CONGRESS, HAVE A HEART: PRACTICAL SOLUTIONS TO PUNITIVE MEASURES PLAGUING THE HEART ACT'S EXPATRIATE INHERITANCE TAX

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I. INTRODUCTION

For decades, rumors surfaced in the federal government and popular media outlets that Americans were casting off their citizenship in favor of fleeing the country with millions, perhaps billions, of dollars tax-free. These urban legends proved true: expatriates had escaped the tax net cast by the Treasury despite congressional attempts to remove tax-avoidance motives of expatriation. It was not until 2008 that Congress responded effectively through its enactment of the Heroes Earnings Assistance and Relief Tax Act (HEART Act).[1] Section 301 of the HEART Act added to the U.S. Internal Revenue Code (the Code)[2] two new sections that fundamentally altered the U.S. government's approach to expatriate taxation. These new provisions modifying the expatriate income and transfer tax regimes constitute Congress's most recent, and by far most drastic, attempt to capture a potentially significant amount of revenue from both U.S. citizens who relinquish citizenship and U.S. residents who abandon residency status for tax-avoidance purposes. The enactment of the HEART Act signifies a new chapter in the federal government's approach to the taxation of expatriates, as the U.S. government has never before imposed a similar tax regime on former citizens and former permanent residents.[3]

Part II of this Article examines the driving force behind expatriation from the United States for tax-avoidance purposes. Part III then charts Congress's struggle to curb tax-motivated expatriation through three separate pieces of legislation: the Foreign Investors Tax Act of 1966; the Health Insurance Portability and Accountability Act of 1996; and the American Jobs Creation Act of 2004. Finally,

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1. Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624 (2008).

2. Unless otherwise indicated, all section references are to provisions of the U.S. Internal Revenue Code.

3. Estate, inheritance, and gift taxes all constitute types of transfer tax. An estate tax is a "tax imposed on the transfer of property by will or by intestate succession"; an inheritance tax is a "tax imposed on a person who inherits property from another"; and a gift tax is a "tax imposed when property is voluntarily and gratuitously transferred." BLACK'S LAW DICTIONARY (9th ed. 2009).

Part IV describes the Heroes Earnings Assistance and Relief Tax Act of 2008 and evaluates the ramifications of Congress's new approach to capturing tax on lifetime and testamentary gifts by expatriates. In particular, Part IV identifies punitive gift tax consequences on U.S. citizen and resident recipients of gifts from expatriates and recommends alterations to the HEART Act's expatriate tax regime based on established tax principles of equity and fairness.

II. FEDERAL TAXATION OF EXPATRIATES & INCENTIVES TO EXPATRIATE

In order to understand Congress's impetus for subjecting former U.S. citizens and resident aliens to an alternative tax regime, it is important to recognize the value of expatriation for those citizens and residents with substantial assets.

A. U.S. Citizen, Resident Alien, or Non-Resident Alien?

The U.S. federal income, estate, and gift tax rules imposed on U.S. citizens and U.S. resident aliens (collectively "U.S. persons") differ considerably from the rules applicable to nonresident aliens. Consequently, U.S. persons generally face a higher U.S. tax burden than nonresident aliens. Whether, and on what, the U.S. government taxes an individual depends on many factors. One important factor is that individual's immigration status relative to the United States. The Internal Revenue Service (IRS or the Service) applies different tax rules depending on whether the person is a U.S. citizen, a U.S. resident alien (e.g., green card holder), or a nonresident alien. The definition of U.S. citizen is fairly straightforward: generally, a U.S. citizen is a "person born or naturalized in the United States and subject to its jurisdiction."[4] The definitions of resident alien and nonresident alien differ depending on the applicable federal tax: (1) estate and gift tax or (2) income tax.[5]

1. Estate and Gift Tax Treatment of Aliens

For estate tax purposes, an alien decedent qualifies as a "resident alien" if, at the time of his death, he had his "domicile" in the United States.[6] An alien has his domicile in the United States if he resides in the United States "with no definite present intention of later removing therefrom."[7] Thus, the alien must satisfy one objective prong and one subjective prong: residence and intent to remain, respectively. A "nonresident alien" decedent, on the other hand, is an individual

4. Treas. Reg. § 1.1-1(c) (2008). The regulation mentions special rules, one of which relates "to certain expatriates who have lost citizenship with a principal purpose of avoiding certain taxes," and directs the reader to I.R.C. § 877 (2012). *Id.* Those "special rules"—the expatriation provisions—are the subject of this Article.

5. Consequently, a non-U.S. citizen may qualify as a resident alien for transfer tax purposes, but may not satisfy the resident alien income tax tests; similarly, an alien may be considered a resident alien for income tax purposes, but not for purposes of the estate or gift tax.

6. Treas. Reg. § 20.0-1(b)(1) (1994). For estate tax purposes, the term "United States" constitutes the fifty states and the District of Columbia. *Id.*

7. *Id.*

who, at the time of his death, had his domicile outside the United States.[8] In other words, a nonresident alien for estate tax purposes is any individual who is not a U.S. citizen and who does not satisfy the requisite residence and intent requirements.

Similar to the definition of resident alien for the estate tax, "resident alien" for purposes of the gift tax is defined as an individual who has his domicile in the United States at the time he made the gift.[9] Not surprisingly, nonresident aliens consist of "[a]ll other individuals."[10]

2. Income Tax Treatment of Aliens

Distinguishing resident aliens and nonresident aliens for federal income tax purposes requires a more objective analysis. The Code provides that "[a]n individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States."[11] An alien individual (i.e., a non-U.S. citizen, whether a resident or a nonresident) is considered a U.S. resident alien for income tax purposes if he satisfies the criteria of one of the following three tests: (1) the individual has been admitted to the United States as a lawful permanent resident (as defined under Section 7701(b)(6)); (2) the individual satisfies the requirements of the "substantial presence test"[12]; or, if neither (1) nor (2), the individual satisfies the resident alien first year election requirements.[13]

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8. *Id.* § 20.0-1(b)(2).

9. Treas. Reg. § 25.2501-1(b) (1983). Domicile is defined identically under the estate and gift tax regulations. *See id.* Like the estate tax, the term "United States" constitutes the fifty states and the District of Columbia for gift tax purposes. *Id.*

10. *Id.*

11. I.R.C. § 7701(b)(1)(B) (2012).

12. The substantial presence test is a bright-line test. To qualify as a resident alien for income tax purposes under the substantial presence test for a given calendar year (the "current year"), an individual (1) must be present in the United States for at least thirty-one days in the current year and (2) must have been in the United States for a total of at least 183 days during the current year and the prior two years. *Id.* § 7701(b)(3). Each day an alien is present in the United States during the current year constitutes a full day; each day in the first preceding year qualifies only as one-third of a day; and each day in the second preceding year constitutes one-sixth of a day. *Id.* Thus, if an alien were in the United States for 125 days in 2011 (the current year), 150 days in 2010 (first preceding year), and 50 days in 2009 (second preceding year), he would qualify as a resident alien for income tax purposes (125 + 150*(1/3) + 50*(1/6) = 183.33 days) under the substantial presence test. The Code provides an exception for aliens who meet the requirements of the substantial presence test if the alien (1) was in the United States for fewer than 183 days of the current year, (2) has a "tax home," defined as his regular or principal place of business or regular place of abode, and maintains more significant ties to that foreign country than to the United States, and (3) is not pursuing U.S. permanent residence. *Id.* § 7701(b)(3)(B)-(C).

13. *Id* § 7701(b)(4).

B. Why Expatriate?: Present Federal Estate, Gift, and Income Tax Laws Applicable to U.S. Citizens, Resident Aliens, and Nonresident Aliens

Under the present U.S. estate and gift tax systems, U.S. persons and nonresident aliens face divergent tax treatment. Federal estate tax law, which imposes tax on the transfer of wealth upon death, subjects to tax the entire value of a U.S. person's worldwide estate without regard to where the decedent was living or the location of the property at the time of death.[14] Similarly, the U.S. gift tax applies to all inter vivos property transfers by U.S. citizens and residents, whether the property is tangible or intangible and wherever situated.[15] For nonresident aliens, however, the estate tax applies only to deathtime transfers of U.S.-situs property,[16] and gift tax is imposed only on inter vivos transfers of tangible property situated within the United States.[17] Inter vivos transfers of *intangible* property by nonresidents are not subject to the federal gift tax.[18]

Under federal income tax law, U.S. persons are subject to tax on worldwide income—that is, income produced both abroad and in the United States—at graduated rates regardless of the source of that income and irrespective of the taxpayer's domicile.[19] In contrast, the United States generally does not tax nonresident aliens on income from sources located outside the United States (foreign-source income), nor does it tax gain derived from the disposition of property.[20] Instead, income tax is imposed only on nonresident aliens' U.S.-source income *not* effectively connected with a U.S. trade or business at a flat thirty percent rate,[21] and at the same graduated rates generally applicable to U.S. persons on income that *is* "effectively connected with the conduct of a trade or business within the United States."[22]

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14. *Id.* § 2001(a) ("A tax is hereby imposed on the transfer of the taxable estate of every decedent who is *a citizen or resident of the United States*." (emphasis added)); *id.* § 2031 ("The value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property, real or personal, tangible or intangible, *wherever situated*." (emphasis added)).

15. *Id.* § 2501(a)(1) ("A tax . . . is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident.").

16. *Id.* § 2101(a) ("[A] tax is hereby imposed on the transfer of the taxable estate . . . of every decedent nonresident not a citizen of the United States."); *id.* § 2103 ("For the purpose of the tax imposed by Section 2101, the value of the gross estate of every decedent nonresident not a citizen of the United States shall be that part of his gross estate . . . which at the time of his death is situated in the United States.").

17. *Id.* § 2501(a).

18. *Id.* § 2501(a)(2).

19. *Id.* § 1; Treas. Reg. § 1.1-1(a)(1) (2008) ("Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the United States, and to the extent provided by section 871(b) or 877(b), on the income of a nonresident alien individual."); *see also* I.R.C. § 2(d) (indicating that income tax imposed on nonresident aliens applies "only as provided by section 871 or 877").

20. However, nonresident aliens are subject to federal income tax on gain from the sale of real property located within the United States. I.R.C. § 897; Treas. Reg. § 20.2104-l(a)(l) (1974).

21. I.R.C. § 871(a).

22. *Id.* § 871(b).

Thus, the federal estate, gift, and income tax laws favor nonresident aliens with lower rates and apply to fewer property transfers and sources of income as compared to the federal tax laws to which U.S. citizens and residents are subject. For example,[23] assume a U.S. citizen or resident purchased $100,000 of stock in Google, a U.S. corporation, and the fair market value of the stock increased to $50,000,000 over the course of several years. When that individual sells the stock at its fair market value of $50,000,000 in 2011, he will realize gain of $49,900,000.[24] Federal law currently imposes income tax at a rate of fifteen percent on long-term capital gain.[25] Thus, the federal government will claim income tax of $7,485,000 on the $49,900,000 gain. Of the $50,000,000 value of the stock, the U.S. person retains $42,515,000. Moreover, upon the U.S. citizen's or resident alien's subsequent death in 2012, federal estate tax will capture thirty-five percent[26] of the remaining $42,515,000 less the $5,000,000 credit, or $13,130,250.[27] In total, the original $50,000,000 will be depleted by federal income and estate taxes of $20,615,250, leaving the taxpayer's heirs with $29,384,750. If, on the other hand, the taxpayer above is a nonresident alien, he would owe no federal income taxes on the disposition of the stock, and his estate would not be subject to tax on the proceeds of the prior disposition.[28]

Consequently, assuming the United States did not impose an alternative tax regime on U.S. expatriates, a citizen, upon expatriation, would be treated as a

23. This example is adapted from Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863, 872 (2004).

24. $50,000,000 (fair market value) - $100,000 (adjusted basis) = $49,900,000 (gain).

