

**BACKGROUND AND ISSUES RELATING TO TAXATION OF
U.S. CITIZENS WHO RELINQUISH THEIR CITIZENSHIP
AND LONG-TERM RESIDENT ALIENS WHO RELINQUISH
THEIR U.S. RESIDENCY**

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

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Prepared by the Staff

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on March 27, 1995, on the issue of the tax treatment of individuals who relinquish their U.S. citizenship and resident aliens who relinquish their U.S. residency. The President's fiscal year 1996 budget, submitted on February 6, 1995, includes a proposal to impose income tax on certain unrealized gains of U.S. citizens who relinquish their U.S. citizenship and of certain long-term residents of the United States who relinquish their U.S. residency. This proposal is included as section 201 of H.R. 981 (introduced by Messrs. Gephardt and Gibbons on February 16, 1995).¹

On March 15, 1995, the Senate Committee on Finance approved an amendment to H.R. 831 (sec. 5 of the bill) to impose Federal income tax on unrealized gains of individuals who relinquish their U.S. citizenship.² The property of such individuals generally would be considered as sold under the bill, and the net gain subject to U.S. income tax. Net gain on the deemed sale would be recognized under the bill only to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom expatriate). On March 21, 1995, the Senate Committee on Finance held a hearing on these issues.

This document³ prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules, the Administration proposal (sec. 201 of H.R. 981), section 5 of H.R. 831 (as approved by the Senate Committee on Finance), background information, and a discussion of issues. Part I of this document is a brief overview of present law. Part II is a description of the Administration proposal, section 5 of H.R. 831, and certain possible modifications to the proposals. Part III discusses background on other countries' tax laws regarding expatriation and immigration and issues relating to the enforcement and collection of taxes owed by former citizens and related issues. Appendix A gives a 1963 opinion of the General Counsel of the Treasury Department regarding the constitutionality of then-proposed legislation to tax capital gains from property transferred by donation or death, and Appendix B gives a 1995 opinion of the Office of Legal Advisor, U.S. Department of State, regarding the application of the Jackson-Vanik Amendment to the proposed expatriation tax.

¹ For a description of H.R. 981 ("Tax Compliance Act of 1995"), see Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 1986 Budget Proposal (H.R. 980 and H.R. 981 and S. 452 and S. 453 (JCS-5-95), February 17, 1995.

² See S. Rept. 104-16, March 20, 1995.

³ This document may be cited as follows: Joint Committee on Taxation, Background and Issues relating to Taxation of U.S. Citizens who Relinquish their Citizenship and Long-Term Resident Aliens who Relinquish their U.S. Residency (JCX-16-95), March 23, 1995.

I. PRESENT LAW

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income (sec. 61 of the Code and Treas. Reg. sec. 1-1.1(b)). The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign income (secs. 901-907). Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business (sec. 871).

The United States imposes tax on gains recognized by foreign persons that are attributable to dispositions of interests in U.S. real property (secs. 897, 1445, 6039C, and 6652(f), known as the Foreign Investment in Real Property Tax Act ("FIRPTA")).⁴ Such gains generally are subject to tax at the same rates that apply to similar income received by U.S. persons. The Code imposes a withholding obligation when a U.S. real property interest is acquired from a foreign person (sec. 1445). The amount required to be withheld on the sale by a foreign investor of a U.S. real property interest is generally 10 percent of the amount realized (gross sales price) (sec. 1445(a)). However, the amount withheld generally will not exceed the transferor's maximum tax liability if a certificate for reduced withholding is issued by the Internal Revenue Service (IRS) (sec. 1445(c)(1)).

Distributions, including lump-sum distributions, that foreign persons receive from qualified U.S. retirement plans generally are subject to U.S. tax at a 30-percent rate. However, to the extent these distributions represent contributions with respect to services performed in the United States after 1986, the distributions are subject to U.S. tax at graduated rates. The U.S. tax is frequently reduced or eliminated under applicable U.S. income tax treaties.

A U.S. citizen who relinquishes U.S. citizenship with a principal purpose to avoid Federal tax may be subjected to an alternative taxing method for 10 years after expatriation (sec. 877). A special rule applies with respect to the burden of proving the existence or nonexistence of U.S. tax avoidance as one of the principal purposes of the expatriation. Under this provision, the Treasury Department may establish that it is reasonable to believe that the expatriate's loss of U.S.

⁴ Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation (USRPHC) at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). A USRPHC is any corporation, the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)).

citizenship would, but for the application of this provision, result in a substantial reduction in the U.S. tax based on the expatriate's probable income for the taxable year (sec. 877(e)). If this reasonable belief is established, then the expatriate must carry the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes.

Under this alternative method, the expatriate generally is taxed on his U.S. source income (net of certain deductions), as well as on certain business profits, at rates applicable to U.S. citizens and residents. Solely for this purpose, gains on the sale of property located in the United States and stocks and securities issued by U.S. persons also are treated as U.S. source income (sec. 877(c)). The alternative method applies only if it results in a higher U.S. tax liability than the amount otherwise determined for nonresident aliens.

The United States imposes its estate tax on the worldwide estates of persons who were citizens or domiciliaries of the United States at the time of death (secs. 2001, 2031), and on certain property belonging to nondomiciliaries of the United States which is located in the United States at the time of their death (secs. 2101, 2103). Special rules apply to the estates of U.S. citizens who resided in a U.S. possession at the time of death. In general, an individual who acquired U.S. citizenship on account of birth or residence in a U.S. possession is treated as a "nonresident not a citizen of the United States" for estate tax purposes (sec. 2209).

Special rules apply to the estate tax treatment of decedents who relinquished their U.S. citizenship within 10 years of death, if the decedent's loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive (sec. 2107). The gross estate of such a decedent is subject to U.S. estate tax rates applicable to the estates of U.S. citizens (sec. 2107(a)). The value of such an estate generally is limited to the value of the U.S.-situs property held by the decedent at death. A special rule treats the decedent as directly holding his pro-rata share of U.S.-situs property held through a foreign corporation in which the decedent had a 10-percent or greater interest, provided that the decedent and related parties together owned greater than 50-percent of the voting power of the corporation (sec. 2107(b)). A reduced unified credit of \$13,000 is available to reduce the estate tax imposed on such former U.S. citizens (sec. 2107(c)).

The U.S. gift tax is imposed on all gifts made by U.S. citizens and domiciliaries, and on gifts of property made by nondomiciliaries where the property is located in the United States at the time of the gift (sec. 2501).

II. DESCRIPTION OF BILL AND PROPOSED MODIFICATIONS

A. Description of Administration Proposal (Sec. 201 of H.R. 981)

Description of Proposal

Under the Administration proposal, a U.S. citizen who relinquishes U.S. citizenship generally would be treated as having sold all of his or her property at fair market value immediately prior to the expatriation. Thus, gain or loss from the deemed sale would be subject to U.S. income tax. Further, any period for the deferral of tax or recognition of income or gain for U.S. tax purposes would terminate on the date of the deemed sale and the deferred tax would be due and payable on that date. The tax also would apply to "long-term residents" who cease to be subject to tax as residents of the United States. The proposal would define a long-term resident as an individual who had been a lawful permanent resident of the United States (i.e., a green-card holder), other than an individual who was taxed as a resident by another country under a treaty tie-breaker rule, in at least 10 of the prior 15 taxable years.⁵

Assets within the scope of the proposal generally would include all property interests that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of the deemed sale, plus certain trust interests that are not otherwise included in the gross estate, and other interests that may be specified by the Treasury Department in order to carry out the purposes of the provision. The first \$600,000 of net gain recognized on the deemed sale would be exempt from tax. 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.⁶ The exception also would apply to interests in qualified retirement plans and, subject to a limit of \$500,000, interests in certain foreign pension plans. The IRS would be authorized to allow a taxpayer to defer, for a period of no more than five years, payment of the tax attributable to the deemed sale of a closely-held business interest (as defined in sec. 6166(b)).

Solely for purposes of this provision, a special election would permit long-term residents to determine the tax basis of certain assets using their fair market value, rather than their historical cost. The election, if made, would apply to all assets within the scope of the proposal that were held on the date the individual first became a U.S. resident and the fair market value would be determined as of such date.

⁵ If a long-term resident surrenders his green card, such person may still be treated as a resident for U.S. income tax purposes if he has a "substantial presence" within the United States. (See sec. 7701(b)(3).) The proposal would not apply so long as such person continues to be treated as a tax resident under the substantial-presence test.

⁶ The exception would apply to all U.S. real property interests, as defined in section 897(c)(1), except the stock of a USRPHC that does not satisfy the requirements of section 897(c)(2) on the date of the deemed sale.

A U.S. citizen would be treated as having relinquished his citizenship on the date that the U.S. Department of State issues a certificate of loss of nationality, and would be subject to U.S. tax as a citizen of the United States until that time. In the case of a naturalized U.S. citizen whose citizenship is revoked, the individual would be treated as relinquishing his citizenship on the date that a U.S. court cancelled the certificate of naturalization, and would be subject to U.S. tax as a citizen of the United States until that time. A long-term resident who ceases to be taxed as a U.S. resident would be subject to the proposal at the time of such cessation.

Effective Date

The proposal would be effective for U.S. citizens who relinquish their U.S. citizenship on or after February 6, 1995, and for long-term residents who cease to be subject to tax as U.S. residents on or after February 6, 1995.

Present law would continue to apply to all others.

