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The Expatriation Tax, Deferrals, Mark to Market, the Macomber Conundrum and Doubtful Constitutionality

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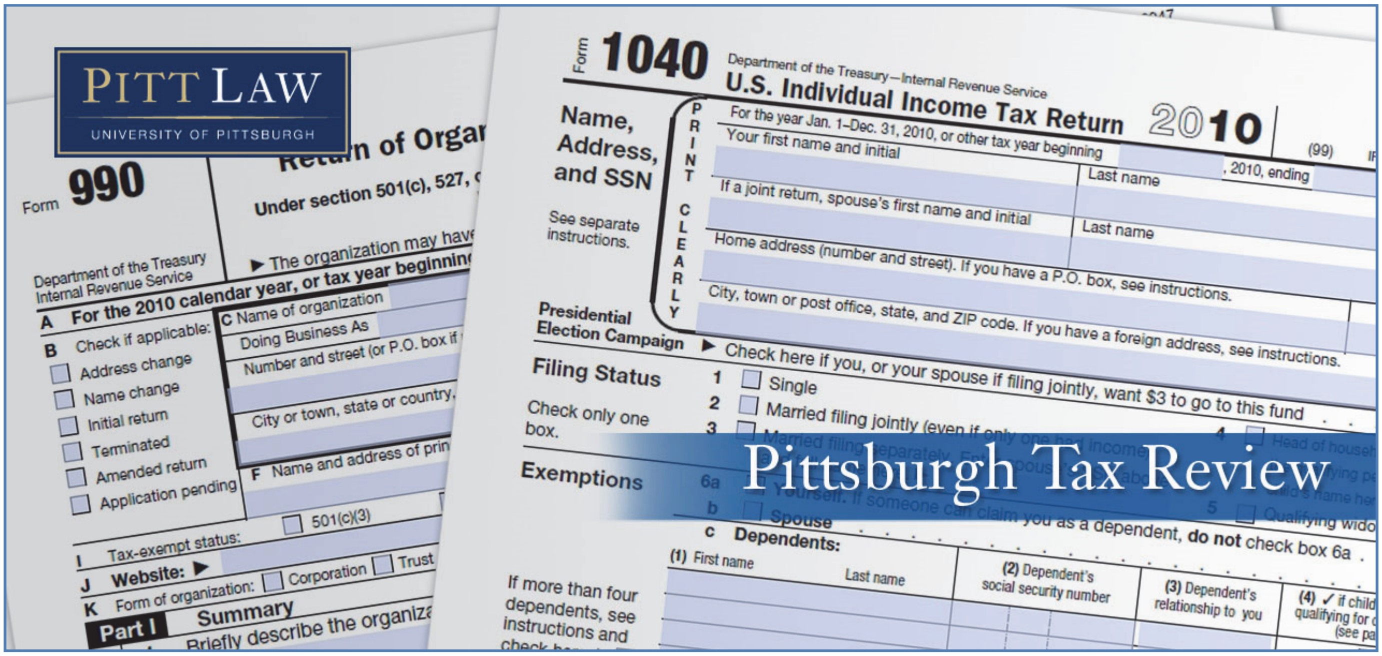

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ARTICLES

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I. INTRODUCTION

Congress added § 877A—captioned "[t]ax responsibilities of expatriation"[1]—to the Internal Revenue Code in 2008[2] to prevent taxpayers who, because they expatriate,[3] will cease to be subject to the U.S. federal income tax on their worldwide income[4] from avoiding U.S. taxation on income, including asset appreciation, arising before expatriation. The expatriation tax terminates the deferral of some income[5] and forces the

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1 This article refers to § 877A as the expatriation or exit tax.

2 Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, Pub. L. No. 110-245, § 301(a), 122 Stat. 1624, 1638.

3 I.R.C. § 877A(g)(2) (defining expatriate as one who relinquishes citizenship or ceases to be a permanent resident).

4 Treas. Reg. § 1.1-1 (as amended in 2008) (worldwide income taxation of citizens and residents).

5 I.R.C. § 1001 For purposes of this article, "deferred income" refers to income the inclusion of which in gross income is deferred to a date later than the earliest date on which the Code could have required the taxpayer to include it in income consistent with the Sixteenth Amendment to the U.S. Constitution. In most instances, deferral results from an express statutory provision, but nonstatutory deferrals exist as well—nonstatutory deferred compensation, for example. The article will also use the term "deferral" in a broader sense to refer to quasideferrals; that is, income that the United States may not tax because the earner of the income is a foreign corporation (albeit owned by U.S. persons) not subject

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recognition of unrealized gains and losses[6] when the taxpayers who were citizens or residents of the United States cease to be citizens or residents. The statute imputes a sale or exchange of the expatriating taxpayers' property at fair market value[7] on the day before the taxpayers' expatriation dates.[8] Absent § 877A, some deferred income[9] and some gain realized and recognized following expatriation would not be taxable in the United States at all, despite the income having been earned and the property having appreciated in value while the taxpayers were U.S. citizens or permanent residents.[10]

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to U.S. taxation; instances in which payment of tax, but not the inclusion in income, is deferred like installment sale gain; and income that would be part of a comprehensive tax base like unrealized gain. *See infra* note 7 and accompanying text on realization and recognition of gain and loss from the sale or exchange of property. *See also infra* Part V.A. for discussion of various deferrals in greater detail.

[6] I.R.C. § 1001 (realization and recognition of gain and loss from the sale or exchange of property). Under § 1001(a) and (b), realization is the determination of the gains and losses from the sale or other disposition of property, and recognition is the inclusion of gain or loss from the sale or exchange of property in income under § 1001(c). Section 1001(a) and (c) are not parallel insofar as § 1001(a) measures the gain on sale or other disposition, rather than sale or exchange of property, and suggests that there may be dispositions of property that result in realization but that are not subject to the recognition rule even though those dispositions historically have not been treated as generating includable income—for example, gifts of appreciated property do not cause the donor to recognize gain from the disposition of the property (a nonstatutory deferral that in combination with the preservation of the donor's adjusted tax basis under § 1015 shifts the tax responsibility for the donor's historic appreciation in the property to a selling donee but no statute expressly prevents the donor from becoming subject to tax on the disposition). *See generally* Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77 (2011) (arguing for giving effect to the "other disposition" language).

[7] I.R.C. § 877A(a)(1). The statute does not define "fair market value," but it is a term used throughout the Code. In the case of market traded securities, it is the market trading price at any moment. For other property, "[t]he fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b) (as amended in 1965).

[8] I.R.C. § 877A(a)(1) (fixing the time for the constructive sale at fair market value), (g)(3) (defining expatriation date).

[9] For example, deferred payments for services rendered by a U.S. person outside the United States for a non-U.S. service recipient.

[10] For example, gain from the sale of appreciated personal property sourced at residence under § 865. *See infra* note 30 and accompanying text.

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In 1920, the U.S. Supreme Court decided *Eisner v. Macomber*,[11] holding that unrealized gain is not income under the Sixteenth Amendment.[12] Absent an actual sale or exchange of property, *Macomber* may remain a barrier to taxing unrealized gain as the expatriation tax does.[13] The Court has never reversed its holding in *Macomber*. Despite *Macomber*, many commentators see no constitutional barrier to taxing unrealized gain. In 1984, Congress enacted the mark-to-market rules of § 1256 of the Code[14] for commodities and certain other investments. Section 1256 requires taxpayers to treat those investment positions as sold, even though no sale or other disposition has taken place, at their fair market values on the last day of the taxable year and to include their gain or loss on those positions in their gross incomes. The Supreme Court has not ruled on the constitutionality of those mark-to-market inclusion rules.[15]

This article discusses the techniques and business structures U.S. persons use to avoid or evade U.S. income tax liability on their foreign activities, and reviews statutory provisions that limit U.S. taxpayers' ability to defer or avoid the U.S. income tax on their incomes from foreign sources. Income from U.S. sources is always taxable for U.S. income tax purposes without regard to the citizenship or residence of the income earner.[16] The

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[11] 252 U.S. 189 (1920).

[12] U.S. CONST. amend. XVI (the income tax amendment). The Court in *Macomber* stated inter alia:

> We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

Macomber, 252 U.S. at 212.

[13] Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution,* Macomber*, and Mark to Market*, 13 VA. TAX REV. 1, 9–10 (1993) (arguing that there is a continuing constitutional barrier to taxing unrealized gain).

[14] I.R.C. § 1256 (added to the Code by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 503(a), 95 Stat. 172, 327).

[15] *See* discussion *infra* Part V.

[16] I.R.C. §§ 871, 881 (imposing a U.S. tax on income received by a non-U.S. person from U.S. sources but not attributable to the conduct of a trade or business in the United States); *id.* §§ 1, 11 (individual and corporate income received by a non-U.S. person from the conduct of trade or business is taxable in the United States).

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article then focuses on permanent expatriation from the United States of U.S. persons to free themselves from U.S. income tax. As expatriation enables U.S. taxpayers to terminate application of the U.S. income tax to their foreign source income, including much of the income that would have been U.S. source before expatriation, the article considers the U.S. continuation taxes and examines the U.S. exit tax applicable to expatriating taxpayers. Specifically, for the exit or expatriation tax, the article inquires whether that tax violates the constitutional realization requirement identified in *Macomber*.[17] The article does not seek to analyze human rights concerns, even though the expatriation tax burdens free movement of individuals and acts as a practical limitation on their freedom to emigrate.[18]

Part II describes the U.S. worldwide taxation system, contrasts it with the territorial taxation systems in other countries, and introduces the concepts of continuation and exit taxes. Part III discusses corporate deferral and avoidance, evasion, and expatriation as means to limit U.S. taxation. Part IV reviews continuation taxes in the United States. Part V classifies various types of deferrals, evaluates the application of the U.S. expatriation tax to those classes of deferrals, and examines the relationship of the tax to realization as a condition to inclusion of gain in income. Part VI identifies some of the peripheral problems that surround taxation of immigrants and emigrants, in the presence of a valid expatriation tax. Part VII concludes by recommending congressional reconsideration of the expatriation tax and substitution of an elective mark-to-market regime accompanying a more robust continuation tax. In the event of a Supreme Court reversal of its *Macomber* decision, the article recommends enactment of a broad-based annual mark-to-market inclusion for all taxpayers and all property annually.

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[17] *See* Ordower, *supra* note 13; *see also* Mark E. Berg, *Bar the Exit (Tax)! Section 877A, the Constitutional Prohibition Against Unapportioned Direct Taxes and the Realization Requirement*, 65 TAX LAW. 181 (2011) (arguing that § 877A imposes an unapportioned direct tax, not an income tax under the Sixteenth Amendment, and is unconstitutional).

[18] William Thomas Worster, *The Constitutionality of the Taxation Consequences for Renouncing U.S. Citizenship*, 9 FLA. TAX REV. 921, 923, 1019 (2010) (arguing that the tax is unconstitutional because it burdens the right to emigrate).

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II. THE FUNDAMENTALS: RESIDENCE-BASED AND WORLDWIDE TAXATION, EXPATRIATION, CONTINUATION, AND EXIT TAXES

A taxpayer who resides in a jurisdiction having a residence-based income taxation system need only relocate to another jurisdiction and, except for income from property located or services performed in the first jurisdiction, the taxpayer will cease to be subject to the income tax in the first jurisdiction. If the taxpayer returns to reside again in the first jurisdiction, as she may after a temporary work assignment in the second jurisdiction, for example, she will become subject to the income tax in the first jurisdiction again.

A taxpayer who resides in a jurisdiction having a worldwide income taxation system, as the United States does,[19] however, remains subject to the income tax in the first jurisdiction until he renounces his citizenship and emigrates or, in the case of a noncitizen resident, relinquishes his right to reside in the first jurisdiction and departs from it. Only following citizenship renunciation or permanent residence relinquishment, accompanied by physical departure from the country,[20] does the taxpayer cease to be subject to the income tax on worldwide income in the first jurisdiction. Then, like all other noncitizens and nonresidents, he is subject to income tax on that portion of his income from sources in the first jurisdiction.

Income from sources within a country includes periodic income as well as gain from the sale or exchange of real property because real property has a unique physical location in that country. Most personal property is moveable and may produce income from its use in multiple jurisdictions. A

[19] The United States is exceptional in this respect. *See generally* Reuven S. Avi-Yonah, *Constructive Unilateralism: U.S. Leadership and International Taxation* (U. of Mich. Pub. L. Research Paper No. 463, 2015), https://ssrn.com/abstract=2622868 or http://dx.doi.org/10.2139/ssrn.2622868. Note, however, that as this article was going to print, the United States limited the worldwide taxation of corporations as Congress passed and the President signed the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017). Discussion of the changes made by the Act limiting worldwide taxation of corporations and related matters is interspersed throughout this article.

[20] In the case of an individual, this article refers to emigration accompanied by renunciation of U.S. citizenship or relinquishment of the right to permanently reside in the United States by a noncitizen taxpayer having that right as "expatriation" and the individual as an "expatriate." The Immigration and Nationality Act controls the mechanics of renunciation of U.S. citizenship. 8 U.S.C. § 1481 (2012). Section 877A(g)(4) links tax treatment to that renunciation.

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taxpayer may be liable for tax wherever the personal property produces income. Tangible personal property may generate revenue from its physical use in each jurisdiction in which it is temporarily or permanently deployed. For example, if a non-U.S. taxpayer transports a microscope to the United States and rents it to someone to use in the United States, the rental income is U.S. source income.[21] Intangible property may generate interest or dividend income, and that income is taxable where the payer of the interest or dividend is located.[22] In the case of intellectual property, income is taxable wherever the intellectual property produces a royalty for its owner.[23] Unless personal property is attributable clearly to a single physical locale—a machine installed in a U.S. factory and not readily removable—gain from the sale or exchange of the personal property is attributed to its owner's residence,[24] but personal property specific to its owner's conduct of a trade or business in a country not the owner's country of residence is located where the trade or business is.[25] Thus, the source of gain from the sale of a work of art, for example, would shift from U.S. source to non-U.S. source when the owner expatriates even if the work of art continues to be located in the United States, if not used in a trade or business conducted in the United States. Sales of most intangible property also are sourced to the taxpayer's residence (subject to the U.S. trade or business exception),[26] but exceptions to residence source apply to payments contingent on productivity for intellectual property,[27] and goodwill is sourced to where it is created.[28]

Wealthy taxpayers in increasing numbers have been willing to abandon their home countries and move permanently to lower tax jurisdictions.[29] Tax

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[21] I.R.C. § 861(a)(4) (rental income from property used in the United States).

[22] *Id.*§ 861(a)(1), (2) (U.S. source interest, dividends).

[23] *Id.* § 861(a)(4) (royalty income).

[24] *Id.* § 865(a)(1) (personal property gain sourced to residence).

[25] *Id.* § 865(e)(2) (fixed place of business).

[26] *Id.* § 865(a)(1), (e)(2).

[27] *Id.* § 865(d)(1)(A) (contingent payments on sale).

[28] *Id.* § 865(d)(3) (goodwill sale).

[29] *See, e.g.*, I.R.S. Notice, Quarterly Publication of Individuals, Who Have Chosen to Expatriate, as Required by Section 6039G, 82 Fed. Reg. 36,188 (Aug. 3, 2017) (listing the names of voluntary citizenship or permanent residence relinquishments); *see also 2017 Second Quarter Published*

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motivations have characterized the decisions to relocate for taxpayers departing both residence-based jurisdictions where relinquishment of citizenship is unnecessary to accomplish the tax goal and worldwide taxing jurisdictions where more radical relinquishment of citizenship (or right to permanent residence) is necessary to achieve the tax goal. In the United States, for example, removal of significant amounts of appreciated personal property from the country's taxing jurisdiction has become a matter of concern in high-tax jurisdictions as wealthy taxpayers expatriate. With expatriation and absent a valid expatriation tax, the United States loses its ability to tax gain from the sale of personal property.[30] Often that gain is attributable to pre-expatriation appreciation in the value of the property that the United States has not taxed because of the realization requirement.[31]

Legislatures have reacted to tax-motivated relocations by enacting continuation taxes and exit taxes.[32] Continuation taxes impose the abandoned jurisdiction's income tax on some or all the departing taxpayer's income despite relocation. Those continuation taxes often are of limited duration—five or ten years being common. Sweden has such a continuation tax. It taxes some expatriates on income from disposition of certain personal property for ten years following expatriation.[33] In the United States, continuation taxes

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Expatriates—Second Highest Ever, INT'L TAX BLOG (Aug. 2, 2017), http://intltax.typepad.com/intltax_blog/2017/08/2017-second-quarter-published-expatriates-second-highest-ever.html.

