ADMINISTRATION'S PROPOSAL RELATING TO THE TAX TREATMENT OF AMERICANS WHO RENOUNCE CITIZENSHIP

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

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ADMINISTRATION'S PROPOSAL RELATING TO THE TAX TREATMENT OF AMERICANS WHO RENOUNCE CITIZENSHIP

MONDAY, MARCH 27, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to call, at 12:10 p.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
March 17, 1995
No. OV-5

CONTACT: (202) 225-7601

JOHNSON ANNOUNCES HEARING TO EXAMINE THE ADMINISTRATION'S PROPOSAL RELATING TO THE TAX TREATMENT OF AMERICANS WHO RENOUNCE CITIZENSHIP

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing to evaluate the provision in the Administration's FY 1996 budget proposals to impose a tax on U.S. citizens who renounce their citizenship and long-term resident aliens who give up their status as residents. **The hearing will be held on Monday, March 27, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 12:00 noon.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

U.S. citizens (regardless of their residence) and resident aliens generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. 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. Under present law, a U.S. citizen who abandons his or her citizenship with a principal purpose to avoid federal income tax may be subjected to an alternative taxing method on his or her U.S. source income for 10 years after expatriation.

Under the Administration's proposal, a U.S. citizen who relinquishes citizenship generally would be treated as having sold all of his or her assets at fair market value immediately prior to the relinquishment, and net gain from the deemed sale would be subject to U.S. income tax. The tax would also apply to a "long-term resident" (generally, a green card holder who resides in the U.S. for at least 10 of the prior 15 taxable years) who ceases to be subject to tax as a resident of the United States. The tax would apply whether or not the principal purpose of relinquishment of U.S. citizenship was tax motivated. The proposal would apply to U.S. residents who relinquish their citizenship and long-term residents who cease to be taxed as U.S. residents on or after February 6, 1995 (the date the Administration announced the proposal). On March 15, 1995, the Senate Committee on Finance adopted a modified version of the Administration's proposal during its consideration of H.R. 831.

H.R. 831, a bill to permanently extend the deduction for the health insurance costs of the self-employed, and for other purposes, was considered before the Committee on Ways and Means on February 8 and was passed by the House on February 2, 1995.

SCOPE OF THE HEARING:

Under present law, taxes are imposed on former U.S. citizens on U.S. source income for ten years following renunciation of citizenship if one of the principal purposes of the renunciation was to avoid U.S. income tax. A similar rule applies to resident aliens who cease to be residents. According to the Department of the Treasury, the existing rules to prevent tax avoidance through expatriation "have proven largely ineffective because departing taxpayers have found ways to restructure their activities to avoid those rules, and compliance is difficult to monitor." However, as the Administration's proposal is drafted, it would apply to *any* U.S. citizen who abandons his or her citizenship, not simply to those who expatriate for tax-motivated reasons.

The Subcommittee will examine the Administration's proposal and specific problems which the Internal Revenue Service has encountered in recent years in enforcing existing laws aimed at taxing former U.S. citizens who abandon their citizenship for tax-motivated reasons. If the aim of the Administration's expatriation proposal is to tighten the rules for tax-motivated expatriations, the Subcommittee wants to learn why the proposed solution applies broadly to all citizens who give up their U.S. citizenship, and consider whether more narrowly-targeted reforms would achieve the Administration's goals.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Monday, April 3, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

*****

Chairman JOHNSON. Good midday, everyone, and thank you for taking part in this hearing with us this afternoon. Today, we will examine the administration's proposal to impose a new tax on people who give up their U.S. citizenship.

Before we begin, I want to observe that while this is a serious proposal dealing with an important matter, much of the rhetoric surrounding this proposal has been less than helpful in focusing on the merits of the issue. People who give up their citizenship are not necessarily economic Benedict Arnolds, as proponents would label them, just as millions of immigrants who created and enriched this Nation over 200 years ago were not traitors to the countries they left.

Opportunity was and is the goal of those who come to the United States and to its citizens. Nor is the proposal necessarily an economic Berlin Wall, as critics have labeled it. The exemption to the proposal is generous enough to impose tax only on those with significant assets. Of course, new tax proposals may often seem benign when enacted and become more onerous with the passage of time and the changing whims of the Congress.

Take, for example, the income tax which started at 1 percent in 1913 and look at the current $600,000 estate tax exemption on which this proposal is modeled and which has been proposed for amendment by current House Minority Leader Gephardt to be reduced to a $200,000 exemption. I am also concerned that this proposal has a broader reach than may be necessary to address the primary concerns raised by the administration.

As I understand the administration's argument, the concern is over U.S. citizens who renounce citizenship for tax avoidance, but who continue to spend significant amounts of time in the United States. This proposal targets all individuals who renounce citizenship, whether or not they have a tax avoidance purpose and whether or not they continue to return to the United States afterward.

I also take very seriously the human rights issues that some of our witnesses today will discuss. While this proposal may not violate any current laws, I think the United States should lead by example. Our national interests may not be best served by drawing what some would see as a narrow distinction between this proposal and similar exit taxes that we have criticized when they were imposed by other countries.

It is possible that this proposal could be rewritten in a way that would more directly address the concerns raised by the administration, but I am concerned that Congress will not have the time to do this in connection with the bill to extend the self-employed health insurance deduction, which we all acknowledge must be enacted very soon.

On Friday, the Subcommittee held a hearing on the taxpayer bill of rights. With the testimony from that hearing fresh in my mind, I want to emphasize how important it is that this proposal not become another source of potential procedural friction between the Internal Revenue Service and law-abiding taxpayers.

For example, I would view it as a significant abuse of taxpayers' rights if the IRS were to attempt to use this proposal, if enacted, to change in any way the treatment of U.S. citizens who have not renounced their citizenship, notwithstanding any suspicion that an

overzealous tax collector may have about a citizen's intentions. That is the gray area and the deep water of this proposal before us.

I would like to express my appreciation to the witnesses who have come here on less than short notice, and I look forward to their testimony. I also appreciate the commitment of my Chairman, Chairman Archer, to not support any tax changes that haven't undergone public hearing in the House, and for that reason, we have convened this hearing, even on rather short notice.

I thank you. I would like to welcome our first witness today, Joseph Guttentag, the International Tax Counsel for the U.S. Department of Treasury—excuse me one moment. Before we proceed, my colleague, Mr. Ramstad, a new and esteemed Member of this Committee and one who has had some important experiences that will be useful to us as we move forward in our work, would like to make an opening comment.

Mr. RAMSTAD. Thank you, Madam Chair. Very briefly, I appreciate your leadership in calling today's hearing on the administration's proposal. I also share your concerns relative to the rhetoric around here and I was interested in the President's radio address over the weekend when he asked that both Republicans and Democrats in the House, in light of last week's debate on the welfare bill, tone down our rhetoric, and I share that concern.

I think we need to work in a bipartisan, pragmatic way on all of these policy issues, but I also think it is important that the administration get the message, too, and tone down its rhetoric, because it is one thing to throw out caveats to keep the dialog from simmering and to be more statesmanlike, but it is another thing when the administration is out there fueling the flames.

So I think it works both ways. I think both ends of Pennsylvania Avenue would be well-served, and certainly the country, more importantly, would be well-served, if we all toned down the rhetoric. This bill, I think, is a good place to start fresh on a beautiful Monday morning here in Washington.

It is particularly timely that we review this proposal. As the Chair mentioned, it was included in the Senate version of the bill we recently passed to restore and make permanent the 25-percent tax deduction for health care costs of self-employed taxpayers.

The inclusion of this particular provision made it possible to raise the deduction to 30 percent beginning with 1995, which is more than appropriate. Some of us would like to see it raised to 100 percent for self-employed individuals, to put them on a level playingfield with their counterparts in the marketplace.

I am particularly interested, Madam Chair, in the testimony of the Treasury Department officials. This provision, while seemingly well-intentioned, appears to create an administrative nightmare for the Internal Revenue Service. I know the IRS already struggles to enforce Code section 877, which allows assessment of U.S. tax with respect to certain types of income for a period of 10 years after relinquishing citizenship.

I am curious how effective the Treasury Department estimates the IRS would be in enforcing the proposal under consideration. I am also curious what Treasury estimates the net Federal revenue gain will be.

In addition, Madam Chair, I share your concerns relative to the issues discussed last week in the taxpayer bill of rights, and I certainly look forward to examining all of these issues with our distinguished witnesses today. Thank you, Madam Chair.

Chairman JOHNSON. Thank you. Mr. Guttentag, will you proceed, please, and welcome.

STATEMENT OF JOSEPH H. GUTTENTAG, INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF TREASURY

Mr. GUTTENTAG. Thank you, Madam Chair and Subcommittee Members. I appreciate the opportunity to testify in support of the administration proposals and section 5, H.R. 831, as approved by the Senate, and designed to prevent a relatively few, very wealthy Americans from avoiding U.S. tax on millions of dollars of gains by renouncing their U.S. citizenship.

I would like to submit my complete statement for the record and summarize the administration's position.

Chairman JOHNSON. That will be done.

Mr. GUTTENTAG. Next month, millions of Americans will settle up with their government and finalize their tax obligations. Recent reports in Forbes and other media have described how a small number of Americans avoid their U.S. tax obligations by giving up their U.S. citizenship.

We believe that when a citizen 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 expatriates should not obtain an unfair advantage over those U.S. citizens who continue to meet their tax obligations to our government.

Many 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 imply that this tax is designed to prevent free immigration or deny other important human rights. The proposal submitted by the administration and as approved by the Senate does not in any way restrict Americans from entering or leaving the country. As a matter of fact, as noted by the Chair, many expatriating former Americans choose to spend a significant amount of their time in the United States, often with family members who have not renounced their citizenship.

My views on the human rights issue are strongly buttressed by others much more learned in this field than I and are set forth in a memorandum prepared by the Legal Advisors Office of the Department of State and in a recent letter to Assistant Secretary Samuels from a distinguished international lawyer, Professor Detlev Vagts of Harvard Law School. I would like to submit them both for the record at this time, Madam Chair.

Chairman JOHNSON. We will include them in the record, Mr. Guttentag.

[The following was subsequently received:]

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

Memorandum of the Department of State
Submitted for the Record by the Department of the Treasury

Hearing Before the Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

March 27, 1995

The Department of State believes that Section 201 of the proposed Tax Compliance Act of 1995 is consistent with international human rights law, on the basis of information provided 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. 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, we understand from Treasury that Section 201 does not treat those who renounce their U.S. citizenship less favorably than 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. We understand that these tax requirements are no more burdensome than those that they would face if they remained U.S. citizens or 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 further understand 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. §§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, 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 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, §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 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, to the extent that Section 201 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 201 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, it is the view of the Department of State that, based on the information described above, 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.

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 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 201 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 201 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 201 or to the status of the individuals who would be subject to that tax.

As stated in the accompanying memorandum, Section 201 would not interfere with the right of an individual to physically depart from the United States, whether temporarily or permanently.

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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

Mr. GUTTENTAG. Thank you. The 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 also 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 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 they were unconstitutional, that it was unconstitutional to tax unrealized income.

We must remember that we are not writing on a clean slate. The proposal under discussion is an amplification and improvement of section 877 of the Code which was enacted almost 30 years ago. Unfortunately, section 877 has proven ineffective in addressing the abuses at which it was targeted. The old section 877 taxed expatriate Americans for 10 years but only on certain gains and in a manner that raised administrative and extra territoriality problems. Section 5 of H.R. 831 is designed to avoid the problems of existing law. With this exemption of up to $1.2 million of gain for a married couple, the provision eliminates from its coverage all but the wealthiest. Although the tax is imposed on gains at the time the citizen renounces citizenship, there are provisions permitting deferral of payment of the tax if adequate security is provided. We would be happy to review this issue further, either now or in the future.

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

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

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

Madam Chair, this concludes my statement. I will be available to answer any questions that the Subcommittee may have.

[The prepared statement follows:]

STATEMENT OF
JOSEPH H. GUTTENTAG
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Madame Chair and members of the Subcommittee, I am pleased today to testify in support of Section 5 of H.R. 831, which requires individuals who renounce their U.S. citizenship to face their tax responsibilities. My testimony is limited to section 5 of H.R. 831 as approved by the Senate and is generally similar to part of the Administration's proposal.[1] The proposal is designed as an improvement of similarly targeted provisions of our tax law that have been in affect for almost thirty years.

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. Property treated as sold would include all items of property that would be included in the individual's gross estate under the Federal estate tax rules as if such individual were to die on the date of expatriation. 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 proposal contains 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. Under the Senate bill, with IRS approval and appropriate security, taxpayers could defer the payment of tax on any asset for up to ten years. The tax would be effective with respect to citizens who relinquished their citizenship on or after February 6, 1995. For this purpose a person generally is considered to relinquish his citizenship on the first date on which the individual gives notice to a U.S. government official.

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[1] The Administration's proposal would also apply the proposed tax regime to a long-term resident, defined as an individual who has 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 treaty tie-breaker rules, in at least ten of the prior fifteen taxable years. A "green card" holder would be taxed when he or she ceases to be subject to U.S. tax as a resident.

Because of the exceptions and conditions described above, Treasury estimates that every year approximately two dozen very wealthy taxpayers with substantial unrealized gains would be subject to the proposed rules. The revenue generated by section 5 of H.R. 831, as passed by the Senate, is dedicated to deficit reduction.

The Administration supports the proposal because we believe that all U.S. persons should 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 and generally avoid substantial further U.S. tax, 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 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 and long-standing 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 that 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 that requires long-term residents of Germany who terminate their German residence to pay tax on a deemed disposition of 25 percent ownership interests in German corporations. Other countries have enacted different approaches to deal with the same problem. Countries that continue to tax former residents under special rules include Denmark, Sweden, the Netherlands, Norway, and Finland. Thus, it is accepted in the international community that a country may enact special anti-abuse rules to address the problem of departing taxpayers. The tax systems described above are more limited than the current proposal as they apply when one of their citizens decides to live in another country. A tax incurred when renouncing citizenship only

applies when a citizen gives up citizenship and not when a citizen just decides to live overseas. Let me emphasize that such a tax is not imposed when taxpayers leave temporarily or permanently. Travel abroad triggers no tax.

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 is 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. A similar change was made in 1984, when Congress deleted from the Code a provision that required a tax avoidance intent before tax would be imposed on certain transfers involving foreign corporations.

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. 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 without paying U.S. tax.

Third, existing expatriation rules are very difficult to enforce. 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, and is usually living overseas, and therefore imposes an undesirable extraterritorial effect.

Section 5 of H.R 831, as passed by the Senate, addresses the basic issues 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 be much simpler to administer and enforce than the current law.

Some have raised concerns about the ability of taxpayers to pay a tax on their illiquid assets if they choose to expatriate. We believe these concerns can be adequately addressed. We support the changes made by the Senate that would allow taxpayers up to ten years to pay the tax. In most cases, a ten-year extension should be adequate time to pay any tax. This provision is based on an existing rule that extends the time that is normally given to pay estate taxes on illiquid assets. Concerns have also been raised about the appropriateness of taxing interests in trusts, particularly remote or contingent interests. The proposal determines trust ownership on

the basis of all the facts and circumstances. Thus, a taxpayer may show that he or she has no interest in a trust even if he or she is a potential beneficiary of the trust. The Senate Finance Committee elaborates on this rule: "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." Of course, payment of any portion of the tax due attributable to the trust interest could be extended as described above. If, however, a taxpayer is unable to pay the tax within that period, pursuant to current authority under the Code, the Internal Revenue Service may permit further deferral of the payment of tax under appropriate agreements. We believe that this combination of procedures should resolve difficulties of the relatively few taxpayers who would ever be subject to the provisions and avoids inserting elaborate complicated rules of limited application into the Code. We are willing however, to review this issue further, now or in the future.

We believe that the Congress has the authority to enact this 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 a 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 gains 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

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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.

Court held that "the taxing power of Congress . . . is exhaustive and embraces every conceivable power of taxation." *See Dillin v. Commissioner*, 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. A memorandum prepared by the Department of State explains why this tax provision is not inconsistent with human rights obligations of the United States under international agreements and customary international law, and is submitted for the record. In brief, 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 proposal would not tax the physical departure from the United States, rather it would impose tax at the time of renunciation of United States citizenship.

Finally, regarding our treaty obligations, the proposal 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.

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

Chairman JOHNSON. I thank you, Mr. Guttentag.

Is it true that regulations have not been issued for current statutory rules regarding U.S. citizens that renounce their U.S. citizenship?

Mr. GUTTENTAG. No regulations have ever been issued over the last 30 years under that section.

Chairman JOHNSON. If expatriation is a major tax avoidance problem, why hasn't the Clinton administration, and why haven't other administrations, issued regulations?

After all, they would only be implementing current law.

Mr. GUTTENTAG. Section 877 has not been—has not worked since its inception, and it was felt that regulations would not provide a means of making an effective provision out of that because of the defects in it. It has proven ineffective in solving the problem for which it was intended.

Chairman JOHNSON. So you would say that the regulations would not overcome the defects in the law?

Mr. GUTTENTAG. That is right.

Chairman JOHNSON. Can you please tell the Subcommittee how many U.S. citizens gave up their citizenship in 1994, 1993, 1992, 1991 and 1990?

Mr. GUTTENTAG. These figures as supplied by the Department of State reflect that in 1990, there were 571 citizens giving up their citizenship; 1991, 619; 1992, 556; 1993, 697; and last year, 1994, 858.

Chairman JOHNSON. How many of those that gave up their citizenship gave up their citizenship for tax motivated reasons in those years?

Mr. GUTTENTAG. We don't have any way of knowing that, Madam Chair. There have been very few cases brought and actions brought under section 877, and of course, we don't have any idea what the intention was of these several hundred people.

Chairman JOHNSON. But, Mr. Guttentag, how do you get revenue estimates for this if you have no idea what part of the 858 last year would be exempted under your bill and how many would be caught in that net? I mean, you must have some information about this or you couldn't have made estimates of the revenue impact.

Mr. GUTTENTAG. Yes. Our revenue estimates for the proposed legislation I believe made the assumption, at least on the Treasury side, that the present 877 was ineffective and did not raise any substantial revenue.

Chairman JOHNSON. So you do not expect this change in the law to raise any substantial revenue?

Mr. GUTTENTAG. I am sorry?

Chairman JOHNSON. So you do not expect the change you are proposing to raise any substantial revenue?

Mr. GUTTENTAG. The change in the law will raise substantial revenue.

Chairman JOHNSON. What I am asking you is, on what do you base that judgment, that revenue estimate, if you know that the current law is ineffective? You know that last year there were 858 renunciations, but you do not know what percentage of those renunciations were for the purposes of avoiding taxes.

Do you know what percentage of those renunciations would have involved assets valued at less than $600,000?

Mr. GUTTENTAG. No, we do not. We do not know, but we are basing our revenue estimate on the proposed legislation which does not require an intent to avoid tax.

Chairman JOHNSON. All right. Do you know then what percentage of the 858 involved estates valued at less than $600,000?

Mr. GUTTENTAG. No, we do not.

Chairman JOHNSON. How can you estimate what your revenue is going to be since they would all be exempted from this law?

Mr. GUTTENTAG. We make these estimates based on our revenue estimators' calculations based on various kinds of evidence which they have as to the number of people who may leave the United States, the number of people who are going to stay, who are in the category of paying high taxes and therefore have high-value assets, and their continued payment of taxes, plus those who would leave the country and pay taxes at the revenue estimate, because it includes people who, aside—if this legislation is not enacted, who would leave the United States and therefore reduce revenues which would otherwise be selected.

Chairman JOHNSON. You may remember that a couple of years ago—I think it was about 1991—this Committee entertained a proposal that imagined that we could collect something like $30 billion by taxing the income of foreign companies the same way we tax income of American companies. We had this extraordinary estimate and we all frankly got very excited about that. That sounded like an easy way to get billions of dollars. When the dust settled, there wasn't any new money there.

Now, I am concerned that we might do this and find no new money there, and I think you are obliged in proposing a change in current law to provide us with some better information about the 858 cases last year, or the 697 the year before, because we need to understand what percentage of these people would have been exempted by your proposal and on what basis you suggest that your proposal is going to bring in $1.4 billion from probably a very small number of cases.

Nothing that you have said in response to my question indicates to me that you have a very concrete grasp of what number of cases are going to pay, how much they are going to pay or why you think they are going to pay that dimension of dollars.

So if you would like to enlarge on any aspect of your preceding comments to make it clearer to me why you think your revenue estimate should be considered as possible, I would be happy to hear those comments.

Mr. GUTTENTAG. Yes, I believe the $1.4 billion estimate was that of the Joint Committee, Madam Chair. I think our—the Treasury estimate was higher than that. The Joint Committee estimate did not include resident aliens who would be subject to tax under the administration proposal. That accounts for part of the difference between our estimates. So while they were different, they are both substantial in amount.

But I would be glad to—these—revenue estimating is a—quite a science, and I do not pretend to be an expert or even knowledgeable in that area. We rely on our revenue estimators, and they

have made these estimates based on collecting facts from various sources. Most of it involves very few people in very high income categories, and if anything, I think they were reasonably conservative.

Chairman JOHNSON. Thank you.

I am going to yield at this time to my colleague, Mr. Ramstad.

Mr. RAMSTAD. Thank you Madam Chair. Mr. Guttentag, let me apologize, I was addressing my questions and opening remarks to Mr. Samuels, not realizing you were in fact pinch hitting. I thought both of you were appearing today. I had a list of witnesses with Mr. Samuels' name on it, but now I can ask you the questions.

I share the Chair's concerns about the revenue projections generated by this tax. You know, the last thing we need around this place is another enforcement nightmare for the IRS that costs the American taxpayers more than revenues would bring in. I think conceptually it is certainly hard to argue that taxing U.S. citizens who give up their citizenship for tax avoidance is not the right thing to do. I think we all agree with that; that it should be the public policy of this country to prevent expatriate tax avoidance.

Let me just ask you a couple of questions for my understanding.

Now, with current law, as your testimony stated, the government must prove intent, that is, intent of tax avoidance.

Mr. GUTTENTAG. That is correct, yes.

Mr. RAMSTAD. So we are trying to make it more of an absolute liability standard?

Mr. GUTTENTAG. Yes. Intent would be irrelevant.

Mr. RAMSTAD. Another reason for the administration's recommended change. As I understand, the current law only applies to certain U.S. source income. You are concerned about the abuses there?

Mr. GUTTENTAG. Yes. The present law applies to U.S. source income and doesn't take into account gains which may be realized from foreign assets; and since U.S. citizens are taxed on a worldwide basis, we believe this proposal should apply on a worldwide basis.

Mr. RAMSTAD. Well, I think before we move this legislation, we should get those revenue estimates about which the Chair probed. I would like to hear a little bit more to ease my concerns as to the cost of enforcement because it seems to me that we could have another enforcement nightmare here that is going to end up costing more than it brings in, and I think that is the last thing we need.

Mr. GUTTENTAG. Well, we would be glad to review those and provide you with additional information.

Let me say that it is my understanding that the way the income was calculated was primarily based on the present keeping—presently—present taxpayers in the United States who might otherwise depart in order to avoid tax. So that we know, based on evidence in the press from public and other media, that certain individuals have left the United States. From that, we can extrapolate as to what would happen under the—this provision, as it would pass, how many of those people would still leave and pay the tax, how many would stay and still be subject to regular U.S. tax as all of us are.

In my discussions with our revenue estimator at Treasury, telling him that I was going to be here this morning, he again confirmed to me that he believes that his estimates are reasonably conservative, and I think the Joint Committee revenue estimates speak for themselves, but they appear to be even more conservative than ours.

Mr. RAMSTAD. Thank you, Mr. Guttentag. You are a very capable pinch-hitter for Mr. Samuels, and I sincerely hope you will take that message back to the White House as the only administration representative here today, or at least the first one that I have seen this week, that we all need to tone down the rhetoric.

Mr. GUTTENTAG. I certainly will.

Mr. RAMSTAD. Thank you, Madam Chair.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Thank you very much. You know, this whole thing of people fleeing to avoid paying taxes has been going on throughout history when the citizens start feeling that government is excessive in its taxation. For instance, the Mayan empire, they collapsed as a result of their citizens just disappearing into the jungles because of excessive taxation. In fact, I would recommend a book to you and everybody over at the Treasury, if you haven't already read it, called "For Good Or Evil: The Impact of Taxes on the Course of Civilization," and that may be the area that we are into now.

If, in fact, we had a reasonable capital gains tax and a reasonable estate tax, these people wouldn't have any reason to leave the country; am I correct in that? If, in fact, your judgment is right that they are leaving for the express purpose of avoiding taxes, if in fact we had reasonable taxes on these people, then they wouldn't want to leave—it wouldn't make any difference; am I correct? There would be no reason for them to leave?

Mr. GUTTENTAG. Well, based again on our analysis of those who do leave, it appears that many of them leave not for the purpose of subjecting themselves to some other tax regime, but most of them leave under circumstances under which they or their estates will not be subject to any meaningful taxes in the future.

So it does not appear to us that the level of capital gains tax or the level of taxes here in the United States is a major consideration. Our taxes here are generally comparable to those in most of the developed countries of the world and the expatriating citizens usually subject themselves to the tax regime of the country.

Mr. HANCOCK. You are telling me that our estate taxes and our capital gains taxes are comparable to other developed countries'? Japan, for all practical purposes, doesn't even have a capital gains tax. I am not too sure about the estate tax. Did I hear you right?

Mr. GUTTENTAG. They have—Japan and the United States, for example, I think—and again, this is not my field—are generally at about the same level of taxes as a percentage of gross domestic product, and their tax rates are not that dissimilar.

Mr. HANCOCK. Let me ask you another question.

As an American citizen, let's say I have got a lot on the ball, which a lot of people would question, but let's, for example, say it looks like I am going to make a lot of money. If I gave up my citi-

zenship before I made the money, I could avoid this tax. One person that has citizenship already down in the Bahamas or someplace, investing in the United States, becomes a billionaire, another one living with a citizenship in the United States becomes a billionaire; they will be taxed differently, right?

Mr. GUTTENTAG. That is correct.

Mr. HANCOCK. So what we are saying is that if you are a citizen of the United States, you need to renounce your citizenship before you become wealthy instead of after.

Mr. GUTTENTAG. Right. That is correct.

Mr. HANCOCK. If an individual happens to come from a family that has a lot of money to invest, the best thing to do is become a citizen of another country before he makes his money; isn't that kind of a disadvantage to the American citizen?

Mr. GUTTENTAG. Well, I know you don't intend at all to speak lightly about the act of giving up your citizenship; and we can see from the relatively few people that do that, it is a very treasured thing to most.

Mr. HANCOCK. I understand that you are talking about it being a buried treasure. There is no question about it. But you are also talking about generating an additional $1.5 million a year as a result of this expatriate law that we are considering.

Now, how are you going to—how many people are going to show up to do that? I mean, you are going to run out of billionaires pretty quickly if, in fact, they started doing it, in my judgment. And here again, I need to talk to some experts in this area because this approach of giving up your citizenship is just recently starting to be suggested by tax advisors to extremely wealthy people in their estate planning.

Now, they have been talking for a long time about moving assets out of the United States. In fact, we are even to the point within the United States that people are changing their State of residence because of the differential between, say, the State of California and the State of Florida. This has been going on ever since the Babylonians. So I certainly cannot support any tax law that gives a foreign citizen an advantage over an American citizen, and that is basically what we would be talking about doing here.

Mr. GUTTENTAG. I think that the U.S. citizen has many advantages. First, giving up the citizenship with the hope that you are going to be earning this money in the future, that may, of course, never happen and you have given up your citizenship.

Mr. HANCOCK. Well, I was being a little facetious when I suggested that. But the fact remains, two people, equal, one of them being a citizen of Peru, and one being a citizen of the United States, if they should decide to give up their citizenship in the United States, as far as dollars are concerned, that individual, when his death comes around or he pays his taxes, if he still has his citizenship in the United States, is going to pay a lot more than that individual who made the same amount of money doing the same thing, but does not have a U.S. citizenship, but made his money in the same place, in the United States.

