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Permalink
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Publication Date
2017-03-07

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No Income Splitting for Domestic Partners: How the IRS Erred

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On February 24 the IRS issued guidance on the federal income tax treatment of registered domestic partners in California. The guidance was long overdue. More significantly, it closed the door on California registered domestic partners who were considering splitting in half the combined domestic partnership income from property and services for purposes of filing federal income taxes. This article demonstrates that the IRS got it wrong in its unpersuasive, historically inaccurate, and ultimately indefensible memorandum.

Introduction

The California Domestic Partner Rights and Responsibilities Act (enacted Sept. 14, 2003; effective Jan. 1, 2005) grants registered domestic partners the same “rights, protections, and benefits” as married couples under California’s community property regime. The law also provides that California domestic partners (a category that includes both same-sex partners and opposite-sex couples in which one partner has reached age 62 and is qualified for old age benefits under Social Security) “shall be subject to the same responsibilities, obligations, and duties under law, whether they derive from statutes, administrative regulations, court rules, government policies, common law, or any other provisions or sources of law, as are granted to and imposed upon spouses.”

Thus, there is a presumption — as there is for opposite-sex married couples during marriage — that all income and property acquired during the domestic partnership is community property, with each spouse enjoying equal ownership interests.

Despite equivalent ownership interests of registered domestic partners under California’s community property law, the IRS concluded in the memorandum that registered domestic partners can’t split income. A California domestic partner, the memorandum concluded, “must report all of his or her income earned from the performance of his or her personal services.” The IRS reached that conclusion even though domestic partners possess ownership interests under California community property law identical to ownership interests enjoyed by opposite-sex married spouses; that is, ownership interests that have allowed California husbands and wives to split income in half when filing federal income taxes for a period that predates by nearly 20 years the enactment of the income-splitting joint return in 1948.

The analysis contained in the memorandum relied heavily on Poe v. Seaborn, the 1930 Supreme Court case granting income-splitting privileges to married couples in the community property state of Washington. The following year, the Supreme Court applied the same analysis to California’s community property law in United States v. Malcolm, holding that a wife in California possessed sufficient ownership interests in combined community income and property to justify allowing each spouse to report and pay tax on one-half of that income.

According to the IRS, the Supreme Court’s decision in Poe v. Seaborn does not apply to the application of...
Earl states “has always arisen solely in the context of marriage” and ownership interests. Management and control and ownership (or “legal title” and “vested” or “expectancy” interests) on the other. Management and control (or “dominion”) over community/marital income and property on one hand, and ownership (or “legal title” and “vested” or “expectancy” interests) on the other. The Court was more concerned with, alternatively, management and control (or “dominion”) over community/marital income and property on one hand, and ownership (or “legal title” and “vested” or “expectancy” interests) on the other. Management and control carried the majority in United States v. Robbins,10 Lucas v. Earl,11 and Corliss v. Bowers12 while ownership won in Poe v. Seaborn, United States v. Malcolm, and Hoeper v. Tax Commission of Wisconsin.13 A quick trip through the history of those cases reveals not just quotable quips of lucid jurists, but more importantly, just how little the Court’s legal reasoning turned on marriage.

Ownership vs. Management & Control Principles

For the faction of the Supreme Court that thought the “management and control principle” rather than the “ownership principle” should determine taxability — a group headed by Justice Oliver Wendell Holmes — might and right were coextensive. In United States v. Robbins (holding that married women in California possessed “mere expectancy” interests in community income and property and thus could not make separate federal income tax returns reporting half the income and property), Justice Holmes penned the opinion of the Court. “For not only should he who has all the power bear the burden,” Holmes wrote, “and not only is the husband the most obvious target for the shaft, but the fund taxed, while liable to be taken for his debts, is not liable to be taken for the wife’s . . . so that the remedy for her failure to pay might be hard to find.”14

Likewise, in Lucas v. Earl (prohibiting contractual assignments of income between spouses), the Court overlooked legal title and emphasized command and control. Before Earl, courts generally allowed spouses to divide income by assignment if the declaration was written and clearly indicated that the husband’s future earnings were to be considered one-half his and one-half his wife’s.15 Earl replaced that technical standard with one that sought to tax income to the spouse who produced the income. Through Justice Holmes, the Court held that a contractual assignment of future income by a husband to a wife did not relieve the husband of his liability to pay income taxes on the assigned portion. In rendering the Court’s decision, Justice Holmes delivered one of the most famous Supreme Court tax opinions. “This case is not to be decided by attenuated subtleties.”16 Rather, “It turns on the import and reasonable construction of the taxing act. There is no doubt that the [tax] statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.”17 Justice Holmes summarized with the oft-quoted sentence: “That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.”18

Corliss v. Bowers provides a third example of the management and control principle that vied for preeminence in the Court’s family tax jurisprudence. In Corliss, the Court considered Congress’s power to tax the income of a revocable trust to the grantor rather than to the trustee. The grantor husband argued that the net income from the trust was paid directly to his wife, the trustee. The income “never was his and he [could not] be taxed for it. The legal estate was in the trustee and the equitable interest in the wife.”19 Once again, Justice Holmes delivered the Court’s opinion. Taxation “is not so much concerned with the refinements of title,” Justice Holmes opined, “as it is with actual command over property taxed — the actual benefit for which the tax is paid.”20 “The income that is subject to a man’s unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.”21

While the management and control faction of the Court carried a number of majorities in family tax cases during the 1920s and 1930s, the most enduring family tax legacy during that period was the establishment of the

18 Pre-1930 assignment of income cases include Blair v. Roth, 22 F.2d 932 (9th Cir. 1927), and Wehe v. McLaughlin, 30 F.2d 217 (9th Cir. 1929).
19 281 U.S. at 114.
20 Id. at 115.