[30] *See* I.R.C. § 865 (with exceptions, sourcing gain from sale of personal property by a nonresident outside the United States). This is explained in the preceding paragraph in the text above.

[31] *Id.* § 1001 (determining realized gain and loss from the sale or other disposition of property, then includable in gross income under § 61).

[32] Alice G. Abreu, *Taxing Exits*, 29 U.C. DAVIS L. REV. 1087 (1996) (analyzing various proposals to counteract the tax loss from expatriation with the income tax and the transfer tax systems).

[33] 3 ch. 19 § INKOMSTSKATTLAG (Svensk författningssamling [SFS] 1999:1229) (Swed.) (taxing Swedish citizens and permanent residents who leave Sweden on income from capital). Similarly, Germany has a ten-year continuation tax based on tax avoidance intent as described in Daniel Gutmann, *La lutte contre "l'exil fiscal": du droit comparé à la politique fiscale*, LE CERCLE DES FISCALISTES (May 24, 2012), http://www.lecercledesfiscalistes.com/publication/la-lutte-contre-lexil-fiscal-du-droit-compare-a-la-politique-fiscale/234. Gutmann distinguishes the Swedish approach as fictionalized continuing residence and the German approach as a modified worldwide taxation—assigning Italy and Spain to the continuation camp, but only if the taxpayer moves to a low-tax jurisdiction. And Gutmann identifies the British and New Zealand approaches that tax gain realized abroad if the individual repatriates within five years of expatriation as if the individual never left. *Id.*

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are found in § 877 of the Code,[34] in the case of an individual, and in § 7874 of the Code,[35] in the case of corporate taxpayers. The individual provision has a ten-year postexpatriation duration.[36] The corporate provision has a ten-year postexpatriation duration for some corporations, but a permanent duration for others.[37]

Other countries,[38] including the United States,[39] impose exit taxes. Unlike tax clearance provisions that require a certification from the taxing authority that an individual departing a jurisdiction has no unpaid taxes,[40] exit taxes impose a one-time tax on departure of the individual from the taxing jurisdiction.[41]

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[34] I.R.C. § 877 (continuation tax on taxpayers relinquishing citizenship for tax avoidance purposes but no longer applicable to new expatriates); *see infra* Part IV.B.

[35] I.R.C. § 7874 (anti–corporate inversion continuation tax); *see infra* Part IV.A.

[36] I.R.C. § 877(a)(1).

[37] *Id.* § 7874 (applying the applicable ten-year period to 60% surrogate corporations but treating 80% corporations as domestic); *see infra* Part IV.

[38] France, for example, required a taxpayer who moves from France to include in income upon exit the unrealized gain on the taxpayer's securities positions if the exiting taxpayer owns, directly and indirectly, more than 25% of the profits interest in the issuer. CODE GENERAL DES IMPOTS (Tax Code) art. 167a (Fr.) (as in effect in 1999). The European Court of Justice in Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2452, found the tax contrary to Community law because it restricted the taxpayer's right to free establishment in any member state when imposed upon taxpayers who relocate to other E.U. countries. Treaty of Rome, art. 52, Mar. 25, 1957, 298 U.N.T.S. 11, http://www.gleichstellung.uni-freiburg.de/dokumente/treaty-of-rome. But more recently, "Advocate General Paolo Mengozzi in *Christian Picart v. France*, C-355/16, called on the Court of Justice of the European Union to find that the 1999 E.U.-Switzerland agreement on free movement of persons doesn't preclude France from imposing exit tax on the unrealized gains of taxpayer who moved to Switzerland." *France May Impose Exit Tax on Taxpayer Who Moved to Switzerland, Advocate General Tells CJEU*, WORLDWIDE TAX DAILY, July 28, 2017, 2017 WTD 144-16 (LEXIS). The Advocate General argued that the fiscal rules applicable to French nationals but restricting freedom of movement within the E.U. are inapplicable to a move to Switzerland governed by a different treaty. *Id.* The Court of Justice has not ruled as yet in the case.

[39] I.R.C. § 877A.

[40] Many noncitizen individuals temporarily or permanently residing in the United States are required to obtain a tax clearance before departing. The clearance is referred to as a departure or sailing permit on IRS Form 2063. I.R.S. Pub. 519, U.S. Tax Guide for Aliens 50 (2017).

[41] *See, e.g.*, Gutmann, *supra* note 33 (describing the French exit tax reaching unrealized gain and comparing it to a closing of the taxpayer's books as in Canada and Australia).

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Exit taxes have a rather unsavory history. Nazi Germany imposed substantial exit taxes as a condition to issuance of travel permits to members of groups against which the government discriminated—Jews, homosexuals, and so forth. The tax was high, arbitrary, and a function of the departing taxpayer's wealth, but rarely low enough at any time to enable any but well-to-do individuals to depart.[42] Exit taxes in the Soviet Union and its satellite countries before the 1990 economic transitions tended to be fixed amounts that would bring hard currency into the country in exchange for permitting individuals to depart. Israel or Jewish agencies paid Romania[43] in exchange for the release of Romanian Jews to Israel. U.S.-based organizations helped Soviet Jews pay the "diploma" tax the Soviet Union enacted as a requirement for an exit visa for college-educated citizens.[44]

Less unsavory are departure taxes that impose a regular income tax on some or all of the taxpayer's outstanding income deferrals, whether statutorily sanctioned deferrals or realization-based deferrals. Under a comprehensive income definition like Haig-Simons,[45] (1) diversion of income into qualified retirement plans[46] and nonqualified deferred compensation plans like "rabbi" trusts,[47] (2) acceleration of deductions

[42] Gerald D. Feldman, *Confiscation of Jewish Assets, and the Holocaust*, *in* CONFISCATION OF JEWISH PROPERTY IN EUROPE, 1933–1945, at 1, 4 (Ctr. for Advanced Holocaust Studies, U.S. Holocaust Memorial Museum, 2003) ("The Reich 'Flight Tax,' for example, was created by the Brüning regime in 1931 to prevent capital flight from Germany; it did so by forcing emigrants to pay twenty-five percent of their assets."). Payment for exit did not guarantee the right to depart, however, but without payment the individual would not get the papers necessary to depart. For a history of the Reich Capital Flight Tax, see DOROTHEE MUSSGNUG, DIE REICHSFLUCHTSTEUER 1931–1953 (1993).

[43] International Jewish organizations and Israel often paid the exit tax for Jews wishing to emigrate and move to Israel. *See generally* RADU IOANID, THE RANSOM OF THE JEWS: THE STORY OF THE EXTRAORDINARY SECRET BARGAIN BETWEEN ROMANIA AND ISRAEL (Ivan R. Dee ed., 2005).

[44] American Jewish organizations often paid the Soviet exit tax to enable Jews in the Soviet Union to emigrate to the United States or Israel. Sana Krasikov, *Declassified KGB Study Illuminates Early Years of Soviet Jewish Emigration*, THE FORWARD (Dec. 12, 2007), http://forward.com/news/12254/declassified-kgb-study-illuminates-early-years-of-00966/.

[45] The classic Haig-Simons definition of income is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question." HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938).

[46] I.R.C. §§ 401 (qualified retirement plans), 408 (individual retirement accounts).

[47] *Id.* § 83 (inclusion in income of property received for services, but no transfer if the property remains subject to the claims of the transferor's creditors). *See generally* Henry Ordower, *A Theorem for*

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through expensing[48] and accelerated cost recovery,[49] (3) exchanges of property for other property,[50] and (4) the realization requirement for taxing appreciation in the value of property[51] are deferrals of income that otherwise would be includable in a comprehensive tax base. Accumulation of income in a foreign corporation owned in whole or in part by U.S. taxpayers customarily is viewed as deferral,[52] although, other than the appreciation in the value of the stock in the foreign corporation, the failure of the U.S. income tax to reach the foreign source income of a foreign corporation would not be deferral of U.S. tax under a comprehensive income definition like Haig-Simons. Section 877A[53] is such an exit tax.[54]

III. Avoiding and Evading the U.S. Worldwide Tax

While the United States taxes its citizens, residents, and domestic corporations on their incomes from all sources worldwide,[55] it generally

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Compensation Deferral: Doubling Your Blessings by Taking Your Rabbi Abroad, 47 TAX LAW. 301 (1994) (evaluating deferred compensation opportunities with offshore rabbi trusts). *But see* I.R.C. § 409A(b) (added by § 885(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1634, and treating a transfer of property offshore as transferred as compensation despite remaining available for payment of the claims of creditors of the transferor).

[48] I.R.C. § 179 (allowing a current deduction for otherwise depreciable property).

[49] *Id.* § 168 (accelerated cost recovery system for depreciable property).

[50] *Id.* §§ 1031 (like-kind exchanges), 351 (transfers to corporations in exchange for stock), 354 (transfers in exchange for stock pursuant to a plan of reorganization under § 368), 721 (transfers in exchange for partnership interests).

[51] *Id.* § 1001 (measurement and inclusion of realized gains and losses); Eisner v. Macomber, 252 U.S. 189 (1920).

[52] *See infra* Part III.A for a discussion of CFCs.

[53] I.R.C. § 877A. Current § 877A follows the mark-to-market proposals introduced in H.R. 831, 104th Cong. (1995), but that were not adopted at that time. *See generally* STAFF OF JOINT COMM. ON TAXATION, 104TH CONG., ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION (Comm. Print 1995) (discussing H.R. 831 proposals).

[54] *See infra* Part V.

[55] I.R.C. § 61 (defining gross income, from which taxable income is derived, as all income from all sources); Treas. Reg. § 1.1-1 (as amended in 2008) (worldwide taxation of citizens and residents). But § 245A, added by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 14101, 131 Stat. 2054, 2089 (2017), now provides a deduction for dividends a U.S. corporation receives from a foreign corporation in which it owns a ten percent or greater interest, effectively eliminating worldwide taxation of certain intercorporate dividends.

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cedes primary taxing jurisdiction to the country in which the income is produced through the foreign tax credit.[56] Techniques to reduce or avoid U.S. income tax on foreign source income are available. Some of those techniques are legal and fully consistent with U.S. tax law principles, while other common avoidance techniques are controversial or illegal. Increasingly, individuals and domestic corporations have shifted income and assets from the United States to lower-tax jurisdictions in order to decrease their respective U.S. tax burdens.[57] Congress and the Internal Revenue Service (IRS) have sought to limit or counteract taxpayers' income tax reduction plans to capture the income tax revenue that otherwise would escape U.S. taxing jurisdiction.

[56] I.R.C. § 901. New § 245A(d) denies a foreign tax credit for deductible dividends under § 245A and the corporate deemed paid credit formerly applicable to ten percent owned corporations has been repealed for tax years beginning after 2017. Tax Cuts and Jobs Act § 14101, 131 Stat. at 2190.

[57] Richard Rubin, *Cash Abroad Rises $206 Billion as Apple to IBM Avoid Tax*, BLOOMBERG BUS. (Mar. 12, 2014, 2:47 PM), http://www.bloomberg.com/news/articles/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax ("The multinational companies have accumulated $1.95 trillion outside the United States, up 11.8 percent from a year earlier, according to securities filings from 307 corporations reviewed by Bloomberg News."). With tax years beginning after 2017, the maximum corporate income tax rate became 21% under § 11, a rate reduction at the highest rate of fourteen percentage points. Tax Cuts and Jobs Act § 13001, 131 Stat. at 2096. It is possible that the rate reduction will diminish the frequency of corporate managers' efforts to shift income offshore to lower tax jurisdictions. However, in light of taxpayers' historical efforts to reap even relatively small tax savings through aggressive tax planning (e.g., the avoidance of the 2.9% Medicare tax with S corporation planning, *see infra* note 350), the effectiveness of the rate reduction in encouraging investment in the United States is uncertain. Elimination of the tax on distributions from ten percent owned foreign corporations under new § 245A, *see supra* note 55, would seem to encourage rather than discourage the shifting of income offshore. An array of new and enhanced antiavoidance rules is designed to discourage the exploitation of the new territorial limitation on corporate taxation. The antiavoidance rules and enhancements include (1) limiting deductions in hybrid transactions with related parties or when a transaction with related parties involves hybrid entities under new § 267A, (2) classifying income of United States shareholders of CFCs in excess of a ten percent return on tangible assets of the foreign corporation as includable in gross income under new § 951A, (3) enhancing both § 482 for reallocating income between or among related parties and § 367(d)(2) for transfers of intangibles to foreign corporations, and (4) a new anti–base erosion minimum tax under § 59A for corporations' transactions with related parties affecting corporations with average revenues in excess of $500 million. Tax Cuts and Jobs Act §§ 14201, 14221(b), 14222, 14401, 131 Stat. at 2208, 2218–19, 2226.

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A. Corporate Deferral/Antideferral Statutes

While U.S. taxpayers, both corporate and individual, conducting foreign operations through a sole proprietorship, branch,[58] or a tax transparent entity[59] are taxable in the United States on their foreign source income when earned from the foreign operations under the worldwide taxing principle underlying U.S. tax law,[60] a foreign corporation is not subject to U.S. tax except on income sourced in the United States.[61] Consistent with the U.S. tax rules, for example, taxpayers may conduct business operations outside the United States through foreign corporations, even wholly owned ones, without the income becoming taxable in the United States, except that subpart F income of a controlled foreign corporation (CFC) is taxable to its United States shareholders.[62] Whether or not U.S. persons own the foreign corporation, the corporation is not taxable in the United States on its foreign source income. The United States taxes non-U.S. corporations, including those with U.S. ownership, only on their income that is effectively connected with the conduct of a U.S. trade or business[63] or that is fixed or determinable annual or periodical income from U.S. sources (FDAP income).[64] The United States, however, may reallocate foreign source income to the U.S. owner of the foreign corporation under several antiavoidance rules[65] that seek to prevent U.S. persons from shifting income inappropriately to foreign entities.

Conducting a foreign business operation through a foreign corporation is a simple technique to prevent the United States from taxing the foreign

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[58] Including disregarded entities like single-owner U.S. limited liability companies under Regulation section 301.7701-3(b)(1)(ii) and qualified subchapter S subsidiaries under § 1361(b)(3).

[59] I.R.C. §§ 702 (partnership income includable in partners' incomes for partnerships and other noncorporate entities); 1363, 1366 (S corporation not subject to tax; shareholders include S corporation income). Tax transparent entities include partnerships, limited and general; limited liability companies; and foreign entities not listed in Regulation section 301.7701-2(b)(8), provided that if all owners of the foreign entity have limited liability, the entity elects tax transparency under Regulation section 301.7701-3(b)(2), (c).

[60] I.R.C. § 61.

[61] *See supra* notes 21–28 and accompanying text.

[62] *See infra* text accompanying notes 78–87.

[63] I.R.C. § 882 (income effectively connected with a U.S. trade or business).

[64] *Id.* § 881 (withholding tax on FDAP income of foreign corporations).