Mr. GUTTENTAG. Well, the administration proposal would tax the long-term resident, immigrant in the United States, the green card

holder, under the administration proposal if that person was here more than——

Mr. HANCOCK. Sir, if you are just investing money in the United States, you don't have to have a green card.

Mr. GUTTENTAG. No.

Mr. HANCOCK. You know, you can make lots of money investing in the United States.

Mr. GUTTENTAG. And we are putting no restrictions on that kind of investment.

Mr. HANCOCK. Well, you are making my point. If I am an American citizen, and I invest in the United States and end up with a lot of money, I am going to be taxed—I am going to pay much bigger capital gains and estate taxes than I would if I was a citizen of England investing here in the United States.

Mr. GUTTENTAG. That is right, and that is the way our tax laws work. They are generally based on two factors, one, the source of your income. We pay tax based on the source. The rest of the tax is based on where you reside. Only in the case of the United States do we also tax based on citizenship and where you reside.

If that person can live in some other country, be a national of that country and be enabled to make money in the United States, he is free to make that money. He does not have the benefits of U.S. citizenship, which we consider important. He is not allowed to live here permanently in the United States. That is true for people all over the world, and there could be a person overseas.

Mr. HANCOCK. And the reason we do that is because we want the investment capital coming into the United States.

Mr. GUTTENTAG. Right.

Mr. HANCOCK. Now, why do we tax people that have accumulated investment capital to the extent that they have got to give up their citizenship so we can retain the investment capital in the United States? I mean, something just doesn't sound quite right to me.

We want the investment capital, but if a citizen of the United States makes it, then we want to tax him, say we don't have the investment capital, then the government ends up with the money to throw away. Thank you. I still think you ought to read this book.

Mr. GUTTENTAG. All right. I certainly will.

Chairman JOHNSON. Mr. Guttentag, your response to my colleague's question that you didn't think it would dampen foreign investment strikes me as very interesting. I can't imagine that that would be so, but it is just a matter of judgment. But the administration's proposal applies to noncitizens. If I were a noncitizen watching this, I would think, what is the next big source of new income? I want it clear in the record that that is simply a matter of judgment and not a matter of fact; and I think we are going to hear testimony later today that it is a matter of fact that Asian immigrants are choosing Canada over the United States, and this kind of action by the United States is certainly going to influence their thinking, at least in my judgment; and I understand that that also is just a matter of judgment. But we are, for whatever reason, seeing some of the most talented immigrants choosing other nations to immigrate to.

I want to get back to my issue of regulations.

Mr. GUTTENTAG. Yes.

Chairman JOHNSON. What is the key change between current law and the law you are proposing that leads you to believe that you will be able to implement regulations that will implement this law and gain the revenue that you suggest is there to be gained?

Mr. GUTTENTAG. The key issue is that this tax that is being proposed would be imposed at the time the U.S. citizen—or the administration proposal, the long-term resident engaged in this expatriating act. And that would be the end of the tax regime for income tax purposes.

Under the proposal—under the legislation as it now exists, the United States imposes tax over a 10-year period when the former U.S. citizen may be living in various countries of the world creating conflicts with our tax treaty network. Assets are outside the United States; there is not even a way to monitor effectively the amount of income earned, as well as being able to convert U.S. source income quite easily to foreign source income and avoiding the tax net under present section 877.

Chairman JOHNSON. I see. Because you impose this at the time of termination of citizenship and collect all the taxes at that time——

Mr. GUTTENTAG. We would——

Chairman JOHNSON [continuing]. This can be more effective?

Mr. GUTTENTAG. Excuse me.

The legislation provides for an ability to defer tax under appropriate—defer payment of the tax under appropriate circumstances, which we think is important.

Chairman JOHNSON. OK. Now, given that, would you discuss how this law applies to trusts and particularly to contingent remainder interests?

Mr. GUTTENTAG. It would apply to trust interests which would be valued in accordance with standard valuation techniques. It would eliminate de minimis interests in trusts based on such valuation so as not to get involved where there is remote and—where there are contingencies, which are reasonably not to come into play, and would also provide—particularly useful in those cases where there was not immediate access to the trust funds—a means of deferring the tax.

Chairman JOHNSON. And so are you suggesting that it would not require somebody with an interest in a trust to convert that interest into income so that they could pay the tax? It would not require, in a sense, escape?

Mr. GUTTENTAG. Well, that would depend on the terms of the trust, whether it could be converted. It would depend on other assets that the citizen had. We would, of course, have to look at all of the assets and all of the gains involved in order to determine how the tax should and would be paid.

Chairman JOHNSON. I wanted to get some examples on the record to be sure that these are also the kinds of cases that would be affected.

Person A fled Cuba in 1959 and became a U.S. citizen. In 1999, Cuba becomes a democracy. A returns to Cuba and renounces his U.S. citizenship. A would be subject to tax under the administra-

tion's expatriation proposal on all assets he had accumulated and all income he had accumulated during his years here, correct?

Mr. GUTTENTAG. That is right, yes.

Chairman JOHNSON. B left Y, his native country, in 1957 because it was ruled by a communist government and he settled in the United States. He never obtained U.S. citizenship, but complied with all immigration laws. After the fall of communism, he returned to Y and decided to make Y his homeland. In 1998, B leaves the United States and returns to Y. B would be subject to tax under the administration's proposal, would he not?

Mr. GUTTENTAG. Yes, he would be.

Chairman JOHNSON. So caught in this net are going to be all those who came here fleeing communism, all those who may have come here because of the unsettled circumstances in the Middle East, all who came here because of the conflict and war in Ireland, and all those who came here for similar reasons from places all over the world and, in good faith, worked hard and developed some resources. And we are, under this proposal, going to then tax them at a level that we tax no other living citizen or noncitizen; is that correct?

Mr. GUTTENTAG. No. We would tax them as we would a U.S. citizen.

You are right, Madam Chair, we opened our doors here to these people. They came here. They took advantage of the U.S. economy, apparently to earn substantial wealth, otherwise they would not be subject to this tax; and if they decide to go home, all we are asking is that they pay U.S. tax on the gains they have realized while they have enjoyed our hospitality here in the United States.

Chairman JOHNSON. But, Mr. Guttentag, we are forcing them to treat things as a sale and so we are forcing them to accumulate cash assets to pay taxes at a time that normally we only do upon death, and in that regard, it can reduce the value of hard-earned assets in a way that we don't force on any other Americans. Wouldn't you say that is fair to say?

Mr. GUTTENTAG. Well, an American, of course, has to prepare also for death and those kinds of taxes and would, of course, in the future be able to prepare for this tax; and as I said, we do plan to have means available to defer the payment of tax to avoid that kind of hardship.

Chairman JOHNSON. I guess my point is that this is not necessarily going to fall on those who are motivated by tax avoidance. Many of the people who came here and worked hard were motivated by all of the motivations that have made America a great and strong country; and without question, this proposal is going to lay on them a burden that no other working American will ever experience. Is that not so?

Mr. GUTTENTAG. The—what we are—the working American who subjects his assets to tax by selling his assets and realizing the gains will, of course, pay tax during his lifetime. But this person who has come to the United States will be allowed to exempt the first $600,000 of gain, which is a substantial amount. That is not assets; that is gain realized during this period of time, 600,000 dollars' worth of gain. He will be able to—he will not have to pay tax on—presumably he would have a home in the United States or

other real estate in the United States. He would not have to pay any tax on that U.S. real estate. He would have, exempt, any money that he would have placed in pension funds for his benefit. So all of those assets would be free and clear of this proposed tax.

Chairman JOHNSON. My staffperson was clarifying for me your exemption for small business assets, which is very important, but if you have saved up and you have your own small business and you invest in stocks, you would be forced to sell them, possibly at a loss, in order to get enough money to pay this exit tax, would you not?

Mr. GUTTENTAG. There are administrative procedures presently in the Internal Revenue Code, Madam Chair, which do permit the deferral of tax collection by the Internal Revenue Service when appropriate security is given and good cause can be shown for—good reason for the deferral.

Chairman JOHNSON. My understanding of the Joint Tax Committee's estimate is that it is based on the assumption that this tax is heavy enough to discourage people from changing their citizenship and that their increase in revenue estimates is based entirely on the fact that people will not choose to make this decision. Is that the assumption behind Treasury's estimate of the revenue increases?

Mr. GUTTENTAG. I think Treasury's methodology and that of the Joint Committee are quite similar.

Chairman JOHNSON. So actually you are not anticipating that people will pay more taxes. You are anticipating that they will not choose to give up their citizenship.

Mr. GUTTENTAG. No. We are estimating that if this law is not passed, that these people will leave the United States and we will not collect that tax. If this law is passed, we will collect more tax than we would if the law is not passed. So we are just assuming that these people will leave the United States if the law is not passed, will give up their citizenship if the law is not passed.

Is that—I am sorry if I am not clear, Madam Chair.

Mr. HANCOCK. Madam Chairman, may I, with your permission?

Chairman JOHNSON. Yes.

Mr. HANCOCK. Are we making the assumption that if you pass the law, then these people will not leave the country, they will not give up their citizenship if the law is passed? Is that what your assumption is?

Mr. GUTTENTAG. Yes. Based on the information we have that the people who have left, the wealthy people who have left really have no interest in leaving the United States. They often spend a considerable amount of time in the United States after they give up their citizenship. They have family here, they have businesses here, that their real reason for leaving is tax avoidance, that if there is a price to pay for tax avoidance, they would stay here.

Mr. HANCOCK. Let me ask you a question then. If your assumption is correct, where is this $1.5 billion going to come from?

Mr. GUTTENTAG. Those people will remain here and would not—if the law is not passed, those people will give up their citizenship and we will not collect the——

Mr. HANCOCK. Wait 1 minute. Let's say we pass the law.

Mr. GUTTENTAG. Right.

Mr. HANCOCK. These people quit leaving the country and giving up their citizenship. Now where does the $1.5 billion increase in revenue come from?

Mr. GUTTENTAG. Well, we have people who are paying millions of dollars a year in tax. Those individuals would continue to pay tax in the United States.

Chairman JOHNSON. So there will be no increased revenue? They are paying it now and they are going to keep paying it?

Mr. GUTTENTAG. Yes. But if the law is not passed, there will be a decrease in revenue and that is considered a revenue gainer.

Mr. HANCOCK. Well, now, are you talking about income tax revenue?

Mr. GUTTENTAG. Yes.

Mr. HANCOCK. Or are you talking about estate tax revenue?

Mr. GUTTENTAG. Income and estate taxes both.

Mr. HANCOCK. Well, I still think, Madam Chairman, we get back to the question that a foreign citizen has a better opportunity to invest in the United States than an American citizen does. I mean, that is what it looks to me like.

Chairman JOHNSON. I am curious as to why the administration didn't focus primarily on those who do return after they have given up their citizenship and continue to do business. It seems to me that wouldn't be too hard to

monitor.

Mr. GUTTENTAG. We have thought about that.

Chairman JOHNSON. That is the real tax avoidance issue.

Mr. GUTTENTAG. That—in some cases, we can't define the situation with respect to all of these people. There are very—relatively few people who are involved in this situation. Many of them who do return, who have obtained U.S. citizenship or obtained a green card permitting them to live permanently in the United States, those people who have been subject to acts of foreign governments which have caused them to come to the United States, when they do have the opportunity to return, very often they keep their citizenship and green cards because of the uncertainty that they don't want to make—they want to make sure if something were to happen again, they would have the United States to return to.

Chairman JOHNSON. Certainly, but if they do that, they are not affected by this tax.

Mr. GUTTENTAG. They are not affected by this tax.

Chairman JOHNSON. If you are really interested in tax avoidance, why don't you go after those who forgo their citizenship but then return and continue to do business? That is the tax avoidance group of all the others. The groups that came from communist-dominated countries and so on and go back for other reasons, that is not really the group you are after. The group you are after are the ones who renounce their citizenship specifically to gain tax benefit.

Now, I would say that my colleague, Mr. Ramstad, pointed out that usually this happens when something has gone awry with the Nation's tax structure. Connecticut loses people every year because our tax structure takes more than people want to pay for seniors, and so people move when they reach 65 to other States. Now, we could fix that in Connecticut and we are trying to fix that.

So I am concerned that we are fixing this in a hostile way when maybe we ought to be fixing it in a positive way. That is one thing that concerns me.

But the other thing that concerns me is that by being overly broad instead of looking at the group that is exploiting our Tax Code, we set up our other people to be gone after by the IRS, and when this gets moving, what will the IRS' stance be in regard to transactions by these people in the months before they declare—just like we get into Medicaid; what happens in the 3 years before you become Medicaid eligible, or in the 5 years before.

So by writing too overbroad a law, you are creating a noose for a lot of innocent folks as well, and that is why we have an obligation to focus this law as narrowly as we can on the problem, and that is why it concerns me that of the numbers of people who renounced their citizenship last year, 858, you don't have any information you can share with me about either what the incomes of these people were, or what was their asset value.

You must know. We have all those records. So I would suggest that you get the Committee some better information. You run your computers overnight, get us back some better information on those folks so that we can see whether or not there is a way we can focus this law more effectively to go after people who are trying to, in a sense, take advantage of international differences in tax burden for their own benefit.

[The information was not available at the time of printing.]

Chairman JOHNSON. But I do worry about the breadth of this bill and particularly the breadth of this proposal for a Nation that has always valued immigration and that believes that opportunity carries with it also certain rights.

So I thank you for your testimony today and we will move on to the next panel.

Mr. GUTTENTAG. Thank you, Madam Chairman.

Chairman JOHNSON. The next panel is Robert Turner, Charles Stockton Professor of International Law, U.S. Naval War College, Newport, Rhode Island, on his own behalf; William Norman of Ord & Norman, Los Angeles; and Lawrence Heller, of Whitman, Breed, Abbott & Morgan, Los Angeles. We will begin with Mr. Turner.

Mr. Turner, if you will proceed.

Let me remind this panel, as well as the next, that your full testimony will be included in the record, and during your time of testimony, would you please summarize your testimony and comment in any way you care to in view of the foregoing discussion. Thank you.

Mr. Turner.

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

Mr. TURNER. Thank you, Madam Chairman.

It is a great honor and a pleasure to be here this afternoon to discuss the human rights ramifications of the so-called exit tax in the Tax Compliance Act of 1995. As you suggested, I will submit my prepared statement for the record.

Before going further, I do have three caveats. One you have already mentioned, and it is very important to note that I was asked to appear before the Committee in my individual capacity and not on behalf of the Naval War College or any other group.

Second, also very important to me, I have absolutely no substantive expertise on tax law, and so to the extent you have questions in that area, I am going to have to leave those to your judgment as the real experts.

Finally, a point you also mentioned, we are I think all here on very short notice. I would like to have had more time to think about this, to do more research. That is all the more important, because there are a number of very distinguished international lawyers who take a very different position than the one I will present. All I would say is, consider the arguments I make on the merits and make your own judgments.

The basic human rights issues raised here are not new to me. Ironically, it was my pleasure to serve on the U.S. Senate staff in 1974 when the Jackson-Vanik amendment was passed, and I worked on that amendment as foreign policy advisor to Senator Bob Griffin of Michigan.

Before I get into a brief summation of the law involved, there is one point of apparent disagreement that perhaps it would be useful for me to identify and focus on briefly. The Office of the Legal Advisor of the Department of State, where I have many very close friends, and I have great respect for them; the Library of Congress Congressional Research Service; and others have tried to draw a distinction between the right to travel and the act of renouncing one's citizenship.

Underlying this distinction, apparently, is the view that there is no legal right of expatriation; that is, no right to renounce citizenship, and since this bill doesn't really stop travel, it only stops renouncing citizenship, they argue human rights law doesn't apply. I simply don't agree with this view.

First of all, having worked closely on the Jackson amendment, I can say that—at least for many of us—our concern involved all of the impediments to emigration and expatriation. Certainly we used the word emigration, but we were talking about the human right of citizens of the Soviet Union to make a permanent departure from that country, and to completely sever the citizen-state relationship as they move to Israel or any other country of choice to become citizens.

This was not merely a debate about travel in the sense of taking vacations to the Holy Land, but rather about making a permanent change of allegiance. I think most of us had in mind at that time not only emigration, but also expatriation.

Second, in response to those who have said that international law is not concerned with the right to renounce one's citizenship, I think they are mistaken. I will try to make that point briefly.

Finally, I would note that the Jackson-Vanik amendment passed unanimously in the Senate and overwhelmingly in the House, and one of the things that we were complaining about was something the Soviets called a "citizenship renunciation fee" of 500 rubles. The Soviets said, If you want to go to Israel, among other things,

you have to pay an extra fee for the purpose of renouncing your citizenship.

More importantly, however, the United States has argued for two centuries there is an international right of expatriation. Indeed, the core of the intellectual justification of the American Revolution was that such a right existed. The very first sentence of the Declaration of Independence, in fact, asserts such a right.

Since this proposal comes from the Treasury Department, it might be worth noting President Thomas Jefferson's June 1806 letter to then Treasury Secretary Albert Gallatin, in which Mr. Jefferson wrote: "I hold the right of expatriation to be inherent in every man by the laws of nature." I would note as an aside here that Jefferson viewed the law of nature as the first source of international law.

He goes on to say, "and incapable of being rightfully taken from him, even by the united will of every other person in the Nation."

Continuing, Mr. Jefferson wrote, "Congress cannot take from a citizen his natural right of divesting himself of the character of a citizen by expatriation." This view was shared by Secretaries of State John Marshall, James Madison, James Monroe and many others; and indeed, also implicitly by the first Congresses, because when they passed naturalization laws, they required would-be American citizens to renounce their citizenship to other governments, implying in the process there was a right to do that.

One can argue that the War of 1812 was in no small part fought over this right, because the British were impressing former British subjects who had become naturalized American citizens when they were found on the high seas, and we thought that was an infringement of their international duty to us and the right of our citizens.

The Congress in 1868 enacted an act concerning the American rights of citizenships in foreign states which provided, in part, "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."

This act, by the way, was enacted during a dispute we were having—one of many—with Great Britain over their principle, "once an Englishman, always an Englishman." The idea was that once you were an English subject, even if you subsequently took other citizenship, you still were subject to the Crown.

Two years after this 1868 enactment, Great Britain finally abandoned this claim and recognized that people who had accepted other citizenship were aliens, and in so doing, it contributed to the development of the customary international law in this area.

Now, let me turn just very briefly to the relevant international legal documents that give us our legal rules. The International Covenant on Civil and Political Rights, which entered into force in March 1976, and was ratified by the United States with the advice and consent of the Senate in 1992, provides in article 12 that, "Everyone shall be free to leave any country, including his own."

It then said, "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."

Now, certainly the right embodied in article 12, which I believe should be construed broadly to include the right not only to emigrate, but the right to change nationality in that process, the right to renounce citizenship, is not an absolute right. It is a fundamental right, but not an absolute right.

For example, citizens who are accused or are being tried for criminal activity or have been convicted of crimes—serious crimes—may be kept behind to serve their punishment and complete the trial; and certainly it is also clear that a State may require a citizen to pay any normal tax obligations or other public debts.

It strikes me that a key issue here is whether or not this is in fact a normal tax obligation that would be applicable to all citizens irrespective of their wish to emigrate. If it is instead a special requirement on individuals because of their desire to emigrate—and indeed I was troubled by the Treasury Department testimony just a few moments ago, which seemed to admit that a purpose of this law is to keep people from leaving. He said, Treasury's expectation is that people will not go out and pay this tax, but rather they will remain U.S. citizens—I have to say that troubles me.

If this is a special requirement that would not otherwise fall on these people at that time, then it strikes me that the government has the burden to establish under the covenant that the law is necessary to protect "national security, public order, public health or morals, or the rights and freedoms of others."

I would note in this connection that the Library of Congress Congressional Research Service memorandum on this issue tried to get around this by saying the term "public order" is "roughly analogous to the concept of public policy and likely includes such notions as economic order." However, during the drafting of article 12, an effort was made to broaden this list to include the terms: General welfare and economic and social well-being, and those provisions were rejected as being too far reaching.

Under the principles of treaty interpretation embodied in the Vienna Convention on the Law of Treaties, these "travaux préparatoire," the "preparatory works," could be considered in the case of ambiguities, and I believe it would be very hard to argue that the convention allows that broad an interpretation, given the fact that such language was expressly rejected.

Now, let me talk just very briefly about customary international law. Perhaps the most important written document that contributes to the development of customer international law in this area is the 1948 Universal Declaration of Human Rights. To be sure, when the universal declaration was passed as a U.N. General Assembly resolution in 1948, it was not intended to be legally binding; but there is a very strong consensus today, I would argue, that the declaration is considered reflective of binding customary international law.

The United States would have no prayer of arguing otherwise, given the fact that we have enacted statutes in this area that embody a very clear rule on this. Article 13 of the universal declaration provides that, "Everyone has the right to leave any country, including his own." Given particularly the suggestion that there is no right to renounce citizenship, I would note that article 15 says,

"No one shall be arbitrarily deprived of his nationality, nor"—and this part is important—"nor denied the right to change his nationality."

It strikes me that this is clear language, and it strikes me that, in particular, given the strong history of the U.S. Congress and American Secretaries of State dating back to our very first Secretary of Foreign Affairs, Thomas Jefferson, embracing the view that there is an inherent human right of expatriation, I just don't believe that it is wise to try to pretend we are not violating the law by pretending there is no such right.

Before closing, let me just briefly discuss the Jackson-Vanik amendment of 1974, a very important statute that, as I mentioned, was unanimously passed in the Senate and overwhelmingly passed in the House. It resulted from a series of measures the Soviet Union placed primarily in the way of Soviet Jews who wished to emigrate and change their allegiance to the state of Israel. The statute was broader than that, but its real underlined purpose was probably especially aimed at protecting Soviet Jews.

Among other impediments, Moscow imposed a diploma tax, and the argument was fairly simple. The argument was that these doctors, scientists, or otherwise technically skilled people had received a free education because Moscow assumed that they would be in the country for many years to come, and thus they would pay it back through their service to the State. But if they want to take that special benefit they have received from the State and move to Israel, the U.S.S.R. was going to require them to pay, on a sliding scale, depending on the skill level and how long they had been practicing, of between $5,000 and $25,000. In addition to that, there was also a 500 ruble "citizenship renunciation fee," that they also had to pay before they could leave.

As enacted into law, the Jackson-Vanik amendment would have denied most-favored-nation trade status to any nonmarket economy state, which, among other things "imposes more than a nominal tax on emigration for any purpose or cause whatsoever."

Again, certainly when I used the word "emigration" in those days, I was thinking in terms of the process of a Soviet citizen leaving the Soviet Union, moving to Israel, becoming an Israeli citizen, and severing all legal relationships with the Soviet Union.

Although I would acknowledge there is a technical difference between emigration and expatriation, I think most people who used the word in those days were considering both a part of the process. Second, Jackson-Vanik applied to any State that "imposed more than a nominal tax as a consequence of the desire of such citizen to emigrate to the country of his choice."

Now, that strikes me as being very difficult language to reconcile with the language in this tax bill. What we are saying is, when you declare your desire to emigrate or to expatriate, if you will, we are then imposing a tax—and I gather this tax will average out to something like $40 million a person, so it would be awfully hard to argue that is just a "nominal" tax. I note that the Library of Congress Congressional Research Service characterizes this proposed tax as an "expatriation tax," and I find it just too similar to the Soviet "citizenship renunciation fee" to be real comfortable with the distinction. Both, after all, are premised on the idea that the

citizen has received a benefit in one State, wishes to leave and take that benefit with him, and that he should pay the State before he goes for the fair value of that benefit.

Now, let me emphasize, it is not illegal under international law to require someone who wishes to emigrate or expatriate to pay a normal tax obligation. That is clear. Nor would it be illegal for the United States to tax unrealized capital gains annually—just to have a rule that says, every year we tally up, and whatever property anyone owns that has increased in value, we will estimate the price and make them pay that.

Similarly, it would not be illegal for the Soviets to have charged a fee for providing an education to their citizens. The legal issue arises when this is not done across the board, but rather where people who wish to leave their country and move permanently to another country are treated less favorably than other citizens by virtue of that fact.

Madam Chairman, again, I want to emphasize that honorable people can and do disagree on this issue. I have been working on it specifically for maybe 10 days now. I may change my own mind as the debate goes on. You will hear from other very respected witnesses later today on this issue. It strikes me that it is not an easy call. I think you have a difficult task.

But if I could in closing inject a personal note into the debate, I would urge you to move cautiously if you have any significant doubts about this provision's compatibility with international law. Because candidly, when I balance the importance of upholding international standards of human rights on the one hand against the possibility of coming up with a few billion dollars to help pay off the deficit, my personal values come down on the side of human rights every time.

Madam Chairman, that concludes my prepared testimony. I would be happy to answer questions at the appropriate time.

[The prepared statement follows:]

Prepared Statement of
PROFESSOR ROBERT F. TURNER
Charles H. Stockton Professor of International Law
U.S. Naval War College
before the
Subcommittee on Oversight
of the
House Ways and Means Committee
27 March 1995

MADAM CHAIRMAN, it is a great honor and a pleasure to appear before the subcommittee this afternoon 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, as your letter of invitation of last Thursday made clear, I was "invited to testify in [my] individual capacity, and not as a representative of the U.S. Naval War College."[2] 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.

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 last week—when I returned to the War College after testifying before the Senate Finance Committee on this same issue—I have been working under time pressures and have found it necessary to use my Senate testimony as a starting point for this afternoon's prepared statement.

The basic human rights issue raised here is 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[3] came before the Senate while I was the senior foreign policy adviser to Senator Robert P. Griffin of Michigan. 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. But both because of my lack of tax expertise and the lack of time to research the issues more thoroughly, I am less certain of my tentative conclusions.

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 also believe that this provision raises a sufficiently serious question under International Law that it warrants careful consideration before making a final decision on Section 201. To that end, Madam Chairman, I commend you for scheduling this hearing.

Even if in the end you conclude that the provision does not, in reality, violate the Nation's solemn human rights obligations, 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.

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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 68.

[2] Letter of invitation from the Honorable Nancy L. Johnson, Chairman, Subcommittee on Oversight, to Robert F. Turner, dated March 23, 1995.

[3] 19 U.S.C. §§ 2192 *et seq.*

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 human 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, as reflected in this excerpt from 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.[4]

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, and to return, safely and securely, by land and by water, saving their fidelity to us"; but even this limited "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."[5] Nor, for that matter, did the right to "travel" included a right of expatriation—a right far more easily sustained in the modern era, now that people have changed from being "subjects" of the King to being "citizens" of the State.

The Alleged Distinction Between "Emigration" and "Expatriation"

MADAM CHAIRMAN, the Office of the Legal Adviser to the Department of State,[6] the Congressional Research Service of the Library of Congress,[7] and some of my colleagues in the international law teaching community are trying to distinguish the right to "travel" from the act of renouncing one'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.

This argument was perhaps first set forward by my good friend and respected University of Virginia colleague, Professor Paul Stephan, in a letter to Assistant Secretary of the Treasury Leslie B. Samuels, in which he wrote:

> [I]t 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. . . . The so-called education tax that the Soviet Union threatened to impose on emigrants, which inspired 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. . . .
>
> The Administration's proposal . . . 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. . . .

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[4] 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).

[5] 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.

[6] *See* "Prepared Statement of Jamison S. Borck, Deputy Legal Adviser, U.S. Department of State, Before the Senate Committee on Finance, March 21, 1995."

[7] Congressional Research Service, American Law Division, Memorandum on "Whether Legislation That Would Tax Property Upon Expatriation Constitutes a Violation of International Law," March 28, 1995 (hereinafter cited as "CRS").

> 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. . . . For these reasons, it is inconceivable to me that the Administration's proposal could be seen as violating international human rights law.[8]

With all due respect to my good and highly respected friend Paul, who joins me on this panel and thus will be able to explain his position in greater detail, I believe he is mistaken on three important points:

- To be sure, the Jackson-Vanik Amendment used the term "emigration"; but I followed that issue closely as a Senate staff member in 1974—at a time when my younger colleague was just entering law school—and I am quite confident that our "concern" involved *all* of the impediments imposed by the Soviet Union to impede the permanent departure of Soviet citizens to other countries and their complete severance of the citizen-State relationship.