B. Description of Section 5 of H.R. 831 as Reported by the Senate Committee on Finance

Description of Provision

In general

Under section 5 of H.R. 831 as reported by the Senate Committee on Finance,⁷ a U.S. citizen who relinquishes citizenship generally is treated as having sold all of his property at fair market value immediately prior to the expatriation. Gain or loss from the deemed sale is recognized at that time, generally without regard to other provisions of the Code.⁸

⁷ The expatriation tax approved by the Senate Committee on Finance made two significant modifications to the Administration's proposal. First, the expatriation tax applies only to U.S. citizens who relinquish their U.S. citizenship, not to long-term resident aliens who relinquish their U.S. residency. Second, the date when an expatriating citizen is treated as relinquishing U.S. citizenship is modified, such that most expatriating citizens are treated as relinquishing their citizenship at an earlier date than under the Administration's proposal. In a small number of cases, the date of relinquishment would be the same as under the Administration's proposal. The expatriation tax approved by the Senate Committee on Finance also made some technical modifications to the Administration's proposal, including a provision to prevent double taxation in the case of certain property that remains subject to U.S. tax jurisdiction.

⁸ See the discussion of the application of the Code's income exclusions under "Other special rules" below.

Net gain on the deemed sale is recognized under the bill only to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom expatriate).

Property taken into account

Property treated as sold by an expatriating citizen under the provision includes all items that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of the deemed sale, plus certain trust interests that are not otherwise includible in the gross estate (discussed below under "Interests in trusts"), and other interests that may be specified by the Treasury Department in order to carry out the purposes of the provision.

The bill provides that certain types of property, although includable in the gross estate were the expatriate to die while subject to U.S. estate tax, are not taken into account for purposes of determining the expatriation tax. U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally are not taken into account.⁹ Also not taken into account are interests in qualified retirement plans, other than interests attributable to excess contributions or contributions that violate any condition for tax-favored treatment. In addition, under regulations, interests in foreign pension plans and similar retirement plans or programs are not taken into account, up to a maximum value of \$500,000.

Interests in trusts

Under the bill, an expatriate who is a beneficiary of a trust is deemed to be the sole beneficiary of a separate trust consisting of the assets allocable to his share of the trust, in accordance with his interest in the trust (discussed below). The separate trust is treated as selling its assets for fair market value immediately before the beneficiary relinquishes his citizenship, and distributing all resulting income and corpus to the beneficiary. The beneficiary is treated as subsequently recontributing the assets to the trust. Consequently, the separate trust's basis in the assets will be stepped up and all assets held by the separate trust will be treated as corpus.

The bill provides that a beneficiary's interest in a trust is determined on the basis of all facts and circumstances. These include the terms of the trust instrument itself, any letter of wishes or similar document, historical patterns of trust distributions, the role of any trust protector or similar advisor, and anything else of relevance. It is expected that the Treasury Department will issue regulations to provide guidance as to the determination of trust interests for purposes of the expatriation tax. It is intended that such regulations disregard de minimis interests in trusts, such

⁹ The exception would apply to all U.S. real property interests, as defined in section 897(c)(1), except the stock of a USRPHC that does not satisfy the requirements of section 897(c)(2) on the date of the deemed sale.

as an interest of less than a certain percentage of the trust as determined on an actuarial basis, or a contingent remainder interest that has less than a certain likelihood of occurrence.

In the event that any beneficiaries' interests in the trust cannot be determined on the basis of the facts and circumstances, the beneficiary with the closest degree of family relationship to the settlor would be presumed to hold the remaining interests in the trust. The beneficiaries would be required to disclose on their respective tax returns the methodology used to determine that beneficiary's interest in the trust, and whether that beneficiary knows (or has reason to know) that any other beneficiary of the trust uses a different method.

It is intended that the special rule for interests in a trust not apply to a grantor trust. The bill follows the grantor trust rules in treating a grantor of a grantor trust as the owner of the trust assets for tax purposes. Therefore, a grantor who expatriates is treated as directly selling the assets held by the trust for purposes of computing the tax on expatriation. Similarly, a beneficiary of a grantor trust who is not treated as an owner of a portion of the trust under the grantor trust rules is not considered to hold an interest in the trust for purposes of the expatriation tax.

Date of relinquishment of citizenship

Under the bill, a U.S. citizen who renounces his U.S. nationality before a diplomatic or consular officer of the United States pursuant to section 349(a)(5) of the Immigration and Nationality Act (8 U.S.C. section 1481(a)(5)) is treated as having relinquished his citizenship on that date, provided that the renunciation is later confirmed by the issuance of a certificate of loss of nationality by the U.S. Department of State. A U.S. citizen who furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act specified in section 349(a)(1) - (4) of the Immigration and Nationality Act (8 U.S.C. section 1481(a)(1) - (4)) is treated as having relinquished his citizenship on the date such statement is so furnished, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality by the U.S. Department of State. Any other U.S. citizen to whom the Department of State issues a certificate of loss of nationality is treated as having relinquished his citizenship on the date that such certificate is issued to the individual. A naturalized citizen is treated as having relinquished his citizenship on the date a court of the United States cancels his certificate of naturalization. If any individual is described in more than one of the above categories, the individual is treated as having relinquished his citizenship on the earliest of the applicable dates.

It is anticipated that an individual who has either renounced his citizenship or furnished a signed statement of voluntary relinquishment but has not received a certificate of loss of nationality from the Department of State by the date on which he is required to file a tax return covering the year of expatriation will file his U.S. tax return as if he expatriated. It is further anticipated that such an individual will amend his return for that year in the event that the Department of State fails to confirm the expatriation by issuing a certificate of loss of nationality.

Administrative requirements

Under the bill, an individual who is subject to the tax on expatriation is required to pay a tentative tax equal to the amount of tax that would have been due based on a hypothetical short tax year that ended on the date the individual relinquished his citizenship.¹⁰ The tentative tax is due on the 90th day after the date of relinquishment. It is expected that Treasury regulations (under the authority of sec. 6011) will require that the expatriate file a tax return at such time. The individual also is required to file a tax return for the entire tax year during which he expatriated reporting all of his taxable income for the year, including gain attributable to the deemed sale of assets on the date of expatriation. The individual's U.S. Federal income tax liability for such year will be reduced by the tentative tax paid with the filing of the hypothetical short-year return.

The bill provides that the time for the payment of the tax on expatriation may be extended for a period not to exceed 10 years at the request of the taxpayer, as provided by section 6161. It is expected that a taxpayer's interest in non-liquid assets such as an interest in a closely-held business interest (as defined in sec. 6166(b)) will be taken into account in determining reasonable cause for the extension of time to pay the tax on expatriation.

In the event that the expatriating individual and the Treasury Department agree to defer payment of the tax on expatriation for a period that extends beyond the filing date for the full-year tax return for the year of expatriation, the bill provides that the individual would not be required to pay a tentative tax. The entire gain on the deemed sale of property on the date of expatriation would be included in the individual's full-year tax return for that year, and would be paid in accordance with the provisions of the deferred-tax agreement under section 6161. It is expected that the Treasury Department will not agree to defer payment of the tax on expatriation unless the taxpayer provides adequate assurance that all amounts due under the agreement will be paid.

It is expected that the Department of State will notify the IRS of the name and taxpayer identification number of any U.S. citizen who relinquishes U.S. citizenship promptly after the date of relinquishment, as defined in the provision.¹¹ In addition, it is anticipated that the Department of State will request of any expatriating citizen, at the time of relinquishment of citizenship, appropriate information to assist the IRS in enforcing the requirements of the provision.

Other special rules

¹⁰ Thus, the tentative tax is based on all the income, gain, deductions, loss and credits of the individual for the year through the date of relinquishment, including amounts realized from the deemed sale of property. The tentative tax is treated as imposed immediately before the individual relinquishes citizenship.

¹¹ That is, without waiting for the issuance of a certificate of loss of nationality.

As noted above, the tax on expatriation applies generally notwithstanding other provisions of the Code. For example, gain that would be eligible for nonrecognition treatment if the property were actually sold is treated as recognized for purposes of the tax on expatriation. In addition, for example, bona fide residence in a U.S. possession or commonwealth does not affect the application of the expatriation tax.¹² However, the bill provides that the portions of the gain treated as realized under the provisions of the expatriation tax are not recognized to the extent they are treated as excluded under the specific income exclusions of sections 101-137 (Subtitle A, Chapter 1B, Part III) of the Code.

Other special rules of the Code may affect the characterization of amounts treated as realized under the expatriation tax. For example, in the case of stock in a foreign corporation that was a controlled foreign corporation at any time during the five-year period ending on the date of the deemed sale, the gain recognized on the deemed sale is included in the shareholder's income as a dividend to the extent of certain earnings of the foreign corporation (see sec. 1248).

The bill provides that any period during which recognition of income or gain is deferred will terminate on the date of the relinquishment, causing any deferred U.S. tax to be due and payable at the time specified by the Treasury Department. For example, where an individual has disposed of certain property (e.g., property that qualifies for like-kind exchange under sec. 1031 or as a principal residence under sec. 1034) but has not yet acquired replacement property, the relevant period to acquire any replacement property is deemed to terminate and the individual is taxed on the gain from the original sale.

The bill authorizes the Treasury Department to issue regulations to permit a taxpayer to allocate the taxable gain (net of any applicable exclusion) to the basis of assets taxed under this provision, thereby preventing double taxation if the assets remain subject to U.S. tax jurisdiction.

Effective Date

The provision is effective for U.S. citizens who relinquish their U.S. citizenship (as determined under the bill) on or after February 6, 1995. The tentative tax will not be required to be paid until 90 days after the date of enactment of the bill.

Present law will continue to apply to U.S. citizens who relinquished their citizenship prior to February 6, 1995.

¹² Because there is no meaningful concept of citizenship of a U.S. territory or possession, it is intended that the provision not be "mirrored" for application in the U.S. territories and possessions that employ the mirror code.