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source income currently. The foreign corporation is not taxable in the United States on its foreign source income that its U.S. owners otherwise would have had to include in their incomes had they conducted the foreign operation directly rather than through the foreign corporation. However, use of a foreign corporation to earn foreign source income traps the foreign income offshore. From the U.S. perspective, the foreign corporation defers the U.S. tax rather than eliminating it.[66] Ultimately, the U.S. owner of the foreign corporation becomes taxable on the foreign source income in the United States. Either the foreign corporation will distribute the foreign source income to its U.S. owner as a dividend taxable to the U.S. owner in the United States or the U.S. owner will capture the income by selling the foreign

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[65] *See infra* Part III.B (discussing income shifting and transfer pricing) and text accompanying notes 74–83 (discussing CFCs); *see also* I.R.C. §§ 482 (reallocation of items among related taxpayers to reflect income clearly), 951 (taxing U.S. shareholders on certain income of CFCs). Under new § 951A, in tax years after 2017, United States shareholders of CFCs become subject to tax on their shares of CFC's global intangible low-taxed income, and under new § 59A, certain corporations with average gross receipts in excess of $500 million are subject to a new minimum tax on payments to foreign related persons to prevent base erosion. *See supra* note 57. In addition, new § 965 includes all the deferred foreign income of each CFC and each non-CFC that has a corporate United States shareholder as subpart F income currently taxable to United States shareholders but provides that the accumulated foreign income is subject to a significantly reduced rate of tax. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 14103, 131 Stat. 2054, 2195 (2017). Deferred foreign income is the accumulated foreign earnings and profits of the foreign corporation; that is, the amount that was not subpart F income taxed to United States shareholders when earned. See *infra* text accompanying notes 79–84 for a discussion of subpart F income and United States shareholders. The reduced rate of tax is 15.5% for accumulated cash and cash equivalents and 8% for the remaining deferred foreign income. The tax is a one-time tax to encourage repatriation of offshore accumulated income but may be paid in installments. Apple Inc., for example, announced that it was going to pay some $38 billion in federal income tax and bring $254 billion of deferred foreign income into the United States because of the reduced tax rates. Daisuke Wakabayashi & Brian X. Chen, *Apple, After Tax Cut Windfall, Will Bring Billions Back to U.S.*, N.Y. TIMES, Jan. 18, 2018, at A1.

[66] This article classifies such a deferral as a pseudodeferral because there is no deferral of income that could be taxed in the United States as it accrues. New § 965, *see supra* note 65, requires United States shareholders to include their shares of deferred foreign income of foreign corporations in their tax year beginning in 2017. New § 965 would seem constitutionally infirm. Under *Macomber*, accumulated earnings and profits of a corporation, whether or not foreign, is not income to its shareholders until distributed. *Cf. infra* notes 107–10 and accompanying text (discussing foreign personal holding company income). The inclusion in income is subject to a significantly reduced rate of tax, so taxpayers have little incentive to challenge the constitutionality of the statute. *Cf. infra* notes 271–73 and accompanying text (discussing the mark-to-market inclusion of commodities gain as 60% long-term and 40% short-term capital gain under § 1256).

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corporation at a gain that includes the growth in value attributable to the retention of foreign earnings.[67]

In the case of capturing the gain from the sale of the shares, the gain has a U.S. source because the shareholder is a U.S. person.[68] Termination of the deferral by sale of shares may yield long-term capital gain to individual shareholders that is taxable at a lower rate than ordinary income.[69] Alternatively, distributions of the foreign corporation's income to its U.S. owners as dividends subjects the owners to tax in the United States on the amount distributed out of the foreign corporation's earnings and profits.[70] U.S. owners receive a tax credit for the withholding tax imposed by the foreign jurisdiction on the dividend distribution,[71] but, for tax years beginning after 2017, corporate owners of at least ten percent of the foreign corporation's shares may deduct the dividend but receive neither a credit for the withholding tax nor a deduction[72] nor the deemed paid credit for the tax imposed on the foreign corporation which they could have claimed in earlier tax years.[73] Thus, the U.S. inclusion remains deferred only until the income

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[67] Note, however, that for ten percent corporate owners, new § 245A provides a 100% dividends received deduction and permanently eliminates the tax on the deferred income when distributed to the corporate United States shareholder, *see supra* note 55, and, in the case of the sale of the foreign corporation's shares, § 1248 reclassifies the gain as dividend. Amended § 1248(j) clarifies that the reclassified gain also is eliminated under the dividends received deduction of § 245A. Tax Cuts and Jobs Act § 14102, 131 Stat. at 2192.

[68] I.R.C. § 865(a)(1) (sourcing gain from the sale of personal property by the residence of the owner).

[69] *Id.* §§ 1222(3), (11) (defining long term capital gain and net capital gain, respectively), 1(h) (imposing a reduced rate of tax on individuals' net capital gain). *But see infra* notes 117–18 and accompanying text (discussing CFC and PFIC share gain).

[70] I.R.C. §§ 301, 312, 316 (inclusion of dividend income, computation of earnings and profits, and defining *dividend*, respectively). Amounts in excess of earnings and profits reduce the shareholders' adjusted bases in their shares and amounts exceeding the adjusted bases yield gain from the sale or exchange of the shares. *Id.* § 301(c).

[71] *Id.* § 901.

[72] I.R.C. § 245A; *see supra* note 55.

[73] *Id.* § 902 (credit for the foreign tax, if any, imposed on the distributing corporation) (repealed by Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 14301(a), 131 Stat. 2054, 2221 (2017)).

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is "repatriated"[74] to the United States through the distribution.[75] U.S.-based multinational entities often accumulate large amounts of earnings in their foreign subsidiaries. Those taxpayers successfully argued for a tax reduction on repatriated earnings to facilitate withdrawal of those trapped earnings to invest them in the United States[76] and are taxable on the deferred foreign earnings at a reduced rate and may freely repatriate the earnings.[77]

To limit manipulative or inappropriate use of foreign income deferral, however, rules governing CFCs[78] disregard the foreign corporation as a separate entity for tax purposes to the extent that tax avoidance, rather than business purpose, seems to direct the foreign source income to the foreign corporation rather than to its U.S. owners. The CFC provisions attribute so-called subpart F[79] income to the underlying owners of that income under a statutory manifestation of assignment of income principles.[80] Subpart F

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[74] Repatriation is the term commonly used for bringing foreign source income into the United States. Like deferral, it probably is a misnomer as the income never was removed from the United States in order to repatriate it. Compare the business definition: *Repatriate*, MERRIAM-WEBSTER, http://www.merriam-webster.com/dictionary/repatriate.

[75] New § 965, *see supra* note 65, constructively repatriates foreign earnings of United States shareholders of CFCs and foreign corporations with a United States corporate ten percent owner and taxes them in the taxpayers' taxable years beginning in 2017.

[76] Under § 965, added by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422, 118 Stat. 1418, 1514, corporations received such a tax holiday in the form of a temporary 85% dividends received deduction for cash distributions from CFCs that were invested by the distributee in the United States. For a discussion of the economic impact of the holiday, see DONALD J. MARPLE & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40178, TAX CUTS ON REPATRIATION EARNINGS AS ECONOMIC STIMULUS: AN ECONOMIC ANALYSIS (2011), http://www.ctj.org/pdf/crs_repatriationholiday.pdf. Bills pending in Congress's last session would have provided another repatriation tax holiday. Howard Gleckman, *Did Multinationals Use a Foreign Earnings Tax Holiday To Burnish Their Financials Rather Than Reduce Taxes?*, FORBES (June 11, 2014, 10:01 AM), http://www.forbes.com/sites/beltway/2014/06/11/did-multinationals-use-a-foreign-earnings-tax-holiday-to-burnish-their-financials-rather-than-reduce-taxes/.

[77] *See supra* note 65.

[78] I.R.C. §§ 951–965 (controlled foreign corporations). A foreign corporation is a CFC if United States shareholders own more than 50% of the voting power or value of its shares. *Id.* § 957(a). United States shareholders are U.S. persons who own, directly or indirectly under constructive ownership rules, 10% or more of the combined voting power of a CFC. *Id.* § 951(b).

[79] *Id.* § 952 (defining subpart F income).

[80] Compare the *Lucas v. Earl*, 281 U.S. 111 (1930) (attributing income to the person who performs services rather than the person with a contractual right to receive the income), and *Helvering v. Horst*, 311 U.S. 112 (1940) (attributing income to the owner of the income producing property), lines of decisions

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income becomes taxable directly to the U.S. shareholders of the CFC[81] without regard to how the jurisdiction of the corporation's residence treats the income. Subpart F income consists, among other things, of passive investment income[82] and income derived from activities having little or no connection with the country of incorporation[83] of the foreign corporation and no closer connection than if the activities had been conducted by a U.S. corporation.[84] The CFC provisions do not seek to extend U.S. taxing jurisdiction to the foreign corporation. Instead, they tax the U.S. owners on their shares of the CFC's income as if the CFC were tax transparent like partnerships are,[85] rather than tax opaque as corporations in the absence of an S election generally are.[86] Unlike partnerships, however, the tax transparency does not preserve the character of the income but treats the United States shareholder's share of the subpart F income as ordinary income in all instances. Repatriation of earnings from CFCs is free from U.S. tax to the extent the income previously was includable in the recipient's income under the CFC rules.[87]

If the foreign corporation is not a CFC[88] or is a CFC but has U.S. persons as shareholders who do not meet the definition of United States shareholders

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that find statutory form, for example, in § 482 (attributing income and deductions to prevent tax evasion or to reflect income clearly). However, new § 965, see *supra* note 65, treats all deferred foreign income as subpart F income and includes it, albeit at a reduced rate of tax, in income for the United States shareholders' taxable year beginning in 2017.

[81] I.R.C. § 951(a)(1) (including a pro rata share of subpart F income in the income of U.S. shareholders).

[82] *Id.* § 954(a)(1) (foreign personal holding company income as part of foreign base company income).

[83] The United States follows an incorporation test for determining whether a corporation is domestic or foreign. *Id.* §§ 7701(a)(4) (defining *domestic* for a corporation or partnership); 7701(a)(5) (*foreign* defined as not domestic).

[84] *Id.* § 954(a)(2), (3) (foreign base company sales and services income, respectively).

[85] *Id.* §§ 702(b) (partner's share treated as received from same source and in same manner as received by partnership), 875 (nonresident alien or foreign corporation doing business within the United States).

[86] *Id.* § 951(a) (including subpart F income in the incomes of United States shareholders of CFCs).

[87] *Id.* § 959(a) (exclusion of previously taxed CFC income).

[88] *Id.* § 1297(d) (excluding United States shareholders of CFCs from the operation of the PFIC rules).

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and the corporation meets a passive income[89] or a passive asset[90] test, the foreign corporation is a passive foreign investment company (PFIC). The antideferral regime for PFICs neither imputes dividends nor disregards the corporation.[91] The PFIC statute[92] characterizes amounts distributed from a PFIC and gain from the sale or exchange of PFIC shares in excess of 125% of the average of the three preceding years' distributions from the PFIC as ordinary income[93] and imposes an interest charge on deferral.[94] The statute measures the deferral by treating the excess as received by the taxpayer ratably on each day in the taxpayer's holding period, but the tax payment being deferred.[95] The corporation is not subject to U.S. tax. Unlike the CFC, the PFIC is not disregarded so that U.S. shareholders are not taxable on their shares of the PFIC's income when it is earned.

U.S. shareholders of a PFIC may elect to avoid the ordinary income classification and interest charge by including their shares of the PFIC's income currently as the PFIC earns the income. Shareholders selecting current inclusion must make a qualified electing fund (QEF) election with respect to their PFIC interests.[96] U.S. shareholders making the QEF election include their shares of the PFIC income as ordinary income or long-term capital gain in much the same manner as shareholders include actual and elective constructive distributions in income from a regulated investment company.[97] Alternatively, U.S. shareholders of publicly traded PFICs may

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[89] *Id.* § 1297(a)(1) (75% or more of its income is passive).

[90] *Id.* § 1297(a)(2) (50% or more of its assets produce, or are held for the production of, passive income).

[91] *Id.* §§ 1291–1298 (added by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1235(a), 100 Stat. 2085, 2566).

[92] *Id.*

[93] *Id.* § 1291(a)(1)(B), (b)(2) (characterizing excess distributions as ordinary income).

[94] *Id.* § 1291(c) (imposing an interest charge on excess distributions).

[95] *Id.* § 1291(a)(1)(A). This interest charge on the deferral under the PFIC provision finds a growing number of applications; for instance, § 453A dealing with certain installment sales and § 877A(b) addressing the elective deferral of the inclusion under the expatriation tax.

[96] *Id.* § 1293(a) (qualified electing fund election).

[97] *Id.* § 854(b)(2)(C) (dividends from regulated investment companies).

elect to mark the shares to market[98] annually and treat the gain as ordinary income rather than capital gain.[99]

Until 2004,[100] closely held foreign investment corporations were foreign personal holding companies (FPHC).[101] The combined operation of the CFC regime[102] and PFIC provisions made the FPHC provisions[103] less necessary to prevent tax avoidance. The FPHC definition, like the definition of domestic personal holding companies, included both income and ownership tests.[104] Unlike the personal holding company rules for domestic corporations that impose a penalty tax on the corporation when it fails to distribute its earnings,[105] the FPHC's passive income was taxable pro rata to its U.S. owners as an imputed dividend from the FPHC.[106] Like the CFC provisions, the FPHC rules did not seek to tax the foreign corporation but focused on the U.S. owners of the foreign corporation.

Operation of the FPHC provisions was constitutionally more problematic than the CFC rules since the FPHC rules respected the existence of the corporation as a separate corporate entity while the CFC rules do not. In the context of the realization requirement for inclusion as identified in *Macomber*,[107] the FPHC rules are more questionable than the CFC rules. The

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[98] The mark-to-market practice of valuing and reporting positions at fair market value originated in futures exchanges. Futures traders would maintain margin with the clearinghouse and would have to post additional margin or could withdraw margin as the futures positions they held advanced or retreated. Positions were marked to market daily in order to facilitate the maintenance of margin. For a brief discussion of this practice, see Ordower, *supra* note 13, at 68–71.

[99] I.R.C. § 1296 (mark-to-market election).

[100] Repealed by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 413, 118 Stat. 1418, 1506.

[101] I.R.C. § 551 (repealed in 2004). Before repeal, § 551 taxed U.S. shareholders of FPHCs on their shares of the earnings of the FPHC as dividend currently.

[102] *See supra* note 78 and accompanying text.

[103] I.R.C. §§ 1291–1298 (rules governing PFICs); *see supra* notes 88–99 and accompanying text.

[104] I.R.C. § 551 (repealed in 2004). At least 60% of income had to be passive and at least 50% of voting power had to be owned, directly and by attribution, by five or fewer individuals.

[105] *Id.* § 541 (imposing a penalty tax on undistributed earnings of personal holding companies).

[106] *Id.* § 551 (repealed).

[107] Eisner v. Macomber, 252 U.S. 189 (1920).

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CFC rules disregard the foreign corporation to the extent of the subpart F income. Those rules do not impute a distribution but "pierce the corporate veil"[108] and treat the corporation as if it were not there with respect to subpart F income because the business purpose for the foreign corporation with respect to the subpart F income is absent.[109] The FPHC rules, on the other hand, imputed a distribution of earnings when there was no distribution. *Macomber* prohibits the taxing of a distribution that is not a real distribution separating income from capital.[110] Nevertheless, the U.S. Court of Appeals for the Second Circuit allowed the FPHC provision to withstand challenge.[111] The court did not address the constitutional realization issue raised in *Macomber* or cite *Macomber*, as the court rejected the argument that "inability to expend income in the United States, or to use any portion of it in payment of income taxes, necessarily precludes taxability."[112]

When no antideferral provisions apply, (quasi)deferral through a foreign corporation frees both foreign source and some U.S. source income,[113] which if earned by a U.S. person would be taxed in the United States, from current imposition of the U.S. income tax. While deferred income bears a potential repatriation cost, for ordinary operating income that is not subpart F income, deferral is valuable. Deferral leaves the income available for reinvestment undiminished by the U.S. income tax and deferred income may permit the foreign earnings to convert to long-term capital gain on sale of the shares.[114]

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[108] Adopting corporate law terminology for situations in which the shareholders use the corporation for an improper purpose and fail to respect corporate formalities.