Justice Owen Roberts delivered the opinion of the Court. Unlike Justice Holmes, Justice Roberts did not believe that management and control was dispositive in assessing tax liability. "While the husband has the management and control of community personal property and like power of disposition thereof as of his separate personal property, this power is subject to restrictions which are inconsistent with denial of the wife's interest as co-owner."22 A careful review of Washington's community property law, Justice Roberts reported in Seaborn, "clear the wife has...a vested property right in the community property, equal with that of her husband; and in the income of the community, including salaries or wages of either husband or wife, or both."23

Meanwhile, the government invoked the management and control principle. Justice Roberts summarized the government's position as arguing that "control without accountability is indistinguishable from ownership," and that "calling the wife's interest vested is nothing to the purpose because the husband has such broad powers of control and alienation, that while the community lasts, he is essentially the owner of the whole community property, and ought so to be considered" for purposes of taxation.24 The Court refused to accept that reasoning, pointing out that the "community must act through an agent" if only for efficiency reasons and for protecting the interests of third parties dealing with one or the other spouse.25 Justice Roberts invoked the "power of partners or of trustees of a spendthrift trust" as "apt analogies."26

In the end, Justice Roberts famously declared that "[p]ower is not synonymous with right. Nor is obligation coterminous with legal remedy. The law's investiture of control and alienation, that while the community lasts, he is essentially the owner of the whole community property, and ought so to be considered" for purposes of taxation.24 The Court refused to accept that reasoning, pointing out that the "community must act through an agent" if only for efficiency reasons and for protecting the interests of third parties dealing with one or the other spouse.25 Justice Roberts invoked the "power of partners or of trustees of a spendthrift trust" as "apt analogies."26

The ownership principle that carried the day in Seaborn directed the Court's thinking in United States v. Malcolm shortly thereafter. The Malcolm Court considered two questions: "must the entire community income of a husband and wife domiciled in California be returned and the income tax thereon be paid by the husband," and did the wife possess "such an interest in the community income that she should separately report and pay tax on one-half of such income."26 The Court answered "no" to the first question and "yes" to the second, citing Seaborn and its companion cases for support. California married residents, like husbands and wives in Arizona, Louisiana, Texas, and Washington, were allowed to divide income equally on separate returns when filing federal income (and estate) taxes.31

Hooper v. Tax Commission of Wisconsin, decided one year after Seaborn, offers one final example of the ownership principle most powerfully articulated in Seaborn. In Hooper, the Supreme Court considered whether the Wisconsin state income tax — which aggregated spousal income and held the husband liable for the whole — violated the Due Process and Equal Protection Clauses of the 14th Amendment.

Justice Roberts's majority opinion examined the property law of Wisconsin as well as the legal rights of men and women within the marital union. Traditionally, under common law, the wife's interests were subsumed in her husband.32 The wife's property, "owned at the date of marriage or in any manner acquired thereafter, is the property of her husband. Her earnings are his, he may dispose of them at will, and he is liable for her debts."33 However, Wisconsin, like many other common-law states in the latter half of the 19th century and early 20th century, had enacted a married women's property rights statute that altered traditional legal and financial arrangements between husbands and wives. Indeed, according to Justice Roberts, the husband's "ownership and control of her property have been abolished" by Wisconsin's "Property Rights of Married Women" law. "Under the law of Wisconsin," the Court found, "the income of the wife does not at any moment or to any extent become the property of the husband."34 Nor were her income and property considered part of the marital community as they would be in community property states. By law, income and property acquired by the wife during marriage remained hers, separate and independent from her husband. Thus, the question was whether the common-law state of Wisconsin had the power to compute a husband's tax liability "not by his own income, but, in part, by that of another."35 In answering in the negative, the Court held, "We have no doubt" [that] "any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income," Justice Roberts added, "cannot be made such by calling it income."36

Unlike in community property states where husbands and wives possessed equal, one-half ownership interests

22282 U.S. at 110.
23Id. at 111.
24Id.
25Id. at 112.
26Id.
27Id. at 113.
28Id.
29Id. at 118.
30282 U.S. at 792.
31Id.
32Wisconsin did not adopt its current community property statute until 1983, effective 1986. Wisconsin Statutes Chapter 766.
33284 U.S. at 214.
34Id. at 216.
35Id. at 215.
36Id.
in all community income and property, spouses in common-law states possessed separate interests in income and property acquired during marriage. In both instances, however, ownership determined taxability.

Notably, while Justice Holmes could not have disagreed more with the outcome in Hoeper, he accepted that ownership was dispositive in determining taxability. His conception of marriage and intrafamily relations, however, prevented him from acknowledging that wives in common law states owned any of the marital income on which tax was owed. In a dissent that revealed both his own gender biases and those of the times, Justice Holmes argued that Wisconsin’s married women’s property statute did not alter traditional family dynamics; therefore, it should not alter the tax treatment of marital income and property under common law that made the husband liable for all marital debts. Any statutory change to a state’s civil code, Justice Holmes wrote, “must be viewed against the background of the earlier rules that husband and wife are one, and that, as the husband took the wife’s chattels, he was liable for her debts.”37 Traditionally, “the husband became the owner of the wife’s chattels on marriage without any trouble from the Constitution, and it would require ingenious argument to show that there might not be a return to the law as it was in 1800. It is all a matter of statute,” Justice Holmes said disparagingly.38 “But for the statute the income taxed would belong to the husband and there would be no question about it.”39 In Justice Holmes’s view, married women in Wisconsin did not (in fact, could not) possess separate ownership interests in income and property. Therefore, the Wisconsin state income tax did not violate due process by holding husbands liable for taxes on the combined income of both spouses. While hardly a progressive analysis, Holmes’s dissent in Hoeper further reinforced the salience of ownership in determining family tax liability.