- Secondly, I believe Paul is mistaken when he asserts that International Law is not "concerned" with the "right to renounce one's citizenship."

- Finally, and I venture this point with less confidence in deference to Paul's greater expertise in Soviet Law, my understanding is that an important component of the Soviet effort to prevent Soviet Jews from emigrating to (and becoming citizens of) Israel was a 500-ruble "citizenship renunciation fee" that few could afford.

I will address each of these points in greater detail in the statement which follows.

The United States and the "Natural Right" of Expatriation

It is important to keep in mind that the claimed "right of expatriation" was at the very *core* of the intellectual justification for the American Revolution and has long been a fundament of US policy.[9] The very first sentence of the Declaration of Independence asserted that "the laws of nature" (which the Declaration's authors believed was a primary basis of International Law[10]) entitled "one people to dissolve the political bands which have connected them with another"[11] by declaring their independence. I hesitate to contemplate the potential consequences if the view voiced by the State Department last week had been shared by our Founding Fathers. But it clearly was not, and even before the Declaration of Independence was written, the great Virginia jurist St. George Tucker noted that Virginia courts had rejected the feudal doctrine of "indefeasible allegiance"—often expressed as "once an Englishman, always an Englishman"—and had recognized a "right of expatriation."[12]

MADAM CHAIRMAN, 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, Thomas 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:

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[8] Letter from Professor Paul B. Stephan III to Leslie B. Samuels, Assistant Secretary of the Treasury for Tax Policy, dated March 20, 1995, submitted for the record during the Senate Finance Committee hearing on this issue.

[9] "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).

[10] 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). *See infra*, note 14 and accompanying text.

[11] "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).

[12] 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).

> [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:

> 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 also to sever the legal relationship which creates legal duties and rights between citizens and 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.[13]

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 statue 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 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 US Congress 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 what he viewed to be principles of International Law. In his view, "[t]he law of nations . . . [was] 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]."[14]

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. It saddens me to witness able attorneys—on behalf of the Department of 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 human right to renounce U.S. citizenship. Having served in

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

[14] 3 WRITINGS OF THOMAS JEFFERSON 228 (Mem. ed. 1904). Today, the International Court of Justice views as "sources" of international law "international conventions," "international custom," the "general principles of law recognized by civilized nations," and "judicial decisions and the teachings of the most highly qualified publicists of the various nations [as subsidiary means]." I.C.J. STATUTE, Art. 38.

the Department of State myself.[15] 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. Secretaries of State John Marshall, James Madison, and James Monroe embraced the same doctrine; and through the early naturalization laws Congress, too, implicitly endorsed the view by requiring new citizens to renounce prior allegiances to former States before becoming Americans.[16] Furthermore, the War of 1812 was fought in no small part for the principle that Great Britain lacked any legal 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.[17]

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 the US Congress in 1868—during another of many controversies with Great Britain concerning the rights of 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.*[18]

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.[19]

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."[20] In the American view, such documents were unnecessary and inappropriate.

More recently, Section 349(a) of the Immigration and Nationality Act recognizes a right of every citizen to relinquish US citizenship.[21] 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."[22]

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 unrecognized appreciation of assets should they wish to exercise this

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[15] I served as Principal Deputy Assistant Secretary of State for Legislative and Intergovernmental Affairs, and for several months as Acting Assistant Secretary, during the Reagan Administration.

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

[17] *Quoted in id.*

[18] Expatriation Act of 1868, 15 Stat. 223 (1868) (emphasis added).

[19] James, *supra* note 16.

[20] *Id.*

[21] 8 U.S.C. § 1481, *quoted in* 87 AM. J. INT'L L. 601 (1993).

[22] *Richards v. Secretary of State*, 752 F.2d 1413 at 1422 (1985).

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 or her property. In reality, there would be no factual issue as to whether the targets of this tax had actually sold the property in question. 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 us 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/Expatriate

MADAM CHAIRMAN, the issue you have invited me to address, I gather, 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 complete 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/expatriate.

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[23]).

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," which will be discussed below under Customary International 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 (19-0) vote. On 2 April 1992, the Senate consented to the ratification of the treaty with a variety of proposed reservations, understandings, and declarations[24]; and the instrument of ratification was deposited with the United Nations on 8 June of that year with the recommended

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[23] 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.

[24] 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).

additions—none of which apply directly to the issue at hand.[25] 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.

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."[26] By its own terms, the Covenant was designed to be a legally-binding international treaty setting forth "inalienable rights" which were said to be "derive[d] from the inherent dignity of the human person"[27]—which sounds an awful lot like Jefferson's "natural law" rationale. 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.[28]

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, prescribe *unreasonable conditions such as exacting taxes or confiscating property* . . . . [emphasis added]"[29]

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,[30] for example, it is clear that a State may require a citizen to pay any normal tax obligations or other public debts.[31] 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."[32] 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 . . . ."[33]

In this regard I noted that the Congressional Research Service legal memorandum on this issue suggests that the term "public order" is "roughly analogous to the concept of public policy and likely includ[es] such notions as 'economic order.'"[34] While I'm not prepared to say that such an interpretation is beyond the pale, 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"—either of which might have arguably justified a special tax provision targeting unrealized appreciation of assets (and perhaps also a tax on the value of a State-funded Soviet education)—but these were *rejected* as

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[25] A possible exception is the first Declaration, specifying that the Covenant is Non-Self-Executing. *Id.* at 651.
[26] REPORT OF THE SENATE COMMITTEE ON FOREIGN RELATIONS ON THE INTERNATIONAL COVENANT ON CIVIL AND POLITICAL RIGHTS, *supra* at 649 (p. 3 of OT).
[27] Preamble, 6 INT'L LEG. MATS. 368 (1967).
[28] Art. 12, *id.* at 372 (**Bold** emphasis added.).
[29] THE MOVEMENT OF PERSONS ACROSS BORDERS 76 (Louis B. Sohn & Thomas Buergenthal, eds. 1992).
[30] *Id.* at 79.
[31] *Id.* at 82.
[32] *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).
[33] International Covenant on Civil and Political Rights, Art. 12.
[34] CRS, *supra* note 7, at CRS-2.

being "too far-reaching."[35] Restrictions on freedom of movement were only to be permitted in "exceptional" circumstances.[36]

I would note in this regard that, to the extent the precise meaning of Article 12 is "ambiguous or obscure," the Vienna Convention on the Law of Treaties[37]—which, although not ratified by the United States, is viewed by our Government as codifying existing customary international law in this respect[38]—permits recourse to "preparatory works" (*travaux préparatoire*).[39] The clear *rejection* of exceptions based upon a State's "general welfare" or "economic . . . well being" would seem to pose a serious obstacle to interpreting the Covenant to permit such an "exit tax" (or, if you prefer the term used by the Congressional Research Service experts, an "expatriation tax"[40]).

Furthermore, 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.[41]

This view is widely shared by other experts in the field.[42] Discussing Article 12 in a lengthy 1987 article in the *Hofstra Law Review*, a group of four attorneys from the New York law 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.[43]

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"[44]—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 Amendment [discussed *infra*] assures that the United States is bound by the highest standards of 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.[45] Time has precluded me from addressing these types of instruments further, but they are probably not critical to a resolution of the issue.

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[35] Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 389.

[36] *Id.* at 389, 394.

[37] U.N. Doc. A/CONF. 39/27 (1969), *reprinted in* 8 INT'L LEGAL MATS 679 (1969).

[38] In submitting the convention to the Senate for its advice and consent to ratification, the Department of State asserted that it is "already recognized as the authoritative guide to current treaty law and practice." S. EXEC. DOC. L., 92nd Cong, 1st Sess. at 1 (1971).

[39] Arts. 31 & 32.

[40] CRS, supra note 7, at CRS-5.

[41] 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.

[42] Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 396.

[43] *Id.* at 406.

[44] 660 U.N.T.S. 194.

[45] 14 INT'L LEG. MATS. 1292 (1975).

Customary International Law

Perhaps the most important written source of customary international human rights law[46] is the Universal Declaration of Human Rights, approved on 10 November 1948 as a UN General Assembly Resolution. Such resolutions do not have legal effect,[47] and the Declaration was clearly viewed as aspirational at the time—indeed, Mrs. Franklin D. Roosevelt, speaking on behalf of the United States delegation, expressly stated:

> In giving our approval to the declaration today, it is of primary importance that we keep clearly in mind the basic character of the document. It is not a treaty; it is not an international agreement. It is not and does not purport to be a statement of law or of legal obligation. It is a declaration of basic principles of human rights and freedoms, to be stamped with the approval of the General Assembly by formal vote of its members, and to serve as a common standard of achievement for all peoples of all nations.[48]

However, there is a *very* strong consensus today that the *Declaration* is legally binding by virtue of reflecting customary international law.[49] It provides:

Article 13

> 1. Everyone has the right to freedom of movement and residence within the borders of each State.
> 2. Everyone has the right to leave any country, including his own, and to return to his country.[50]

In view of the current attempt by supporters of the proposed new tax to distinguish the right of "emigration" from the act of renouncing citizenship, it should be noted that the Declaration also provides:

Article 15

> 1. Everyone has the right to a nationality.
> 2. *No one shall be* arbitrarily deprived of his nationality nor *denied the right to change his nationality.*[51]

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.[52] In reality, its only "legal" value is as evidence of binding customary law—but as such it is quite powerful. Its status as evidence of customary law 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,[53] rules of International Law are established by the *consent* of States. This can be done explicitly by ratifying a treaty or other international agreement,

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[46] 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).

[47] 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.

[48] 19 DEP'T STATE BULL. 751 (1948).

[49] *See, e.g.*, RICHARD B. LILLICH & FRANK C. NEWMAN, INTERNATIONAL HUMAN RIGHTS: PROBLEMS OF LAW AND POLICY 7 (1979); LOUIS SOHN & THOMAS BUERGENTHAL, INTERNATIONAL PROTECTION OF HUMAN RIGHTS 518-19 (1973); and Humphrey, *The UN Charter and the Universal Declaration of Human Rights*, in THE INTERNATIONAL PROTECTION OF HUMAN RIGHTS 51 (Luard, ed., 1951).

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

[51] *Id* (emphasis added).

[52] *See, e.g.*, 120 CONG. REC. 39787 (1973) (referring to the "ratifying nations" of the Declaration).

[53] 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.

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[54]—a State is not considered bound by customary legal rules against which it clearly protested during formation. Thus, it is at least arguable[55] that the Soviet Union was not bound by the Declaration as customary law in 1974.

The United States, in contrast, played a leading role in the drafting of the Declaration and has frequently treated its provisions as reflective of customary international law. In addition to the Jackson-Vanik Amendment, I would note that on 9 November 1982 the Department of State expressly invoked the Declaration in denouncing Romania's "public education tax."[56]

The 1974 Jackson-Vanik Amendment

MADAM CHAIRMAN, it is important to keep in mind that the United States Congress 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 don't know how many current members of the subcommittee served in the Ninety-Third Congress, so it may be useful for me to review the history of the "Jackson-Vanik" Amendment—also know as the "Freedom of Emigration" Amendment[57]—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.

The genesis of the Amendment was the effort by the Soviet Union to restrict Jewish emigration to Israel. In 1972, Moscow announced that future emigrants who had received higher education at the State's expense would have to pay a "diploma tax" to compensate for the value of the skill they were taking out of the country. In addition, at least as reported in the *New York Times* at the time, Soviet citizens wishing to emigrate to countries that lacked diplomatic relations with the USSR had to pay an additional 500-ruble "citizenship renunciation fee."[58]

As I said earlier, I am most hesitant to get into a quarrel with my good friend Paul Stephan about the details of Soviet law, as he is far more knowledgeable than I am on that general subject. However, I did take the liberty to look up "Emigration" in the two-volume 1973 *Encyclopedia of Soviet Law*, and I found an entry which read in part:

> [T]he current exodus of Jews from the USSR to Israel has led to the adoption of new restrictive administrative practices calculated to curb the flow of departures, intimidate potential applicants for exit permits, or bar the emigration of certain individuals whose qualifications are considered too valuable by the authorities to risk losing their services. These measures have included . . . *adherence to the requirement that the petitioner first formally relinquish his Soviet citizenship and pay a 500-rouble fee for the privilege of so doing*, [and] the imposition of an exorbitant surtax on those seeking an emigration visa justified as indemnification owed to the state for the cost of their education and professional training . . . .[59]

If Paul believes that these reports were in error, he may well be right for all I know and I would urge you to consider his evidence carefully. However, the fact remains that these were the kinds of reports we were getting on the Hill at the time; and even if they were mistaken they certainly influenced our thinking. Thus, when Paul writes that "we"—and here I assume the antecedent is the supporters of the Jackson-Vanik Amendment in the Legislative branch—were "indifferen[t]" to "[w]hether the communist regimes also made it difficult to surrender citizenship," he is simply mistaken.[60]

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[54] *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.

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

[56] *See*, Statement of State Department Press Spokesman John Hughes, 9 Nov. 1982.

[57] *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).

[58] *See, e.g.*, Gregory I. Teitelbaum, *Not This Year in Jerusalem*, NEW YORK TIMES, 9 February 1973, p. 35.

[59] 1 ENCYCLOPEDIA OF SOVIET LAW 245 (F.J.M. Feldbrugge, ed. 1973) (emphasis added).

[60] States may impose a wide range of substantial burdens on their citizens who reside abroad, ranging from various types of taxes to a requirement that they return to their homeland upon demand for military service, to appear in judicial proceedings, and the like. The clear objective of the Jackson-Vanik Amendment was not merely that Moscow allow Soviet Jews (and others) to make occasional tourist excursions to Israel (or elsewhere), but that these

As reported out of the House, Section 402 of the Trade Act of 1974 (H.R. 10710) included the so-called "Vanik Amendment"[61] 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."[62] In its accompanying report, this Committee referred to the "right to emigrate" as a "basic human right . . . ."[63]

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 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, the Jackson Amendment was introduced in the Senate with 78 co-sponsors[64] and was approved unanimously.[65]

As enacted into law, the provision provided 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 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).[66]

MADAM CHAIRMAN, even if you conclude that the proposed exit tax is not in conflict with the terms of the Covenant on Civil and Political Rights and the Universal Declaration of Human Rights, it strikes me that—given in particular the strong message sent by Congress via the Jackson-Vanik Amendment—it would be wise to consider 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—all the more so if the motivation for the move is perceived to be the avoidance of tax liability. Indeed, I think it is probably fair to assume that an underlying purpose for this proposal is to deter the so-called "super rich" from renouncing their citizenship; as, if they can be persuaded to maintain that relationship, we can probably extract even greater sums in tax revenues over the decades ahead.

While one might normally view this as a "political" problem for Congress to factor in during 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 more

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Soviet citizens be permitted to depart permanently from the USSR and to sever all legal connections with that country.

[61] 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).

[62] FINANCE COMMITTEE REPORT at 7213.

[63] *Id.* at 7338.

[64] 120 CONG. REC. 39782 (1974).

[65] *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.

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

hospitable environment in which to do business[67]—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 alienating more Americans and surrendering their right to vote in any case. One can see how this proposed new tax 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.[68]

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. Both arguments are premised upon the idea that the citizen who wishes to abandon his country has received benefits of calculable value from a relationship with the State, and from which the State would likely benefit over the years if the relationship continued. Thus, if they wish to terminate the citizen-State relationship, it is only fair that they compensate the State for the value they have received through the efforts (or at least the indulgence) of the State.

Indeed, one might argue that the Soviet argument was the stronger one. There, the State *paid* the costs of education—turning ordinary people into doctors, engineers, scientists, and the like—with the expectation that the cost would be recouped over years of service to society. In contrast, presumably the targets of the Administration's proposed new tax gained their wealth by building better "mousetraps," investing wisely, or taking exceptional financial risks with their own resources—and perhaps getting "lucky." The State in this case did not "take them to raise," it simply sought to run a "fair gaming table" at which all citizens could seek their fortune. If a large casino in that circumstance sought to insist that "big winners" leave their profits behind when they left, many of us would think it unfair.

Under existing law, as I understand it, the Treasury Department (IRS) will have a legal right to a large chunk of these people's money *if* they eventually sell their property—but not before. However, the Treasury Department is in desperate need of additional money to help offset the deficit, and if these "super rich" citizens are allowed to walk away from the table and take their money to another "game" we probably won't be able to collect all of that money. So, they are asking you to pass a new law providing that, if certain particularly attractive targets have the audacity to "walk away from the game" by renouncing their US citizenship, we will simply *pretend* that they have at the same time sold all of their property. We can then hit them with multi-million dollar tax bills on the basis of these nonexistent "sales." Hopefully, this will deter most of them from leaving; but, even if some of them do get away, under this bill we can grab much of *their* wealth as they get on the boat to leave.

Obviously, everyone in this room will benefit if we can find another couple of billion dollars to apply toward deficit reduction. I'm not unaware of that, and, like most of you, I would like to see the deficit reduced. But, at the risk of sounding an unpopular note, it does strike me that there are some rather serious ethical and legal issues which need to be addressed.

Let me emphasize that it would *not* be illegal under these rules of International Law for the United States to tax unrealized capital gains annually, or 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. It strikes me that this proposal does that. I'm no tax expert, but it appears to me that, in at least some circumstances, changing markets might dramatically decrease the value of some of the assets in question by the time they were actually sold; and other appreciated assets might actually avoid capital gains taxation entirely through the demise of the owner.[69] But even if I am mistaken, and Treasury can tell us with certainty that every penny they wish to assess through this provision would eventually be due from these individuals over a period of time, I would suggest that *time* is in itself more than a "nominal" penalty.[70] While most of us presumably can't relate to the idea of

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[67] 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.

[68] 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).

[69] To be sure, they might then be subject to an inheritance tax.

[70] Does anyone believe the courts would enforce a statutory provision requiring that dissidents who burn the American flag must pay their income taxes earlier than other citizens?

owing tens of millions of dollars in income taxes, my point can be affirmed by simply asking how many Americans voluntarily pay their federal income taxes years before they are due?[71]

Congress Can 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 interrelated,[72] 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.[73] The theory underlying this policy is that treaties and statutes have a co-equal standing as "supreme law of the land,"[74] and the lawmaking authority—be it the two chambers of the Legislative Branch acting with the approval (or over the veto) of the Executive,[75] or the Executive acting with the consent of two-thirds of those Senators present and voting[76]—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,[77] the oft-cited 1900 Supreme Court case of *The Paquete Habana* held that "the customs and usages of civilized nations" (customary international law) is part of US law "*where there is* no treaty and *no controlling* executive or *legislative act* or judicial decision . . . ."[78] Furthermore, while the recently ratified Covenant clearly creates a solemn legal obligation upon the United States under International Law, it is not self-executing and thus will not be implemented by US courts in the absence of independent legislative authority.[79]

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.[80] If the Congress elects to approve a statute that is contrary to the Covenant, it will by so doing make the United States an international lawbreaker.

To be sure, Congress in the past has on occasion enacted legislation which placed the Nation in such a status.[81] Such a decision has consequences, however. Not only might other treaty Parties have available meaningful remedies under International Law,[82] but violations of International Law by the United States contribute to a lack of respect for the rule of law in general and greatly undermine the ability of the United States to persuade 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.

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[71] On a somewhat lighter note, I believe it was Oscar Wilde who a century ago remarked: "Time is waste of money." Half-a-century later, George Bernard Shaw observed: "He who robs Peter to pay Paul can always depend on the support of Paul."

[72] 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.

[73] *See, e.g., Whitney v. Robertson*, 124 U.S. 190 (1888).

[74] US CONST. Art. VII

[75] *Id.* Art. I, Sec. 7.

[76] Id. Art. II, Sec. 2.

[77] *See, e.g.*, Louis Henkin, *The Constitution and United States Sovereignty*, 100 HARV. L. REV. 853 (1987).

[78] 175 U.S. 677 (1900) (emphasis added).

[79] 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).

[80] The only exception would be if a treaty were to provide for termination by act of a national legislature.

[81] 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 "Magnuson Fisheries and Conservation Act," passed around 1976. *See* the minority views of my former employer, Senator Robert P. Griffin, included in the Foreign Relations Committee's report on this bill for a discussion of this problem.

[82] 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*).

Conclusion

MADAM CHAIRMAN, as I indicated when I began, I did not come here today with the intention of taking a definitive position on this legislation on the merits. 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 proposed statute.

One thing that does strike me as being fairly clear is that drawing a distinction between "emigration" and "expatriation" is not the answer. To deny the right of expatriation would conflict with centuries of precedent in U.S. practice of International Law, not to mention Article 15 of the Universal Declaration of Human Rights. It would be contrary to statutory declarations by Congress dating back more than a century, not the least of which is the 1974 Jackson-Vanik Amendment.

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.[83] 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.

If the proposed "exit tax" is designed to discourage citizens from exercising their right to renounce US citizenship, I think it is contrary to the law. If it 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 to another country—and it 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 recognize capital gains liability), then I think you have a very serious problem. In that event, 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 than the United States Congress argued reflected the minimal requirements of International Law two 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.[84] 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[85]; and the issue of freedom of emigration has also been central to the debate over MFN status for China.[86] 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 may well 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,"[87] you may ultimately 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 similar fundamental 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 various

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[83] 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).

[84] 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).

[85] *Id.*

[86] *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).

[87] I hope I am not the only one who has been alarmed by the tone of some of the rhetoric in this debate. Indeed, if you but changed the nouns, some of the invectives now being directed against "super rich" Americans might easily be mistaken for Soviet diatribes against "Jews" a couple of decades ago.

provisions of the Covenant on Civil and Political Rights will receive in reply a counter-charge concerning American "violations" of Article 12—not to mention the Universal Declaration and our own Jackson-Vanik law.

In summary, last week's State Department testimony not withstanding, it has been the view of the United States government since George Washington was President that citizens of every State have a natural "right" to disavow their political connection with that State and to establish a citizenship relationship with another. That right is now a part of International Law, and it has been codified in American law for more than a century. The question each of you must answer is whether this proposed new "exit tax" places more than a nominal burden on the exercise of that right.

Unlike my friend Paul, I don't regard arguments on either side of this issue to be "inconceivable." On the contrary, I think you have a difficult task. But if I might inject a very personal element into the debate, I would urge you to move cautiously if you have any significant doubts about this provision's compatibility with International Law. Because, candidly, when I balance the importance of upholding international standards of human rights against the possibility of coming up with a billion dollars or so to help pay off the deficit, my personal values come down on the side of human rights every time.

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

Chairman JOHNSON. Thank you, Mr. Turner. I appreciate your very thoughtful testimony.

I think history does matter. I think the effort to be consistent with our own beliefs in different areas is important, and I appreciate your advice to be cautious.

I think it is particularly important in this era in which we just passed a GATT Agreement that is going to require the nations of the world to respect America's definition of the importance of individual property rights, both tangible and intellectual. I think it is very important that we be sure that we act consistently, particularly in regard to uniform values and uniform rights, and I appreciate your testimony.

Mr. Norman.

STATEMENT OF WILLIAM K. NORMAN, ESQ., PARTNER, ORD & NORMAN, LOS ANGELES, CALIFORNIA

Mr. NORMAN. Thank you. Madam Chairman and Members of the Subcommittee, I am here to testify in opposition to the proposal of the administration to impose a new tax on individuals who renounce their citizenship. I am appearing on my personal behalf.

I believe that the administration, the Department of Treasury and various Members of Congress who have been supporting the new proposed expatriation tax have failed to make the necessary public policy case. Only a political case has been made, not so much here today by Mr. Guttentag, but in the press releases and in the Senate hearings.

As a tax lawyer working in the field, I believe the tax policy implications of the proposal and the need for this tax need to be examined more closely. Congress should determine why our citizens are considering to expatriate in the first place.

You have asked today a member of the Treasury why they never issued regulations. I have to admit it is the first time I have ever heard the IRS say they haven't issued regulations because they thought the underlying law couldn't be enforced. We should ask why they haven't issued forms, special forms when people expatriate so we can identify who these 800 people who expatriated are, for instance, this year.

I think more time and more study and hearings are needed to determine if we as a country actually have an expatriation problem and if so, what is the appropriate response.

I think Congress probably had the power to enact the proposed tax or something like this tax, but we need to consider whether we should enact it, not just whether Congress has the power, if we just modify it here and there. Tax motivated expatriation can be discouraged through more positive measures.

Just from my own practice, the lowering of capital gains rates would make a big difference, if not eliminate the motivation for a great many of these people who do expatriate for tax reasons; more effective estate tax deferral provisions when you have deaths with a closely held business would also help.

Congress should also recognize, as has been mentioned here earlier in the Chair's remarks, that dual citizens, U.S. and foreign country citizens, often have legitimate nontax motivated reasons

for renouncing their U.S. citizenship and retaining a foreign country citizenship.

In particular, I suggest that the proposed tax should not be adopted for three reasons. They are in my prepared remarks, but I'd like to summarize them. First, I think it is bad tax policy with likely detrimental economic consequences. Some of our most successful individuals that do not yet have a high net worth or appreciation in their assets will now have a new threshold that is going to get them thinking about whether they should expatriate or not. Because if they build up too high a net worth in the United States, they will be subject to a limitation if they ever leave the country.

There are a large number of people, at least in my practice, who have left—largely in terms of my own total experience—who have renounced not for tax-motivated reasons principally, but for patriotic or personal political allegiance or religious reasons. We are talking about individuals going to Ireland, Israel and some of the Eastern bloc countries. These possibilities with the cold war essentially over and the gulf war resolving questions of political military power in the Middle East have opened up possibilities for many of our dual citizens that were not present before or were unthinkable before.

Second, the proposed tax will discourage foreign resident individuals from becoming long-term residents, if that is the coverage of the proposal, or long-term residents from becoming naturalized citizens. We are going to have a class of wealthy aliens who are residents and who are going to be afraid just for protection of their family and for economic reasons to seek U.S. citizenship, because once they are in the system, they never can leave, they can never make that choice to go back home if their circumstances change.

Wealthy foreign individuals who consider countries to which they emigrate, and there are large numbers of these each year, certainly from the Far East and Asia that we see in California, are going to stay away from a country that seems to need an exit tax or what is perceived to be an exit tax, and not get into what in fact this tax really is, or needs such a tax to keep its citizens home. That tax is just not going to be attractive. It is going to be discussed in international seminars. It is going to be in the South China Morning Post. It is going to be something that is going to be well known to this class of individuals throughout the world.

The United States is going to continue to lose out in competition for the economically successful emigrants. It is already losing out to Canada, a much smaller country that has many more immigrants coming to its shores. Canada, even though it has a so-called exit or departure tax, does have special reliefs for immigrants.

A third—I think the proposal represents a major departure in Federal tax policy. We need to think about what this means in terms of our tax treaty relationships. Time is needed to renegotiate these treaties. We just finished a long negotiation with Canada where we had to accommodate their capital gains tax which is a form of exit or departure tax with our own estate and gift tax sections. It is just difficult and takes time if we are going to go this route.

We don't know what the real policy basis is for these various thresholds and why foreign assets are in the base. They were not

essentially in the base under section 877, the section we are talking about. Why is there no indexing of the exemption amounts? Why do we treat—rather, why don't we treat all expatriates the same instead of only those with appreciated assets? Maybe the threshold should be on net taxable estate. We are talking about the superrich leaving. Why not use something like a net worth of $10 million which is where our highest estate tax rates come in.

In the meantime, I think we ought to encourage the IRS to enforce the current law. They should issue regulations. They should develop compliance procedures.

If we must change 877 because it is not enforceable, I have some suggestions which are not in my remarks, but just bear with me for a moment. We could change the presumption of correctness in the statute, so that the determination of the IRS, as they have in intercompany pricing cases under section 482, would be presumed correct. It would be up to the taxpayer to show he didn't have a tax motivation.