C. Description of Certain Possible Modifications to Expatriation Tax Proposals

Application to long-term residents

As proposed in the President's fiscal year 1996 budget proposal,¹³ the tax on expatriation also would apply to "long-term residents" who cease to be subject to tax as residents of the United States. The proposal would define a long-term resident as an individual who had been a lawful permanent resident of the United States (i.e., a green-card holder), other than an individual who was taxed as a resident by another country under a treaty tie-breaker rule,¹⁴ in at least 10 of the prior 15 taxable years.¹⁵ The original proposal also contains a special election that would permit long-term residents to determine the tax basis of certain assets on the basis of their fair market value, rather than their historical cost. The election would apply solely for purposes of determining the tax on expatriation. If made, the election would apply to all assets within the scope of the proposal that were held on the date the individual first became a U.S. resident and the fair market value would be determined as of such date.

Possible modifications to the Administration's original proposal as it applies to long-term residents include, but are not limited to, the following. One modification would impose the tax on expatriation when a long-term resident is no longer treated as a lawful permanent resident of the United States as that term is defined in section 7701(b)(6) or when the person claims to be a resident of another country under the tie-breaking provisions of a U.S. income tax treaty. A second modification would provide that individual taxpayers have a fair market value basis in

¹³ See section 201 of H.R. 981 (introduced by Messrs. Gephardt and Gibbons).

¹⁴ Bilateral income tax treaties typically provide tie-breaker rules to specify the residence of an individual who may be subject to tax as a resident under the domestic laws of both countries (e.g., a U.S. citizen who resides in Germany). Under the OECD model treaty, a dual resident individual will be deemed to be a resident of the country in which he has a permanent home available to him. If this test is inconclusive because the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his personal and economic relations are closer, i.e., his "center of vital interests." If the country in which he has his center of vital interests cannot be determined, he will be deemed to be a resident of the country in which he has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, he shall be deemed to be a resident of the country of which he is a national. If he is a national of both countries or neither of them, the competent authorities of the two countries are to settle the question of residence by mutual agreement. The residence tie-breaker rule in many U.S. income tax treaties follows the corresponding provision of the OECD model treaty.

¹⁵ If a long-term resident surrenders his green card, such person may still be treated as a resident for U.S. income tax purposes if he has a "substantial presence" within the United States. (See sec. 7701(b)(3)). The proposal would not apply so long as such person continues to be treated as a tax resident under the substantial presence test.

property owned by the individual as of the earlier of: (1) the date the individual first became a U.S. citizen or resident, or (2) the date the property first became subject to U.S. tax because it was used in a U.S. trade or business or it was a U.S. real property interest. The fair market value basis would apply for purposes of computing gain or loss on actual or deemed dispositions (i.e., not solely for purposes of determining the tax on expatriation), but would not apply for purposes of computing depreciation.

Another possible modification of the Administration's proposal would clarify that all long-term residents subject to the expatriation tax would be presumed to be domiciled in the United States for purposes of the expatriation tax; consequently, gains and losses from a deemed sale of all their worldwide properties would be subject to the tax on expatriation.

Change in "sailing permit" requirement

Another possible modification related to the proposed expatriate tax would replace the current "sailing permit" requirement under section 6851(d) with a new requirement to file a short-year tax return. Section 6851(d) and the regulations thereunder currently require any alien who physically leaves the country--regardless of the duration of the trip--to obtain a certificate from the IRS District Director that he has complied with all U.S. income tax obligations. For example, an alien who is a lawful permanent resident of the United States who lives near the Canadian or Mexican border is required to personally file an income tax return with the IRS District Director, and pay all taxes due for the year, before crossing the border to shop or have dinner. Compliance with this requirement is infrequent. The possible modification would require any alien resident of the United States who becomes a nonresident to file a tax return within 90 days of the date that he ceases to be a U.S. resident, and pay the relevant tax. Nothing would be required of a resident alien who returns to the United States as a resident within 90 days of departure or otherwise maintains U.S. residence.

Avoidance of double taxation

As noted above, using fair market valuation for property brought in by immigrants would restrict the scope of U.S. taxation to the appreciation of the property while it is held by a U.S. resident or citizen. If the same fair market value rule is adopted by the foreign country to which a U.S. expatriate emigrates, then the appreciation accrued during the period of the individual's U.S. citizenship or residency that is subject to the tax on expatriation would not again be taxed by another country when the property is disposed of. Also as noted above, section 5 of H.R. 831, as reported by the Senate Committee on Finance, grants authority to the Treasury Department to relieve double taxation on gain from the appreciation of property subject to the tax on expatriation that subsequently remains within U.S. tax jurisdiction.

The bill also could be modified so that the tax on expatriation would be allowed as a credit against U.S. estate tax imposed on the estate of a former citizen in the event that property subject

to the tax on expatriation is subsequently subject to U.S. estate tax solely by reason of section 2107 (as discussed under Part I, Present Law).

III. BACKGROUND AND ISSUES RELATING TO THE IMPOSITION OF AN EXPATRIATION TAX

A. Summary of Other Countries' Tax Laws Regarding Expatriation and Immigration

Overview

The following is a preliminary survey of other countries' taxation of citizens and residents.¹⁶ While not an exhaustive survey, it reveals that most nations generally tax the worldwide income of their residents, whether citizens or aliens, but only the domestic source income of their nonresidents, whether citizens or aliens. Hence, unlike in the United States, the criterion of residence rather than citizenship is central to the liability to tax in these countries. Two exceptions are the Philippines, a former U.S. colony, and Eritrea. The Philippines and Eritrea also tax their nonresident citizens on their worldwide income.

Several European countries impose income tax on their former citizens or residents for some period of time after they become nonresidents. Australia and Canada are the only countries that impose an exit tax when a resident leaves the country. Also, it is generally the case that among those countries that tax capital gains, the gain is taxed upon realization by a resident taxpayer, regardless of whether some part of that gain may have accrued to the individual prior to his or her immigration to such country. Australia, Canada, and Israel are exceptions to this general rule. The relevant provisions relating to taxation of former residents, exit taxes, and the taxation of immigrants' accrued gains are described below.

Taxation of former residents

Germany.--Germany imposes a so-called "extended limited tax liability" on German citizens who emigrate to a tax-haven country or do not assume residence in any country and who maintain substantial economic ties with Germany (measured based on the relative amount of the individual's German source income or assets). This tax applies to a German citizen who was a tax resident of Germany for at least five years during the 10-year period immediately prior to the cessation of his residence. The individual is taxed as a German resident for 10 years after expatriation. This provision is similar to the present-law provision of the United States.

A long-term (at least 10-year) resident of Germany, including a German citizen, who terminates his residence is deemed to have disposed of his ownership in certain German corporations. Specifically, the individual is treated as having sold his interest in domestic corporations in which he owns more than 25 percent. The gain from the deemed sale is taxed at

¹⁶ The staff of the Joint Committee on Taxation conducted this survey with the assistance of the staff of the Law Library of Congress. The results reported should not be interpreted as an authoritative representation of foreign laws, but rather as a more preliminary reading of foreign tax statutes.

half of the regular tax rate. If the taxpayer held the interest in the German corporation when he first became a German resident, he may use the fair market of the stock (in lieu of the historical cost) at the time he became a resident in computing the gain.

The Netherlands.--The Netherlands asserts jurisdiction to tax the capital gains from the sale of substantial holdings in Dutch companies during the five years following emigration by a Dutch citizen. A Dutch citizen who emigrates continues to be treated as a resident of the Netherlands for 10 years following emigration for gift and inheritance tax purposes.

Denmark.--If an individual leaves Denmark after having been a permanent resident for at least four years, he remains a resident for income tax purposes for up to an additional four years unless he can establish that he is subject to a substantially equivalent income tax in his new country of residence. In addition, a departing individual who has been resident for at least five of the preceding 10 years is deemed to have disposed of bonds and certain holdings of stock. The deemed disposal of stock applies only to stock owned by shareholders holding a substantial interest in the business. Payment of the tax liability may be postponed (with security) until actual sale occurs or the shareholder dies. In addition, there are provisions for double tax relief in the case where the individual's new country of residence imposes a tax on the actual sale.

Sweden.--A Swedish citizen or resident remains a resident for income tax purposes as long as he maintains essential ties with Sweden. If the individual was a resident of Sweden for at least 10 years, he is deemed a resident for five years following departure unless it can be established that the individual has not maintained essential ties with Sweden. If after the initial five-year period the Swedish government can establish that the individual has maintained essential ties with Sweden, the individual will continue to be taxed as a Swedish resident. "Essential ties" to Sweden can include a family present in Sweden, a home available for use in Sweden, and the extent of economic activity in Sweden.

Norway.--Norway asserts tax liability on individuals who terminate their residence for tax purposes and who dispose of shares in a Norwegian company or partnership within five years of the year in which residence is terminated. The tax liability extends to options or other financial instruments connected to such shares or partnership interests. In certain circumstances, Norway may also tax the net capital gains of individuals who terminate Norwegian residence.

Finland.--A Finnish citizen who leaves the country is deemed to remain a resident for income tax purposes for three years unless he can establish that he has not maintained essential ties with Finland. After three years the individual is a nonresident unless the tax authorities can establish otherwise.

France.--As provided by treaty, France can tax as a French resident any French citizen who moves to Monaco. Emigration from France to anywhere else creates no French tax liability.

Philippines.--As noted above, like the United States, the Philippines asserts tax liability on all citizens based on their worldwide income. A non-resident citizen is one who establishes to the satisfaction of the revenue authorities his physical presence abroad with the definite intention of residing there. Nonresident citizens are taxed separately on their income from sources within the Philippines and on income from sources outside the Philippines. Tax rates on income from sources within the Philippines range from one to 35 percent. The tax imposed on income from sources outside the Philippines permits a personal exemption and then has three rate brackets: 1 percent on income greater than \$0 and less than or equal to \$6,000;¹⁷ 2 percent on income greater than \$6,000 and less than or equal to \$20,000; and 3 percent on income in excess of \$20,000.

