali*) may well lead to a narrow customary practice prevailing over a more general treaty obligation.

Such resolutions do not have legal effect,[19] and the *Declaration* was clearly viewed as aspirational at the time—indeed, the United States delegate expressly stated that the resolution "is not and does not purport to be a statement of law or of legal obligation."[20] However, there is a *very* strong consensus today that the *Declaration* is legally binding by virtue of reflecting customary international law. It will be discussed below under customary law.

The International Covenant on Civil and Political Rights

In an effort to follow up the *Declaration* with a series of binding treaties, in 1966 the United Nations General Assembly unanimously approved the *International Covenant on Civil and Political Rights,* which entered into force on 23 March 1976. The following year, it was signed by the Carter Administration and on 23 February 1978, it was submitted to the Senate for its advice and consent.

In 1991, President Bush asked the Senate to consider the treaty, and hearings were held late that year in the Foreign Relations Committee, which recommended approval of the treaty by a unanimous vote (19-0). On 2 April 1992, the Senate consented to the ratification of the treaty with a variety of proposed reservations, understandings, and declarations[21]; and the instrument of ratification was deposited with the United Nations on 8 June of that year with the recommended additions—none of which apply directly to the issue at hand.[22] The United States thus joined more than 100 other States in assuming a solemn international legal obligation to abide by the terms of the *Covenant.*

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[19] However, a UNGA resolution expressing legal principles approved by an overwhelming vote of Member States may serve as powerful evidence of the existence of a legally-binding international custom.
[20] 19 DEP'T STATE BULL. 751 (1948).
[21] REPORT OF THE SENATE COMMITTEE ON FOREIGN RELATIONS ON THE INTERNATIONAL COVENANT ON CIVIL AND POLITICAL RIGHTS, *reprinted in* 31 INT'L LEG. MATS. 645 (1992).
[22] A possible exception is the first Declaration, specifying that the Covenant is Non-Self-Executing. *Id.* at 651.

It is perhaps worth noting that the unanimous report of the Foreign Relations Committee on this treaty categorized the "rights enumerated in the Covenant" as being "the cornerstones of a democratic society."[23]

The *Covenant* was designed to be a legally-binding international treaty setting forth "inalienable rights" which were "derive[d] from the inherent dignity of the human person."[24] Article 12 of the *Covenant* provides:

Article 12

> 1. Everyone lawfully within the territory of a State shall, within that territory, have the right to liberty of movement and freedom to choose his residence.
> 2. Everyone shall be free to leave any country, including his own.
> 3. **The above mentioned rights shall not be subject to any restrictions except those which are provided by law, are necessary to protect national security, public order (*ordre public*), public health or morals or the rights and freedoms of others,** and are consistent with the other rights recognized in the present Covenant.
> 4. No one shall be arbitrarily deprived of the right to enter his own country.
> [**Bold** emphasis added.][25]

The American Society of International Law commissioned an excellent study of *The Movement of Persons Across Borders*, edited by two of the nation's foremost scholars in this area (Professors Louis B. Sohn and Thomas Buergenthal), which provides important background on the interpretation of the Article 12 of the *Covenant*. Among other things, the authors note that one of the reasons Article 12 was written was that, "[n]otwithstanding Article 13(2) of the . . . [*Declaration*], some countries prevent their nationals from leaving,

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[23] REPORT OF THE SENATE COMMITTEE ON FOREIGN RELATIONS ON THE INTERNATIONAL COVENANT ON CIVIL AND POLITICAL RIGHTS, *supra* at 649 (p. 3 of OT).
[24] Preamble, 6 INT'L LEG. MATS. 368 (1967).
[25] Art. 12, *id.* at 372.

prescribe *unreasonable conditions such as exacting taxes or confiscating property . . . .* [emphasis added]"[26]

While Article 12 embodies a "fundamental right," it is not an "absolute right" in the sense that a State may not legitimately place some reasonable restrictions by law on the right of emigration. In addition to preventing individuals accused of serious crimes from leaving,[27] for example, it is clear that a State may require a citizen to pay any normal tax obligations or other public debts.[28] However, people who wish to emigrate may not lawfully be required to surrender their "personal property," and "Property or the proceeds thereof which cannot be taken out of the country shall remain vested in the departing owner, who shall be free to dispose of such property or proceeds within the country."[29]

It seems to me that a key issue with respect to the proposed US "exit tax" is whether or not it represents a normal tax obligation applicable to all citizens irrespective of their wish to emigrate. To the extent that it constitutes a special requirement on individuals because of their desire to emigrate, then the Government would presumably have the burden under the *Covenant* of establishing that the law is "necessary to protect national security, public order (*ordre public*), public health or morals or the rights and freedoms of others . . . ."[30]

It may be relevant that efforts were made during the drafting of Article 12 to broaden this list of permissible exceptions to include such concepts as promoting a State's "general welfare" and "economic and social well-being," and these were rejected as being "too far-reaching."[31] Restrictions on freedom of movement were only to be permitted in

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[26] THE MOVEMENT OF PERSONS ACROSS BORDERS 76 (Louis B. Sohn & Thomas Buergenthal, eds. 1992).
[27] *Id.* at 79.
[28] *Id.* at 82.
[29] *Id.* at 81, quoting Article 6 of the 1989 Strasbourg Declaration on the Right to Leave and Return (prepared by a group of international experts under the auspices of the International Institute of Human Rights).
[30] International Covenant on Civil and Political Rights, Art. 12.
[31] Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 389.

"exceptional" circumstances.[32] Professor Louis Henkin, of Columbia Law School, has noted that:

> The Covenant . . . is not to be read like a technical commercial instrument, but "as an instrument of constitutional dimension which elevates the protection of the individual to a fundamental principle of international public policy." Rights are to be read broadly, and limitations on rights should be read narrowly, to accord with that design.[33]

This view is widely shared by other experts in the field.[34] Discussing Article 12 in a lengthy 1987 article in the *Hofstra Law Review*, a group of four attorneys from the New York firm of White & Case concluded:

> Although it is accepted that there may be restrictions imposed on the right to emigrate, these restrictions are of an exceptional character and must be strictly and narrowly construed. The right to emigrate is primary; the restrictions on that right are subordinate and may not be so construed as to destroy the right itself.[35]

For the record, the United States is now also a party to the *International Convention on the Elimination of All Forms of Racial Discrimination*, which prohibits barring freedom of movement (and many other enumerated rights) on the basis of "race, colour, or national or ethnic origin"[36]—however, this treaty does not appear to be relevant to the issue at hand. There are several other international conventions which guarantee the right to emigrate, including regional agreements underlying the European, African, and Inter-American human rights systems. However, the United States is not a Party to these, so in the interest of time I have not addressed their specifics. (While they do serve as evidence of customary legal obligations, in this area the statutory language of the Jackson-Vanik

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[32] *Id.* at 389, 394.
[33] THE INTERNATIONAL BILL OF RIGHTS: THE COVENANT ON CIVIL AND POLITICAL RIGHTS 24 (Louis Henkin, ed. 1981), *quoted in* Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 395.
[34] Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 396.
[35] *Id.* at 406.
[36] 660 U.N.T.S. 194.

Amendment [discussed *infra*] assures that the United States is bound by customary law in this area.)

Other International Instruments of Relevance

As already noted, the Universal Declaration of Human Rights was intended to be aspirational and not legally binding upon the 48 States that voted to approve it. Because it reflects customary law, it will be discussed under that heading—but it also stands as an important non-treaty human rights document.

Another very important international document clearly not intended to create binding legal rights was the Final Act of the Conference on Security and Cooperation in Europe (Helsinki Accords), which expressly incorporated the *Declaration*.[37] Time has precluded me from addressing these types of instruments further, but they are probably not critical to a resolution of the issue.

Customary International Law

Perhaps the most important written source of customary international law[38] is the *Universal Declaration of Human Rights*, approved as a UN General Assembly Resolution on 10 November 1948 and already noted above. The *Declaration* provides:

Article 13

> 1. Everyone has the right to freedom of movement and residence within the borders of each State.

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[37] 14 INT'L LEG. MATS. 1292 (1975).

[38] To constitute binding international customary law, a rule must reflect "a general practice" that has been "accepted as law" (*opinio juris*). *See* STATUTE OF THE INTERNATIONAL COURT OF JUSTICE, Art. 38 (1) (b).

> 2. Everyone has the right to leave any country, including his own, and to return to his country.[39]

Give the debate that has now arisen about the right to expatriation, I would note that Article 15 of the Declaration expressly recognizes the human right of every person "to change his nationality."

During the debate on the Jackson-Vanik Amendment in 1974 (discussed *infra*), this document was occasionally portrayed as an international treaty designed to create legal rights.[40] In reality, its only "legal" value is as evidence of binding customary law. This may be important background for the discussion which follows, because the Soviet Union voted against Article 13 during the drafting process and did not vote in favor of the *Declaration* itself in the General Assembly. With a few exceptions, which are not relevant to the issue at hand,[41] rules of International Law are established by the *consent* of States. This can be done explicitly by ratifying a treaty or other international agreement, or it may be done implicitly by taking part in the development of a consistent and general practice accepted as law. But—again, with some exceptions[42]—a State is not considered bound by customary legal rules against which it clearly protested during formation. Thus, it is at least arguable[43] that the Soviet Union was not bound by the *Declaration* as customary law in 1974.

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[39] UNGA Res. 217 A (III), 3 UNGAOR 71, UN Doc. A/810 (10 Nov. 1948).

[40] NOTE TO FOLLOW.

[41] Some rules of International Law are of such fundamental importance that they are considered "peremptory norms" (*jus cogens*) and bind all States irrespective of consent. A thorough discussion of this issue is precluded by the short time available to prepare this testimony. Some human rights principles have this status—it is doubtful that this is one of them. The issue is of only academic interest given the strong statement of the right to emigrate as constituting binding International Law contained in the Jackson-Vanik Amendment to the 1974 Trade Act (discussed below). Thus, the United States could hardly protest that it is not bound by this rule and claim to have protested against its creation.

[42] *Jus cogens* rules (discussed *supra*) bind all States, and newly-formed States are bound by all rules of customary law in existence when they are created.

[43] In reality, a strong case can be made that the Soviet Union was bound by this provision of the *Declaration* in 1974. Among other things, abstention in the General Assembly does not constitute an adequate "protest" to protect against being bound (although it does not constitute "consent" either). The following year the issue was arguably resolved when Moscow signed the Helsinki Accords (which, as discussed *supra*, incorporated the text of the *Declaration*.) While the Helsinki Accords were not designed to

The 1974 Jackson-Vanik Amendment

Mr. Chairman, it may be worth noting this Committee, and the United States Congress, have played a prominent role in the affirmation of customary international law governing the right of citizens to emigrate without having to pay burdensome special taxes. I believe that Chairman Packwood, Majority Leader Dole, and Senator Roth are the only current members of the Finance Committee who served in the Senate during the Ninety-Third Congress, so it may be useful to review the history of the "Jackson-Vanik" Amendment—also know as the "Freedom of Emigration" Amendment[44]—briefly at this time. I remember it reasonably clearly, for, as I mentioned, I was serving at the time on the staff of Senator Bob Griffin and I followed the Amendment closely.

As reported out of this committee, Section 402 of the Trade Act of 1974 (H.R. 10710) included the House-passed "Vanik Amendment"[45] which prohibited the President from granting "nondiscriminatory tariff treatment" to any "non-market economy country" which "imposes more than a nominal tax, levy, fine, fee or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice."[46] In its accompanying report, this Committee referred to the "right to emigrate" as a "basic human right . . . ."[47]

When the trade bill reached the Senate floor in mid-December 1974, this provision was strengthened by the enactment of the famous "Jackson Amendment" (with the final

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be legally binding in themselves, Moscow's acceptance of the principles of the *Declaration* would undercut any Soviet claim that it objected to these principles as *customary* law.

[44] *See, e.g.*, Senate Report No. 93-1298 (Committee on Finance), *reprinted in* 4 U.S. CODE CONGRESSIONAL & ADMIN. NEWS 7338 (93d Cong., 2d Sess., 1974) (hereinafter cited as FINANCE COMMITTEE REPORT).

[45] This amendment, introduced by Representative Charles Vanik, was approved on the House floor on 11 December 1974 by a vote of 319-80. *See* 120 CONG. REC. 39782 (1974).

[46] FINANCE COMMITTEE REPORT at 7213.

[47] *Id.* at 7338.

language affirming the right of emigration thus widely referred to as the "Jackson-Vanik Amendment"). Although strongly opposed by the Ford Administration as an impediment to détente with the Soviet Union, and Jackson Amendment was introduced in the Senate with 78 co-sponsors.[48] Significantly, it received a *unanimous* vote after a lengthy (if entirely one-sided) floor debate.[49] The three current members of this Committee who served in the Senate at the time were co-sponsors of the Jackson Amendment[50] and voted for its passage.[51]

In testimony before this committee, the legendary Hans J. Morgenthau, at the time Leonard Davis Distinguished Professor of Political Science at the City University of New York, characterized the right of emigration as "one of the tests of civilized government."[52] Senator Dole termed it a "fundamental freedom," and described the Soviet requirement that citizens seeking to emigrate first pay a "diploma tax" to reimburse the State for its investment in their education as being in conflict with "America's traditional concern for the rights of individuals."[53] Addressing the Senate following passage of his amendment, Senator Jackson noted that the "fundamental human right to emigrate" was guaranteed "in the Universal Declaration of Human Rights which was adopted unanimously 26 years ago this week."[54] As enacted into law (19 U.S.C.A. § 2432), the provision provides in part:

> **§ 2432. Freedom of emigration in East-West trade**
>
> . . . .
>
> (a) To assure the continued dedication of the United States to fundamental human rights, and notwithstanding any other provision of law, on or after . . . January 3, 1995, products from any nonmarket economy country shall not be eligible to receive nondiscriminatory treatment (most-favored-nation treatment), such country shall not participate in any program of the Government of the United States which extends credits or credit guarantees

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[48] 120 CONG. REC. 39782 (1974).
[49] *Id.* at 39806. The final vote was 88-0, with 12 Senators absent. All but two or three of the absent Senators were co-sponsors of the amendment.
[50] *Id.* at 39782.
[51] *Id.* at 39806.
[52] 120 CONG. REC. 39787.
[53] *Id.* at 39802.
[54] *Id.* at 39806.

> or investment guarantees, directly, or indirectly, and the President of the United States shall not conclude any commercial agreement with any such country, during the period beginning with the date on which the President determines that such country—
>
> (1) denies its citizens the right or opportunity to emigrate;
>
> (2) *imposes more than a nominal tax on emigration* or on the visas or other documents required for emigration, *for any purpose or cause whatsoever*; or
>
> (3) imposes more than a nominal tax, levy, fine, fee, or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice,
>
> and ending on the date on which the President determines that such country is no longer in violation of paragraph (1), (2), or (3).[55]

Even if you conclude that the proposed exit tax is not in conflict with the terms of the Covenant on Civil and Political Rights, it strikes me that—given in particular this Committee's and the Senate's unanimous support for the Jackson-Vanik Amendment—careful consideration ought to be given to whether this proposal complies with that standard as well.

Reconciling the Proposed US "Exit Tax" with Jackson-Vanik

Subjectively, of course, all of us can presumably agree that there is a substantial difference in the motivation behind the proposed US "exit tax" and the impediments placed in the path of Soviet Jews (and others) in the early 1970s designed clearly to discourage emigration (especially by dissident Jews to Israel). The United States understandably does not wish to lose the substantial sums in tax revenues which the Treasury Department projects could be lost if especially wealthy US citizens elect to renounce their citizenship and emigrate to foreign points.

While one might normally view this as a "political" problem for Congress to factor in to the drafting of the tax laws—how to extract maximum tax revenues from the wealthy without exceeding the point that the "geese that lay the golden eggs" will fly off to find a

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[55] Trade Act of 1974, 19 U.S.C.A. § 2432 (emphasis added).

more hospitable environment in which to do business[56]—there are obvious political attractions to the exit tax approach. Presumably few constituents will be directly affected by this legislation (and "soaking the rich" is not all that unpopular with many Americans of more ordinary means in these troubled times), and in order to be subject to the special "tax" an individual will have to renounce his or her American citizenship—in the process surrendering their right to vote in any case. One can see how this might have appeared to be a virtually cost-free (from a political standpoint) way to raise a couple of billion additional dollars over the next five or six years.[57]

From the standpoint of International Law, however, it may be more difficult to make the distinction between the old Soviet practice of charging a special "diploma tax" to compel citizens who wish to emigrate to compensate the State for its investment in their education, and the proposed US "exit tax" designed to compel citizens who wish to emigrate to compensate the State for income taxes they would likely eventually owe if they remained citizens. (It would not be illegal under these rules of International Law for the United States to tax unrealized capital gains annually, or for the for the Soviets to charge a fee for providing an education—the legal issue arises when people who seek to emigrate are treated less favorably than others because of their decision to exercise their legal right to emigrate.)

To be sure, we can probably agree that the old Soviet regime was made up of "bad guys," and our own government is much "nicer." Even as many of us search around for professional assistance in reducing our own tax liabilities, it is probably true that most Americans have a visceral antipathy for "tax dodgers." Nor do many of us identify very

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[56] While I claim no special expertise on matters of finance or tax policy, I was impressed with *Forbes* magazine editor James W. Michaels' observation that "It's not that legislators sympathize with rich tax dodgers. It's that they realize it's time to worry less about soaking the rich and more about changing the tax code to make the country more hospitable to the capital that produces jobs and economic growth." James W. Michaels, "You can't take it (all) with you," FORBES, 13 March 1995, p. 10.

[57] The Treasury Department estimates that this provision will produce $2.2 billion in additional tax revenues between FY 1995 and FY 2000. DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 17 (Feb. 1995).

closely with individuals who would voluntarily renounce their American citizenship as a means of reducing tax liability. While it may be in part that our relatively more limited liability makes their decision difficult to comprehend, I like to think that most of us view our status as American citizens as among our most cherished rights. Many of us still recall Sir Walter Scott's moving words, as we read them in high school in Hale's "A Man Without a Country":

> Breathes there the man, with soul so dead,
> Who never to himself hath said,
> This is my own, my native land!
> Whose heart hath ne'er within him burn'd
> As home his footsteps he hath turn'd
> from wandering on a foreign strand!
> If such there breathe, go, mark him well;
> For him no Minstrel raptures swell;
> High though his titles, proud his name,
> Boundless his wealth as a wish can claim;
> Despite those titles, power, and pelf,
> the wretch, concentered all in self,
> Living, shall forfeit fair renown,
> And, doubly dying, shall go down
> to the vile dust, from whence he sprung,
> Unwept, unhonor'd, and unsung.[58]

I suspect that the outcry from your constituents over the proposed exit tax—even if it is perceived as nothing more than an effort to "stick it to rich expatriates"—is not likely to be very considerable.