25. I.R.C. § 1(h)(1)(C). Section 1(h)(1)(C) was amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 301(a)(2), 117 Stat. 752 (2003), and it effectively reduced the long-term capital gains rate from 20% to 15%. Though the provision was scheduled to sunset after December 31, 2008, the 15% capital gains rate was extended through 2010 as part of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109–222, 120 Stat. 345 (2006), and Congress further extended the life of the provision through 2012 as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (2010).

26. Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the maximum estate tax rate for 2011 and 2012 is 35%. For the sake of simplicity, this calculation assumes a 35% flat estate tax rate.

27. This is a simplified example. Among other factors not taken into consideration, it ignores any of the taxpayer's other assets, fails to take consumption into account, and assumes the taxpayer did not reinvest the $50,000,000 or engage in estate reduction techniques.

28. *See generally* I.R.C. § 871 (2010). If the nonresident alien had *not* disposed of the Google stock prior to his death in 2012 and instead died with the shares in his estate, the entire $50,000,000 fair market value of the stock would be subject to estate tax under Section 2101 because stock in a U.S. corporation is considered U.S.-situs property. Treas. Reg. § 20.2104-1(a)(5) (1974). However, through simple planning, a nonresident alien could effect an inter vivos transfer of the Google stock to a foreign corporation wholly owned by the alien. In so doing, the alien avoids gift tax because that tax applies only to transfers by nonresident aliens of *tangible* property (and stock is intangible property), and the alien avoids estate tax because he would not own stock in a domestic corporation at death; rather, he would own 100% of the foreign corporation, which falls beyond the reach of the federal estate tax.

nonresident alien of the United States for tax purposes. As a result, expatriates—especially those with a substantial amount of income and who have amassed considerable estates—would have significant incentives to renounce citizenship or terminate residency to benefit from the federal tax treatment enjoyed by nonresident aliens. Through the enactment of various laws over the course of nearly a half-century, and particularly since the mid-1990s, Congress has attempted to remove incentives that encourage expatriation for tax-avoidance purposes.

III. CONGRESSIONAL STRUGGLE: U.S. TAX TREATMENT OF EXPATRIATES

A. Pre-1966 Federal Income and Transfer Tax Treatment of Citizens and Nonresident Aliens

1. Income Tax Law Before

Before the enactment of the Foreign Investors Tax Act (FITA) in 1966,[29] U.S. citizens and nonresident aliens faced far less divergent tax treatment than they do today. Consistent with current law, U.S. citizens were subject to tax on their worldwide income at progressive marginal tax rates.[30] For nonresident aliens, however, the federal government limited the scope of the tax to income derived from U.S. sources, and no additional tax was imposed on the foreign-source income of nonresident aliens who had relinquished U.S. citizenship.[31]

2. Estate and Gift Tax Law Before 1966

The federal estate tax applied to the transfer of citizens' worldwide estates.[32]

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29. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1541 (1966).

30. S. Rep. No. 89-1707, at 42 (1966), *reprinted in* 1966 U.S.C.C.A.N. 4446, 4488.

31. *Id.* at 27. The applicable rate of tax for a nonresident alien's U.S.-source income depended on whether the alien was engaged in a trade or business in the United States. For an alien engaged in a U.S. trade or business, the regular graduated and capital gains rates applicable to U.S. citizens applied. *Id.* at 22. For a nonresident alien *not* engaged in a U.S. trade or business, tax treatment depended on whether his U.S.-source income exceeded $21,200, while U.S. citizens were subject to the regular rates regardless of amount of income. *Id.* at 21. If a nonresident alien earned $21,200 or less, the applicable income tax rate was a flat 30% rate on specified U.S.-source income, including, for example, "interest, dividends, rents, salaries, wages, and other fixed or determinable annual or periodical gains, profits, and income." *Id.* Where a nonresident alien not engaged in a trade or business in the United States earned more than $21,200 from U.S. sources, the applicable tax rate was the greater of (1) the regular progressive rates or (2) a flat 30% rate. *Id.* at 22. In addition, a nonresident alien *not* engaged in a U.S. trade or business faced capital gains tax only if he was (1) physically present in the United States when the income was realized or (2) physically present in the United States for a total of at least ninety days during the year. The applicable rate of tax depended on whether the nonresident alien's U.S.-source income exceeded $21,200. *Id.* If $21,200 or less, a flat 30% rate applied to the capital gains. *Id.* If more than $21,200, the applicable rate of tax was the regular capital gains rate if the graduated income tax rates (calculated including the capital gains tax) resulted in a higher tax than the flat 30% rate. *Id.* If not, the flat 30% rate applied. *Id.*

32. *Id.* at 53. The estates of U.S. citizen decedents were provided with a foreign estate tax

For nonresident aliens, however, only the transfer of property (both tangible *and* intangible) located within the United States by the decedent at death fell within the purview of the federal estate tax, and no additional tax was imposed on the transfer of property at death of nonresident aliens who had relinquished citizenship.[33] Finally, the federal gift tax applied to the inter vivos transfers of all tangible and intangible property by both U.S. citizens and nonresident aliens; however, for nonresidents, the tax was limited to transfers of U.S.-situs property.[34]

Consequently, because an expatriate's status for U.S. federal tax purposes was transformed at the moment of expatriation to nonresident alien, a nonresident who had relinquished U.S. citizenship—irrespective of whether such relinquishment was for tax-avoidance purposes—faced the same tax treatment as other nonresident aliens.

B. Foreign Investors Tax Act of 1966

The Foreign Investors Tax Act of 1966 (FITA)[35] fundamentally altered prior U.S. tax law by decreasing the tax burden on nonresident aliens, effectively establishing the dual tax system that remains in operation today: one applicable to former U.S. citizens and residents, the other affecting all other nonresident aliens. To remove tax deterrents to foreign investments in the United States, FITA "eliminated progressive taxation of nonresident noncitizens for income that was not effectively connected with the conduct of a U.S. trade or business."[36] Following FITA's enactment, nonresident aliens were subject instead to U.S. income tax at a flat thirty percent rate on U.S.-source income *not* effectively connected with a trade or business and at graduated rates on income that *was* effectively connected with a U.S. trade or business[37] and to U.S. estate tax on their gross estates located within the United States, including real and tangible property as well as stock issued by U.S. corporations.[38] Further, nonresident aliens no

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credit for death taxes paid to foreign governments with respect to non-U.S.-situs property. *Id.*

33. *Id.* at 48, 53-54. While the same estate tax rates applied to both citizens and nonresident aliens, citizens benefited from more favorable deductions, credits, and exemptions. *Id.* at 48. For example, $60,000 of a U.S. citizen's estate was exempt from taxation, while only $2,000 was exempt from a nonresident alien's estate, an amount the Senate Finance Committee deemed "so low as to place an unreasonable and inequitable tax burden on the estates of nonresident aliens." *Id.* at 48, 52. Similarly, deductions for expenses and losses generally were limited in proportion to a nonresident alien's U.S. estate relative to his entire estate, and, unlike the estates of U.S. citizens, the estates of nonresident aliens were not eligible for the marital deduction or for the credit for death taxes paid to foreign governments. *Id.* at 48.

34. *Id.* at 56.

35. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1541 (1966).

36. STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., JCS-2-03, REVIEW OF THE PRESENT-LAW TAX AND IMMIGRATION TREATMENT OF RELINQUISHMENT OF CITIZENSHIP AND TERMINATION OF LONG-TERM RESIDENCY 76 (Comm. Print 2003) [hereinafter 2003 JCT REPORT].

37. I.R.C. § 871 (1966).

38. *Id.* § 2101 (1966).

longer faced gift tax on lifetime transfers of intangible property.[39] As a result, nonresident aliens potentially faced more favorable tax treatment (i.e., a smaller U.S. tax burden) than U.S. citizens.

Congress recognized that providing more favorable tax treatment to nonresident aliens might prompt some U.S. citizens to forfeit citizenship, thereby classifying themselves as nonresident aliens, to take advantage of the new tax law.[40] Accordingly, along with the provisions in FITA affording beneficial treatment to nonresident aliens, Congress enacted, for the first time, an alternative tax regime for the taxation of expatriates.[41] Under this new regime, the U.S. government ostensibly continued to tax expatriates as citizens, however its jurisdiction was limited to transfers of property located within the United States and to all U.S.-source income for a period of ten years following expatriation.[42] Though Congress may have enacted such a regime to accomplish a variety of objectives, "the legislative history to the enactment of the alternative tax regime in 1966 and its [subsequent] modifications . . . indicates that Congress primarily intended the alternative tax regime to serve the purpose of eliminating unintended tax incentives for citizenship relinquishment."[43]

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39. *Id.* § 2501(a)(2)-(3) (1966). As mentioned above, pre-1966 law imposed gift tax on inter vivos transfers of *intangible* U.S.-situs property (in addition to tangible property located in the U.S.) by nonresident aliens who were engaged in a U.S. trade or business, however the rule proved unenforceable. *See supra* text accompanying note 33; S. Rep. No. 89-1707, *supra* note 30, at 56.

40. 2003 JCT REPORT, *supra* note 36, at 76; S. Rep. No. 89-1707, *supra* note 30, at 27-28.

41. 2003 JCT REPORT, *supra* note 36, at 77. The tax system established by FITA, which remained largely in place until 2004, is referred to as an "alternative" tax regime because the new income, estate, and gift tax rules imposed on expatriates applied only if the amount of tax exceeded the amount for which a non-expatriate nonresident alien would be liable under Section 871 (the provision applicable to nonresident aliens). *Id.*

42. I.R.C. § 877 (1966). The FITA expatriation tax provisions as originally enacted applied only to former U.S. *citizens* and not to resident aliens. In 1984, Congress enacted the Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984), which expanded the scope of individuals to whom the alternative tax regime's income tax rules applied beyond former U.S. citizens to include resident aliens if the alien resided in the United States for three years prior to his departure and reestablished residency in the United States within three years of that departure. I.R.C. § 7701(b)(9) (1966) (subsequently renumbered as I.R.C. § 7701(b)(9)). Because "Congress believed that these aliens should share with other U.S. persons in the financial responsibility for the operations of the Federal Government," the Act taxed resident aliens as tax-motivated expatriates who "spen[t] much time in the United States because of the political stability or economic opportunities our country affords." STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., JCS-41-84, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 485 (1984).

43. 2003 JCT REPORT, *supra* note 36, at 75. Other plausible motives may include "(1) expressing official disapproval of tax-motivated citizenship relinquishment or residency termination; (2) deterring or punishing tax-motivated citizenship relinquishment or residency termination; (3) removing unintended tax incentives for relinquishing citizenship or terminating residency, thereby achieving tax neutrality in the decision to take such actions; (4) taxing appreciation and asset value that accrues while a person is a U.S. citizen or resident; (5) ensuring that individuals cannot enjoy any tax benefits that may arise from relinquishing citizenship or terminating residency while still maintaining significant ties to the country." *Id.*

1. Dissuading Tax-Motivated Expatriation Under FITA's Alternative Tax Regime

a. Income Tax Under FITA: New Section 877

Section 877, originally enacted as part of FITA, governed the income tax treatment of former U.S. citizens who had renounced their citizenship to avoid federal income or transfer tax liability and established the new alternative tax regime applicable to such persons.[44] For expatriates to which the new regime applied, Section 877 imposed the alternative income tax for a period of ten years after the date of expatriation.[45] An expatriate falling within the purview of Section 877 was subject to tax on (1) income derived from U.S. sources and (2) worldwide income effectively connected with a trade or business, including sources not taxable to non-expatriate nonresident aliens.[46]

Further, under the new regime, the rules determining what constituted U.S.-source income were expanded to include gains from the sale or exchange of U.S. property, stock issued by U.S. corporations, and debt obligations of U.S. persons or of the United States[47]—all of which were (and still are) not includible as gross income for nonresident aliens.[48] In addition, the new regime altered the applicable tax rate for expatriates: while U.S. income tax subjected nonresident aliens to a thirty percent flat rate,[49] the progressive rates under Section 1 applied to expatriates for a period of ten years if relinquishment of citizenship was tax motivated.[50]

b. Estate Tax Under FITA: New Section 2107

Consistent with U.S. estate tax treatment of nonresident aliens, Section 2107,

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44. I.R.C. § 877(a) (1966).