Eritrea.--On February 10, 1995, Eritrea enacted a new tax law that applies only to its non-resident citizens. The law imposes a 2-percent tax on the net income of non-resident citizens. The Eritrean Ministry of Foreign Affairs is responsible for collecting such taxes through its embassies and consulates. It is unclear what the tax status is of an Eritrean who gives up his citizenship.

Imposition of exit tax on citizens or long-term residents

Australia.--Australia imposes an exit tax when an Australian resident (including an Australian citizen) leaves the country. For purposes of the exit tax, the resident is treated as having sold all of his non-Australian assets at fair market value at the time of departure. An election is available for a taxpayer to defer the tax from the deemed sale on any asset until it is sold. Electing individuals are expected to report voluntarily their gains and associated tax upon a subsequent disposition.¹⁸ No security is required to obtain the deferment of tax.

There may be significant potential for noncompliance with respect to such an exit tax. Assets that leave the country before the resident leaves are effectively beyond the reach of the Australian tax authorities.

¹⁷ The income of nonresident citizens from sources outside the Philippines is taxed on the basis of income expressed in U.S. dollars. The local currency is the peso.

¹⁸ Nonresidents are subject to capital gains tax on taxable Australian assets including real property situated in Australia, stock holdings in non-publicly traded Australian companies, stock holdings in publicly traded companies where the nonresident shareholder (and related parties) hold 10 percent or more of the stock, interests in Australian partnerships, and holdings in Australian unit trusts (i.e., mutual funds) where the nonresident owner (and related parties) hold 10 percent or more of the unit trust. Bilateral income tax treaties often preclude taxation by one treaty country of capital gains realized by residents of the other treaty country, except for gains from the disposition of real property situated in the first country. The U.S.-Australia income tax treaty, however, generally allows each country to tax capital gains from sources in that country realized by residents of the other country.

Canada.--A taxpayer is deemed to have disposed of all capital gain property at its fair market value upon the occurrence of certain events, including death or relinquishment of residence. Like Australia, a departing individual may elect to defer the tax on the accrued gain on any asset until the asset is sold. However, the Canadian tax authorities generally require an electing taxpayer to provide security necessary to ensure that the deferred tax will be collected.

Treatment of accrued gains of immigrants

If an individual emigrates from one country to another and if the former country either imposes a tax upon accrued gain at the time of exit or asserts tax liability on former residents, double taxation of income from capital gain may occur. This problem would be eliminated if the immigrant country were to forgo taxation of any gain accrued on property owned by an immigrant prior to his or her immigration. Both Australia and Canada, countries with an exit tax, forgo taxation of gain accrued prior to immigration. An individual who becomes an Australian resident is permitted to take a basis in his non-Australian assets equal to their fair market value at that time, for all purposes. The step-up is not a taxable event in Australia. An individual who becomes a Canadian resident also is permitted to take a basis in his non-Canadian assets equal to their market value at that time, for all purposes. The step-up is not a taxable event in Canada. In both Australia and Canada, the exemption for previously accrued gain is permanent regardless of whether the individual subsequently sells the asset or holds it until death.

-- Israel offers a limited exemption for gain accrued prior to immigration. Immigrants are exempt from tax on capital gains from the realization of assets which they possessed prior to immigrating to Israel and which are sold within seven years of immigration.¹⁹ If such property is sold more than seven years after immigration, the entire gain is subject to Israeli tax.

Australia, Canada, and Israel appear to be exceptions. Most countries do not offer immigrants a step-up in basis on their assets (Australia and Canada) or a limited exemption (Israel). Among countries surveyed, the following countries tax the realized capital gains of residents, including gain accrued by immigrants prior to immigration: Chile, Columbia, Czech Republic, Denmark, Ecuador, Finland, France, India, Iran, Ireland, Japan, Korea, Mexico, Norway, Pakistan, Philippines, Portugal, Spain, Sweden, Taiwan, United Kingdom, and Venezuela.²⁰

¹⁹ The exemption appears to extend to any gain that accrues to the asset during the immigrant's first seven years in Israel.

²⁰ Among countries listed above as imposing taxes on former residents, no information was found relating to the taxation of capital gains in Eritrea.

Among the countries listed above as imposing taxes on former residents, Germany generally exempts from income taxation gains on assets held for longer than six months.²¹ The Netherlands also generally exempts gain from tax except with respect to business assets and substantial interests in a Dutch company.

B. Issues in the Enforcement and Collection of Taxes Owed by Former Citizens

1. Current enforcement of Code section 877

Under Code section 877, a U.S. citizen who relinquishes his citizenship for the purpose of avoiding payment of the U.S. tax on worldwide income may continue to be assessed U.S. tax with respect to certain types of income (discussed in Present Law, above) for a period of 10 years after the relinquishment of citizenship. Because the element of intent is involved, there is no data available on the number of citizens who relinquish their citizenship with a principal purpose of avoiding U.S. tax.²² This provision of the Code has been applied in very few cases.

The IRS views the current structure of section 877 as inherently difficult to enforce. Because a citizen may choose to relinquish citizenship for a variety of reasons, those properly subject to section 877 are not readily identifiable. The imposition of the tax must often wait until property is sold, at which time the individual already has relinquished citizenship and left the United States, making it unlikely that the IRS will know of the sale and difficult to collect the tax even if it does learn of the sale. Given these circumstances it may not be efficacious for the IRS to devote substantial resources to enforcement of section 877.

On the other hand, the IRS has not requested the Department of State to regularly provide lists of Americans who renounce their citizenship. Such a list could be cross-matched against the IRS's listing of "stop filers," that is, those taxpayers who do not file an income tax return in a year subsequent to having filed an income tax return. While thousands of stop filers result from death of the taxpayer or retirement from the labor force, matching citizenship relinquishments against stop filers who had reported income above a certain level in the prior year, or prior several years, may indicate taxpayers who relinquished citizenship with a tax motivation.²³

2. Enforcement under the proposal

²¹ Germany subjects to income taxation gains from the sale of certain "speculative" assets and gain from the sale of real estate held for less than two years.

²² Since 1990, total relinquishments have ranged between 600 and 900 per year.

²³ Such matching could be facilitated if upon relinquishment the individuals were required to provide their taxpayer identification numbers. Such a requirement could necessitate changes to Department of State regulations or procedures.

Like present law, absent enforcement initiatives by the IRS, the proposal relies on the voluntary compliance of expatriating citizens. The major change in terms of voluntary compliance is to deem all expatriates with certain accrued capital gains in excess of \$600,000 liable for tax. Where present law requires the expatriate to make a judgement about whether his relinquishing of citizenship was tax motivated and then file returns for the subsequent 10 years, the proposal requires the expatriate whose accrued gains exceed the threshold to file a tax return within 90 days of expatriation. Elimination of the "intent" test will provide clarity. On the other hand, the IRS can expect disputes over valuation of assets that are deemed to have been sold when no transaction, in fact, took place.

Under both present law and the bill, the IRS may not learn about the expatriation until the individual has physically left the country. As under present law, absent administrative changes, the IRS will not know that an expatriate is liable for tax. As under present law, under the proposal, physical separation from the United States may hinder the ability of the IRS to collect any tax owed. With notification, the IRS can attempt to determine whether an expatriate possesses any assets within the United States that could be seized to satisfy the tax liability. Seizure of assets for failure to pay taxes is permitted under present law. In addition, the IRS could coordinate with the Customs Service and Immigration and Naturalization Service to detain noncompliant expatriates who attempt to re-enter the United States. Present law would permit such coordination for purposes of collecting taxes assessed under section 877, if the IRS would seek to assess and collect such taxes. On the other hand, by limiting the tax liability to individuals with accrued gains in excess of \$600,000 and by removing the "intent" test, the IRS may find it efficacious under the proposal to devote more resources to the taxation of expatriates than it does under present law.

C. Related Issues

1. Constitutionality of the proposal

The expatriation tax, as reported by the Committee on Finance (sec. 5 of H.R. 831), would treat property held by a U.S. citizen who relinquishes his U.S. citizenship as if it were sold immediately before expatriation. Thus, the act of expatriation would be treated as an event that causes the realization of gain.

There has been an issue in Federal income tax law for the past 75 years whether, or to what extent, the 16th amendment to the Constitution permits Congress to levy income tax on income that has not actually been realized. The U.S. Supreme Court in *Eisner v. Macomber*, 252 U.S. 189 (1920), considered whether or not a stock dividend constituted income to the shareholders. The Court held that by receiving a stock dividend, the shareholders had received nothing out of the corporation's assets for their separate use and benefit. Therefore, they had received no income. In response to the government's alternative argument that the tax was imposed on the shareholders' respective shares of the corporation's undistributed profits, the

Court declared that such a tax would constitute the taxation of property because of ownership, and would be beyond the scope of income taxation permitted under the 16th amendment.²⁴ The *Macomber* decision has become known for the principle that Federal income taxation must apply only to realized income.