Congress May By Statute Violate International Law

Perhaps I should make one additional point. The United States belongs to the *dualist* school and views municipal and international law as being separate, if often

[58] Sir Walter Scott, *The Lay of the Last Minstrel, canto VI, st. 1.*

interrelated,[59] legal systems. United States courts will thus first attempt to reconcile the language of apparently inconsistent statutes and treaties, but if that proves unreasonable, they will apply the "later in time" doctrine (*lex posterior derogat priori*) and give legal effect to the instrument of most recent date.[60] The theory underlying this policy is that treaties and statutes have a co-equal standing as "supreme law of the land,"[61] and the lawmaking authority—be it the two chambers of the Legislative Branch acting with the approval (or over the veto) of the Executive,[62] or the Executive acting with the consent of two-thirds of those Senators present and voting[63]—is presumed to know the existing law when it acts and to intend the logical consequences of its actions. Thus, if the Congress enacts the provision in question and it is subsequently challenged as contrary to the nation's solemn treaty commitments, American courts will not strike down the statute because of the treaty. Similarly, while some scholars quarrel with the rationale,[64] the oft-cited 1900 Supreme Court case of *The Paquete Habana* held that customary international law ("the customs and usages of civilized nations") is part of US law "where there is no treaty and no controlling executive or legislative act or judicial decision . . . ."[65] Furthermore, while the recently ratified Covenant clearly creates a solemn legal obligation upon the United States under International Law, it is not self-executing[66] and thus will not be implemented by US courts in the absence of independent legislative authority.[67]

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[59] As will be discussed, treaties are a part of the "supreme law of the land" and customary international law "is part of our law" too. The *monist* school views international law to be superior to municipal law in a single legal system.
[60] *See, e.g.*, *Whitney v. Robertson*, 124 U.S. 190 (1888).
[61] US CONST. Art. VII
[62] *Id.* Art. I, Sec. 7.
[63] Id. Art. II, Sec. 2.
[64] *See, e.g.*, Louis Henkin, *The Constitution and United States Sovereignty*, 100 HARV. L. REV. 853 (1987).
[65] Note to follow.
[66] For a discussion by Chief Justice Marshall of the distinction between self-executing and non-self-executing treaties, *see Foster and Elam v. Neilson*, 27 U.S. (2 Pet.) 253 (1829).
[67] Note to follow.

However, this is not to say that Congress has the legal power to relieve the United States from its solemn treaty obligations under International Law. On the contrary, no such right exists (unless the relevant treaty provides for termination by act of a national legislature), and if the Congress elects to approve a statute that is contrary to the Covenant it will make the United States a lawbreaker.

To be sure, Congress in the past has on occasion enacted legislation which placed the Nation in such a status.[68] Such a decision has consequences, however. Not only might other treaty Parties have available meaningful remedies under International Law,[69] but violations of International Law by the United States contributes to a lack of respect for the rule of law in general and greatly undermines the ability of the United States to pressure other States to comply with such rules. Thus, in particular when the issue involves solemn undertakings in the area of international human rights, one would hope that legislators would be careful to avoid even the appearance of breaching provisions of a treaty.

Conclusion

MR. CHAIRMAN, as I indicated when I began, I did not come here this morning with the intention of taking a definitive position on this legislation on the merits. Because the invitation to take part in the hearing came with such short notice, I have not been able to analyze the issue to the extent I might have wished. The comments which follow are offered with more than a little hesitation and uncertainty.

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[68] This sometimes occurs inadvertently when legislation is considered by members who are simply unaware of a conflicting treaty provision (as may be the case in this Committee's approval of the statute being considered in this hearing), but it also occurs occasionally even after the conflict with a treaty has been identified. An example of this that comes readily to mind was S-961, the "Ma[illegible]on Fisheries and Conservation Act," passed around 1976. *See* the minority views of my former empl[illegible] Senator Robert P. Griffin, included in the Foreign Relations Committee's report on this bill for a discussion of this problem.

[69] These may range from judicial settlement to reciprocal breach or simply the "horizontal enforcement" of retorsionary behavior to pressure our Country to observe its solemn international legal obligations (*pacta sunt servanda*).

I have primarily tried to set forth the basic international legal rules in my testimony, and I suspect that honorable men and women might reach different conclusions when applying those rules to this bill. I came into the hearing with some reservations, but it may be that after I have heard other perspectives I will be less concerned about the compatibility of the "exit tax" with Article 12 of the Universal Covenant on Civil and Political Rights.

Even if that occurs, however, it still leaves us with the perhaps more difficult problem of reconciling this tax with the spirit and language of the 1974 Jackson-Vanik Amendment. I'm not going to pre-judge that issue for you, either, other than to say that I personally find it somewhat more troubling. If this were merely a statute providing that citizens must "pay their lawful taxes" before they may renounce their citizenship and move to a foreign State they find more attractive, I think it could pass legal muster with little difficulty.[70] But I'm not sure that's the situation. You understand the tax system far better than I do, and I will defer to your expertise in the final analysis.

As I stressed at the beginning, I am not even arguably an authority on the tax code; but it is my initial impression that the proposed "exit tax" is designed to impose an immediate and substantial financial burden upon citizens—on the specific and expressed grounds that they have elected to renounce their citizenship and emigrate—and that this is a burden that would not be imposed upon otherwise identically situated citizens who elected to remain American citizens (and did not elect to sell or dispose of their property or take other action that would realize capital gains liability).

If that is true, in all candor, I think I would want my money "up front" if I were asked to argue before an international tribunal that the proposed US exit tax complies with the spirit of the Jackson-Vanik Amendment—which no less an authority that the United States Congress argued reflected the minimal requirements of International Law two

[70] The Department of State, for example, has warned that "Persons considering renunciation [of US citizenship] should also be aware that the fact that they have renounced U.S. nationality may have no effect whatsoever on their U.S. tax or military service obligations." 87 AM. J. INT'L L. 602 (1993).

decades ago. (I think I would base my Jackson-Vanik case upon the technicality that the United States is not covered because it does not have a "non-market economy"—but the underlying rule of customary international law is not so qualified and could not be evaded by that consideration. Trying to argue that international human rights standards have *declined* since 1974 would clearly not pass the "straight face" test.)

The experts are divided about whether the Jackson-Vanik Amendment is a "relic of the Cold War" and ought to be repealed.[71] Secretary of State Christopher and the Congressional Helsinki Commission have both voiced opposition to removing Jackson-Vanik from the statute books on the grounds, *inter alia*, that some "refuseniks" are still being denied the right to emigrate from Russia[72]; and the issue of freedom of emigration has also been central to the debate over MFN status for China.[73] It is simply unrealistic to believe that the underlying principle of freedom of emigration will no longer face serious challenges, and the ability of the United States to use moral suasion to further such important values will depend in no small part upon the international perception of our own record in upholding these rights. As Jefferson noted in a 19 April 1809 letter to James Madison: "[I]t has a great effect on the opinion of our people and the world to have the moral right on our side."

Unless someone can do a better job that I have heard thus far in distinguishing an exit tax targeted at "super rich Americans" from one aimed at "educated Jews," however, you may find as a practical matter that you will need to make a choice between enacting this provision and attempting in the years ahead to uphold the Jackson-Vanik Amendment and

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[71] For a useful summary of this debate (reaching the conclusion that "Jackson-Vanik has continuing relevance today," see Kevin M. Cowan, *Cold War Trade Statutes: Is Jackson-Vanik Still Relevant*, 42 U. KAN. L. REV. 737 (1994).
[72] *Id.*
[73] *See, e.g.*, Lucille A. Barale, *U.S. MFN Renewal for China: The Jackson-Vanik Amendment*, 12 E. ASIAN EXEC. REP'T 6 (1990); Randall Green, *Human Rights and Most-Favored-Nation Tariff Rates for Products from the People's Republic of China*, 17 U. PUGET SOUND L. REV. 611 (1994); and Marian Nash (Leich), *Contemporary Practice of the United States Relating to International Law*, 88 AM. J. INT'L L. 719 (1994); Executive Order 12,850 (1993).

similar human rights norms. If this provision is enacted into law, I believe the odds are good that future US protests calling upon China, Iraq (which last month imposed an exit tax of its own to curtain the flow of capital), Iran, and other flagrant human rights violators to comply with the provisions of the Covenant on Civil and Political Rights will receive in reply a reference to American "violations" of Article 12.

MR. CHAIRMAN, that concludes my prepared statement. I will be happy to attempt to answer any questions you or your colleagues might have.

COMMUNICATIONS

VINSON & ELKINS L.L.P
(REGISTERED LIMITED LIABILITY PARTNERSHIP
ATTORNEYS AT LAW

STATEMENT OF
JOHN E. CHAPOTON

I am pleased to present our views on the proposal to tax U.S. citizens upon expatriation I am the Managing Partner of the Washington Office of Vinson and Elkins L.L.P., a law firm with a large international tax practice.

The principal purpose of my testimony is to make certain the Committee is aware of serious technical difficulties in the application of the expatriation tax to beneficiaries of trusts. We represent a U.S. trust the beneficiaries of which would be adversely affected by the proposed legislation in what we think are unintended ways. We have discussed these problems with the Committee staffs, the Joint Committee staff, and the Treasury Department's Office of International Tax Counsel, and I believe they are considering what, if any, changes in the proposal might be appropriate in response. The facts with respect to the trust are set out, in simplified form, below.

I would make three preliminary comments about the proposal you are considering before going into our specific problems. First, I would point out that the Code already contains provisions designed specifically to prevent expatriation by a U.S. citizen for the purpose of avoiding U.S. tax. It is obvious that the Treasury Department believes these provisions to be inadequate, and the Administration thus has proposed an "exit tax" as a substitute for existing law. The exit tax is a wholly new type of tax, without precedent in the Internal Revenue Code. That is a bold and unproven course to follow. The difficulty of designing an entirely new scheme of taxation in this area is illustrated by the many problems that have been identified in just a brief time in attempting to apply this new scheme to trust beneficiaries. It is likely there are other, undiscovered difficulties in the application of such a provision in other fact situations will emerge. It might be prudent to consider amending the provisions of existing law to make them work more effectively, rather than to adopt immediately such a radical new approach. We make some suggestions toward that end at the conclusion of this statement.

Secondly, the proposed exit tax, if enacted, would often be a major factor in an individual's decision to relinquish U.S. citizenship (from the U.S. to the country of the individual's birth or where he or she was raised and may now live, for example). The potential of a tax burden on expatriation or change in residency also could be a significant factor to a

citizen of another country who is contemplating emigrating to the U.S Only two or three other countries now attempt to impose such a tax, and even in those few cases the countries concerned modify the tax to make its application less stringent than the provision adopted by the Committee. If the United States adopts an exit tax, it is quite possible (even likely) that such taxes will become the international norm. The Committee should consider carefully whether it wants all countries to impose these types of taxes on individuals who change citizenship, and if so whether the United States should adopt some sort of stepped-up basis rule for immigrants who enter this country, to prevent U.S. taxation of the gain in assets they bring with them that was accrued before they became U.S. citizens.

My third and final preliminary comment is to point out that the exit tax would, of course, be imposed without the realization of any income by the taxpayer. That is virtually unheard of in our income tax system; the only arguable precedents I can think of relate to so-called "section 1256 contracts" (where a mark-to-market rule was adopted to deal with specific tax avoidance problems through the use of straddles) and to mark-to-market tax rules for professional securities dealers, who already keep their books under a mark-to-mark system and whose assets are readily convertible into cash. The exit tax would thus not only impose a tax at a much earlier point in time than would normally be the case (which is in itself a penalty), but would necessitate collection by the IRS when there may be no liquid assets with which to pay the tax, and in some cases (such as the case of the trust beneficiary described below) when the taxpayer has no access to the assets the gain on which is being taxed. These problems can be ameliorated, but not solved entirely, by deferral in collection of the tax. The important point to realize is that taxing appreciation in the assets of individuals before it is realized is a big step, and a step that unavoidably causes problems in application of the tax.

Problems in Application of the Exit Tax to Trusts

The beneficiary of a trust who might contemplate relinquishing his or her U.S. citizenship would face special problems under the provision proposed by the Treasury and under the version of the proposal adopted by the Committee. The difficulties are principally a result of the fact that a trust beneficiary ordinarily has no access to the assets of the trust even though he or she has a beneficial interest in those assets. It does not at all follow that because a person is named a contingent beneficiary in a trust, even a large trust, he or she has any assets apart from that interest. Family estate planning that concentrates family assets in a trust often leads to the result that, though the trust may grow large over the years, subsequent generations of family members have no significant personal assets. The problem is compounded in the case of remainder beneficiaries because it may be many years before they receive any income or assets from the trust; and the problem is further compounded if, as is often the case, the remainderman's interest is contingent, and thus will only be realized if he or she outlives the life beneficiary.

Even in the seemingly simple case of a life beneficiary who is receiving distributions of income from the trust, the exit tax would have surprising consequences. If that individual expatriates, the gain on the trust's assets would be taxed to him or her even though all the capital of the trust, including all appreciation, will go not to that individual but to the remaindermen

who ultimately receive the trust's assets. Further, the income beneficiary would not apparently obtain any step-up in basis.

Facts

The trust we represent was created many years ago. The trust instrument requires that all trust income be paid to a single beneficiary for his life, and upon his death and the death of his siblings, the trust terminates. The assets of the trust are then to be distributed to the children of the income beneficiary who are alive at that time. If any child of the income beneficiary is deceased, the assets of the trust are to be distributed to his or her children.

The trustees have no discretion to pay any principal to the income beneficiary or the contingent remaindermen (the children and grandchildren of the income beneficiary). Furthermore, the trust contains a strict spendthrift provision, which prevents any beneficiary from selling, assigning, or otherwise anticipating his or her beneficial interest in any way; for example, a beneficiary could not use a beneficial interest in the trust as collateral for a loan.

The income beneficiary and several of the remaindermen live abroad. In fact, some were born abroad and have never lived in the United States. The income beneficiary has lived in a high tax Western European country for more than 20 years, never even visiting the United States. He obviously will not realize a U.S. income tax benefit if he expatriates, but he is considering doing so for personal reasons. If the exit tax were adopted in its present form, the U.S. tax penalty, as described below, would be severe and, indeed, prohibitive in the case of the contingent remaindermen because it would significantly exceed the value of their other assets.

The Income Beneficiary

If the income beneficiary should expatriate, he would have tax liability determined by using the trust's basis in the assets "attributable" to his income interest. Presumably, the interest attributed to him would be based on the value of his life expectancy relative to the total value of trust assets. Under the exit tax provision adopted by the Committee, the following problems would be presented.

- The income beneficiary will pay tax on a portion of the unrealized capital gains in the trust's assets even though *he can never receive any portion of those capital gains.*

- The income beneficiary *will not have access to either trust assets or income in order to pay the tax* because the income beneficiary cannot anticipate his future income from the trust (which would stop tomorrow if he were to die).

- Certain U.S. source fixed or determinable income of the trust paid to the income beneficiary would be subject to U.S. withholding taxes, apparently with *no basis adjustment to reflect the fact he had paid a full tax* on part of the value of his

income interest. It is unclear who, if anyone, would ever receive the benefit of the basis created by the deemed sale of trust assets.

The Contingent Remainder Beneficiaries

If a child of the income beneficiary expatriates, he or she will have a tax liability based on the unrealized capital gains on the proportionate share of trust assets attributed to his or her contingent remainder interest, as if the trustee has sold those assets and distributed the proceeds to the beneficiary.

- On an actuarial basis, it will be more than 22 years before any remainderman can expect to receive the assets on which he or she will pay a tax, and then only if surviving. Furthermore, the grandchildren of the income beneficiary have an even more remote interest they are not likely ever to receive (their grandparent would have to survive their parent). *Such interests can be extremely remote* but nevertheless can be subject to the tax as proposed.

- *A remainderman cannot reach trust assets to pay the tax*, so as in the case of the income beneficiary, a remainderman would have to pay tax out of other assets, if any. If a remainderman did not have assets adequate to pay the tax (and in the case posited, none of them do), *the provision would prevent him or her from expatriating.*

- A remainderman's interest is contingent, either on surviving the income beneficiary (in the case of a child of the income beneficiary), or on his or her parent not surviving the grandparent (in the case of a grandchild of the income beneficiary). *A remainderman would be required to pay the exit tax on gain in assets he or she may never receive.*

- A remainderman may obtain no basis in trust assets for foreign tax purposes, thus *potentially subjecting gains to international double taxation.*

Proposed Solutions

We think these problems can be ameliorated, if not solved altogether, by the following amendments to the provision adopted by this Committee.

Income Beneficiary

At the election of the income beneficiary, no sale of assets should be deemed to have occurred. Instead, for some period (10 years, for example) the trust income would continue to be taxable to the income beneficiary as received, in the same manner as if he or she had not expatriated.

Remainder Beneficiaries

With respect to remainder beneficiaries of trusts, the following rules should be adopted:

a. De minimis rule. The interest should not be taxed if it is so remote as to represent an insubstantial proportion of the total interest in the trust determined on an actuarial basis (for example, 10 percent).

b. 1. Trust-level tax. Any tax with respect to a remainderman should be imposed on the trust, which has the assets with which to pay the tax, rather than on the income and remainder beneficiaries. The trustees can adjust trust interests and basis to take such payments into account to properly allocate the burden and benefit of the tax under many applicable local probate laws. *See, e.g., Estate of Warms,* 140 N.Y. Supp.2d 169, 171 (1995); *Estate of Bixby,* 140 Cal App.2d 326, 388 P.2d 68 (1956).

2. Deferral of tax. Alternatively, a remainder beneficiary could be allowed to defer the payment of the tax until the interest vests and is distributed. The tax should continue to be calculated based on the gain with respect to the beneficiary's share of trust assets at the time of expatriation because any subsequent appreciation in value is accumulated at a time when the beneficiary no longer enjoys the protection of U.S. citizenship and U.S. law.

Furthermore, no interest should be assessed on the deferral because the exit tax is imposed upon unrealized gains, in advance of the time when those gains would normally be taxed. Deferral of tax until realization does not ordinarily carry with it an interest charge, and it should not in this case.

c. Refund procedure. Any tax paid with respect to a contingent remainderman should be refundable to the trust in the event the trust terminates without any interest vesting in that remainderman. Alternatively, the exit tax should not be due with respect to a contingent remainderman unless and until the remainderman becomes entitled to trust assets.

