Comments

INTERNAL REVENUE CODE SECTION 877: EXPANDED PURVIEW GENERATES DISCORD IN TAXATION OF THE TAX-MOTIVATED EXPATRIATE

United States citizens who relinquish their citizenship face the possibility of severe tax consequences for ten years following their loss of citizenship.[1] Recent application of Internal Revenue Code section 877 (I.R.C. § 877) has resulted in a broadening of United States taxing power beyond that which was originally intended by Congress.[2] As a result, individuals originally not intended to be subjected to the taxing power of I.R.C. § 877 may find themselves within the scope of this code section. These individuals will endure stringent tax consequences.

To illustrate how I.R.C. § 877 operates to tax certain individuals, consider the following example. The illustration compares United States taxation of the nonresident alien[3] with that of a United States citizen who has relinquished citizenship.

Taxpayer *A* is a nonresident alien not engaged in any trade or business in the United States. Taxpayer *A's* income will be taxed at a flat rate of 30 percent.[4] Taxpayer *B* is a former United States citizen. Taxpayer *B's* loss of citizenship was determined to be moti-

1. I.R.C. § 877 (1982). If the principal purpose behind renunciation of United States citizenship is avoidance of United States taxes, I.R.C. § 877 may be applied. If applied, the result is harsher taxation of these individuals than persons whose loss of citizenship is not deemed to be tax-motivated.

2. See generally textual discussion in Section IV *infra* for an analysis of the impact of I.R.C. § 877 when applied beyond the purview originally intended by Congress. For specific provisions contained within I.R.C. § 877, see Section III *infra*.

3. The nonresident alien, though not defined by statute, is afforded recognition according to guidelines within the Treasury Regulations. It is stated in Treas. Reg. § 1.871-4(b) that an alien is presumed to be a nonresident due to his "alienage," but the presumption is a weak one. As stated in Treas. Reg. § 1.871-4(c)(2), additional factors must be taken into account. The regulation states that factors to be considered include declaration of intent, establishment of a home, presence of spouse or family, and participation in social business activities within the United States. Though one factor alone may not be sufficient to characterize an alien as a resident or nonresident, a balancing of all elements will determine status. *See* Budhwani v. CIR, 70 T.C. 287 (1978).

4. I.R.C. § 871(a) (1982).

vated by a desire to avoid United States tax liability.[5] Taxpayer *B* is not engaged in any trade or business within the United States. Taxpayer *B* will be subjected to tax rates applicable to United States citizens on this income, provided that the domestic rate would exceed the rate applied to Taxpayer *A*.[6] In other words, Taxpayer *B* is taxed at a harsher rate than Taxpayer *A*. Furthermore, Taxpayer *B* will be subjected to such taxation for ten years following loss of citizenship.[7]

Serious considerations of international and domestic import have been raised in response to recent application of I.R.C. § 877. Recent application has expanded United States taxing power under I.R.C. § 877 well beyond that which was originally intended by Congress.[8] Such application of I.R.C. § 877 has resulted in noncompliance by the United States with certain treaty obligations.[9]

I.R.C. § 877 was enacted for the specific purpose of discouraging tax-motivated expatriation.[10] I.R.C. § 877 was not enacted with the intent of denying tax-motivated expatriates any benefits which they might enjoy under provisions within tax treaties.[11] Therefore, I.R.C. § 877 should not apply to individuals who relinquish citizen-

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5. See *infra* text accompanying notes 107-12 regarding burden of proof of tax-motivation which may put the former citizen at a tremendous disadvantage.

6. I.R.C. § 877(a) (1982). This provision of the Code is applied as an "alternative tax." Taxpayer *B* will be taxed at rates normally applicable to nonresident aliens pursuant to I.R.C. § 871 *or* under domestic rates as imposed by I.R.C. § 877, whichever is higher. Domestic rates refer to graduated rates as applied to United States citizens. The maximum rate under domestic law currently is 50 percent. *See generally* I.R.C. § 1 (1982).

7. I.R.C. § 877(a) (1982).

8. See generally textual discussion in Section II *infra* for legislative history and intent behind I.R.C. § 877.

9. *See generally* textual discussion in Section IV *infra*. Rev. Rul. 79-152 applied I.R.C. § 877 without regard for existing treaty provisions.