The realization principle has been criticized, limited, distinguished, and ignored since 1920, although it has never been reconfirmed or overruled. In a leading commentary on principles of income taxation, Henry C. Simons disagreed with the reasoning of the *Macomber* decision:

The decision that stock dividends should be ignored in calculating taxable income ... was eminently sound, as a judgment about a question of legislative policy. It is most unfortunate, however, that a constitutional issue was ever raised; ... Actually, an utterly trivial issue was made the occasion for injecting into our fundamental law a mass of rhetorical confusion which no orderly mind can contemplate respectfully, and for giving constitutional status to naive and ridiculous notions about the nature of income and the rationale of income taxes.²⁵

In a review of the cases that followed *Macomber*, Stanley S. Surrey characterized the Supreme Court as paying its respects to *Macomber*, but limiting the scope of a realization requirement.²⁶ Based on 20 years of further development, Surrey reached a "sound conclusion that the formalistic doctrine of realization proclaimed by that decision is not a constitutional mandate."²⁷

Congress has repeatedly approved income tax measures that appear to apply to unrealized income. Beginning with the foreign personal holding company rules, which were enacted in 1937, and including the controlled foreign corporation rules (enacted in 1962) and the passive foreign investment company rules (enacted in 1986), the Federal income tax has taxed certain domestic shareholders on undistributed earnings of foreign corporations that meet certain characteristics. The constitutionality of the foreign personal holding company rules, as applied in a case where

²⁴ Such a tax would be clearly within the power to Congress to impose, but without the protection of the 16th amendment, would require apportionment.

²⁵ *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, at 198-99 (1938). Simons would define income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question." *Id.*, at 50. That is, consumption plus net increase in wealth during the period.

²⁶ "The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions," 35 *Ill. L. Rev. of Northwestern Univ.* 779, 782 (1941).

²⁷ *Id.*, at 791.

distribution of the foreign income to the domestic shareholders was precluded by foreign currency controls, was upheld in *Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943), without reference to *Macomber*. Following *Eder*, the same court upheld the constitutionality of the controlled foreign corporation rules in *Garlock, Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974) ("The argument that [the controlled foreign corporation rules ... are] unconstitutional we think borders on the frivolous *Id.*, at 202), also without citing *Macomber*. The controlled foreign corporation rules were upheld again in *Estate of Whitlock v. Commissioner*, 59 T.C. 490, *aff'd in part and rev'd in part*, 494 F.2d 1297 (10th Cir.), *cert. denied*, 419 U.S. 839 (1974). The Tax Court in *Whitlock* both distinguished *Macomber* as applicable to accumulated rather than current earnings, and observed "that the continuing vitality of the *Macomber* doctrine is in considerable question." *Id.*, at 509, n.21.

In the domestic area, the Federal income tax law has begun to require certain financial assets to be marked to market, or deemed to be sold, with income tax applicable to the gain that was not actually realized. Mark-to-market regimes are applicable to commodities futures (sec. 1256 of the Code, since 1981) and to securities dealers (sec. 475 of the Code, since 1993). The constitutionality of these provisions under the *Macomber* doctrine has not been subject to a judicial challenge.²⁸ Most commentators see the *Macomber* doctrine of realization as surviving in the tax law not as a constitutional requirement but only as a rule of administrative convenience or legislative generosity.²⁹ Some others, however, see the realization requirement of *Macomber* yet valid, despite such repeated apparent violations.³⁰

Some have argued that the proposed expatriation tax most closely resembles never-enacted proposals to impose income tax at death on the unrealized appreciation of decedent's property. Deemed realization at death has been criticized as an inappropriate event for a deemed realization: "The event of death hardly qualifies as a tax realization transaction. During his lifetime, a taxpayer has a choice of realizing gain on sale of an asset, paying the tax, and keeping the net proceeds, or of retaining the asset and not realizing a gain on it. The occurrence of his

²⁸ The constitutionality of section 1256 was upheld on a theory of constructive receipt in *Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993). The court explicitly declined to address the constitutionality of Federal income taxation of unrealized gains on capital assets.

²⁹ Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, at 5-20 (1989). See also, Noël B. Cunningham and Deborah H. Schenk, "Taxation Without Realization: A 'Revolutionary' Approach to Ownership," 47 *Tax L. Rev.* 725, 741 n.69 ("Although an early case, *Eisner v. Macomber*, 252 U.S. 189 (1920) could be interpreted as supporting the restriction of income to realized gains, no case since then lends much credence to that argument. ... The scholarly consensus is that Congress may treat gains as realized at any point. [citations omitted]").

³⁰ See, e.g., Henry Ordower, "Revisiting Realization: Accretion Taxation, the Constitution, *Macomber*, and Mark to Market," 13 *Va. Tax Rev.* 1 (1993).

death is hardly a voluntarily chosen event upon which to base the realization of gain."³¹ Inasmuch as the event of expatriation, unlike death, generally is under the control of the taxpayer, the proposed expatriation tax might be more appropriately compared to unenacted proposals to tax the unrealized appreciation of property upon a gratuitous transfer of the property. When the Kennedy Administration proposed such a tax to Congress in 1963 (as well as a tax on appreciation at death), the Administration presented to Congress a legal memorandum from Treasury General Counsel Belin to Treasury Secretary Dillon, dated February 5, 1963, arguing that a taxpayer making a gratuitous transfer has control of the appreciation and transfers the appreciation in accordance with his decision. The memorandum concluded with the "opinion that *Eisner v. Macomber* has limited, if any, application The constitutionality of the tax can be supported by the conclusions that an appreciation in property may be taxed upon the occurrence of an appropriate taxable event, which event is for Congress to determine, and that the taxpayer has realized the appreciation in value by his exercise of control over it and by his accomplishment of his economic objective with respect to that income."³²

Some others have suggested that the proposed expatriation tax could be justified as a substitute for a reduced-rate estate tax. If the proposal were structural as an estate tax, the 16th amendment and any realization requirement thereunder would be inapplicable.

The Committee may wish to consider the extent to which the Constitution requires that Federal income taxes be imposed only on realized income, and the extent to which the proposed expatriation tax is consistent with any such requirement.

2. Coordination with international conventions

Income tax treaties

U.S. citizens generally are subject to U.S. income taxation on their worldwide income, regardless of their residence (see Part I, Present Law, above). Most other nations generally tax the worldwide income of their residents (whether citizens or aliens). Thus, a U.S. citizen who resides outside the United States may be subject to tax on the same income by both the United States and the country of residence. To avoid double taxation, however, the taxpayer's U.S. tax may be reduced or offset by a credit allowed for foreign taxes paid with respect to certain foreign income.

³¹ Statement of Treasury Secretary William Simon, *Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Committee on Ways and Means*, pt. 2, 94th Cong., 2d Sess. 1188-89 (1976).

³² *President's Tax Message of 1963: Hearings Before the House Committee on Ways and Means*, 88th Cong., 1st Sess. 596, 602 (1963). The text of the memorandum is reproduced in Appendix A.

Bilateral income tax treaties typically provide rules to specify the residence of an individual who may be subject to tax as a resident under the domestic laws of both countries. The United States typically includes a "saving clause" in its bilateral income tax treaties in order to preserve its right to tax U.S. citizens who are residents of treaty partners. The saving clause generally provides that notwithstanding any provision of a treaty, the United States may assert its jurisdiction to tax a citizen, or former citizen for a period of 10 years, as if the treaty had not come into effect.

The proposed expatriation tax is triggered by a deemed sale of property that is treated as occurring immediately prior to the time when a U.S. citizen relinquishes his citizenship. Thus, the tax is deemed to be imposed at a time when the expatriating individual is still a citizen of the United States and subject to U.S. tax on that basis. As a result of the saving clause, a U.S. citizen who is a resident of a treaty partner may not escape the tax by claiming treaty benefits as a resident of the foreign country.

General Agreement on Trade in Services (GATS)

Article XVII of GATS generally requires member nations to grant national treatment to all other member nations with respect to services and service suppliers. The proposed expatriation tax applies to the accrued gain of individuals based on their U.S. citizenship. The provision does not accord more or less favorable treatment to service suppliers of any nation that is a member to GATS. Consequently, the provision would not violate GATS.

North American Free Trade Agreement (NAFTA)

Article 2103 addresses taxation matters under NAFTA. Paragraph 2 of Article 2103 (Taxation) states that a tax convention³³ shall generally prevail to the extent of any inconsistency with NAFTA. The two exceptions to this rule, pertaining to national treatment available with respect to market access and export taxes, are not relevant to the tax on expatriation. Because the proposal is consistent with the application of income tax treaties (see discussion under "Income tax treaties," above), it is outside the scope of NAFTA.³⁴

³³ Defined as a convention for the avoidance of double taxation or other international taxation agreement or arrangement, under Article 2107 of NAFTA.

³⁴ Even if the provision is interpreted to be outside of the scope of an income tax treaty because it is not specifically addressed by such treaty, the provision would not violate NAFTA because the subject matter is not addressed in Section 2103 of NAFTA.

3. Application of the Jackson-Vanik amendment

The right to leave a country is a fundamental tenet of human rights, both the right to physically leave, or emigrate,³⁵ and the right to relinquish citizenship, or expatriate.³⁶ In an effort to support these rights, especially with regard to emigration from the Soviet Union, Congress in 1974 adopted the Jackson-Vanik amendment, which generally denies trade and other economic benefits to any "nonmarket economy country" that prohibits or unduly burdens emigration.³⁷ The question has been raised whether the proposed expatriation tax is inconsistent with the human rights principles embodied in the Jackson-Vanik amendment.

Specific Soviet anti-emigration policies considered objectionable under the Jackson-Vanik amendment included:

³⁵ Article 13 (2) of the Universal Declaration of Human Rights, adopted by the United Nations General Assembly on December 10, 1948, provides that: "Everyone has the right to leave any country, including his own, and to return to his country."

³⁶ Article 15 (2) of the Universal Declaration of Human Rights, adopted by the United Nations General Assembly on December 10, 1948, provides that: "No one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality."