Even if these solutions were adopted, there would be the potential for double taxation of gain on trust assets if the exit tax is applies to beneficial interests in trusts. There does not appear to be any way other than renegotiation of international tax treaties to address this problem.

Alternative Approach

The unforeseeable technical and policy problems that might flow from the adoption of an exit tax in such a short time frame might suggest that a more viable alternative would be to make section 877 more effective. For example, consideration might be given to one or more of the

following with respect to a U.S taxpayer who wishes to expatriate.

a. The taxpayer could be required to file with the IRS a complete financial statement, which would include a description of all assets.

b. The taxpayer could be required to agree to file annual information returns for a 10-year period following expatriation.

c. The taxpayer could be required to grant a lien on U.S. property or provide other acceptable security to assure payment of any future U.S. tax liability.

d. The taxpayer could be required to appoint a U.S. agent for the purpose of service of process.

Conclusion

We appreciate the Committee's consideration of the problems the tax on expatriation would cause for beneficiaries of trusts. We hope you agree that these consequences are undesirable and unintended.

TUFTS UNIVERSITY

The Fletcher School
of Law and Diplomacy
Administered with the cooperation of Harvard University

31 March 1995

The Honorable Daniel Patrick Moynihan
United States Senate

Attention: Patricia McClanahan

BY FAX

Re: Tax Compliance Act of 1995, H.R. 981

Dear Senator Moynihan:

I wrote you on 24 March expressing my concern over the possible human rights implications of the so-called "exit tax" called for in the above-referenced bill. As I noted then, what appeared to be the imposition of a tax solely on the ground that a person was renouncing his or her citizenship could interfere with the right of every person "to leave any country, including his own," which is guaranteed under article 12 of the Covenant on Civil and Political Rights.

I am gratified that the human rights issues related to this bill have become a subject of serious debate, and I appreciate your contribution to that debate. Having now received additional and more specific information about the tax, however, I have become convinced that neither its intention nor its effect would violate present U.S. obligations under international law.

Although imposition of a special tax on those who wished to renounce U.S. citizenship might be questionable, it is my understanding that the tax in question is based on accrued income and, in effect, treats renunciation of citizenship as the financial equivalent of death for the purpose of attaching tax liability. There are undoubtedly negative consequences to the individual concerned in having to pay taxes on gains while he or she is alive rather than after death, but there is no internationally protected right to escape taxation by changing citizenship. However, in order to clarify that the purpose and effect of the proposed tax are non-discriminatory, the language

Medford, Massachusetts 02155

might be rewritten to offer the individual the option of complying with the new tax or electing to have realized gains taxed only as part of the individual's estate -- subject to an appropriate escrow account being established for money which would otherwise be expected to be beyond U.S. jurisdiction at the time of death.

In sum, imposition of a non-discriminatory tax on accrued income at the time citizenship is renounced, in a manner consistent with the way in which that same income would be treated at the time of death, does not appear to me to violate either the internationally protected right to emigrate or the (somewhat less well protected) right to a nationality.

Thank you for the opportunity to clarify my views on this important matter.

Yours sincerely,

Hurst Hannum
Associate Professor
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March 14, 1995

Comments in Response to Title II of H.R. 981,
The Proposed "Tax Compliance Act of 1995" (the "Proposal")

Prepared By: Michael Rosenberg,
Dennis Ginsburg, and
Leslie A. Share

1. Sec. 201 - Revision of Tax Rules on Expatriation.

We believe that if a citizen's expatriation does not have as one of its principal purposes the avoidance of U.S. taxes, proposed § 877A should not apply. There are many situations where a citizen may expatriate for non-tax motivated reasons. Automatic income taxation regardless of motive is a harsh consequence, especially noting that the tax avoidance purpose has long been a sound statutory requirement in the existing § 877 expatriation tax rules. A review of the § 877 history should reflect that very few citizens have been able to expatriate while overcoming the tax avoidance motive.

We recognize the government's objective to preclude the avoidance of U.S. income taxation where such avoidance does not appear justified, but we feel the Proposal is too broad and thus appears to be confiscatory in nature. To activate an "immediate" income tax consequence at the time a U.S. citizen relinquishes citizenship or a long-term resident ceases to be subject to tax as a resident, contradicts our system of fairness. Hereafter, such persons are referred to as expatriates and their acts are referred to as expatriation or expatriating. Also, we see no need to limit the term "long-term resident" to include only a lawful permanent resident who otherwise satisfies the 10 out of 15 taxable years rule discussed below. Because the existing and proposed expatriation provisions are "tax" driven, we believe that any U.S. income tax resident that satisfies the 10 out of 15 taxable years rule should be subjected to the provisions. The Proposal should provide a definite mechanism whereby the income tax would not be due until such time that each particular asset is in fact sold or otherwise disposed of in a realization event.

We do not believe that Treasury has adequately considered the potential repercussions of the proposed "toll charge" tax. For example, assuming the Proposal is intended to tax extremely wealthy U.S. citizens [the type highlighted in the Treasury News Release dated February 7, 1995 ("TNR") and the February 22, 1995 PrimeTime Live television show], it may follow that such individuals own one or more closely held U.S. corporations or businesses which employ hundreds, if not thousands, of U.S. citizens and residents. If the act of expatriation were to be treated as an immediate sale for income tax purposes, the tax liabilities could in many cases result in a total liquidation of such U.S. corporations or businesses. The result could be tremendous potential unemployment and related social problems to the employees involved. There are many provisions in the U.S. tax law and regulations thereunder that provide for "security and collateral arrangements" and from an equitable viewpoint, we suggest that an appropriate security or collateral alternative be included in the Proposal. As addressed below, we believe that the Proposal's 5-year maximum deferral for the payment of tax is insufficient.

Next, we believe that to conclude that expatriates holding "certain interests in trust" own trust assets as their assets for purposes of the expatriation tax, and possibly own "other interests in property specified by the Secretary as necessary or appropriate to carry out the purposes of this section," is unrealistic. If the proposed § 679(e) rules are applied for this purpose, expatriates would likely be subject to immediate tax on amounts which have never been actually owned by them and which they have no rights to receive and in fact may never receive under long-established trust law concepts. Such a confiscatory concept is unfamiliar to the U.S. and is possibly unconstitutional as the result could be taxation without income. At a minimum, we recommend assets held in trusts at the effective date of the Proposal be "grandfathered" as neither the settlors nor the beneficiaries of such trusts will have been able to consider the economic impact of the Proposal as to these assets. Such "grandfathering" is the norm and not the exception. See Chapters 13 and 14 of the Internal Revenue Code of 1986, as amended.

The Proposal to terminate deferrals relating to income or gain recognition (e.g., installment sales) and extensions of time for payment of tax are also overly broad. We reiterate our strong contention that if the Proposal is ultimately enacted, it should include a mechanism for expatriates to tender security or collateral arrangements to defer the U.S.

income tax until a "real" taxable sale or disposition occurs (i.e., defer taxation until income realization).

For assets deemed sold under the § 877A proposal, we feel it would be extremely unfair to limit the basis election "step-up" to only non-citizen long-term residents (and not to U.S. citizens). Numerous citizens were initially permanent residents and they too may have owned assets long before they obtained citizenship (or U.S. income tax resident alien status). Their assets may have in fact depreciated since they obtained citizenship status or lawful permanent resident status. We suggest that any citizen who at one time was previously a non-citizen of the U.S. be entitled to the basis step-up offered to the long-term resident. We also feel that to tax all assets which would be subject to estate tax if the individual had died at the time of expatriation is overly broad as it subjects such assets both to the Proposal and to the continuing estate tax anti-expatriation rules. Certainly, at a minimum, assets which would be considered as held as of the Proposal's effective date but of which the taxpayer cannot obtain ownership of to assist in the payment of the tax should be exempted.

From a fairness viewpoint, many long-term residents who would be entitled to the basis step-up election (and hopefully U.S. citizens as well if our comments are ultimately incorporated in the Proposal) may have already sold or disposed of assets in a prior year in a taxable transaction where U.S. income tax may have been paid as a result of such individual's not previously being entitled to any basis step-up provision. We suggest that any individual in this situation be given a reasonable period of time to file for a refund of U.S. income tax and not be foreclosed from such refund opportunity as a result of the normal statute of limitations.

Any extensive overhaul of the expatriation tax rules should be carefully drafted. Preventing certain U.S. citizens from "possibly" expatriating by inserting the proposed February 6, 1995 retroactive date should not outweigh the more important need to draft the Proposal in an equitable manner. The Proposal should consider the many different scenarios and not just those highlighted in the TNR and the PrimeTime Live show. For example, there will be U.S. born citizens owning assets in and/or outside the U.S., and U.S. citizens who have only recently obtained citizenship and a majority of whose wealth is attributable to assets outside of the U.S. (which assets, for instance, may have depreciated in value since such individual became a U.S. citizen or a U.S. income tax resident

alien). We are a strong and great country, and although it is possible that certain individuals may expatriate in the interim, we believe that the Proposal should contain as an effective date the date of enactment. Prior thereto, all relevant scenarios should be properly considered in the Proposal. We believe that to quickly enact such an overly broad and sweeping tax change with a retroactive date is bad tax policy and alters our standards of fairness. Retroactive taxation could have consequences far worse than the loss of the tax dollars associated with those few who may possibly expatriate prior to the enactment of an appropriate and fair statute. In addition, to avoid future confusion and unfairness, the most logical and effective means of administering these rules would be to provide all nonresident aliens who become U.S. citizens or income tax residents with a contemporaneous step-up in basis for their assets. This step-up should, at a minimum, apply to those assets which otherwise would not have been subject to U.S. income tax in the hands of a nonresident alien individual.

A deferral for closely-held business interests for an expatriating long-term resident for not more than 5 years is an insufficient deferral. As stated above, we believe that the income tax should be deferred until an actual sale or exchange (realization event) occurs, with proper security or collateral made available to the government until the tax is paid. However, if such a mechanism is not ultimately included in the Proposal, we suggest that a more reasonable payout period be included such as 20 years. Furthermore, because no "real" sale or exchange will have occurred, and assuming the government is adequately secured or collateralized, it does not seem just that a taxpayer should be charged interest for his or her deferring the payment of tax on a "hypothetical" gain which has not yet been realized. If the government's primary objective is to make certain that income tax is paid to the U.S. in connection with "built-in gains" of an expatriate's assets, and in particular U.S. assets, we feel strongly that the type of individual involved will be able to enter into a combination security/collateral arrangement and income tax payment schedule that should more than adequately protect the U.S. government. Also, we contend that for any expatriation income tax purpose, "built-in gains" should be limited to the asset appreciation which occurred while the expatriate was a U.S. citizen or a U.S. income tax resident but not for appreciation occurring prior thereto.

The TNR generally provides that gains accruing during the time that a taxpayer was a citizen or long-term resident should be subject to U.S. tax if those persons abandon their U.S. status. The Proposal goes far beyond that statement unless each expatriate is able to obtain a basis step-up for gains accruing prior to such citizen or long-term resident status. Also, the reference therein to the Canadian tax system seems misplaced, especially noting that Canada has long given a step-up to foreigners immigrating to Canada for purposes of Canadian taxation. Furthermore, from a social and economic viewpoint and noting that we are not experts in statistics concerning persons emigrating from one country to another, based on our years of experience, it would appear that far more individuals leave Canada for the U.S. or elsewhere than do U.S. citizens or long-term residents for Canada or elsewhere. A reason often cited to us by persons leaving other countries is the increasingly confiscatory tax policies of such countries. As previously stated above, we fear that the social and economic image of the U.S. will be adversely affected if our citizens and long-term residents begin to view our tax policies as confiscatory in nature.

The proposed $500,000 exclusion for amounts earned in foreign pension plans similarly requires considerable clarification. Many former foreign persons come to the U.S. with substantial amounts already invested by them or on their behalf in connection with amounts earned for services performed in his or her capacity as a nonresident alien individual entirely outside the United States.

Next, the illustration involving Mr. Greenback and Retail, Inc. may not be totally accurate. We have met several clients who have indicated that where intangible property is concerned, other countries better protect such rights and oftentimes offer more supplemental type benefits for businesses to be started or maintained in such jurisdictions. Also, many clients cite the costly U.S. labor market, our high crime rates, our drug problems, and our educational crisis as negative factors when compared to certain foreign countries. To "hand-pick" an illustration that may not reflect facts which exist in all or a majority of the perceived abuses is arguably misleading.

With democracy expanding throughout the world and there being a great opportunity for our country to attract new citizens and residents (i.e., new taxpayers), we should carefully incorporate fairness into our tax legislation or the U.S. too will find an increasing number of people opting to

reside elsewhere. In addition, as stated above, if the Proposal is intended to eliminate certain perceived abusive U.S. income tax avoidance, we feel that it should be expanded to include as a long-term resident any alien who has been subject to U.S. income tax as a resident for at least 10 taxable years during the period of 15 taxable years ending with the taxable year during which the expatriation occurred, regardless of lawful permanent status for immigration purposes.

In general, we believe that most of our existing tax laws are more than adequate - the lack of compliance is the problem. For instance, for tax years beginning after December 31, 1984, a statutory definition of an income tax resident alien has existed, yet we believe that thousands of aliens fail to file Forms 1040 while having U.S. income tax resident alien status. More effort should be focused on compliance, not on the constant introduction of complex and unnecessary new laws.

2. Sec. 202 - Improved Information Reporting on Foreign Trusts.

We are in agreement with the need for rigid information reporting requirements. Compliance must be assured in situations where a U.S. person has transferred property to a foreign trust which will ultimately benefit one or more U.S. person beneficiaries. However, the provision can be read so as to require reporting whenever there is any transfer by a U.S. person to the trust. For example, interest paid by a U.S. banking institution or otherwise where there is full consideration. Such transfers for full and adequate consideration should not result in reporting.

3. Sec. 203 - Modification of Rules Relating to Foreign Trusts Having One or More U.S. Beneficiaries.

We agree with the Proposal to eliminate abuses through transfers by reason of death or transfers where gain is recognized in transactions which, from a commercial viewpoint, do not encompass arm's-length standards both from a substantive and procedural viewpoint. However, we disagree with the proposed "grantor trust" treatment if a foreign person becomes a U.S. income tax resident within 5 years after directly or indirectly transferring property to a foreign trust.

If there is a genuine abuse and we do not believe there is (as those who completely and genuinely make transfers to foreign trusts before becoming a U.S. person no longer derive

any benefits therefrom), we could understand some reasonable time period (e.g., possibly 12 months) in order to preclude the perceived abuses, but it appears totally unjustifiable to treat, as a U.S. person-transferor, a foreign person who later decides to become a U.S. income tax resident 2, 3, 4, or up to 5 years after his or her transfers to the foreign trust. If, <u>based on existing rules</u>, the real problem from a compliance viewpoint is making certain that appropriate parties associated with foreign trusts satisfy the requisite reporting and pay any U.S. tax due, our suggestion would be to enhance the notice, return and filing requirements as proposed by Sec. 202 but not to enact unnecessary and somewhat illogical rules to result in conclusions that should not otherwise apply. If an individual who transfers property to a foreign trust having one or more U.S. person beneficiaries is in fact a U.S. person at the time of the transfer, or possibly "shortly thereafter" (e.g., words similar to those used in the proposed generation-skipping transfer tax anti-abuse rules), we can understand such rationale. However, to attempt to incorporate a 5-year period does not seem appropriate especially where there is no inquiry under the rule as to why the trust may have been established or even for how long the beneficiaries may have been U.S. persons.

The Proposal regarding the determination of a beneficiary's interest in a trust does not follow standards consistent with that applied for the tax treatment of trust beneficiaries in general. We have stated certain of our objections above in our comments relating to the Proposal regarding expatriation. To "overhaul" normal long-standing tax rules solely for the purpose of closing "perceived" abuses in the international tax arena is not appropriate unless the same tax principles are simultaneously overhauled for all purposes of U.S. tax law. There are many circumstances where, for valid non-tax related reasons, a trust beneficiary may never receive anything approximating his "deemed" interest in the trust. For example, assume a parent establishes a discretionary trust providing an independent trustee with total discretion to make distributions to his 4 children, 1 or 2 of whom have had strained relationships with their parent. The trustee was to carefully watch the development and maturity process of the children to determine when and if any distributions from the trust would be paid to any one of them. Litigation and inequitable taxation will certainly result if any beneficiary would be assessed tax under the Proposal as if such person had received an equal distribution when, in fact, he or she may never receive anything. Such overkill does not seem appropriate and may result in more problems than were anticipated when

the Proposal was drafted. We reiterate, at a minimum, that assets held as of the effective date should be grandfathered.

4. Sec. 204 - Foreign Persons Not to be Treated as Owners Under Grantor Trust Rules.

Existing § 672(f) indeed corrects the former abusive nominee grantor planning technique. Such a technique was so abusive that we feel it would not have withstood attack by the Service under normal U.S. tax rules, case law, etc. even prior to its enactment. However, to expand § 672(f) to actual situations where a real (not nominee) grantor is a foreign person who chooses to utilize a foreign trust vehicle for the ultimate benefit of beneficiaries which may or may not include eventual U.S. persons is illogical, unfair, and a major contradiction of the long-standing grantor trust provisions.

For many years, the grantor trust provisions have resulted in surprising or adverse U.S. tax consequences to individuals who were unfamiliar with the broad-based application of those rules. We feel that it would not be justified to eliminate tax benefits in the international tax arena solely because certain U.S. person beneficiaries may benefit. Furthermore, the Proposal could significantly hurt the international trust business which includes numerous subsidiaries or affiliates of major U.S. and foreign financial institutions. Many of these institutions employ U.S. citizens and income tax residents.

For example, if a foreign grantor wishes to place $2 Million in a foreign trust for the benefit of his children, one or more of whom may be, or may eventually be, U.S. person beneficiaries, if such foreign grantor retains the power to revoke the trust (a real power), he is now considered the taxpayer for U.S. income tax purposes. Whether or not U.S. tax will be due will depend upon the type of investment made by the trust. If the income is dividends from a U.S. corporation, the normal regular or tax treaty rate withholding tax is due. However, if the income is from U.S. certificates of deposit or portfolio interest exempt investments (the types intended by Congress to attract foreign investors and which provide exempt interest), no tax should be due.