We could have regulations that define tax avoidance. The Treasury just did this in proposed form with respect to the multiparty financing regulations under section 7701. They define what a tax avoidance plan is.

We could have reporting at the time of expatriation, or require a statement supporting why the expatriation is not for tax avoidance purposes. We have similar statements now with respect to nonaliens who claim to have a closer connection with a foreign country. They have to file a statement.

We could provide that these individuals will continue to be treated as residents of the United States if they stay or have a physical presence in the United States beyond 90 days in the next 3 years, so we know they really have gone and they really are serious about their expatriation.

We could even have changes in our immigration law. These people should have to go to the back of the line so that they don't come back and get green cards and even citizenship in some short period of time. Maybe a 5-year period where they couldn't apply for a green card. Why should they expatriate and then have them come back through our system?

I think just to close up, there are very few dual citizens who will make the choice to go to a foreign country. But I think we have to respect the fact that for some individuals who do not have tax motivation, that in their own view, it is the right choice, and we should respect it.

Our country was founded on people who made such a choice, and those who made the wrong choice, if you go back and look at history, went to the Bahamas or Bermuda. These very places that were mentioned in the Forbes article that the Treasury representative referred to. But look how many people are there, a handful, and just a handful are ancestors of these people who made that choice at the time our country was founded.

That concludes my statement.

[The prepared statement follows:]

PREPARED STATEMENT

of

William K. Norman, Esq.
Partner
Ord & Norman
Attorneys at Law
Los Angeles, California

Before
Committee on Ways and Means
Subcommittee on Oversight
U.S. House of Representatives

Room 1100 of the Longworth House Office Building

Monday, March 27, 1995

Madam Chairman and Members of the Subcommittee, I am here to testify in opposition to the proposal of Administration to impose a new tax on individuals who renounce their United States citizenship. I have in the past represented individuals who have renounced their United States citizenship or surrendered their green cards. I and my firm currently represent clients who have an interest in the proposal relating to expatriation before the Subcommittee today and the other proposals relating to foreign trusts contained in the original proposal of the Administration released on February 6, 1995. I am testifying here today on my own behalf and I am personally bearing the expenses of preparing my statement and appearing here today.

I believe that the Administration, Department of the Treasury and various members of Congress supporting the new proposed expatriation tax have failed to make the necessary public policy case for their proposal. Only a political case has been made. The new tax is technically not a tax on change of residency or on travel itself. It is in essence a tax targeted against the dual citizen who chooses to become a citizen of only one country, a foreign country, rather than the United States. As a tax lawyer working in the field, I believe the tax policy implications of the proposal need to be examined more closely. Congress should determine why our citizens are considering expatriating in the first place. The Internal Revenue Service should be asked why it has never embarked on serious enforcement efforts in this area. Specifically, the IRS should be asked why it has never issued regulations under the existing Internal Revenue Code provisions dealing with expatriation or why it has never required special forms to be filed at the time of expatriation.

More time, including hearings, are needed to determine if we, as a country, actually have an expatriation problem and, if so, what is the appropriate legislative response, if any. If Americans for tax reasons are in fact leaving this country and abandoning their citizenship in crisis numbers, it cannot be for the healthcare facilities in Belize or Nevis or the low taxes in Australia, Canada or the United Kingdom. Congress should not devise and enact legislative solutions to nonexistent crises or to a crisis not understood. Did not the voters in 1992 and in 1994 send a clear message that Congress and the President should find real solutions to real problems? Even if a new tax seems warranted, we need to consider the international implications, *i.e.*, how will the proposed new tax mesh with the tax systems of other countries, especially the tax systems of our treaty partners. Congress probably has the power to enact the proposed tax but it needs to consider carefully whether it should do so. Tax motivated expatriation can be discouraged through more positive measures such as lowering the capital gains tax rates. Congress should recognize that dual citizens often have legitimate non-tax motivated reasons for renouncing United States citizenship and retaining a foreign country citizenship.

The new tax as proposed should not be adopted for the following three reasons:

First, the imposition of an exit tax on certain U.S. citizens who renounce their citizenship is bad tax policy with likely detrimental economic consequences. Some of our most successful individuals will be encouraged to expatriate before they build up the threshold levels of appreciation in their assets. Further, the new provision is unfair to dual citizen individuals who seek to renounce their United States citizenship and return to their homeland either for patriotic or religious reasons. If somebody is going to move abroad and become, for example, politically active in Ireland or Israel, why should they retain their United States citizenship? The individual is not an economic traitor to this country. The individual is merely being true to his

or her own beliefs and heritage. Only a handful of individuals, perhaps a dozen, will be annually subject to significant levels of tax under the proposal. Surely, a less radical approach can be found.

Second, the proposed tax will discourage foreign resident individuals from becoming long term residents of the United States and long term resident aliens from becoming naturalized U.S. citizens. Specifically, resident aliens will be encouraged to remain United States residents for economic reasons and not seek United States citizenship. Once an alien becomes a U.S. citizen, he will not be able to remove himself from the U.S. tax system without being subject to tax on the appreciation in his assets provided the thresholds are reached. The United States will be sending the wrong message to the potential immigrants. Wealthy foreign individuals considering countries to which to immigrate will be shy of a country that needs an exit tax to keep its citizens home. In general, the United States will continue to lose out in the competition for economically successful immigrants to Canada, Australia and others. For example, even though Canada imposes a tax somewhat like the proposed exit tax, it provides a fresh start in the form of a new basis for the assets of its immigrants. Further, Canada permits establishment of pre-immigration foreign trusts to avoid Canadian taxation on income derived from assets acquired by an immigrant before he or she establishes Canadian residency.

Third, since the proposal represents a major departure in federal tax policy, a detailed study is warranted. In this connection, a number of matters should be studied. Consideration should be given to providing a grace period in order that the United States will be able to renegotiate its income tax treaties to accommodate this new system. The United States just went through a rather long period of negotiation with Canada to accommodate the Canadian capital gains tax with our own estate and gift tax system. Additionally, a stronger policy rationale for the coverage and exemptions in the proposal needs to be developed. Should only U.S. citizens be covered? Should short term and long term residents be covered? What is the policy basis for the various thresholds or exemption amounts? Why are foreign assets even in the tax base? Why is there no indexing of the exemption amounts? Why are not all expatriates treated the same, instead of only those owning assets with the threshold amounts of appreciation? Perhaps the threshold should be based on net taxable estate and not on a specified amount of built-in appreciation. Further, consideration should be given to providing a February 6, 1995 fresh start tax basis for all taxpayers who become subject to the tax. Finally, if the proposed tax is intended only to be imposed on the very rich, why not increase the threshold amount to persons with net asset values of $10 million dollars or more -- the levels where the very top United States estate tax rates are imposed.

In the meantime, Congress should encourage the IRS to enforce the current law concerning tax motivated expatriation. Congress should ask the IRS to issue regulations, just as Congress has done a number of times with respect to inter-company pricing. Congress should ask the IRS to develop compliance procedures that will help it identify cases of expatriation that are tax motivated and subject to the current regime in the Code. The IRS could develop a procedure for "quarantining" United States assets at the time of expatriation so that the tax imposed under existing Section 877 will be collected at the time there is a realization event. Finally, Congress should ask the IRS to add these projects to its current 1995 business plan.

In 1966, Congress apparently enacted the existing Code Section 877 dealing with tax motivated expatriation because it believed it was at the same time making the United States tax laws too attractive for nonresident aliens. Now in 1995, a handful of U.S. citizens apparently believe that our tax laws have made it too burdensome for them to remain American citizens. If this is so, how can enacting a new tax, a tax on the freedom to abandon dual citizenship be ameliorative? Congress should find out why some U.S. citizens are considering expatriating while at the same time immigration to this country is at a record high. If the policies of our country are driving our rich citizens to expatriate and encouraging the alien poor to immigrate, we certainly have a problem. If such a problem exists, careful congressional study is called for. Any legislative solution needs to be carefully crafted.

The use of the proposed new tax on expatriates as a favorite revenue offset is not responsible given the serious harm that may result from the enactment of the proposal as currently formulated. We need a "Stay American" and "Invest American" Tax Incentive Act and not an Act that will make Americans the pariah of the world's rich, successful and entrepreneurially able. We should not wage economic warfare on some of our most successful citizens and residents and call them "Economic Benedict Arnolds." Even those who give up United States citizenship or long term residency should not be discouraged from investing in the United States. Finally, those wealthy aliens currently living abroad seeking a country to which to immigrate should not be discouraged by a U.S. tax system hostile to change in residency or even citizenship. We live in a world of change.

Mr. HANCOCK. I want to take this opportunity to underline, Madam Chairman, if you would yield, this one sentence that you have in your testimony, Mr. Norman. It says, If the policies of our country are driving our citizens to expatriate and encouraging the alien poor to immigrate, I mean we really have a problem. And I don't think you meant—you should have emphasized that a lot more.

Mr. NORMAN. I was trying to tone down the rhetoric in response to the other Member.

Chairman JOHNSON. Mr. Heller.

STATEMENT OF LAWRENCE H. HELLER, ESQ., PARTNER, WHITMAN BREED ABBOTT & MORGAN, LOS ANGELES, CALIFORNIA

Mr. HELLER. Thank you.

Madam Chairman and Members of the Subcommittee, I am here today to testify in opposition to to the President's budget proposals to impose a tax on U.S. citizens who renounce their citizenship and long-term resident aliens who give up their resident status. I am testifying in my personal capacity.

I would like to submit my statement for the record, and will take this opportunity now to summarize some of the key elements of my statement.

I feel that the administration's proposal is deficient and unnecessary for several reasons, many of which we have heard today. I feel the most compelling are, number one, the Treasury has failed to issue regulations or take any serious measures to improve enforcement of section 877. We have talked about that many times today. We have an existing statute. The statute has been around for almost 30 years, and yet testimony by Treasury and other witnesses has confirmed that nothing has been done about it. Let's use that statute, let's take a look at it and see how it can be used to put a—or to work with some of the perceived problems.

Number two, the proposal fails to recognize the need for the international coordination of taxes. This is a complex area, and it needs further study and analysis. The proposal fails to—excuse me. The revenue estimates are based on flawed assumptions and are thus incorrect.

And finally, the proposal fails to recognize and adequately address the various administrative problems that will result from the new tax regime.

With regard to section 877, as I have indicated before, and this is the current statute, I find no evidence to support the proposition that the existing rules have been tested and are ineffectual. These expatriation tax rules were originally enacted over 30 years ago, as I have indicated. What were they designed to accomplish?

These rules were designed in section 877, which is attached as an exhibit to my statement, to impose a tax on U.S. citizens who expatriate. That is what we are talking about today. Basically, it was designed to impose a tax over a 10-year period in areas that are not otherwise covered by the normal tax regime. Non-U.S. taxpayers are only taxed on their U.S.-source income.

The 877 went one step further and attempted to impose a tax on U.S. citizens who expatriate by adding a restriction and imposing

a tax on their assets that are sold during that 10-year period, assets that may otherwise not be subject to taxation. This was the purpose of the statute in 1966. It is covered by the Committee reports.

Why does the Treasury feel that this section needs to be overhauled? As one of their reasons they have cited that the burden on the Treasury is too onerous to establish the tax avoidance motive. Well, let's look at that. There are several situations where in the past the burden has been shifted. Maybe we ought to take a look at shifting the burden to the taxpayer or, as Mr. Norman indicated, providing guidance so that we know under what situation the burden will be imposed.

The imposition of tax must wait until the property is actually sold, requiring the IRS to monitor these transactions. That is another perceived problem with the current section 877. Well, in the Treasury's own testimony, they have indicated that this would be a problem with the new proposed section 877.

There are many ways to monitor the transaction short of issuing an exit tax. An interim measure is a little bit of an overkill when the current statute hasn't even been utilized.

I won't go into the details now, but if you look at my statement, I have indicated ways that the IRS and the Department of State can coordinate their efforts to monitor the expatriating citizens and to find out who is paying their taxes and who isn't, who is filing returns and who isn't.

Mr. Norman indicated, and I support the idea of filing a statement when you expatriate and providing the IRS with information. After all, this is a voluntary tax system. We do base our entire system on voluntary compliance.

As I have indicated, the proposal fails to recognize the need for international coordination of taxes. Much has been said about this. I will only state that I feel this requires considerable study. Analysis needs to be made of the various tax treaties.

I think there is a serious problem involved with double taxation. If you tax the U.S. citizen now and then when he sells his assets, when he is a resident of another country, he is going to be subject to a second tax, without the ability to use any of the credits that are now available. This is going to create a real treaty problem, and I think maybe it can be worked out and maybe not. But it is part of the administrative nightmare that we are looking at.

What about the fact that we are trying to tax our citizens on a nonrealization event? Take the hypothetical situation of Mr. A who has an interest in the closely held corporation. If he expatriates, then he may be forced to pay the tax without having the cash to—or the cash flow to pay the tax. Where is he going to get the tax? Where is he going to get the funds? Is he going to have to liquidate his business? Is he going to have to borrow from the bank? Is this going to further skew our national economy? Yes.

The Treasury has suggested that maybe under certain circumstances, specifically section 6166 of the Internal Revenue Code, this individual would be able to defer his tax, maybe 5 or 10 years. But he is deferring his tax, he is still paying interest on that deferral, and if you look at section 6166, it is not a full deferral, but it

is basically an installment payment of the taxes. So it doesn't solve the problem at all.

Somebody mentioned earlier today that death is a nonrealization event. Well, that is true. However, as an estate planner practicing in this area for over 25 years, we learn to plan to pay for the taxes in the event of death. Life insurance is available, and there are other planning techniques that help eliminate this nonrealization event and provide for the liquidity that is necessary in the situation. There is no liquidity provided with this exit tax that is being proposed by the Treasury.

We are very aware of the flawed revenue estimates and the assumptions here. I haven't heard anything today that changes my concerns in this area. I feel that there is nothing that really has convinced me that the $970 million that have been projected by the Treasury to raise in 5 years from the 24 taxpayers will ever be realized. So I think this is a real concern and something that has to be fully analyzed.

Finally, I think that we have to look at ways to encourage our citizens to stay here, fix the problems at home, reduce the capital gains rates as an example, work on our other problems. Let's see why these citizens are leaving; let's conduct studies in this area.

I think that with the proper analysis and the proper study, we can work together to solve the problem that can be readily solved without taking these extreme measures.

This concludes my remarks and I will be glad to answer any questions.

[The prepared statement and attachment follow:]

PREPARED STATEMENT

OF

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CHAIR, INTERNATIONAL, PROPERTY, ESTATE AND TRUST LAW
COMMITTEE
SECTION OF INTERNATIONAL LAW AND PRACTICE
AMERICAN BAR ASSOCIATION

(TESTIFYING IN PERSONAL CAPACITY)

BEFORE

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
UNITED STATES HOUSE OF REPRESENTATIVES

ROOM 1100 OF THE LONGWORTH HOUSE OFFICE BUILDING

MONDAY, MARCH 27, 1995

Madame Chairman and members of the Subcommittee, I am here today to testify in opposition to the President's FY 1996 budget proposals to impose a tax on United States citizens who renounce their citizenship and long-term resident aliens who give up their resident status. I am testifying in my personal capacity as a partner in the law firm of Whitman Breed Abbott & Morgan.

Under the Administrations's proposal, if, after February 6, 1995, 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. This "deemed realization" provision would also apply to a "long-term resident" defined, under the proposal, 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. For this purpose, property that would be treated as sold would include all items of property (with the exception of certain U.S. real property interests and interests in domestic retirement plans) 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.

On March 15, 1995, the Senate Committee on Finance adopted a modified version of the Administrations proposal as an amendment to H.R. 831, a bill extending the health insurance deduction for the self-employed. Under Section 5 of H.R. 831 the proposal's application to resident aliens was eliminated and the effective date for the renunciation of citizenship was clarified to be the date the individual initiated the process with the State Department. H.R. 831 also attempted to clarify the treatment of beneficial interests held in trusts by expatriating citizens.

The Administration's proposal is deficient and unnecessary for several reasons, the most compelling of which are that: (i) the Treasury has failed to issue regulations or take any serious measures to improve enforcement of section 877, (ii) the proposal fails to recognize the need for the international coordination of taxes, (iii) the revenue estimates are based on flawed assumptions and are, thus, incorrect and (iv) the proposal fails to recognize and adequately address the various administrative problems that will result from the new tax regime.

I. **Failure to Recognize That the New Law is Not Necessary Given the Lack of IRS Efforts With Respect to Existing Provisions.**

I find no evidence to support the proposition that the existing rules under current section 877 (see Exhibit "1") have been tested and are ineffectual. These expatriation tax rules were originally enacted in 1966 and in the almost 30 year period since, the Treasury has failed to enact any regulations interpreting Section 877 or provide any guidance for their application. Furthermore, the tax reasons for expatriating are overstated and the disincentives to move to low tax jurisdictions are understated.

Despite this lack of prior attention to the current section 877, the Treasury has concluded that section 877 does not work[1] and needs to be overhauled, citing as its reasons: (i) that the burden on the Treasury to establish that the taxpayer has a tax avoidance motive is too onerous, (ii) since current section 877 only applies to U.S. source income, it is subject to abuse because taxpayers are able to convert U.S. source income into foreign source income and avoid tax altogether, (iii) the rules are extraterritorial in nature and, thus, may unfairly tax the expatriate for post relinquishment U.S. source income earned during the ten year period, and (iv) the imposition of the tax must wait until the property is actually sold requiring the IRS to monitor transactions that occur long after an individual relinquishes his citizenship.

Burden of proof with respect to the tax avoidance motive. I find no merit in the Treasury's position that the burden of establishing that the taxpayer has a tax avoidance motive is too onerous.[2] At the outset, the scope of the Treasury's burden of proof should be examined, in light of what is *not* required. The Commissioner's burden under current Section 877 is *not* to establish that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, but rather the Treasury Department must establish that it is *reasonable* to believe that the expatriate's loss of U.S. citizenship would, but for the application of section 877, result in a substantial reduction in the U.S. tax based on the expatriate's probable income for the taxable year (sec. 877(e)). Establishing this reasonable belief shifts 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 to the taxpayer.

Furthermore, even if there was a legitimate basis for the Treasury's position, current section 877 could be amended to shift the burden of proof to the expatriating citizen from the outset.

Ability to convert U.S. source income to foreign source income. The Treasury is concerned 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 and that some practitioners advise their clients on ways to accomplish this conversion in a manner that purports to avoid section 877. Even if this was a legitimate problem, less draconian measures are available such as amending current law, i.e., section 367 or issuing regulations under existing section 877.

Post emigration gains should not be subject to U.S. taxation. The Treasury believes that[3], since existing ten-year expatriation rules are extraterritorial in nature, and therefore, tax gains accruing between expatriation and the sale of the asset, it is unfair to tax an expatriate who purchased U.S. stock the year after he relinquished his citizenship and sold

the stock eight years later. I hardly find this to be a compelling reason to change the existing provisions and arguably, it is just as unfair to impose an exit tax on the same person before there has been a realization event.

Monitoring post relinquishment sales. The Treasury is concerned that the requirement of current law that the imposition of the tax must wait until the property is actually sold requires it to monitor transactions that occur long after an individual relinquishes his citizenship.[4] The above notwithstanding, coordinated efforts among the IRS, the State Department, Custom Service and Immigration and Naturalization can improve enforcement of the current section 877. Currently, the IRS does not request 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 relinquishment 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.

With coordinated notification efforts, the IRS can determine whether an expatriate possesses any assets within the United States that could be seized to satisfy the tax liability in situations where a concern that the revenue may not be collected exists. Seizure of assets for failure to pay taxes is permitted under present law. Also, 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.

II. The Proposal Fails to Recognize the Need for International Coordination of Taxes.

I do not intend to dwell on the public policy arguments that have been raised by those who consider the proposal to be draconian and nothing more than an "exit tax" on emigrating U.S. citizens and long-term residents aliens.[5] Rather, my concern is that, without responsible fiscal analysis and review of the broad policy and international implications of these proposals, the impact of creating a negative image in the international community may outweigh any hypothetically perceived revenue returns. Imposing an exit tax on U.S. citizens sends the wrong signals to the international community. The proposal is already having serious repercussions outside the United States with some wealthy foreigners even considering divesting their U.S. investments.[6]

The broad policy implications do not stop there. There will be a need to mitigate the double tax effects in the new jurisdiction upon the actual subsequent sale of assets by the departing taxpayer and there will be a need to thoroughly analyze and renegotiate treaties to accommodate timing differences. The proposal also fails to provide transitional relief for bonafide dual citizens.

III. Failure to Recognize the Administrative Problems.

The administrative problems raised by the proposal are considerable. Without a "realization event," extra resources must be devoted to determining the value of the assets of the taxpayer who is relinquishing his or her citizenship. Additional costs will be involved since, in many circumstances, professional appraisals will be necessary, thereby adding additional expense to a taxpayer who may already be burdened with "cash flow" problems.

Imposition of an Income Tax where there is a Nonrealization Event.

A taxpayer should not be required to pay income tax until there has been a sale or other disposition of property. Under the proposal, 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 day of expatriation. Gain or loss from the deemed sale is recognized at that time, generally without regard to other provisions of the Code. Such a provision puts an undue cash flow and liquidity burden on the taxpayer. Taxing unrealized gains also mismatches the timing of U.S. and foreign income tax so that foreign tax credits will not be effective to prevent double tax.

Further study is required for many reasons. Additional time is needed for coordination with both domestic and foreign estate and gift tax rules. The proposal fails to impose any obligations on the IRS to issue regulations. An analysis should be made and a study undertaken to determine the hidden costs of enforcement of the new provisions. 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. The IRS can expect disputes over valuation of assets that are deemed to have been sold when no transaction, in fact, took place. This will result in additional costs in terms of auditors and other IRS personnel.

Jeopardy Assessment. The proposal raises several other administrative questions. First, is the proposal necessary in light of the jeopardy and termination assessment procedures already available under Sections 6851 et seq. of the IRC? Under the jeopardy and termination assessment procedures, the IRS may assess the taxpayer's tax and immediately commence collection if: (i) it appears that the taxpayer is or appears to be designing to depart quickly from the United States or to conceal himself; (ii) if the taxpayer is or appears to be planning to quickly place his assets beyond the reach of the IRS; or (iii) if the taxpayer's financial solvency is or appears to be imperiled. If the IRS makes a jeopardy or termination assessment based on reasonable grounds that suggest one of the above-referenced situations is taking place, it must provide the taxpayer with a written statement setting forth the information which the IRS used in making the assessment. The taxpayer then has the earlier of (a) thirty (30) days from the receipt of the written statement or (b) thirty-five (35) days from the date of the assessment to file an administrative appeal. Failure to file such an appeal will permit the IRS to proceed with enforcement procedures to collect the unpaid taxes.[7]

Consequently, if the IRS is notified by the U.S. State Department of U.S. citizens seeking to relinquish their citizenship or by the Custom Services or the Immigration and Naturalization Services of U.S. of aliens seeking to leave the United States, the IRS could then utilize the jeopardy and termination assessment procedures to collect necessary taxes. However, the IRS has not requested the State Department 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" to determine which taxpayers may have relinquished citizenship with a tax motivation.

Conflict between Sections 6851 et seq.and the proposal.

Under the proposal, an individual who is subject to the tax on expatriation is required to pay within ninety (90) days 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. On the other hand, under the jeopardy and termination assessment procedures, the IRS could enforce collection actions within thirty (30) days after giving notice to the taxpayer. Presently, there is no provision in the

jeopardy and termination assessment procedures, the existing law (under the current section 877) or the proposal that addresses this conflict.

In this regard, the U.S. Senate's Joint Committee on Taxation released a report (JCX-14-95) on taxation of U.S. citizens who relinquish citizenship which suggests that Section 877 would govern over the jeopardy and termination assessment procedures. At the end of Part II of the report, the Committee acknowledges that the Senate-modified section 877 "would replace the current 'sailing permit' requirement under Section 6851(d) of the jeopardy and termination assessment procedures with a new requirement to file a short-year tax return" (i.e. the ninety (90) day filing requirement of Section 877). Section 6851(d) and the regulations thereunder currently require any alien who leaves the United States, regardless of the duration of the trip, to obtain a certificate from the IRS District Director showing that the alien has complied with all U.S. income tax obligations before the alien can leave the country. Obviously, compliance with this requirement is infrequent. Under H.R. 831, however, any alien who leaves the United States would be required to file a tax return and pay the relevant tax within ninety (90) days of the date that the alien ceases to be a U.S. resident. Nothing would be required of a resident alien who returns to the United States as a resident within ninety (90) days of departure or otherwise maintains U.S. residence.

The Joint Committee's interpretation that H.R. 831 would govern over Section 6851(d) would appear to be equally applicable in instances involving U.S. citizens who relinquish their citizenship. Thus, pursuant to the Joint Committee's analysis above, the tax liabilities of a U.S. citizen who relinquished his citizenship would be governed by H.R. 831 instead of the jeopardy and termination assessment procedures.

IV. **Failure to Recognize the Flawed Assumptions Under which the Revenue Estimates were Made.**

If the Administration's proposal becomes law only the marginal taxpayer will continue to expatriate, thereby eliminating any immediate significant sources of revenue. Even if wealthy U.S. citizens continue to emigrate, the revenue impact can hardly be significant. In fact, according to the Treasury's own estimates[8], wealthy taxpayers are emigrating at the rate of only two dozen per year. Taxing our citizens a dozen at a time can hardly justify the use of the legislative and administrative resources that will be called to bear. The negative image and mixed signals that this will give to the rest of the world and the international community by imposing such an exit tax hardly compare with the hypothetical revenue increases. Consideration should thus be given to the revenues lost by discouraging high net worth foreign individuals from immigrating to the United States.

Other concerns include the fact that the high cost of administration has not been reflected, losses from discouraging domestic investment by wealthy foreign individuals needs to be considered, and losses from United States citizens encouraged to plan for low appreciation in their assets and future high income potential may be a factor to consider, as well as does the loss from entrepreneurs and high income potential (for current low net worth) citizens who expatriate before developing a high net worth.

V. **Other Solutions Exist**

A. "Quarantine" U.S. assets at time of expatriation and impose tax at time realization event occurs. U.S. assets may be "quarantined," *e.g.*, QDT and tax imposed only upon a subsequent realization event.

B. Reduce capital gains rate to eliminate motivation.

C. There is no public policy rational for the proposed exemption: foreign vs. domestic pensions, foreign assets in tax base, no indexing of exemption amounts, all expatriates should be treated the same.

D. Authorize IRS to conduct study and issue anti-abuse regulations under current law.

E. Apply tax only to appreciation occurring after February 6, 1995.

F. Provide the tax is not applicable to existing dual citizens for five years.

G. Provide the tax is not applicable to individual who become citizens of a treaty country for five years.

H. Additional suggested changes to current proposal.

i) Foreign personal residences and foreign pension plans should be exempt. More than 5 years should be allowed to pay tax attributable to business interests.

ii) 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.

iii) 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.

FOOTNOTES

1. Statement of Assistant Secretary of the Treasury (Tax Policy), Leslie B. Samuels, delivered during the Oversight Committee of Finance of the United States Senate hearings on March 21, 1995.