45. *Id.* After the ten-year period elapsed, an expatriate was no longer subject to the alternative income, estate, and gift tax regimes; consequently, he was taxed as a nonresident alien.

46. I.R.C. § 877(b)(1), (c) (1966; S. Rep. No. 89-1707, *supra* note 30, at 28. In other words, an expatriate was taxed as if he were a U.S. citizen (with the exclusion of foreign-source income) if the application of the new rules resulted in greater tax liability than those applicable to non-expatriate nonresident aliens. I.R.C. § 877(a)-(b) (1966).

47. I.R.C. § 877(c) (1966).

48. Until the enactment of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), one method an expatriate could employ to avoid U.S. income tax was to conduct a tax-free exchange of U.S. property for foreign property. STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., JCS-10-87, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1050 (1987). For the "new" foreign-source property, federal income tax would not capture gain upon the expatriate's disposition of the property. *Id.* Had the property retained its characterization as "U.S.-source" property, any gain would be subject to tax. *Id.* Under the 1986 Act, Congress amended Section 877 to capture tax on gain from the disposition of foreign-source property that had undergone such a tax-free exchange. *Id.* This amendment reflected Congress's belief that "expatriates should not be permitted to accomplish indirectly that which they are prohibited from doing directly." *Id.* In other words, where the substance of the expatriate's transaction reflected a tax-avoidance motive, the expatriate would suffer the tax.

49. I.R.C. § 871(a) (1966).

50. I.R.C. § 877(b) (1966).

enacted as part of FITA, continued to subject to federal estate tax an expatriate decedent's gross estate located within the United States.[51] However, Section 2107 provided a special rule for the taxation of an expatriate decedent's estate, not applicable to non-expatriate nonresident aliens, if one of the principal purposes of the decedent's expatriation was to avoid U.S. income or estate tax, and that provision applied only if the decedent died within ten years of the date of his expatriation.[52] The new estate tax provision captured as part of the expatriate decedent's estate the ratio of the value of the stock in a foreign (non-U.S.) corporation owned by the decedent at the time of his death to the assets owned by that foreign corporation located in the United States as compared to that corporation's total assets worldwide (1) if he owned at least ten percent of the voting power in the corporation and (2) if he owned or constructively owned more than fifty percent of the total voting power of all classes of stock of the corporation.[53] Congress enacted this provision "to prevent [expatriates] from avoiding U.S. tax on [their] estate[s] by transferring assets with a U.S. situs to a foreign corporation in exchange for its stock."[54]

c. Gift Tax Under FITA: Section 2503(a)(3)

Finally, FITA expanded the pre-1966 gift tax provisions to capture tax revenue on inter vivos transfers by expatriate donors.[55] Unlike gift tax treatment of non-expatriate nonresident aliens (who, after the enactment of FITA, were subject only to tax on lifetime transfers of *tangible* property located in the United States), expatriate donors were subject to tax whether the U.S.-situs property transferred was tangible *or* intangible.[56] As with the income and estate tax provisions, this gift tax applied to expatriates for ten years following the date of expatriation and only if one of the primary purposes of their relinquishment of citizenship was tax avoidance.[57]

d. Burden of Proof

Under the income, estate, and gift tax provisions added to the Code under FITA, once the Service established a reasonable belief that one of the principal purposes for which an expatriate relinquished citizenship was to avoid taxes, demonstrated by a substantial reduction in the expatriate's U.S. tax liability, the expatriate (or executor of the expatriate decedent's estate) carried the burden of proving the contrary—that avoidance of income or transfer tax was not, in fact, one of his primary purposes for expatriation.[58] However, where an individual's loss

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51. I.R.C. § 2107 (1966).
52. I.R.C. § 2107(a) (1966).
53. I.R.C. § 2107(b) (1966).
54. S. Rep. No. 89-1707, *supra* note 30, at 54.
55. I.R.C. § 2501(a) (1966).
56. I.R.C. § 2501(a)(3) (1966).
57. *Id.*
58. I.R.C. § 877(e) (1966) (income tax provision); I.R.C. § 2107(e) (1966) (estate tax provision); I.R.C. § 2501(a)(4) (1966) (gift tax provision).

of citizenship occurred under circumstances in which it was unlikely that the expatriation was tax-motivated, the alternative tax regime did not apply.[59]

2. The Failure of FITA

Although Congress intended for FITA's expatriation provisions to deter tax-motivated expatriation, the alternative regime largely failed to achieve its objectives. Indeed, soon after FITA was enacted, then-law professor Stanford G. Ross opined that the IRS would have substantial difficulties enforcing the expatriate provisions, suggesting instead that "the major impact of the provisions will be to have an *in terrorem* effect on any Americans considering expatriation."[60]

In a letter to the Chief of Staff of the Joint Committee on Taxation, IRS Commissioner Margaret Milner Richardson wrote that the expatriate provisions are "of limited scope that can be easily avoided and [are] difficult to enforce."[61] The Service indicated that no expatriate had complied with the new provisions, either because individuals to whom the alternative tax regime applied (i.e., tax-motivated expatriates) likely would not admit to expatriating for tax-avoidance purposes or because they had successfully (and legally) planned to avoid falling prey to the alternative regime.[62] Commissioner Richardson identified three fundamental issues: (1) the new regime "require[d] proof of a tax avoidance motive before it applie[d]"; (2) "it only applie[d] to income from U.S. source[s] that is earned or realized within a 10-year period following the date of expatriation," as well as transfers of U.S.-source property within the 10-year post-expatriation window; and (3) it "pose[d] a difficult enforcement challenge because it require[d] continued monitoring of taxpayers and their income [and transfers] long after they [had] departed from the United States."[63]

First, the Service had to establish that the relinquishment of an expatriate's citizenship had as one of its principal purposes the avoidance of federal income, estate, or gift tax in order to subject the expatriate to the alternative tax regime.[64] To do so, the Service had to show that expatriation resulted in a substantial reduction of the former citizen's tax liability before the burden shifted to the expatriate to establish a non-tax-avoidance motive.[65] If the taxpayer successfully

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59. S. Rep. No. 89-1707, *supra* note 30, at 28. The Senate Report notes, by way of example, that the alternative regime "does not apply where the person acquired dual citizenship at birth and loses his U.S. citizenship by residing, for a certain period, in the foreign country of which he is also a citizen by birth." *Id.*

60. Stanford G. Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX L. REV. 277, 346 (1967).

61. STAFF OF THE JOINT COMM. ON TAXATION, 104TH CONG., JCS-17-95, ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION G-43 (1995) [hereinafter 1995 JCT REPORT].

62. *Id.* at 61-62.

63. *Id.* at G-43.

64. *See supra* notes 58-59 and accompanying text.

65. *Id.* One practitioner noted that "where tax advice is sought prior to the loss of citizenship, it is likely to be difficult, if not impossible, to counter an IRS claim that the loss of

established a non-tax-avoidance motive, the Service had the significant burden of rebutting that motive, requiring an "[investigation of] the taxpayer's personal motivations regarding expatriation, [compilation of] family histories, and [examination of] the tax regime of the new country or countries of residence. Such an examination [was] tedious and require[d] the cooperation of taxpayers who no longer live[d] in the United States and who generally [were] no longer otherwise subject to U.S. law."[66]

Indeed, even when it did conduct an investigation and commence litigation, the Service was not terribly successful in proving the subjective intent behind an individual's expatriation required to subject him to the alternative regime. In *Furstenberg v. Commissioner*,[67] the Tax Court required that the IRS show that tax motivation was *the* principal purpose—not just one of the former citizen's principal purposes—of expatriation and held that Section 877 did not apply to the taxpayer because she "did not have tax avoidance as one of her principal or 'first in importance' purposes in expatriating."[68] Consequently, the Tax Court made it "more difficult for the IRS to establish tax motivation" in the context of expatriation.[69] Due to the difficulty in successfully proving a tax-avoidance motive, the Service indicated that "it [was] not worthwhile to devote significant resources to the enforcement of [the FITA expatriate provisions]."[70]

Second, Commissioner Richardson identified the limited scope of the expatriate legislation as a primary drawback to the legislation's effectiveness.[71] To avoid expatriate tax treatment, a former citizen could engage in tax-planning techniques following his expatriation. For example, despite the enactment of Section 877(c), an individual post-expatriation could have "contribute[d] U.S. assets into a foreign corporation. The foreign corporation [could have then sold] the U.S. assets and distribute[d] the proceeds of the sale to the expatriate."[72] Thus, the expatriate could effectively (and easily) convert U.S.-source income into foreign-source income which was not subject to U.S. tax under the expatriate income tax provisions. Transfers of such property, either during life or at death, similarly would avoid the expatriate gift and estate tax provisions.

In addition, because the expatriate provisions did not apply to foreign-source

U.S. citizenship had tax avoidance as one of its principal purposes." David S. Zimble, *Expatriate Games: The U.S. Taxation of Former Citizens*, 61 TAX NOTES 617, 618 (Nov. 1, 1993).

66. 1995 JCT REPORT, *supra* note 61, at G-44.

67. Furstenberg v. Comm'r, 83 T.C. 755 (1984).

68. *Id.* at 775-76 (citing Dittler Bros, Inc. v. Comm'r, 72 T.C. 896, 915 (1979), *aff'd without published opinion*, 642 F.2d 1211 (5th Cir. 1981)) (construing the term "principal purpose" to mean "first in rank, authority, importance, or degree") (internal quotation marks omitted).

69. 1995 JCT REPORT, *supra* note 61, at G-44. In the only other expatriate tax-avoidance case brought under Section 877, the Service successfully proved that the taxpayer had expatriated with a principal purpose of tax avoidance. Kronenberg v. Comm'r, 64 T.C. 428 (1975).

70. 1995 JCT REPORT, *supra* note 61, at 63.

71. *Id.* at G-44. Section 877 "applie[d] [only] to a limited category of income and [was] easily avoided." *Id.*

72. *Id.* at G-45.

income or transfers of foreign assets, individuals to whom the expatriate rules applied may not have had significant U.S. tax liability because "a large portion of the income and assets of U.S. citizens living abroad [was] likely to be foreign sourced as a natural outgrowth of their living outside the United States."[73] Moreover, if an expatriate waited ten years after expatriation to realize gain (even on gain that accrued while the taxpayer was a U.S. citizen) or to carry out an inter vivos transfer, the expatriate rules were inapplicable.[74]

Finally, as Commissioner Richardson recognized, monitoring an expatriate's activities, such as realization of gain or inter vivos or deathtime transfers of property, which "require[d] the cooperation of taxpayers who no longer live[d] in the United States and who generally [were] no longer otherwise subject to U.S. law," was administratively impossible.[75] Furthermore, the Service faced an additional procedural barrier in identifying individuals who had relinquished U.S. citizenship in the first place.[76]

In sum, in order to effectively administer the tax provisions applicable to expatriates, the IRS had to overcome significant hurdles, including identifying individuals subject to the tax, investigating those potentially subject to the regime, proving in court that expatriation was primarily motivated by tax avoidance, and tracking income and transfers for ten years following expatriation. Even if the Service had been successful, the tax applied to a limited category of assets, and expatriates could legally employ tax-planning mechanisms to avoid the tax or wait ten years to realize income or to carry out transfers of property that would otherwise be subject to the new regime. Thus, notwithstanding the enactment of FITA, expatriates could still achieve significant tax savings. Consequently, the alternative tax regime enacted under FITA was unsuccessful in curtailing expatriation for tax-avoidance purposes.