If the grantor chooses not to exercise his power of revocation, but instead allows the trust corpus to grow by recontributing thereto (through his or her non-action) the yearly income or part thereof, such funds should be corpus for all purposes including for the purposes of taxation of the

beneficiaries, if and when such funds are later distributed to a U.S. person beneficiary. We believe it would serve no substantive purpose to require the foreign person to withdraw annual income and make current gifts, or to instead administer his assets through a will, a bank account, or some other type of vehicle that would require probate or would significantly reduce the numerous advantages to utilizing a trust (one of the most popular vehicles used throughout the U.S. in connection with estate plans). We are in agreement with the Proposal regarding situations where certain tainted provisions are included in the trust in order to make it a grantor trust [e.g., the § 674(c) power to add to the class of beneficiaries or the § 675(4)(c) power to reacquire the trust corpus by substituting other property of an equivalent value]. However, it is unreasonable to eliminate grantor trust status where a foreign grantor or his spouse retains real powers, benefits, rights, or interests in the trust income and corpus (for example, where current §§ 673 or 677 would apply).

In Internal Revenue Service Commissioner Margaret Milner Richardson's March 2, 1995 speech before the International Fiscal Association's USA Branch meeting, she stated in part: "On the inbound side, wealthy foreign families are establishing foreign trusts for the benefit of U.S. persons who live well in this country without paying income taxes." Taking into account our unified U.S. estate and gift tax exemptions, the marital deduction, tax exempt bonds, and other planning possibilities, there are likely numerous situations where U.S. persons "live well in this country without paying income tax." This should not be a reason to target the foreign grantor trust for change unless our Congress wishes to also target those many U.S. persons who live well in this country without paying income taxes.

5. Sec. 205 - Gratuitous Transfers by Partnerships and Foreign Corporations.

The Proposal is a fair approach to establishing appropriate reporting to make certain that the "alleged" donee has received a non-taxable gift and not "accumulated trust income" or some other form of income.

6. Sec. 206 - Information Reporting Regarding Large Foreign Gifts.

The Proposal is a fair reporting requirement from a compliance viewpoint. However, consistent with our prior comments, we feel that any reporting requirements should not be used to convert what in fact is a gift into taxable income.

For example, assume: (a) a foreign person establishes a foreign trust with $2 Million cash, (b) the foreign person retains the power to revoke the trust, (c) the annual trust income is $160,000, and (d) the trustee, pursuant to the terms of the foreign trust, pays such amount to a U.S. person beneficiary because the foreign grantor did not exercise his or her power to withdraw the income. This payment is a gift pursuant to Rev. Rul. 69-70. The ruling is a proper application of long-standing trust income tax rules.

Had the foreign grantor instead: (a) opened a $2 Million certificate of deposit with a foreign bank, and (b) collected and immediately transferred the $160,000 to a U.S. person beneficiary, the beneficiary would have no U.S. income. The Proposal, thus, is overly-broad in disregarding the grantor trust rules where the grantor is not a U.S. citizen or a U.S. income tax resident. As stated previously, the Proposal will disrupt the international financial trust industry without any reasonable rationale.

If the sole purpose for the Proposal relating to reporting requirements is to make certain that U.S. person beneficiaries who are in fact receiving income (not corpus) from the trust, or some other form of income that might be subject to U.S. income tax under other existing principles (e.g., for the fair rental value of property owned by a foreign trust which is used by a U.S. person beneficiary), then we applaud the reporting requirements for those purposes.

7. Sec. 207 - Rules Relating to Foreign Trusts Which Are Not Grantor Trusts.

We are in agreement with the Proposal subject to our prior comments objecting to eliminating the application of the grantor trust rules to a non-U.S. person grantor who in fact maintains appropriate benefits, rights, powers, or interests in the trust, for example, through the power to revoke. We are also in agreement with the proposed interest rate charge changes. Also, we applaud the Proposal that the interest charge not apply to any portion of an accumulation which

occurred during the period in which the beneficiary was not a U.S. citizen or U.S. income tax resident alien. We believe the Proposal confirms the legislative intent regarding the interest charge.

In general, we agree with the Proposal dealing with the treatment of using trust property but consideration should be given to establishing appropriate rules so that any "use value" that is treated as an amount paid to a trust participant (other than from income for the taxable year) is not taxed a second time when actual accumulated income is in fact distributed to a beneficiary.

Next, we believe that the special rule for cash equivalents is too broad and should not apply where the borrower is required to pay an arm's-length interest rate. Arm's-length loans are a basic general principle of income taxation, and domestic and foreign trusts should not be treated any differently in this context.

Furthermore, to disregard any subsequent transaction such as a repayment between the trust and the original borrower does not seem appropriate and possibly the borrower should be entitled to "reverse" or apply for a refund (notwithstanding the normal statute of limitations) should the Proposal be enacted. It is illogical to impute income in a situation where the taxpayer having income imputed to him or her ultimately repays the amount borrowed. It would be reasonable to impute some type of "use value" where the interest rate paid is not arm's-length but the Proposal seems unfairly broad.

8. Sec. 208 - Residence of Estates and Trusts.

We are in agreement with the Proposal as it will eliminate much of the unnecessary confusion relating to the foreign versus domestic status of an estate or trust.

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March 20, 1995

FEDERAL EXPRESS

The Honorable Bob Packwood
Chairman, Committee on Finance
United States Senate
Dickson Senate Office Building
Room 219
Washington, DC 20510

The Honorable Daniel P. Moynihan
Ranking Minority Member,
Committee on Finance
United States Senate
Hart Senate Office Building
Room 203
Washington, DC 20510

Dear Chairman Packwood and Senator Moynihan:

I would like to comment on the provisions of Section 5 of H.R. 831 as reported by the Committee on Finance (the "Committee Bill").

I am a partner in the law firm Ropes & Gray in Boston, where I practice international tax law on behalf of U.S. and non-U.S. corporate and individual clients. Prior to joining Ropes & Gray, I served as International Tax Counsel to the U.S. Treasury Department. Altogether, I served in the Treasury Department for five years during the Reagan Administration.

Although I am Vice Chairman of the American Bar Association Section of Taxation's Committee on Foreign Activities of U.S. Taxpayers and an active member of several other bar and professional associations, my comments are not made as a representative of Ropes & Gray or any of its clients, the American Bar Association Tax Section or any of the other bar or professional associations of which I am a member. My comments are directed exclusively to tax policy aspects of the proposal in the Committee Bill to amend the Internal Revenue

Code of 1986, as amended, by adding proposed Section 877A.[1] Subject to certain technical comments referred to below, I strongly support enactment of proposed Section 877A.

Description of Current Law

The United States exercises personal jurisdiction to tax individuals by taxing the worldwide income of U.S. citizens (whether or not resident or domiciled in the United States) and residents.[2] A U.S. taxpayer may elect to credit foreign income taxes against his U.S. tax, subject to a limitation that applies with respect to categories of foreign source income to restrict the credit to the amount of U.S. tax paid with respect to income in that category.

The United States asserts a source-based tax on nonresident aliens.[3] Nonresident aliens are taxed on the gross amount of U.S.-source interest, dividends, rents, and other fixed or determinable income at a flat rate of 30 percent (or a lower treaty rate). This tax generally is collected by withholding. A nonresident alien is taxed at regular graduated rates on income that is effectively connected with a U.S. trade or business, less deductions that are properly allocable to the effectively connected income. A nonresident alien individual is allowed a foreign tax credit under Section 906 only for foreign taxes paid with respect to income effectively connected with a U.S. trade or business.

Under current law, the only income tax provision governing a change from citizenship to non-citizenship status is Section 877, first enacted in 1966. Under Section 877, a U.S. citizen who relinquishes his U.S. citizenship with a principal purpose to avoid Federal income tax is taxed either as a nonresident alien or under an alternative taxing method, whichever yields the greater tax, for 10 years after expatriation. For purposes of determining the tax under the alternative method, gains on the sale of property located in the United States and stocks and securities issued by U.S. persons are treated as U.S.-source income, taxable at rates

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and as proposed to be amended by the Committee Bill.

[2] Taxation on the basis of citizenship is different from the practice of most countries, which is to tax individuals on the basis of residence. The Supreme Court, however, has upheld the constitutionality of taxing a nonresident citizen. *Cook v. Tait*, 265 U.S. 47 (1924).

[3] A nonresident alien individual is an individual who is neither a U.S. citizen nor a resident alien. Generally, an alien individual is a resident alien for U.S. tax purposes under Section 7701(b) if he or she (1) is a lawful permanent resident of the United States (i.e., holds a green card), or (2) satisfies the "substantial presence" test as a result of being physically present in the United States for a prescribed amount of time.

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applicable to U.S. citizens.[4]

Whether tax avoidance is a principal purpose for the expatriation is determined by all of the relevant facts and circumstances. If the I.R.S. establishes that it is reasonable to believe that the loss of U.S. citizenship would result in a substantial reduction in the taxpayer's income taxes for the year (taking account of U.S. and foreign taxes), the burden of proving that the loss of citizenship did not have tax avoidance as one of its principal purposes is on the taxpayer. This presumption is rebuttable.[5]

A foreign tax credit is not allowed for foreign taxes on income that is deemed to be U.S.-source income under the alternative method. The effect of the source rules generally is to transform foreign income that would not be effectively connected income into U.S gross income. Because Section 877(c) does not cause the income to be effectively connected income, the Section 906 foreign tax credit will not apply. Any foreign taxes imposed on the income re-sourced under Section 877(c) therefore would give rise to double taxation.

The so-called savings clause found in most modern income tax treaties generally provides that the United States may tax its citizens and residents as though the treaty had not come into effect.[6] Although the I.R.S. has published a revenue ruling taking the position that

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[4] These same taxing rules also are applied under Section 7701(b)(10) in the case of a resident alien individual who is resident in the United States for three consecutive years, then ceases to be a resident, and subsequently becomes a resident within three years after the close of the initial residency period. This anti-abuse rule protects the U.S. tax base from erosion by a resident alien who transfers residence from the United States for a limited period of time in order to sell a highly appreciated asset and then resumes his or her U.S. residence.

[5] See, e.g., *Furstenberg v. Commissioner*, 83 T.C. 755 (1984).

[6] See U.S. Department of the Treasury, Proposed Model Convention Between the United States and ___________ for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Art. 1(3) (1981), reprinted in 1 Tax Treaties (CCH) ¶ 208 (1994) (hereinafter "U.S. Model Treaty"). An important exception to the savings clause is the obligation of a contracting state to give double tax relief for taxes imposed by the source country.

The savings clause implements the U.S. policy that tax treaties generally are not intended to affect U.S. taxation of U.S. citizens or residents. American Law Institute, Federal Income Tax Project: International Aspects of United States Income Taxation (Proposals of the American Law Institute on United States Income Tax Treaties), 229, N. 606 (1992).

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the savings clause preserved U.S. taxation of former citizens taxable under Section 877,[7] the Tax Court held in *Crow v. Commissioner*, 85 T.C. 376 (1985), that the savings clause of the 1942 United States - Canada Income Tax Convention did not apply to a former citizen who, it was assumed for purposes of deciding petitioner's motion for summary judgment, expatriated to Canada for a principal purpose of avoiding United States tax. The Court found that, properly interpreted, the Convention prohibited the United States from taxing the taxpayer's capital gain from the sale of stock under Section 877. Based on the *Crow* decision, it is doubtful whether the United States may tax a treaty resident under Section 877 on income that a treaty reserves for taxation by the country of residence unless the treaty specifically preserves the U.S. right to tax a Section 877 expatriate.

Current U.S. treaty policy is to cover Section 877 expatriates under the savings clause to permit the United States to tax income or gains of a Section 877 expatriate who is resident in the treaty partner country notwithstanding other articles of the treaty.[8] Even where the savings clause covers taxation of an expatriate under Section 877, the coverage may be less than complete.[9]

It does not appear that treaties remedy the failure of the domestic law foreign tax credit mechanism to avoid double taxation under Section 877. For example, the 1980 Convention between the United States and Canada allows the United States to impose tax on gains from the sale of stock in a U.S. company realized by a Section 877 expatriate who is resident in Canada.[10] Canada also would be allowed to tax the gains.[11] For purposes of

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[7] Rev. Rul. 79-152, 1979-1 C.B. 237 (holding that a liquidating distribution would be taxable to a Section 877 expatriate that acquired residence in a treaty country even though the treaty did not preserve U.S. right to tax under Section 877).

[8] See U.S. Department of the Treasury, Proposed Model Convention Between the United States and ___________ for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Art. 1(3) (1981), reprinted in 1 Tax Treaties (CCH) ¶ 208 (1994).

[9] The 1993 U.S. treaty with the Netherlands, for example, does not cover Section 877 expatriates who are Dutch nationals. Convention Between the United States of America and The Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Art. 24(1).

[10] Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital ("U.S. - Canada Treaty"), Art. XXIX(2).

[11] U.S. - Canada Treaty, Art. XIII(4).

applying the foreign tax credit provisions of the Convention, the gains from the sale of stock would be treated as Canadian-source income,[12] however, the United States does not commit to allow a credit for the Canadian tax.[13]

Deficiencies of Current Law

The reason for enactment of Section 877 in 1966 was that the elimination of graduated rates with respect to non-effectively connected income of a nonresident alien could encourage some individuals to surrender their U.S. citizenship and move abroad. The 89th Congress did not have any experience as to whether the other changes in taxation of nonresident aliens made by the Foreign Investors Tax Act of 1966 would induce expatriations and chose to employ a tax avoidance purpose condition to the application of Section 877.

The facts of the *Furstenberg* case, in which the Tax Court found that the taxpayer's expatriation did not have tax avoidance as a principal purpose, illustrate why a tax avoidance purpose standard is ill-advised. To satisfy a commitment made before her marriage to her new husband, Mrs. Furstenberg renounced her U.S. citizenship immediately after her honeymoon on December 23, 1975. As a result of the Tax Court's decision that Section 877 did not apply, it appears that Mrs. Furstenberg paid no U.S. tax on as much as $9.8 million of capital gains from selling securities owned at the time of her expatriation in the two years following her expatriation.

There is ample precedent for a U.S. claim to tax appreciated assets at a time when the asset will no longer be subject to U.S. personal taxing jurisdiction. Under sections 367 and 1491, the United States overrides otherwise applicable nonrecognition rules in order to tax transfers of appreciated assets to foreign entities. It is accepted that this principle should apply in circumstances where there is no actual transfer of an asset, for example, upon the termination of an election by a foreign corporation to be treated as a domestic corporation under section 1504(d) or when a foreign trust ceases to be a grantor trust with a U.S. grantor. Amendments in 1984 to sections 367 and 1492 deleted exceptions to taxation of such outbound transfers where the taxpayer could establish that the transfer did not have as one of its principal purposes the avoidance of Federal income taxes. The principal purpose test similarly should be deleted from Section 877.[14]

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[12] U.S. - Canada Treaty, Art. XXIV(3)(b).

[13] See U.S. - Canada Treaty, Art. XXIV(1).

[14] There are a series of exceptions to taxation at the time of transfer under sections 367 and 1491 that are based in substantial part on the fact that the transferring shareholder

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A second difficulty with current Section 877 relates to the assertion of U.S. taxing jurisdiction after the taxpayer has renounced U.S. citizenship. At that point, the taxpayer may be resident in another taxing jurisdiction that may rightfully feel that it has the primary right to tax gains of a resident from the sale of tangible property (other than real estate in another country) and intangible property. It is not surprising that there may be disagreement as to which country should be considered to have the primary right to tax. A tax imposed at the time of expatriation, however, would accurately delineate gains properly subject to U.S. taxing jurisdiction. This would improve the position of the United States if it asks treaty partners to increase a taxpayer's basis in property taxed by the United States on expatriation for purposes of taxation by the treaty partner. If taxation at the time of expatriation is adopted, I would urge the Treasury to take such a position in treaty negotiations.

A third problem with current Section 877 is that it is easily avoided. I quote from a 1993 article published in Tax Notes International:

> "Even for those nonresident former U.S. citizens with substantial U.S assets and income, there are techniques that can greatly reduce the impact of the anti-abuse rules by converting U.S. income and assets into foreign income and assets or by deferring income and taxable transfers until after the 10-year period under the anti-abuse rules has expired.
>
> For example, consider the plight of a tax-motivated former U.S. citizen living abroad and owning a portfolio of U.S. stocks and bonds. Without taking any measures, such a person would be subject to U.S. income tax on interest, dividends and capital gain from the portfolio and would be subject to a U.S. estate and gift tax on taxable transfers of assets in the portfolio. Such an individual could, however, transfer the portfolio to a foreign corporation that is not engaged in a U.S. trade or business with drastically more favorable results.
>
> For income tax purposes, the foreign corporation would itself be taxed in the same manner as an NRA who had never been a U.S. citizen (i.e., gross U.S.-source dividends would be subject to a flat 30- percent-or-lower withholding tax, certain types of U.S.-source interest would be subject to a similar flat withholding tax while other types of U.S.-source interest would be exempt under the portfolio interest or other exemptions and capital gains would be exempt from tax unless real estate related).

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remains subject to residence-based taxation on property that receives a carryover basis in the exchange for the transferred property. That circumstance is not present in the context of Section 877.

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> While a sale of stock in the foreign corporation by the former U.S citizen would be treated as taxable U.S.-source income under the anti-abuse rule, a sale of the U.S stocks and securities in the portfolio by the foreign corporation would not. Moreover, dividends by the foreign corporation to its shareholders would be foreign-source, and therefore free from U.S. tax, even if the foreign corporation's earnings out of which it pays the dividends are U.S.-source interest, dividends, and capital gains." (Footnotes omitted.)[15]

In light of the increasing sophistication of taxpayers, it is not surprising that the easy pickings of tax-motivated expatriation are too tempting for some to resist. Based on informal discussions with the State Department, the Staff of the Joint Committee on Taxation has reported that 697 citizens expatriated in 1993 and 858 in 1994.[16] There is evidence that some of these expatriations will result in substantial revenue loss as a result of the infirmities of current Section 877. It is time to amend the law to address current realities

Description of Proposed Section 877A

Under the Committee Bill, a U.S. citizen who relinquishes U.S. citizenship generally would be treated as having sold all of his or her property at fair market value immediately prior to relinquishing citizenship and gain or loss from the deemed sale would be subject to U.S. income tax. In addition, the deferral of tax or income recognition (e.g., due to the installment method) would terminate on the date of the deemed sale and the deferred tax would be due and payable on that date.

Generally property interests that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of the deemed sale, plus certain trust interests that are not otherwise included in the gross estate, would be taxed on the expatriation date. The first $600,000 of net gain recognized on the deemed sale would be exempt from tax. If a taxpayer were determined to hold an interest in a trust for purposes of Section 877A, the trust would be treated as though it sold the taxpayer's share of assets of the trust and the proceeds were distributed to the taxpayer and recontributed to the trust

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[15] Zimble, "Expatriate Games: The U.S. Taxation of Former Citizens," Tax Notes Int'l (Nov. 2, 1993), LEXIS 93 TNI 211-15.