[109] The CFC rules simply treat the income of the CFC as if the shareholders had not interposed the corporation, because it was improper to do so.

[110] 252 U.S. 189. New § 965, *see supra* note 65, similarly taxes deferred foreign income without any distribution.

[111] Eder v. Comm'r, 138 F.2d 27 (2d Cir. 1943) (holding that earnings of a FPHC in a blocked currency is includable in the U.S. shareholder's income but remanding on the question of value).

[112] *Id.* at 28. *But see* Comm'r v. First Sec. Bank of Utah, 405 U.S. 394 (1972) (holding income from originating insurance not taxable to a national bank because the bank was prohibited from acting as insurance agent).

[113] *E.g.*, I.R.C. § 881(d) (interest income from deposits in U.S. financial institutions).

[114] *Id.* §§ 1221, 1222(1)–(3).

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In many instances taxpayers use contentious transfer pricing techniques to augment the amount of deferred income.[115]

Sales of shares of foreign corporations that are neither CFCs nor PFICs, even if accumulation of foreign earnings produce the increase in the value of those shares, is capital gain to the U.S. shareholder, long- or short-term depending on the holding period.[116] U.S. shareholders' sales of shares of CFCs, however, may be recharacterized as a dividend to the extent of the foreign corporation's earnings and profits.[117] Similarly, gain from the sale of PFIC shares generates ordinary income.[118]

B. Avoidance and Transfer Pricing

Consistent with the opportunity to place foreign source income in non-U.S. corporations so that the income is not subject to the worldwide reach of the U.S. income tax, corporations and individuals place income-producing assets, intellectual property in particular, into non-U.S. corporations. To the extent that the property is used outside the United States, income from its use is not subject to U.S. income tax even though it would have been if the property's ownership had remained in the United States. Following movement of the property to non-U.S. ownership, only to the extent the property is used in the United States does the income from the property remain subject to U.S. income tax. Corporations and individuals that employ substantial amounts of intellectual property often move intellectual property into, or develop intellectual property in, their foreign subsidiaries based in low-tax jurisdictions so that royalties from use outside the United States do not become subject to the U.S. tax on worldwide income that would be

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[115] *See infra* Part III.B.

[116] I.R.C. §§ 1221, 1222(1)–(3) (defining capital asset and short-term and long-term capital gain). The distinction between capital gain and ordinary income is much less significant to corporate taxpayers than it is to noncorporate taxpayers because there is no rate differential for corporate taxpayers. The Tax Cuts and Jobs Act's new dividends received deduction under § 245A, *see supra* note 55, for ten percent corporate owners of foreign corporations and the reduction in corporate rates of tax magnifies differences in interests between corporate and noncorporate taxpayers with respect to the operation of foreign corporations and may cause economic conflict between corporate and noncorporate owners in a foreign corporation.

[117] *Id.* § 1248 (taxing gain from the sale of CFC shares as a dividend).

[118] *Id.* § 1291 (PFIC distributions and gain).

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applicable to income of a U.S. owner. Only royalties that the U.S. person pays for use of the property in the United States is U.S. source income to which the U.S. income tax applies.[119] For example, if a pharmaceutical developer creates a pharmaceutical in its foreign subsidiary and licenses it for manufacture outside the United States, the royalty under the license will not be taxable in the United States. Only the royalty for manufacture in the United States is sourced in the United States.

Similarly, if the royalty cost for use of intellectual property is absorbed into the cost of inventory and the inventory is created or manufactured outside the United States,[120] purchase by a U.S. reseller of the property is not subject to U.S. tax. Only the excess of the resale price over the purchase price becomes subject to U.S. tax.[121] Accordingly, the price at which the property transfers from the non-U.S. producer to the U.S. reseller controls how much or how little of the resale price becomes subject to tax in the United States. Increasingly, that transfer price becomes a matter of disagreement between the IRS and the taxpayer.

While the IRS may reallocate income between or among related persons,[122] establishing that the transfer price the parties have fixed is not supportable is difficult. Transfer pricing regulations are complex with multiple possible methods for determining an arm's-length price.[123] While the arm's-length standard underlies transfer pricing and requires that the determination of a price between related taxpayers be the same as the price on which uncontrolled taxpayers would agree, the regulation acknowledges that comparable uncontrolled transactions establishing an arm's-length price often are not available.[124] Taxpayers wishing to avoid U.S. tax push the boundaries of acceptable transfer prices.

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[119] *Id.* § 861(a)(4) (royalties for use of intellectual property in the United States is U.S. source income).

[120] *Id.* § 263A (capitalization of inventory costs).

[121] *Id.* § 861(a)(6) (profit from inventory sales in the United States is U.S. source).

[122] *Id.* § 482 (allocation to prevent evasion of tax and to reflect income clearly).

[123] Treas. Reg. § 1.482-3 (as amended in 1995) (outlining methods for transfer pricing).

[124] *Id.* § 1.482-1(c) (as amended in 2009) (arm's-length standard).

Transfer pricing has become a primary focus for legislatures, tax collectors, and international tax policy advisors like the Organization for Economic Cooperation and Development (OECD). Much of the effort of the OECD's base erosion and profit shifting (BEPS) project addresses the issue of transfer pricing.[125]

In addition to focus on the transfer price to prevent avoidance of U.S. tax, Congress added the super-royalty provision for intangible property to § 482 in 1986 in an effort to prevent transfers of intangibles to offshore related parties at low prices.[126] Similarly, deferral of gain recognition when a corporation transfers its assets to a foreign corporation in exchange for shares is unavailable for intangible property.[127] Yet, development of the intangible property outside the United States avoids application of the super-royalty provision and the recognition rule for intangible property. But even where transfer pricing successfully shifts income to another jurisdiction, it defers the income only until the corporation repatriates it to the United States.[128]

The Tax Cuts and Jobs Act[129] alters the U.S. tax treatment of offshore intangibles and related party transactions.[130] After 2017, United States shareholders of CFCs must include in income their shares of the CFC's global intangible low-taxed income.[131] Global intangible low-taxed income is substantially equivalent to the CFC's income in excess of ten percent of its adjusted tax basis in its physical operating assets. Similarly targeting income from intangibles, transfers of intangibles (but not development of the intangible property offshore) is subject to enhanced reallocation rules and tighter limitations on valuation of the intangibles when transferred

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[125] *See generally* Centre for Tax Policy and Administration, *Base Erosion and Profit Shifting*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/ctp/beps.htm (last visited Nov. 20, 2017).

[126] I.R.C. § 482 (last sentence added by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562–63).

[127] *Id.* § 367(a)(3)(B) (excepting intangible property from the rules deferring gain on the transfer of assets to an active foreign business).

[128] *See supra* Part III.A.

[129] Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[130] *See supra* note 57.

[131] *See supra* note 57.

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offshore.[132] Further limitations on tax base erosion are in the new denial of deductions for related party payments that involve hybrid transactions or entities.[133] Hybrid refers to the tax arbitraging emanating from differing tax characterization between the U.S. tax rules and those of another country in which the entity or transaction would be taxable. In addition, a new base erosion minimum tax applies to related party transactions between a U.S. corporation having average revenue in excess of $500 million that yield a tax benefit in the United States.[134]

C. Evasion

While transfer pricing remains a contentious, but permissible, means to reduce income tax liability, secreting assets and income in foreign accounts is illegal.[135] Some, generally very wealthy, U.S. taxpayers shifted investment assets to and maintained investment accounts in low- or no-tax jurisdictions[136] that have strong bank secrecy laws so that the U.S. beneficial ownership of those accounts was rarely detectable. Despite being taxable on their worldwide incomes because they were U.S. citizens or permanent residents, some of those taxpayers failed to report the transfer of assets to the foreign accounts or the income generated by those accounts. Protected from discovery by the bank secrecy laws, absent voluntary compliance, the income was not taxed in the United States. Hiding assets was not a problem unique to U.S. tax collection but common to European countries as well. The OECD's project on unfair tax competition[137] enjoyed some success in securing cooperation from government agencies in low-tax jurisdictions to

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[132] *See supra* note 57.

[133] *See supra* note 57.

[134] *See supra* note 57.

[135] *Report of Foreign Bank and Financial Accounts (FBAR)*, IRS, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Report-of-Foreign-Bank-and-Financial-Accounts-FBAR (last updated Sept. 25, 2017).

[136] Often the jurisdictions (e.g., Switzerland) offered a low- or no-tax investment regime to nonresidents while taxing their own residents at rates comparable to those of moderate- to high-tax jurisdictions.

[137] ORG. FOR ECON. CO-OPERATION & DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

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identify taxpayers secreting assets and income. Enactment of the Foreign Account Tax Compliance Act (FATCA)[138] in 2010 by the United States, with its imposition of increased civil and criminal penalties on U.S. beneficial owners of foreign accounts and its sanctions on foreign financial institutions with which the U.S. beneficial owners invest,[139] increased the risk of detection of U.S. taxpayers of seeking to hide investments.[140]

D. Expatriation

To free themselves permanently from the U.S. income tax on their foreign source income, U.S. taxpayers must cease to be U.S. taxpayers.

For corporations, cessation means reincorporation outside the United States.[141] Recently, a number of U.S. corporations have altered their corporate structure to make a non-U.S. corporation the parent of a group of corporations that includes a U.S. corporation conducting operations in the United States. The U.S. group member owns neither the intellectual property the group uses nor the non-U.S. subsidiaries in the group even if those properties and subsidiaries were owned historically by a U.S. corporation. The structural change removed all but the U.S.-source operating income from U.S. taxing jurisdiction, and, in many instances, resulted in the U.S. corporation paying royalties for use of intellectual property it formerly owned to the foreign parent or another non-U.S. member of the corporate group.[142] "Inversion" refers to this category of restructurings to shift group ownership offshore. Inverting corporations use several acquisition techniques to cause the parent of an operating corporate group to become a

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[138] Hiring Incentives to Restore Employment (HIRE) Act of 2010, Pub. L. No. 111-147, § 501, 124 Stat. 71, 97.

[139] I.R.C. § 1471 (withholding on certain foreign financial institutions' accounts).

[140] *Id.* § 6038D; *see also* Peter J. Spiro, *The (Dwindling) Rights and Obligations of Citizenship*, 21 WM. & MARY BILL RTS. J. 899 (2013) (discussing FATCA).

[141] I.R.C. § 7701(a)(4), (5) (domestic corporation is a corporation formed and existing under the laws of the United States or any of the states; a foreign corporation is a corporation that does not meet the definition of a domestic corporation).

[142] Elizabeth Chorvat, *Expectations and Expatriations: A Long-Run Event Study* 6 (U. Chi., Pub. Law Working Paper No. 445, 2016), https://ssrn.com/abstract=2309915 (comprehensive inversion study linking inversions and intangibles).

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foreign corporation rather than a U.S. corporation.[143] With its tax home in a low-tax jurisdiction or one with territorial taxation, only U.S. source FDAP income[144] and U.S. source net business income[145] remain subject to U.S. taxation.[146]

For individuals, ceasing to be a U.S. taxpayer means not only emigration, but also renunciation of citizenship or, in the case of a noncitizen resident, permanent relinquishment of U.S. residence.[147] The individuals who emigrate and renounce citizenship or relinquish residence remain subject to U.S. tax on net income attributable to the conduct of a trade or business in the United States[148] and the U.S. withholding tax on FDAP income from U.S. sources.[149] For both corporations and individuals, a treaty with the new jurisdiction of tax residence may impact the exposure to the U.S. income tax with respect to rates and definitions.[150]

The media have devoted considerable attention to corporate inversions as several major pharmaceutical manufacturers recently have engaged in takeover discussions that would have resulted in their departure from the U.S.

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[143] *See* Hal Hicks, *Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, 30 TAX NOTES INT'L 899 (2003) (describing and analyzing basic inversion techniques).

[144] I.R.C. § 881 (withholding tax on U.S. source fixed and determinable annual or periodic income).

[145] *Id.* § 882 (taxation of effectively connected income under the net income tax).

[146] The Tax Cuts and Jobs Act impacts the taxation of foreign held intangibles, *see supra* note 57 and notes 129–34 and accompanying text. The new rules for inverted corporations are less favorable than for other foreign corporations. *See infra* note 163.

[147] Treas. Reg. § 1.1-1 (as amended in 2008) (U.S. citizens and residents taxable on their worldwide income).

[148] I.R.C. § 872 (taxation of effectively connected income under the net income tax). Taxpayers who are partners in U.S. partnerships and members of U.S. limited liability companies are considered to be engaged in a U.S. trade or business if the partnership or limited liability company is engaged in a U.S. trade or business. *Id.* § 875(1). A foreign partner's share of the foreign source income of a domestic partnership or limited liability company should not become subject to U.S. tax liability for the same reason that the entity's tax transparency preserves income source. *Id.* § 702(b).

[149] *Id.* § 871 (withholding tax on U.S. source fixed or determinable annual or periodic income).

[150] For example, the U.S.-Canada Income Tax Convention (1980) reduces the withholding rate under §§ 871 and 881 and modifies the definition of resident. Income Tax Convention, U.S.-Can., arts. IV, X, Sept. 26, 1980, T.I.A.S. No. 11,087, TAX TREATIES (CCH) ¶ 1301.

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through inversions.[151] Less attention has gone to individual expatriations although the numbers of U.S. individuals expatriating has grown substantially over the last couple of years.[152] As Caribbean jurisdictions became increasingly stable and safe and computer technology facilitated instantaneous and simple communication with remote locales, expatriation became a less radical choice than it would have seemed when the Caribbean jurisdictions were less stable and communication slow and unwieldy. Congress has added provisions to the Code to discourage both corporate and individual expatriation with a continuation tax for inverting corporations[153] and a continuation tax[154] for individuals, which was later made inapplicable to individuals who expatriate after June 17, 2008[155] when expatriating individuals became subject to the exit tax for individuals.[156]

IV. Continuation Taxes and Expatriation

Both the corporate and individual continuation taxes reach income that would have been taxable in the United States but is not because of entity or individual expatriation. In the case of an individual, the individual renounced his or her U.S. citizenship or relinquished the privilege to reside permanently in the United States. In the case of a corporation or partnership, a foreign corporation was interposed between the income and the U.S. person so that the income would accumulate outside the United States free from U.S. tax

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[151] *See, e.g.*, Stephen Gandel, *Why New Tax Inversion Rules Won't Stop Pfizer-Allergan Deal*, FORTUNE (Nov 20, 2015), http://fortune.com/2015/11/20/why-new-tax-inversion-rules-wont-stop-pfizer-allergan-deal/.

[152] *See supra* note 29.

[153] I.R.C. § 7874 (added by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 801(a), 118 Stat. 1418, 1562).

[154] *Id.* § 877. Added initially by the Foreign Investors Tax Act of 1966, Pub. L. 89-809, § 103(f)(1), 80 Stat. 1539, 1551, and applicable only in cases of a primary tax avoidance motivation, the statute adopted an objective standard in 2004 when it was amended by the American Jobs Creation Act of 2004, § 804. *See generally Expatriation Tax*, IRS, https://www.irs.gov/Individuals/International-Taxpayers/Expatriation-Tax (last updated Aug. 17, 2017).

[155] Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, Pub. L. No. 110-245, § 301(d), 122 Stat. 1624, 1646.

[156] I.R.C. § 877A.

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while control of the income-producing entity remained substantially unchanged.