Ownership Principle & Calif. Domestic Partners

Appreciating the foregoing history would certainly have assisted the IRS in its analysis of how to tax California domestic partners. It would have revealed, in particular, that marriage, per se, had nothing to do with the Supreme Court’s family tax jurisprudence in the 1920s and 1930s and that the Court was exclusively concerned with principles of ownership on one hand, and management and control on the other. In fact, “marriage” informed the Court’s analysis only to the extent that rights and obligations under community property law — as well as any attendant tax advantages — were reserved for married couples in 1930.

The IRS need not have immersed itself in the minutiae of the above case law (though I do not think it would have been too much to ask) to determine that the case it relies on to deny income-splitting privileges to California domestic partners (Poe v. Seaborn) had everything to do with the principle of ownership under community property law and very little to do with marriage, but it needed to read Seaborn more carefully. “We are of opinion,” Justice Roberts held for the majority, “that under the law of Washington the entire property and income of the community can no more be said to be that of the husband, than it could rightly be termed that of the wife.”40 On the basis of equal ownership, the Court affirmed the district court’s decision that “the husband and wife were entitled to file separate returns, each treating one-half of the community income as his or her respective income.”41

By misinterpreting the basis on which the Supreme Court grounded its opinion in Seaborn, the IRS makes three additional errors in its analysis in the memorandum.

First, the memorandum does not appreciate the significance of equal treatment for domestic partners and married couples under California’s community property law. The California community property regime applies equally to married couples and domestic partners, granting domestic partners the same “rights, protections, and benefits” as opposite-sex married couples, a fact the memorandum acknowledges. Indeed, if the law withheld any significant “rights, protections, and benefits” from domestic partners, we would not be having this conversation; that is, without equivalent rights as married couples, domestic partners could not be said to possess the same ownership interests and thus, under Seaborn, would be unable to claim the same federal income tax treatment afforded California spouses.

The IRS seems to argue that a provision in California’s domestic partnership law prohibiting registered domestic partners from splitting domestic partnership income for purposes of the state income tax restricts domestic partnership rights and thereby alters the federal income tax analysis. Section 297.5(g) of the California Family Code indicates that domestic partners, in filing state income taxes, “shall use the same filing status as is used on their federal income tax returns, or that would have been used had they filed federal income tax returns. Earned income may not be treated as community property for state income tax purposes.”42 But that provision is a red herring for purposes of our analysis. For one thing, domestic partners would likely file as single persons, regardless of the statutory “prohibition,” when and if relying on Poe v. Seaborn to achieve income splitting for federal income tax purposes. To do otherwise would violate the Defense of Marriage Act, which prohibits domestic partners from claiming rights reserved for married persons under federal law, including section 1(a) of the IRC, the federal income tax schedule for married persons filing jointly. Moreover, section 297.5(g) does not change in any meaningful way the application of California’s community property law to ownership of income from property and services for domestic partners. Thus, regarding the federal income tax and Poe v. Seaborn, the prohibition is simply inapposite.

37 Id. at 219.
38 Id. at 220.
39 Id.
40 282 U.S. at 113.
41 Id. at 118.
42 California Family Code section 297.5(g).
Second, the IRS’s analysis suggests that ownership of domestic partnership income ends up in one or the other partner not by operation of law, but under some other (as yet, unexplained) theory. By gift? By contract? It is impossible to tell from the memorandum. I suspect the sleight of hand derives from the awareness that if the IRS acknowledged ownership interests for domestic partners on a par with married couples under California community property law, it would have to treat — and tax — the two groups the same.

Third, and finally, the IRS concludes that Poe v. Seaborn does not apply to the application of community property law “outside the context of a husband and wife” (even though, as explained above, the Supreme Court cared about marriage only to the extent that rights and obligations of community property law were reserved for spouses 15 years ago).43 “In our view,” the IRS goes on to say, quoting from Commissioner v. Harmon, “the rights afforded domestic partners under the California Act are not ‘made an incident of marriage by the inveterate policy of the State.”’44 Of course not. Domestic partners are prohibited from participating in the civil union of marriage. But the rights afforded domestic partners are made an “incident” of registering as domestic partners with the California secretary of state, the same way equivalent rights under California’s community property law are made an “incident” of entering into the civil union of marriage. In Harmon, the Court was concerned that married couples in Oklahoma could elect or choose to be covered by that state’s community property statute. In California, domestic partners — and married partners, too — are not given that election.

In the end, it may be appropriate to ask from a current policy or administrative or political perspective whether the analysis in Poe v. Seaborn should be limited to marriage or whether it should apply to all relationships with equivalent legal rights to income from property and services. Furthermore, it may be appropriate to suggest that continuing to apply the ownership principle articulated in Seaborn generates a number of problems, including issues of uniformity. And it may even be appropriate to query whether Poe v. Seaborn survived the enactment of the income-splitting joint return in 1948. But, it is certainly not appropriate to conclude that Seaborn’s application is limited to marriage and to prohibit income splitting for California domestic partners based on what Seaborn actually held. Seaborn (as well as its companion cases and subsequent case law that applied its reasoning) was about ownership of income from property and services under community property law. And, as this article has demonstrated, domestic partners in California possess the same ownership interests in income from property and services as married couples. Thus, they should be taxed the same under the federal income tax.

43 Supra note 1, p. 4.
I. Where Do Things Stand?

The exit tax provisions are in the Senate-passed version of H.R. 4297. In the form of S. 2020, they were approved on November 18, 2005. They were added to H.R. 4297 when that bill was taken up and approved by the Senate on February 14. (The bill was labeled the Tax Relief Extension Reconciliation Act of 2005 when it passed the House; the name was changed to the Tax Relief Act of 2005 when it was amended and approved by the Senate.) A conference committee will decide in the coming weeks whether those provisions stay in the bill or are cut out.