[16] Staff of the Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 1996 Budget Proposal,"Footnote 6 (JCS-5-95, Feb. 15, 1995).

The Honorable Bob Packwood
The Honorable Daniel P. Moynihan
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U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally would be excepted from the proposal.[17] Certain interests in qualified retirement plans and, subject to a limit of $ 500,000, interests in foreign pension plans (as provided in regulations) also would be excepted from the deemed sale rule

A U.S. citizen would be treated as having relinquished his citizenship on the earlier of (i) the date he renounces citizenship before a diplomatic or consular officer, (ii) the date he provides to the State department a signed statement of voluntary relinquishment of citizenship confirming an act of expatriation under the Immigration and Nationality Act, (iii) the date that the U.S. Department of State issues a certificate of loss of nationality, or (iv) the date a court cancels a naturalized citizen's certificate of naturalization. The tax would be due on the 90th day after the expatriation date. The Internal Revenue Service would be authorized to allow a taxpayer to defer payment of the tax for up to 10 years under section 6161 as though the tax were an estate tax imposed by chapter 11.

The Committee Bill's Section 877A would be effective for U.S. citizens who relinquish their U.S. citizenship on or after February 6, 1995. No tax would be due before 90 days after enactment.

Analysis of Proposed Section 877A

The Committee Bill meets the three objections to current law Section 877 described above. It deletes the tax avoidance purpose test. It imposes tax on gain determined as of the date a taxpayer relinquishes citizenship and thereby properly measures the gain subject to U.S. personal taxing jurisdiction. As a consequence of these changes it will be more administrable and not subject to easy avoidance.

The Committee Bill also reflects several significant improvements over the text released in the original version of H.R. 981. The definition of when a taxpayer relinquishes citizenship has been modified to relate to the earliest of several substantive acts that manifest an intent to voluntarily relinquish citizenship. This should adequately protect taxpayers who have relied on current law. The I.R.S. authority to extend the time to make payment of the tax is expanded to permit deferral of up to 10 years under rules that are commonly used in the estate tax context. These changes are welcome.

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[17] The exception would apply to all U.S. real property interests, as defined in section 897(c)(1), except stock of a U.S. real property holding corporation that does not satisfy the requirements of section 897(c)(2) on the date of the deemed sale.

I suggest another modification to the Committee Bill. I recommend that an alien that becomes a naturalized citizen take a "fresh start" fair market basis in his or her assets for purposes of Section 877A. The measuring date for this purpose should be the earliest of (i) the date the alien becomes a naturalized citizen, (ii) the date the alien becomes a resident alien, and (iii) the date the asset is "effectively connected" with a U.S. trade or business of the alien. This measure is important to support the position that the U.S. claim to tax is truly related to its personal or source taxing jurisdiction.

I reserve comment on certain technical aspects of the proposal and would be pleased to work with the Committee staff on the details of final legislation. In particular, I do not comment, without further study, on the approach taken by the Committee Bill to interests in trusts or to the interaction of Section 877A with estate and gift tax rules.

Finally, I respectfully disagree with certain initial criticisms of H.R. 981 in comments prepared by other individual members of the American Bar Association.

The weight of scholarship rejects the view that realization is or should be constitutionally required to tax gains. Since, in my experience, Congress, and this Committee, exercises an appropriate skepticism regarding professorial musings, perhaps the more relevant precedent is that Congress has enacted at least two provisions that tax gains before they are realized. Section 1256 was added to the Code in 1981 and provides that certain regulated futures and foreign currency contracts are marked-to-market on the last day of a taxpayer's taxable year and gain or loss recognized.[18] Section 475, enacted in 1993, requires securities dealers to mark-to-market securities held in inventory on the last day of the taxable year and recognize gain or loss. Moreover, fairness to taxpayers as well as the Government's revenue interests may require that such mark-to-market treatment be expanded to a broader range of circumstances. It would be extremely unwise for this Committee to adopt the holding of *Eisner v. Macomber*[19] in a way that could be viewed as imposing a constitutionally-based realization requirement.

I also would not in any way equate the imposition by the United States, in 1995, of a tax on its fair share of the appreciation in assets owned by U.S. persons during their period of U.S. citizenship to an exit tax imposed on Jewish and politically motivated emigrants from the Union of Soviet Socialist Republics during the State-sponsored repression of the Brezhnev

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[18] The Ninth Circuit has passed favorably on the constitutionality of Section 1256. *Murphy v. United States*, 992 F. 2d 929 (9th Cir. 1993)

[19] 252 U.S. 189 (1920).

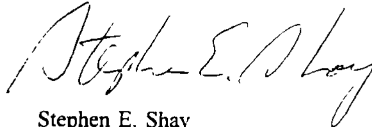
era. A tax that excludes the first $600,000 of gain can hardly be viewed as a barrier to emigration.

Conclusion

The Committee's proposed Section 877A is a improvement over current law, is sound international tax policy and deserves the strong support of your Committee

Please do not hesitate to contact me if I may be of assistance to the Committee

Sincerely,



Stephen E. Shay

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BACKGROUND AND ISSUES RELATING TO TAXATION OF U.S. CITIZENS WHO RELINQUISH CITIZENSHIP

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

of the

SENATE COMMITTEE ON FINANCE

on March 21, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 20, 1995

JCX-14-95

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BACKGROUND AND ISSUES RELATING TO TAXATION OF U.S. CITIZENS WHO RELINQUISH CITIZENSHIP

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 21, 1995, on the issue of the tax treatment of individuals who relinquish their U S citizenship The President's fiscal year 1996 budget proposals submitted on February 6, 1995, included a proposal to impose income tax on unrealized gains of U.S citizens who relinquish their U.S citizenship and certain long-term residents of the United States who relinquish their U S residency This proposal was included as section 201 of S 453 (introduced by Senators Daschle and Moynihan on February 16, 1995)

On March 15, 1995, the Committee on Finance approved an amendment to H.R 831 (sec 5 of the bill) to impose Federal income tax on unrealized gains of individuals who relinquish their U.S citizenship The property of such individuals generally would be considered as sold under the bill, and the net gain subject to U.S income tax. Net gain on the deemed sale would be recognized under the bill only to the extent it exceeds $600,000 ($1 2 million in the case of married individuals filing a joint return, both of whom expatriate)

This document[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules, section 5 of H.R 831 and the Administration proposal (sec 201 of S 453), background information, and a discussion of issues Part I of this document is a brief overview of present law. Part II is a description of section 5 of H R 831 and certain possible modifications to the provision. Part III discusses background on other countries' tax laws regarding expatriation and immigration and issues relating to the enforcement and collection of taxes owed by former citizens and related issues Appendix A gives a 1963 opinion of the General Counsel of the Treasury Department regarding the constitutionality of then-proposed legislation to tax capital gains from property transferred by donation or death, and Appendix B gives a 1995 opinion of the Office of Legal Advisor, U S Department of State, regarding the application of the Jackson-Vanik Amendment to the proposed expatriation tax

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[1] This document may be cited as follows: Joint Committee on Taxation, Background and Issues relating to Taxation of U S Citizens who Relinquish Citizenship (JCX-14-95), March 20, 1995

I. PRESENT LAW

U S citizens and residents generally are subject to U S income taxation on their worldwide income (sec 61 of the Code and Treas Reg sec 1-1 1(b)) The U S tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign income (secs 901-907) Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U S sources, and at regular graduated rates on net profits derived from a U S business (sec 871)

The United States imposes tax on gains recognized by foreign persons that are attributable to dispositions of interests in U S real property (secs 897, 1445, 6039C, and 6652(f), known as the Foreign Investment in Real Property Tax Act ("FIRPTA")) [2] Such gains generally are subject to tax at the same rates that apply to similar income received by U S persons The Code imposes a withholding obligation when a U S real property interest is acquired from a foreign person (sec 1445) The amount required to be withheld on the sale by a foreign investor of a U S real property interest is generally 10 percent of the amount realized (gross sales price) (sec 1445(a)) However, the amount withheld generally will not exceed the transferor's maximum tax liability if a certificate for reduced withholding is issued by the Internal Revenue Service (IRS) (sec 1445(c)(1))

Distributions, including lump-sum distributions, that foreign persons receive from qualified U S retirement plans generally are subject to U S tax at a 30-percent rate However, to the extent these distributions represent contributions with respect to services performed in the United States after 1986, the distributions are subject to U S tax at graduated rates The U S tax is frequently reduced or eliminated under applicable U S income tax treaties

A U S citizen who relinquishes U S citizenship with a principal purpose to avoid Federal tax may be subjected to an alternative taxing method for 10 years after expatriation (sec 877) A special rule applies with respect to the burden of proving the existence or nonexistence of U S tax avoidance as one of the principal purposes of the expatriation Under this provision, the Treasury Department may establish that it is reasonable to believe that the expatriate's loss of U S

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[2] Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U S Virgin Islands Also included in the definition of a U S real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U S real property holding corporation (USRPHC) at any time during the five-year period ending on the date of the disposition of the interest (sec 897(c)(1)(A)(ii)) A USRPHC is any corporation, the fair market value of whose U S real property interests equals or exceeds 50 percent of the sum of the fair market values of (i) its U S real property interests, (ii) its interests in foreign real property, plus (iii) any other of its assets which are used or held for use in a trade or business (sec 897(c)(2))

citizenship would, but for the application of this provision, result in a substantial reduction in the U S tax based on the expatriate's probable income for the taxable year (sec 877(e)) If this reasonable belief is established, then the expatriate must carry the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U S income, estate or gift taxes

Under this alternative method, the expatriate generally is taxed on his U S source income (net of certain deductions), as well as on certain business profits, at rates applicable to U S citizens and residents Solely for this purpose, gains on the sale of property located in the United States and stocks and securities issued by U S. persons also are treated as U S source income (sec 877(c)) The alternative method applies only if it results in a higher U S tax liability than the amount otherwise determined for nonresident aliens

The United States imposes its estate tax on the worldwide estates of persons who were citizens or domiciliaries of the United States at the time of death (secs 2001, 2031), and on certain property belonging to nondomiciliaries of the United States which is located in the United States at the time of their death (secs 2101, 2103) The U.S gift tax is imposed on all gifts made by U S citizens and domiciliaries, and on gifts of property made by nondomiciliaries where the property is located in the United States at the time of the gift (sec 2501)

II. DESCRIPTION OF BILL AND PROPOSED MODIFICATIONS

A. Description of Section 5 of H.R. 831 as Reported by the Senate Committee on Finance

In general

Under section 5 of H R 831 as reported by the Senate Committee on Finance, a U S citizen who relinquishes citizenship generally is treated as having sold all of his property at fair market value immediately prior to the expatriation Gain or loss from the deemed sale is recognized at that time, generally without regard to other provisions of the Code [3]

Net gain on the deemed sale is recognized under the bill only to the extent it exceeds $600,000 ($1 2 million in the case of married individuals filing a joint return, both of whom expatriate)

Property taken into account

Property treated as sold by an expatriating citizen under the provision includes all items that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of the deemed sale, plus certain trust interests that are not otherwise includible in the gross estate (discussed below under "Interests in trusts"), and other interests that may be specified by the Treasury Department in order to carry out the purposes of the provision

The bill provides that certain types of property, although includable in the gross estate were the expatriate to die while subject to U S estate tax, are not taken into account for purposes of determining the expatriation tax U S. real property interests, which remain subject to U S taxing jurisdiction in the hands of nonresident aliens, generally are not taken into account [4] Also not taken into account are interests in qualified retirement plans, other than interests attributable to excess contributions or contributions that violate any condition for tax-favored treatment In addition, under regulations, interests in foreign pension plans and similar retirement plans or programs are not taken into account, up to a maximum value of $500,000

Interests in trusts

Under the bill, an expatriate who is a beneficiary of a trust is deemed to be the sole

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[3] See the discussion of the application of the Code's income exclusions under "Other special rules" below

[4] The exception would apply to all U.S real property interests, as defined in section 897(c)(1), except the stock of a USRPHC that does not satisfy the requirements of section 897(c)(2) on the date of the deemed sale

beneficiary of a separate trust consisting of the assets allocable to his share of the trust, in accordance with his interest in the trust (discussed below) The separate trust is treated as selling its assets for fair market value immediately before the beneficiary relinquishes his citizenship, and distributing all resulting income and corpus to the beneficiary The beneficiary is treated as subsequently recontributing the assets to the trust. Consequently, the separate trust's basis in the assets will be stepped up and all assets held by the separate trust will be treated as corpus

The bill provides that a beneficiary's interest in a trust is determined on the basis of all facts and circumstances These include the terms of the trust instrument itself, any letter of wishes or similar document, historical patterns of trust distributions, the role of any trust protector or similar advisor, and anything else of relevance It is expected that the Treasury Department will issue regulations to provide guidance as to the determination of trust interests for purposes of the expatriation tax It is intended that such regulations disregard de minimis interests in trusts, such as an interest of less than a certain percentage of the trust as determined on an actuarial basis, or a contingent remainder interest that has less than a certain likelihood of occurrence

In the event that any beneficiaries' interests in the trust cannot be determined on the basis of the facts and circumstances, the beneficiary with the closest degree of family relationship to the settlor would be presumed to hold the remaining interests in the trust The beneficiaries would be required to disclose on their respective tax returns the methodology used to determine that beneficiary's interest in the trust, and whether that beneficiary knows (or has reason to know) that any other beneficiary of the trust uses a different method

It is intended that the special rule for interests in a trust not apply to a grantor trust The bill follows the grantor trust rules in treating a grantor of a grantor trust as the owner of the trust assets for tax purposes Therefore, a grantor who expatriates is treated as directly selling the assets held by the trust for purposes of computing the tax on expatriation Similarly, a beneficiary of a grantor trust who is not treated as an owner of a portion of the trust under the grantor trust rules is not considered to hold an interest in the trust for purposes of the expatriation tax

Date of relinquishment of citizenship

Under the bill, a U S citizen who renounces his U S nationality before a diplomatic or consular officer of the United States pursuant to section 349(a)(5) of the Immigration and Nationality Act (8 U S C section 1481(a)(5)) is treated as having relinquished his citizenship on that date, provided that the renunciation is later confirmed by the issuance of a certificate of loss of nationality by the U S Department of State A U.S citizen who furnishes to the State Department a signed statement of voluntary relinquishment of U S nationality confirming the performance of an expatriating act specified in section 349(a)(1) - (4) of the Immigration and Nationality Act (8 U S C section 1481(a)(1) - (4)) is treated as having relinquished his citizenship on the date such statement is so furnished, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality by the U.S Department of State Any other U.S citizen to whom the Department of State issues a certificate of loss of nationality

is treated as having relinquished his citizenship on the date that such certificate is issued to the individual A naturalized citizen is treated as having relinquished his citizenship on the date a court of the United States cancels his certificate of naturalization If any individual is described in more than one of the above categories, the individual is treated as having relinquished his citizenship on the earliest of the applicable dates

It is anticipated that an individual who has either renounced his citizenship or furnished a signed statement of voluntary relinquishment but has not received a certificate of loss of nationality from the Department of State by the date on which he is required to file a tax return covering the year of expatriation will file his U S tax return as if he expatriated It is further anticipated that such an individual will amend his return for that year in the event that the Department of State fails to confirm the expatriation by issuing a certificate of loss of nationality

Administrative requirements

Under the bill, an individual who is subject to the tax on expatriation is required to pay a tentative tax equal to the amount of tax that would have been due based on a hypothetical short tax year that ended on the date the individual relinquished his citizenship [5] The tentative tax is due on the 90th day after the date of relinquishment It is expected that Treasury regulations (under the authority of sec 6011) will require that the expatriate file a tax return at such time The individual also is required to file a tax return for the entire tax year during which he expatriated reporting all of his taxable income for the year, including gain attributable to the deemed sale of assets on the date of expatriation The individual's U S Federal income tax liability for such year will be reduced by the tentative tax paid with the filing of the hypothetical short-year return

The bill provides that the time for the payment of the tax on expatriation may be extended for a period not to exceed 10 years at the request of the taxpayer, as provided by section 6161 It is expected that a taxpayer's interest in non-liquid assets such as an interest in a closely-held business interest (as defined in sec 6166(b)) will be taken into account in determining reasonable cause for the extension of time to pay the tax on expatriation

In the event that the expatriating individual and the Treasury Department agree to defer payment of the tax on expatriation for a period that extends beyond the filing date for the full-year tax return for the year of expatriation, the bill provides that the individual would not be required to pay a tentative tax The entire gain on the deemed sale of property on the date of expatriation would be included in the individual's full-year tax return for that year, and would be paid in accordance with the provisions of the deferred-tax agreement under section 6161 It is

[5] Thus, the tentative tax is based on all the income, gain, deductions, loss and credits of the individual for the year through the date of relinquishment, including amounts realized from the deemed sale of property The tentative tax is treated as imposed immediately before the individual relinquishes citizenship

expected that the Treasury Department will not agree to defer payment of the tax on expatriation unless the taxpayer provides adequate assurance that all amounts due under the agreement will be paid

It is expected that the Department of State will notify the Internal Revenue Service (IRS) of the name and taxpayer identification number of any U S citizen who relinquishes U S citizenship promptly after the date of relinquishment, as defined in the provision [6] In addition, it is anticipated that the Department of State will request of any expatriating citizen, at the time of relinquishment of citizenship, appropriate information to assist the IRS in enforcing the requirements of the provision

Other special rules

As noted above, the tax on expatriation applies generally notwithstanding other provisions of the Code For example, gain that would be eligible for nonrecognition treatment if the property were actually sold is treated as recognized for purposes of the tax on expatriation In addition, for example, bona fide residence in a U S. possession or commonwealth does not affect the application of the expatriation tax [7] However, the bill provides that the portions of the gain treated as realized under the provisions of the expatriation tax are not recognized to the extent they are treated as excluded under the specific income exclusions of sections 101-137 (Subtitle A, Chapter 1B, Part III) of the Code

Other special rules of the Code may affect the characterization of amounts treated as realized under the expatriation tax For example, in the case of stock in a foreign corporation that was a controlled foreign corporation at any time during the five-year period ending on the date of the deemed sale, the gain recognized on the deemed sale is included in the shareholder's income as a dividend to the extent of certain earnings of the foreign corporation (see sec 1248)

The bill provides that any period during which recognition of income or gain is deferred will terminate on the date of the relinquishment, causing any deferred U.S. tax to be due and payable at the time specified by the Treasury Department For example, where an individual has disposed of certain property (e g , property that qualifies for like-kind exchange under sec 1031 or as a principal residence under sec 1034) but has not yet acquired replacement property, the relevant period to acquire any replacement property is deemed to terminate and the individual is taxed on the gain from the original sale