10. I.R.C. § 877(a) (1982). For purposes of this Comment, individuals taxed under I.R.C. § 877 are referred to as tax-motivated expatriates. Generally, expatriation may result through the renouncing of one's citizenship or otherwise. *See* 8 U.S.C. §§ 1481-1489 (1966). As referred to in this Comment, a tax-motivated expatriate is a nonresident alien of former citizenship whose loss of citizenship has been determined to be the result of an attempt to avoid United States income taxes. Essentially, a tax-motivated expatriate is a nonresident alien. The one factor that separates the tax-motivated expatriate from other nonresident aliens is former citizenship. This single factor has posed a number of conflicts in domestic and international law with regard to taxation of these individuals. *See* Ness, *Federal Tax Treatment of Expatriates Entitled to Treaty Protection*, 21 TAX LAW. 393, 394 (1967). Application of I.R.C. § 877 results in a variance of tax treatment between the tax-motivated expatriate as a nonresident of former United States citizenship from other nonresident alien individuals. The tax imposed by I.R.C. § 877 results in harsher tax consequences for the tax-motivated expatriate than other nonresident aliens, thereby subjecting I.R.C. § 877 to possible constitutional attack under equal protection. *See infra* note 201 and accompanying text.

11. Hereinafter "tax treaty" and "tax convention" will be used interchangeably

ship and take up residence in a treaty country.[12]

Since the enactment of I.R.C. § 877, however, recent application of this code section has deviated considerably from the original legislative intent.[13] The result is that individuals classified as tax-motivated expatriates are taxed under this code provision without regard to any existing tax treaties.[14] Such application of I.R.C. § 877 has been severely criticized as abrogating the intent of Congress.[15]

Concern is further expressed over integration of the taxing power under I.R.C. § 877 into recently proposed tax conventions.[16] Language within recent conventions has been altered to reserve United States taxing power under domestic law over individuals of former citizenship,[17] resulting in an expansion of United States taxing power. Previously, the United States reserved this power only over citizens of the United States.[18] The principal concern of critics is whether such expansion of taxing power will interfere with harmonious treaty relations. Further concern focuses on maintaining consistent domestic tax law.

This Comment examines the international and domestic repercussions produced by recent application of I.R.C. § 877. Initially, the purpose and progression of tax conventions will be addressed in a general overview. The legislative history and intent surrounding the enactment of I.R.C. § 877 will then be examined. This portion of the analysis will focus on revisions within domestic tax laws which were brought about by the enactment of I.R.C. § 877. A study of the provisions within I.R.C. § 877 and problems relating to

throughout this Comment. See generally textual discussion in Section I *infra* which addresses the general purpose behind tax conventions.

12. "Treaty country" refers to countries that are partners to a tax convention.

13. See generally textual discussion in Section IV *infra* for an analysis of the impact I.R.C. § 877 when applied beyond the purview originally intended by Congress.

14. Rev. Rul. 79-152, 1979-20 C.B. 14. See generally textual discussion in Section IV *infra* for factual analysis of this revenue ruling.

15. *See, e.g.*, Roberts, *Revenue Ruling Denies Treaty Advantages to Canadian Residents Who Were Formerly U.S. Citizens*, 28 CANADIAN TAX 225, 226 (1980).

16. 1977 U.S. MODEL TREATY, Treasury Dept. News Release B-235 (May 17, 1977), 1 TAX TREATIES (P-H) ¶ 1019. See generally textual discussion in Section V *infra* for discussion of the 1977 U.S. MODEL TREATY. See also the newly proposed tax treaty between the United States and Canada, signed September 26, 1980, 1 TAX TREATIES (CCH) ¶ 1301-1317. These treaties contain a provision within the "saving clause" which allows for taxation of tax-motivated expatriates as if no tax treaty had ever come into effect. See *infra* note 141 and accompanying text for purpose and scope of the "saving clause."

17. Patrick, *A Comparison of the United States and OECD Model Income Tax Conventions*, 10 LAW & POL'Y INT'L BUS. 613, 618 (1978).

18. *Id.*

enforcement will follow. Recent application of I.R.C. § 877 will be assessed, focusing on Revenue Ruling 79-152, and integration of the taxing power under I.R.C. § 877 into the "saving clause" of recently proposed United States tax conventions. Finally, this Comment will address the following two-step proposed solution. First, it is proposed that I.R.C. § 877 be repealed. Second, recently proposed tax conventions should reinstate the United States policy of reserving the right to tax citizens only under domestic tax law. This policy should not be expanded to include former citizens. The feasibility of this proposed solution will be considered in light of possible domestic and international repercussions.