2. There are numerous civil provisions in the Code that explicitly place the burden of proof on the Commissioner in specifically designated circumstances: (a) Fraud. Any proceeding involving the issue of whether the taxpayer has been guilty of fraud with intent to evade tax (secs. 7454(a); 7422(e)). (b) Foundation Managers. Any proceeding involving the issue of whether a foundation manager has knowingly participated in prohibited transactions (sec. 7454(b)). (c) Transferee Liability. Any proceeding in the Tax Court to show that a petitioner is liable as a transferee of property of a taxpayer (sec. 6902(a)). (d) Review Of Jeopardy Levy Or Assessment Procedures. Any proceeding to review the reasonableness of a jeopardy levy or jeopardy assessment (sec. 7429(g)(1)). (e) Property Transferred In Connection With Performance Of Services. In the case of property subject to a restriction that by its terms will never lapse and that allows the transferee to sell only at a price determined under a formula, the price is deemed to be fair market value unless established to the contrary by the Secretary (sec. 83(d)(1)). (f) Illegal Bribes, Kickbacks, And Other Payments. As to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment (sec. 162(c)(1) and (2)). (g) Golden Parachute Payments. As to whether a payment is a parachute payment on account of a violation of any generally enforced securities laws or regulations (sec. 280G(b)(2)(B)). (h) Unreasonable Accumulation Of Earnings And Profits. In any Tax Court proceeding as to whether earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, provided that the Commissioner has

not fulfilled specified procedural requirements (sec. 534). (i) Expatriation. As to whether it is reasonable to believe that an individual's loss of citizenship would result in a substantial reduction in the individual's income taxes or transfer taxes (secs. 877(e); 2107(e); 2501(a)(4)). (i) Public Inspection Of Written Determinations. In any proceeding seeking additional disclosure of information (sec. 61 10(f)(4)(A)). (k) Penalties For Promoting Abusive Tax Shelters, Aiding And Abetting The Understatement Of Tax Liability, And Filing A Frivolous Income Return. As to whether the person is liable for the penalty (sec. 6703(a)). (l) Income Tax Return Preparers' Penalty. As to whether a preparer has willfully attempted to understate tax liability (sec. 7427). (m) Bankruptcy Claims. As to whether the IRS has a valid claim against the debtor's assets in any bankruptcy proceeding (11 U.S.C. 3001(f)). (n) Status As Employees. As to whether individuals are employees for purposes of employment taxes (sec. 530 of the Revenue Act of 1978).

3. See Samuels, Endnote 1.

4. See Samuels, Endnote 1.

5. See Robert F. Turner's statement during the March 21, 1995 Senate Finance Committee hearings and his discussions of the Jackson-Vanik right of emigration Amendment.

6. Statement of Marshall J. Langer delivered during the Oversight Committee of Finance of the United States Senate hearings on March 21, 1995.

7. Obviously there are numerous other procedural steps involved in jeopardy and termination assessments (e.g. time for appeals, judicial review). Notwithstanding, the principal of jeopardy and termination assessments provides an alternative method to collect taxes currently lost to expatriation.

8. See Samuels, Endnote 1.

EXHIBIT "1"

[¶ 28,120] EXPATRIATION TO AVOID TAX

Sec. 877 [1986 Code]. (a) IN GENERAL.—Every nonresident alien individual who at any time after March 8, 1965, and within the 10-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

(b) ALTERNATIVE TAX.—A nonresident alien individual described in subsection (a) shall be taxable for the taxable year as provided in sections 1, 55, or 402(d)(1), except that—

(1) the gross income shall include only the gross income described in section 872(a) (as modified by subsection (c) of this section), and

(2) the deductions shall be allowed if and to the extent that they are connected with the gross income included under this section, except that the capital loss carryover provided by section 1212(b) shall not be allowed; and the proper allocation and apportionment of the deductions for this purpose shall be determined as provided under regulations prescribed by the Secretary.

For purposes of paragraph (2), the deductions allowed by section 873(b) shall be allowed; and the deduction (for losses not connected with the trade or business if incurred in transactions entered into for profit) allowed by section 165(c)(2) shall be allowed, but only if the profit, if such transaction had resulted in a profit, would be included in gross income under this section.

(c) SPECIAL RULES OF SOURCE.—For purposes of subsection (b), the following items of gross income shall be treated as income from sources within the United States:

(1) SALE OF PROPERTY.—Gains on the sale or exchange of property (other than stock or debt obligations) located in the United States.

(2) STOCK OR DEBT OBLIGATIONS.—Gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of United States persons or of the United States, a State or political subdivision thereof, or the District of Columbia.

For purposes of this section, gain on the sale or exchange of property which has a basis determined in whole or in part by reference to property described in paragraph (1) or (2) shall be treated as gain described in paragraph (1) or (2).

(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to a nonresident alien individual whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

(e) BURDEN OF PROOF.—If the Secretary establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction for the taxable year in the taxes on his probable income for such year, the burden of proving for such taxable year that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B shall be on such individual.

'86 Code

Chairman JOHNSON. I thank the panel for your thoughtful testimony.

I have a number of questions, and I will start with Mr. Turner, at least I think I will start with Mr. Turner. I think I will have to come back to Mr. Turner. I am sorry, I can't find the notes I made on that.

Let me start with the other two panelists first, then. Both of you raised the issue of enforcement of current law. Why is it the administration can't tell me anything more about the numbers of people who have given up their citizenship in the last few years?

Can you tell me anything more about them in terms of their assets, or any information that might be relevant to whether this law is important and whether it will work and whether it will produce revenue? Why can't they tell me that?

Mr. NORMAN. I don't know for sure, but my educated guess would be that at the time that the people expatriate, they basically do it by going before a U.S. consulate outside the country. They do it before a consular officer and not before an IRS officer. There is really no coordination between the renunciation of citizenship, which is usually done by signing an oath outside the country and any IRS filing.

Chairman JOHNSON. What about these forms that you refer to that they would have the power to develop under the current law?

Mr. NORMAN. I would say that they have the power to require such forms.

Chairman JOHNSON. But they don't have forms currently. If they had had these forms, couldn't they give me a lot more information about who is renouncing and what their assets were?

Mr. NORMAN. Yes. What I am suggesting is that they require a statement. The statement would say I am renouncing and it would set forth the reasons why it is not for tax motivation, similar to what you do now, if you want to establish as an alien that you are not a resident alien. They also could have a balance sheet you must file if you say, I can't pay my taxes when due.

People file returns. They say, I just don't have the money. There is a special form where you set forth your balance sheet. The IRS could use that same concept and have a second page to this form so we would know who is expatriated. At the time they expatriate, we would know why or at least their statement as to why, and we would know what assets they have to determine if it is worthwhile auditing that particular case.

I think now they just don't know and they read it in Forbes or wherever, the Wall Street Journal. There is not an effective tie between the act of renouncing——

Chairman JOHNSON. In other words, they could have the information that we need to make rational policy and we don't have it because there has been no effort to implement the law and that is the conclusion I am drawing from your testimony, that they could have adopted regulations, they could have had forms, and if they had done those things, we would have a different——

Mr. NORMAN. I think they have the authority and the general regulatory power to issue regulations that would require these taxpayers to file a special form. We have a special permit when aliens

leave the country where they have to file a tax return in certain circumstances to leave the country.

I don't know why we couldn't have a similar procedure for citizens who expatriate. But again, I haven't worked for the IRS or Treasury, so I don't know the specifics of why they don't.

Chairman JOHNSON. Mr. Heller, do you have any comment?

Mr. HELLER. Well, I think it is significant to note that the IRS has a complete filing of stop-filers. These are people that are no longer filing tax returns.

Now, a lot of these are the result of the death of the taxpayer, but it would be appropriate, and I think I would suggest that one approach would be for the IRS to do a cross-check with the State Department of those stop-filers with those U.S. citizens who expatriate.

Chairman JOHNSON. Thank you.

Mr. Heller, in your statement you mention that disincentives to move to low-tax jurisdictions are understated by the Treasury. Could you enlarge on some of the disincentives to move to low-tax jurisdictions?

Mr. HELLER. Well, one of the major disincentives are the lack of adequate medical facilities. Many of the individuals that may expatriate and go back to their homeland behind the former Iron Curtain or go back to Cuba, these are older citizens. They don't want to be living in BVI or Turks and Caicos or the Bahamas. I don't know, you know, how often you have been down there, but I wouldn't want to get sick on one of those islands. In fact, we have documented cases where some of the wealthier people that did move down there have returned to other jurisdictions because of this real problem.

Chairman JOHNSON. All right. And also, both of you spoke about the need to look more carefully at how this change would affect other international agreements that we have. Could you give us more specific examples of problems that would be created by passage of this legislation for already negotiated tax treaties, how many would we have to renegotiate, how substantial would the issues be? How complex have those negotiations been in the past?

You know a lot more about this than I do. Give us some insight as to what passage of this kind of a provision would do to agreements already in place.

Mr. NORMAN. I think our best example is the negotiations we just concluded with Canada with respect to their protocol. They have a capital gains tax which is imposed when you give up residency in Canada or when you die. That is really a replacement for an estate tax. We have Canadians who are in the United States who would be subject to their capital gains tax and our estate tax. There would be no corresponding credit because one tax is an income tax and one tax is an estate tax and we don't allow crediting across those kinds of taxes.

Chairman JOHNSON. So those negotiations protect people from double taxation.

Mr. NORMAN. That is right. And the countries to be most important for these or those others that I can think of would be the United Kingdom, New Zealand, Canada, Australia, France, perhaps, Switzerland, and Germany. So there are a number of these coun-

tries, at least from my practice and from practitioners that I know in the area, where these issues would arise. So at least 10 or 15 treaties would be important. I think we have over 40 treaties, but not all of the countries would necessarily have a lot of these types of expatriates.

Chairman JOHNSON. I have some other questions, but I am going to yield at this time to my colleague, Mr. Hancock. I am pleased to welcome our colleague, Mr. Herger. I appreciate the attendance of my colleagues at this hearing.

Mr. HANCOCK. We have two witnesses that are actively practicing, in fact maybe all three of you are actively practicing tax law.

Mr. Turner, you are not a tax attorney; is that correct?

Mr. TURNER. That understates the case, sir. I know nothing about tax law.

Mr. HANCOCK. OK. Well, but the other two gentlemen are actively practicing.

Let me ask you this. But you are an expert on international law, Mr. Turner. Do you know of other governments that actually prohibit not the taxation, but prohibit the transfer of assets; in other words, that say OK, you can leave the country, but you can't take anything with you.

Mr. TURNER. I don't know. My primary area is public international law, and what you are talking about is comparative law or internal foreign law, and I really haven't looked at that at all.

Mr. HANCOCK. Let me ask Mr. Heller and Mr. Norman. Is this true some countries, especially the Third World countries, prohibit removal or the moving of assets in and out of the country, is that not correct? In fact, hasn't that been one of the problems down in Mexico?

Mr. NORMAN. That was one of the problems in Mexico. South Africa had exchange controls. Exchange controls are now coming off in many, many countries. In most of the countries that we have trade relationships, we don't have really significant exchange control, but in many of the less developed countries they do exist.

Mr. HANCOCK. But historically in your judgment, is the restrictions upon the free flow of funds one of the things that has kept those countries in the economic condition they are in because nobody wants to go in and invest in a country when they can't get their money out of the country?

Mr. NORMAN. Well, clearly, that is one of the first things we talked about when a U.S. company or a U.S. individual considers investing in a foreign country, that is the very first question we talk about. First the tax treatment and then, can we repatriate our profits if we make money or even get our money out of the country if we sell it out.

Mr. HANCOCK. OK. Would this bill that has been introduced by the administration create a little bit of that question in an individual's mind when there is talk about investing or coming in or making his money here in the United States if he knew he could be subjected to this tax ahead of time? Would you agree with that statement?

Mr. NORMAN. It is going to be perceived as an exit tax, and I think it is mostly high net worth individuals who are going to look at this tax and say I don't want to get in this system because I

can't get out without having these deemed sales which is going to cause some of the cash flow problems that Mr. Heller talked about as well as the tax.

So it is going to be a barrier. It is going to be talked about, as I said, in newspapers and business magazines; it is going to be in tax seminars. This is going to become a major topic of discussion when somebody thinks about investing in the United States. It is going to be a negative.

Mr. HELLER. And I might add if I may that when you are sitting down with a client from a foreign country, inevitably that is one of the questions that comes up, will there be any restrictions on the free flow of funds. And many of these individuals have had very negative experiences with other countries.

Mr. HANCOCK. This is just now beginning to get a little publicity, I heard about it a few years ago, you know, that there were certain people that were not only considering expatriating, moving their citizenship, but also moving their assets to offshore tax shelters. It has been going on for a long time. We have all heard the stories about the secret bank accounts in Switzerland and what have you.

In the past few years, in your practice, and I know there are a lot of wealthy individuals out along that golden shoreline over there where you are from, the Los Angeles area.

Is the publicity on this issue starting to cause people to call you and say, hey—you have a lot of people that live out there that are worth $25 million, $50 million, which is a lot of money, but not all that much—30 years ago it was a lot of money.

Are you getting more inquiry in this area?

Mr. NORMAN. I think what I am saying is, we have more of what I call multinational families. We have families where all of the members are not citizens or residents of a single country. We have Taiwanese, Hong Kong, Indonesian, Philippine people coming into the United States. Their parents may stay back in the home country, the children may not all come to the United States, some may go to Canada, some may go to the United Kingdom, and those people are concerned about these kinds of measures and also the measures that were in the broader administration proposal dealing with foreign trust.

In terms of the people worried about moving assets offshore, some people are worried about tort liability and using foreign trusts as asset protection devices. There is no tax advantage to that; it is more protection from future creditors. You do see that.

In terms of persons worried about capital gains taxes, every year in my practice, and there is probably a half a dozen or so of us on the West Coast that have some reputation in advising in this area, every year or so I get a half a dozen or so people who are either worried about capital gains or worried about estate tax. Very few of them, once you get the whole picture out in front of them, are interested in expatriation, because it requires a major change in lifestyle, problems with—I even had a 92-year-old woman whose children thought it was crazy that she was thinking about it. She never did it. It is just not practical.

It is an estate tax avoidance device for most people. Capital gains taxes, people were concerned when tax rates started creeping up after the 1986 act, and there is interest in that area, and there are

a few, to take the Treasury's word, there are 24 people, there are a few, some on the West Coast who are concerned about the capital gains tax. But if that rate was reduced, I don't think the interest would be there.

Mr. HANCOCK. I would just like to make one comment. Almost ever since I have been an observer of what is going on in this country, after getting out of school, also especially since I have been here in the U.S. Congress and the rhetoric that I have been hearing up here, especially right now, is you have to be in favor of taxing the rich if you are going to be politically correct.

That theory of taxing the rich started about 100 or so years ago with a socialistic concept, and the redistribution of the wealth, and it would appear to me, and I am just going to make a statement, and I won't ask for you to make a comment, it would appear to me that this is another move on the part of certain people to get back to that theory, well, they are not entitled to accumulate all of this big money, they had to be dishonest or something, they didn't provide a service or anything else. But anyway, with that, thank you, Madam Chairman.

Chairman JOHNSON. Mr. Herger.

Mr. HERGER. Thank you very much, Madam Chair. Just a follow-up on that line of questioning.

We would like to think that here in America, that the ideal is that people could work hard, be entrepreneurs, work hard in their business and profession and do well and hopefully not be taxed out of everything they have if they happen to reach that point. But I would like to think back to several years ago, when the members of that other party were controlling both the House and the Senate, we had, in this same vein, the luxury tax.

We were really going to sock it to those people who acquired anything that was a "luxury," and you can see what we did to the yacht business. We basically destroyed the yacht business. People did not continue buying yachts with the high taxes. We saw industry basically go out of business over a couple years before we finally repealed that. People just didn't buy them. We had people on welfare then who were paying taxes prior to that.

But I guess in this line, I am just interested, Mr. Heller, what your advice would be to your clients who are either renouncing their citizenship, and I might ask that first question, what would be your advice to a—someone who is currently a citizen who would be considering renouncing their citizenship to go to maybe the land they emigrated from, for example, if this tax bill were to go through.

Mr. HELLER. Well, if this tax bill went through and I was advising an individual who was considering expatriating and moving back to their foreign homeland, say Czechoslovakia or Hungary, I would have to advise them what the tax consequences would be, and we would have to sit down and actually evaluate their assets, do something that we wouldn't have to do now because the problem is they may want to leave the country or give up their citizenship, but they want to—they may want to continue owning the business, and if they continue owning the closely held business, then we will, as U.S.—the government will continue to collect taxes from this business.

If, on the other hand, they are required to liquidate the business in order to pay the taxes, then everybody is a loser. They are a loser and we are the loser, and the question really is, you know, does this discourage or encourage somebody to do this by imposing this exit tax. I suggest that it isn't the proper approach.

The proper approach is to work within the current system, within the current statute, and allow these people to pay their taxes when there is a realization event, when they sell those properties, and we can put in the necessary checks and balances and do some of the administrative things, working with the existing statute.

Mr. HERGER. Now, if these individuals are paying the same amount of tax—well, they are currently citizens so, therefore, they are paying the same tax as everyone else. Let's maybe look on the other side of the coin somewhat. Let's say there is an immigrant that is considering coming to this country, considering—here is someone with business skills, someone who is a professional person, someone who theoretically is going to be adding to our society here, like so many of the immigrants.

My grandparents, two of my four grandparents were immigrants to this country. My father didn't know any English when he started school. That was common in those days. It is not an uncommon thing today, nor was it then, nor was it since our country was founded, but let's say those immigrants who are considering coming here, what would be your—would you have recommendations to them that would be any different were this legislation to go through than what it would be now?

And Mr. Norman, if either one of you have a comment.

Mr. NORMAN. Clearly what you would have to say if these are high net worth individuals you have got to think twice about getting into our system, depending on the scope of the proposal. If it covers only citizens, then you are only worried about those individuals who convert or become U.S. citizens, because only those taxpayers would be subject to tax if they later returned to their home country. But if you are talking about—if the scope of the provisions would cover long-term residents, we are going to advise against long-term residents, if taxes mean anything to them.

And at this point, when somebody is just considering immigrating to the United States, they are in a decisionmaking mode. They have a choice of coming to the United States and being stuck in a tax system that doesn't allow them make a second choice, so to speak, to reevaluate whether they really want to be long-term residents or not, for other reasons, which may or may not be tax motivated. They have Canada which is very friendly toward new immigrants, gives them a new tax basis at the date they become a resident, allows them to set up trusts, preimmigration trusts that will not end up subjecting them to the tax for 5 years if they change their mind, as many Hong Kong people have.

They come to Canada, they stay there 3 years, get their citizenship, which is what they want because they are uncertain about the status of Hong Kong, and now they have a Canadian citizenship and they can give up their residency and Canada has not imposed a tax. And those are the places they are going to go, and they are going to Australia.

Even if they have exit taxes, which the Treasury has pointed out or the Joint Committee in some of their testimony, they are very friendly toward immigrants. This provision is, at least in the original version of it, is not for only the long-term immigrants, the long-term residents that remain aliens, and it clearly is not for those who become citizens.

Often these people retain dual citizenship and at some later date, at retirement, upon a change of circumstance at home, a change in opportunities at home, political changes at home, they don't have to be as radical as from communism to noncommunism, just political changes, they will go back home. It is certainly convenient for them to just be a citizen of one country, and they often do that, and it is not because they are traitors to our country. They really have a dual loyalty from the beginning and they are just making a choice.

And I think you are going to have a lot of these people not wanting to come here and clearly not staying here a long time and certainly not converting or becoming a citizen.

That is going to be on every immigration lawyer's checklist, the tax consequences of becoming a citizen. That you are in the system and you can never make a second choice, you can't go back to Switzerland, you can't go back to Israel or Hong Kong or wherever it is. You are in it, and that could be a big thing, because these people are not only concerned about their own wealth, but passing wealth on to their children, giving their children a good start in life, and if they have a big family, $600,000 of appreciation doesn't go a long way especially if you have a really big family like some of these immigrants do.

Mr. HERGER. Well, thank you very much. And again, as I reflect back on my heritage, I think of the greatness of this country as really the freedom of choice. And what I am concerned about with this type of legislation is that we are taking away many of the freedoms because of what penalties are being inflicted on those who could contribute to our society, and I think we should all not take this action lightly. We should consider it, should consider the dynamics.

I thank you for your testimony here today. Thank you.

Chairman JOHNSON. I have just two more questions that I want to ask. Is it possible for two people who have similar histories of earning and assets to be taxed differently under this law?

Mr. NORMAN. This law taxes two things. It taxes people who make a choice—practically, we are talking about dual citizens because nobody is going to give up their U.S. citizenship if they have no other citizenship. So it taxes that and it also taxes—in fact only imposes taxes if you have appreciation that rises to some threshold level.

So you could have persons who have high income potential, are making a lot of money but have been spending it or not investing in ways that have created appreciation and those people slip right through the proposed new system if you will.

Chairman JOHNSON. So this doesn't treat all people the same according to income. This isn't a tax on their net worth, this is only a tax on their gain.

Mr. NORMAN. A tax on their built-in gain.

Chairman JOHNSON. So two people could have exactly the same asset profile and not be subject to the same tax.

Mr. NORMAN. If you inherited, say, $5 million, you would get a new stepped-up basis. If that person wanted to expatriate under this provision, they wouldn't be taxed. If the same person had $5 million in assets and it represented the buildup in the value of a business over time, then that appreciation would be taxed.

Chairman JOHNSON. I think that is very important to recognize. This isn't about just rich-poor. This is really actually not even about equity. This is about looking at a very specific type of gain and going after that specific type of gain, and this will not prevent people who have high value assets in this country or high income from not escaping if they care to, as long as they don't have a net gain.

Mr. NORMAN. I have had situations where people, because of the recession in the real estate market or because of stock market changes where they might have had a very huge total net worth, I mean, relatively huge in my view, say $10 or $15 million, they now have no net appreciation or very little net appreciation.

Chairman JOHNSON. So what you might advise a client is, where you have a big loss impending in some part of your portfolio and when it offsets it, you can change your citizenship or renounce your citizenship without any tax consequences, but if your portfolio does well, don't renounce.

Mr. NORMAN. What is going to happen is you are going to have new planning techniques. If you are going to make a lot of money in the future, get out now, or if you have, as you suggested, you have losses that offset gains, now is the time to expatriate. I don't think we want those kinds of incentives in the law.

Chairman JOHNSON. One last question to Mr. Turner.

You know, Mr. Turner, you really pointed out some very powerful phrases in legislation and in international agreements to which we are a party that make it very, very clear that we have taken the position that people have a right to citizenship and have a right to change their citizenship, and I thought the portion that you pointed out from section 2432 of freedom of immigration, East-West trade that says that no country shall have the right to impose more than a nominal tax on immigration or on the visas or other documents required for immigration for any purpose or cause whatsoever or, and it goes on to say, impose more than a nominal tax, levy, fine, fee on any charge on any citizen as a consequence of the desire of such citizen to immigrate to the country of his choice, was very powerful.

And when you put that up against the assumptions behind both Joint Tax's estimates and the Treasury's estimates, because we just had testimony from Treasury that they thought their assumptions were the same as Joint Tax's assumptions. Joint Tax's assumptions are that this levy will be significant enough that people will decide not to change their citizenship, not to relinquish their citizenship and we get the money because they continue to pay what they are currently paying.

Now, a fee that is so powerful that it would lead you to not relinquish, when you had desired to relinquish, seems to me in very direct contradiction of the laws and agreements that you have called

to our attention. Do you think the assumptions behind their estimates do call into question our commitment under these treaties?

Mr. TURNER. Madam Chairman, I think it raises a very serious problem. I think the United States has led the world in some respects in this area, in the right of citizens not just to travel, not just to spend a weekend in the Holy Land, but to actually pick up and renounce their citizenship in one State, move to another State, settle there permanently and pledge allegiance to that State, I think one can argue technically that perhaps you can get around the language of the covenant.

I think the covenant is arguable one way or the other; but having spent an awful lot of time working on the Jackson-Vanik amendment, I really have a lot of trouble trying to get around that. It is very strong language—"for any purpose or cause whatsoever,"—and again, I can say from my own recollection, having worked on it 21 years ago, it is my strong sense that Scoop Jackson and the other people involved in this were talking about affirming the right, especially of Soviet Jews, but of anyone in the Soviet Union, to renounce that citizenship relationship, to move free of molestation to another State, and to set up a new life there and be totally free of any further control by the Soviet Union.

If we had said, well, yes, they have the right to travel, but they don't have a right to give up their citizenship, then in theory the Soviets could have required them to return for military service, or for taxes, or for a variety of other purposes in the years that followed. One of the problems we had in this country that so upset Jefferson, and led Congress to pass the statute I quoted back in 1868, was if someone came to the United States and established American citizenship and then traveled back to Ireland—which then denied this right to renounce citizenship, this right of expatriation—then the Irish Government could harass that person and say, you owe us taxes, or you owe us military service, or you owe us some other obligation that the U.S. Government has historically said was not within their rights under international law to claim.

You are going to hear from Paul Stephan, who is a very able scholar, a very bright man, and he is going to disagree strongly with me—and he may well be right. Professor Detlev Vagts, I gather, has submitted a letter. I talked to Professor Lou Henken, a very distinguished scholar at Columbia University, who told me he didn't see a problem here.

It may be because I have only had a few days to look at this that I have been misled, but it strikes me the values at stake are so important and, relatively speaking, the money we are talking about here is almost trivial. I know $1 billion is a lot of money, but in terms of human rights values that this country has stood for since the days of Thomas Jefferson, $1 or $2 billion toward the deficit is not worth sacrificing one iota of human rights in my view.

Chairman JOHNSON. I very much appreciate your being able to testify and, as you pointed out, on very short notice, but these are big enough issues, and underlying this proposal are some very big issues, both in terms of our historic commitment to human rights of our international obligations, of the concept of equitable treatment, of taxpayers in similar circumstances, and what kinds of incentives are we going to create for investors in our economy that

even on short notice, this is worth the kind of attention that we are giving it today and that I hope we will give it in the months ahead.

I would conclude this panel that one of the things that you have brought out that has been very useful to us is that this would create new and perverse incentives for people to relinquish their citizenship before they hit the threshold if they were likely to hit it, and want to move. So it would precipitate that decision early which means that we wouldn't get the money nor the penalty, neither one, and in not many years, that would all come to pass.

Unless the Members have more questions of this panel, we will move to the next one. Thank you very much for your testimony.

The next panel consists of Stephen Shay of Boston, Massachusetts; Paul Stephan, professor at the University of Virginia Law School; Carlyn McCaffrey, New York; and Rabbi Jack Moline, vice president of the Washington Board of Rabbis.

We will start with Stephen Shay.

Mr. Shay.

STATEMENT OF STEPHEN E. SHAY, ESQ., PARTNER, ROPES & GRAY, BOSTON, MASSACHUSETTS; AND FORMER INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. SHAY. Thank you, Madam Chair. Thank you and other Members of the Subcommittee for inviting me to testify today regarding the administration's proposal. I would like to submit my statement for the record.

I am a partner in the law firm of 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 in 1987, I served as International Tax Counsel to the U.S. Treasury during the Reagan administration.

I am testifying today in an individual capacity. My comments are not made as a representative of my law firm, its clients, or of any bar or professional associations of which I am a member.

I have submitted detailed comments that I don't propose to summarize here. Subject to some technical modifications in those comments, I strongly support the administration proposal. I think it is helpful to keep this simple. The United States taxes citizens and residents on their worldwide income. We tax nonresidents only on U.S. source income.

I think it is appropriate for the United States to tax appreciated assets at the time that a citizen or resident moves from full taxing jurisdiction to partial taxing jurisdiction for reasons I will describe very briefly. This is a vast improvement over current law because it accurately measures, and imposes U.S. tax on the appreciation that has accrued during the time a taxpayer is subject to full U.S. taxation jurisdiction. I express this view without any regard to the issue of tax motivation.

You can think of it most simply in terms of you and your neighbor. Assume that both of us work very hard and at the point in time where we are each fortunate enough to have assets that have appreciated over $600,000, one of us leaves the country and renounces citizenship, or if that person is a long-term resident, for

whatever reason he took up residence in the United States, after having been here in excess of 10 years under the administration's proposal, leaves in a situation where, after leaving, he sells that asset and recognizes the gain without U.S. tax.

In my view, the gain that has accrued up to the point of departure is an appropriate gain to be subject to U.S. taxing jurisdiction. Moreover, I, as a person who is here, or perhaps it is you or your colleague, cannot sell that asset without being subject to full capital gains tax at whatever rate it happens to be. I have made all of my remarks and testimony on the basis of current law, without expressing perhaps a hoped-for view that the law might change in one direction or another.