A. Corporations

The corporate continuation tax[157] distinguishes among expatriating corporations based upon continuing ownership. Inverted corporations are treated as domestic corporations and remain taxable on their worldwide incomes as long as they are inverted corporations.[158] An inverted corporation is a foreign corporation meeting a property, an ownership, and a business activities test. The corporation meets the property test if it acquired substantially all the properties of a domestic corporation or all the properties constituting a trade or business of a domestic partnership or limited liability company. The corporation meets the ownership test if the former owners of the domestic corporation, partnership, or limited liability company the assets of which the foreign corporation acquired own at least 80% of the foreign corporation's stock by vote or value and acquired the stock by reason of their ownership in the acquired U.S. entity.[159] The corporation meets the business operation test if the corporation along with its expanded affiliate group[160] does not have substantial business activity in the country of its incorporation and operation in comparison with its worldwide activities.[161]

Other expatriated entities remain subject to the U.S. income tax on their inversion gain for ten years following acquisition. An expatriated entity is a domestic corporation, partnership, or limited liability company with respect to which a foreign corporation is a surrogate foreign corporation. A surrogate

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[157] *Id.* § 7874.

[158] *Id.* § 7874(b).

[159] *Id.* § 7874(a)(2), (b). Compare the control definition in § 368(c) (requiring not vote or value but vote and percentage of each class of shares). For purposes of the ownership determination, stock owned by members of the corporation's expanded affiliated group and stock sold in a public offering related to the acquisition is disregarded.

[160] *Id.* § 7874(c)(1) (expanded affiliated group includes corporations having common ownership greater than 50% rather than the 80% necessary for an affiliated group).

[161] *Id.* § 7874(a)(2)(B)(iii) (substantial business activities); Treas. Reg. § 1.7874-3(b) (as amended in 2016) (defining substantial threshold: 25% of employees, compensation, and revenue in country of organization).

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foreign corporation is a corporation meeting the property, ownership, and business activities tests described in the preceding paragraph except that the ownership test is at least 60% and less than 80% of the stock by vote or value is owned by the former owners of the acquired domestic corporation or partnership by reason of their ownership of the acquired entity.[162] Inversion gain is the gain recognized from transfers of property by the expatriated corporation to a foreign person so that, following the inversion, the United States continues to tax the sale or licensing of property that would have been subject to U.S. tax had the entity not expatriated.[163]

Enactment of the corporate continuation tax in 2004 may have retarded the rate at which corporations inverted, but the statute did not stop the inversion trend. The statute did impact the structure of inversions. Recent inversions have involved increasing numbers of foreign corporate takeovers in which the existing, operating foreign corporation is closer to equal size with or larger than the U.S. corporation so that the shareholders of the U.S. corporation own less than 60% of the foreign corporation after the expatriating acquisition.[164] Potential tax revenue continues to disappear from the U.S. treasury as a result of inversions.

B. Individuals

The individual continuation tax[165] taxes expatriates on income they receive after expatriation. The statute's caption—"Expatriation to avoid tax"—identifies the original purpose of the continuation tax. Before its

[162] I.R.C. § 7874(a)(2)(B) (defining surrogate corporation).

[163] *Id.* § 7874(d)(2). Provisions of the Tax Cuts and Jobs Act treat the United States shareholders of expatriated corporations less favorably than they do United States shareholders of other foreign corporations. For example, the reduced rate of tax accompanying inclusion of deferred foreign income under new § 965, *see supra* note 66, is denied to expatriated corporations and recaptured where the corporation expatriates within ten years of the date of enactment of the Tax Cuts and Jobs Act. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 14103, 131 Stat. 2054, 2195, 2205–06 (2017) (to be codified at I.R.C. § 965(*l*)).

[164] *See generally* Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions*, 136 TAX NOTES 429 (2012) (discussing the limited effectiveness of § 7874).

[165] I.R.C. § 877.

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amendment in 2004,[166] the continuation tax was applicable only if tax avoidance was one of the principal reasons for the expatriation. The statute imputed a tax avoidance purpose to expatriations of individuals with average incomes greater than $100,000 or assets greater than $500,000.

Under the most recent version of the statute, a tax avoidance purpose was unnecessary to application of the statute. Any taxpayer who expatriated between 2004 and 2008—when the tax ceased to apply to new expatriates[167]—who had either (1) average annual net income of $124,000, as adjusted for inflation, for the five years before expatriation; (2) net worth of at least $2 million; or (3) who failed to certify five-year compliance with the income tax or submit evidence as required of compliance became subject to the continuation tax.[168]

The continuation tax employs an alternative tax mechanism.[169] The expatriate pays the greater of the withholding tax on noncitizen, nonresident individuals on FDAP income[170] or a tax computed under the regular tax[171] (or the alternative minimum tax, if greater)[172] on gross income that includes FDAP income and an enhanced amount of effectively connected income.[173] Special sourcing rules include in the continuation tax base for the alternative computation (1) gains from sales of personal property located in the United States (other than stock or debt), (2) stock or debt issued by U.S. persons, and (3) income that would have been subpart F income of a U.S. shareholder if the individual held more than 50% control of the CFC at any time during the two years preceding expatriation.[174] In addition, realized gain on

[166] *Id.* § 877 (prior to amendment by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 804, 118 Stat. 1418, 1569).

[167] *See supra* text accompanying notes 154–56.

[168] I.R.C. § 877(a)(2).

[169] *Id.* § 877(a)(1) (comparing the alternative minimum tax mechanism under § 55).

[170] *Id.* § 871.

[171] *Id.* § 1.

[172] *Id.* § 55.

[173] *Id.* §§ 877(b), 872(a).

[174] *Id.* § 877(d).

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nonrecognition transactions[175] is included in the tax base if the exchanged property would have produced U.S. source income and the property received would produce foreign source income.[176]

Subject to promulgation of regulations, removal of appreciated tangible property from the United States and other occurrences that change the source of income from U.S. to foreign are treated as exchanges resulting in realization of gain. If promulgated, the regulations might have resulted in taxing gain without realization contrary to the Sixteenth Amendment and the long-standing decision in *Macomber*.[177] Treasury has not promulgated regulations.

V. The Expatriation Exit Tax

The 2008 expatriation tax terminates certain expatriates'[178] deferrals of income.[179] It does not continue to tax income arising after expatriation. Expatriates to whom the expatriation tax applies are referred to as "covered expatriates."[180] Covered expatriates must mark their properties to market and include in their gross incomes[181] the unrealized gain or loss in the value of their properties as if they had sold each property for its fair market value on the day preceding their expatriation, even though no actual sale or other disposition of the property takes place.[182] In addition to marking property to market, the expatriating taxpayer is deemed to have received the present value of deferred benefits under deferred compensation plans,[183] unless the

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[175] *E.g.*, *id.* § 1031 (like-kind exchanges).

[176] *Id.* § 877(d)(2).

[177] *See infra* Part V (discussing realization and *Eisner v. Macomber*, 252 U.S. 189 (1920)).

[178] *See supra* note 20 (defining expatriates).

[179] I.R.C. § 877A. For a discussion of the expatriation tax, see *infra* Part V.A and *supra* notes 2, 39, 53 and accompanying text.

[180] I.R.C. § 877A(g)(1); *see infra* Part V.C.

[181] I.R.C. §§ 1001 (explaining the tax consequences of a gain from the sale or other disposition of property), 61(a)(3) (explaining that gross income includes gains from dealings in property).

[182] *Id.* § 877A(a)(1), (2). The exit tax exempts an inflation-adjusted $600,000 per expatriate from the general inclusion in income subject to the tax. *Id.* § 877A(a)(3).

[183] *Id.* § 877A(d)(2)(A)(i).

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deferred compensation meets eligibility tests;[184] compensation items that are deferred because they are not transferable or are subject to a risk of forfeiture[185] become includable in income;[186] specified tax-deferred accounts are deemed distributed;[187] and open deferral items like nonsimultaneous like-kind exchanges[188] close and become taxable.[189] In addition, while not the termination of a deferral but termination of the taxing of the trust rather than the covered expatriate, trust distributions to a covered expatriate are subject to a withholding tax.[190]

A. Terminating Deferrals and Legislative Authority

Statutory deferrals under the income tax postpone inclusion of amounts received or accrued in gross income for income tax purposes[191] even though the amounts are ripe for inclusion under the Sixteenth Amendment and the definition of gross income.[192] Nonstatutory deferrals similarly may be ripe for inclusion in income, but valuation uncertainty or potential intervening interests may result in an administrative or judicial decision to postpone inclusion.[193] Under a comprehensive tax base definition of economic income,[194] increase in the value of a taxpayer's property would be includable

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[184] *Id.* § 877A(d)(3).

[185] *Id.* § 83(a).

[186] *Id.* § 877A(d)(2)(A)(ii).

[187] *Id.* § 877A(e).

[188] *Id.* § 1031(a)(3).

[189] *Id.* § 877A(h)(1).

[190] *Id.* § 877A(f)(1)(A).

[191] *See id.* §§ 401 (income set aside in a qualified plan), 1031 (like-kind exchanges of property).

[192] U.S. CONST. amend. XVI and its statutory manifestation in § 61 (gross income includes all income from whatever source derived).

[193] Unsecured promises to pay compensation in the future, for example, even if funded through a rabbi trust. *See* Ordower, *supra* note 47 and discussion *infra* note 211 and accompanying text.

[194] See the Haig-Simons definition of income *supra* note 45.

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in income. Judicial decisions[195] conclude that income under the Sixteenth Amendment does not include unrealized gain. As a condition to inclusion, realization constitutes a limiting principle of income and is a nonstatutory deferral of economic income. Although the realization requirement has a statutory manifestation,[196] the realization requirement is independent of the statute. Alteration of the statute to undercut the realization concept may be unconstitutional.[197] In this category of nonstatutory deferral is all appreciation in a taxpayer's property that the taxpayer continues to hold in the U.S. realization-based tax system.[198] And in addition to statutory and nonstatutory deferrals, there are quasideferrals that do not defer inclusion but only the time for payment of the tax on includable income[199] and the pseudodeferral of income earned by offshore corporations owned in whole or part by U.S. taxpayers.[200]

Statutory deferrals generally reflect a congressional policy preference. For example, because of the policy preference for facilitating the accumulation of assets for employees to consume when they retire, an employee is not taxable on contribution for the employee's benefit to a qualified retirement plan even if the amount irrevocably is set aside for the employee's benefit.[201] Absent the statutory deferral, the amount contributed for a specific employee's benefit by the employer would be includable in the employee's income as an includable economic benefit.[202] Similarly, a taxpayer's exchange of appreciated property for like-kind property causes the

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[195] Eisner v. Macomber, 252 U.S. 189, 189 (1920). Many commentators consider the realization limitation to be a matter of administrative convenience rather than constitutionally definitional. *See infra* Part V.B.

[196] I.R.C. § 1001 (realization from sale or other disposition).

[197] *See infra* Part V.B.

[198] *Macomber*, 252 U.S. at 211.

[199] *See* I.R.C. § 453 (installment sales); *see also infra* note 204.

[200] *See supra* note 66 and accompanying text.

[201] I.R.C. §§ 401 (qualified plan definitions and requirements), 402 (distributions from qualified plans).

[202] *ITG FAQ #10 Answer—What is the Economic Benefit Doctrine*?, IRS, https://www.irs.gov/government-entities/indian-tribal-governments/itg-faq-10-answer-what-is-the-economic-benefit-doctrine (last updated Oct. 1, 2017).

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taxpayer to realize gain,[203] but recognition of the gain is postponed until the taxpayer sells or exchanges the property received in the exchange.[204] The statute enables taxpayers to exchange properties that the taxpayers might continue to hold in order to prevent taxation of the gain despite a favorable sale price and when the prospective buyer might develop the property to its highest and best use. The potential gain is preserved for future recognition because the taxpayer transfers his or her historical basis to the property received in the exchange.[205]

As to statutory matters, the legislature is free to alter the rules governing the deferral and terminate the deferral—perhaps with retroactive effect.[206] Statutory deferrals of inclusion of compensation in income are one of the major deferral groups. Change or termination of the statutory compensation deferrals under qualified retirement plans by the expatriation tax seems unproblematic.[207] Receipt of property for services subject to a risk of forfeiture[208] also is straightforward and Congress may include the value of the employee's interest in the property when received and then possibly offer a deduction if the forfeiture occurs, although determination of the value of the property may be difficult.[209]

Nonstatutory deferrals of compensation are more problematic since they are not a function of legislative choice but rather a product of decisional law or administrative practice. In either event, there is no income to an employee

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[203] I.R.C. § 1001(a) (gain or loss realized).

[204] Section 1031, dealing with like-kind exchanges, is an exception to the recognition of gain and inclusion in income under § 1001(c). Contrast, however, the statutory deferral of a tax payment under §§ 453 and 453A, for example, to which § 877A(h)(1)(B) applies. The Tax Court would seem to have erred in its recent decision in *Topsnik*, in which it held that the taxpayer must mark installment sale contracts to market under § 877A(a)(1) rather than § 877A(h)(1)(B) governing deferred payments of tax. Topsnik v. Comm'r, 146 T.C. 1 (2016); *see* I.R.C. § 877A(a)(1), (h)(1)(B). When payment rather than inclusion is postponed, the unpaid tax accrues interest at the statutory rate under § 6621.

[205] I.R.C. § 1031(d).

[206] *See generally* Charlotte Crane, *The Law and Economics Approaches to Retroactive Tax Legislation*, *in* RETROACTIVITY OF TAX LEGISLATION 129 (Hans Gribnau & Melvin Pauwels eds., 2013).

[207] I.R.C. § 877A(d)(2)(A)(i).

[208] *Id.* § 83.

[209] *Cf. id.* § 83(b) (permitting the recipient to elect to include the property subject to the forfeiture risk in income upon receipt of the property).

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from the employer's designation of compensation for the employee without payment.[210] For example, compensation that the employer designates for the employee but retains[211] or transfers to a trust subject to the claims of the employer's general creditors[212] has not been transferred to the employee for tax purposes so there is no income to the employee.[213] However, if the plan or arrangement restricts the funds to the benefit of the employee when the employer's financial health changes[214] or provides for the transfer offshore of the retained compensation or the trust, the compensation becomes includable in the employee's income even if the funds or the trust remains subject to the claims of the employer's general creditors.[215] Likewise welfare and Social Security benefits historically were not considered to be income,[216] but recent statutes have included some or all of those benefits in income.[217] Despite the departure from historical practice in all those instances, there seems to be no constitutional barrier to inclusion in income. Similarly, personal injury awards were not viewed as income historically,[218] and the taxpayer in the case of *Murphy v. Internal Revenue Service*[219] argued

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[210] "Employee" and "employer" include all service providers and recipients whether or not the relationship between them is employment, as does § 83.

[211] Rev. Rul. 60-31, 1960-1 C.B. 174 (unsecured promise to pay compensation in the future not includable in employee's income).

[212] I.R.S. Priv. Ltr. Rul. 81-13-107 (Dec. 21, 1980) (establishing no transfer in a deferred compensation trust a congregation established for its rabbi). This private letter ruling gave the product the name of "rabbi" trust.

[213] Minor v. United States, 772 F.2d 1472 (9th Cir. 1985) (providing that a transfer to a trust for employees subject to employer's creditors is a grantor trust under § 671 and its income is taxable to the employer).

[214] I.R.C. § 409A(b)(2) (there is a transfer under § 83). Change in financial health in customary documentation refers to deterioration in financial health usually based on balance sheet criteria.

[215] *Id.* § 409A(b)(1).

[216] Rev. Rul. 57-102, 1957-1 C.B. 26 (holding Pennsylvania welfare for the blind excludable from gross income); I.T. 3230, 1938-2 C.B. 136 (excluding state unemployment benefits); I.T. 3194, 1938-1 C.B. 114 (excluding lump sum Social Security benefits). The Code includes no express provision for this general welfare exclusion.

[217] *E.g.*, I.R.C. § 86 (including a portion of Social Security benefits in income).

[218] T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918) (excluding personal injury awards from taxable income).

[219] 493 F.3d 170, 186 (D.C. Cir. 2007) (damages for nonphysical injury includable in taxpayer's income).