There is some chance that the bill, even though reported out by the conference committee, will not become law because the committee’s handiwork could be rejected by either or both houses, which would be highly unlikely, or could be vetoed by the president, which again would be highly unlikely. With the Republican Party controlling both houses of Congress and the White House, it is hard to imagine the conference committee’s version of the bill not becoming law.

The exit tax is a bad idea for policy and technical reasons. Not only should it not be enacted into law, but it should also be dropped once and for all.

The bill is approximately 400 pages in length and contains roughly 150-200 provisions. The exit tax provisions are included alongside a number of other “revenue offset provisions,” meaning provisions that raise, rather than lose, revenue. The total revenue raised by the exit tax is estimated to be $251 million over five years, a pittance in the scheme of things. If something is enacted, the effective date is anyone’s guess; it could be March 15 or April 15 or any other date in the not-too-distant future. Indeed, it is entirely possible that the new rules will not be enacted during this Congress.

Obviously, the dilemma for individuals who might be affected is: Should I do something now? Complicating the matter is the fact that it is very difficult to complete a renunciation in less than several weeks, and that period can be significantly longer if it is necessary to “catch up” with past-due filings. A renunciation will not be effective for U.S. income tax purposes until the individual can attest that he is fully compliant with all tax filings. Relinquishment of a green card can proceed much quicker.

II. Who Cares?

The subject is of interest to U.S. nationals (citizens) that may wish to renounce their U.S. citizenship and to U.S. long-term residents (individuals that are lawful permanent residents — typically “green card” holders — in 8 out of the most recent 15 years) that may wish to terminate their permanent residence status. It is also of interest to companies and individuals that are interested in attracting highly skilled immigrants to work in the United States, “accidental Americans” that happen to be U.S. citizens by virtue of birth in the country or birth to a U.S. parent, and immigrants who possess a green card but who might one day want to return, say, to their country of birth.

The provisions affect more than just wealthy Americans that want to stop paying tax in the United States, which is a very small group consisting of perhaps two dozen millionaires per year. The provisions also affect tens of thousands of individuals who are dual nationals — that is, of U.S. and some other nationality — because they were born in the United States or were born to a U.S. parent. Many of those individuals live outside the United States. The provisions also affect many thousands of long-term residents (that is, individuals who came to the United States and ended up staying for one reason or another). Surprisingly, there are large numbers of green card holders living in places like London, Paris, Geneva, Hong Kong, and Taipei.

Dual nationals and long-term residents must be concerned because the existing rules for taxation of expatriating individuals would be changed by the exit tax provisions. If they were to renounce or relinquish their residency status after the effective date of the new law, they would be penalized. The effective date, as drafted now, is the date of enactment — that is, the date the president signs the bill into law.

The effective date is anyone’s guess; it could be March 15 or April 15 or any other date in the not-too-distant future. Indeed, it is entirely possible that the new rules will not be enacted during this Congress.

III. What Are the Rules Now?

A. General Rules

U.S. citizens and residents are generally subject to U.S. income tax on their worldwide income, regardless of source, residence, or location, and to U.S. estate tax on their “deathtime” transfers and to gift tax on their “lifetime” transfers, regardless of where their property is located.

Also, while often overlooked, U.S. citizens and residents must file an annual foreign bank account reports on (FBARs), reporting all non-U.S. bank, brokerage, and other financial accounts that they own or control. That is...

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5Those individuals might be born in the United States of a non-U.S. parent who was a foreign worker, student, exchange visitor, business visitor, or tourist that came to the country with a spouse or partner. Many of those individuals are not current in their U.S. income tax obligations and in filing required forms, which include Treasury Department Form 90-22.1, “Report of Foreign Bank and Financial Accounts.”
a nontax, Bank Secrecy Act law with USA Patriot Act undertones. It is a subject in itself, that will not be dealt with here.⁶

B. 1995-2004 Tax Rules

Individuals who expatriated between February 6, 1995, and June 3, 2004 — both U.S. citizens who renounced their United States citizenship and long-term residents who terminated their U.S. residency with a "principal purpose of avoiding U.S. taxes" — became subject for a 10-year period to an alternative method of income taxation, rather than that generally applicable to nonresident aliens.

Those individuals generally were made subject to income tax only on U.S.-source income at the rates then applicable to U.S. citizens.

Individuals who relinquished citizenship or terminated residency were treated as having done so — that is, presumed to have done so — with a principal purpose of tax avoidance and therefore were generally subject to the alternative tax regime if: (a) their average annual U.S. federal income tax liability for the five tax years preceding citizenship relinquishment or residency termination exceeded $100,000; or (b) their net worth on the date of relinquishment or termination equaled or exceeded $500,000. Those amounts were adjusted annually for inflation.

Some categories of individuals (for example, dual residents) could avoid being deemed to have had a tax avoidance purpose by obtaining a ruling from the IRS in some circumstances.

Antiabuse rules were provided to prevent the circumvention of the alternative tax regime. Special estate and gift tax rules similarly applied. The estate tax rules applied to tax transfers of U.S.-situs, but not foreign-situs, property, including the decedent’s pro rata share of the U.S. property held by a foreign corporation.

U.S. citizens who renounced citizenship and long-term residents who terminated residency generally were required to provide information about their assets held at the time of expatriation. However, that information was required only once.

C. The Reed Amendment

Apart from tax rules, in 1996 Congress enacted amendments to the immigration law prohibiting individuals who renounce U.S. citizenship for purposes of avoiding taxation from entering the United States — the so-called Reed amendment.

Under that provision, any alien who is a former citizen of the U.S. who officially renounced U.S. citizenship and who is determined by the U.S. attorney general to have renounced citizenship for the purpose of avoiding taxation by the United States is inadmissible; that is, he can be prevented from entering the country. If the individual flunked one of the two monetary thresholds in the tax provisions (see above), he automatically — at least on the face of things — fell within the reach of that very punitive immigration rule. The tax rules treated the individual as having expatriated for tax avoidance purposes, and therefore the immigration authority needed only, in effect, to adopt that finding for purposes of applying the immigration rule.