I. TAX CONVENTIONS: PURPOSE AND PROGRESSION

The analysis within this Comment may be better understood by examining briefly the progression of tax conventions[19] within the international arena. The interaction of this progression with domestic tax law as provided by the Internal Revenue Code (Code) is of particular importance.

The primary purpose of tax conventions is the avoidance of double taxation which occurs when the taxing powers of two countries reach the same source.[20] The United States taxes citizens, residents and domestic corporations on the basis of worldwide income, whereas nonresident aliens and foreign corporations are taxed only on United States source income.[21] In order to promote "international trade and economic development," tax treaties provide for reciprocal recognition of each treaty country's taxing powers.[22] A treaty country allows exemptions and deductions according to the treaty partner's taxing jurisdiction.[23] Furthermore, tax conventions seek to discourage tax evasion.[24] Provisions for information exchange and possible "reciprocity in the collection of taxes" are methods of enforcing the law.[25]

Provisions within the Code reflect the business world as constantly changing.[26] Therefore, all treaties presently in existence are

19. "Treaties" and "conventions" are used interchangeably throughout this Comment.

20. 8 FED. TAXES (P-H) ¶ 42,001 (1982). *See* I.R.C. § 894 (1982). *See also* 1 TAX TREATIES (CCH) ¶ 153 (May 17, 1977).

21. 3 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 65-5 (1981).

22. 8 FED. TAXES (P-H) ¶ 42,001 (1982).

23. White, *Income Tax Treaties*, 52 A.B.A.J. 756 (1966).

24. 8 FED. TAXES (P-H) ¶ 42,001 (1982).

25. *Id.*

26. *Id.*

evaluated with regard to their need to be modernized.[27] The aim is to facilitate maintenance of a free flow of capital goods between developed countries, and to encourage United States investment in underdeveloped countries.[28] Tax conventions are advantageous to the promotion of international fiscal, business and trade relations.

Essentially, tax conventions affect many sources of income and often allow either complete exemption or a reduced rate of taxation.[29] A typical tax convention is illustrated by the following example. Countries *X* and *Y* are partners to a tax convention. Country *X* agrees to tax residents of Country *Y* at a reduced rate on income derived within *X's* territory. Country *X* will also grant residents of Country *Y* exemptions on certain sources of income as defined within the treaty. Country *Y* will reciprocate this tax treatment for residents of Country *X*. The result is more efficient taxation of individuals residing within the taxing jurisdiction.[30]

The enactment of I.R.C. § 877 resulted in a potential conflict of interests. Concern focused on whether the domestic taxing power under I.R.C. § 877 would abrogate any provisions of existing tax conventions. If the tax-motivated expatriate were taxed under this code provision without regard to exemptions or reductions available under an existing treaty, abrogation of treaty law would result. For example, individuals governed by the existing tax treaty between the United States and Canada enjoy a capital gains exemption and a reduced tax rate.[31] These benefits would be denied if an individual were taxed at domestic rates under I.R.C. § 877.

The Supremacy Clause in Article VI of the United States Constitution provides that the laws of the United States and treaties are of equal force, operating as the "supreme Law of the Land."[32] A statute enacted subsequent to a treaty which is in conflict with that

27. *Id.*

28. *Id.*

29. White, *supra* note 23, at 756.

30. *Id.*

31. Tax Convention, Mar. 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983, 989; Supplementary Tax Conventions, June 12, 1950, United States-Canada, 2 U.S.T. 2235, T.I.A.S. No. 2347; Supplementary Tax Convention, Aug. 8, 1956, United States-Canada, 8 U.S.T. 1619, T.I.A.S. No. 3916; Supplementary Tax Convention, Oct. 25, 1966, United States-Canada 18 U.S.T. 3186, T.I.A.S. No. 6415. But see the newly proposed tax treaty between the United States and Canada, signed September 26, 1980, 1 TAX TREATIES (CCH) ¶ 1301-1317. Though not yet in effect, the new treaty determines taxation of capital gains differently than the existing treaty. The broad exemption under the existing treaty is significantly refined. *See also* Bissell, *The New Canadian Tax Treaty: Impact on Individuals*, 7 INT'L TAX J. 379, 382 (1981).