I think, Madam Chair, this is an issue of equity. The fact is that section 877 today is laughably avoidable. A well-advised expatriate should not pay U.S. tax whether he is renouncing his citizenship or if a long-term resident, ceasing to be a resident, on assets not disposed of before he leaves.

There are a series of technical problems with section 877 under today's law, one of which I will mention. Because that section applies in those rare cases where a principal purpose to avoid tax is found, and I say that is rare because of the case law under that section which I have cited in my testimony, it will tax appreciation after the person has left. In my view, the section taxes too much in that case. That is why I favor the administration proposal as taxing the right amount when tax is indeed due.

I think I would like to make one last personal comment which is not in my testimony. I am no expert on human rights but I have evaluated my views on this provision by a very simple test. My wife, 8-year-old son and 4-year-old daughter are Jewish. I have asked myself, should they decide to expatriate to go to Israel later in our lives, would I feel it appropriate to pay tax on the gains that I have been fortunate enough to realize as a citizen of the United States up until the time we leave, and my unquestioning answer, Madam Chair, is yes.

Thank you.

[The prepared statement follows:]

PREPARED STATEMENT OF
STEPHEN E. SHAY
BEFORE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 27, 1995

Madame Chairman, Members of the Subcommittee:

Thank you for inviting me to testify today regarding the Administration's proposals to impose a tax on U.S. citizens who renounce their citizenship and long-term resident aliens who cease to be subject to tax as residents.[1]

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.

I am testifying today in an individual capacity. My comments are not made as a representative of Ropes & Gray or any of its clients, or of any of the other bar or professional associations of which I am a member.

Subject to certain technical comments discussed below, I strongly support the Administration's proposal. It is appropriate for the United States to tax appreciated assets at the time a U.S. citizen or resident moves from full U.S. personal taxation jurisdiction to being subject solely to U.S. source taxation. The proposal is an improvement over current law because it more accurately measures and imposes U.S. taxes on appreciation that accrues while a taxpayer is subject to full U.S. personal taxation jurisdiction.

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

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[1] I wish to thank my colleague, Debra Brown Allen, Esq., for her assistance in preparing this testimony.

[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.

to the effectively connected income. A nonresident alien individual is allowed a foreign tax credit under Section 906[4] 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 special taxation regime applies to a U.S. citizen who relinquishes his U.S. citizenship with a principal purpose of avoiding Federal income tax. Such an individual may be 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 applicable to U.S. citizens.

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),[5] then the burden of proving that the loss of citizenship did not have tax avoidance as one of its principal purposes shifts to the taxpayer.[6]

The taxing rules of Section 877(b) (which does not include the principal purpose test) 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 before the end of the third calendar year beginning 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 an appreciated asset and then resumes his or her U.S. residence.

Deficiencies of Current Law

Section 877 was enacted in 1966 as part of the Foreign Investors Tax Act, which was intended to spur foreign investment in the United States by eliminating graduated rates with respect to non-effectively connected income of a nonresident alien. Section 877 was adopted because Congress was concerned that this rule could encourage some individuals to surrender their U.S. citizenship and move abroad.[7] 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 would induce expatriations and chose to employ a tax avoidance purpose condition to the application of Section 877.

Section 877 has several weaknesses, both on its own and as a function of its interplay with other aspects of the U.S. tax scheme. The weaknesses include: (1) Section 877 is triggered only if the expatriate had tax avoidance as a principal purpose; (2) tax treaties with other countries may prevent the United States from taxing nonresidents, even with the existence of Section 877; (3) Section 877, by deferring tax until the expatriate sells his assets, generally does not properly tax the gain (or loss) that accrued while the taxpayer was a U.S. citizen; (4) the interplay of Section 877, Section 906 and tax treaties with other countries may result in

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[4] 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.

[5] *See Enrico di Portanova v. United States*, 690 F.2d 169, 176 (Ct. Cl. 1982) (citing H.R. Rep. No. 1480, 89th Cong., 2d Sess. 82, reprinted in 1966-2 C.B. 965, 1025).

[6] The presumption of tax avoidance is rebuttable. *See, e.g., Furstenberg v. Commissioner*, 83 T.C. 755 (1984).

[7] H.R. Rep. No. 1450, 89th Cong., 2nd Sess. 22 (1966).

inappropriate double taxation; and (5) Section 877 easily may be avoided by holding assets for more than ten years or converting U.S. income and assets into foreign income and assets. Although Section 7701(b)(10) does not require proof of a principal purpose of tax avoidance, it is otherwise subject to the same infirmities as 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 asserting a tax on 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, when a foreign trust ceases to be a grantor trust with a U.S. grantor.[8] 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. Because a principal purpose test is difficult to administer and subject to abuse, it similarly should be deleted from Section 877.[9]

Another difficulty with both current Section 877 and Section 7701(b)(10) is that the United States may be unable to collect taxes due under the terms of these sections because of treaty provisions. Although 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[10] and the I.R.S. has published a revenue ruling taking the position that the savings clause preserved U.S. taxation of former citizens taxable under Section 877,[11] 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 U.S. 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

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[8] Rev. Rul. 87-61, 1987-2 C.B. 219.

[9] 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 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.

[10] 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"). 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).

[11] 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).

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.[12] However, even where the savings clause covers taxation of an expatriate under Section 877, the coverage may be less than complete.[13]

If a nonresident alien otherwise subject to Section 7701(b)(10) were resident in a treaty country for purposes of an income tax treaty between the United States and that country, the treaty would apply to the nonresident without regard to the savings clause. Most (but not all) U.S. income tax treaties would prohibit U.S. taxation of such a treaty resident's gains from the sale of property other than real estate or assets connected with a U.S. trade or business.

Perhaps the most significant objection to current law Sections 877 and 7701(b)(10) is that they rarely, if ever, will measure correctly, and thus tax, gains that accrued while the taxpayer subject to a Section 877 tax was a U.S. citizen or resident. This is because Sections 877 and 7701(b)(10) defer U.S. taxation, imposing such tax on gains realized within a ten or three-year expatriation period. Sections 877 and 7701(b)(10) therefore may result in either over-taxation or under-taxation, depending upon whether the asset appreciates or depreciates in value between the time of expatriation and the time of sale or disposition. For example, if a U.S. citizen expatriates with a tax avoidance motive and, seven years later, sells an asset, Section 877 would subject the entire gain from the sale to U.S. taxation, including any gain that accrued post-expatriation. Similarly, under Section 7701(b)(10), if a resident alien ceases to be treated as a resident, sells an asset two years later and subsequently returns to the United States, he will be taxed on the full gain from the sale, including any gains that accrued during the two years in which he was not a U.S. resident. These post-expatriation gains (or gains accruing during a period of non-residency), should not be subject to U.S. tax. Conversely, under both Section 877 and Section 7701(b)(10), if the taxpayer's assets declined in value during either post-expatriation or the taxpayer's period of non-residency, the United States would not capture all of the gains that had accrued during citizenship or residency, which, arguably, should be subject to U.S. tax. A tax imposed at the time of expatriation, however, would accurately delineate gains properly subject to U.S. taxing jurisdiction.

The current taxation scheme under Section 877 may result in double taxation. 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. Section 877(c) transforms foreign income that would not be effectively connected income into U.S.-source gross income, but does not cause the income to be effectively connected income. The Section 906 foreign tax credit therefore does not allow a credit for any foreign tax that may be imposed on the re-sourced income (assuming that the taxpayer had sufficient foreign tax credit limitation to credit the tax).

It does not appear that treaties remedy the failure of the domestic law foreign tax credit mechanism to avoid double taxation for expatriating citizens under Section 877, even where the gain accrues after the taxpayer's expatriation. 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

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[12] See U.S. Model Treaty, Art. 1(3).

[13] 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).

in a U.S. company realized by a Section 877 expatriate who is resident in Canada.[14] Canada also would be allowed to tax the gains.[15] For purposes of applying the foreign tax credit provisions of the Convention, the gains from the sale of stock would be treated as Canadian-source income,[16] however, the United States does not commit to allow a credit for the Canadian tax.[17]

Yet another problem with current Sections 877 and 7701(b)(10) is that they are easily avoided. Residents who cease to be treated as residents and sell appreciated assets during the period of non-residency can avoid Section 7701(b)(10) merely be extending their period of non-residency beyond the three-year period. Section 877 may be avoided as easily. 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). 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.)[18]

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.[19] There is evidence that some of these

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[14] 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).

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

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

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

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

[19] 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,

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 the Administration's Proposal and Modifications Made by H.R. 831 as Reported by the Senate Finance Committee

Under the Administration's Proposal, a U.S. citizen who relinquishes U.S. citizenship or a long-term resident who ceases to be subject to tax as a resident generally would be treated as having sold all of his or her property at fair market value immediately prior to relinquishing citizenship or ceasing to be subject to tax as a resident (the "expatriation date") 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. The first $600,000 of net gain recognized on the deemed sale would be exempt from tax. Under the Administration's Proposal, a long-term resident is any individual who is not a U.S. citizen and who is subject to tax as a resident, as a result of being a lawful permanent resident of the United States, for 10 of the last 15 years. A citizen would be treated as relinquishing citizenship on the date the Department of State issues to the individual a certificate of loss of nationality or the date a U.S. court cancels a naturalized citizen's certificate of naturalization.

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 trust interests that are attributed to the taxpayer under expanded attribution rules, would be taxed on the expatriation date. A long-term resident would be allowed to elect to take a fair market value basis in property owned on the date the individual first became a resident for purposes of the period of long-term residency and treated as sold on the expatriation date.

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.[20] 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. The I.R.S. would be authorized to reach an agreement with a taxpayer to defer payment of the tax on an interest in a closely-held business (as defined in Section 6166(b)) for up to five years.

The Administration Proposal would be effective for U.S. citizens who relinquish their U.S. citizenship on or after February 6, 1995 and long-term residents who cease to be subject to tax as residents of the United States on or after that date.

The version of H.R. 831 reported by the Senate Finance Committee (the "Senate Finance Bill") only would have applied to expatriating citizens, but included several significant modifications to the Administration Proposal. Under the Senate Finance Bill, 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 and no tax would be due before 90 days after enactment. The I.R.S. would be authorized to allow a taxpayer to defer payment of the tax for up to 10 years under Section 6161 as though the

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1995).

[20] 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.

tax were an estate tax imposed by chapter 11. 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.

Analysis of Proposed Section 877A Under the Administration Proposal and as Modified in the Senate Finance Bill

The Administration Proposal meets the objections to current law Section 877 and Section 7701(b)(10) described above. It deletes the tax avoidance purpose test of Section 877 and does not implicate treaties. Most importantly, it imposes tax on gain determined as of the date a taxpayer ceases to be subject to full U.S. personal taxation jurisdiction 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 and abuse.

The Senate Finance Bill makes 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.

The Administration's Proposal to apply Section 877A to expatriating long-term residents, in addition to U.S. citizens, is reasonable since such individuals are subject to full U.S. personal taxing jurisdiction like citizens. Gains that accrued to their property during residency should not escape U.S. taxation upon their departure.

The Administration Proposal would allow a long-term resident who is not a citizen to take a "fresh start" fair market value basis in his or her assets for purposes of Section 877A as of the date the individual became a resident. I recommend that this provision be broadened and modified. First, it also should apply to an alien who becomes a naturalized citizen. For such aliens, the measuring date should be the earliest of (i) the date the alien becomes a resident alien, (ii) the date the alien becomes a naturalized citizen, and (iii) the date the asset first becomes "effectively connected" with a U.S. trade or business of the alien. Second, the "fresh start" fair market value basis should be for all purposes, not solely for purposes of Section 877A.[21] By limiting the "fresh start" basis to determining gains for purposes of Section 877A, property that is sold while the person is a U.S. resident will be subject to tax on gains that accrued prior to the person becoming a U.S. resident. Such gains arguably should not be caught within the U.S. taxing net. In addition, by subjecting such gains to U.S. taxation if the property is sold while the owner is a U.S. resident, but not if the owner expatriates when he still owns the property, the proposal will have a "lock-in" effect similar to that of the Section 1014 step-up in basis at death. There could be a strong incentive not to sell an asset until after ceasing to be a U.S. citizen or resident. Finally, the fair market basis provision should not be an election; it should be applied across-the-board so that taxation under Section 877A does what it intends to do: accurately measure and tax those gains that accrue while the taxpayer is subject to U.S. personal taxing jurisdiction.

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[21] According to the Joint Committee on Taxation, both Canada and Australia, which both impose a departure tax on residents, treating them as having sold their assets at the time of departure, allow individuals who become residents to take a basis in their foreign assets equal to the assets' fair market value at that time for all purposes. Staff of the Joint Committee on Taxation, *"Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Citizenship,"* (JCX-14-95, March 20, 1995).

I recommend adding an exception from Section 877A for property that is effectively connected with a U.S. trade or business of the taxpayer. As a corollary to this recommendation, Section 864(c)(7) should be amended to tax a nonresident alien individual subject to Section 877A on gain at the time such an asset ceases to be held for use in the U.S. trade or business.[22]

It should be possible to mitigate double taxation that could occur under the Administration's Proposal by negotiating with 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 and, if requested by a taxpayer, under a mutual agreement article's competent authority procedure. To the extent that such a basis step-up would not be allowed under the domestic law of the expatriate's new country of residence (assuming that it imposed an income tax), a well-advised taxpayer could take self-help measures to avoid the second tax.

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

I respectfully disagree with an asserted "constitutional" objection to this proposal that rests on dictum in the 1920 Supreme Court decision in *Eisner v. Macomber*.[23] In *Eisner*, the Supreme Court defined income not as a gain "accruing to capital", but as something "severed from" capital. It has been suggested that *Eisner v. Macomber* accords constitutional significance to the "realization" principle. However, since 1920, *Eisner v. Macomber* has been distinguished and limited,[24] and, according to at least one court, "insofar as it [*Eisner v. Macomber*] purported to offer a definition of the term income, as used in the Sixteenth Amendment, it has been discarded."[25] Similarly, the weight of scholarship rejects the view that realization is or should be constitutionally required to tax gains.[26] Proposed Section 877A would not be the first provision to tax gains prior to realization. Congress has approved, repeatedly, income tax measures that apply to income that has not been realized by the taxpayer.[27] Section 1256, which was added to

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[22] Consistent with this recommendation and the recommendations in the preceding paragraph, a long-term resident alien's basis in property contributed to his U.S. trade or business should take a fair market value basis as of the date of contribution.

[23] 252 U.S. 189 (1920) (holding that a stock dividend should not be included in taxable income).

[24] *See e.g., Helvering v. Bruun*, 309 U.S. 461 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940).

[25] *United States v. James*, 333 F.2d 748, 752 (9th Cir. 1964).

[26] *See e.g.*, Surrey and Warren, *"The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness,"* 66 Harv. L. Rev. 761, 770-71 (1953) ("Essentially the concept of income is a flexible one, with the result in a particular case being determined by the interplay of common usage, accounting concepts, administrative goals, and finally judicial reaction to these forces.").

[27] In 1937, with the foreign personal holding company rules, in 1962 with the controlled foreign corporation rules, and in 1986 with the passive foreign investment company rules, Congress enacted provisions that taxed certain domestic shareholders on undistributed earnings of certain foreign corporations. The constitutionality of the foreign personal holding company rules and the controlled foreign corporation rules have been upheld. *See Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943) (upholding U.S. tax on taxpayers owning stock in Columbian company under foreign personal holding company rules, even though distribution of pesos

the Code in 1981, 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 is recognized.[28] 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* in a way that could be viewed as imposing a constitutionally-based realization requirement.

Conclusion

Proposed Section 877A would constitute an improvement over current law and, modified as suggested above, deserves the strong support of your Committee.

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

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blocked pursuant to Columbian law); *Garlock v. Commissioner*, 489 F.2d 197 (2d Cir. 1973) (upholding constitutionality of requiring shareholders in controlled foreign corporation to include in gross income their pro rata share in the controlled foreign corporation even if there had been no distribution to the shareholders. The court, in fact, stated that the argument that the controlled foreign corporation rules are unconstitutional "borders on the frivolous . . . .").

[28] The Ninth Circuit has passed favorably on the constitutionality of Section 1256, but did not address the realization issue directly. *Murphy v. United States*, 992 F. 2d 929 (9th Cir. 1993).

Chairman JOHNSON. Thank you, Mr. Shay.
Mr. Stephan.

STATEMENT OF PAUL B. STEPHAN III, PROFESSOR, UNIVERSITY OF VIRGINIA SCHOOL OF LAW, CHARLOTTESVILLE, VIRGINIA

Mr. STEPHAN. I have prepared my remarks for the record and I will submit them as they stand. I want very briefly to make a couple of key points with regard to the international law issues that may be raised by this legislation.

I would like to emphasize two distinctions, one of which I think is significant, the other which might seem like hair splitting. I think it is very significant to distinguish emigration from expatriation. Emigration might include expatriation, but it doesn't have to. Expatriation means the renunciation of one's citizenship.

If one focuses on the human rights conflicts of the sixties, seventies and eighties, I think it is absolutely clear that we were concerned with emigration and that questions of renunciation of one's citizenship were tertiary at best.

There has been some discussion of the Jackson-Vanik amendment. One of the witnesses in his prepared testimony suggested that my recollection of those events might be faulty because I was only entering law school. I am always happy to have my youth used against me, but I would point out that 1974 was the year that I left the Central Intelligence Agency to start law school, that my responsibilities at the CIA included political analysis with respect to the Soviet Union and particularly with respect to human rights and immigration issues. That was essentially my account.

So I do feel I know something about the events that inspired the Jackson-Vanik legislation, and I am fairly firm in my recollection that one of the articulated concerns of Congress at the time was that the Soviet Union arbitrarily insisted that those who wished to emigrate also expatriate, were not given a choice as to expatriation. The concern that they also were charged for the expatriation was part of that, but it was clear Congress understood at the time that emigration was distinct from expatriation.

Now, this is not, I think, an immaterial technical lawyer's point. Emigration means your physical security. Expatriation means an ongoing bond with a country which only can be enforced if you come once again within their territory. I don't mean to suggest that expatriation is insignificant. It is not. We have had cases where people have expatriated themselves from the Soviet Union, come back as tourists because they expatriated themselves in the context of World War II. The Soviet Union did not recognize their expatriation and proceeded to prosecute them for what were alleged to be war crimes. I think that was improper.

But that is not at all what this legislation here involves. This is an expatriation-triggered tax. It has nothing to do with emigration in the sense of changing one's residence. If it were otherwise, I would have deep concerns about it.

As a tax on expatriation, this gets into another distinction that may seem more like hair splitting, the distinction between international law and consistent U.S. policy. As a lawyer, I look at international law as an obligation that is enforceable by at least

some means, if even only by the consensus of the international community. I look at instruments, I look at customary international law.

I do not find in any of the instruments that deal expressly with the right to travel, the right to leave one's country, an obligation having to do with expatriation. Neither in customary international law do I find a clearly established right. Indeed we see many constraints on this.

On the other hand, it has been consistent U.S. policy that the right to expatriate exists. Whether or not it is recognized by other nations, it has been our policy, and I think it ought to be respected, I think the United States should not do things that are inconsistent with that policy. But I do not think it is inconsistent with that policy to impose reasonable restrictions that are not discriminatory.

Now, this of course depends on how you characterize this tax, and here I would affiliate myself with Mr. Shay's remarks. If in the abstract, you say, well, the only people who pay taxes on realized gains are people who are changing their citizenship, that is discrimination. But I can flip that and say that the only people who are U.S. citizens who accumulate unappreciated wealth who do not have to face either an income tax or an estate tax, one or the other, not necessarily both, are those people who change their citizenship. In that sense, I think this law, with its imperfections, which I would like to touch on, does simply prevent the expatriating from being treated more favorably than people who remain behind.

Indeed, it is still reasonably favorable, compared to the estate tax, because 39.6 percent on the net is a lot better than 55 percent on the gross under the estate tax. There are, I think, some technical problems here. I touch upon what effective date to use in my remarks. I would be happy to answer questions about those.

Thank you.

[The prepared statement follows:]

Prepared Statement of Professor Paul B. Stephan III on Section 5 of H.R. 831

Madam Chairwoman and members of the Committee, it is an honor to appear before you to discuss the merits of the Administration's proposal to collect an income tax on certain unrealized gains upon the relinquishment of U.S. citizenship. I appear before you in my capacity as an academic specialist on matters of international law, U.S. tax law, and Soviet-American relations. I am sure you are more interested in the strength of my arguments than in my credentials, but for the record I hold the Percy Brown, Jr. Chair and the Hunton & Williams Chair at the University of Virginia School of Law. At Virginia I have taught tax law for sixteen years, as well as a range of international courses. On occasion I have advised various U.S. government agencies on matters of international law, in both Republican and Democratic Administrations. One of the books I have edited, a text on public international law, is used as a course book in both Russia and the United States; my former student Bob Turner, who appears here with me, co-authored one of the chapters. Not that political affiliation matters on questions of this nature, but in 1992 I served as national vice-chair of Law Professors for Bush-Quayle and today am a paid-up member of the Virginia Republican Party.

I understand that you are primarily interested in the question of whether the Administration's proposal would conflict with any obligation under international law to which the United States is subject. In particular, you want to know whether treating renunciation of citizenship as a realization event raises even a suspicion of conflict with the international law of human rights. In addition, there are issues as to the constitutionality of the proposal and its merits as a matter of tax policy. I will dwell principally on the first issue but will touch on the latter two.

In terms of positive international law, there are two multilateral instruments to which the United States is a party that deal specifically with freedom to leave one's country. The first is the International Covenant on Civil and Political Rights, to which the Senate extended its consent to ratification in 1992. The other is the Final Act of the Conference on Security and Cooperation in Europe (Helsinki Accords), signed by the Ford Administration in 1975 but not regarded as a treaty and therefore never submitted to Congress for consent to ratification. Both of these protect freedom of movement. Article 12(2) of the Covenant states that "Everyone shall be free to leave any country, including his own." This language tracks closely that of Article 13(2) of the Universal Declaration of Human Rights, a UN General Assembly Resolution. The Helsinki Accord on Cooperation in Humanitarian and Other Fields, I(d), provides:

> The participating States intend to facilitate wider travel by their citizens for personal or professional reasons and to this end they intend in particular:
>
> —gradually to simplify and to administer flexibly the procedures for exit and entry;
>
> —to ease regulations concerning movement of citizens from the other participating States in their territory, with due regard to security requirements.
>
> They will endeavour gradually to lower, where necessary, the fees for visas and official travel documents.

As a technical matter, the Covenant constitutes an explicit obligation of the United States under international law, although subject to certain reservations expressed by the Senate; the Accords are considered political rather than a legal, although they provide a gloss on the meaning of more general treaties such as the Charter of the United Nations.

These are weighty commitments, and the United States should not violate them. 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. What becomes immediately clear upon reviewing these instruments is that they deal with the freedom of individuals to cross borders. They are concerned with travel and residence, with physical movement. Citizenship is different: It is an abstract legal relationship that exists regardless of the physical location of the citizen. States should not hold their citizens captive; people should be free to cross borders subject only to reasonable restrictions of a general and nondiscriminatory nature. This important principle has nothing to do with citizenship, but rather with physical presence.

The reason why international human rights law focuses on travel and not citizenship is fairly simple. As long as people are held within a country, they are subject to the full weight of sovereign state power. Once they leave a country's territory, they are freed of an immediate threat of physical coercion and incarceration. Whether persons outside a country's boundaries retain the formal status of citizen or not is an entirely different matter. Citizenship is not meaningless, but a state cannot throw you in jail or torture you simply because it still claims you as a citizen. And it is exactly abuses of state power over people that prompted these human rights instruments.

When one turns to customary international law, one finds the same distinction between freedom to travel and the power to change one's citizenship. Perhaps the clearest statement of the U.S. position on the obligation to permit freedom to travel can be found in the Jackson-Vanik Amendment to the Trade Act of 1974. The Amendment, in part, condemns any state that imposes more than "a nominal tax" on emigration, 19 U.S.C. § 2432(a)(2), and goes on to specify that other duties and charges levied on persons seeking to exercise their right to emigrate similarly are abhorrent. But by emigration, the drafters of this legislation meant leaving the country, not renunciation of citizenship. Indeed, one of the abuses cited at the time was the Soviet practice of requiring emigrants to surrender their Soviet citizenship as a condition of departure. Congress believed that emigration did not involve a change of citizenship, and denounced countries such as the Soviet Union that sought to link the two.

More generally, the human rights concerns that dominated our encounters with the Soviet Union and other totalitarian regimes during the 1970s and 1980s were based on unambiguous 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.

I do not mean to suggest that the refusal of a state to permit a nonresident person to renounce his citizenship is never a matter of concern under the international law of human rights. Early in our nation's history, we protested vigorously, even to the point of war, when nations such as England would claim as their own citizens and seize American sailors found on the high seas. But this problem is different in kind from that presented by the freedom to travel. And today the conduct that triggered the American protests—arbitrary seizure of persons on the high seas—would likely be seen as a human rights violation regardless of any claims of citizenship.

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 our 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 unrecognized 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 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 person who severs the bond of U.S. citizenship and does not continue to reside in the United States will pay neither income, gift, nor estate tax (except as to 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 almost entirely 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.

Next, is the Administration's proposal unconstitutional? Here the issue is the enduring validity of *Eisner v. Macomber*, 252 U.S. 189 (1920). You will find in the analysis of the Joint Committee all of the relevant precedent, and its judgment that the realization requirement no longer

has a constitutional basis is one that I have expressed in print on several occasions. To appreciate why this conclusion is persuasive, if not ineluctable, one should recall that *Eisner* itself rested on *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895). That notorious case struck down the 1894 federal income tax on two grounds: a tax on income functioned as a direct tax in violation of Article I, Section 9, Clause 4, and a tax on interest paid by States on their debts amounted to a violation of intergovernmental immunity. The second prong of *Pollock*, namely its holding on State immunity from federal taxation, was explicitly overruled by the Supreme Court in *South Carolina v. Baker*, 485 U.S. 505 (1988). The first prong was a wholly illegitimate exercise of judicial lawmaking, contrary to the intent of the framers and the Court's own precedent. The direct taxes prohibition of Article I was motivated by a concern that the federal government, dominated by a coalition of poorer States, would impose a real estate property tax that would disproportionately burden the rich landowners of New York, Virginia, and a few other prosperous States. Income taxation as such did not exist then, and the framers did not have it in mind when they crafted the language of Article I. The *Pollock* Court was not at all interested in wealth redistribution among the States, clearly the framers' only concern, but rather with the social and economic implications of progressive taxation, a problem addressed, if at all, only in the Takings Clause of the Fifth Amendment. It is not surprising, therefore, that the first prong of *Pollock*, on which *Eisner* rests, has become so irrelevant that the modern Court has never felt the need explicitly to overrule it.

Finally, I would like to touch on the wisdom of this measure as a matter of tax policy. Whether you should like this proposal or not, I believe, turns on what you think of the federal estate tax. If you think the estate tax is an appropriate mechanism for addressing a significant deficiency in a realization-based income tax that steps up basis at death, then you should support the proposal. It deals only with holdings that are outside the estate tax's zero bracket, it excludes property that will be subject to the estate tax regardless of the decedent's citizenship and residence, and it provides a much cleaner and easier-to-administer rule than current law's tax avoidance standard. If, on the other hand, you want to abolish the estate tax, then you also should reject the proposal.

I can appreciate the merits of a system that only taxes consumption and leaves returns to capital out of the base. For now, however, that is not our system. What I cannot understand is a system that generally levies a tax on capital appreciation, but excludes appreciation belonging to persons willing to renounce their ties to the United States. That simply makes no sense to me.