The bill authorizes the Treasury Department to issue regulations to permit a taxpayer to

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[6] That is, without waiting for the issuance of a certificate of loss of nationality

[7] Because there is no meaningful concept of citizenship of a U S. territory or possession, it is intended that the provision not be "mirrored" for application in the U.S territories and possessions that employ the mirror code

allocate the taxable gain (net of any applicable exclusion) to the basis of assets taxed under this provision, thereby preventing double taxation if the assets remain subject to U S tax jurisdiction

Effective date

The provision is effective for U.S citizens who relinquish their U S citizenship (as determined under the bill) on or after February 6, 1995 The tentative tax will not be required to be paid until 90 days after the date of enactment of the bill

Present law will continue to apply to U S citizens who relinquished their citizenship prior to February 6, 1995

B. Description of Certain Possible Modifications to Section 5 of H.R. 831

Application to long-term residents

As proposed in the President's fiscal year 1996 budget proposal,[8] the tax on expatriation also would apply to "long-term residents" who cease to be subject to tax as residents of the United States The proposal would define a long-term resident as an individual who had been a lawful permanent resident of the United States (i.e , a green-card holder), other than an individual who was taxed as a resident by another country under a treaty tie-breaker rule,[9] in at least 10 of the prior 15 taxable years [10] The original proposal also contains a special election that would

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[8] See section 201 of S 453 (introduced by Senators Daschle and Moynihan)

[9] Bilateral income tax treaties typically provide tie-breaker rules to specify the residence of an individual who may be subject to tax as a resident under the domestic laws of both countries (e g , a U.S citizen who resides in Germany) Under the OECD model treaty a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him If this test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i e , his "center of vital interests " If the country in which he has his center of vital interests cannot be determined, he will be deemed to be a resident of the country in which he has an habitual abode If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a national If he is a national of both countries or neither of them, the competent authorities of the two countries are to settle the question of residence by mutual agreement The residence tie-breaker rule in many U S income tax treaties follows the corresponding provision of the OECD model treaty

[10] If a long-term resident surrenders his green card, such person may still be treated as a resident for U S income tax purposes if he has a "substantial presence" within the United States (See sec. 7701(b)(3)) The proposal would not apply so long as such person continues to be treated as a tax resident under the substantial presence test

permit long-term residents to determine the tax basis of certain assets on the basis of their fair market value, rather than their historical cost The election would apply solely for purposes of determining the tax on expatriation If made, the election would apply to all assets within the scope of the proposal that were held on the date the individual first became a U S. resident and the fair market value would be determined as of such date

Possible modifications to the Administration's original proposal as it applies to long-term residents include, but are not limited to, the following The first modification would impose the tax on expatriation when a long-term resident is no longer treated as a lawful permanent resident of the United States as that term is defined in section 7701(b)(6) or when he claims to be a resident of another country under the tie-breaking provisions of a U S income tax treaty The second modification would provide that individual taxpayers have a fair market value basis in property owned by the individual as of the earlier of (1) the date he first became a U S citizen or resident, or (2) the date the property first became subject to U S tax because it was used in a U S trade or business or it was a U.S real property interest The fair market value basis would apply for purposes of computing gain or loss on actual or deemed dispositions (i e , not solely for purposes of determining the tax on expatriation), but would not apply for purposes of computing depreciation

Another possible modification of the Administration's proposal would clarify that all long-term residents subject to the expatriation tax would be presumed to be domiciled in the United States for purposes of the expatriation tax; consequently, gains and losses from a deemed sale of all their worldwide properties would be subject to the tax on expatriation

Change in "sailing permit" requirement

Another possible modification related to the proposed expatriate tax would replace the current "sailing permit" requirement under section 6851(d) with a new requirement to file a short-year tax return Section 6851(d) and the regulations thereunder currently require any alien who physically leaves the country--regardless of the duration of the trip--to obtain a certificate from the IRS District Director that he has complied with all U.S income tax obligations For example, a lawful permanent resident of the United States who lives near the Canadian or Mexican border is required to personally file an income tax return with the IRS District Director, and pay all taxes due for the year, before crossing the border to shop or have dinner Compliance with this requirement is infrequent The possible modification would require any alien resident of the United States who becomes a nonresident to file a tax return within 90 days of the date that he ceases to be a U S resident, and pay the relevant tax Nothing would be required of a resident alien who returns to the United States as a resident within 90 days of departure or otherwise maintains U S residence

III. BACKGROUND AND ISSUES RELATING TO THE IMPOSITION OF AN EXPATRIATION TAX

A. Summary of Other Countries' Tax Laws Regarding Expatriation and Immigration

Overview

The following is a preliminary survey of other countries' taxation of citizens and residents [11] While not an exhaustive survey, it reveals that most nations generally tax the worldwide income of their residents, whether citizens or aliens, but only the domestic source income of their nonresidents, whether citizens or aliens Hence, unlike in the United States, the criterion of residence rather than citizenship is central to the liability to tax in these countries Two exceptions are the Philippines, a former U S colony, and Eritrea The Philippines and Eritrea also tax their nonresident citizens on their worldwide income

Several European countries impose income tax on their former citizens or residents for some period of time after they become nonresidents Australia and Canada are the only countries that impose an exit tax when a resident leaves the country Also, it is generally the case that among those countries that tax capital gains, the gain is taxed upon realization by a resident taxpayer, regardless of whether some part of that gain may have accrued to the individual prior to his or her immigration to such country Australia, Canada, and Israel are exceptions to this general rule The relevant provisions relating to taxation of former residents, exit taxes, and the taxation of immigrants' accrued gains are described below

Taxation of former residents

Germany --Germany imposes a so-called "extended limited tax liability" on German citizens who emigrate to a tax-haven country or do not assume residence in any country and who maintain substantial economic ties with Germany (measured based on the relative amount of the individual's German source income or assets) This tax applies to a German citizen who was a tax resident of Germany for at least five years during the 10-year period immediately prior to the cessation of his residence The individual is taxed as a German resident for 10 years after expatriation This provision is similar to the present-law provision of the United States

A long-term (at least 10-year) resident of Germany, including a German citizen, who terminates his residence is deemed to have disposed of his ownership in certain German corporations Specifically, the individual is treated as having sold his interest in domestic corporations in which he owns more than 25 percent The gain from the deemed sale is taxed at

[11] The staff of the Joint Committee on Taxation conducted this survey with the assistance of the staff of the Law Library of Congress The results reported should not be interpreted as an authoritative representation of foreign laws, but rather as a more preliminary reading of foreign tax statutes

half of the regular tax rate If the taxpayer held the interest in the German corporation when he first became a German resident, he may use the fair market of the stock (in lieu of the historical cost) at the time he became a resident in computing the gain

Denmark --If an individual leaves Denmark after having been a permanent resident for at least four years, he remains a resident for income tax purposes for up to an additional four years unless he can establish that he is subject to a substantially equivalent income tax in his new country of residence In addition, a departing individual who has been resident for at least five of the preceding 10 years is deemed to have disposed of bonds or substantial holdings of stock

The Netherlands --The Netherlands asserts jurisdiction to tax the capital gains from the sale of substantial holdings in Dutch companies during the five years following emigration by a Dutch citizen A Dutch citizen who emigrates continues to be treated as a resident of the Netherlands for 10 years following emigration for gift and inheritance tax purposes

Sweden --A Swedish citizen or resident remains a resident for income tax purposes as long as he maintains essential ties with Sweden If the individual was a resident of Sweden for at least 10 years, he is deemed a resident for five years following departure unless it can be established that the individual has not maintained essential ties with Sweden If after the initial five-year period the Swedish government can establish that the individual has maintained essential ties with Sweden, the individual will continue to be taxed as a Swedish resident "Essential ties" to Sweden can include a family present in Sweden, a home available for use in Sweden, and the extent of economic activity in Sweden

Norway --Norway asserts tax liability on individuals who terminate their residence for tax purposes and who dispose of shares in a Norwegian company or partnership within five years of the year in which residence is terminated The tax liability extends to options or other financial instruments connected to such shares or partnership interests

Finland --A Finnish citizen who leaves the country is deemed to remain a resident for income tax purposes for three years unless he can establish that he has not maintained real connections with Finland

France --As provided by treaty, France can tax as a French resident any French citizen who moves to Monaco Emigration from France to anywhere else creates no French tax liability

Philippines --As noted above, like the United States, the Philippines asserts tax liability on all citizens based on their worldwide income A non-resident citizen is one who establishes to the satisfaction of the revenue authorities his physical presence abroad with the definite intention of residing there Nonresident citizens are taxed separately on their income from sources within the Philippines and on income from sources outside the Philippines. Tax rates on income from sources within the Philippines range from one to 35 percent The tax imposed on income from sources outside the Philippines permits a personal exemption and then has three rate brackets 1

percent on income greater than $0 and less than or equal to $6,000,[12] 2 percent on income greater than $6,000 and less than or equal to $20,000, and 3 percent on income in excess of $20,000

Eritrea --On February 10, 1995, Eritrea enacted a new tax law that applies only to its non-resident citizens The law imposes a 2-percent tax on the net income of non-resident citizens The Eritrean Ministry of Foreign Affairs is responsible for collecting such taxes through its embassies and consulates It is unclear what the tax status is of an Eritrean who gives up his citizenship

Imposition of exit tax on citizens or long-term residents

Australia --Australia imposes an exit tax when an Australian resident (including an Australian citizen) leaves the country For purposes of the exit tax, the resident is treated as having sold all of his non-Australian assets at fair market value at the time of departure An election is available for a taxpayer to defer the tax from the deemed sale on any asset until it is sold Electing individuals are expected to report voluntarily their gains and associated tax upon a subsequent disposition [13] No security is required to obtain the deferment of tax

There may be significant potential for noncompliance with respect to such an exit tax Assets that leave the country before the resident leaves are effectively beyond the reach of the Australian tax authorities

Canada --A taxpayer is deemed to have disposed of all capital gain property at its fair market value upon the occurrence of certain events, including death or relinquishment of residence Like Australia, a departing individual may elect to defer the tax on the accrued gain on any asset until the asset is sold However, the Canadian tax authorities generally require an electing taxpayer to provide security necessary to ensure that the deferred tax will be collected

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[12] The income of nonresident citizens from sources outside the Philippines is taxed on the basis of income expressed in U S dollars The local currency is the peso

[13] Nonresidents are subject to capital gains tax on taxable Australian assets including real property situated in Australia, stock holdings in non-publicly traded Australian companies, stock holdings in publicly traded companies where the nonresident shareholder (and related parties) hold 10 percent or more of the stock, interests in Australian partnerships, and holdings in Australian unit trusts (i e , mutual funds) where the nonresident owner (and related parties) hold 10 percent or more of the unit trust Bilateral income tax treaties often preclude taxation by one treaty country of capital gains realized by residents of the other treaty country, except for gains from the disposition of real property situated in the first country The U S -Australia income tax treaty, however, generally allows each country to tax capital gains from sources in that country realized by residents of the other country

Treatment of accrued gains of immigrants

If an individual emigrates from one country to another and if the former country either imposes a tax upon accrued gain at the time of exit or asserts tax liability on former residents, double taxation of income from capital gain may occur This problem would be eliminated if the immigrant country were to forgo taxation of any gain accrued on property owned by an immigrant prior to his or her immigration Both Australia and Canada, countries with an exit tax, forgo taxation of gain accrued prior to immigration An individual who becomes an Australian resident is permitted to take a basis in his non-Australian assets equal to their fair market value at that time, for all purposes The step-up is not a taxable event in Australia An individual who becomes a Canadian resident also is permitted to take a basis in his non-Canadian assets equal to their market value at that time, for all purposes The step-up is not a taxable event in Canada In both Australia and Canada, the exemption for previously accrued gain is permanent regardless of whether the individual subsequently sells the asset or holds it until death

Israel offers a limited exemption for gain accrued prior to immigration Immigrants are exempt from tax on capital gains from the realization of assets which they possessed prior to immigrating to Israel and which are sold within seven years of immigration [14] If such property is sold more than seven years after immigration, the entire gain is subject to Israeli tax

Australia, Canada, and Israel appear to be exceptions Most countries do not offer immigrants a step-up in basis on their assets (Australia and Canada) or a limited exemption (Israel) Among countries surveyed, the following countries tax the realized capital gains of residents, including gain accrued by immigrants prior to immigration Chile, Columbia, Czech Republic, Ecuador, Ethiopia, India, Iran, Japan, Korea, Mexico, Pakistan, Portugal, South Africa, Spain, Sweden, Taiwan, Turkey, United Kingdom, and Venezuela [15]

Among the countries listed above as imposing taxes on former residents, Germany generally exempts from income taxation gains on assets held for longer than six months [16] The Netherlands also generally exempts gain from tax except with respect to business assets and substantial interests in a Dutch company

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[14] The exemption appears to extend to any gain that accrues to the asset during the immigrant's first seven years in Israel

[15] Among countries listed above as imposing taxes on former residents, the survey reveals that Denmark, France, Finland, Norway, and the Philippines tax capital gains of residents, but no clear information was available on the treatment of gains that had accrued prior to an individual's immigration to one of these countries No information was found relating to the taxation of capital gains in Eritrea

[16] Germany subjects to income taxation gains from the sale of certain "speculative" assets and gain from the sale of real estate held for less than two years

B. Issues in the Enforcement and Collection of Taxes Owed by Former Citizens

1. Current enforcement of Code section 877

Under Code section 877, a U S citizen who relinquishes his citizenship for the purpose of avoiding payment of the U.S tax on worldwide income may continue to be assessed U S tax with respect to certain types of income (discussed in Present Law, above) for a period of 10 years after the relinquishment of citizenship Because the element of intent is involved, there is no data available on the number of citizens who relinquish their citizenship with a principal purpose of avoiding U S tax [17] This provision of the Code has been applied in very few cases

The IRS views the current structure of section 877 as inherently difficult to enforce Because a citizen may choose to relinquish citizenship for a variety of reasons, those properly subject to section 877 are not readily identifiable The imposition of the tax must often wait until property is sold, at which time the individual already has relinquished citizenship and left the United States, making it unlikely that the IRS will know of the sale and difficult to collect the tax even if it does learn of the sale Given these circumstances it may not be efficacious for the IRS to devote substantial resources to enforcement of section 877

On the other hand, the IRS has not requested the Department of State to regularly provide lists of Americans who renounce their citizenship Such a list could be cross-matched against the IRS's listing of "stop filers," that is, those taxpayers who do not file an income tax return in a year subsequent to having filed an income tax return While thousands of stop filers result from death of the taxpayer or retirement from the labor force, matching citizenship relinquishments against stop filers who had reported income above a certain level in the prior year, or prior several years, may indicate taxpayers who relinquished citizenship with a tax motivation [18]

2. Enforcement under the proposal

Like present law, absent enforcement initiatives by the IRS, the proposal relies on the voluntary compliance of expatriating citizens The major change in terms of voluntary compliance is to deem all expatriates with certain accrued capital gains in excess of $600,000 liable for tax Where present law requires the expatriate to make a judgement about whether his relinquishing of citizenship was tax motivated and then file returns for the subsequent 10 years, the proposal requires the expatriate whose accrued gains exceed the threshold to file a tax return within 90 days of expatriation Elimination of the "intent" test will provide clarity On the other hand, the

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[17] Since 1990, total relinquishments have ranged between 600 and 900 per year

[18] Such matching could be facilitated if upon relinquishment the individuals were required to provide their taxpayer identification numbers Such a requirement could necessitate changes to Department of State regulations or procedures

IRS can expect disputes over valuation of assets that are deemed to have been sold when no transaction, in fact, took place

Under both present law and the bill, the IRS may not learn about the expatriation until the individual has physically left the country. As under present law, absent administrative changes, the IRS will not know that an expatriate is liable for tax As under present law, under the proposal, physical separation from the United States may hinder the ability of the IRS to collect any tax owed With notification, the IRS can attempt to determine whether an expatriate possesses any assets within the United States that could be seized to satisfy the tax liability Seizure of assets for failure to pay taxes is permitted under present law In addition, the IRS could coordinate with the Customs Service and Immigration and Naturalization Service to detain noncompliant expatriates who attempt to re-enter the United States Present law would permit such coordination for purposes of collecting taxes assessed under section 877, if the IRS would seek to assess and collect such taxes On the other hand, by limiting the tax liability to individuals with accrued gains in excess of $600,000 and by removing the "intent" test, the IRS may find it efficacious under the proposal to devote more resources to the taxation of expatriates than it does under present law

C. Related Issues

1. Constitutionality of the proposal

The expatriation tax, as reported by the Committee on Finance (sec 5 of H R 831), would treat property held by a U S citizen who relinquishes his U S citizenship as if it were sold immediately before expatriation Thus, the act of expatriation would be treated as an event that causes the realization of gain

There has been an issue in Federal income tax law for the past 75 years whether, or to what extent, the 16th amendment to the Constitution permits Congress to levy income tax on income that has not actually been realized The U.S Supreme Court in *Eisner v. Macomber*, 252 U S 189 (1920), considered whether or not a stock dividend constituted income to the shareholders The Court held that by receiving a stock dividend, the shareholders had received nothing out of the corporation's assets for their separate use and benefit Therefore, they had received no income In response to the government's alternative argument that the tax was imposed on the shareholders' respective shares of the corporation's undistributed profits, the Court declared that such a tax would constitute the taxation of property because of ownership, and would be beyond the scope of income taxation permitted under the 16th amendment [19] The *Macomber* decision has become known for the principle that Federal income taxation must apply only to realized income

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[19] Such a tax would be clearly within the power to Congress to impose, but without the protection of the 16th amendment, would require apportionment

The realization principle has been criticized, limited, distinguished, and ignored since 1920, although it has never been reconfirmed or overruled In a leading commentary on principles of income taxation, Henry C Simons disagreed with the reasoning of the *Macomber* decision

> The decision that stock dividends should be ignored in calculating taxable income was eminently sound, as a judgment about a question of legislative policy It is most unfortunate, however, that a constitutional issue was ever raised, Actually, an utterly trivial issue was made the occasion for injecting into our fundamental law a mass of rhetorical confusion which no orderly mind can contemplate respectfully, and for giving constitutional status to naive and ridiculous notions about the nature of income and the rationale of income taxes [20]

In a review of the cases that followed *Macomber*, Stanley S Surrey characterized the Supreme Court as paying its respects to *Macomber*, but limiting the scope of a realization requirement [21] Based on 20 years of further development, Surrey reached a "sound conclusion that the formalistic doctrine of realization proclaimed by that decision is not a constitutional mandate "[22]