32. U.S. CONST. art. VI, § 2.

treaty will override the treaty to the extent of the conflict.[33] However, of major significance is the requirement that Congress specifically state its intention to override treaty law.[34] "[T]he purpose by statute to abrogate a treaty or any designated part of a treaty, or the purpose by treaty to supersede the whole or part of an act of Congress, must not be lightly assumed, but must appear clearly and distinctly from the words used in the statute or in the treaty."[35]

With the enactment of I.R.C. § 877, Congress realized the potential for conflict between the provisions of I.R.C. § 877 and existing tax conventions. Therefore, Congress clearly defined the confines within which I.R.C. § 877 was intended to operate. The Legislature never indicated that the code section was to countermand tax conventions operating between treaty partners. To the contrary, Congress specifically stated that I.R.C. § 877 was *not* to override any treaty provisions.[36]

I.R.C. § 877 was enacted within the Foreign Investors Tax Act of 1966 (FITA).[37] The code section should therefore be examined in conjunction with FITA. Significant changes were brought about with the enactment of FITA which considerably altered the taxation of nonresident aliens.[38] An examination of these changes and the resulting tax consequences will aid in interpretation of I.R.C. § 877.

II. LEGISLATIVE HISTORY AND INTENT BEHIND THE ENACTMENT OF FITA AS APPLIED TO I.R.C. SECTION 877

A. *United States Taxation of the Nonresident Alien*

One of the primary objectives of FITA was to lessen the tax

33. The Head Money Cases, 112 U.S. 580 (1884); The Cherokee Tobacco Case, 78 U.S. 616 (1870); Chan Ping v. United States, 130 U.S. 581 (1889).

34. United States v. Lee Yen Tai, 185 U.S. 213 (1902); Chew Heong v. United States, 112 U.S. 536, 550 (1884); Cook v. United States, 288 U.S. 102, 120 (1933).

35. United States v. Lee Yen Tai, 185 U.S. 213, 221 (1902).

36. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 110, 80 Stat. 1575 (not codified as part of Internal Revenue Code).

37. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539-90 (codified as amended in scattered sections of 26 U.S.C.).

38. *Id.* FITA further revised taxation of foreign corporations, foreign partnerships, and foreign trusts and estates. *See* Ness, *Federal Tax Treatment of Expatriates Entitled to Treaty Protection*, 21 TAX LAW. 393 (1967). *See also* Tillinghast, *The Foreign Investors Tax Act of 1966*, 20 ABA SECTION TAXATION No.2, at 87 (1967).

burden on nonresident aliens.[39] This objective was accomplished by reducing the tax rate on specified sources of income from within the United States.[40] The approach for determining these sources of income and the resulting tax consequences underwent drastic revision with the enactment of FITA.

Prior to FITA, tax consequences to the nonresident alien were determined according to whether the individual was conducting a trade or business[41] within the United States.[42] The following illustrates taxation of nonresident aliens prior to the enactment of FITA.

A nonresident alien *not engaged* in a trade or business in the United States was taxed at a 30 percent rate on fixed or determinable[43] United States source income.[44] If the nonresident alien's total income from such sources, however, exceeded $21,200, graduated rates under domestic tax law were applied.[45]

A nonresident alien *engaged* in a trade or business within the United States was subject to a much wider scope of taxation. This nonresident alien was taxed on all income from within the United States without regard as to the manner in which such income was derived.[46] The tax imposed was fixed according to domestic rates.[47] By virtue of this nonresident alien being engaged in a trade or business in the United States, it was concluded that a sufficient nexus existed to warrant such taxation.[48] In determining tax consequences, it was unnecessary to consider whether income was related to the trade or business.[49] This method of determining taxation is

39. S. REP. NO. 1707, 89th Cong., 2d Sess. 9, *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 4446.

40. Roberts, *Force of Attraction: How the FITA of 1966 Affects Treaties*, 28 J. TAXATION 274 (1968).

41. "Trade or business" is used approximately 170 times in the Code, but nowhere does the Code provide a refined definition. *See generally* Saunders, *Trade or Business, Its Meaning Under the Internal Revenue Code*, 1960 SO. CALIF. TAX INST. 693.

42. Mehlman, *The Foreign Investors Tax Act of 1966*, 1966 SO. CALIF. TAX INST. 625, 627.

43. Treas. Reg. § 1441-2(a) (1966). "Fixed or determinable" income includes such income as dividends, rents, salaries, wages, royalties, annuities and premiums.