There is one technical point, however, on which the bill should be improved. Proposed Section 877A(e)(2) would fix the time of the tax as of date an individual notifies the Department of State of the performance of an act of expatriation as specified by paragraphs (1) through (4) of Section 349(a) of the Immigration and Nationality Act (if this is earlier than any of the other expatriating events specified in Section 877A(e)). But as I understand the Immigration and Nationality Act, a person loses his citizenship when he performs the specified act, not later if and when he notifies the Secretary of State. *Cf. Vance v. Terrazas*, 444 U.S. 252 (1980). There is no reason why the tax rule should be any different from the citizenship rule. The timing of the tax should not turn on the formality of notice, which an individual might manipulate to reduce his burden. Indeed, I could imagine a case where a person loses his citizenship through an act of expatriation but never notifies the Department of State that he has done this. At death such a person could claim immunity from the estate tax because of his status as a nonresident alien, but because of the lack of notice to the State Department would not have been subject to tax under proposed Section 877A. I therefore recommend that the language of Section 877A(e)(2) be amended to make clear that the date of the tax should be when the specified act of expatriation occurs, not when notice is given. This would also affect when the enacted tax would first take effect, because persons who have performed acts of expatriation without a tax avoidance purpose before February 6, 1995, would not be covered by Section 877A. Since there is no good reason to make this tax retroactive, I would assume this change would be uncontroversial.

Chairman JOHNSON. Thank you, Mr. Stephan.
Rabbi Moline.

STATEMENT OF RABBI JACK MOLINE, VICE PRESIDENT, WASHINGTON BOARD OF RABBIS, WASHINGTON, DC

Rabbi MOLINE. Madam Chairperson and Members of the Subcommittee, thank you for inviting me to testify today regarding the proposed expatriation tax. I serve as the rabbi of Agudas Achim Congregation in Alexandria, Virginia. I have held leadership positions in the Washington Board of Rabbis and the Rabbinical Assembly of Conservative Judaism. I mention those credentials not because I represent those organizations in my testimony, I do not. It is simply to indicate that my perspective and concerns are not unusual among the leadership of Jewish community in the United States and abroad and I respectfully ask you to reject this tax.

I have spent many years struggling with foreign governments on behalf of Jews wishing to leave oppressive societies for the freedom afforded by our country and others. I traveled to the Soviet Union in 1978 for the purpose of meeting Jews who wanted to emigrate but were denied that opportunity on the basis of legal technicalities and most onerously, excessive taxes placed on their request to emigrate. They were described beautifully by Professor Turner.

Their stories were heartbreaking and indeed many Members of Congress remember well their own advocacy on behalf of these refuseniks.

I also had the privilege of serving a congregation whose membership includes Jews from many countries. Among the families is a large extended family from Iran. The restrictions placed on their emigration were so severe that young and old alike, they had to endure torturous overland trips and be smuggled out of Iran leaving behind all their possessions.

I might add that this family was well-to-do in Iran, but they were unable to afford the taxes that were placed upon emigrants. In order to reach freedom, they had to abandon all their property. The few members of their family remaining in Iran live in fear of the seizure of their property and possessions as payment for the emigration of others.

Our government responded to such tactics by taking the moral high ground. The Jackson-Vanik amendment successfully enacted 20 years ago used the human rights issue as the wedge to the most accessible crack in Soviet culture. By making clear our willingness to sacrifice gains in trade and influence for the cause of human rights, the United States established itself as a champion of its own principles: Life, liberty, and the pursuit of happiness, and now that moral high ground is threatened.

A small group of wealthy Americans, seeking to avoid the responsibilities of citizenship, seems to be a lucrative and popular target for much needed revenue in a time of fiscal crisis. And nobody, including me, has much sympathy for the greed which motivates their actions. But the abuse of our freedom by a few does not call for legal remedies which lay the groundwork for threatening the freedom of the many. For while we Americans may understand the fine lines we draw regarding income, assets, capital gains and tax

liabilities, foreign dictators will find them irrelevant. The arguments are the same. We simply draw the line in a different place.

Any number of times I have sat face to face with representatives of the Soviet Government and heard them defend exit taxes on the basis of repaying a debt to society. The claim was that there had been an investment in the Jews who wished to emigrate. They were educated in the USSR, that they had enjoyed health care, guaranteed employment, housing and security, that they had served in the military and they knew secrets. If they wished to take the fruits of their life away from the tree which bore them, then it was reasonable to reimburse the workers who must remain behind to pick up the slack. Such ingrates were to be punished for rejecting the blessings of Soviet society. They would repay their benefactors for the decision not to endorse the particular social contract and political agenda of that country.

I heard the same arguments articulated by a staff member of a congressional Committee just last week and I was horrified. This tactic has been used not only by the Soviets and the Iranians but by the Iraqis, the previous government of South Africa, pre-Zimbabwe, Rhodesia, and, to add to this rogues' gallery, Adolf Hitler's Germany.

The victims have been the disenfranchised of every ilk, not just Jews, but Bahais and Christians and Muslims, black majorities and white minorities. This provision would begin the construction of a wall around this country. The wall would not defend us against hostile invaders but imprison those who wish to leave. Mr. Guttentag himself offered that opinion in his testimony.

The limited application and target population of this provision may look safe in the short term, but the precedent it sets is frightening in its potential to undermine our basic commitment to human rights and it eviscerates Jackson-Vanik.

I make no representation as to whether this provision passes muster under the Constitution or international law. I also make no representation about whether this is good tax policy. Discussions on those matters will focus on technicalities and twists of language, on graphs and on growth theories.

I raise only the overarching moral questions, do we wish to trade a short-term economic gain for the standing we have as the exemplars of human rights, even for those who exercise them in unpopular ways? I assure you, I wish no peace to those who abandon this great country for material gain, but I can live with my resentment of the success of their greed and manipulation. I would be humiliated, however, if I spoke up on behalf of an oppressed minority anywhere, and I will, and had to respond to some smug tyrant who waved a copy of this provision in my face.

I appreciate your willingness to hear my testimony. These conclude my remarks and I am available for any questions.

Chairman JOHNSON. Thank you. Thank you very much, Rabbi Moline.

Ms. McCaffrey.

STATEMENT OF CARLYN S. McCAFFREY, ESQ., PARTNER, WEIL, GOTSHAL & MANGES, NEW YORK, NEW YORK

Ms. McCAFFREY. Madam Chair, Members of the Subcommittee, I welcome the opportunity to share with you the concerns I have with Treasury's proposal to impose a tax on citizens who give up their citizenship.

I am a tax partner at the law firm of Weil, Gotshal & Manges, a member of the adjunct faculty of law at the New York University School of Law and have practiced and taught tax and trusts and estates law for more than 25 years. I appear today in my individual capacity and I am going to talk about tax and trust law.

The proposed legislation would replace the provisions of current law that subject former citizens to tax on U.S. source income for 10 years if a principal purpose of expatriation was to avoid U.S. tax. The problems with the current expatriation rules are well known. The requirement of a tax avoidance motive provides a reason for not reporting and creates an obstacle to enforcement. The 10 years may be insufficient to capture all gain that should be caught, and as Mr. Shay told us earlier this afternoon, tax practitioners have created various techniques over the years that make it quite easy to avoid its reach.

These factors have all combined to enable individuals to avoid tax on income and unrealized gain that accrue during periods of U.S. citizenship.

I agree that the Code should be strengthened to ensure that income and gain that accrued while an individual was enjoying the advantages of U.S. citizenship do not escape U.S. taxation. Treasury's proposal, however, extends far beyond that legitimate objective. My concerns with the bill relate both to its substance and to a number of technical flaws.

As to substance, I am concerned that expatriation is not an appropriate tax event and with the proposed scope of the tax as well. The bill treats relinquishment of U.S. citizenship as a tax recognition event. The event of expatriation, it seems to me, is not an appropriate recognition event since it produces neither the cash to pay the tax, nor a way of accurately measuring an individual's gain or loss and their assets.

As Mr. Guttentag testified, the bill attempts to deal with the liquidity problem by extending the estate tax deferral provisions to the expatriation tax. These provisions permit the Internal Revenue Service, for reasonable cause, to extend the time for the payment of the estate tax for 10 years. At current rates, deferral requires the payment of interest at 9 percent compounded daily. A taxpayer who defers using this provision will risk incurring an interest obligation to the United States that ultimately exceeds her profits from her retained assets. In most cases, this will not be a viable or a sensible option.

Although expatriation should not be a recognition event, this doesn't mean that an expatriate should escape U.S. income tax. There are reasonable alternatives that should be explored that are consistent with our general policy of deferring tax on income until collection and on gains until recognition.

One alternative is to require an expatriate to identify the assets she holds at the time of expatriation and to require her to pay U.S.

income tax on those assets when they are actually sold or transferred by gift for a debt to the extent that they are not subject to the U.S. gift or estate tax.

In terms of timing and measurement, the expatriate would then remain in the same position as a U.S. citizen. I think this should be the objective. Collection of the tax could be assured by requiring a bond or a deposit of assets in the U.S. trust. A similar technique is now required by the U.S. estate tax law in connection with the allowance of a marital deduction for bequests to noncitizen spouses.

An easier and perhaps better alternative, as several witnesses have suggested earlier this afternoon, is simply to strengthen the provisions in existing law that impose an income tax on an expatriate's U.S. source income for 10 years. The exception for non-tax-motivated expatriations could be eliminated, and most importantly, the sections that impose a tax on the transfer of appreciated property to foreign corporations, partnerships and trusts could be amended to apply to transfers by expatriates during the 10-year period.

In fact, most of the abuse that centers around section 877 probably stems from an inadvertent change to section 367 as part of the 1976 reform act. Before that date, section 367 would have caught any expatriate who transferred assets to a foreign corporation, but that was changed and since then it has been fairly simple to avoid 877 by making transfers of that sort.

If these steps were taken, it is likely that the United States would tax most of the income and gain that should be taxed and would do so without creating a new layer of complex Code provisions that would require a long process of technical corrections and regulations to be workable.

As to the scope of the tax, the bill treats the expatriating citizen as owning those assets that would have been included in her gross estate if she had died on the date of expatriation, certain interests and trusts, including discretionary trusts, and any other interest in property specified by the secretary.

These categories are too broad because they reach assets which the individual doesn't own and to which he has no access. Additionally, it reaches property that probably would never have been subject to any U.S. tax at all if the individual had retained her citizenship.

The bill's application of the tax to a beneficiary's interest in a discretionary trust created by another reflects a disregard for the reality of those rules of trust law that stand between a beneficiary and the assets of a trust. When a beneficiary is subject to tax on account of her interests in a trust, she won't be able to compel the trustee to distribute assets, nor will she be able to sell her interest in the trust. Unless she has sufficient other assets to pay the tax, this new expatriation tax will make it economically impossible for her to relinquish her citizenship.

In addition to my concerns with the substance of the bill, I have a number of technical concerns that are explained in my written statement. But I would like to summarize just a few of them now.

The first four problems that are described can combine to result in a U.S. income tax, a foreign income tax and a U.S. estate or gift

tax on the same amount of gain all without any adjustment to avoid what could amount to a tax in excess of 100 percent.

As described in my written statement, the bill appears to reach all rights to receive future income, including the alimony rights an expatriating husband or wife takes when he or she returns to his or her native land and expatriates after a divorce.

The consequence of this provision is not only to tax the expatriate on the present value of rights to future alimony, but also to deny an alimony deduction to the paying spouse who remains behind.

Finally, no attempt has been made in the bill to deal with the very difficult problem of creating a rational system for the future taxation of a trust and its beneficiaries after one of its beneficiaries has expatriated, causing a portion of the trust assets to be subject to tax.

Last week, Mr. Samuels concluded his testimony on this bill before the Senate Finance Committee by stating 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.

I agree. They should be asked to pay, but a tax paid sooner is obviously more burdensome than one paid later, and a tax paid on assets that may never be received creates what appears to be an unconscionable burden. To ask an expatriate to assume a greater burden than a similarly situated citizen creates an unseemly exit tax. It punishes a politically unpopular group of U.S. citizens for choosing to exercise their right to give up their citizenship.

This concludes my prepared remarks, and I would be happy to answer any questions.

[The prepared statement follows:]

HEARINGS ON H.R. 831 BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 27, 1995

STATEMENT BY CARLYN S. McCAFFREY

Madame Chair and members of the Subcommittee, my name is Carlyn McCaffrey. I welcome the opportunity to share with you the serious concerns I have with Treasury's proposal to impose a tax on U.S. citizens who renounce their citizenship.

I am a tax partner at the law firm of Weil, Gotshal & Manges, a member of the adjunct faculty at the New York University School of Law and have practiced and taught tax and trusts and estates law for more than twenty-five years.

The proposed legislation would replace provisions under current law that now subject expatriating citizens to U.S. tax on U.S. source income for 10 years after expatriation if a principal purpose of the expatriation was to avoid U.S. tax. It is part of a larger legislative proposal to expand the exposure of foreign trusts and their U.S. beneficiaries to U.S. reporting requirements and tax.

The problems with the current expatriation rules, set forth in Code Sections 877, 2107, and 2501(a)(3), are well known. The requirement of a tax avoidance motive provides taxpayers a basis for not reporting taxable events, and presents an obstacle to enforcement. The 10 year limitation may be insufficient to capture all gain that should be captured. Over the almost thirty years since these provisions were enacted, tax practitioners have created various techniques that make it easy to avoid its reach. These factors have all combined to enable individuals to avoid tax on income and unrealized gain that accrue during periods of U.S. citizenship.

The Code should be strengthened to ensure that income and gain that accrued while an expatriate was enjoying the advantages of U.S. citizenship do not escape U.S. taxation. Expatriates should be taxed on such gain and income in the manner they would have been taxed if they had not expatriated. Treasury's proposal, however, extends far beyond that legitimate objective. It does so by taxing an event that does not appropriately measure an expatriate's income or gain from any asset and that does not give her the funds to use to pay the tax.

Treasury's expatriation proposal, since its announcement on February 6, 1995, has had two versions, one in section 201 of H.R. 981, which was introduced on February 16, 1995, and one in an amendment to H.R. 831, which was approved by the Senate on March 24, 1995. The principal difference between the two versions is the deletion from the later version of a

similar tax on resident aliens who give up their residency. My comments today relate to the latter version.

My concerns with the Bill relate both to its substance and to its technical structure.

THE SUBSTANCE OF THE PROPOSAL

1. ***The Taxable Event.*** H.R. 831's treatment of the relinquishment of U.S. citizenship as a tax recognition event imposes a cost on expatriation. This cost is not necessary to prevent the avoidance of U.S. tax on income and gain accrued prior to expatriation. As suggested above, the event of expatriation is not an appropriate tax recognition event since it produces neither the cash to pay the tax nor a way of accurately measuring an individual's gain or loss in any particular asset.

The Bill attempts to deal with the liquidity problem by extending the provisions of Code Section 6161 to the expatriation tax. Code Section 6161 permits the Internal Revenue Service, for "reasonable cause" to extend the time for the payment of the estate tax for a period not in excess of 10 years. The examples of "reasonable cause" provided in Treas. Reg. § 20.6161-1 all require a lack of sufficient liquid assets to pay the tax. No option is given to a taxpayer to elect to defer because she wants to retain an asset for investment reasons. Moreover, deferral will require the payment of interest on the deferred tax. A taxpayer who is given the opportunity to defer will risk incurring an interest obligation to the U.S. that ultimately exceeds her profits from her retained assets. In most cases, this will not be a viable or sensible option.

Expatriation should not be a recognition event. But, this does not mean that an expatriate should escape U.S. income tax on income and gains accrued at the time of expatriation. Alternatives that are consistent with our general policy of deferring tax on income until collection and on gains until recognition should be considered.

One alternative is to require an expatriate to identify the assets she holds at the time of expatriation and to require her to pay U.S. income tax on those assets when they are actually sold or transferred by gift or at death, to the extent not subject to the U.S. gift or estate tax. This approach would preclude an expatriate from avoiding U.S. tax on income and gain appropriately taxed in the U.S. by relinquishing citizenship without artificially accelerating the imposition of tax. In terms of the timing and measurement of tax, the expatriate would remain in the same position as U.S. citizens. This should be the objective. Collection of the tax could be assured by requiring a bond or the deposit of the assets in a U.S. trust. A similar technique is required by the U.S. estate tax law in connection with the allowance of the marital deduction for bequests to non-citizen spouses. See Code Section 2056A.

Another alternative is to strengthen the provisions in existing law that impose an income tax on an expatriate's U.S. source income for 10 years after expatriation. The exception for non-tax motivated expatriations could be eliminated and Code Sections 367 and 1491, the

sections that impose a tax on the transfer of appreciated property to foreign corporations, partnerships, and trusts, could be amended to apply to transfers by expatriates during such 10 year period.[1] If this were done, it is likely that the U.S. would tax most of the income and gain that accrued prior to expatriation.

2. ***The Scope of the Tax.*** H.R. 831 treats the expatriating citizen as owning: (1) those assets that would have been included in her gross estate if she had died on the date of expatriation, (2) certain interests in trusts, and (3) "any other interest in property specified by the Secretary as necessary or appropriate to carry out the purposes of this section."

These categories are too broad because they reach assets to which the individual has no access. As a result, she will have no funds to use to pay the tax either at the time of expatriation or, if deferral is permitted, at any later date.

In some cases, the lack of access is attributable to action taken by the expatriate before the announcement of H.R. 831; in others, it is attributable to action taken by a third party over which she has no control. Examples of assets in the first category include certain assets that have been given away irrevocably within three years of expatriation, and interests held in trusts created by the individual with respect to which she has retained a limited right such as the right to receive income or a power to select among alternate beneficiaries. Examples of assets in the second category include an individual's interests in trusts created by others of which she is a discretionary beneficiary.

The Bill's application of the expatriation tax to a beneficiary's interest in a discretionary trust created by another reflects either a disregard for or a disbelief in the reality of those rules of trust law that stand between a discretionary beneficiary and the assets of a trust. When an expatriating beneficiary is subject to tax on account of her interest in a trust, she often will not be able to compel the trustee to distribute trust assets to her nor will she be able to sell her interest in the trust. Unless she has sufficient other assets to pay the tax, the expatriation tax will make it economically impossible for her to relinquish her citizenship.[2]

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1. Curiously, until 1976, Code Section 367 did apply to transfers to foreign corporations by expatriates. The exclusion of expatriates by the amendments made to Code Section 367 by the Tax Reform Act of 1976 (P.L. 94-455, § 1042(a)) was probably inadvertent. Such inadvertent changes are symptomatic of a legislative process that often proceeds too quickly with changes to the Internal Revenue Code. The current complexity of the Internal Revenue Code and the intricate pattern of relationships among its various sections create a high degree of risk that a change to one provision will have an unexpected and undesirable impact on another.

2. The reality of these rules has been made clear in a series of state court decisions that refuse to compel the trustees of discretionary trusts to make distributions to beneficiaries who are welfare recipients. *E.g.*, *Lang v. Commonwealth*, 515 Pa. 428,

(continued...)

The final category raises additional concerns as to the scope of Treasury discretion. To grant Treasury unlimited discretion to characterize any item of property as held by an individual for purposes of the tax creates an unacceptable degree of uncertainty as to the scope of the provision.

The Bill exempts the first $600,000 of gross income attributable to the deemed sale. The use of this figure, which is equivalent to the maximum amount that most U.S. taxpayers may give or bequeath free of U.S. estate or gift tax, suggests a connection between the expatriation tax and the U.S. transfer tax system. It is unclear whether the use of this number is coincidental or if its use signals an eventual attempt to extend the principles of this tax to the transfer tax system.

TECHNICAL CONCERNS

1. ***Foreign Gains Are Subject to U.S. Tax.*** The same logic that justifies subjecting the expatriate to U.S. tax on income and gain that accrued while she enjoyed the benefits of U.S. citizenship or residency compels the conclusion that any income or gain that accrued in any U.S. person's assets before the time she became a resident of the U.S. or prior to her receipt of such assets from a foreign donor or decedent should be protected from the expatriation tax and from all other U.S. income taxes by appropriate basis adjustments.[3] The Bill contains no basis adjustment for either purpose.

2. ***Two U.S. Income Taxes May Be Imposed on the Same Income.*** If an individual is deemed to have sold her assets upon expatriation for an amount equal to fair market value, her basis in such assets should thereafter be adjusted to fair market value. The basis adjustment is significant because the expatriate, for a variety of different reasons, may continue to be subject to U.S. income tax. Instead of providing for such a basis adjustment, the Bill directs Treasury to draft regulations to permit an adjustment. The basis adjustment provisions should be a part of the Bill. The expatriate should not be required to await the issuance of regulations in order to determine her basis in assets which are deemed to have been sold and on which tax has been imposed.

Additional technical problems arise for the expatriate who pays an expatriation tax on an asset that will continue to grow in value and that will be disbursed to her over a period of time. The type of technical problems that will arise can be illustrated by the following example:

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2. (...continued)
528 A.2d 1335 (1987); *First Nat'l Bank of Maryland v. Department of Health & Mental Hygiene,* 284 Md. 720, 399 A.2d 891 (1979); *Portsmouth v. Shackford*, 46 N.H. 423 (1866).

3. The basis adjustment suggested for individuals immigrating to the U.S. is often referred to as "landed basis."

Example 1: Kate is an employee of the X Corporation. Under the terms of her unqualified deferred compensation arrangement with X, she will be entitled to receive annuity payments from X when she retires in 10 years. The annuity payments will be equal to 50% of her highest annual compensation. X transfers her to a foreign country and she expatriates. At the time of her departure from the U.S. and her expatriation, the value of her deferred compensation arrangement is $400,000. When she begins receiving annual payments of $100,000, how will she be taxed? Will the first payments received be excluded from U.S. income tax until she has collected the $400,000 on which she already has paid the income tax? Or, will she be required to allocate the $400,000 over the number of years of expected payments? When will X be able to deduct the $400,000 - on expatriation or on actual payment?

3. ***A Foreign Tax and a U.S. Tax May Be Imposed on the Same Income.*** When the expatriate later sells an asset on which the expatriation tax has been paid, she is likely to be subjected to tax on the same gain by her country of residence. If she had not surrendered her U.S. citizenship before the sale, she would have been protected from double tax by the U.S. foreign tax credit. The imposition of two taxes on an expatriate is a penalty that would not have been imposed on her if she had become a nonresident without surrendering her U.S. citizenship. To avoid the double tax penalty, the U.S. foreign tax credit provisions should be amended to permit a refund of the expatriation tax to the extent of the foreign tax credit that the U.S. would have permitted an expatriate if she had not surrendered her citizenship before the sale.

4. ***A U.S. Income Tax and a U.S. Gift or Estate Tax May Be Imposed on the Same Income.*** If an expatriate is subjected to the expatriation tax on gain accrued in a particular asset and if she later gives that asset away or dies holding it, the gain on which the expatriation tax was paid may be subject to a U.S. gift or estate tax. The combination of the two taxes can exceed 99%. An adjustment should be provided to prevent this result.

5. ***The Exemptions Are Too Narrow.*** The Bill exempts interests in U.S. real estate, interests in qualified pension plans, and interests in foreign pension plans (under regulations prescribed by Treasury up to $500,000). It is understood that U.S. real estate interests are excluded because these will continue to be subject to U.S. income tax under Code Section 897. But U.S. real estate interests are not the only assets that will continue to be subjected to U.S. income tax. A nonresident alien is also taxed on income effectively connected with a trade or business conducted within the United States under Code Section 871(b). Assets used in connection with such a trade or business should similarly be exempted.

6. ***Deduction for Personal Losses May Be Allowed.*** The calculation of the expatriation tax provides that, "notwithstanding any other provision" of the Code, all gains or losses are to be taken into account. A literal application of this provision would permit the expatriate to reduce investment gains by losses on personal assets. Such losses are not ordinarily deductible. It is not clear that this was intended.

7. ***Alimony and Other Rights to Future Income May Be Taxed.*** The Bill does not exempt rights to future payments of income. As a result, it appears to reach rights that it may not be intended to reach. If it is intended to reach these rights, technical changes must be made to other provisions of the Code to preserve the structural balance between income and deductions.

For example, subjecting an expatriating divorced spouse's right to receive future alimony payments seems inappropriate. The right to receive alimony relates not so much to gain that accrued under the protection of the U.S. but to the future support needs of the alimony recipient. But, if the Bill is intended to reach alimony payments, Code Section 215, which allows an alimony deduction only when a payment is actually made and then only if included in the gross income of the receiving spouse under Code Section 71, should be amended to avoid the loss of the deduction to the paying spouse. In addition, Code Section 71(f) should be amended to remove the possibility of the so-called "front-loading" tax if the expatriation of an alimony recipient is treated as an accelerated payment of alimony.

8. ***The Trust Provisions Are Flawed.*** As indicated above, the Bill treats an expatriate as owning certain interests in trusts. The method by which such interests are to be determined is unclear. Moreover, the manner in which the Bill subjects such interests to the expatriation tax is technically flawed and fundamentally inconsistent with existing statutory methods for taxing trusts and their beneficiaries.

a. ***Determining the Beneficiary's Interest.*** A beneficiary's interest in a trust is to be determined based upon "all relevant facts and circumstances" including, not only the terms of the trust instrument, but also a group of factors that, at best, reflect the expatriate's expectations as to her trust interest rather than any definable property interest. These include "any letter of wishes or similar document, historical patterns of trust distributions, and the existence of and functions performed by a trust protector or any similar advisor."

Except where an individual's trust interest can be actuarially valued, as in the case of an interest such as the right to receive trust income for a term, it is impossible to predict how these factors can possibly be utilized to measure an individual's interest in a trust.

An alternate method is provided for those cases where a beneficiary's interest cannot be determined based on facts and circumstances. The alternate method treats the beneficiary or beneficiaries who have the closest degree of kinship to the grantor as holding the trust interests regardless of whether she has any actual access to or expectation of receiving trust distributions. The application of this approach can be illustrated by the following example:

Example 2: Mary established a discretionary trust for her all of her issue 10 years ago. The terms of the trust instrument give complete discretion to a corporate trustee as to the timing and amount of distributions. The trust is to

last until the last to die of Mary's issue living at the time of the trust's creation. At that time, all trust property will be paid to charity. When Mary created the trust, she had three living children and ten living grandchildren. Ten years after the trust's creation, Maureen, one of Mary's daughter's expatriates. Maureen's two sisters are alive at the time of expatriation. There are no letters of wishes and no trust protector or advisor. No distributions have ever been made because the trustee has determined that none of Mary's issue is in need of funds. Maureen has no reason to believe she will ever receive any distributions from the trust. Since it is impossible to determine trust interests on the basis of facts and circumstances, Maureen will be deemed to hold one-third of the trust.

In the case of a grantor trust whose grantor and beneficiary expatriate, the Bill appears to impose the expatriation tax on both of them with respect to the same trust assets. The report entitled "Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Citizenship" prepared by the Staff of the Joint Committee on Taxation dated March 20, 1995 states that this result is not intended. Language should be added to the Bill to make this clear and to explain how to treat trusts that are only partially grantor trusts.

b. ***Calculating the Tax.*** The expatriate who is deemed to hold an interest in a trust must calculate her expatriation tax allocable to the trust interest in the following manner:

(1) The Bill appears to assume that the expatriate's interest will be quantifiable as a percentage share of the trust as a whole. This share is then to be treated as a separate trust.

(2) The deemed separate trust is then deemed to have sold all of its assets for their fair market value immediately before the beneficiary expatriates and to have distributed all such assets to the expatriate.

(3) The expatriate is then deemed to have recontributed the distributed assets back to the trust.

It is understood that the object is to require the expatriate to include in her gross income any gain deemed to have been recognized on the deemed sale as well as any previously undistributed income allocable to the beneficiary's share. This result, however, interacts uneasily with the various existing methods for taxing trusts and their beneficiaries and creates a number of anomalies and unanswered questions. For example:

(1) Will capital gain realized on the deemed sale of assets be included in distributable net income so that the deemed distribution to the beneficiary will make the beneficiary (rather than the trust) taxable on capital gain? Normally capital gain is not included in distributable net income of a domestic trust.

(2) Will these rules apply if the trust actually sells assets and distributes amounts to the expatriating beneficiary?

(3) After the expatriate is treated as having recontributed the assets to her separate trust, will the trust continue to be treated as a separate trust so that she will receive the benefit of the basis adjustment to the contributed assets if they are distributed to her in the future? If so, how will the trust treat future distributions? In the example set forth above, will future income distributions from the trust to any beneficiary other than Maureen be treated as coming from the two-thirds share of the trust that is not her share? If so, an actual distribution of all trust income to Maureen's sister will give rise to a deduction of only two-thirds of such income. The sister will pay tax on only two-thirds of the income while tax on the remaining income will be imposed on the trust.