C. Health Insurance Portability and Accountability Act of 1996

1. Enactment of the Health Insurance Portability and Accountability Act of 1996

In response to the expatriate tax regime's inherent administrative and substantive flaws under FITA, a number of wealthy Americans took advantage of the beneficial tax treatment afforded to expatriates by relinquishing citizenship. Popular media publications—including the New York Times, Forbes Magazine, and Time Magazine, among others—demonized the expatriations of high-profile

73. Zimble, *supra* note 65, at 620.

74. 1995 JCT REPORT, *supra* note 61, at G-44. Similarly, if an expatriate survived at least ten years following the date of his expatriation, the expatriate estate tax provision would be inapplicable. I.R.C. § 2107 (1996).

75. 1995 JCT REPORT, *supra* note 61, at G-45.

76. In a letter to Robert Packwood, Vice Chairman of the Joint Committee on Taxation, the Department of State indicated that "[i]t generally refuse[d] to confirm or to deny an individual's citizenship status in response to inquiries from third parties." *Id.* at G-32.

Americans, prompting the Clinton Administration and Congress to overhaul the expatriate tax regime and "close what [President Clinton] [saw] as an unfair tax loophole for the super-rich."[77] Indeed, prior to the 1996 legislative action regarding expatriate taxation, "President Clinton and many Democrats persist[ed] in deriding [expatriates] as unpatriotic."[78]

Following the Clinton Administration's proposal for a revised expatriate tax regime, the Houses of Congress battled over the most effective course of action to contend with the problem of expatriate taxation.[79] While the Senate supported the

77. Jennifer Lin, *Campbell Soup Heir Escapes Taxes—In Ireland*, BUFFALO NEWS, July 16, 1995, at A8. In a February 1995 press release, the U.S. Department of the Treasury announced that "the Clinton Administration was proposing legislation aimed at 'stopping U.S. multimillionaires from escaping taxes by abandoning their citizenship or by hiding their assets in foreign tax havens.'" 1995 JCT REPORT, *supra* note 61, at 11; *see also* 141 CONG. REC. H3998 (daily ed. Mar. 30, 1995) (Rep. Robert Matsui stated: "Forbes Magazine last year wrote a major piece on the number of people that are taking advantage of [tax-motivated expatriation]. . . . They said, this is outrageous; they are taking advantage of the Tax Code."); Alan S. Lederman & Bobbe Hirsh, *New Tax Liabilities and Reporting Obligations Imposed on Expatriates*, 85 J. TAX'N 325, 325 (1996) (noting that the changes to expatriation legislation were enacted "[i]n response to increased publicity regarding U.S. citizens . . . who obtain tax benefits through expatriation").

78. Lin, *supra* note 77. The author notes that "Rep. Patricia Schroeder, D.-Colo., attacked Dorrance in a . . . speech on the floor of the House of Representatives: 'Every time you buy a jar of soup, think of that can of soup and the guy living in Ireland, thumbing his nose at American taxpayers. That is what this is about.'" *Id.* One New York Times article described Clinton's proposal to tax expatriates, singling out Joseph Bogdanovich, former vice chairman of the Heinz Company, and detailing the potentially significant amount of revenue the tax would capture. Robert D. Hershey, Jr., *Closing a Tax Loophole and Opening Another*, N.Y. TIMES, July 10, 1995, at A1. Another article identified expatriates who escaped millions of dollars of U.S. income and transfer taxes purportedly for reasons other than expatriation, including the founder of Carnival Cruise Lines and the Campbell Soup heir. Karen DeWitt, *Some of Rich Find a Passport Lost is a Fortune Gained*, N.Y. TIMES, Apr. 12, 1995, at A1. In another article, a partner at a large Philadelphia law firm stated that he "talk[s] to a new client interested in expatriating every week" because "[m]any people can't pay the federal tax rate and live in the style they want." Robert Lenzner & Philippe Mao, *The New Refuges*, FORBES, Nov. 21, 1994, at 131. That piece, which portrays other ultra-wealthy expatriates (Robert Miller, co-owner of Duty Free Shoppers International Ltd.; Jane Siebels-Kilnes, vice president of Templeton, Galbraith & Hansberger), describes strategies to expatriate and worthwhile expatriation destinations. *Id.* In a scornful response to *The New Refugees*, one journalist fueled the legislative fire by describing expatriates as "fleeing the draft – of their wallets, not their bodies." Michael Kinsley, *Love It or Leave It*, TIME, Nov. 28, 1996, at 96.

79. The Clinton Administration "advocated an alternative approach, contained in the Senate version of the 1996 legislation and ultimately rejected, under which individuals who left U.S. tax jurisdiction [i.e., expatriated], irrespective of motive, generally would be deemed to have sold their assets at [fair market value] on the date of loss of citizenship or residency and would be taxed on gains in excess of $600,000. The taxpayer could elect to defer the tax until death or actual sale of the asset if a bond were posted to cover the tax on the deemed sale plus interest on the deferred tax. Alternatively, the departing person could elect to be subject to U.S. income and transfer taxes as a U.S. citizen on a modified basis, if a bond were posted to secure payment of the tax. A U.S. person who received an inheritance or gift from the departing person would be subject to U.S. income tax on its value." Lederman & Hirsh, *supra* note 77, at 328. For a comprehensive overview of the legislative history resulting in the enactment of HIPAA, *see* Kirsch, *supra* note 23, at 883-86.

Administration's approach, the House "generally favored retaining the existing expatriate regime."[80] In April 1995, Congress directed the Joint Committee on Taxation ("Joint Committee") to report on issues relating to the tax treatment of expatriation and the Clinton Administration's proposed expatriate tax reforms.[81] The Joint Committee presented the results of its study on June 1, 1995, finding shortcomings under both the FITA expatriate tax regime as well as the Administration's proposal.[82] Congress nevertheless enacted the House's modifications of the extant alternative tax regime as part of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA").[83]

2. Dissuading Tax-Motivated Expatriation Under HIPAA's Alternative Tax Regime

HIPAA was the first piece of legislation to significantly modify the alternative tax regime. While recognizing "that U.S. citizens have a basic right under both U.S. and international law . . . to relinquish their citizenship," Congress enacted these modifications in an attempt to achieve FITA's objectives of removing tax incentives for expatriation.[84] In enacting HIPAA, Congress was determined to overcome the shortcomings of FITA's alternative tax regime by "expand[ing] and substantially strengthen[ing] in several ways the [then] present-law provisions that subject[ed] U.S. citizens who los[t] their citizenship for tax avoidance purposes to special tax rules for 10 years after such loss of citizenship."[85]

As was the case under FITA, a U.S. citizen who abandoned his citizenship for tax-avoidance purposes remained subject to the alternative tax regime for a period of ten years following the date of his expatriation.[86] In addition, HIPAA enlarged

80. Jeffrey M. Colón, *Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy*, 34 SAN DIEGO L. REV. 1, 4 (1997).

81. Act of Apr. 11, 1995, Pub. L. No. 104-7, § 6, 109 Stat. 93 (1995).

82. *See* 1995 JCT REPORT, *supra* note 61, at 1-5.

83. Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, § 511, 110 Stat. 1936 (1996).

84. 2003 JCT REPORT, *supra* note 36, at 79. Though Congress purportedly intended to remove the tax incentives of expatriation when modifying the FITA alternative tax regime through HIPAA, shortly following the enactment of HIPAA, Congress enacted the Illegal Immigration Reform and Immigrant Responsibility Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009-546 (1996), which barred from entry to the United States former U.S. citizens who had relinquished citizenship for tax-avoidance purposes. 8 U.S.C. § 1182(a)(9)(E) (1996) (subsequently renumbered as 8 U.S.C. § 1182(a)(10)(E)). Such an endeavor suggests that Congress's intent in enacting both pieces of legislation may at least in part have been punitive. *See* Lederman & Hirsh, *supra* note 77, at 325; *see also* Robert Lenzner, *And Don't Come Back*, FORBES, Nov. 18, 1996, at 44-45 ("'[T]axpatriates' will now be treated as exiles without any visiting rights, just like the illegal immigrants the U.S. wants to cut off."). In any case, as of February 2003, no former citizen had been denied reentry to the U.S. under this immigration provision. 2003 JCT REPORT, *supra* note 36, at 5.

85. H.R. REP. NO. 104-736, at 273, *reprinted in* 1996 U.S.C.C.A.N. 1990, 2136.

86. I.R.C. §§ 877, 2107, 2503(a)(3) (1996).

the expatriate tax base under FITA by subjecting certain former long-term resident aliens of the United States to the same expatriate tax regime as former U.S. citizens.[87] Residents who terminated their residency status for tax-avoidance purposes were subject to the alternative regime for the ten-year period following residency termination only if they had held permanent residence status for at least eight of the fifteen years prior to the date of expatriation.[88] Prior to the enactment of HIPAA, former U.S. permanent residents had faced no such tax consequences.[89]

HIPAA purported to simplify the determination of whether an individual expatriated[90] with a principal purpose of avoiding federal tax by taking an objective approach.[91] While FITA required a showing by the IRS that the expatriate's *subjective* purpose in relinquishing citizenship was to avoid tax, an expatriate under HIPAA was statutorily presumed to have expatriated to avoid taxes if one of two objective tests was fulfilled: (1) the tax liability test or (2) the net worth test.[92] Under the tax liability test, the expatriate regime applied to an individual whose average annual U.S. income tax liability for the five years preceding the date of his expatriation was greater than $100,000 (indexed for inflation if expatriation occurred after 1996).[93] Under the net worth test, an individual whose net worth was at least $500,000 (indexed for inflation if expatriation occurred after 1996) on the date of his expatriation was subject to the expatriate tax.[94] Thus, an individual meeting *either* test was subject to both the expatriate income and transfer tax provisions. In addition, even where an individual did not meet either of these two tests, the HIPAA regime retained as a backstop FITA's subjective approach: a former citizen's or resident's expatriation with the principal purpose of avoiding tax triggered application of the expatriate tax provisions.[95]

Still, Congress excluded from the expatriate provisions certain former citizens to whom the regime would otherwise have applied if such persons had requested a private letter ruling from the IRS within one year of expatriation.[96]

87. I.R.C. § 877(e)(1) (1996).

88. I.R.C. § 877(e)(2) (1996). For purposes of the eight-year residency test, an alien was not deemed a lawful permanent resident for any year during which the alien was considered a resident alien of another country under a U.S. tax treaty with that country so long as the alien did not elect to waive the treaty's benefits. *Id.*

89. *See* Colón, *supra* note 80, at 48 ("Under the FITA expatriate regime, resident aliens were subject to the expatriate income tax regime only if they abandoned U.S. residency and regained it within three calendar years.").

90. The term "expatriate" is hereinafter used to refer both to former U.S. citizens who had relinquished citizenship as well as former residents of the United States who had terminated their residency.