44. Mehlman, *supra* note 42, at 627. "United States source income" refers to income from sources within the United States.

45. *Id.*

46. *Id.* at 628.

47. *Id.*

48. *Id.*

49. *Id.*

known as the "force of attraction" doctrine.[50] This doctrine was abolished with the enactment of FITA.[51]

Essentially, FITA was enacted "to provide more equitable tax treatment for foreign investment in the United States."[52] In order to provide for more favorable tax treatment[53] of nonresident aliens, FITA utilized a different test for determining the scope and method of taxation.[54] This new test[55] incorporated the concept of "effectively connected" income into United States tax laws.[56]

Under the "effectively connected" concept, tax consequences are determined according to whether United States source income is sufficiently related to the conduct of a trade or business within the United States.[57] Essentially, the "effectively connected" concept defines income as either business or non-business, and taxes the income accordingly.[58]

United States source income of a nonresident alien which is deemed "effectively connected" will be taxed at regular, domestic tax rates.[59] On the other hand, that portion of United States source

50. Spuehler, *So You Want to Leave?: Tax Planning for the Departing Alien or U.S. Expatriate*, 47 L.A. BAR BULL. 114, 116 (1972).

51. *Id.*

52. H. R. REP. NO. 1450, 89th Cong., 2d Sess., *reprinted in* 1966-2 C.B. 967.

53. "Favorable tax treatment" is the result of applying a uniform tax rate on qualified sources of United States source income versus applying graduated domestic rates. See I.R.C. § 864(c)(2) for determining qualified income. *See infra* text accompanying notes 54-56.

54. I.R.C. § 864(c) (1982).

55. This concept first appeared in a draft convention prepared in 1963. *See*, Draft Double Taxation Convention on Income and Capital, 1 TAX TREATIES (CCH) ¶ 3025.

56. I.R.C. § 864(c)(2) (1982). Essentially, the "effectively connected" concept examines: (1) whether the nonresident alien is involved in the conduct of a trade or business in the United States, and (2) if so, whether income is derived from or significantly related to that business. *See* 1 E. OWENS, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION, § IV B (1980).

57. I.R.C. § 864(c)(2). The test provided within this code section is applied to nonresident aliens engaged in a trade or business within the United States. The test defines whether United States source income (including fixed or determinable income and capital gains and losses) is "effectively connected." The following criteria must be met: (1) the income must be derived from "assets used in or held for use in the conduct of such [U.S.] trade or business," or (2) the activities of such [U.S.] trade or business must be a "material factor in the realization of the income . . . ." Furthermore, "due regard" will be given to the method of accounting and whether the income was accounted for through the business. *But see* I.R.C. § 864(c)(4) (1982). The definition of "effectively connected" varies considerably when applied to foreign source income (income not derived within the United States).

58. Mehlman, *supra* note 42, at 621. See *infra* note 59 and accompanying text concerning additional considerations as to the type of income derived and resulting tax consequences.

59. I.R.C. § 871(b) (1982). Tax consequences of "effectively connected" income vary depending upon the type of income derived. See, for example, I.R.C. § 871(b) (1982), which

income which is defined as *not* "effectively connected" generally will be taxed at a more favorable rate.[60] The following illustrates the favorable tax treatment of a nonresident alien's United States source income which has been characterized as *not* "effectively connected."

Fixed or determinable income which is deemed to be *not* "effectively connected" will be taxed at a flat rate of 30 percent.[61] Prior law imposed graduated rates on such income when it exceeded a certain amount.[62] Capital gains which are classified as *not* "effectively connected" generally will be exempt from taxation, unless the individual concerned was present in the United States for 183 days or more during the taxable year, or involved in the sale of a real property interest.[63] When such capital gains are subject to taxation, a 30 percent rate is applied.[64]

The revisions in tax law brought about by FITA allow the nonresident alien to conduct business activities within the United States without damaging favorable tax treatment[65] of lucrative, independent United States investments.[66] More stringent tax consequences[67] are limited to that portion of United States source income which is deemed "effectively connected."[68] Therefore,

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provides for taxation of fixed or determinable income and other income defined within I.R.C. § 871(a)(1) at domestic rates. *Compare* I.R.C. § 863(C)(4); I.R.C. § 864(c)(5) (1982). These code sections allow for taxation of foreign source income under domestic law. Though otherwise not taxed, this income becomes taxable by virtue of its nexus with a United States business. Long-term capital gains that are "effectively connected" are generally taxed at domestic rates under either I.R.C. § 1201 or I.R.C. § 1202. *See* 1 E. OWENS, *supra* note 56, at § VI A.