If dual nationals and long-term residents were to renounce or relinquish their residency status after the effective date of the new law, they would be penalized.

The Reed amendment has never been officially applied to exclude (refuse entry to) any individual because, among other reasons, the attorney general has never been authorized to obtain the necessary tax returns and other tax information.⁷

D. Today’s Rules

In 2004, effective for expatriations (relinquishments or renunciations) after June 3, 2004, more objective and somewhat simplified rules came into existence. Those rules are the ones in effect today, and they will remain in effect until amended:

- Objective standards for determining whether former citizens or former long-term residents are subject to the alternative tax regime. The American Jobs Creation Act of 2004 (P.L. 108-357) replaced the subjective determination of tax avoidance as a principal purpose for renunciation of citizenship or relinquishment of permanent residency status with objective rules. A former citizen or former long-term resident will be subject to the alternative tax regime for a 10-year period following renunciation or relinquishment, unless, in general, he: (1) establishes that his average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and that his net worth does not exceed $2 million; and (2) certifies that he has complied with all U.S. federal tax obligations for the preceding five years and provides any evidence of compliance that may be required. If a former citizen exceeds either or both of the monetary thresholds set forth immediately above, that person can still be excluded (excused) from the alternative tax regime under extraordinary circumstances, which are defined in detail. Interests in trusts are taken into account. IRS Notice 97-19, issued under a prior set of provisions, provides detailed information and examples on the point.

- Tax-based (instead of immigration-based) rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. federal tax purposes. An individual continues to be treated as a U.S. citizen or long-term resident for U.S. federal tax purposes until


⁷The authors believe that some consular officers in American embassies have unofficially, and improperly, applied the rule to refuse to grant a visa to a former U.S. citizen.
COMMENTARY / VIEWPOINTS

Federal Register

The names of all former citizens that have in one way or another renounced or otherwise lost their U.S. citizenship.

Several things should be noted about the rules that exist today:

- Those rules are far clearer and easier to work with than the predecessor rules. For individuals whose recent average tax liability and current net worth do not exceed the $124,000 and $2 million levels, after expatriating there is no further obligation to report or pay taxes.

- If the expatriate is subject to the alternative tax regime for the 10-year period, only U.S.-source income is subject to tax. Income from salary or consulting fees earned outside the United States is not taxed. Also, income from the sale of non-U.S. securities is not taxed.

- The 30-day rule can be a problem. However, it does not apply to individuals falling below the monetary threshold. Others will simply have to live with the rule.

- Many people, including the spouse of the principal "breadwinner" or a child, ordinarily will be able to renounce or relinquish without exceeding the monetary thresholds.

- The issue often is not imposition of the tax rules but imposition of the immigration-based sanctions. Persons that are determined to have relinquished U.S. citizenship for tax purposes can be excluded under the Reed amendment from entering the country by the U.S. Citizenship and Immigration Services (now part of the Department of Homeland Security). Regulations under the Reed amendment have not been promulgated, and that power has never officially been invoked.

- The tax rules enacted in 2004 have been stripped of any tax motivation; that is, they operate without any regard to tax motivation. It can no longer be said, therefore, that a person who is "caught" by the tax rules has expatriated with a principal purpose of tax avoidance. Developments regarding those immigration rules should nonetheless be carefully watched.

IV. Will Tomorrow’s Rules Include an Exit Tax?

What might be enacted in the coming weeks is a form of exit tax. (Congress and the Treasury Department prefer calling it a mark-to-market tax.)

That approach was proposed by the Clinton administration in February 2000. Several members of Congress, including Ways and Means ranking minority member Charles B. Rangel, D-N.Y., who is a conference on H.R. 4297, offered proposals along the same lines in 1999 and 2002. In 2002 the Senate approved an amendment to a House-passed bill that looked very similar to the proposal that was approved by the Senate last November. There are subtle differences in those proposals. We will focus only on the version currently being considered.

Those provisions arose as part of the version of the tax reconciliation bill proposed by Senate Finance Committee Chair Chuck Grassley, R-Iowa, when it came through his committee. It is believed that Grassley, assisted by the Finance Committee staff, simply reached for proposals that previously had been adopted by the committee or
the Senate as a whole but not enacted into law. In other
words, they pulled old proposals off the shelf.8

A. In General
The Senate bill subjects some U.S. citizens who relinquish their citizenship and long-term U.S. residents who terminate their residence to tax on the net unrealized gain in their property as if that property were sold for fair market value on the day before the relinquishment or termination.

Gain from the deemed sale will be taken into account at that time without regard to other tax code provisions; any loss from the deemed sale generally will be taken into account to the extent otherwise provided in the code. Presumably the gain will be ordinary income or capital gains as provided under normal rules.

Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million for married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount is increased by a cost-of-living adjustment factor for calendar years after 2005.

B. Individuals Covered
The exit tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term resident if he was a lawful permanent resident for at least 8 out of the 15 tax years ending with the year in which the residency termination occurs. A number of details and a few highly circumscribed exceptions can apply.

Election to be treated as a U.S. citizen. An individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen regarding all property that otherwise is covered by the expatriation tax. That election is an “all or nothing” election; an individual can’t pick and choose properties to which it will be applied.

The individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. Also, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes.

To make that election, the individual is required to waive any treaty rights that would preclude the collection of the tax. The individual also would be required to provide security to ensure payment of the tax. The amount of tax that would have been owed but for the election (including any interest, penalties, and some other items) will constitute a lien in favor of the U.S. government on all U.S.-situs property owned by the individual.