91. I.R.C. §§ 877(a)(2), 2107(a)(2)(A), 2501(a)(3)(B) (1996).

92. I.R.C. § 877(a)(2) (1996).

93. *Id.*

94. *Id.*

95. I.R.C. § 877(e) (1996).

96. I.R.C. § 877(c)(1)(A)-(B) (1996); I.R.S. Notice 97-19, 1997-1 C.B. 394, *as modified by* I.R.S. Notice 98-34, 1998-2 C.B. 29 [hereinafter Notice 97-19]. Such former citizens included: (1) those who held dual citizenship at birth and continued to be citizens of the other country; (2)

Notwithstanding fulfillment of the requirements of either the tax liability test or the net worth test, these individuals avoided expatriate tax treatment by obtaining an IRS ruling to the contrary—that the expatriation did not have tax avoidance as one of its principal purposes.[97]

As with the alternative regime under FITA, the HIPAA modified expatriate tax regime applied only where the expatriate's tax liability under the expatriate tax provisions exceeded the tax calculated as if the expatriate were a non-expatriate nonresident alien.[98]

a. Expatriate Income Tax Rules under HIPAA

While non-expatriate nonresident aliens still enjoyed favorable tax rates,[99] the federal government under HIPAA continued to tax expatriates' income effectively connected with a trade or business in the United States and U.S.-source income not effectively connected with a trade or business in the United States at the graduated income tax rates to which U.S. citizens were subject.[100] However, an expatriate's foreign-source income, as under FITA, was not subject to tax.[101]

The HIPAA alternative tax regime continued to tax an expatriate's income under FITA's broader definition of U.S.-source income as compared to that which applied to non-expatriate nonresident aliens. Specifically, HIPAA continued to tax expatriates on U.S.-source income and gain resulting from the disposition of both tangible and intangible property located in the United States, including stock held in U.S. corporations and debts of U.S. persons,[102] while income from the sale of personal property owned by non-expatriate nonresidents would have constituted

those who obtained citizenship in the country of their or their parents' or spouse's birth; (3) those who had spent no more than thirty days in the United States during any of the ten years preceding the date of expatriation; and (4) those who expatriated prior to attaining age eighteen and a half. I.R.C. § 877(c)(2) (1996).

97. Section 877(e)(3)(A) provided that Section 877(c), which allowed former U.S. citizens who fulfilled one of the two objective tests to apply for a ruling from the IRS so as not to be taxed as an expatriate, did not allow former resident aliens who met the requirements of one of those tests to do the same. I.R.C. § 877(e)(3)(A) (1996). In 1997, however, the IRS issued Notice 97-19, modified in 1998 by Notice 98-34, which allowed long-term U.S. residents who became fully liable to tax in that country by reason of the individual's residence to submit a ruling request if: (1) the individual became within a reasonable period a resident fully liable to income tax in the country where he, his spouse, of his parents were born; (2) the individual was not present in the United States for more than thirty days during each year for the ten-year period preceding his expatriation; or (3) the individual ceased to be taxed as a lawful permanent resident or commenced to be treated as a resident of another country under an income tax treaty and did not waive the benefits of such treaty applicable to residents of the foreign country before reaching age eighteen and one half. Notice 97-19, *supra* note 96. These exceptions replicate those applicable to former U.S. citizens.

98. I.R.C. § 877(b) (1996).

99. *See* I.R.C. § 871 (1996) (providing for a flat 30% tax rate on a non-expatriate nonresident alien's income not connected with a U.S. trade or business).

100. I.R.C. § 877(b)(1), (c) (1996).

101. I.R.C. § 877(b) (1996).

102. I.R.C. § 877(d)(1)(A)-(B) (1996).

non-taxable foreign-source income.[103]

Moreover, in response to the relative ease by which expatriates could convert U.S.-source gains into non-taxable foreign-source gains, HIPAA cast a broader net by expanding FITA's characterization of U.S.-source income.[104] For example, income or gain derived from foreign stock constituted U.S.-source income if, at any time within the two years preceding expatriation, the expatriate owned more than fifty percent of either the total value of stock or voting power of the corporation.[105]

Further, to preclude a citizen or long-term resident contemplating expatriation from converting U.S. assets to foreign assets, the modified alternative tax regime under HIPAA provided a new rule requiring that an expatriate immediately recognize gain on the exchange of property producing U.S.-source income for property producing foreign-source income, determined as if the property had been sold at its fair market value.[106] However, this immediate gain recognition rule would not apply if the expatriate and the IRS entered into an agreement whereby any income or gain derived from the property producing foreign-source income acquired in that exchange would be treated as U.S.-source income.[107] Upon the expatriate's subsequent disposition of the newly acquired property, that agreement would terminate, and the expatriate would recognize any unrecognized gain.[108]

Also intended to impede planning opportunities, HIPAA prevented expatriates from avoiding income tax by transferring property that produced U.S.-

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103. I.R.C. § 865(a)(2) (1996).

104. H.R. REP. NO. 104-736, *supra* note 85, at 275-76.

105. I.R.C. § 877(d)(1)(C) (1996). The amount of income subject to tax was limited to the amount of the corporation's earnings and profits attributable to the expatriate's stock that were earned and accumulated (1) prior to his expatriation and (2) during periods that the aforementioned ownership requirements were met. *Id.*

106. I.R.C. § 877(d)(2)(A)-(B) (1996). While this rule applied to non-recognition exchanges occurring during the ten-years following expatriation, Notice 97-19, *supra* note 96, expanded Section 877(d)(2)(A)-(B) to non-recognition exchanges occurring within the five-year window before an individual's expatriation. 2003 JCT REPORT, *supra* note 36, at 107. In addition, Notice 97-19 treated as an "exchange" subject to this rule the removal from the United States of appreciated tangible personal property having an aggregate fair market value in excess of $250,000 within the fifteen-year period beginning five years before an individual's expatriation. *Id.*

107. I.R.C. § 877(d)(2)(C) (1996).

108. *Id.* For example, assume an expatriate owned stock in X Corp., a U.S. corporation, with a basis of $100,000 and a fair market value of $150,000. The expatriate (subject to the HIPAA expatriate provisions) transferred that stock to X Corp.'s wholly-owned foreign subsidiary corporation, Z Corp., and received stock in Z Corp. in return. Before HIPAA, the expatriate would not have recognized gain on the exchange. *See* I.R.C. § 351(a). On the date of the exchange, the expatriate would be deemed to have sold the X Corp. stock for $150,000 (its fair market value) and would have been subject to income tax on the $50,000 gain. Had the expatriate entered into a gain recognition agreement, he would not have experienced gain as of the date of the exchange, however he would have been subject to tax on dividend income derived from Z Corp., as such income would have been treated as U.S.-source income. Finally, if the expatriate caused Z Corp. to dispose of the X Corp. stock, the gain recognition agreement would terminate, and the expatriate would have had to realize the $50,000 of gain at that time. *See* H.R. REP. NO. 104-736, *supra* note 85, at 327 (discussing a similar hypothetical scenario).

source income that otherwise would be taxable to the expatriate to a controlled foreign corporation.[109] HIPAA provided that the expatriate, who would have been a U.S. shareholder (as defined under Section 951(b)) but for his relinquishment of citizenship or termination of residency, would be liable for the tax on such income earned by the foreign corporation and on gain from the transfer.[110]

b. Expatriate Estate & Gift Tax Rules Under HIPAA

As with FITA, if an expatriate relinquished citizenship (or terminated residency) for tax-avoidance purposes within the ten-year period prior to his death, the Section 2107 estate tax provisions applied.[111] Consistent with U.S. estate tax treatment of nonresident aliens, Section 2107 continued to subject to federal estate tax an expatriate decedent's gross estate located within the United States, including real and tangible property as well as stock issued by a U.S. corporation.[112]

In addition, HIPAA expanded the scope of property to which U.S. estate tax applied. Section 2107 captured as part of the expatriate decedent's estate the ratio of the stock in a foreign (non-U.S.) corporation owned by the decedent at the time of his death to the value of assets owned by that foreign corporation that were located in the United States (as compared to that corporation's total assets worldwide) if (1) he owned at least ten percent of the total combined voting power in the corporation, or (2) he owned or constructively owned more than fifty percent of the total voting power of all classes of stock of the corporation.[113] Section 2107 had the effect of preventing the expatriate from transferring U.S.-situs assets to a foreign corporation and then transferring the stock in the corporation free of transfer tax where such assets remained in the United States.[114]

The HIPAA gift tax provisions remained the same as those under FITA. While the federal gift tax for aliens limited its reach to gifts of tangible U.S.-situs property only, the expatriate gift tax under HIPAA, as under FITA, attached to lifetime transfers of both tangible and intangible property, such as a gift of stock in a domestic corporation.[115]

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109. I.R.C. § 877(d)(4) (1996); *see also* Colón, *supra* note 80, at 53 ("Under the FITA expatriate regime, an expatriate could transfer property to a foreign corporation tax-free under Section 351 and have the foreign corporation accrue the income. If the foreign corporation were incorporated in a treaty country, the U.S. tax could be reduced or limited under an applicable treaty provision. In addition, a sale of the property by the foreign corporation would not have been taxed under section 877.").

110. I.R.C. § 877(d)(4) (1996).

111. I.R.C. § 2107(a)(1) (1996).

112. I.R.C. § 2107(b) (1996).

113. *Id.* In other words, "the value of stock of a closely held foreign corporation that own[ed] U.S. situs assets [was] part of the expatriate's taxable estate." Colón, *supra* note 80, at 57.

114. Colón, *supra* note 80, at 57.

115. I.R.C. §§ 2501(a)(2)-(3) , 2511(a) (1996).

3. The Failure of HIPAA

While the HIPAA alterations to the existing tax treatment of U.S. expatriates applied to a broader tax base (through the addition of long-term resident aliens) and subjected a broader range of items to which income and transfer taxes attached (through redefining U.S.-source income to include income from certain foreign assets), the modified regime, like FITA, failed to adequately remove the tax incentives of expatriation. As an initial matter, the IRS generally did not enforce the provisions of the alternative regime, primarily (and understandably) because expatriates neglected to alert the IRS of their expatriation.[116] Accordingly, the Service was unable to track expatriates' activities over the ten-year period that would have triggered the alternative tax.[117]

Furthermore, expatriates satisfying the tax liability and net worth tests still could have avoided expatriate tax treatment by obtaining an IRS ruling that expatriation did not occur for the principal purpose of avoiding federal income or transfer taxes.[118] One practitioner suggested that "an expatriating U.S. citizen determined to avoid full U.S. taxation could have done so by marrying a nonresident alien, submitting a ruling request to the IRS indicating the intention to renounce her U.S. citizenship, and moving to the country of the spouse's birth."[119] While Congress intended that the determination of tax-avoidance motive be objective, private IRS rulings necessarily required a subjective evaluation of the expatriate's intent.[120] Thus, Congress failed to remedy the same underlying problem that had afflicted the FITA regime.

In addition, like FITA, because the expatriate provisions did not apply to transfers of foreign assets nor to foreign-source gain, individuals "contemplating expatriation [had] an incentive to forego investments in the U.S.," and therefore may not have had significant U.S. tax liability under the HIPAA regime following expatriation.[121] Also, because the HIPAA estate and gift tax provisions did not include the expanded definition of U.S.-source property, an expatriate could have converted U.S. property to foreign property by transferring U.S. property to a controlled foreign corporation or exchanging U.S.-source property for stock in a

116. *See* 2003 JCT REPORT, *supra* note 36, at 5 (stating that a key reason for lack of enforcement was the difficulty in obtaining necessary information from expatriates).

117. *Id.*

118. An expatriating individual meeting the objective thresholds who did not fall within one of the exclusion categories set forth in Notice 97-19, *supra* note 96, may have found himself automatically subject to the expatriate provisions. Lederman & Hirsh, *supra* note 77, at 329.