(4) How will the deductions of the trust, such as the deductions for expenses and charitable contributions, be allocated and reflected in the expatriate's tax calculation?

(5) For what tax purposes will the expatriate be treated as having received a distribution? If she is a grandchild of the trust's grantor (or otherwise assigned to the grantor's grandchildren's generation), will she be subject to the generation-skipping transfer tax on account of her receipt of a taxable distribution? If so, will the generation-skipping transfer tax be deductible in computing the expatriation tax. Arguably, expatriation should not accelerate the generation-skipping transfer tax. If it does not, the generation-skipping transfer tax should be amended to permit the expatriate to reduce the amount of any future actual taxable distributions by the expatriation tax.

(6) For what tax purposes will the expatriate be treated as having recontributed the assets? Will she be subject to the normal gift and estate tax consequences that flow from contributions to trusts? If she is a child of the trust's grantor (or is otherwise assigned to the grantor's children's generation), will she be treated as the transferor of the trust for generation-skipping transfer tax purposes, thereby avoiding the generation-skipping transfer tax on subsequent distributions to the grantor's grandchildren.

(7) In the case of an expatriate whose trust interest consists of an income interest, should such recontribution be treated as a purchase of an income interest so that she would be able to take an amortization deduction against future income distributions? If so, Code Section 167(e), which generally precludes the amortization of term interests when related persons hold the remainder interests, should be amended.

(8) Will the expatriate's share of the trust be treated as a so-called "grantor trust" as to the recontributed share with the result that all items of income, deduction, and credit allocable to her share will be attributable to her?

(9) In the case of an interest in a charitable remainder trust, how is the distribution to be allocated among the various categories of accumulated income? Will the expatriate receive a charitable deduction for the deemed recontribution of assets back to the trust? Will a charitable remainder annuity trust lose its status as a charitable remainder trust because of the deemed contribution by its expatriating beneficiary? Charitable remainder annuity trusts are not permitted to accept additions.

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

As suggested by the examples above, the Bill's provisions regarding the taxation of interests in trusts raise serious technical problems. The appropriate solution requires further study. In the case of an expatriating individual's interest in U.S. trusts, however, the best solution may simply be to impose a withholding tax on distributions to the expatriate to the extent such distributions are attributable to pre-expatriation income or gain of the trust.

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Last week Mr. Samuels concluded his testimony on H.R. 831 before the Senate Finance Committee by stating 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."

I agree. They should be asked to pay. But a tax paid sooner is significantly more burdensome than one paid later. And, a tax paid on assets the expatriate may never receive creates an unconscionable burden. To ask an expatriate to assume a greater burden than a similarly situated citizen creates an unseemly "exit tax" that punishes U.S. citizens who make the politically unpopular choice of exercising their right to expatriate.

This concludes my prepared remarks. I would be happy to answer any questions.

Chairman JOHNSON. I thank you very much.

Mr. Stephan and Mr. Shay, you testified that this is fair. We have had a lot of testimony. This isn't going to fall fairly on people. I will put two questions to you. One is, why don't we write regulations about the current law? Why didn't we write forms? Why don't we know of all the people who decided to relinquish their citizenship last year, what the values of their assets are and who in fact might be affected by this?

And do you think it is good public policy to change a law in a way that will have both domestic and international ramifications with literally no information that is reportable about the 858 people in this category as reported by the Treasury.

Mr. SHAY. I will start with a response on the regulations. As I am sure you are aware, the resources of the Treasury Department and the IRS are limited. From my perspective, devoting resources to write regulations to a statute that is currently not effectively enforceable, no matter what regulation you write, is a waste of time. A regulation——

Chairman JOHNSON. Mr. Shay, let me talk about that just a minute. This law has been on the books 30 years. Don't you think it is not hard to write at least a regulation about forms to get the information so that anyone who makes this declaration will at least know? We have done that in other laws. This is not unique. This is not difficult.

We have asked for this kind of declaration in other circumstances and, to defend the Treasury on the basis that they can't write the regulations because the law is not enforceable, they do that all the time. They could have at least written regulations that ask for a declaration that says what the assets of these people are and so on and so forth so we would have the information.

Mr. SHAY. Madam Chair, I think earlier in the day there was a lot of comment regarding cost-benefit analysis. The only point I was making was applying a cost-benefit analysis to seek to write regulations that, even if fully enforced, would not yield a tax because of a deficiency in law or perhaps to impose a recordkeeping requirement that, again, would not have any effect under current law in terms of increased revenue. I could understand that from the Treasury perspective that would be a waste of time.

Chairman JOHNSON. Would you suggest, then, that Treasury might come to the same conclusion about the new law, because once the new law is written and the regulations are written, anyone in their right mind who is going to expatriate would expatriate before they hit the threshold and so it is not going to affect anything anyway?

Mr. SHAY. I agree that the new law would not apply unless there is gain in excess of $600,000 and, therefore, certainly some planning would revolve around whatever point you place that threshold.

I also agree that the new law would have some significant effect even without regulations. I think it does have some technical infirmities described in my testimony, but it certainly would have an immediate prophylactic effect starting from the proposed effective date of February 6.

If I may turn to another question you asked, which was the relationship of the proposal to treaties. Speaking only of income tax treaties, the administration proposal is less intrusive on the taxing rights of foreign governments than is current law. Under current law, the tax would be deferred until there is a disposition event. Typically—I mean, as the law is structured, that disposition event will always be at a time when the person selling is resident in another country.

Now, two things can occur. First, some of our older treaties would prevent the United States from collecting any tax on that sale in the case of long-term residents who move to another country. Second, some of our older treaties do not preserve the U.S. right to tax under existing section 877 because they have not been amended recently enough to pick up that rule.

Notwithstanding that the IRS has tried to impose that tax when somebody has gone to such a treaty country, the Tax Court has ruled against them; I think that the Tax Court decision is correct and would be upheld by other courts. So under current law, section 877 could not be applied effectively with respect to people who change their residency to certain other treaty countries.

There has also been, I think, a very correct reference to the possibility of there being a double tax, and I address that in my testimony. First, if, after the time a person has expatriated there is a tax under the administration proposal and a foreign country taxes that gain again, every income tax treaty that the United States has, except one, has an effective mutual agreement procedure that allows the two countries to settle issues of double taxation.

In my statement, I have strongly urged the Committee to urge the Treasury that, if this proposal passes in something like this present form, they reach mutual agreements with treaty partners to be sure that that expatriate gets full basis for the taxes paid on the gain that was accrued while in the United States so that other countries would not double tax that income.

There is no guarantee that this would occur. But I would also urge that you combine that with a recommendation to the Treasury that in negotiating all future treaties, that they try to include such a provision in the treaty itself so that there is not an issue of a possible disagreement under the mutual agreement procedure.

Chairman JOHNSON. May I clarify that point, Mr. Shay, because you didn't go through your testimony in detail. Are you saying that with all but one country, our tax treaties are such that they would allow a clarification of this point, though with some further negotiation?

Mr. SHAY. What these tax treaties have is an arrangement where the two tax authorities, when the same income has been taxed by both countries, sit down and they can discuss what the appropriate tax is in order to avoid double taxation. That is the purpose of the treaty.

If a taxpayer paid the tax upon exit, moved to a country with whom the United States does have an income tax treaty and were taxed again on the same gain, it would be entirely appropriate, and indeed I think we should encourage that taxpayer to go to the tax authority and initiate a procedure under that treaty.

The one problem with this is those two tax systems or administrators don't have to agree. This is not binding, although actually two of our newer treaties have binding arbitration clauses that would make it binding, but they are not implemented yet. But the objective of the tax authorities is to avoid double taxation and they should be able to resolve which country is appropriately taxing the gain.

Chairman JOHNSON. So in other words, all but one of our current treaties addresses this issue, though not in a binding way, and you would recommend that we renegotiate all of those treaties so that it is binding but that we make it binding in any future treaties?

Mr. SHAY. I agree. But if I may clarify just one point. I would recommend that we take as a negotiating position that this be binding in future treaties. But treaties include a lot of benefits and tradeoffs and I am not sure I would recommend that the United States have to have that, because you always have this procedure. The mutual agreement procedure has been criticized in the past for being slow, but the IRS has worked very hard on improving that procedure and I think that is a relief valve. It is not perfect, but it is an appropriate relief valve for the potential double taxation that could arise.

Chairman JOHNSON. But it is at the discretion of the other country.

Mr. SHAY. It is at the discretion of both countries, yes.

Chairman JOHNSON. Thank you.

Ms. McCaffrey, do you have any comment on that point?

Ms. MCCAFFREY. Well, I am not familiar with how that—those provisions have actually been used and I wonder if they have ever been used in a similar situation where the United States taxes income in 1 year and the other country isn't going to tax it until 10 years into the future.

I had thought the preferable way of dealing with this problem, and my remarks talk about this, is that our foreign credit, tax credit provision should be amended so as to allow the expatriate a refund in a year of later sale to the extent that she would have been permitted a foreign tax credit if she hadn't given up her citizenship.

Because what this provision is now doing is subjecting somebody to a greater tax who is in exactly the same position with one exception. If A and B both leave the United States with the same amount of appreciated assets and move to country X, and A gives up her citizenship and B doesn't, A is going to wind up paying a tax when she leaves, B won't.

Now, when they later sell the asset in the new country, A will pay a tax all over again and B will only pay one tax because the foreign tax credit provisions now in force will allow her a credit for her U.S. tax against the tax paid to the foreign jurisdiction.

Mr. SHAY. Just one point. I think, though, the credit would allow credit for the foreign tax against the U.S. tax.

Ms. MCCAFFREY. That is the point I am making. But in its current form, that won't work. So before we implement the expatriation tax, one of the kind of corresponding technical changes that ought to be made is a change to our foreign tax credit provisions

to allow a refund later on equal to the credit that would have been allowed if citizenship hadn't been relinquished.

Mr. SHAY. I respectfully disagree and I think this is a useful discussion. Precisely because under the foreign tax credit mechanism of U.S. law, the United States gives a credit for foreign tax imposed on the same gain that is taxed by the United States when it is considered foreign source income. So in other words, we are ceding our taxing right to the more senior taxing right, so to speak, of the other country. Frankly, when the tax is imposed at the time that that person is resident in the other country, that is not an unreasonable position. But I do think it ends up with the wrong result in cases where that other country taxes gain that has accrued up to the point of departure.

I think the United States should have the primary right to tax that gain. Indeed, under the mutual agreement procedure we just discussed, I think the right answer for the U.S. negotiators in that procedure is to say to the other country, we respect your right to tax this, but we think you should give a credit for the U.S. tax. That way the U.S. tax base is not eroded and I think you get the correct answer internationally.

Chairman JOHNSON. Is there any precedent for that?

Mr. SHAY. Yes. I don't know all of the competent authority cases because they are confidential, but I do know one competent authority case that deals with a very analogous point, and that has been made public. It is part of the record of the ratification of the U.S. treaty with Canada, and in that arrangement, the United States obtained a Canadian agreement to allow greater depreciation deductions to U.S. drillers, offshore drillers, who brought their rigs into the Canadian waters and then were taxed upon departure, in essence by recapturing of the depreciation in Canada, denying them when they were in Canada a full depreciation deduction.

The mechanics are very different than what we are talking about today, but the principles are precisely the same. It was used under the U.S.-Canadian treaty vis-a-vis their departure tax imposed on businesses, not individuals, to achieve a fair resolution of the taxing rights of the two countries.

Chairman JOHNSON. Ms. McCaffrey, has this approach been used generally in the taxation of foreign source income?

Ms. MCCAFFREY. Well, I am not aware of many instances where this kind of complex procedure is used for individuals who move from one country to the other, but I think this dialog is useful in that it points out that I think both of us agree, and most tax lawyers agree, that this legislation is creating a problem, a problem of double tax that ought to be cured, perhaps the way Mr. Shay suggests through treaties, perhaps the way I suggest with the modification of our foreign tax credit provision, but until it is clear that the system is going to avoid the double tax provision, I think the expatriation tax ought not to be passed.

This is a problem that needs to be worked out in advance. I don't think we should leave it up to the individuals in the future to negotiate their own tax breaks with the foreign governments in the foreign countries to which they move.

Chairman JOHNSON. Isn't one of your points that this not only creates a double tax problem, but it creates it over time? In other words, it might create it over a 10- or 15- or 20-year span of time.

Ms. MCCAFFREY. Part of the problem, of course, is the timing. In the normal course of events, the person that moves to country *x* and doesn't give up her citizenship doesn't have to pay this tax until an actual sale. But the person that moves to country *x* at exactly the same time has to pay the tax——

Chairman JOHNSON. So we have a choice. We create a better law that is more enforceable so that we can tax at the time of realization, whether you are here or there, or we have got this kind of situation where we have to solve the double taxation problem over time, and I would suggest that I am drawing the conclusion from this dialog between you that solving this double taxation problem will be administratively very complex.

Mr. SHAY. I think two points should be observed, though. One is, as I point out in my testimony, the current law provides no foreign tax credit whatsoever. It is completely deficient in that regard. So this is an issue that should be addressed.

Second, addressing it by waiting until realization weakens the claim of the United States to tax what I strongly urge the Committee to view as its fair share of the income as opposed to allowing France or Germany or the other country to tax it. Now, frankly, when the other country is the Bahamas, as it is in the case of at least one expatriate, I don't think we should worry too much.

Chairman JOHNSON. Would you consider quarantining of U.S. assets an appropriate response? Quarantining at the time of expatriation, and then you impose the tax at the time of realization, so you hold the asset.

Mr. SHAY. The advantage of quarantine, as I understand it, is that you are in essence creating a collection mechanism, but it doesn't surmount the problem that I have identified with respect to waiting for realization, because by that time the person has already entered the tax jurisdiction of another country. That creates the issue of double taxation.

Take this test, if I may suggest——

Chairman JOHNSON. But wouldn't it be easier to solve the problem of double taxation if you are dealing with it at the time of realization than if you are dealing with it at two different points, one at proclaimed realization and one of actual realization.

Mr. SHAY. Well, not necessarily, and for this reason: What the IRS has urged taxpayers to do in the transfer pricing world has been, at the time that a foreign country is claiming that the taxpayer has paid too little income to that country because, let's say, it has charged too large a royalty so there is a deduction in that country and the United States is getting all the income, the United States lags significantly in doing audits compared to some other countries, the IRS has said, when that country asserts a transfer pricing allocation, you tell us as soon as possible.

By the same token, under this regime, a taxpayer could notify the foreign government at the time of moving there in the first instance, the treaty authority, and try and set that procedure in place before selling the asset, so that that issue is something that is dealt with with certainty.

Second, I think we are overlooking here the fact that we are dealing with well-advised taxpayers, taxpayers who have gained in excess of $600,000, and I would be delighted to advise any of you or others as to how to take some self-help measures to avoid the double tax problem. To put it crudely, and I wouldn't advise a client to do this, but just for example, for illustration, if you were that concerned about the double taxation and you really did like the Bahamas as a place to sojourn for 1 or 2 years or whatever time it takes, you might move there for a period of time, sell your asset without tax, get current basis, and then move to the country where you want to live. This is not recommended.

What is recommended is to let people—hopefully people don't guide their lives by taxes such as we are describing here. But there is a potential for self-help that creative taxpayers can come up with.

Chairman JOHNSON. Wait 1 minute, Mr. Shay. Do I understand you to say, even if we changed the law, there would be ways to advise clients so that they could circumvent?

Mr. SHAY. Not so they could circumvent the U.S. tax, but so they could circumvent or avoid the double tax that could occur if they moved to another country. Two country's tax laws often don't work properly together.

Chairman JOHNSON. Is there any way we could focus on those whose purpose was tax avoidance and particularly those whose purpose was tax avoidance and who actually came back then and participated in our economic life quite extensively? Wouldn't it be possible to deal with that issue specifically rather than, in a sense, spreading such a broad net?

Mr. SHAY. It is possible, but I think the question has to be asked as follows: This tax only applies when an individual takes a strong affirmative step either to relinquish citizenship, which requires you to march in and file something with the State Department, or to give up your green card, give up your right to legal permanent resident status in the United States.

The simplest tax planning of all here to avoid these problems is to hold on to your citizenship and to hold on to your green card if you are going to come back. In that way, you are not going to have double taxation that isn't already relieved by our domestic law foreign tax credit mechanism, that isn't already relieved by treaties.

The point I am trying to make, Madam Chairman, is quite simple and that is we are dealing in a world where the tax is potentially so significant that I think individuals will take account of it.

I think the equities are in favor of adopting the administration proposal, recognizing that there are some technical changes that have to be made. I think the problems are in many respects more theoretical than real to a well-advised taxpayer. I do add that caveat, but that caveat I think is appropriate when you are restricting the gain to in excess of $600,000.

Chairman JOHNSON. Well, I am going to yield to my colleague, Mr. Hancock.

Mr. HANCOCK. I think, Mr. Shay, one of the comments that you made when you mentioned the word "fair share," and quite frankly, I think that is part of the problem that we have with our old tax law now, is that there is an awful lot of people that feel like, espe-

cially the investors, the ones that are making the personal sacrifices to investment of accumulated assets, now all of a sudden they feel like they are paying more than their fair share because of the way our tax law operates.

Ms. McCaffrey, you mentioned in your testimony, it indicates that you have been practicing tax law for approximately 25 years. Twenty-five years ago, or let's say 20 years ago, how often did you have anybody even talk to you about giving up their citizenship as a method to avoid or to postpone or to change their tax liability?

Ms. MCCAFFREY. Twenty years ago I wasn't having many people come to me to discuss that.

Mr. HANCOCK. What about 10 years ago?

Ms. MCCAFFREY. I would say it has been within the last 5 to 10 years.

Mr. HANCOCK. All right. Quite frankly since 1986, would you say?

Ms. MCCAFFREY. Over that period of time.

Mr. HANCOCK. When we got rid of the capital gains tax, and when we also went to a 28-percent tax and started getting rid of deductions, now we say, Well, our tax rate is actually less now, even though it is at 38 percent, it is less than it was at one time when it was up to 40 percent, but yet at that time you had deductions and now you don't have any deductions, except the interest on a residence. You know, that is about it.

Ms. MCCAFFREY. Those few clients of mine who have expressed an interest in perhaps expatriating for tax reasons, and I do emphasize that there have been very few, have been at least, equally, if not more concerned, with the estate tax burden than the income tax, although income tax is a concern.

But many of them, when they think about moving, think about moving to jurisdictions that pay—that have an income tax that in some cases are even higher than ours. It is the estate tax that is the problem.

Mr. HANCOCK. But Mr. Shay has indicated, and we respectfully disagree, that anybody that has assets over $600,000 is wealthy. I guess for a husband and wife that is 1.2 million. You know, 1.2 million wouldn't last very long in this day and age now, especially if you live 25 years, you may have trouble getting by. If you should have a widow who inherited $1,200,000, and if she happens to live to age 90, she is liable to become dependent on the government. If they are 65 now, 30 years from now I don't know what it is going to cost, and nobody else does, except I think you can just move your decimal point one place to the right and that will give you your cost of living 30 years from now. I am talking about what an average family or average person would have to have to stay in a retirement home, take the current process and just move the decimal point.

But it would appear to me that this statement that was made by the earlier panel, Mr. Norman, and I would like to get the response from this, or from each one of you: "If the policies of our country are driving our rich citizens to expatriate and encouraging the alien poor to emigrate, we have a problem." Now that was the statement made.

Well, let me ask the question. Does that exist? Is that what we are doing? Are we encouraging people with our tax laws to give up their citizenship and encouraging the alien poor to emigrate?

Mr. SHAY. If you are asking me whether current law, which creates the opportunity to renounce citizenship for the citizen and to expatriate for the long-term resident alien, if that creates the incentive, as professionals, we have to advise clients of that opportunity. Not everyone takes it, because many view the value of being a resident or a citizen of the United States to exceed the issue of taxes. But some do, and more will, I think, unless the issue is addressed, and the question is, do you want to let that continue or do you want to address the problem?

Mr. HANCOCK. But, in other words, I think everybody then pretty well agrees with what Mr. Shay said. However, should we address the problem by penalizing those people that have been successful rather than to make it beneficial for them to give up their citizenship, change the tax law to where it is beneficial to retain their citizenship, because they are the type of people that we need in this country.

Mr. STEPHAN. Congressman, I in my statement make the argument that a radical revision of our tax system would be attractive. I myself would favor replacing the income and the estate tax with a cash flow consumption tax. That is part of my good Republican credentials to make this assertion.

I do think that pressure for significant tax reform is thwarted by the continuation of loopholes in the law. I think given existing law, section 877 amounts to a loophole that 877(a) would block.

In other words, I am making the argument that it might be easier to move toward significant tax reform by taking away the opportunities to skirt a system that may be fundamentally flawed.

Mr. SHAY. I also would point out that while the tax lawyers at the two ends of the panel may be prescribing potentially differing approaches, I think I am hearing agreement that the current situation is unfortunate.

Ms. MCCAFFREY. I think that is right. I share your concern with the many problems in the tax system as a whole, but I am not sure that we should wait to cure this particular problem until we have a more rational overall tax system. This problem ought to be solved one way or the other. Mr. Shay and I simply disagree on the method to be used to solve it.

Mr. HANCOCK. But is this an opportunity to take a look at a more rational overall tax system.

Ms. MCCAFFREY. I agree.

Mr. HANCOCK. For instance, Stanford Hoover Institute's flat tax that they are suggesting, is it time we address that? You all are tax practitioners. Can we continue to what I call compound the felony by writing more regulations or tax law?

Ms. MCCAFFREY. No. I think it is time to take a hard look at the system. Its complexity has grown to the extreme that we have problems of this sort and when we try to cure a particular problem with a Band-Aid in one area, we find that we are creating two or three other problems in another area.

Mr. HANCOCK. Well, as a personal note I met with my CPA yesterday afternoon at 1 o'clock. He had his computer, I had my com-

puter, and along about 4 or 5 o'clock we finally figured out that maybe we were close to getting my income tax ready to file for 1994.

You know, I mean something is wrong, something is wrong when it takes that amount of time, and two computers, you know, when you have to carry your portable over to your CPA to look up information and still not even know for sure whether you are right or wrong.

Thank you, Madam Chairman.

Chairman JOHNSON. Ms. McCaffrey, am I correct in concluding from your testimony that you believe we can strengthen the current law and correct the problems in the current law to deal with this problem more effectively than adapting the administration's proposal?

Ms. MCCAFFREY. That is my testimony; that is what I believe. I believe section 877 can be strengthened to solve most of the problems. You are not going to wind up with a perfect system, but I don't think what the administration is proposing is going to be a perfect system either. I think over a 10-year period, if we are taxing U.S. source income, that the United States will wind up taxing most of what is appropriate for it to tax.

Chairman JOHNSON. Mr. Shay, would you agree that one of the problems in the current proposal is that while you can defer payment, you must make it and you accrue interest at a rate that could result in your paying more than the value of the asset in taxes?

Mr. SHAY. I guess I don't view that as much of a problem as others do because I think in part it is the price for taxing the correct amount and for assuring that the United States rather than another country gets to tax its fair share.

Chairman JOHNSON. Of course, there is a very significant difference here. We are forcing taxation on assets that must either be sold at a time when it is unfavorable and therefore, you are going to get an undervaluing of it, or in the trust area, aren't we forcing a cash obligation that there may not be any way to gain the cash to make good on? I mean, isn't that true? Isn't that one of the possibilities under this law?

Then you would have no choice but to ask for deferral, have no choice but to pay interest and have no choice in the end but to be liable for something greater than the assets. Correct me if I'm wrong, Ms. McCaffrey.

Ms. MCCAFFREY. I am glad you are turning your attention to the trust aspects of this proposal, because I think that those aspects are the most seriously flawed of all of the proposals, because what the proposal does is impose a tax on assets that a beneficiary has no right to have, and in the normal course of events may never receive.

There is an example in my prepared remarks that illustrates it, yet in order to give up an individual's citizenship, she is going to have to pay a tax on her deemed share of assets inside a trust. That seems to me to be very bad tax policy.

Mr. SHAY. I don't want to comment on the trust aspects of this. I specifically reserve technical comment on that in my testimony.

Chairman JOHNSON. Do you think there are problems in the trust aspects?

Mr. SHAY. I have not formed a strong enough view to express a view one way or the other which is what I said in my prepared testimony. I think it is a complex area, and actually, I defer to my colleague on my right as being far more expert in that area than I am.

But in response to your question, I want to again remind ourselves that the act that we are talking about of renouncing citizenship or of passing in your green card is one that the individual himself or herself will affirmatively take. So taxes will come into play for that act, if you think that you are better off by waiting, then you may pay another year's U.S. income tax to wait for the proposal.

Chairman JOHNSON. Of course then you do get back to Rabbi Moline's problem.

Mr. SHAY. But that doesn't affect your ability to leave.

Chairman JOHNSON. Even if you are paying taxes, Mr. Shay, it surely does affect your ability to leave. I mean, at least be honest about what we are talking about. I don't disagree you made some excellent points, but we are going to impose a tax. That for many will mean that you cannot exit, period. I mean, we ought to be honest about that.

Mr. SHAY. I am having trouble.

Chairman JOHNSON. You could give examples from your experience of the trust area of taxes that can be imposed that there will be no way that anyone can sell anything or do anything to realize that tax to pay. So you cannot by definition leave.

I mean, that is what we are doing here. That is not all of what we are doing here. And there is the problem that we all agree is there, that we do not want people to be able to renounce their citizenship for the purposes of evading taxes. That we are in agreement about.

But not to recognize that there is a downside here that is so significant that we are going to actually deny our own citizens the right to do something that in many other instances we have declared a sort of fundamental human right, the implications of that are very significant.

Mr. STEPHAN. Congresswoman, if I could jump in there, we are not addressing leaving in this bill.

Chairman JOHNSON. Well, we are making leaving impossible or possible.

Mr. STEPHAN. No, ma'am. Someone can become a permanent resident overseas and not be affected by this law. This law only applies to expatriation.

Mr. SHAY. Madam Chairman, I would agree that it is incumbent on us, if this proposal is going to move forward, to address the trust issues in a manner that would not have the outcome that you are describing. And I am frankly skeptical that it is beyond the realm of our imagination either in the bar or elsewhere, to come up with an approach that would avoid that result.

Chairman JOHNSON. Well, we will certainly relay that information to the conference committee, that there are problems in this bill that really have to be addressed before they bring it out of con-

ference committee, or it will have some very negative impact. My understanding is that it will be out of the conference committee in a very few days.

I would ask you, do you think the problems in this bill can be corrected in the next 3 or 4 days? I open that to all the panel.

Ms. McCAFFREY. I think it is going to take much more than 2 or 3 days. I think that the people who are drafting the legislation and the corrective legislation need to draw on the resources of lawyers in the various bar groups across the country in order to help deal with this problem.

I am a member of the committee of the N.Y. State Bar Association tax section that has begun to study this a week or so ago, and we expect that we are going to have a report that will make some suggestions as to how the bill can be improved within the next several weeks. Other bar associations are conducting similar studies, and I think the information and the reports that come out as a result of that can be helpful to you to come up with a good proposal, one that could be passed maybe later this year, but not within the next several days.

Chairman JOHNSON. Thank you. We will be interested in those reports.

I do thank you all for your comments on, as I say, very short notice. Our notice was short as well as yours was short, and I think perhaps with your help, we perhaps can make rational sense of all of this.

Thank you very much.

Mr. SHAY. Thank you for your attention.

Chairman JOHNSON. Thank you.

[Whereupon, at 3:15 p.m., the hearing was adjourned.]

[A submission for the record follows:]

STATEMENT OF
JOHN E. CHAPOTON
SUBMITTED TO THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

March 27, 1995

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 Finance 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 Finance 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 Finance 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 the Finance 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.