8Because, unusually, no committee report accompanied the bill when reported by the Senate Finance Committee, we have had to rely on the statutory language of the bill and on the Finance Committee tax staff’s 21-page memorandum entitled “Summary of Tax Relief Act of 2005,” dated November 18, 2005. The memorandum is available at http://www.finance.senate.gov/sitpages/leg/110805legbill.pdf. See also JCS-2-03, supra note 2, describing prior versions of the exit tax.

Date of citizenship relinquishment. The bill sets forth rules for establishing the date of relinquishment. In the most common case, that will be the date the individual swears or affirms his oath of renunciation in front of a consular officer and witnesses. For State Department purposes, the process is not complete until the individual receives a certificate of loss of nationality (CLN) signed by the State Department in Washington, but he is treated as having “renounced” as of the date of the taking of the oath of renunciation. It can take several months for a CLN to be issued.

Deemed sale of property on expatriation. The deemed sale rule generally applies to all property interests held by the individual on the date of citizenship renunciation or residency termination. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax under the Foreign Investment in Real Property Tax Act, generally are excepted from the tax.

Tax is due on the 90th day after the date of expatriation (renunciation or termination).

Retirement plans and similar arrangements. Special rules apply to employer-sponsored retirement plans or deferred compensation arrangements, as well as interests in an individual retirement account or annuity.

Deferral of payment of tax. An individual can elect to defer payment of the mark-to-market tax, in which case interest will be charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments (currently 5 percent rather than 3 percent).

Detailed rules spell out how that deferral is effected and how the government is secured. Death of the individual abruptly ends the deferral.

Interests in trusts. Trusts pose special problems. Detailed rules apply to trust interests held by an individual at the time of citizenship relinquishment or residency termination. The treatment of trust interests depends on whether the trust is a qualified trust.

A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust. (That coincides with the definition of domestic trust in section 7701(a)(30).)

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In those cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying those provisions.

Also, an individual who holds (or who is treated as holding) a trust interest at the time of expatriation is required to disclose on his tax return the method used to determine his interest in the trust and whether that individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the exit tax due regarding that trust interest. The individual’s interest in the trust is treated as a separate trust consisting of the trust assets allocable to that interest. That separate trust is treated as having sold its net assets as of the date of citizenship.
relinquishment or residency termination and having distributed the assets to the individual, who then is treated as having recontributed the assets to the nonqualified trust.

The rules of section 6324A(d)(1), (3), and (4) (regarding liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under that provision. The individual is subject to the exit tax regarding any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the exit tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments (currently that figure would be 9 percent).

A beneficiary’s interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and the historical pattern of trust distributions.

If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual’s trust interest is calculated at the time of citizenship relinquishment or residency termination. In determining that amount, all contingencies and discretionary interests are assumed to be resolved in the individual’s favor (that is, the individual is allocated the maximum amount that he could receive).

The exit tax imposed on those gains is collected when the individual receives distributions from the trust or, if earlier, on the individual’s death. Interest is charged for the period the tax is deferred at a rate 2 percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the exit tax on the receipt of distributions from the trust. Those distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual expatriates, the exit tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event, mercifully, will the tax imposed exceed the deferred tax amount regarding the trust interest.

For that purpose, the deferred tax amount is equal to: the tax calculated regarding the unrealized gain allocable to the trust interest at the time of citizenship relinquishment or residency termination, increased by interest thereon, and reduced by any exit tax imposed on prior trust distributions to the individual.

If any individual’s interest in a trust is vested as of the citizenship relinquishment or residency termination date (for example, if the individual’s interest in the trust is noncontingent and nondiscretionary), the gain allocable to the individual’s trust interest is determined based on the trust assets allocable to his trust interest. If the individual’s interest in the trust is not vested as of the citizenship relinquishment or residency termination date (for example, if the individual’s trust interest is a contingent or discretionary interest), the gain allocable to his trust interest is determined based on all of the trust assets that could be allocable to his trust interest, determined, not so mercifully, by resolving all contingencies and discretionary powers in the individual’s favor.

If more than one trust beneficiary is subject to the exit tax regarding trust interests that are not vested, the rules are intended to apply so that the same unrealized gain regarding assets in the trust is not taxed to more than one individual.

The exit tax becomes due if the trust ceases to be a qualified trust, the individual disposes of his qualified trust interest, or the individual dies. In those cases, the amount of exit tax equals the lesser of: (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event; or (2) the deferred tax amount regarding the trust interest as of that date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax regarding those distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against that individual regarding the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies. The creation of liability for the trustee is especially noteworthy.

Coordination with current alternative tax regime. The existing expatriation income tax rules in section 877 and the accompanying expatriation estate and gift tax rules will not continue to apply to a former citizen or former long-term resident whose expatriation occurs on or after the date of enactment of the new provisions. A conforming amendment at section 422(e) of the Senate version of the bill, adding new section 877(h), states, “This section shall not apply to an expatriate (as defined in section 877A(e)) whose expatriation date (as so defined) occurs on or after the date of the enactment of this subsection.”

Treatment of gifts and inheritances from a former citizen or former long-term resident. The exclusion from income for the value of property acquired by gift or inheritance (section 102) generally will not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (that is, an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to some exceptions regarding dual citizens and minors.

Accordingly, a U.S. taxpayer who receives a gift or inheritance from that individual is required to include the value of that gift or inheritance in gross income and is subject to U.S. tax on that amount. Having included the value of the property in income, the recipient would then take a basis in the property equal to that value.

The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or to property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on that return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules).

Also, the tax does not apply to property when no estate or gift tax return is required to be filed, when no such return would have been required to be filed if the
former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

The practical considerations attached to a wholly discretionary foreign trust when the class of beneficiaries can be expanded or contracted are formidable. There will also be problems for a beneficiary needing to obtain information about a trust. For example, the beneficiary may not be entitled to information concerning a letter of wishes or distributions to other beneficiaries. Also, how a recipient of a gift or bequest is supposed to know about the citizenship or residency of the donor or deceased is not explained.