³⁷ The Jackson-Vanik amendment, section 402 of the Trade Act of 1974 (19 U.S.C. sec. 2432), provides in principal part as follows:

(a) To assure the continued dedication of the United States to fundamental human rights, and notwithstanding any other provision of law, on or after the January 3, 1975, products from any nonmarket economy country shall not be eligible to receive nondiscriminatory treatment (most-favored-nation treatment), such country shall not participate in any program of the Government of the United States which extends credits or credit guarantees or investment guarantees, directly, or indirectly, and the President of the United States shall not conclude any commercial agreement with any such country, during the period beginning with the date on which the President determines that such country --

- (1) denies its citizens the right or opportunity to emigrate;
- (2) imposes more than a nominal tax on emigration or on the visas or other documents required for emigration, for any purposes or cause whatsoever; or
- (3) imposes more than a nominal tax, levy, fine, fee, or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice,

and ending on the date on which the President determines that such country is no longer in violation of paragraph (1), (2), or (3).

- A passport application fee of 1000 rubles.³⁸
- An exit visa fee of 200 rubles.
- Education repayment fees, in amounts that often exceeded 10,000 rubles, imposed on emigrants to non-Communist countries.
- Immediate loss of Soviet citizenship (and revocation of Soviet passports) by applicants for emigration to Israel.

The Soviet anti-emigration policies restricted the opportunities for citizens of the Soviet Union to travel outside the country and to live outside the country. They were not directed toward Soviet citizens who voluntarily relinquished Soviet citizenship. In addition, the Soviet exit fee operated as a head tax, applying without regard to the citizen's income or wealth.

The U.S. Department of State, Office of the Legal Adviser, has prepared a letter expressing its opinion that an expatriation tax in the form originally proposed by the Administration³⁹ is consistent with international human rights law, and with the principles of the Jackson-Vanik amendment. The opinion makes three points. First, economic controls such as taxation on unrealized gains do not constitute a *de facto* denial of an individual's right to emigrate. Second, the proposed expatriation tax, unlike the Jackson-Vanik amendment, concerns expatriation rather than emigration. Third, the proposed expatriation tax would apply in most cases to individuals who had already physically left the United States. The text of the letter appears in Appendix B.

Notwithstanding the opinion of the Department of State, the Committee may wish to consider the extent to which the proposed expatriation tax is consistent with principles of international human rights and also represents sound policy in light of those principles.

³⁸ The average monthly salary of a Soviet individual was approximately 370 rubles at that time. Jim Nichol, *The Soviet Emigration and Travel Law: Assessments and Implications for U.S. Interests*, CRS Report to Congress No. 91-518F, at CRS-12 (September 5, 1991).

³⁹ Section 201 of the Tax Compliance Act of 1995 (H.R. 981).

APPENDICES

APPENDIX A:

1963 Opinion of the General Counsel of the Treasury Regarding the Constitutionality of Proposed Legislation to Tax Capital Gains from Property Transferred by Donation or Death

THE GENERAL COUNSEL OF THE TREASURY,
Washington, February 5, 1963.

To: Secretary Dillon.
From: G. d'Andelot Belin.
Subject: Constitutionality of proposed legislation to tax capital gains from property transferred by donation or death.

My opinion has been asked on the question whether Congress may constitutionally amend the provisions of the statutes taxing capital gains as income to provide that upon the transfer of property by donation or death the appreciated value of the property over the cost basis may be taxed as a capital gain to the donor or decedent.

I. PRESENT STATUTORY FRAMEWORK

At the outset, I will outline briefly the present relevant congressional definition of income and the applicable statutory framework. Congress has provided the basic definition of income in the Internal Revenue Code of 1954, 26 U.S.C., is section 61(a). This section states that "gross income means all income from whatever source derived, including (but not limited to) the following items: *** (3) gains derived from dealings in property; ***." The determination of the amount, and the recognition, of gains derived from the disposition of property are provided for in subchapter O, sections 1001 *et seq.* In brief, a gain occurs on the sale or other disposition of property when the amount realized is in excess of the cost, sections 1001(a) and 1012. The amount realized is "the money received plus the fair market value of the property (other than money) received," section 1001(b). Congress has accorded, in subchapter P, a reduced tax treatment to those gains from the disposition of property which meet the definition of net long-term capital gains, sections 1201 *et seq.* A net long-term capital gain is the gain from the sale or exchange of a "capital asset," which term is defined as property held by a taxpayer, with certain specific exceptions, in section 1221.

The present law does not provide for taxation of gains (or the comparable treatment of losses) from the disposition of property by donation or at death. The basis of property passing to a recipient in these events is, however, provided in sections 1014 and 1015. In the event of a gift, the donee takes the property on the cost basis of the last owner who has not received the property

by gift, section 1015(a). Therefore, the donee may be taxed on the appreciation of value, including that which occurred while held by the donor, when the donee sells or disposes of the property. The proposed amendment would alter this arrangement by taxing the donor on the appreciation of the property up to the time of his gift, and the donee would, consequently, receive the property with the cost basis being the market value as obtained from the donor. At present, in the event of death, the beneficiary receives the property of the decedent at the fair market value at the time of the death or at the optional alternate valuation date, section 1014. Consequently, the appreciation of value of the property while held by the decedent is lost to income taxation.

II. CONSTITUTIONAL POWER OF CONGRESS

I turn now to the question whether there is any constitutional limitation on Congress which would prevent it from providing for recognition of a taxable gain or loss under the income tax law on the disposition of property by donation or death.

The first power given to Congress by Article 1, section 8, of the Constitution, is the "Power To lay and collect Taxes." The 16th amendment, adopted in 1913, provides that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

In the 50 years since this amendment was adopted, Congress has defined and redefined income subject to tax, often as a result of restrictive court rulings.⁴⁰ The Federal courts, in dealing with the concept of income, have come to recognize that Congress intended, in 26 U.S.C. 61(a) and its predecessor sections, to use its full taxing power and that the courts should give a liberal construction to that power, recognizing broad discretion in Congress to define income. See, e.g., *James v. U.S.* (1961) 366 U.S. 213, at 218, 219; *Commissioner v. Glenshaw Glass Co.* (1955) 348 U.S. 426, at 429-431; and the following analytical commentaries: Alexander, "Federal Tax Handbook" (1960) at p. 8; Paul, "Taxation in the United States" (1954) at pp. 634, 637, 640, and Rapp, "Some Recent Developments in the Concept of Taxable Income," 11 *Tax L. Rev.* 329 (May 1956) at p. 331.

III. TAXABILITY OF APPRECIATION OF CAPITAL

Since 1920, definitions of income have often referred to the Supreme Court's dicta in the case of *Eisner v. Macomber*, 252 U.S. 189, concerning the taxation of gains accruing to capital. In this case the Supreme Court held that a common stock dividend distributed to a common stockholder of the corporation which did not alter his ownership interest in the corporation was not income but the evidence of capital ownership. The Court's definition of income was as follows: "****Here we have the essential matter: not a gain accruing to capital, not a growth or

⁴⁰ See, e.g., 26 U.S.C. 61(8), including alimony in gross income and thus overturning the effect of *Gould v. Gould* (1917), 245 U.S. 151.

increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however, invested or employed, and coming in, being 'derived,' that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;--that is income derived from property. Nothing else answers the description." [Italics omitted.]

This opinion will demonstrate that the foregoing definition is not an obstacle is the proposed legislation for at least the following two reasons: (1) later Supreme Court cases have so modified and qualified its concepts that there is every probability that the Supreme Court will now recognize power in Congress to tax appreciation in value as income at appropriate times; specifically, the Supreme Court has held taxable as income at an appropriate occasion appreciation in value which had not been severed from the capital asset and such appreciation which, by virtue of the control over it exercised by the taxpayer, had been received or held by another than the taxpayer; and (2) the proposed legislation is not inconsistent with the foregoing definition as it proposes to tax as income "something of exchangeable value" that is "drawn by" the taxpayer for his disposal." The increase in value, having exchangeable value, would be disposed of by the taxpayer according to his wishes to accomplish his economic objectives. Under modern court rulings this disposition may be said to be a realization of income, as will be demonstrated in part IV of this opinion.

Point (1) was fully developed in the Opinion of my predecessor, No. 748, dated June 12, 1961, supporting the constitutionality of section 13 of H.R. 10650, placing a tax on the undistributed profits of certain foreign corporations controlled by U.S. citizens. This tax was enacted as section 12 of Public Law 87-834, October 16, 1962, 78 Stat. 1006.

Suffice it to point out here that succeeding Supreme Court cases have greatly eroded both the holding and the dicta of *Macomber*. With respect to stock dividends in particular, the case has been clearly limited by subsequent decisions to the precise holding of a distribution of capital by a particular corporation to its stockholders which did not alter the interest of those stockholders in the identical corporation. *United States v. Phellis* (1921), 257 U.S. 156; *Rockefeller v. United States* (1921), 257 U.S. 176; *Marr v. United States* (1925), 268 U.S. 536; *Koshland v. Helvering* (1936), 298 U.S. 441; *Helvering v. Gowran* (1937), 302 U.S. 238; and see *Helvering v. Griffiths* (1943), 318 U.S. 371, 375.