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unsuccessfully that longstanding exclusion of personal injury awards, whether physical or not, established that the awards were not income under the Sixteenth Amendment and could not be taxed without apportionment.[220]

Another group of deferrals is statutory and addresses gains from sales or exchanges of property that otherwise would be includable in a taxpayer's income. Taxpayers realize gain or loss when they sell or otherwise dispose of property,[221] but may defer recognition of the gain they realize in a variety of transactions.[222] The Code defers the recognition of realized gain when taxpayers transfer assets to entities in exchange for interests in those entities.[223] Similarly, taxpayers may exchange their property for property of like kind without recognizing the gain they realize on the exchange.[224] Such statutory deferrals are not elective. If the conditions for deferral are met, the taxpayer must defer, even though in most instances minimal restructuring of the transaction would permit recognition and inclusion. Congress may repeal or limit those statutory deferrals as it wishes.

In some situations, Congress has imposed conditions on deferral of realized gain. For example, deferral of realized gain on transfer of appreciated property to a corporation in exchange for corporate stock[225] is

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[220] *Id.*; *see also* Deborah A. Geier, Murphy *and the Evolution of "Basis"*, 113 TAX NOTES 576 (2006) (discussion of *Murphy*, 493 F.3d 170, in the context of human capital).

[221] I.R.C. § 1001(a) (measures gain or loss on sale or other disposition of property). Since the statute requires a determination of the taxpayer's amount realized under § 1001(b), the statute always requires a receipt or something of measurable value so that a taxpayer realizes gain only on a transaction that is a sale or exchange. The exchange may be of property or services. Thus, for example, a donor realizes no gain on a gift of appreciated property, since the donee provides nothing of measurable value in return. *Cf.* Kwall, *supra* note 6 (arguing that the word *disposition* should be given broader effect to include other realization events).

[222] I.R.C. § 1001(c) ("Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.").

[223] *E.g.*, *id.* § 721 (transfers to partnerships and limited liability companies in exchange for ownership interests). Limited liability companies with two or more members are classified as partnerships for tax purposes unless the members elect corporate classification. Treas. Reg. § 301.7701-2(a) (as amended in 2005).

[224] I.R.C. § 1031 (defining like-kind exchanges).

[225] *Id.* § 351.

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limited to taxpayers who are in control[226] of the corporation following the exchange of property for stock. However, if the transferee corporation is foreign, the transferor recognizes the realized gain on the transfer because the statute treats the corporation as if it were not a corporation.[227] A separate rule for transfers of intangibles imputes periodic payments commensurate with income attributable to the intangibles.[228]

Similarly, the transfer of appreciated property to a foreign trust is deemed a sale of the property for its fair market value in a transaction in which the transferor recognizes gain.[229] And the conversion of a domestic trust to a foreign trust or a foreign grantor trust to a nongrantor trust also triggers recognition of gain on the trust's assets as if it sold the assets at their fair market values.[230] While no transfer of assets appears to have occurred in the conversion of the trust, a different taxpayer from the one which owned the assets before the conversion owns the assets after the conversion. Foreign trusts are entities governed by non-U.S. law, and domestic trusts are entities governed by domestic law. The foreign trust and the U.S. trust are different persons. There is a constructive transfer of assets from one taxpayer to another—trust to trust. Compare the reincorporation outside the United States of a formerly U.S. corporation. The identity reorganization creates a new corporate entity existing under and governed by foreign law.[231] The trustee and beneficiaries in the case of transfer from a domestic trust to a

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[226] *Id.* § 368(c) (defining control as at least 80% of the voting power and shares of each class of corporate stock).

[227] *Id.* § 367(a) (listing exceptions for various transfers within the statute that defer the recognition of realized gain).

[228] *Id.* § 367(d).

[229] *Id.* § 684.

[230] *Id.* § 684(c).

[231] Corporations exist only by virtue of statutory authority. Reincorporation in a different jurisdiction creates a new corporation existing under the authority of and governed by different laws than in its former jurisdiction. Thus, the transfer of property to the new corporation in exchange for its stock is a realization event and would be taxable if §§ 368(a)(1)(F) and 354 did not defer the realized gain. In *United States v. Phellis*, 257 U.S. 156 (1921), for example, shareholders recognized gain on exchange of their shares of the new corporation that differed from the old corporation primarily with respect to its state of incorporation. Compare *Weiss v. Stearn*, 265 U.S. 242 (1924), in which there was no change in the state of incorporation so the shareholders did not realize gain or dividend on exchange of their shares. *See generally* Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 563–65 (1991) (applying *Phellis* and *Weiss* in interpreting the realization requirement in § 1001).

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foreign trust and the shareholders in the case of change of place of incorporation have relinquished their interests in the old trust or corporation and substituted interests in the new entity. Accordingly, changes in an entity's location of creation and governing law is a transaction involving the exchange of property requiring realization but not necessarily recognition of gain. Congress may modify the tax law to cause the taxpayer to recognize that realized gain.

Congress also may terminate incomplete deferral transactions such as nonsimultaneous like-kind exchanges[232] and reinvestments of proceeds from involuntary conversions,[233] as the expatriation tax does.[234] Termination of an acquisition period becomes a trap for taxpayers who expatriate but are unaware of the rule. Had they acquired the replacement property before expatriating, the replacement property would have been treated like all other property. It would be marked to market upon expatriation, but the taxpayer could elect to defer payment of the tax.[235] Termination of the time period for acquisition results in immediate inclusion in income of the gain that would have been deferred, and, unlike mark-to-market inclusion,[236] payment of the tax on that gain cannot be deferred because this inclusion fails to meet the deferred payment criteria.[237]

B. Mark to Market, Termination of Realization-Based Deferrals, the Sixteenth Amendment, and the Macomber *Conundrum*

Taxation of gain upon changes of entity identity, transfers of property, and termination of delayed deferral transactions raise no constitutional questions. Each transaction includes a realization event because all involve exchanges of property between different taxpayers—consideration for consideration. Mark to market under the expatriation tax, however, requires

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[232] I.R.C. § 1031(a)(3) (treating as a like-kind exchange certain nonsimultaneous exchanges or dedication of sale proceeds to acquisition of like-kind property).

[233] *Id.* § 1033.

[234] *Id.* § 877A(h)(1)(A) (terminating time for acquiring property to defer recognition of gain).

[235] *Id.* § 877A(b).

[236] *See infra* Part V.B.

[237] *See infra* Part V.B. The inclusion is not under § 877A(a) as § 877A(b) requires.

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no transaction, no transfer of property from one person to another, and no exchange of consideration.[238]

Termination of realization-based deferral by the expatriation tax differs from other terminations of deferrals. Unlike an artificial entity formed and existing under enabling legislation, an individual who is a U.S. citizen or resident does not change identity or become a different individual because he or she expatriates. The expatriate does not transfer property upon expatriation but simply continues to own his or her property. No realization event occurs when the individual expatriates.

In *Towne v. Eisner*,[239] the Supreme Court previously held that stock dividends were not income under the earlier income tax that did not identify them specifically as income. While the language of the opinion—"the corporation is no poorer and the stockholder is no richer than they were before"[240]—suggests that the stock dividend was not income under the Sixteenth Amendment as well, Congress enacted an express statutory inclusion for stock dividends[241] that did not exist under the earlier act.[242] In *Macomber*,[243] the Supreme Court invalidated that express statutory inclusion in income of the value of a stock dividend and confirmed realization as a constitutional requirement for inclusion in gross income of appreciation in

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[238] But see STAFF OF JOINT COMM.ON TAXATION, 104TH CONG., ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION 73 (Comm. Print 1995), for an argument that the property itself changes characteristics from U.S. property to foreign because of the change in its jurisdictional attributes. One might make the same argument that gain is realized (and recognized absent a nonrecognition exception to § 1001(c) when the owner of personal property moves from one state to another. Domestically, the constitutional right to travel might form an additional barrier to taxation. United States v. Guest, 383 U.S. 745 (1966). Compare the outcome in the E.U. in Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, 2004 E.C.R. I-2452. *See supra* note 38.

[239] 245 U.S. 418 (1918) (holding stock dividends not to be income under the Income Tax Act of 1913, Pub. L. No. 63-16, 38 Stat. 114).

[240] *Id.* at 426.

[241] Revenue Act of 1916, Pub. L. No. 64-271, § 2(a), 39 Stat. 756, 757 (1916).

[242] Income Tax Act of 1913, Pub. L. No. 63-16, 38 Stat. 114, 116, 167 (1913).

[243] Eisner v. Macomber, 252 U.S. 189, 197 (1920).

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the value of a taxpayer's property.[244] While *Macomber*[245] addresses only stock dividends that do not alter the taxpayer's investment in the issuing corporation but give the taxpayer additional pieces of paper representing an unchanged bundle of ownership rights, such a change in ownership differs little from subdivision of a parcel of real property without the sale or exchange of any part, cleft of a precious gemstone without a sale or exchange, and other similar divisions of property into multiple properties. Realization requires separation of the income from the capital or transformation of the property into something else whether money, other property, or services. The *Macomber* opinion confirms the continuing validity of the apportionment requirement[246] for direct taxes that are not taxes on income under the Sixteenth Amendment as it finds that the stock dividend gives the taxpayer nothing different from what the taxpayer had before the dividend so that there is no income within the meaning of the Sixteenth Amendment or otherwise.[247]

There is disagreement among tax commentators concerning whether realization is a rule of administrative convenience[248] or a constitutional limitation.[249] While most commentators view realization as a matter of administrative convenience and not a barrier to inclusion,[250] the Supreme

[244] *Id.* at 205–06 (distinguishing a tax on income under the Sixteenth Amendment from a direct tax on property not contemplated by the Sixteenth Amendment).

[245] *Id.* at 189.

[246] U.S. CONST. art. I, § 9, cl. 2 ("No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.").

[247] *Macomber*, 252 U.S. at 219. New § 965 includes undistributed, accumulated corporate earnings, albeit foreign, in United States shareholders' incomes. In that factual likeness to the facts in *Macomber*, § 965 seems clearly to require shareholders to include in gross income something that is not income under *Macomber*'s interpretation of the Sixteenth Amendment.

[248] *See* Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779, 782–85 (1941).

[249] *See* Ordower, *supra* note 13; *see also* Alvin Warren, *Financial Contract Innovation and Income Tax Policy Commentary*, 107 HARV. L. REV. 460, 462 (1993) (realization as a possible constitutional requirement from *Macomber*).

[250] The Court has used administrative convenience language in both *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (referring to realization in the context of cash basis accounting and deferring inclusion until receipt of payment), and *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 565 (1991) (dictum).

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Court never overruled *Macomber* even when invited to do so.[251] Neither did the Court limit its conclusion in *Macomber* that unrealized gain is not income under the Sixteenth Amendment. And the Supreme Court never has approved the taxation of unrealized appreciation in any context. Decisions that commentators cite as relegating realization to an administrative convenience category do so in dicta and are distinguishable on their facts.[252]

There are of course well-accepted theoretical income definitions that would include the annual increase in the value of a taxpayer's property as income.[253] And there is a great deal of literature arguing inter alia that (1) realization is a matter of administrative convenience,[254] (2) a tax on unrealized appreciation is not an unapportioned direct tax on capital,[255] and (3) accrual or accretion based taxation is preferable and fairer than realization based taxation.[256] In addition, industry uses unrealized appreciation to determine compensation in a number of performance-based settings including corporate executives and investment managers, the latter particularly in the case of managers of hedge and private equity funds. On sound economic theory, there is no reason for taxation not to follow that model.[257]

Despite these many strong arguments for abandoning realization as a requirement for inclusion of gain in income, the Supreme Court has not

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[251] Helvering v. Griffiths, 318 U.S. 371 (1943).

[252] *Cf.* Ordower, *supra* note 13, at 36–56 (discussing that body of case law).

[253] *See, e.g.*, *supra* note 45.

[254] *E.g.*, Surrey, *supra* note 248.

[255] *E.g.*, Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2377 (1997).

[256] *E.g.*, Deborah H. Schenk, *An Efficiency Approach to Reforming a Realization-Based Tax*, 57 TAX L. REV. 503 (2004); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817 (1990); *see* Henry Ordower, *Schedularity in U.S. Income Taxation and Its Effect on Tax Distribution*, 108 NW. U. L. REV. 905, 912 (2014) (arguing that eliminating the realization requirement would remove a major benefit to high wealth taxpayers that is present in the U.S. schedular tax system).

[257] *See, e.g.*, Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 358 (2007); David I. Walker, *Reconsidering Realization-Based Accounting for Equity Compensation* (Bos. U. Sch. of Law, Law & Econ. Research Paper No. 16-03 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2715624.

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reversed its holding in *Macomber* and until 1981,[258] Congress did not seek to tax unrealized appreciation under the income tax.[259] The mark-to-market annual inclusion of unrealized gain and loss on commodities futures,[260] later expanded to foreign currency contracts,[261] nonequity options and dealer equity options,[262] was a departure from realization-based taxation. Mark to market for commodities futures was part of legislation designed to constrain a growing commodities-based tax shelter industry and included provisions that prevented taxpayers from recognizing losses on commodities straddles when the taxpayers continue to hold offsetting positions.[263] That mark-to-market regime has remained in effect, virtually unchallenged,[264] since 1981 and has expanded to dealers' positions in securities, but not securities that dealers hold for investment rather than sale to customers.[265]

The mark-to-market mechanism for including unrealized gain and loss in income is mandatory in only three provisions of the Code[266] and appears

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[258] I.R.C. § 1256 (mark-to-market taxation for certain financial positions); *see supra* note 14.

[259] Except possibly under the FPHC rules. *See supra* text accompanying notes 101–12. New § 965, like the FPHC rules, may be unconstitutional as it requires current inclusion in United States shareholders' incomes of accumulated but undistributed earnings of foreign corporations. *See supra* note 66.

[260] I.R.C. § 1256. The discussion in the text below is based primarily on Part III of Ordower, *supra* note 13, at 58–99.

[261] *See* Technical Corrections Act of 1982, Pub. L. No. 97-448, § 105(c), 96 Stat. 2365, 2385–86 (1983).

[262] *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 102–07, 722, 98 Stat. 494, 620–30, 972 (1984).

[263] *See* I.R.C. § 1092 (deferring deductibility of loss if the taxpayer held offsetting positions). The technique involved lifting the loss leg of the straddle at the end of the taxable year by closing the position and recognizing the loss but retaining the gain leg of the straddle and often further straddling by entering into a different offsetting position to protect against loss in value of the gain leg. *See, e.g.*, Smith v. Comm'r, 78 T.C. 350, 355–57 (1982) (providing butterfly straddle lacks economic profit motive—loss not deductible).

[264] *See* Murphy v. United States, 992 F.2d 929, 931 (9th Cir. 1993) (mark to market constitutional under taxing power because of constructive receipt from daily markings of position and adjustment of margin in the futures industry).

[265] I.R.C. § 475 (added by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13223(a), 107 Stat. 312, 481).

[266] *Id.* §§ 1256 (mark to market for regulated futures contracts and other positions), 475 (mark to market for dealer inventoried securities), 877A (expatriation tax).

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as an election in other statutes.[267] Congress considered, but did not enact, a mark-to-market inclusion for property held at a taxpayer's death.[268] Mark to market for futures contracts corresponds roughly to industry practice. The clearinghouse that acts as the counterparty in futures contracts marks to market all open positions at the end of each trading day. If a trader's positions have retreated in value the trader must post additional margin to cover the clearinghouse's risk from depreciated positions, and, conversely, if the trader's positions have advanced in value, the trader may withdraw margin (i.e., receive cash). Congress viewed the industry practice as constructive receipt[269] of the increase in value because the taxpayer could withdraw that increase immediately. Congress built mark-to-market taxation on that constructive receipt platform. Yet, no such industry practice was in place for foreign currency contracts, nonequity options, or dealer equity options to which mark to market also applies. And Congress did not seek to apply mark to market in other contexts such as a borrower increasing a nonrecourse debt and receiving cash because loan collateral increases in value.[270]

Introduction of mark-to-market taxation for commodities futures came with a significant trade-off for market participants. Without regard to the holding period of the position, gain and loss on positions, referred to as "§ 1256 contracts,"[271] that are subject to the statute are 60% long-term capital gain or loss and 40% short-term capital gain or loss. At enactment, major participants in the industry tended to hold positions for less than one year so the rule was favorable to them. It effectively converted 60% of gain from

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[267] *E.g.*, I.R.C. §§ 338 (deemed asset sale election in corporate stock acquisition uses asset sale at fair market value but does not use mark-to-market terminology), 1296 (election to mark to market marketable PFIC stock).