119. Eva Farkas-DiNardo, *Is the Nation of Immigrants Punishing its Emigrants: A Critical Review of the Expatriation Rules Revised by the American Jobs Creation Act of 2004*, 7 FLA. TAX REV. 1, 30 (2005).

120. *See id.* For citizens who relinquished citizenship and long-term residents who terminated their residency and did *not* meet either of the objective tests, the HIPAA tax regime required a subjective evaluation of their expatriation motives as was the case under FITA. 2003 JCT REPORT, *supra* note 36, at 119.

121. Colón, *supra* note 80, at 59; *see also* 2003 JCT REPORT, *supra* note 36, at 108 ("Nothing prevents an individual from investing in foreign-source assets over time. In fact, the more time an individual spends abroad, the more likely that is to occur.").

foreign corporation (i.e., foreign-source property), suffered the income tax,[122] and, following expatriation, transferred the foreign stock during life or at death.[123] By structuring the transaction this way, the expatriate could have avoided gift and estate tax.[124] Moreover, as under FITA, the HIPAA expatriate provisions were inapplicable to expatriates who waited ten years after expatriation to carry out an inter vivos transfer or to realize gain through disposition of property, even if the gain that accrued constituted U.S.-source income under the broader HIPAA definition.[125]

Further, though HIPAA subjected permanent residents to the expatriate regime if they held permanent residence status for eight of the fifteen years prior to the date of expatriation, it failed to tax both (1) permanent residents who had not resided as permanent residents for the same period prior to terminating their residency status and (2) residents who did not hold permanent residence status but who had been resident in the United States for eight of the fifteen years prior to their departure. While "[s]ound tax policy would dictate that all persons leaving residence basis taxation who satisfy [the HIPAA objective] thresholds be subject to the expatriate regime, regardless of the duration of time that they were subject to residence basis taxation,"[126] Congress's bright-line approach provided opportunities for tax planning: an individual could have consciously decided not to become a lawful permanent resident or, if he had already adjusted his status, could have chosen to terminate residency before commencing his ninth year as a permanent resident in the United States in order to remain beyond the scope of the rule.[127]

Thus, HIPAA's modifications to the expatriate tax regime failed to execute Congress's mission to remove the tax incentives of expatriation. While HIPAA expanded classes of persons to whom the expatriate tax regime applied to include certain long-term residents, its bright line application excluded certain resident aliens in the United States from expatriate tax treatment. Even if the IRS had determined that a former citizen or resident had expatriated for tax-avoidance purposes, it had no mechanism by which to track income and transfers during the

122. *See* I.R.C. § 877(d)(2), (4) (1996); 2003 JCT REPORT, *supra* note 36, at 131 ("To the extent that the income tax rules under the alternative tax regime appl[ied] to certain conversion or exchange transactions, they may not [have been] sufficient to deter estate and gift tax avoidance, because the income tax applie[d] at rates substantially lower than those under the estate and gift tax. Moreover, the income tax provisions appl[ied] to the extent there is gain, depending on the value and the basis of the property. The estate and gift tax applie[d] to the value of a taxpayer's entire interest in property. Thus, the income tax rules may [have] serve[d] as an inadequate deterrent in many cases of individuals who [sought] to avoid U.S. estate and gift tax.").

123. Lederman & Hirsh, *supra* note 77, at 331-32.

124. *Id.*

125. Similarly, if an expatriate survived at least ten years following the date of his expatriation, the expatriate estate tax provision would be inapplicable. I.R.C. § 2107 (1996).

126. Colón, *supra* note 80, at 49.

127. *See* Lederman & Hirsh, *supra* note 77, at 329-330.

ten years following expatriation.[128] Further, HIPAA's reach was limited to U.S. property, and individuals contemplating expatriation could have engaged in tax planning strategies to legally recharacterize U.S. property as foreign property. Finally, like FITA, HIPAA did not apply where an expatriate retained possession of U.S. property beyond the ten-year window following expatriation before realizing income or transferring that property. Consequently, notwithstanding the enactment of the HIPAA modified expatriate tax regime, former citizens and long-term residents purportedly subject to the expatriate tax regime continued to enjoy the tax benefits available to nonresident non-expatriate individuals.

D. American Jobs Creation Act of 2004

1. American Jobs Creation Act of 2004: Another Attempt to Dissuade Tax-Motivated Expatriation Under the AJCA's Alternative Tax Regime

The American Jobs Creation Act ("AJCA"),[129] signed into law on October 22, 2004, was enacted as another attempt to eliminate tax incentives associated with expatriation and serves as Congress's second overhaul of the alternative tax regime originally established under FITA. Congress implemented some of the Joint Committee on Taxation's recommendations in enacting the AJCA, including: (1) new objective tests to determine whether an expatriate is subject to the alternative regime with limited, objective exceptions; (2) a new rule that subjects expatriates who return to the United States for more than thirty days in a year to normal income and transfer tax rules applicable to U.S. persons; and (3) an expanded expatriate gift tax provision.[130]

a. Completely Objective Inquiry

Based on the Joint Committee's recommendation, Congress amended Section 877 under the AJCA to implement new objective tests in order to conclusively determine whether a U.S. citizen's or resident's expatriation was tax motivated and, hence, whether the individual is subject to the alternative tax regime.[131] Unlike the subjective approach under FITA and HIPAA, which had proven difficult to administer, an expatriate's actual intent for expatriation is no longer relevant under the AJCA.

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128. For an extensive discussion of the IRS' barriers to enforcing the HIPAA expatriate tax regime, *see* 2003 JCT REPORT, *supra* note 36, at 83-102.

129. In 1999, the Joint Committee on Taxation was again directed to review the HIPAA alternative tax regime and to determine "whether [the modified expatriate tax] rules [had] been applied in the manner intended by Congress and whether the rules [had] been effective in deterring tax-motivated citizenship relinquishment and residency termination." 2003 JCT REPORT, *supra* note 36, at 1. The Joint Committee issued its findings in a February 2003 report along with recommendations for the improvement of the expatriate regime. *Id.*

130. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1571 (2004); *see* 2003 JCT REPORT, *supra* note 36, at 204. The alternative tax regime under the AJCA continues to apply to expatriates who relinquished citizenship or terminated residency prior to June 16, 2008.

131. I.R.C. § 877(a)-(b) (2012); *see* 2003 JCT REPORT, *supra* note 36, at 205-08.

The AJCA's alternative tax regime applies to "covered expatriates," which includes any former citizen or long-term resident[132] who: (1) had an average annual net income tax liability for the five years preceding expatriation of more than $124,000 (indexed for inflation) [income tax test]; (2) had a net worth of at least $2 million (not indexed for inflation) at the time of expatriation [net worth test]; or (3) failed to certify under penalty of perjury that he had complied with U.S. tax law during the five-year period preceding his expatriation [legal compliance test].[133] Consistent with prior iterations of the expatriate regime, the AJCA's expatriate rules subject covered expatriates to federal income and transfer taxes for a period of ten years following the expatriate's relinquishment of citizenship or termination of residency.[134]

The AJCA abandoned HIPAA's exception for individuals who obtained a favorable ruling from the IRS that their expatriation was not tax motivated and excludes certain former citizens from expatriate tax treatment only if they fall within one of two narrow, objective exceptions.[135] Under the first exception, the expatriate regime does not apply if the former citizen: (1) became a dual citizen of the United States and another country at birth; (2) continued to be a citizen of that other country; and (3) had never had substantial contact with the United States.[136] Under the second exception, the expatriate regime does not apply if: (1) the former citizen was a U.S. citizen at birth; (2) neither of his parents were U.S. citizens when he was born; (3) he had not reached the age of eighteen and one half when he relinquished his citizenship; and (4) he had not been present in the United States for more than thirty days during any of the ten years preceding his loss of citizenship.[137]

b. New Rule for Expatriates who Return to the United States for Extended Periods

To prevent an expatriate from taking advantage of the tax benefits of expatriation while maintaining a level of physical presence in the United States, the AJCA also provides a new rule whereby any covered expatriate who is physically present in the United States for more than thirty days during any year

132. The definition of lawful permanent resident remains the same under the AJCA as it was under HIPAA: the Code defines a long-term resident as an individual who held lawful permanent resident status (i.e., a green card holder) for eight of the prior fifteen years. I.R.C. §§ 877(e), 7701(b)(6).

133. *Id.* § 877(a).

134. *Id.*

135. The AJCA provides no exceptions for former *long-term residents* who are subject to its expatriate regime.

136. I.R.C. § 877(c)(2). An individual has no substantial contacts if he (i) was never a resident of the United States (as defined in Section 7701(b)), (ii) has never held a U.S. passport, and (iii) had not been present in the United States for more than thirty days during any of the ten years preceding his loss of citizenship. *Id.*

137. *Id.* § 877(c)(3).

within the ten-year period following his expatriation is taxed as a U.S. resident.[138] However, a covered expatriate can exclude a maximum of thirty days per year from the calculation if (1) he is in the United States for work for a non-related employer (days excluded are limited to actual workdays only) and (2) he retains ties to another country or has had "minimal prior physical presence in the United States."[139]

c. Expatriate Income Tax Rules Under the AJCA

HIPAA's income tax rules remain generally unchanged under the AJCA: while foreign-source income generally avoids federal tax, a covered expatriate continues to be taxed on income derived from U.S. sources at the graduated rates normally applicable to U.S. persons.[140] The same expanded anti-abuse source rules apply, including taxing as U.S.-source income gain from the sale or exchange of property located in the United States; gain from the sale or exchange of U.S. stock or debt obligations of a U.S. person; and income or gain from a controlled foreign corporation if the expatriate owned or constructively owned at any time during the two years preceding his expatriation more than fifty percent of the total voting power or total value of the stock in that corporation.[141] In addition, as under HIPAA, the alternative tax regime requires an expatriate who exchanges property that produces U.S.-source income for property that produces foreign-source income that otherwise would not result in recognition to recognize gain, calculated as if the property is sold at fair market value.[142] Finally, if an expatriate contributes property that produces U.S.-source income to a controlled foreign corporation at any time during the fifteen-year period beginning five years before his expatriation, he is liable for any income or gain earned by the foreign corporation.[143]

d. Expatriate Estate and Gift Tax Rules Under the AJCA

As with the AJCA expatriate income tax provisions, the AJCA estate tax rules largely continue HIPAA's alternative tax regime. The AJCA continues to levy tax on the transfer of an expatriate decedent's estate as if he were a non-expatriate

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138. *Id.* § 877(g); *see* 2003 JCT REPORT, *supra* note 36, at 210-12. Recall that U.S. citizens and permanent residents are subject to U.S. tax on their worldwide income, on all inter vivos transfers, and on transfers of their worldwide assets at death. *See supra* Part II.B. This new rule is significant, as foreign assets for covered expatriates, as for non-expatriate nonresident aliens, are generally free of income, gift, and estate taxes.

139. I.R.C. § 877(g)(2). "Minimal prior physical presence in the U.S." means that, for each year during the ten-year period prior to an individual's expatriation, he was physically present in the United States for thirty days or less.

140. *Id.* § 877(b).

141. *Id.* § 877(d)(1).

142. *Id.* § 877(d)(2). Section 877(d)(2) does not apply if the expatriate entered into a gain recognition agreement with the Secretary of the Treasury providing that, during the ten-year period following expatriation, any income or gain derived from the foreign-source property acquired in the exchange is treated as U.S.-source income. *Id.* § 877(d)(2)(C).