Congress has repeatedly approved income tax measures that appear to apply to unrealized income Beginning with the foreign personal holding company rules, which were enacted in 1937, and including the controlled foreign corporation rules (enacted in 1962) and the passive foreign investment company rules (enacted in 1986), the Federal income tax has taxed certain domestic shareholders on undistributed earnings of foreign corporations that meet certain characteristics The constitutionality of the foreign personal holding company rules, as applied in a case where distribution of the foreign income to the domestic shareholders was precluded by foreign currency controls, was upheld in *Eder v. Commissioner*, 138 F 2d 27 (2d Cir 1943), without reference to *Macomber* Following *Eder*, the same court upheld the constitutionality of the controlled foreign corporation rules in *Garlock, Inc. v. Commissioner*, 489 F.2d 197 (2d Cir 1973), *cert. denied*, 417 U S 911 (1974) ("The argument that [the controlled foreign corporation rules are] unconstitutional we think borders on the frivolous *Id.*, at 202), also without citing *Macomber* The controlled foreign corporation rules were upheld again in *Estate of Whitlock v Commissioner*, 59 T.C 490, *aff'd in part and rev'd in part*, 494 F 2d 1297 (10th Cir), *cert.*

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[20] *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, at 198-99 (1938) Simons would define income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question " *Id* , at 50 That is, consumption plus net increase in wealth during the period

[21] "The Supreme Court and the Federal Income Tax Some Implications of the Recent Decisions," 35 *Ill. L. Rev. of Northwestern Univ.* 779, 782 (1941)

[22] *Id.*, at 791

denied, 419 U S 839 (1974) The Tax Court in *Whitlock* both distinguished *Macomber* as applicable to accumulated rather than current earnings, and observed "that the continuing vitality of the *Macomber* doctrine is in considerable question " *Id.*, at 509, n 21

In the domestic area, the Federal income tax law has begun to require certain financial assets to be marked to market, or deemed to be sold, with income tax applicable to the gain that was not actually realized Mark-to-market regimes are applicable to commodities futures (sec 1256 of the Code, since 1981) and to securities dealers (sec 475 of the Code, since 1993) The constitutionality of these provisions under the *Macomber* doctrine has not been subject to a judicial challenge [23] Most commentators see the *Macomber* doctrine of realization as surviving in the tax law not as a constitutional requirement but only as a rule of administrative convenience or legislative generosity [24] Some others, however, see the realization requirement of *Macomber* yet valid, despite such repeated apparent violations [25]

Some have argued that the proposed expatriation tax most closely resembles never-enacted proposals to impose income tax at death on the unrealized appreciation of decedent's property Deemed realization at death has been criticized as an inappropriate event for a deemed realization "The event of death hardly qualifies as a tax realization transaction During his lifetime, a taxpayer has a choice of realizing gain on sale of an asset, paying the tax, and keeping the net proceeds, or of retaining the asset and not realizing a gain on it The occurrence of his death is hardly a voluntarily chosen event upon which to base the realization of gain "[26] Inasmuch as the event of expatriation, unlike death, generally is under the control of the taxpayer, the proposed expatriation tax might be more appropriately compared to unenacted proposals to tax the unrealized appreciation of property upon a gratuitous transfer of the property When the

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[23] The constitutionality of section 1256 was upheld on a theory of constructive receipt in *Murphy v. United States,* 992 F 2d 929 (9th Cir 1993) The court explicitly declined to address the constitutionality of Federal income taxation of unrealized gains on capital assets

[24] Boris I Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts,* at 5-20 (1989) See also, Noel B Cummingham and Deborah H Schenk, "Taxation Without Realization A 'Revolutionary' Approach to Ownership," 47 *Tax L. Rev.* 725, 741 n 69 ("Although an early case, *Eisner v. Macomber,* 252 U S 189 (1920) could be interpreted as supporting the restriction of income to realized gains, no case since then lends much credence to that argument The scholarly consensus is that Congress may treat gains as realized at any point [citations omitted]")

[25] See, e g , Henry Ordower, "Revisiting Realization Accretion Taxation, the Constitution, *Macomber,* and Mark to Market," 13 *Va. Tax Rev.* 1 (1993)

[26] Statement of Treasury Secretary William Simon, *Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Comm. on Ways and Means,* pt 2, 94th Cong , 2d Sess 1188-89 (1976)

Kennedy Administration proposed such a tax to Congress in 1963 (as well as a tax on appreciation at death), the Administration presented to Congress a legal memorandum from Treasury General Counsel Belin to Treasury Secretary Dillon, dated February 5, 1963, arguing that a taxpayer making a gratuitous transfer has control of the appreciation and transfers the appreciation in accordance with his decision The memorandum concluded with the "opinion that *Eisner v. Macomber* has limited, if any, application The constitutionality of the tax can be supported by the conclusions that an appreciation in property may be taxed upon the occurrence of an appropriate taxable event, which event is for Congress to determine, and that the taxpayer has realized the appreciation in value by his exercise of control over it and by his accomplishment of his economic objective with respect to that income "[27]

Some others have suggested that the proposed expatriation tax could be justified as a substitute for a reduced-rate estate tax If the proposal were structural as an estate tax, the 16th amendment and any realization requirement thereunder would be inapplicable

The Committee may wish to consider the extent to which the Constitution requires that Federal income taxes be imposed only on realized income, and the extent to which the proposed expatriation tax is consistent with any such requirement

2. Coordination with international conventions

Income tax treaties

U S citizens generally are subject to U S income taxation on their worldwide income, regardless of their residence (see Present Law, above) Most other nations generally tax the worldwide income of their residents (whether citizens or aliens) Thus, a U S citizen who resides outside the United States may be subject to tax on the same income by both the United States and his country of residence To avoid double taxation, however, the taxpayer's U S tax may be reduced or offset by a credit allowed for foreign taxes paid with respect to certain foreign income

Bilateral income tax treaties typically provide rules to specify the residence of an individual who may be subject to tax as a resident under the domestic laws of both countries The United States typically includes a "saving clause" in its bilateral income tax treaties in order to preserve its right to tax U S citizens who are residents of treaty partners The saving clause generally provides that notwithstanding any provision of a treaty, the United States may assert its jurisdiction to tax a citizen, or former citizen for a period of 10 years, as if the treaty had not come into effect

The proposed expatriation tax is triggered by a deemed sale of property that is treated as

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[27] *President's Tax Message of 1963: Hearings Before the House Comm. on Ways and Means,* 88th Cong , 1st Sess 596, 602 (1963) The text of the memorandum is reproduced in Appendix A

occurring immediately prior to the time when a U S citizen relinquishes his citizenship Thus, the tax is deemed to be imposed at a time when the expatriating individual is still a citizen of the United States and subject to U S tax on that basis As a result of the saving clause, a U S citizen who is a resident of a treaty partner may not escape the tax by claiming treaty benefits as a resident of the foreign country

General Agreement on Trade in Services (GATS)

Article XVII of GATS generally requires member nations to grant national treatment to all other member nations with respect to services and service suppliers The proposed expatriation tax applies to the accrued gain of individuals based on their U S citizenship The provision does not accord more or less favorable treatment to service suppliers of any nation that is a member to GATS Consequently, the provision would not violate GATS

North American Free Trade Agreement (NAFTA)

Article 2103 addresses taxation matters under NAFTA Paragraph 2 of Article 2103 (Taxation) states that a tax convention[28] shall generally prevail to the extent of any inconsistency with NAFTA The two exceptions to this rule, pertaining to national treatment available with respect to market access and export taxes, are not relevant to the tax on expatriation Because the proposal is consistent with the application of income tax treaties (see discussion under "Income tax treaties," above), it is outside the scope of NAFTA [29]

3. Application of the Jackson-Vanik amendment

The right to leave a country is a fundamental tenet of human rights, both the right to physically leave, or emigrate,[30] and the right to relinquish citizenship, or expatriate [31] In an effort to support these rights, especially with regard to emigration from the Soviet Union, Congress in

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[28] Defined as a convention for the avoidance of double taxation or other international taxation agreement or arrangement, under Article 2107 of NAFTA

[29] Even if the provision is interpreted to be outside of the scope of an income tax treaty because it is not specifically addressed by such treaty, the provision would not violate NAFTA because the subject matter is not addressed in Section 2103 of NAFTA

[30] Article 13 (2) of the Universal Declaration of Human Rights, adopted by the United Nations General Assembly on Dec 10, 1918, provides that "Everyone has the right to leave any country, including his own, and to return to his country "

[31] Article 15 (2) of the Universal Declaration of Human Rights, adopted by the United Nations General Assembly on Dec 10, 1918, provides that "No one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality "

1974 adopted the Jackson-Vanik amendment, which generally denies trade and other economic benefits to any "nonmarket economy country" that prohibits or unduly burdens emigration [32] The question has been raised whether the proposed expatriation tax is inconsistent with the human rights principles embodied in the Jackson-Vanik amendment

Specific Soviet anti-emigration policies considered objectionable under the Jackson-Vanik amendment included

- A passport application fee of 1000 rubles [33]
- An exit visa fee of 200 rubles
- Education repayment fees, in amounts that often exceeded 10,000 rubles, imposed on emigrants to non-Communist countries
- Immediate loss of Soviet citizenship (and revocation of Soviet passports) by applicants for emigration to Israel

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[32] The Jackson-Vanik amendment, section 402 of the Trade Act of 1974 (19 U S C sec 2432), provides in principal part as follows

(a) To assure the continued dedication of the United States to fundamental human rights, and notwithstanding any other provision of law, on or after the January 3, 1975, products from any nonmarket economy country shall not be eligible to receive nondiscriminatory treatment (most-favored-nation treatment), such country shall not participate in any program of the Government of the United States which extends credits or credit guarantees or investment guarantees, directly, or indirectly, and the President of the United States shall not conclude any commercial agreement with any such country, during the period beginning with the date on which the President determines that such country --

> (1) denies its citizens the right or opportunity to emigrate,
> (2) imposes more than a nominal tax on emigration or on the visas or other documents required for emigration, for any purposes or cause whatsoever, or
> (3) imposes more than a nominal tax, levy, fine, fee, or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice,

and ending on the date on which the President determines that such country is no longer in violation of paragraph (1), (2), or (3)

[33] The average monthly salary of a Soviet individual was approximately 370 rubles at that time Jim Nichol, *The Soviet Emigration and Travel Law: Assessments and Implications for U.S. Interests*, CRS Report to Congress No 91-518F, at CRS-12 (September 5, 1991)

The Soviet anti-emigration policies restricted the opportunities for citizens of the Soviet Union to travel outside the country and to live outside the country They were not directed toward Soviet citizens who voluntarily relinquished Soviet citizenship In addition, the Soviet exit fee operated as a head tax, applying without regard to the citizen's income or wealth

The U S Department of State, Office of the Legal Adviser, has prepared a letter expressing its opinion that an expatriation tax in the form originally proposed by the Administration[34] is consistent with international human rights law, and with the principles of the Jackson-Vanik amendment The opinion makes three points First, economic controls such as taxation on unrealized gains do not constitute a *de facto* denial of an individual's right to emigrate Second, the proposed expatriation tax, unlike the Jackson-Vanik amendment, concerns expatriation rather than emigration Third, the proposed expatriation tax would apply in most cases to individuals who had already physically left the United States The text of the letter appears in Appendix B

Notwithstanding the opinion of the Department of State, the Committee may wish to consider the extent to which the proposed expatriation tax is consistent with principles of international human rights and also represents sound policy in light of those principles

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[34] Section 201 of the Tax Compliance Act of 1995 (S 453)

APPENDICES

APPENDIX A:

1963 Opinion of the General Counsel of the Treasury Regarding the Constitutionality of Proposed Legislation to Tax Capital Gains from Property Transferred by Donation or Death

THE GENERAL COUNSEL OF THE TREASURY,
Washington, February 5, 1963

To Secretary Dillon
From G d'Andelot Belin
Subject Constitutionality of proposed legislation to tax capital gains from property transferred by donation or death

My opinion has been asked on the question whether Congress may constitutionally amend the provisions of the statutes taxing capital gains as income to provide that upon the transfer of property by donation or death the appreciated value of the property over the cost basis may be taxed as a capital gain to the donor or decedent

I. PRESENT STATUTORY FRAMEWORK

At the outset, I will outline briefly the present relevant congressional definition of income and the applicable statutory framework Congress has provided the basic definition of income in the Internal Revenue Code of 1954, 26 U S C , is section 61(a) This section states that "gross income means all income from whatever source derived, including (but not limited to) the following items *** (3) gains derived from dealings in property, *** " The determination of the amount, and the recognition, of gains derived from the disposition of property are provided for in subchapter O, sections 1001 *et seq.* In brief, a gain occurs on the sale or other disposition of property when the amount realized is in excess of the cost, sections 1001(a) and 1012 The amount realized is "the money received plus the fair market value of the property (other than money) received," section 1001(b) Congress has accorded, in subchapter P, a reduced tax treatment to those gains from the disposition of property which meet the definition of net long-term capital gains, sections 1201 *et seq* A net long-term capital gain is the gain from the sale or exchange of a "capital asset," which term is defined as property held by a taxpayer, with certain specific exceptions, in section 1221

The present law does not provide for taxation of gains (or the comparable treatment of losses) from the disposition of property by donation or at death The basis of property passing to a recipient in these events is, however, provided in sections 1014 and 1015 In the event of a gift, the donee takes the property on the cost basis of the last owner who has not received the property

by gift, section 1015(a) Therefore, the donee may be taxed on the appreciation of value, including that which occurred while held by the donor, when the donee sells or disposes of the property The proposed amendment would alter this arrangement by taxing the donor on the appreciation of the property up to the time of his gift, and the donee would, consequently, receive the property with the cost basis being the market value as obtained from the donor At present, in the event of death, the beneficiary receives the property of the decedent at the fair market value at the time of the death or at the optional alternate valuation date, section 1014 Consequently, the appreciation of value of the property while held by the decedent is lost to income taxation

II. CONSTITUTIONAL POWER OF CONGRESS

I turn now to the question whether there is any constitutional limitation on Congress which would prevent it from providing for recognition of a taxable gain or loss under the income tax law on the disposition of property by donation or death

The first power given to Congress by Article 1, section 8, of the Constitution, is the "Power To lay and collect Taxes " The 16th amendment, adopted in 1913, provides that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration "

In the 50 years since this amendment was adopted, Congress has defined and redefined income subject to tax, often as a result of restrictive court rulings [35] The Federal courts, in dealing with the concept of income, have come to recognize that Congress intended, in 26 U S C 61(a) and its predecessor sections, to use its full taxing power and that the courts should give a liberal construction to that power, recognizing broad discretion in Congress to define income See, *e.g.*, *James v. U.S.* (1961) 366 U S 213, at 218, 219; *Commissioner v. Glenshaw Glass Co.* (1955) 348 U S 426, at 429-431, and the following analytical commentaries. Alexander, "Federal Tax Handbook" (1960) at p 8, Paul, "Taxation in the United States" (1954) at pp 634, 637, 640, and Rapp, "Some Recent Developments in the Concept of Taxable Income," 11 Tax L Rev 329 (May 1956) at p 331

III. TAXABILITY OF APPRECIATION OF CAPITAL

Since 1920, definitions of income have often referred to the Supreme Court's dicta in the case of *Eisner v. Macomber*, 252 U S 189, concerning the taxation of gains accruing to capital In this case the Supreme Court held that a common stock dividend distributed to a common stockholder of the corporation which did not alter his ownership interest in the corporation was not income but the evidence of capital ownership The Court's definition of income was as follows "***Here we have the essential matter not a gain accruing to capital, not a growth or

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[35] See, e g , 26 U S C 61(8), including alimony in gross income and thus overturning the effect of *Gould v. Gould* (1917), 245 U S 151

increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however, invested or employed, and coming in, being 'derived,' that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal,--that is income derived from property Nothing else answers the description " [Italics omitted]

This opinion will demonstrate that the foregoing definition is not an obstacle is the proposed legislation for at least the following two reasons (1) later Supreme Court cases have so modified and qualified its concepts that there is every probability that the Supreme Court will now recognize power in Congress to tax appreciation in value as income at appropriate times, specifically, the Supreme Court has held taxable as income at an appropriate occasion appreciation in value which had not been severed from the capital asset and such appreciation which, by virtue of the control over it exercised by the taxpayer, had been received or held by another than the taxpayer, and (2) the proposed legislation is not inconsistent with the foregoing definition as it proposes to tax as income "something of exchangeable value" that is "drawn by" the taxpayer for his disposal " The increase in value, having exchangeable value, would be disposed of by the taxpayer according to his wishes to accomplish his economic objectives Under modern court rulings this disposition may be said to be a realization of income, as will be demonstrated in part IV of this opinion

Point (1) was fully developed in the Opinion of my predecessor, No 748, dated June 12, 1961, supporting the constitutionality of section 13 of H R 10650, placing a tax on the undistributed profits of certain foreign corporations controlled by U S citizens This tax was enacted as section 12 of Public Law 87-834, October 16, 1962, 78 Stat 1006

Suffice it to point out here that succeeding Supreme Court cases have greatly eroded both the holding and the dicta of *Macomber*. With respect to stock dividends in particular, the case has been clearly limited by subsequent decisions to the precise holding of a distribution of capital by a particular corporation to its stockholders which did not alter the interest of those stockholders in the identical corporation *United States v. Phellis* (1921), 257 U S 156, *Rockefeller v. United States* (1921), 257 U S. 176, *Marr v. United States* (1925), 268 U S 536, *Koshland v. Helvering* (1936), 298 U S 441, *Helvering v. Gowran* (1937), 302 U S 238, and see *Helvering v. Griffiths* (1943), 318 U.S 371, 375

Moreover, the Supreme Court has refused to be hobbled by that definition in determining other gross income questions not involving stock dividends. *United States v. Kirby Lumber Co.* (1931), 284 U S 1, *Helvering v. Bruun* (1940), 309 U S 461, *Commissioner v. Glenshaw Glass Co.* (1955), 348 U S 426, and *General American Investors Co. v. Commissioner* (C A 2d 1954), 211 F 2d 522, aff'd (1955), 348 U S 434 In the *Glenshaw Glass Co.* case the court said "*** it [*Eisner v. Macomber*] was not meant to provide a touchstone to all future gross income questions" (p 431) These and other recent Supreme Court cases have led many tax authorities to conclude that the doctrine of realization as formulated in 1920 is not a constitutional requirement and that any economic accretion to wealth may be taxable when it may be

conveniently measured [36]