[268] U.S. DEP'T OF TREASURY, 91ST CONG., TAX REFORM STUDIES AND PROPOSALS 106, 331–51 (Comm. Print 1969).

[269] The "constructive receipt doctrine" is the longstanding tax principle that if a taxpayer fails to take into account income to which the taxpayer has an unrestricted right, the taxpayer constructively receives the income and must include it in gross income. RICHARD A. WESTIN, WG&L TAX DICTIONARY 132 (2002).

[270] Note, however, that § 72(e)(4) treats loans from insurance and annuity contracts as distributions of the inside increase in policy value that becomes taxable when withdrawn but that inside increase is attributable to untaxed income rather than capital appreciation.

[271] I.R.C. § 1256(b) (defining § 1256 contracts).

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short-term to long-term capital gain taxed at a preferential rate.[272] Accordingly, for industry participants with the means and power to launch a strong constitutional challenge, mark to market was advantageous. The U.S. Court of Appeals for the Ninth Circuit remains alone in considering a challenge to mark to market.[273] No taxpayers took challenges to other Circuit Courts of Appeals to generate a split in the circuits that might encourage the Supreme Court to review the statute.

Congress chose not to require mark to market when it first considered it for the expatriation tax[274] and also when it considered mark-to-market taxation for decedents.[275] Unlike § 1256, constructive receipt as a theoretical basis upon which to support mark to market was not available for inclusion of gain at death or at expatriation. Thus, Congress had to confront the realization limitation on inclusion directly. It considered *Macomber* and some of the commentary on realization.[276] While political considerations, rather than tax theory, may have dissuaded Congress from imposing a tax on unrealized appreciation at death and on expatriation, it is also possible that Congress viewed the *Macomber*-based realization requirement as too robust to overturn. Had Congress imposed mark-to-market inclusion at death, realization may have been a weaker barrier there than in the case of expatriation. At a taxpayer's death, all the decedent's property passes to a different taxpayer. The new owner either is the taxpayer's estate or another individual under operation of law for survivorship tenancies. That transfer may be a realization event just as change in identity of a corporation is a

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[272] Currently, § 1(h) applies a lower rate of tax to net capital gain (as defined under § 1222(11)) than applies to net short-term capital gain and ordinary income. When mark to market was added to the Code in 1981, net capital gain was subject to a reduced individual rate of tax but the mechanism was different. Under § 1202 (1954), 60% of net capital gain was deductible from gross income under § 62(3) (1954), as then in effect. The deduction reduced the rate of tax on net capital gain to 40% of the ordinary income rate.

[273] *See* Murphy v. United States, 992 F.2d 929 (9th Cir. 1993).

[274] *See* STAFF OF THE JOINT COMM. ON TAXATION, 104TH CONG., ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION (Comm. Print 1995); *see also supra* note 53.

[275] *See* U.S. DEP'T OF TREASURY, *supra* note 268, at 106, 331–51.

[276] STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 274, at 69–81.

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realization event involving a new taxpayer as owner of the property.[277] The decedent's tax year ends at death. The same analysis applies to gifts of appreciated property. The property transfers to a different taxpayer and that may be a realization event. There is no property transfer to accompany expatriation and support realization.[278]

Somewhat surprisingly, mark-to-market taxation on expatriation seems to have enjoyed the immunity from challenge that characterized mark to market in the commodities industry even though the constructive receipt upon which the single decision upholding mark to market for commodities positions relied[279] is absent in the case of the expatriation tax. Under § 1256, taxation was a matter of timing. Gain would be taxed currently under § 1256 but later in the absence of § 1256. Under the expatriation tax, the trade-off is not just a matter of timing, but also imposition of tax in the United States,[280] although it may be only a matter of timing with respect to U.S. real property.[281] Absent the expatriation tax, personal property investments escape U.S. taxation completely as expatriation shifts the source of the expatriating individual's gain from the United States to the country of the individual's new residence or citizenship for U.S. tax purposes.[282]

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[277] Section 1001(a) computes the gain or loss from a "sale or other disposition." *See supra* text accompanying note 6. *Cf. supra* note 231 (discussing corporate reorganizations and taxpayer change).

[278] The taxpayer is not changed despite possible relinquishment of citizenship. Unlike a corporation, the individual exists whether she is subject to one body of law or another. Absent a legal framework, a corporation does not exist.

[279] Murphy v. United States, 992 F.2d 929 (9th Cir. 1993).

[280] STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 274, at 69–81. Before enactment of new § 965, accumulated foreign income could have been deferred indefinitely but if the foreign accumulation were repatriated to the foreign corporation's United States shareholders, it would become subject to tax. The statute provides an opportunity to repatriate the accumulated earnings at a reduced rate of tax because of § 965's embedded deduction under § 965(c) that is lower than the maximum rate on net capital gain on noncorporate taxpayers under § 1(h), and, for corporations for which there is no reduced rate generally on net capital gain, lower than the 2017 corporate maximum rate of 35% under § 11 and even lower than the new maximum corporate rate under the Tax Cuts and Jobs Act of 21%. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13001, 131 Stat. 2096 (2017). The trade-off of paying tax currently at a significantly reduced rate of tax or further deferring with a challenge to constitutionality would seem to favor paying without challenge.

[281] I.R.C. § 897 (taxing gain on U.S. real property interests).

[282] *Id.* § 865.

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The constituency affected by the expatriation tax receives neither reduction in tax rates nor partial exclusions that might counteract its resistance to mark to market. Many expatriates are sufficiently wealthy that the potential tax savings from a determination that the expatriation tax is unconstitutional may outweigh the cost of litigating the constitutionality of the expatriation tax.[283] Given that taxpayers control the choice of forum on tax matters,[284] litigation would seem likely to follow in multiple circuits. A split in the circuits is imaginable resulting in some expatriates avoiding the tax and others not. The issue is of sufficient importance in the presence of a split in the circuits that the Supreme Court well might grant certiorari to resolve the split. In the interim, dubious constitutionality casts a pall over enforcement of the statute.

Yet, litigation has not ensued during the years since the statute entered into force in 2008,[285] despite increasing numbers of expatriates.[286] One might speculate that perhaps assessments of the expatriation tax have been minimized through discounting techniques similar to those common to the estate tax.[287] Further tax liability reductions may be forthcoming in negotiated settlements of the tax based on hazards of litigation.[288] The threat of taxpayer-initiated litigation encourages such settlements as the litigation would be a drain on limited government resources in a time in which Congress has been parsimonious with allocations of resources to tax

[283] STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 274, at 11. The original expatriation tax proposals were to "stop[] U.S. multimillionaires from escaping taxes by abandoning their citizenship." *Id.*

[284] Gerald A. Kafka, *Choice of Forum in Federal Civil Tax Litigation (Part 1)*, PRAC. TAX LAW., Winter 2011, at 55.

[285] Section 877A is applicable to any individual whose expatriation date is on or after June 17, 2008. Hero's Earnings Assistance and Relief Tax (HEART) Act of 2008, Pub. L. No. 110-245, § 301(g), 122 Stat. 1630, 1638–47 (2008).

[286] *See supra* note 29.

[287] IRS ENGINEERING/VALUATION PROGRAM DLOM TEAM, DISCOUNT FOR LACK OF MARKETABILITY: JOB AID FOR IRS VALUATION PROFESSIONALS (2009), https://www.irs.gov/pub/irs-utl/dlom.pdf.

[288] IRS Appeals, District Counsel, and the Department of Justice Tax Division have authority to settle tax liability based on the hazards of litigation so that the government and taxpayers may have been eschewing litigation on the issue. Least likely, it would seem, is that the wealthiest expatriates have been paying the full tax since the statute's effective date.

determination and collection.[289] It is also possible that some expatriates have secreted assets offshore and may be settling the expatriation tax liability on assets they have not secreted offshore in order to distract from potential liability under FATCA on hidden assets.[290]

Nevertheless, challenges to the expatriation tax seem both inevitable and desirable. Removing the constitutional pall the *Macomber* decision creates is critical to future, robust enforcement of the tax. A Supreme Court decision upholding the expatriation tax or a denial of certiorari following appellate court decisions upholding the tax might encourage legislators to enact a general, annual mark-to-market requirement for all taxpayers.[291] With a more comprehensive tax base applicable to all, increases in asset values would be included annually under a broad mark-to-market system. Administrative arguments against generalized marking to market that emphasize the difficulty in determining property values already have lost force with adoption of mark to market as a practical choice for expatriating individuals.

Significant tax simplification would follow from general application of mark to market. Current inclusion of gain and loss from capital assets weakens the argument for preferential tax rates applicable to net capital gain[292] that capital gain develops over extended periods and causes a

[289] I.R.S. News Release IR-2013-3 (Jan. 9, 2013). Despite statistics that show that for each sum spent on the IRS, the additional tax collection is many times the amount spent, Congress has been unwilling to increase—and tends to decrease—IRS funding. Press Release, Nat'l Treas. Emp. Union (NTEU), Reardon to Congress: Stop Cutting IRS Budget (July 26, 2017), https://www.nteu.org/media-center/news-releases/2017/07/26/irs-budget-release.

[290] *See supra* text accompanying notes 138–40.

[291] A commentator recently suggested enacting a mark-to-market regime for the assets of taxpayers whose annual income exceeds $2.5 million. The commentator concludes that mark to market would be constitutional while a wealth tax would not be. David S. Miller, *A Comprehensive Mark-to-Market Tax for the 0.1% Wealthiest and Highest-Earning Taxpayers* (Jan. 4, 2016) (unpublished manuscript), https://ssrn.com/abstract=2710738. For arguments for and against a continuing realization requirement, see Ilan Benshalom & Kendra Stead, *Realization and Progressivity*, 3 COLUM. J. TAX L. 43 (2011), and Reuven S. Avi-Yonah & Dmitry Zelik, *Are We Trapped by Our Capital Gains* (U. Mich. Pub. Law Research Paper No. 476, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2642860 (criticizing the realization requirement and arguing for eliminating the rate differential between ordinary income and capital gain).

[292] I.R.C. §§ 1222(11) (defining net capital gain as the "excess of net long-term capital gain over net short-term capital loss"), 1(h) (applying a lower than ordinary income rate to net capital gain).

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bunching of income that would distort liability and force taxpayers into higher marginal brackets.[293] At the same time, no longer would the new basis rule for property received from a decedent[294] be needed, and capital gain would not escape income taxation permanently under that rule. Similarly, provisions facilitating deferral of gain recognition become unnecessary as annual change in value would have been taken into account and the taxpayer's basis adjusted to reflect all but the current year's change in value.[295]

At the same time, the argument that capital gain is primarily or substantially a function of inflation that should not be taxed[296] loses its force. Adjustments, whether to basis or inclusion, to separate the effect of inflation from real economic gain[297] would not be better justified for capital assets than for compensation for services and periodic returns on investments. The same inflationary impact burdens ordinary income production. Various inflation adjustments to marginal brackets, personal exemptions, the standard deduction, and so forth already address inflation and generally are not specific to a limited type of income.[298]

Certainly, there are liquidity concerns arising from taxation of gain without proceeds from sale, but annual gains are unlikely to be extreme. That characteristic of long-term, untaxed increases in value disappears after the transition period to the new mark-to-market tax regime. For liquid assets such as marketable securities, taxpayers might have to sell some portion of the assets to generate cash. Such sales contribute to regular trading and market

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[293] Walter Blum made this argument against realization-based taxation of capital gain in 1957. Walter J. Blum, *A Handy Summary of the Capital Gain Arguments*, 35 TAXES 247, 253 (1957). Professor Blum identified the capital gain preference as "the main source of complexity in our income tax." *Id.* at 265. The Tax Reform Act of 1986, Pub. L. 99-514, § 1235(a), 100 Stat. 2085, 2566, temporarily eliminated the rate differential with a decreased ordinary income tax rate.

[294] I.R.C. § 1014 (new basis at death).

[295] *Id.* §§ 1031 (like-kind exchanges), 721 (contributions to partnerships), 351 (contributions to corporations).

[296] Blum, *supra* note 293, at 255.

[297] Roger E. Brinner, *The Peculiar Taxation of Capital Gain Income*, 134 TAX NOTES 549 (2012) (discusses various arguments on inflation adjustment and taxing gain at death).

[298] For a list of inflation adjustments, see Rev. Proc. 2016-55, 2016-2 C.B. 707.

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stability. For illiquid properties, the current taxation of moderate amounts of annually accrued gain may not be significantly greater than the issues already raised by local, ad valorem property taxes. Occasionally taxpayers must borrow against the property to pay their taxes, but such arguments are probably not compelling for the bulk of taxpayers.[299] Where liquidity is of great concern, the new mark-to-market system could address liquidity by enabling payment deferrals with interest charges—a system equivalent to borrowing tax payment amounts from the taxing authority.[300]

Elimination of realization-based taxation may contribute to moderating the increasing wealth disparities and the increasing regressivity of U.S. taxation that have characterized the past several decades,[301] as individuals with investment wealth that less affluent taxpayers are unlikely to have often may defer the incidence of taxation indefinitely until they choose to dispose of investment assets.[302] Many also avoid taxation of gain by continuing to hold investment assets until their deaths.[303] Current inclusion of capital gain will force wealthier taxpayers to pay tax on their economic incomes rather than their smaller, realization-based taxable incomes. With the broader tax base that annual inclusion of capital gain brings and the absence of rate differentials between capital gain and ordinary income, revenue increases may facilitate decreases in rates as well. Issues like the "carried interest" taxed at net capital gain rates would disappear without special legislation.[304]

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[299] Most homeowners pay their property taxes and probably are more likely to default on mortgages than on tax payments. Many investors who own dividend-paying shares and mutual funds automatically reinvest their dividends and find the liquidity elsewhere to pay the tax on the dividends.

[300] *Cf.* I.R.C. § 877A(b).

[301] Ordower, *supra* note 257, at 911.

[302] The Tax Cuts and Jobs Act exacerbates, rather than improves, the disparity in labor/capital income taxation by further decreasing the maximum ordinary rate of tax on capital (or deemed capital) income. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11011, 131 Stat. 2054, 2063 (2017) (deduction of twenty percent of qualified business income to be codified at I.R.C. § 199A).

[303] I.R.C. § 1014 (assets held by an individual at death take a new fair market value basis).

[304] Carried interest refers to the technique of a general partner receiving a share of a partnership's profits for services to the partnership that the IRS has determined will not be taxable on receipt. The technique has been used extensively in the private equity fund industry to secure for the manager capital gain as a share of partnership profit rather than ordinary income from services. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) (analyzing various arguments for taxing a profits interest but concluding that the private equity fund managers should have ordinary income from their profits interests in the private equity funds); Henry Ordower, *Taxing*

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If the courts strike down the exit tax, or Congress repeals the expatriation tax to avoid the unnecessary controversy it may generate, other techniques may present themselves to capture pre-expatriation gain. A tax clearance procedure supplementing a broad-based continuation tax like the taxation of inverted corporations[305] might be possible and require expatriating individuals to post bond to secure payment of tax on their unrealized gain. The United States already has tax clearance for noncitizens so expanding an existing mechanism to include citizens is not so burdensome.[306] A mark-to-market election might supplement the continuation tax giving taxpayers the option of closure in the form of a final U.S. tax return.[307]

C. Operational Features of the Expatriation Tax

Like the continuation tax,[308] the expatriation tax applies primarily to moderately wealthy and wealthy taxpayers whom it labels as "covered expatriates."[309] A "covered expatriate" is as defined in the continuation tax.[310] The statute exempts individuals who otherwise would meet one of the covered expatriate criteria (1) who are dual nationals and remain citizens and are taxed as residents in the other state of nationality[311] or (2) who expatriate

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Service Partners to Achieve Horizontal Equity, 46 TAX LAW. 19 (1992) (arguing that the profits interests should be taxable as open transactions).