Information reporting. The Senate-passed provisions provide that some information reporting requirements under current law applicable to former citizens and former long-term residents also apply for purposes of those provisions.

Immigration Rules. The immigration rules that deny tax-motivated expatriates reentry into the United States would be modified to remove the requirement that the citizenship relinquishment be tax-motivated, and instead former citizens would be denied reentry if the individual is determined not to be in compliance with his tax obligations (regardless of the subjective motive for expatriating).

For that purpose, the amendment permits the IRS to disclose some items of return information of an individual, on written request of the attorney general or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act.

Specifically, the amendment would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether that taxpayer is in compliance with section 877A and to identify the items of noncompliance.

It is worth noting that the provision in effect creates a truly draconian penalty for failure to file proper returns — one loses his ability to ever enter the country.

Effective date. The provisions as approved by the Senate generally are effective for U.S. citizens who relinquish their citizenship or long-term residents who terminate their residency on or after the date of enactment, whenever that is.

The provisions regarding gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after the date of enactment, whose citizenship relinquishment or residency termination occurs on or after that date; therefore, individuals that expatriated in the past, and their children, can have a sigh of relief.

The provisions of the bill regarding former citizens under U.S. immigration laws likewise are effective on or after the date of enactment.

Some significant points to note are:

- The new rules do not sit on top of the existing rules. The existing provisions of the code do not apply to individuals that are subject to new section 877A. That means, among other things, that the monetary thresholds in section 877 will have no application.

- The alternative tax regime for taxing U.S.-source income for a 10-year period will not apply. The physical presence rules intended to penalize expatriates that return to the United States for extended periods of time (typically 30 days) will be irrelevant.
- The provision taxing gifts and bequests from tax expatriates goes beyond the bounds of enforceability and sets a dangerous precedent. As noted, how will a recipient know whether her uncle renounced U.S. citizenship after such-and-such date? Will the IRS maintain a database for all to access? The existing rules for reporting, but not paying tax on, large foreign gifts and bequests do not require disclosure of the donor or deceased. Will that form be changed? The size of payments from the United States to persons in other countries is very large; a significant number of those payments come from individuals who have emigrated from another country to the United States, losing their former citizenship in the process. Will the tax authorities of those other countries want to follow suit and tax recipients of gifts and bequests in the same way?
- The provisions targeted at individuals with interests in domestic and other trusts break new ground in draftsmanship and may be almost unenforceable.
- Those provisions, as unique as they are, are estimated to pick up only $251 million over five years — a relatively small amount when viewed in the context of a $56 billion to $70 billion act. Of course, those estimates do not include offsetting estimates for losses in revenues from highly talented individuals or well-capitalized entrepreneurs who may be dissuaded from establishing U.S. residency or citizenship.

C. What Is the Likelihood of Enactment?

No one knows. As unsatisfactory an answer as that is, that is the case.

The provisions are buried in a large piece of legislation. They have not received much attention. There apparently are no interested parties speaking out. The administration has not stated its position on the subject. The provisions may slide by simply because the revenue pickup is needed to meet a target figure, without regard to any other considerations.

D. When Might the Provisions Become Law?

Again, it is impossible to say. They may never be enacted.

If enacted, they probably — no guarantee — would become law in the next 30 to 45 days. The conference committee, it is thought, will begin work soon. To become law, the exit tax provisions have to be approved by the conference committee, the conference committee’s report has to be adopted by both the House and the Senate, and the president has to sign the bill into law. As drafted, those provisions would not become effective until the president signs the bill.

V. Practical Considerations

Here are some important practical considerations. Some will militate in favor of acting quickly. Others may lead the individual to want to wait until the new rules are enacted.
in place. As can be seen, the landscape is strewn with tricky technical and judgmental issues.

A. Built-In Gain Property

If one were considering expatriating at some time and had property with large amounts of built-in gain, he probably should think about doing that before enactment of this bill to avoid the exit tax. The provisions for taxing U.S. beneficiaries of gifts and bequests in many cases also will be a significant detriment. Also, in particular cases, the provisions targeted at beneficiaries of a trust can create serious problems and invite tortuous audits.

It is difficult, if not impossible, to renounce U.S. citizenship on short notice. It normally requires several weeks. State Department forms need to be filled out and presented in advance. An appointment with a consular officer must be made. The tax form (Form 8854) must be completed. Of course, a renunciant must have a satisfactory "other" nationality.

Also, if the expatriate is not current with his tax filings, those to be brought up to date. An individual renouncing citizenship or terminating long-term residency must certify that he has complied with all U.S. federal tax obligations for the preceding five years and must provide any evidence of compliance that may be required. Otherwise, he will be treated for tax purposes as not having renounced residency; in other words, he will be a U.S. taxpayer even though he is for immigration purposes an alien. Terminating permanent residency status can be accomplished relatively quickly.

B. No Built-In Gain Property

If one did not have property with built-in gain in excess of the $600,000 exemption level — for example, if he had mainly cash and cash equivalents — he might prefer to be under the new rules. That individual would not have to face the provisions taxing future U.S.-source income, and he would not have to worry about the 30-day rule. If that individual was not too concerned about the taxing of U.S. recipients of gifts and bequests, that would act as further encouragement to wait to expatriate.

VI. The Exit Tax Should Be Rejected

The conference committee should reject the provisions. No one is particularly worried about wealthy individuals renouncing their U.S. citizenship. Those individuals can bring their U.S. income tax burden down to an acceptable level in a dozen ways. The capital gains rates, which are addressed elsewhere in the bill, are a major factor, as are tax-exempt bonds and pension arrangements. Also, death taxes are steadily being reduced or eliminated. In any event, the existing rules provide an effective deterrent. The focus when considering an exit tax should be on dual residents, especially accidental Americans and long-term residents (immigrants).