Moreover, the Supreme Court has refused to be hobbled by that definition in determining other gross income questions not involving stock dividends. *United States v. Kirby Lumber Co.* (1931), 284 U.S. 1; *Helvering v. Bruun* (1940), 309 U.S. 461; *Commissioner v. Glenshaw Glass Co.* (1955), 348 U.S. 426, and *General American Investors Co. v. Commissioner* (C.A. 2d 1954), 211 F. 2d 522, aff'd (1955), 348 U.S. 434. In the *Glenshaw Glass Co.* case the court said "**** it [*Eisner v. Macomber*] was not meant to provide a touchstone to all future gross income questions" (p. 431). These and other recent Supreme Court cases have led many tax authorities

to conclude that the doctrine of realization as formulated in 1920 is not a constitutional requirement and that any economic accretion to wealth may be taxable when it may be conveniently measured.⁴¹

In analyzing the present question, it is important to emphasize that the proposal is not to tax appreciation in value of property held by an owner, either periodically or as it accumulates, but when it is transferred. The courts do generally deny taxation of mere appreciation when it appears to them that this has been undertaken by the Internal Revenue Service without congressional direction. See *Campbell v. Prothro* (C.A. 5th 1954) 209 F. 2d 331, 335. However, in the *Bruun* case, *supra*, the Supreme Court upheld the assessment by the Internal Revenue Service against a landlord of an income tax on the value added to the real estate by a building erected by a tenant, the value being determined at the time of the forfeiture of the lease. Against the contention of the taxpayer that this taxation was unconstitutional under the Supreme Court's definition of income as gain "severed from capital" for the taxpayer's "separate use, benefit and disposal," the Court explained that definition was meant to clarify the distinction between an ordinary dividend and a stock dividend, that "the realization of gain need not be in cash derived from the sale of an asset," and that it was "not necessary to recognition of taxable gain" that the taxpayer should be able to sever the gain from the capital (p. 469).

The extent to which the Supreme and Circuit Courts have gone in allowing a taxpayer to be taxed on income not "realized" or received by him in the traditional sense, point (2), will be discussed in part IV, below. Most important for present purposes, however, is the fact that the concept of realization of income has been broadened in recent years, particularly in the area of the taxation of capital gains and gifts of income.

Moreover, Congress has, in fact, taxed appreciation of property not received by the taxpayer when it was under this control and direction, as in the Foreign Personal Holding Company Act, enacted in 1937, now 26 U.S.C. 551 *et seq.* The constitutionality of this enactment was upheld in *Eder v. Commissioner* (C.C.A. 2d 1943), 138 F. 2d 27, and acceptance of the act was indicated in *Helvering v. National Grocery Co.* (1938), 304 U.S. 282 fn. 4 at p. 288.

IV. REALIZATION OF INCOME BY DISPOSITION ON DONATION OR DEATH

In my opinion, the proposed legislation is primarily an extension and elaboration of the concept of the capital gains tax itself, namely, that the appreciation in value of a capital asset may

⁴¹ See, e.g., Bittker, "Federal Income Taxation of Corporations and Shareholders" (1959) at p. 169; Griswold, "Cases and Materials on Federal Taxation" (5th ed. 1960) at p. 142; Mintz, "Basic Concepts of Taxable Income," an article contained in "Practical Aspects of Federal Taxation" (1946) at p. 17; Rabkin and Johnson, "Federal Income, Gift and Estate Taxation" (1956 ed.) sec. 1.02(2); and Wright, "The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts," 8 *Stanford L. Rev.* 164, at pp. 201, 205 (March 1956).

be taxed as income upon its transfer; the transfer being the taxable event at the time of which the appreciation in the value may be measured and taxed as income. The Supreme Court quickly rejected a taxpayer's contention that the doctrine of *Eisner v. Macomber* prevented the taxation of the increase in value of stock determined upon the occasion of its sale. The Court pointed to its definition in that case as including profits gained from the sale or conversion of capital assets. *Merchants Loan and Trust Co. v. Smetanka* (1921), 255 U.S. 509.

The income tax now falls upon the occasion of a "sale or other disposition" of property, and the capital gains rate is applied upon the occasion of a "sale or exchange" of a capital asset. The taxable event may be the voluntary act of the taxpayer or the happening of an event not the volition of the taxpayer, such as the taking of property in a condemnation proceeding (*Commissioner v. Kieselbach* (C.C.A. 3d 1942), 127 F. 2d 359, aff'd (1943) 317 U.S. 399) or for nonpayment of taxes (*Helvering v. Nebraska Bridge Supply & Lumber Co.* (1941), 312 U.S. 666, reversing (C.C.A. 8th 1941) 115 F. 2d 288). The proposed legislation would include as taxable events the act of the taxpayer in making a donation and the death of the taxpayer, on which events his property is measured, including the increase in value during his period of holding.

If these two events, upon both of which property is transferred, are appropriate occasions for measuring the increase in value of property held by the taxpayer, as I believe they are, the next question is whether Congress is prevented by the Constitution from so designating them because the taxpayer may receive only the intangible benefits which cause and accompany benefactions, including the accumulation of property for the benefit of the taxpayer's heirs.

The courts have already foreshadowed, without the benefit of statute, the possibility of recognizing as income subject to capital gains tax, the appreciation of property disposed of for which a value is received which cannot readily be described as having a "fair market value" under section 1001(b). The accomplishment of an economic objective of an intangible nature, the value of which can be measured only approximately by the amount of the appreciation of the property disposed of, has been held sufficient to justify the taxation of the appreciation to the taxpayer.

The outstanding example of this recognition of capital gain is the recent Supreme Court decision in *United States v. Davis* (1962) 370 U.S. 65. Here the Supreme Court reversed the Court of Claims' decision, *Davis v. United States* (1961) 287 F. 2d 168, which held that there was no taxable gain to the husband on the transfer of appreciated stock to his divorced wife in settlement of the wife's interest in his property. The Court of Claims believed that the provisions of the capital gains tax could not apply as the amount realized by the husband was not determinable. It had concluded that the value of the rights of the wife in the husband's property could not be estimated. In this holding it followed the opinion of the 6th Circuit Court in 1960, in *C.I.R. v. Marshman* 279 F. 2d 27, cert. den. (1960) 364 U.S. 918. The Supreme Court, however, reversed the Court of Claims and reestablished the holdings of the 3d and 2d Circuit Courts, *Commissioner v. Mesta* (C.C.A. 3d 1941) 123 F. 2d 986, cert. den. (1941) 316 U.S. 695, and *Commissioner v. Halliwell* (C.C.A. 2d 1942) 131 F. 2d 642, cert. den. (1942) 319 U.S. 741, which conflicted with the *Marshman* case. Furthermore, it cited with approval two other

important holdings under the capital gains statute, *United States v. General Shoe Corp.* (C.A. 6th 1960) 282 F. 2d 9, cert. den. (1961) 365 U.S. 843, and *International Freighting Corp. v. Commissioner* (C.C.A. 2d 1943) 135 F. 2d 310.

The rationale of the Supreme Court in this case is important for our purposes. It argued that the income tax consequences of the stock transfer required a two-step analysis: first, "Was the transaction a taxable event?" and, second, "If so, how much taxable gain resulted therefrom?" (p. 67). In deciding that the transfer was "an appropriate occasion for taxing the accretion to the stock" (p. 68), the Court stated that there was no doubt that Congress by its inclusive definition of income subject to taxation as "all income from whatever source derived, including *** gains derived from dealings in property" intended that the economic growth of this stock be taxed. "The problem confronting us is simply *when* is such accretion to be taxed. Should the economic gain be presently assessed against the taxpayer or should this assessment await a subsequent transfer of the property by the wife? The controlling statutory language, which provides that gains from dealings in property are to be taxed upon 'sale or other disposition' is too general to include or exclude conclusively the transaction presently in issue" (pp. 68, 69). The Court decided that the transfer was similar to a taxable transfer of property in exchange for the release of an independent legal obligation and that the transfer was therefore a taxable event. It pointed out that the Court of Claims recognized this to be true but had "balked" at the "measurement" of the taxable gain realized by the taxpayer (p. 71). The Supreme Court recognized that the measurement of the wife's rights, complicated by the emotion, tension, and practical necessities of divorce negotiations, could not be exact. However, it concluded that "once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences" (pp. 72, 73). It, therefore, held that the husband had realized the appreciation in the value of the stock from its cost basis to the time of the transfer to his wife and that this was taxable as a capital gain.

The conclusions to be drawn from this *Davis* decision are, therefore, that appreciation in capital may be recognized as taxable upon the event of the disposition of the capital and that the gain may be measured by the amount of the appreciation itself where intangible subjective factors account for the disposition of the property.

It is significant that the Supreme Court in the *Davis* case referred not only to the *Mesta* and *Halliwell* cases, *supra*, as precedent, they being marital obligation cases, but also to the *General Shoe* and the *International Freighting Corp.* cases, *supra*, which involved an economic realization by the taxpayer not consisting of either money or the fair market value of property. In the *General Shoe* case, the Corporation made a contribution to its employees' retirement fund of property which had appreciated in value and deducted from its income tax as a contribution the current market value of that property. The Court held that the Corporation had realized capital gains on this transfer of appreciated property to the same extent as if it had sold the property and donated the proceeds to the retirement fund. The Court found support in the reasoning of the Supreme Court in *Helvering v. Horst* (1940) 311 U.S. 112, 115 (discussed further below), in

which the Court said "where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him." The 6th Circuit Court went on to say in the *General Shoe* case:

**** To argue, as the taxpayer does here, that there can be no gain because nothing is realized, is unrealistic. Literally the taxpayer is correct in its contention that it did not receive a tangible benefit *** however, we do not conceive that in this day and age we are restricted to tangibles in tax matters where there is actual recognizable benefits, albeit intangible, the taxation of which is implicit in the statutory scheme, and where such benefit is clearly capable of being evaluated on an objective basis."

The opinion in the *General Shoe Corp.* case was also built upon the *International Freighting Corp.* case (C.C.A. 2d 1943) 135 F. 2d 310. In that case the Circuit Court held that the Corporation realized taxable gain on the appreciation of the shares of stock which it owned and transferred to its employees as a bonus, deducting the fair market value of these shares as a business expense. The Court recognized that the transfer was an appropriate business expense, not a gift, but that no money or property having a fair market value had been realized on the transfer of the shares. However, the Court said, "in similar circumstances, it has been held that 'money's worth' is received and that such a receipt comes within section 111(b) [presently section 1001(b)]," citing the *Mesta* and *Halliwell* decisions.