143. *Id.* § 877(d)(4).

nonresident alien[144] and also subjects to tax the proportion of the value of the stock in a foreign (non-U.S.) corporation owned by the decedent at the time of his death to the assets owned by that foreign corporation that were located in the United States as compared to that corporation's total assets worldwide if (1) the expatriate owned at least ten percent of the total combined voting power in the corporation and (2) he owned or constructively owned more than fifty percent of the total voting power of all classes of stock of the corporation.[145]

The AJCA gift tax generally remains unchanged. While non-expatriate nonresident aliens are not subject to gift tax on gifts of intangible property,[146] such as corporate stock, the expatriate provisions tax covered expatriates on any inter vivos transfers of property, both tangible and intangible.[147] In addition, the AJCA modified the expatriate gift tax provisions as recommended by the Joint Committee[148] to apply to gifts of stock in a foreign corporation so long as the expatriate, at the time of the transfer, owns at least ten percent "of the total combined voting power of all classes of stock entitled to vote" in the corporation and constructively owns under the attribution rules fifty percent or more of either the total voting power of all classes of stock entitled to vote in the corporation or of the total value of the corporation's stock.[149]

2. The Shortcomings of the AJCA

The AJCA made significant strides pertaining to the tax treatment of expatriates, including the establishment of wholly objective tests to determine the persons to whom the alternative regime applies, which increased the administrability of the regime, and the creation of the thirty-day physical presence rule, which decreased potential for tax avoidance.[150] Nevertheless, the modified regime continues to suffer from the same inherent structural flaws as the FITA and HIPAA regimes. For example, foreign property owned by a covered expatriate falls beyond the scope of the expatriate provisions. In addition, the regime's limited ten-year scope perpetuates enforceability problems under the prior regimes, as an expatriate to whom the regime applies could wait ten years following his expatriation to realize gain or transfer property that otherwise would be subject to

144. *See id.* § 2103 (defining non-expatriate nonresident alien decedent's gross estate for purposes of the U.S. estate tax). Federal estate tax generally applies only to a non-expatriate nonresident alien decedent's property located in the United States. *Id.* §§ 2103, 2106.

145. *Id.* § 2107(b).

146. *Id.* § 2501(a)(2).

147. *Id.* § 2501(a)(3).

148. 2003 JCT REPORT, *supra* note 36, at 212-13.

149. I.R.C. § 2501(a)(5). This rule parallels the estate tax rule in Section 2107(b). The taxable gift includes that portion of the fair market value of the stock in the foreign corporation transferred by the expatriate which the fair market value of any asset owned by that corporation and situated in the United States bears to the total value of all of the foreign corporation's assets. *Id.* § 2501(a)(5)(C). The rule applies whether or not the stock was situated in the United States. *Id.* § 2501(a)(5)(A)(i).

150. Farkas-DiNardo, *supra* note 119, at 32, 39.

the regime, removing from federal tax jurisdiction any value accrued while the expatriate was a U.S. citizen or resident. Accordingly, while the AJCA certainly improved the alternative tax regime, it failed to adequately remove the tax incentives associated with relinquishment of citizenship or termination of residency.

IV. HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008: NEW SECTIONS 877A & 2801

A. Winds of Change: Enactment of the HEART Act

The federal government had not yet abandoned its efforts to eradicate tax-motivated expatriation, notwithstanding its failure to do so through prior legislation. Before it enacted HIPAA and the AJCA, Congress had considered implementing a novel approach to expatriate taxation, focused primarily on a mark-to-market exit tax, that would replace the FITA regime altogether.[151] Finally, legislators in support of a mark-to-market exit tax succeeded in enacting the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act").[152]

In enacting the HEART Act, Congress replaced the prior alternative tax regime under the AJCA for individuals expatriating after June 16, 2008[153] with a new approach to expatriate taxation that considerably modified both the transfer tax and income tax rules applicable to covered expatriates. Whereas the pre-HEART Act expatriate rules imposed tax on income and transfers during the ten-year period following an expatriate's relinquishment of citizenship or termination of residency, new Section 877A taxes a covered expatriate's unrealized gain on his worldwide property as of the day before expatriation, and new Section 2801 imposes an inheritance tax on the recipient of an expatriate's property as a result of the expatriate's transfer by gift or bequest.

B. The HEART Act: Current Taxation Treatment of Expatriates

Like the AJCA, the HEART Act's expatriation provisions apply only to "covered expatriates": U.S. citizens who relinquish citizenship and long-term

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151. For example, President Clinton's administration proposed an exit tax in 1995, which was introduced in Congress in 1996 by Senator Moynihan and subsequently rejected in favor of the modified FITA alternative tax regime. *See* U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 16 (1995); S. 700, 104th Cong. (1995) (introducing a mark-to-market provision where expatriate's property would be treated as sold for tax purposes immediately before expatriation). *See generally* 2003 JCT REPORT, *supra* note 36, at 177-203 (describing various legislative activity relating to the mark-to-market expatriate tax treatment).

152. Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624 (2008).

153. STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., JCX-44-08, TECHNICAL EXPLANATION OF H.R. 6081, THE "HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008," AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON MAY 20, 2008 45-46 (2008) [hereinafter 2008 JCT REPORT].

residents[154] who terminate their residency status and who fulfill one of the three objective tests (income tax, net worth, and legal compliance tests) established under the AJCA's revision of the alternative regime under Section 877(a)(2).[155] As under the AJCA, an expatriate's actual motivation for expatriation is not relevant under the HEART Act.

A former citizen who would otherwise be subject to the HEART Act's alternative tax regime under the income tax or net worth tests is excluded from expatriate tax treatment only if he falls within one of two narrow, objective exceptions.[156] Under the first exception, the expatriate regime does not apply if the former citizen: (1) became a dual citizen of the United States and another country at birth; (2) continues to be a citizen of, and is taxed as a resident of, that other country as of the date of his expatriation; and (3) was a U.S. resident (as defined in Section 7701(b)(1)(A)(ii)) for a maximum of ten years during the fifteen-year period preceding his expatriation.[157] Under the second exception, the expatriate regime does not apply if the former citizen: (1) relinquished his U.S. citizenship prior to reaching age eighteen and one half; and (2) was a U.S. resident (as defined in Section 7701(b)(1)(A)(ii)) for a maximum of ten years preceding his expatriation.[158] Thus, if a former U.S. citizen satisfies one of the aforementioned exceptions, the expatriate tax regime does not apply.[159]

1. Expatriate Income Tax Rules Under the HEART Act: New Section 877A

New Section 877A, the expatriate income tax provision added to the Code by the HEART Act, subjects covered expatriates to a mark-to-market exit tax, effectively taxing the unrealized gain on their worldwide assets as though the

154. A long-term resident is an individual who has held lawful permanent resident status (i.e., a green card holder) for eight of the prior fifteen years. I.R.C. §§ 877A(g)(5), 877(e)(2).

155. *Id.* § 877A(g)(1). For purposes of Section 2801, Section 877A(g)(1) determines who qualifies as a covered expatriate. *Id.* § 2801(f).

156. *Id.* § 877A(g)(1)(B). The Code provides no exception to the expatriation provisions where an expatriate falls within the purview of the third test, the legal compliance test. *Id.* Also, as with the AJCA, the HEART Act provides no exceptions for former long-term residents who are subject to the expatriate tax regime. *Id.* Section 877(e)(2), however, provides that a long-term resident "shall not be treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for the taxable year under the provisions of a tax treaty between the United States and the foreign country and does not waive the benefits of such treaty applicable to residents of the foreign country."

157. *Id.* § 877A(g)(1)(B). Section 7701(b)(1)(A)(ii) indicates that "[a]n alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) . . . [s]uch individual meets the substantial presence test." The substantial presence test is set forth in Section 7701(b)(3).

158. *Id.* § 877A(g)(1)(B).

159. In addition, the HEART Act did not retain the AJCA's thirty-day physical presence rule prohibiting a covered expatriate from visiting the United States for more than thirty days during any year during the ten years following expatriation. *See supra* notes 138-39 and accompanying text.

property had been sold at fair market value the day before the date of expatriation.[160] A covered expatriate will owe income tax on any gain from this deemed sale in excess of $600,000 (adjusted for inflation).[161] A covered expatriate may irrevocably elect to defer payment of the tax on a property-by-property basis so long as he (1) furnishes adequate security, such as a bond, with respect to property on which he defers the tax and (2) irrevocably waives any rights under any U.S. treaty that would preclude assessment or collection of the exit tax under Section 877A.[162]

2. Expatriate Inheritance Tax Rules Under the HEART Act: New Section 2801

Section 2801 taxes transfers of any "covered gift or bequest" by covered expatriates to U.S. citizens or residents at the highest gift or estate tax rate.[163] A "covered gift or bequest" is defined as any property acquired by gift or bequest from a covered expatriate.[164] Where a covered expatriate transfers property to a U.S. citizen or resident after June 16, 2008, the property still may escape Section 2801 inheritance tax treatment. The category of "covered gifts and bequests" excludes any property for which the covered expatriate timely files a gift tax return or the executor of the decedent's estate files an estate tax return[165] as well as any property for which a marital or charitable deduction would be allowed.[166]

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160. I.R.C. § 877A(a). Section 877A excludes certain property interests held by a covered expatriate from the mark-to-market regime, including deferred compensation items, specified tax deferred accounts, or interests in non-grantor trusts. *Id.* § 877A(c). Though excluded from the mark-to-market tax, deferred compensation items, specified tax deferred accounts, and interests in non-grantor trusts are subject to special rules under Section 877(d)-(f). See Steven J. Arsenault, *Surviving a Heart Attack: Expatriation and the Tax Policy Implications of the New Exit Tax*, 24 AKRON TAX J. 37, 52-56 (2009) for a detailed description of the mark-to-market income tax provisions. *See also* 2008 JCT REPORT, *supra* note 153, at 39-44.

161. I.R.C. § 877A(a)(3)(A).

162. *Id.* § 877A(b)(1), (4)-(5). The covered expatriate or his estate may not extend payment of the deferred tax (plus interest) beyond the year during which the expatriate dies. *Id.* § 877A(b)(3), (7).

163. *Id.* § 2801(a). Section 2001(c) provides the applicable estate tax rate, and Section 2502(a) provides the applicable gift tax rate. Although the Section 2801 inheritance tax is imposed on the recipient of a covered gift or bequest, the tax on such gifts *and* bequests applies only to the value of the property that exceeds the applicable annual gift tax exclusion. *Id.* §§ 2801(c), 2503(b). In addition, Section 2801 taxes only the value of the covered gift or bequest in excess of the amount of gift or estate tax paid to a foreign country for the covered gift or bequest. *Id.* § 2801(d).

164. *Id.* § 2801(e). Where a covered expatriate transferred property before June 17, 2008, the previous expatriate regime under the AJCA controls U.S. federal income, estate, and gift tax consequences.

165. *Id.* § 2801(e)(2).

166. *Id.* § 2801(e)(3). The new regime also provides special rules for transfers to domestic and foreign trusts. *Id.* § 2801(e)(4). Section 2801 taxes domestic trusts as citizens of the United States, and therefore imposes the inheritance tax on the domestic trust itself for receipt of a covered gift or bequest. *Id.* § 2801(e)(4)(A). Where the covered gift or bequest is transferred to a foreign trust, Section 2801 imposes tax on the U.S. citizen or resident recipient on receipt of distributions from the foreign trust attributable to the covered gift or bequest as if the distribution

C. The HEART Act's Tax-Inclusive Gift Tax Regime

Under prior alternative tax regimes, due to jurisdictional and administrability difficulties exacerbated by the relative ease by which an expatriate could avoid the tax, the expatriate provisions failed to adequately threaten an expatriate's assets such that taxation under the regime would deter tax-motivated expatriation. Though the federal government had on several occasions considered different approaches to the tax treatment of expatriates,[167] it was not until 2008 when Congress fundamentally altered the course of expatriate taxation through the enactment of the HEART Act.