Imposition of an exit tax will discourage highly skilled immigrants from coming to and staying in the United States.9 An exit tax will cause people wanting to work in the United States to avoid applying for a green card. The avenue of choice will become one of the nonimmigrant visas. Those include specialty workers (H-1B), intracompany transferees (L-1), treaty traders and investors (E-1/ E-2), persons of extraordinary ability (O-1), artists and entertainers (P-1/-2/-3), religious workers (R-1), and North American Free Trade Agreement treaty professionals (TN). The system will become more problematic and more arbitrary. The H-1B category is already overrun. The E-1/E-2 category is available only to nationals of a country that has a Treaty of Friendship, Commerce, or Navigation or equivalent treaty with the United States.10

Aspects of the exit tax, as a practical matter, are frankly unenforceable. Because the tax is not actually collected before or at the time of expatriation, if it is not paid, it will in all likelihood have to be collected from an individual living outside the United States with assets outside the country. There is no mechanism for doing that. A U.S. individual receiving a bequest from her aunt in Germany has no way of knowing reliably that her aunt resided years ago in the United States as a legal resident for eight or more years before leaving. How can the IRS realistically hope to catch transfers that pass from the aunt to someone else, from that person to a third person, and from that person to the U.S. recipient? Those cases involve individuals and families, not big companies with audit committees and armies of accountants and attorneys, all subject to the Sarbanes-Oxley rules. Also, because the exit tax creates a deemed sale, often it will engender difficult valuation problems.

9A recent book, Flight Capital: The Alarming Exodus of America's Best and Brightest, by David Heenan, argues that America's Best and Brightest

The rules set a bad precedent and risk upsetting the international norm applicable to the taxation of remittances. Most countries do not tax the receipt of an intrafamily gift or bequest. Certainly the United States does not. If the United States chooses to tax, say, a family member who remains in the country on remittances from a father who has moved back to his native country, why shouldn’t countries that currently do not tax remittances from citizens that have emigrated from that country to the United States change their rules? The tax treatment of remittances is an enormously important subject, and changes should be approached with great care.11

The rules for taxing the act of expatriation have changed three times over the last 10 years. The IRS tax rules sit alongside USCIS (immigration), State Department, and Social Security Administration rules. Everyone, including the consular officers that oversee the renunciation process, needs a breathing spell. Enacting a set of exit tax rules that increases the complexity of this part of the code exponentially would not be welcome, we suspect, in any quarter.

The application of the exit tax, in fact, can be quite arbitrary. Not “hit” — that is, not treated as a “covered expatriate” — is an individual who became at birth a citizen both of the United States and another country, who as of the date of renunciation continues to be a citizen of and is taxed as a resident of the other country, and who has not been a resident of the United States during the most recent five years. Thus, if A was born in the United States of German parents and at the time of renunciation continues to reside in and pay taxes in Germany, and has not resided in the United States at any time during the last five years, he is not taxed. If the same facts apply, but the country is Saudi Arabia rather than Germany, the individual apparently is taxed; Saudi Arabia does not have an income tax. The same problem would arise regarding Bermuda. Also, A would be taxed if, instead of living in Germany, he took advantage of the EU rules for free movement of people to work in the United Kingdom. (Perhaps he could move back to Germany for a few months, but it seems odd to make that a requirement.)

Also not hit is a young person who renounces before attaining age 18½, but only if he has resided in the United States for not more than five years before renunciation. Therefore, not even all minors will be exempted. Of course, there probably will not be many wealthy minors that will actually incur the tax; if such a person exists, presumably the family can send them away from the United States before crossing over the five-year line, but again it is peculiar to be forcing families to perform those maneuvers.12

The exit tax affects long-term residents in especially perverse ways. The counting of the years — 8 out of the most recent 15 — picks up years before the effective date of the bill. For example, B obtained a green card in 1998. If he returns to his native country, say, Italy, in 2007, he will be taxed as a relinquishing long-term resident. There is no relaxation or transition rule.

**The tax on gifts and bequests to U.S. persons is remarkable in its application and sets a very bad precedent.**

There will be problems with the timing of a long-term resident’s relinquishment. Normally, it will be the date he hands in his green card.13 There are, however, a large number of green card holders that have abused the system by, in fact, residing outside the United States and not paying U.S. taxes. If caught, their green cards will probably be taken away by an immigration inspector and they may well be treated for immigration purposes as having relinquished the green cards at some point in the past; yet they will not have relinquished for tax purposes because they are not current with their U.S. taxes and they have not filed the necessary tax form.14 That leaves the whole matter in a very messy state. Simply leaving the United States without handing in the green card but not paying U.S. tax and not filing FBARs is obviously a bad idea. That person is not entitled to permanent residency status any longer and yet is subject to all the U.S. tax and related rules. If the new US-VISIT procedures for tracking entries and exits are extended to green card holders, that will make it difficult for people simply to fade into the background. Also, the day will come when the enforcement of the various day-counting and other rules is greatly improved by information sharing between the immigration authorities and the IRS.15

**VII. Conclusion**

The conferees should discard the exit tax proposal. In doing so, they should make clear that this type of proposal will not simply be put back on the shelf but will be retired for all time. Even the cloud of an exit tax will discourage talented and well-to-do immigrants from coming to the United States. It is a perfectly bad idea.

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13That step is best done by meeting with a consular officer at one of the American embassies, handing the officer the green card, getting a receipt, and at the same time, giving the officer a copy of Form 8854. The original form should be mailed to the IRS service center in Philadelphia. Simply handing the green card to a USCIS official at a port of debarkation will not accomplish relinquishment for tax purposes.

14Form 8854 (Rev. May 2005), “Initial and Annual Expatriation Information Statement.”