From the foregoing cases it appears that a taxable capital gain will be recognized by the court although the taxpayer has achieved some economic objective other than receipt of money or property having a fair market value, as specified by the statute. It is sufficient if, as said in the *Horst* case, he has "the fruition of the economic gain which has already accrued to him." The fact that a taxable gain is not recognized from a gift of appreciated property is due solely to the absence of statutory definition. This was recognized by the court in *Campbell v. Prothro* (C.A. 5th 1954) 209 F. 2d 331, in declining to recognize a taxable gain from a gift by a farmer of calves to the Y.M.C.A. The court said that Congress had not so far adopted the rule that a gift of appreciated property makes the donor taxable on the appreciation and that under the statutes "as they exist" the court may not do so (p. 336). The court concluded that a gift of farm products was a gift of capital assets and not of ordinary income to which the doctrine of *Helvering v. Horst, supra*, would apply, as contended by the Commissioner. See note (1954) 22 G.W.L. Rev. 789, analyzing tax problems in gifts of farm products in the absence of the kind of statute now proposed.

It would appear likely, therefore, that the courts would recognize any transfer of appreciated property as a taxable event if Congress broadens the statutory definition of the amount realized upon such a transfer to include the intangible economic values obtained from the making of a gift or bequest or devise or acceptance of intestacy.

With respect to income other than capital gains, it has been established that a taxpayer who gives away such income over which he had control nevertheless realizes this income and may be taxed upon it. This was the decision of the Supreme Court in *Helvering v. Horst* (1940) 311 U.S. 112, in which case a father who was the owner of a bond was held taxable on the interest received by the son after the gift to the son of the coupon which mature later in the same year. The reasoning by Justice Stone in this case on what constitutes realization of income and on the purpose of the revenue laws has been widely quoted and followed by the Supreme Court and the Circuit Courts generally. This reasoning, because of its importance, is set forth in the following quotations:

**** Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others, which constituted an economic gain to him.

"Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event, rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him" (p. 115).

**** But the rule that income is not taxable until realized has never been taken to mean that the taxpayer even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. Cf. *Aluminum Castings Co. v. Rutzahn*, 282 U.S. 92, 98. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth" (p. 116).

**** Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such nonmaterial satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son" (p. 117).

"The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it" (p. 118).

"The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. See, *Corliss v. Bowers*, *supra*, 378; *Burnet v. Guggenheim*, 288 U.S. 280, 283. The tax laid by the 1934 Revenue Act upon income 'derived from *** wages, or compensation for personal service, of whatever kind and in whatever form paid, ***; also from interest ***' therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received" (p. 119).

By comprehending "capital gain" within the term "income" or by substituting capital gain" for "income" in the appropriate places in the foregoing quotations one may see how readily the Court's thinking in this 1940 case could accommodate the concept of taxing capital gains upon such an event as death or gift, despite the fact that these gains were not paid to or received by the taxpayer in the ordinary sense of the word.

The *Horst* decision was a development of the holding in *Lucas v. Earl* (1930), 281 U.S. 111, in which a husband was held taxable on all his income although he had made a valid contract with his wife that all his future income should be held by them jointly. In that case Justice Holmes interpreted the Federal income tax law as allowing for no "arrangement by which the fruits are attributed to a different tree from that on which they grew" (p. 115). This metaphor has provided the rationale in many later income tax cases.

The *Horst* was also followed in the companion case of *Helvering v. Eubank* (1940) 311 U.S. 122, holding a life insurance agent taxable on commissions paid in 1933 to persons to whom he assigned these commissions in 1924 and 1928. *Horst* was also followed in *Harrison v. Schaffner* (1941) 312 U.S. 579 to hold taxable the donor of certain dollar amounts of income from a life estate. Besides extensive quotations from the *Horst* opinion, the Court said that the exercise of power to procure payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever" (p. 580). In both *Commissioner v. Tower* (1946) 327 U.S. 280 and *Lusthaus v. Commissioner* (1946) 327 U.S. 293, the husband was held taxable on income received by the wife from the corpus of property which he had previously given to her, indicating that the rule may be applied where the underlying income-producing property is disposed of. In *Commissioner v. Sunnen* (1948) 333 U.S. 591, the *Horst* rule was applied to a taxpayer who had assigned royalty agreements, and in *Commissioner v. Lester* (1961) 366 U.S. 299, the rule of the *Horst* case that "the power to dispose of income is the equivalent of ownership of it" was applied to determine the appropriate taxpayer.

The principles of the *Horst* case have been followed in a number of circuit court cases which look behind various business arrangements to tax the increase to the true owner and to place the income tax on the person who created and had control of the income even though he did not receive it. See, e.g., *Home Furniture Company v. C.I.R.* (C.C.A. 4th 1948) 168 F. 2d 312; *Paster v. C.I.R.* (C.A. 8th 1957) 245 F. 2d 381; *Factor v. C.I.R.* (C.A. 9th 1960) 281 F. 2d 100.

The *Horst* case, its precursors and its successors demonstrates that a taxpayer realizes taxable income when he exercises control over income that is compensation for services or derived from business or royalties or other interests by giving it away. There is thus no logical reason why Congress could not provide that this same principle shall apply to the exercise of control over income from gains from dealings in property when this control is exercised through donation, devise, bequest, or intestacy.

The making of a donation, devise, or bequest is an affirmative act of control over property to obtain certain objectives of the taxpayer. In either case the taxpayer has control of the appreciation in value and it is transferred in accordance with his decision. In many cases the acceptance of intestacy is also a decision of the taxpayer which exercises control over the property by permitting its distribution in accordance with laws which would accomplish his own objectives. To be sure, in some cases the "decision" of the taxpayer may be theoretical or nonexistent or may even have been contrary to his unexpressed wishes. His will may even have been invalidated as the result of a contest. Nonetheless, there seems no great conceptual difficulty in including intestate transfers along with those made by will as appropriate events upon which to measure and tax the gains which are by law distributable to the decedent's spouse and next of kin or heirs.

V. SUMMARY

To recapitulate, it is my opinion that *Eisner v. Macomber* has limited, if any, application and does not stand in the way of the present proposals; that the transfers of appreciated property by gift or by death present appropriate occasions to measure the increase in the value of the property and to tax the capital gain to the donor or decedent, and that such a tax would be constitutional. The constitutionality of the tax can be supported by the conclusions that an appreciation in property may be taxed upon the occurrence of an appropriate taxable event, which event is for Congress to determine, and that the taxpayer has realized the appreciation in value by this exercise of control over it and by his accomplishment of his economic objective with respect to that income.

APPENDIX B:

**Opinion of the Office of Legal Advisor, U.S. Department of State
Regarding the Application of the Jackson-Vanik Amendment to the
Proposed Expatriation Tax**

United States Department of State
Washington, D.C. 20520

March 16, 1995

Edward Knight, Esq.
General Counsel
U.S. Department of the Treasury
Room 3000
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Knight:

Your staff has inquired as to whether section [201] of the proposed Tax Compliance Act of 1995 raises legal questions concerning freedom of emigration, international human rights law, or provisions of Title IV of the Trade Act of 1974 (commonly known as "the Jackson-Vanik amendments").

The proposal in section [201] taxes the assets of U.S. citizens who elect to renounce U.S. citizenship and the assets of U.S. permanent residents who are no longer taxed as U.S. residents as a result of a change in their immigration status. For this purpose, a taxpayer would be treated as owning those assets that would be included in the taxpayer's gross estate, as if that estate had been created on the date of expatriation. The proposed provision would be applied to those assets, subject to a \$600,000 exemption and other provisions.

In our view, this provision does not conflict with international human rights law concerning an individual's right to freely emigrate from, i.e., leave, his or her country of citizenship. The right to leave the territory of a state (including one's country of nationality) and the right to renounce one's own citizenship are well recognized in international human rights law. (See, e.g., Universal Declaration of Human Rights articles 13(2) and 15(3), International Covenant on Civil and Political Rights article 12(2).)

It is also equally well recognized that a state, in order to protect its interests, may impose economic controls on departure (e.g., currency restrictions, taxes) as long as such controls do not result in a de facto denial of an individual's right to emigrate. (See, e.g., Hurst Hannum, The Right to Leave and Return in International Law and Practice 39-40 (1987).) Requiring individuals to pay taxes on gains that accrue prior to expatriation does not constitute a de facto denial of an individual's right to leave a country. These are comparable taxes to those which U.S. citizens or permanent residents would have to pay were they in the United States at the time they disposed of the assets or at their death. Proposed section [201] does not apply to emigration (but to renunciation of citizenship) and would not serve as a pretext for denying the right to emigrate from the United States or to renounce U.S. citizenship to all or any segment of the population.

In addition, the proposal does not conflict with the Jackson-Vanik amendments to the Trade Act of 1974 (19 U.S.C. 2432). Those amendments restrict the granting of most-favored-nation treatment and of certain trade related credits and guarantees to a limited number of non-market economies that unduly restrict the emigration of their nationals. They do not apply to emigration from the United States or to the renunciation of U.S. citizenship.

Neither does the proposed tax provision raise questions of disparate standards applicable to the United States as against the nonmarket economies subject to Jackson-Vanik restrictions. This tax provision does not interfere with the right of an individual to physically depart from the United States, whether temporarily or permanently. It only applies at the time an individual renounces his or her U.S. citizenship (or at the time a permanent resident is no longer eligible to be taxed as a resident of the U.S.) and not to the act of emigration.

We also note that, under most circumstances, the proposal in section [201] will affect U.S. citizens who have already departed the United States and, therefore, is unlikely to have any relation to their freedom of emigration. (See, 8 U.S.C. 1481(a).)

I hope this information is helpful.

Sincerely,

Michael J. Matheson
Acting Legal Adviser