[305] *See supra* Part IV.A.

[306] *See supra* note 40.

[307] *Cf. supra* note 98 and accompanying text. In a realization-based system, it is unclear whether a mark-to-market election is permissible since gain and loss cannot be taken into account without an event of realization. An election would not seem to be such an event.

[308] I.R.C. § 877; *see supra* Part IV.B.

[309] I.R.C. § 877A(a)(1).

[310] Section 877A(g)(1) defines covered expatriate by cross reference to the application of § 877(a)(2). The covered expatriate definition is reminiscent of, but not identical to, the accredited investor standard for private placements of securities under Regulation D, 17 C.F.R. § 230.501 (1982). *See supra* text accompanying notes 167–68.

[311] Katrin Bennhold, Boris Johnson, *British Foreign Secretary, Drops Dual U.S. Citizenship*, N.Y. TIMES (Feb. 8, 2017), https://www.nytimes.com/2017/02/08/world/europe/britain-boris-johnson-renounces-american-citizenship.html?_r=0. Johnson relinquished citizenship purportedly because he no

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before age 18½.[312] For both dual nationals and under-18½ expatriates, more than ten years of U.S. residence disqualifies them for the exemption.[313]

The expatriation tax applies primarily to realization-based deferrals.[314] While the tax terminates the expatriating taxpayer's statutory deferrals as well as realization-based deferrals, exemptions from the tax are available for eligible deferred compensation items[315] and interests in nongrantor U.S. trusts are exempt from current inclusion[316] subject to requirements protecting collection of the tax in the future. Each expatriate may exclude an inflation-adjusted $600,000 from the mark-to-market inclusion in income subject to the tax.[317] For mark-to-market inclusion, the taxpayer may defer payment of the tax, but not determination of the tax liability, by so electing and providing adequate security for payment.[318] The deferred tax payment accrues interest at the statutory underpayment rate.[319]

For both exemptions of eligible deferred compensation and nongrantor U.S. trusts, collection of tax in the United States upon termination of the deferral is generally unproblematic because a third party subject to U.S. jurisdiction controls the payments to the expatriate.[320] That third party must withhold 30%[321] from the payments to fulfill a tax withholding obligation to

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longer wished to be taxable in the United States. *Id.* Johnson would fall within this exception to the covered expatriate definition and be free from the expatriation tax.

[312] I.R.C. § 877A(g)(1)(B)(i), (ii).

[313] *Id.* The ten-year rule is ten of the last fifteen years for dual nationals and ten years before relinquishment for the 18½ rule covering individuals who immigrated as children

[314] *Id.* § 877A(a)(1), (2) (mark to market).

[315] *Id.* § 877A(c)(1), (d)(3) (eligible deferred compensation items); *see also supra* text accompanying note 184.

[316] I.R.C. § 877A(c)(3), (f)(3) (interest in a nongrantor trust).

[317] *Id.* § 877A(a)(3) ($600,000 exclusion from mark to market).

[318] *Id.* § 877A(b) (deferral of payment).

[319] *Id.* §§ 6601, 6621 (interest on underpayments); 877A(b)(7) (interest from due date for payment without the election to defer payment).

[320] The plan administrator or trustee in the case of a deferred compensation plan and the trustee in the case of a nongrantor trust. *Id.* § 877A(d)(1)(A), (f)(1)(A).

[321] The withholding percentage applicable to fixed or determinable annual or periodical income unreduced by any applicable treaty provision. *Id.* §§ 871 and 881.

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the United States.[322] The payor of the deferred compensation must be or must elect to be treated as a U.S. person[323] having an obligation to withhold,[324] and the covered expatriate must notify the payor of her covered expatriate status and relinquish any claim to reduced withholding under any treaty.[325] Deferred compensation items broadly include qualified and nonqualified plans.[326]

Unlike the election to defer tax on the mark-to-market income,[327] the interest charge does not apply to continuing deferrals of inclusion under deferred compensation plans or attributable to the covered expatriate as a beneficiary of a nongrantor trust. If, however, the payor is not a U.S. person and does not consent to being treated as a U.S. person or the taxpayer fails to notify the payor of covered expatriate status or does not waive treaty rights, the covered expatriate must include in income the present value of her accrued benefit under most deferred compensation plans on the day preceding expatriation.[328] Similarly, for plans in which the tax on the covered expatriate's interest was deferred because of nontransferability or a risk of forfeiture,[329] the interest is deemed to vest on the day preceding expatriation thereby terminating the deferral.[330]

The trustee of a nongrantor trust is obligated to withhold 30% on distributions out of the trust's distributable net income.[331] For distributions in kind from nongrantor trusts, the expatriation tax statute imputes a sale by the trust to the covered expatriate at fair market value on the date of

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[322] *Id.*; *see also id.* § 1461 (withholding obligation and indemnity).

[323] *Id.* § 877A(d)(3)(A).

[324] *Id.* § 1461.

[325] *Id.* § 877A(d)(3)(B).

[326] *Id.* § 877A(d)(4).

[327] *Id.* § 877A(b).

[328] *Id.* § 877A(d)(2)(A)(i).

[329] *Id.* § 83(a)(1).

[330] *Id.* § 877A(d)(2)(A)(ii).

[331] *Id.* §§ 652, 662 (inclusion of distributable net income).

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distribution causing the trust itself to recognize taxable gain.[332] That gain increases the trust's distributable net income[333] so that the distribution in kind carries distributable net income to the covered expatriate on which the trustee must withhold. The statute also deems the covered expatriate to have relinquished any claim to reduced withholding under any treaty.[334]

Specified tax deferred accounts are disqualified from continuing deferral.[335] The covered expatriate must include the full amount of her account in income the day before expatriation, but is relieved from early distribution penalties.[336] The term "specified tax-deferred accounts" refers to a narrow group of deferral arrangements—an individual retirement plan;[337] a qualified tuition program;[338] a Coverdell education savings account;[339] a health savings account;[340] and an Archer MSA.[341]

Since a covered expatriate may continue to defer compensation without the interest charge that the United States imposes on deferred payments of tax,[342] as long as a third party has an obligation to withhold, collection of the tax following expatriation would seem of primary concern. The mark-to-market rule applies, however, even in instances where an expatriate continues to be taxable in the United States after expatriation for gain from U.S. real property interests as gain from the sale or exchange of property effectively

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332 *Id.* § 877A(f)(1)(B). This provision obliquely raises the question of whether the realization requirement might be a barrier to compelling a donor to recognize gain from the appreciation in gift property. But § 1001(a) suggests that dispositions that are not sales or exchanges (e.g., gratuitous transfers) might be realization events even though they have not been treated as such historically. *See* Kwall, *supra* note 6 (arguing for giving effect to the "other disposition" language).

333 I.R.C. §§ 651, 661.

334 *Id.* § 877A(f)(4)(b).

335 *Id.* § 877A(c)(1), (3).

336 *Id.* § 877A(e)(1).

337 As defined in § 7701(a)(37).

338 As defined in § 529.

339 As defined in § 530.

340 As defined in § 223.

341 As defined in § 220.

342 I.R.C. § 6601 (interest on underpayments). For example, § 453A imposes an interest charge on the deferred inclusion of gain from certain installment sales.

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connected with the conduct of a U.S. trade or business,[343] and a third party has a withholding obligation.[344] Transferees of U.S. real property interests must withhold ten percent of the purchase price. Collection of the tax is assured as it is in the case of deferred compensation.[345] Gain from the sale of some personal property may continue to be sourced in the United States as well.[346] Accordingly, for U.S. real estate gain and certain personal property, the expatriation tax simply accelerates the inclusion of appreciation in income rather than capturing income that might otherwise escape U.S. taxing jurisdiction.

For other property, including U.S. securities and foreign real and personal property, the statute captures appreciation in value to the moment of expatriation. Postexpatriation appreciation no longer is subject to U.S. tax. For example, a covered expatriate who owns a vacation home offshore is taxable on the increase in value of the home until expatriation, but further appreciation after expatriation is not subject to U.S. tax. Exclusions from income continue to apply despite expatriation but deferrals generally cease. Gain on the covered expatriate's primary residence, for example, would be excludable within applicable limits.[347] Even if payable after expatriation, receipt of proceeds paid by reason of the death of an insured[348] and awards

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[343] *Id.* § 897.

[344] *Id.* § 1445 (10% withholding obligation on the transferee). The expatriation tax could set the withholding obligation at 30% as it does with deferred compensation.

[345] Compare specified tax deferred accounts, discussed *supra* text accompanying notes 335–41, on which the institution holding the account could withhold on distributions to collect the tax but may be unwilling to withhold.

[346] I.R.C. §§ 865(c)(1), (2) (depreciation recapture sourced in the United States to the extent it is attributable to U.S. source depreciation allowances), 865(d)(3) (gain from goodwill sourced to where the goodwill was created).

[347] *Id.* § 121 (permitting a single taxpayer to exclude $250,000 of gain and married filing jointly taxpayers $500,000 pf gain on the sale of their qualifying personal residence). The exclusion from § 121(a) under § 121(e) for sales of personal residences by taxpayers subject to § 877A(a)(1) should not prevent the exclusion.

[348] *Id.* § 101.

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or settlements for physical personal injuries, including future payments under a structured settlement, continue to be excludable.[349]

VI. Peripheral Problems of a Valid Expatriation Tax

Whether litigation ensues or taxpayers come to accept that the tax is valid without contest,[350] the expatriation tax adds complexity to the tax law. With a valid expatriation tax, immigrants to the United States must maintain records for two bases in many of their assets. One basis is their historical cost, while a second basis is the fair market value of the property at the moment of immigration. The expatriation tax only reaches the difference between the fair market value at date of immigration and fair market value at expatriation,[351] presumably as adjusted for depreciation and improvements.[352] A nonexpatriating immigrant will recognize the difference between his or her historical cost, also as adjusted, and the actual sale price when a sale occurs.[353]

Even with that basis complexity, a reciprocity issue remains. Immigrants to the United States might be treated less favorably than emigrants from the United States in the country to which they immigrate. Unless U.S. tax rules on expatriation apply reciprocally to immigrants, as if the country from which they emigrated imposed such a tax, immigrants would maintain their historical basis in their assets when they immigrate while U.S. emigrants would have a new basis in their assets in their new

349 *Id.* § 104(a)(2) (presumably the exclusion overrides the withholding tax under § 871 despite the settlement producing a periodic payment).

350 Following presentation of an earlier draft of this article at the Taxation and Citizenship Conference at the University of Michigan, one member of the audience argued that taxpayers would pay the expatriation tax willingly to finalize their U.S. tax liability when they expatriate so they could free themselves from any tax on the future growth in the value of their assets. In response to the comment, I expressed skepticism in that wealthy taxpayers tend to be unwilling to pay any tax, however small. Henry Ordower, *The Culture of Tax Avoidance*, 55 ST. LOUIS U. L.J. 47, 85 (2010) (discussing tax products to shelter low taxed net capital gain). Similarly, Newt Gingrich, John Edwards, and others avoided a 2.9% FICA tax in their S corporations. Janet Novack, *Gingrich Used Payroll Tax Ploy Often Attacked by IRS*, FORBES (Jan. 22, 2012), http://www.forbes.com/sites/janetnovack/2012/01/22/gingrich-used-payroll-tax-ploy-often-attacked-by-irs/#248092f84608.

351 I.R.C. § 877A(h)(2) (step-up in basis at commencement of residency).

352 *Id.* § 1016 (adjustments to basis).

353 *Id.* § 1001.

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country of residence because they have recognized their built-in gain. Conversely, if the country to which the U.S. expatriate immigrates has a realization-based tax system, tax treaty changes will be necessary to prevent double taxation of the U.S. emigrant's gain from historical basis if the new country of residence does not recognize expatriation as a realization event. U.S. tax treaties have not addressed tax basis at all. Rather the treaties may provide for taxation of gain only in the jurisdiction of residence.[354]

Absent a treaty agreement, U.S. expatriates risk a second tax in the new jurisdiction which would have been foreign tax creditable if it had been imposed at the same time as the U.S. tax.[355] Without a U.S. statutory change, the U.S. expatriate may not claim the potential foreign tax as a credit against U.S. liability under the expatriation tax or claim a refund of the U.S. tax sometime in the future when the new country of residence taxes the built-in gain in the taxpayer's properties.

Certainly, opportunities to avoid the expatriation tax with advance planning also loom. An individual, in anticipation of expatriation, may make gifts of substantially appreciated property to noncitizen, nonresident individuals. While the donor may be taxable under the gift tax on the value of the gifts, the donor does not recognize gain and, for much investment property, the gift removes the built-in gain from U.S. taxing jurisdiction. With discounting techniques commonly used by estate planners, the future expatriate may be able to remove significant gain from U.S. taxing jurisdiction at a relatively small gift tax cost, especially in those instances in which the future expatriate plans well in advance. A modification of the gift rules to tax gain on a gift of appreciated property may become necessary to limit this plan.[356]

VII. CONCLUSION

Taxpayers shift income offshore with lawful devices like operating through a foreign corporation. Taxpayers have enhanced the amount of that income lodged outside the United States with transfer pricing strategies. And

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[354] *See, e.g.*, U.S. MODEL INCOME TAX TREATY, art. 13 (2016) (personal property only taxable in jurisdiction of residence).

[355] I.R.C. § 901 (foreign tax credit).

[356] *Cf. id.* § 684 (taxing gain on transfers to foreign trusts).

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taxpayers have evaded U.S. taxation of their worldwide income by secreting assets and income in tax haven, bank secrecy jurisdictions. CFC rules prevent use of foreign corporations to lodge income offshore when no business purpose for the foreign placement of income is present. Regulations and litigation have sought to limit transfer pricing planning. Penalties for taxpayers and their foreign hosts have been enacted to prevent the hiding of assets offshore. This article has reviewed many of those techniques and statutory or regulatory responses.[357]

Expatriation, however, removes taxpayers' foreign source income from U.S. taxing jurisdiction including appreciated property that changes source as the taxpayer expatriates. In response to increasing numbers of expatriating Americans, loss of potential tax revenue from those expatriates has become a growing concern. Capture of a portion of the expatriate's wealth produced while in the United States, under the protections of U.S. law, and with the assistance of U.S. social, financial, and governmental resources, seems justified and desirable.[358] Continuing U.S. taxing jurisdiction over pre-expatriation increases in wealth is difficult to enforce as the individual may be beyond the reach of U.S. authorities. Hence, Congress enacted the expatriation tax to capture those increases in wealth at the moment of expatriation while the United States still has jurisdiction over the taxpayer. Yet, requiring an expatriating individual to pay a tax on increases in wealth that accrued while the individual was subject to the U.S. income tax—largely unrealized appreciation in value—is problematic in a realization-based tax system like the United States has. Even if taxation is permissible, taxing expatriation is a barrier to emigration and in that it treats emigrating taxpayers differently and less favorably from all other U.S. taxpayers. Expatriation is not an event of realization and longstanding U.S. Supreme Court precedent determined that absent realization, gain is not income. This article addresses that constitutional conundrum and identifies the income that the United States may tax without question and emphasizes the constitutional barrier to taxing the unrealized appreciation. The article anticipates litigation of the constitutional issue and recommends that if the tax withstands constitutional challenge Congress enact a comprehensive tax base reaching

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[357] The Tax Cuts and Jobs Act alters rules for offshore corporate deferral and transfer pricing. *See supra* Part III.

[358] Cook v. Tait, 265 U.S. 47 (1924) (establishing the power of the United States to tax its citizens residing abroad under those principles).

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all unrealized appreciation for all taxpayers. That comprehensive base would both simplify the tax law and help to level the growing disparity between wealthy and poor in the United States.

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