In analyzing the present question, it is important to emphasize that the proposal is not to tax appreciation in value of property held by an owner, either periodically or as it accumulates, but when it is transferred The courts do generally deny taxation of mere appreciation when it appears to them that this has been undertaken by the Internal Revenue Service without congressional direction See *Campbell v. Prothro* (C A 5th 1954) 209 F 2d 331, 335 However, in the *Bruun* case, *supra*, the Supreme Court upheld the assessment by the Internal Revenue Service against a landlord of an income tax on the value added to the real estate by a building erected by a tenant, the value being determined at the time of the forfeiture of the lease Against the contention of the taxpayer that this taxation was unconstitutional under the Supreme Court's definition of income as gain "severed from capital" for the taxpayer's "separate use, benefit and disposal," the Court explained that definition was meant to clarify the distinction between an ordinary dividend and a stock dividend, that "the realization of gain need not be in cash derived from the sale of an asset," and that it was "not necessary to recognition of taxable gain" that the taxpayer should be able to sever the gain from the capital (p 469)

The extent to which the Supreme and Circuit Courts have gone in allowing a taxpayer to be taxed on income not "realized" or received by him in the traditional sense, point (2), will be discussed in part IV, below Most important for present purposes, however, is the fact that the concept of realization of income has been broadened in recent years, particularly in the area of the taxation of capital gains and gifts of income

Moreover, Congress has, in fact, taxed appreciation of property not received by the taxpayer when it was under this control and direction, as in the Foreign Personal Holding Company Act, enacted in 1937, now 26 U S C 551 *et seq.* The constitutionality of this enactment was upheld in *Eder v. Commissioner* (C C A 2d 1943), 138 F 2d 27, and acceptance of the act was indicated in Helvering v National Grocery Co (1938), 304 U S 282 fn 4 at p 288

IV. REALIZATION OF INCOME BY DISPOSITION ON DONATION OR DEATH

In my opinion, the proposed legislation is primarily an extension and elaboration of the concept of the capital gains tax itself, namely, that the appreciation in value of a capital asset may be taxed as income upon its transfer, the transfer being the taxable event at the time of which the appreciation in the value may be measured and taxed as income The Supreme Court quickly

[36] See, e g , Bittker, "Federal Income Taxation of Corporations and Shareholders" (1959) at p 169, Griswold, "Cases and Materials on Federal Taxation" (5th ed 1960) at p 142, Mintz, "Basic Concepts of Taxable Income," an article contained in "Practical Aspects of Federal Taxation" (1946) at p 17, Rabkin and Johnson, "Federal Income, Gift and Estate Taxation" (1956 ed) sec 1 02(2), and Wright, "The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts," 8 Stanford L Rev 164, at pp 201, 205 (March 1956)

rejected a taxpayer's contention that the doctrine of *Eisner v. Macomber* prevented the taxation of the increase in value of stock determined upon the occasion of its sale The Court pointed to its definition in that case as including profits gained from the sale or conversion of capital assets *Merchants Loan and Trust Co. v. Smietanka* (1921), 255 U S 509

The income tax now falls upon the occasion of a "sale or other disposition" of property, and the capital gains rate is applied upon the occasion of a "sale or exchange" of a capital asset The taxable event may be the voluntary act of the taxpayer or the happening of an event not the volition of the taxpayer, such as the taking of property in a condemnation proceeding *(Commissioner v. Kieselbach* (C C A 3d 1942), 127 F 2d 359, aff'd (1943) 317 U S 399) or for nonpayment of taxes (*Helvering v. Nebraska Bridge Supply & Lumber Co.* (1941), 312 U S 666, reversing (C C A 8th 1941) 115 F 2d 288) The proposed legislation would include as taxable events the act of the taxpayer in making a donation and the death of the taxpayer, on which events his property is measured, including the increase in value during his period of holding

If these two events, upon both of which property is transferred, are appropriate occasions for measuring the increase in value of property held by the taxpayer, as I believe they are, the next question is whether Congress is prevented by the Constitution from so designating them because the taxpayer may receive only the intangible benefits which cause and accompany benefactions, including the accumulation of property for the benefit of the taxpayer's heirs

The courts have already foreshadowed, without the benefit of statute, the possibility of recognizing as income subject to capital gains tax, the appreciation of property disposed of for which a value is received which cannot readily be described as having a "fair market value" under section 1001(b) The accomplishment of an economic objective of an intangible nature, the value of which can be measured only approximately by the amount of the appreciation of the property disposed of, has been held sufficient to justify the taxation of the appreciation to the taxpayer

The outstanding example of this recognition of capital gain is the recent Supreme Court decision in *United States v. Davis* (1962) 370 U S 65 Here the Supreme Court reversed the Court of Claims' decision, *Davis v. United States* (1961) 287 F 2d 168, which held that there was no taxable gain to the husband on the transfer of appreciated stock to his divorced wife in settlement of the wife's interest in his property The Court of Claims believed that the provisions of the capital gains tax could not apply as the amount realized by the husband was not determinable It had concluded that the value of the rights of the wife in the husband's property could not be estimated In this holding it followed the opinion of the 6th Circuit Court in 1960, in *C.I.R. v. Marshman* 279 F 2d 27, cert den (1960) 364 U S 918 The Supreme Court, however, reversed the Court of Claims and reestablished the holdings of the 3d and 2d Circuit Courts, *Commissioner v. Mesta* (C C A 3d 1941) 123 F 2d 986, cert den (1941) 316 U S 695, and *Commissioner v. Halliwell* (C C A 2d 1942) 131 F 2d 642, cert den (1942) 319 U S 741, which conflicted with the *Marshman* case Furthermore, it cited with approval two other important holdings under the capital gains statute, United States v General Shoe Corp (C A 6th 1960) 282 F 2d 9, cert den (1961) 365 U S 843, and *International Freighting Corp. v.*

Commissioner (C C A 2d 1943) 135 F 2d 310

The rationale of the Supreme Court in this case is important for our purposes It argued that the income tax consequences of the stock transfer required a two-step analysis first, "Was the transaction a taxable event?" and, second, "If so, how much taxable gain resulted therefrom?" (p 67) In deciding that the transfer was "an appropriate occasion for taxing the accretion to the stock" (p 68), the Court stated that there was no doubt that Congress by its inclusive definition of income subject to taxation as "all income from whatever source derived, including *** gains derived from dealings in property" intended that the economic growth of this stock be taxed "The problem confronting us is simply *when* is such accretion to be taxed Should the economic gain be presently assessed against the taxpayer or should this assessment await a subsequent transfer of the property by the wife? The controlling statutory language, which provides that gains from dealings in property are to be taxed upon 'sale or other disposition' is too general to include or exclude conclusively the transaction presently in issue" (pp 68, 69) The Court decided that the transfer was similar to a taxable transfer of property in exchange for the release of an independent legal obligation and that the transfer was therefore a taxable event It pointed out that the Court of Claims recognized this to be true but had "balked" at the "measurement" of the taxable gain realized by the taxpayer (p 71) The Supreme Court recognized that the measurement of the wife's rights, complicated by the emotion, tension, and practical necessities of divorce negotiations, could not be exact However, it concluded that "once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences" (pp 72, 73) It, therefore, held that the husband had realized the appreciation in the value of the stock from its cost basis to the time of the transfer to his wife and that this was taxable as a capital gain

The conclusions to be drawn from this *Davis* decision are, therefore, that appreciation in capital may be recognized as taxable upon the event of the disposition of the capital and that the gain may be measured by the amount of the appreciation itself where intangible subjective factors account for the disposition of the property

It is significant that the Supreme Court in the *Davis* case referred not only to the *Mesta* and *Halliwell* cases, *supra*, as precedent, they being marital obligation cases, but also to the *General Shoe* and the *International Freighting Corp* cases, *supra*, which involved an economic realization by the taxpayer not consisting of either money or the fair market value of property In the *General Shoe* case, the Corporation made a contribution to its employees' retirement fund of property which had appreciated in value and deducted from its income tax as a contribution the current market value of that property The Court held that the Corporation had realized capital gains on this transfer of appreciated property to the same extent as if it had sold the property and donated the proceeds to the retirement fund The Court found support in the reasoning of the Supreme Court in *Helvering v. Horst* (1940) 311 U S 112, 115 (discussed further below), in which the Court said "where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the

economic gain which has already accrued to him " The 6th Circuit Court went on to say in the *General Shoe* case

"*** To argue, as the taxpayer does here, that there can be no gain because nothing is realized, is unrealistic Literally the taxpayer is correct in its contention that it did not receive a tangible benefit *** however, we do not conceive that in this day and age we are restricted to tangibles in tax matters where there is actual recognizable benefits, albeit intangible, the taxation of which is implicit in the statutory scheme, and where such benefit is clearly capable of being evaluated on an objective basis "

The opinion in the *General Shoe Corp.* case was also built upon the *International Freighting Corp.* case (C C A 2d 1943) 135 F 2d 310 In that case the Circuit Court held that the Corporation realized taxable gain on the appreciation of the shares of stock which it owned and transferred to its employees as a bonus, deducting the fair market value of these shares as a business expense The Court recognized that the transfer was an appropriate business expense, not a gift, but that no money or property having a fair market value had been realized on the transfer of the shares However, the Court said, "in similar circumstances, it has been held that 'money's worth' is received and that such a receipt comes within section 111(b) [presently section 1001(b)]," citing the *Mesta* and *Halliwell* decisions

From the foregoing cases it appears that a taxable capital gain will be recognized by the court although the taxpayer has achieved some economic objective other than receipt of money or property having a fair market value, as specified by the statute It is sufficient if, as said in the *Horst* case, he has "the fruition of the economic gain which has already accrued to him " The fact that a taxable gain is not recognized from a gift of appreciated property is due solely to the absence of statutory definition This was recognized by the court in *Campbell v. Prothro* (C A 5th 1954) 209 F 2d 331, in declining to recognize a taxable gain from a gift by a farmer of calves to the Y M C A The court said that Congress had not so far adopted the rule that a gift of appreciated property makes the donor taxable on the appreciation and that under the statutes "as they exist" the court may not do so (p 336) The court concluded that a gift of farm products was a gift of capital assets and not of ordinary income to which the doctrine of *Helvering v. Horst, supra,* would apply, as contended by the Commissioner See note (1954) 22 G W L Rev 789, analyzing tax problems in gifts of farm products in the absence of the kind of statute now proposed

It would appear likely, therefore, that the courts would recognize any transfer of appreciated property as a taxable event if Congress broadens the statutory definition of the amount realized upon such a transfer to include the intangible economic values obtained from the making of a gift or bequest or devise or acceptance of intestacy

With respect to income other than capital gains, it has been established that a taxpayer who gives away such income over which he had control nevertheless realizes this income and may be taxed upon it This was the decision of the Supreme Court in *Helvering v. Horst* (1940) 311

U S 112, in which case a father who was the owner of a bond was held taxable on the interest received by the son after the gift to the son of the coupon which mature later in the same year The reasoning by Justice Stone in this case on what constitutes realization of income and on the purpose of the revenue laws has been widely quoted and followed by the Supreme Court and the Circuit Courts generally This reasoning, because of its importance, is set forth in the following quotations

"*** Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others, which constituted an economic gain to him

"Admittedly not all economic gain of the taxpayer is taxable income From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it And 'realization' is not deemed to occur until the income is paid But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him" (p 115)

"*** But the rule that income is not taxable until realized has never been taken to mean that the taxpayer even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property Cf *Aluminum Castings Co. v. Routzahn*, 282 U S 92, 98 This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth" (p 116)

"*** Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such nonmaterial satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son" (p 117)

"The power to dispose of income is the equivalent of ownership of it The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it" (p 118)

"The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid See, *Corliss v.*

Bowers, supra, 378, *Burnet v. Guggenheim*, 288 U S 280, 283 The tax laid by the 1934 Revenue Act upon income 'derived from *** wages, or compensation for personal service, of whatever kind and in whatever form paid, ***, also from interest ***' therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received" (p 119)

By comprehending "capital gain" within the term "income" or by substituting capital gain" for "income" in the appropriate places in the foregoing quotations one may see how readily the Court's thinking in this 1940 case could accommodate the concept of taxing capital gains upon such an event as death or gift, despite the fact that these gains were not paid to or received by the taxpayer in the ordinary sense of the word

The *Horst* decision was a development of the holding in *Lucas v Earl* (1930), 281 U S 111, in which a husband was held taxable on all his income although he had made a valid contract with his wife that all his future income should be held by them jointly In that case Justice Holmes interpreted the Federal income tax law as allowing for no "arrangement by which the fruits are attributed to a different tree from that on which they grew" (p 115) This metaphor has provided the rationale in many later income tax cases

The *Horst* was also followed in the companion case of *Helvering v. Eubank* (1940) 311 U S 122, holding a life insurance agent taxable on commissions paid in 1933 to persons to whom he assigned these commissions in 1924 and 1928 *Horst* was also followed in *Harrison v Schaffner* (1941) 312 U S 579 to hold taxable the donor of certain dollar amounts of income from a life estate Besides extensive quotations from the *Horst* opinion, the Court said that the exercise of power to procure payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever" (p 580) In both *Commissioner v. Tower* (1946) 327 U S 280 and *Lusthaus v. Commissioner* (1946) 327 U S 293, the husband was held taxable on income received by the wife from the corpus of property which he had previously given to her, indicting that the rule may be applied where the underlying income-producing property is disposed of In *Commissioner v. Sunnen* (1948) 333 U S 591, the *Horst* rule was applied to a taxpayer who had assigned royalty agreements, and in *Commissioner v. Lester* (1961) 366 U S 299, the rule of the *Horst* case that "the power to dispose of income is the equivalent of ownership of it" was applied to determine the appropriate taxpayer

The principles of the *Horst* case have been followed in a number of circuit court cases which look behind various business arrangements to tax the increase to the true owner and to place the income tax on the person who created and had control of the income even though he did not receive it See, e g , *Home Furniture Company v. C.I.R* (C C A 4th 1948) 168 F 2d 312, *Paster v. C.I.R.* (C A 8th 1957) 245 F 2d 381, *Factor v. C.I.R.* (C A 9th 1960) 281 F 2d 100

The *Horst* case, its precursors and its successors demonstrates that a taxpayer realizes

taxable income when he exercises control over income that is compensation for services or derived from business or royalties or other interests by giving it away There is thus no logical reason why Congress could not provide that this same principle shall apply to the exercise of control over income from gains from dealings in property when this control is exercised through donation, devise, bequest, or intestacy

The making of a donation, devise, or bequest is an affirmative act of control over property to obtain certain objectives of the taxpayer In either case the taxpayer has control of the appreciation in value and it is transferred in accordance with his decision In many cases the acceptance of intestacy is also a decision of the taxpayer which exercises control over the property by permitting its distribution in accordance with laws which would accomplish his own objectives To be sure, in some cases the "decision" of the taxpayer may be theoretical or nonexistent or may even have been contrary to his unexpressed wishes His will may even have been invalidated as the result of a contest Nonetheless, there seems no great conceptual difficulty in including intestate transfers along with those made by will as appropriate events upon which to measure and tax the gains which are by law distributable to the decedent's spouse and next of kin or heirs

V. SUMMARY

To recapitulate, it is my opinion that *Eisner v. Macomber* has limited, if any, application and does not stand in the way of the present proposals, that the transfers of appreciated property by gift or by death present appropriate occasions to measure the increase in the value of the property and to tax the capital gain to the donor or decedent, and that such a tax would be constitutional The constitutionality of the tax can be supported by the conclusions that an appreciation in property may be taxed upon the occurrence of an appropriate taxable event, which event is for Congress to determine, and that the taxpayer has realized the appreciation in value by this exercise of control over it and by his accomplishment of his economic objective with respect to that income

APPENDIX B:

Opinion of the Office of Legal Advisor, U.S. Department of State Regarding the Application of the Jackson-Vanik Amendment to the Proposed Expatriation Tax

United States Department of State
Washington, D C 20520

March 16, 1995

Edward Knight, Esq
General Counsel
U S Department of the Treasury
Room 3000
1500 Pennsylvania Avenue, N W
Washington, D C 20220

Dear Mr Knight

Your staff has inquired as to whether section [201] of the proposed Tax Compliance Act of 1995 raises legal questions concerning freedom of emigration, international human rights law, or provisions of Title IV of the Trade Act of 1974 (commonly known as "the Jackson-Vanik amendments")

The proposal in section [201] taxes the assets of U S citizens who elect to renounce U S citizenship and the assets of U S permanent residents who are no longer taxed as U S residents as a result of a change in their immigration status For this purpose, a taxpayer would be treated as owning those assets that would be included in the taxpayer's gross estate, as if that estate had been created on the date of expatriation The proposed provision would be applied to those assets, subject to a $600,000 exemption and other provisions

In our view, this provision does not conflict with international human rights law concerning an individual's right to freely emigrate from, i e , leave, his or her country of citizenship The right to leave the territory of a state (including one's country of nationality) and the right to renounce one's own citizenship are well recognized in international human rights law (See, e g , Universal Declaration of Human Rights articles 13(2) and 15(3), International Covenant on Civil and Political Rights article 12(2))

It is also equally well recognized that a state, in order to protect its interests, may impose economic controls on departure (e g , currency restrictions, taxes) as long as such controls do not result in a de facto denial of an individual's right to emigrate (See, e g , Hurst Hannum, The Right to Leave and Return in International Law and Practice 39-40 (1987)) Requiring individuals to pay taxes on gains that accrue prior to expatriation does not constitute a de facto denial of an individual's right to leave a country These are comparable taxes to those which U S citizens or permanent residents would have to pay were they in the United States at the time they disposed of the assets or at their death Proposed section [201] does not apply to emigration (but to renunciation of citizenship) and would not serve as a pretext for denying the right to emigrate from the United States or to renounce U S citizenship to all or any segment of the population

In addition, the proposal does not conflict with the Jackson-Vanik amendments to the Trade Act of 1974 (19 U S C 2432) Those amendments restrict the granting of most-favored-nation treatment and of certain trade related credits and guarantees to a limited number of non-market economies that unduly restrict the emigration of their nationals They do not apply to emigration from the United States or to the renunciation of U S citizenship

Neither does the proposed tax provision raise questions of disparate standards applicable to the United States as against the nonmarket economies subject to Jackson-Vanik restrictions This tax provision does not interfere with the right of an individual to physically depart from the United States, whether temporarily or permanently It only applies at the time an individual renounces his or her U S citizenship (or at the time a permanent resident is no longer eligible to be taxed as a resident of the U S) and not to the act of emigration

We also note that, under most circumstances, the proposal in section [201] will affect U.S citizens who have already departed the United States and, therefore, is unlikely to have any relation to their freedom of emigration (See, 8 U S C 1481(a))

I hope this information is helpful

Sincerely,

Michael J Matheson
Acting Legal Adviser

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