Under the HEART Act, which provides a solution to the jurisdictional flaws underlying the prior alternative tax regime,[168] property is marked-to-market and deemed sold through an artificial realization event occurring the day before expatriation, resulting in the assessment of income tax.[169] Congress's solution to the *transfer tax* jurisdictional problem, on the other hand, was to impose the tax on the *recipient* of the gift or bequest, rather than on the transferor expatriate who, under normal circumstances, would have been liable for any gift or estate tax owed.[170] Thus, the HEART Act's taxation scheme is more administrable than the prior regime as it allows the IRS to secure tax authority over property that perhaps had long departed from U.S. jurisdiction.[171] In addition, the new regime arguably acquires tax jurisdiction over the "right" property, at least to the extent that the property accrued gain while the covered expatriate was a citizen or resident.[172]

Nevertheless, while Congress draws nearer to a more suitable solution to the expatriate tax problem by subjecting the recipients of covered gifts or bequests to inheritance tax, the HEART Act gives rise to inequities in the inter vivos transfer tax context for the recipient of covered gifts as compared to normal U.S. gift tax treatment and expatriate gift tax treatment under prior regimes. First, the HEART Act's gift tax, reconfigured as an inheritance tax, generates particularly injurious

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itself were a covered gift or bequest. *Id.* § 2801(e)(4)(B). The foreign trust may irrevocably elect to be treated as a domestic trust under Section 2801, after which it would be liable for the inheritance tax as if it were a U.S. citizen. *Id.* § 2801(e)(4)(B)(iii).

167. *See supra* note 151.

168. While the United States may have achieved jurisdiction over transferred property by taxing the recipient, whether the IRS has a mechanism to actually track a U.S. citizen or resident recipient's receipt of property from a covered expatriate such that it can collect tax is questionable.

169. I.R.C. § 877A(a)(1).

170. *Id.* §§ 2001(a), 2501(a)(1).

171. Of course, because the HEART Act's transfer tax provisions focus only on the recipient of the gift or bequest rather than the type of property, the IRS theoretically can tax recipients on receipt of foreign-source property from a covered expatriate, which was beyond the scope of the alternative tax regime under FITA and its successors. *See supra* text accompanying notes 42, 115.

172. *See* 2003 JCT REPORT, *supra* note 36, at 75 (noting that one of Congress's potential motives for taxing expatriates' property following relinquishment of citizenship or termination of residence was because the property appreciated in value while the individual was a U.S. citizen or resident).

gift tax consequences for the recipient. In addition, the inheritance tax provisions apply the highest gift tax rate to the transfer,[173] creating an additional potentially significant and unnecessary burden on the recipient. Lastly, the inheritance tax problem is exacerbated where the property transferred is comprised of an interest in an illiquid family business.

1. The Burden of the Tax-Inclusive Nature of the Inheritance Tax

First, the HEART Act reconfigured the gift tax to subject the recipient of the gift to the tax, rather than the donor. Under normal transfer tax rules, a donor is liable for gift tax on inter vivos transfers of property.[174] In other words, after the donor gifts property to the donee, the donor must pay any tax derived from the transfer of that gift. The rate of tax imposed on the transfer is referred to as "tax-exclusive" because any gift tax owed is paid, not from the value of the gift itself, but rather *in addition* to the value of the gift. In contrast, the tax rate imposed on property transferred at death is tax-*inclusive* because any estate tax owed is levied upon and paid out of the total value of the decedent's estate.[175]

By way of example, suppose Parent (P) transfers to her Child (C) $3 million in cash. For the sake of simplicity, assume that the estate and gift tax rates are unified at a flat rate of fifty percent, and no exclusions, deductions, or credits exist. P would be subject to gift tax of $1.5 million, yet C would still receive the entire $3 million. This demonstrates the tax-exclusive nature of the gift tax. Now, assume instead that P retained the $3 million gift and $1.5 million of gift tax. In her will, P bequeaths to C her entire $4.5 million estate. Upon P's death, the IRS would claim $2.25 million of estate tax, and the remaining $2.25 million would transfer to C. Thus, in this example, the cost of a deathtime transfer is $750,000 more than the cost of a lifetime transfer because the estate tax is imposed on a tax-inclusive basis.

The HEART Act's expatriate regime effectively converts a traditionally tax-exclusive gift tax system to a tax-inclusive inheritance tax system. Where a covered expatriate transfers property to a U.S. citizen or resident recipient and fails to timely file a gift tax return,[176] the property transferred constitutes a covered gift.[177] Under the HEART Act's expatriate transfer tax regime, the *recipient* would be subject to tax on the value of the gift in excess of the annual exclusion at the highest transfer tax rate in effect during the year of transfer.[178] For example, if P in the above example were a covered expatriate[179] and P gifted $4.5 million to C, a

173. I.R.C. § 2801(a); *see also supra* note 163 and accompanying text.

174. *Id.* § 2502(c) ("The tax imposed by section 2501 [the provision imposing the gift tax] shall be paid by the donor.").

175. *Id.* § 2001(a) ("A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.").

176. *Id.* § 2801(e)(2)(A) (excluding property transferred by an expatriate to a U.S. person from the definition of "covered gift or bequest" where the expatriate timely filed a gift tax return).

177. *Id.* § 2801(a), (e)(1).

178. *Id.* § 2801(a)-(c) ("The tax imposed by [Section 2801(a)] on any covered gift or bequest shall be paid by the person receiving such gift or bequest.").

179. *Id.* § 877A(g)(1); *see also supra* notes 154-59 and accompanying text.

U.S. citizen, C would be required to pay $2.25 million of tax to the IRS upon receipt of the gift.

This result produces a number of negative, albeit avoidable, consequences. While this transfer would be tax-exclusive for a U.S. citizen donor, who would under normal circumstances pay any gift tax directly to the federal government, the HEART Act instead penalizes the U.S. recipient.[180] As demonstrated, the practical effect of the inheritance tax is to leave the U.S. citizen or resident donee with a smaller gift because the tax on the gift must be paid by the recipient out of the gift itself. Thus, the tax serves as a punishment to the disadvantaged recipient. Moreover, the HEART Act imposes the highest rate of gift tax on transfers by covered expatriates to U.S. citizens and residents,[181] creating an additional burden to be borne by the recipient.

In addition, if two covered expatriates each carried out such a transfer and only one filed a gift tax return, the transferee of the expatriate who complied with normal gift tax rules by filing the return would receive the *entire* gift, and the expatriate transferor may have avoided the maximum gift tax rate (depending on the value of the property transferred), while the recipient of the same gift transferred by a non-complying expatriate would initially receive the same gift, but would owe gift tax calculated at the maximum rate to be paid from the gift itself. Again, the government punishes the latter *recipient* while the former enjoys the entire gift simply because the latter expatriate *donor* failed to comply with the statute. While taxing the covered expatriate on a gift transfer is arguably justified as a punitive measure or based on other policy grounds, such tax policy gives rise to horizontal equity[182] and fairness problems because similarly situated U.S. taxpayers (i.e., U.S. citizen and resident recipients of gifts from (1) a covered expatriate versus anyone else or (2) a complying covered expatriate versus a non-complying covered expatriate) would sustain very different tax liabilities through no fault of their own.

Congress may have evaluated such a situation and concluded that this result is justified, perhaps for administrability purposes or perhaps to punish expatriates for relinquishing U.S. citizenship or terminating residence along with failing to comply with gift tax return filing requirements. If Congress did not intend such a result, however, the problem can be easily remedied by applying principles similar to those set forth under Section 2035. Section 2035 is an estate tax provision that

180. *See supra* notes 174 and 178 and accompanying text.

181. I.R.C. § 2801(a); *see also supra* notes 163 and 173 and accompanying text.

182. The principle of "horizontal equity" in taxation states that similarly situated taxpayers should face the same tax treatment. *See, e.g.*, Dilts v. United States, 845 F. Supp. 1505, 1510 (D. Wyo. 1994) ("One fundamental purpose of the tax code is to achieve 'horizontal equity'—that is, to treat similarly situated people in the same manner."); David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43-44 (2006) ("The principle of horizontal equity demands that similarly situated individuals face similar tax burdens. It is universally accepted as one of the more significant criteria of a 'good tax.' . . . Violation of horizontal equity, while not necessarily fatal, is nevertheless considered a serious flaw in any proposed tax arrangement.").

requires that any gift tax paid as a result of transfers by a decedent within three years of his death be added back into his gross estate,[183] which removes the benefit of the tax-exclusive nature of the gift tax. In the context of the HEART Act gift tax provisions, Congress should allow the donee taxpayer to achieve the opposite result by converting the burdensome tax-inclusive rate to the appropriate tax-exclusive rate using a fairly simple formula: (total value of gift * tax-inclusive rate) / (1 + tax-inclusive rate) = total inheritance tax due to the IRS to be paid by the donee out of the gift. Using the above example, where the total value of the gift is $4.5 million and the tax-inclusive rate is fifty percent, the total inheritance tax due equals $1.5 million.[184] Thus, of the $4.5 million gift, the taxpayer would retain $3 million and owe inheritance tax of $1.5 million to the IRS. This is more appropriate than the previous result as it allocates amounts transferred to the donee and to the IRS as if the donor were subject to normal gift tax rules, thereby achieving horizontal equity between similarly situated taxpayers and realizing the IRS's interest in imposing tax on expatriate donors' transfers of property by gift.

2. Inter Vivos Transfers of Illiquid Property

An additional issue created by the HEART Act's expatriate transfer tax regime exists where a covered expatriate carries out an inter vivos transfer of illiquid property, such as an interest in a family partnership or stock in a closely-held family corporation, and the U.S. citizen or resident recipient is not financially capable of paying the tax, particularly where family wealth is tied up in the family business. By way of illustration, assume P transfers to C fifty percent of the outstanding shares in the family corporation. As a practical matter, if C cannot sell some of her newly-acquired shares (and otherwise has few or no liquid assets), she will not be able to pay the tax.

This situation likely resulted from congressional oversight rather than a deliberate effort to penalize such recipients because it would be impractical to levy a tax which the taxpayer cannot pay. Assuming Congress did not intend this result, it could apply the principles set forth in Section 6166 to this situation. Section 6166, also a provision applicable to the estate tax, allows the executor of an estate to defer estate tax payment for up to five years and to pay the tax in installments for up to ten subsequent years where at least thirty-five percent of the value of the estate consists of an interest in a closely-held business, such as a partnership or corporation.[185] Thus, by application of this rule, C could defer tax payments and subsequently pay tax in installments over the course of fifteen years. Because the expatriate HEART Act's inheritance tax is tax-inclusive, this estate tax rule may be particularly suitable for a donee in these circumstances.

V. CONCLUSION

While the HEART Act has resolved to an extent the jurisdictional issues that

183. I.R.C. § 2035.

184. ($4.5 million * 0.5) / (1 + 0.5) = $1.5 million.

185. I.R.C. § 6166.

plagued the alternative tax regime under FITA and its subsequent modifications under HIPAA and the AJCA, its shift in applying gift tax from the donor to the donee in the expatriate inheritance tax context, which effectively converted a traditionally tax-exclusive inter vivos gift tax system to the tax-inclusive inheritance tax system under the HEART Act's expatriate tax regime, generates comparatively disadvantageous tax treatment relative to the prior regimes. Assuming Congress created these issues unintentionally, the Code provides solutions that, if applied in this context, could reduce the punitive nature of the HEART Act's gift tax and equalize overall tax treatment for similarly situated donors and recipients. Although Congress has yet to achieve the ideal expatriate tax system, it has made significant developments as compared to the prior alternative tax regimes, and changes such as those presented and described above will continue to improve the fairness of the expatriate tax.