60. Mehlman, *supra* note 42, at 658. The rate is favorable compared to the rate imposed on "effectively connected" income. In determining tax consequences of *not* "effectively connected" income, the type of income is again taken into consideration. *See infra* notes 61-64 and accompanying text.

61. I.R.C. § 871(a) (1982). The 30 percent tax rate may be reduced if a lower treaty rate applies. FITA accords full recognition of exemptions and reductions within tax conventions between signatory States. This allows for further limitation of tax liability for citizens and residents of such treaty countries beyond the 30 percent flat rate. *See* Spuehler, *supra* note 50, at 115.

62. *See supra* text accompanying note 45.

63. I.R.C. § 871(a)(2) (1982). See I.R.C. § 897 (1982) for recent legislation affecting taxation of foreign taxpayers' gain or loss due to disposition of United States real property.

64. *Id.*

65. Favorable tax treatment refers to rates applied to income that is not "effectively connected." *See supra* notes 61-64 and accompanying text.

66. Spuehler, *supra* note 50, at 116.

67. *See supra* note 59 and accompanying text.

68. Spuehler, *supra* note 50, at 116.

under FITA, nonresident aliens receive liberal tax treatment on income which is *not* "effectively connected."

Due to this liberal tax treatment of nonresident aliens within the new method of taxation implemented by FITA, Congress entertained a growing concern. Congress realized the potential for United States citizens to relinquish their citizenship in order to take advantage of the new legislation.[69] The response to this concern was the enactment of I.R.C. § 877.[70]

B. Legislative Intent Behind I.R.C. § 877

An examination of the legislative intent surrounding the enactment of I.R.C. § 877 will illustrate the clarity with which Congress stated its position with regard to application of the code provision. Since I.R.C. § 877 was enacted within FITA, the following analysis will take into account FITA's legislative intent as it relates to I.R.C. § 877.

A primary concern of Congress which was initiated by the enactment of FITA was that individuals might relinquish their United States citizenship in order to take advantage of favorable tax treatment brought about by FITA.[71] Congress voted to impose a harsh tax on these individuals under I.R.C. § 877,[72] the purpose being to deter tax-motivated expatriation.[73]

Another concern addressed by Congress was the potential for conflict between the newly enacted FITA and provisions within existing tax conventions.[74] To avoid such conflict, Congress explicitly stated its legislative intent within section 110 of FITA:

> No amendment made by this title [FITA] shall apply in any case where its application would be contrary to any treaty obligation of the United States. For purposes of the preceding sentence, the extension of a benefit provided by any amendment made by this title shall not be deemed to be contrary to any treaty obligation of the United States.[75]

This language is unequivocal with regard to a resident of a

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69. Ness, *Federal Tax Treatment of Expatriates Entitled to Treaty Protection*, 21 TAX LAW. 393 (1967). *See* S. REP. No. 1707, 89th Cong., 2d Sess. 9 (1966).

70. See also companion provisions for estate and gift tax, I.R.C. § 2107 and § 2501 (respectively).

71. Ness, *supra* note 69, at 393. *See* S. REP. No. 1707, 89th Cong., 2d Sess. 9 (1966).

72. I.R.C. § 877(a) (1982).

73. Ness, *supra* note 69, at 393. *See* S. REP. No. 1707, 89th Cong., 2d Sess. 9 (1966).

74. *See supra* note 31 and accompanying text.

75. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 110, 80 Stat. 1575.

foreign country with which the United States is a treaty partner. Such a resident is not to be denied treaty benefits regardless of I.R.C. § 877. The Legislature's statement of intent is consistent with general policy as reflected in the Code, which provides that tax treaties take precedence over code provisions.[76] The Code states, "[i]ncome of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income . . . ."[77] The Code further states, "[n]o provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States . . . ."[78] No provision within FITA was to be applied at the expense of United States' treaty obligations.[79] However, contrary to the legislative intent of Congress and general policy of the Code,[80] I.R.C. § 877 has been applied to the extent of overriding benefits afforded by tax treaties.[81]

An analysis of I.R.C. § 877 will aid in comprehension of the confines within which the code section was intended to be applied. In particular, this analysis will compare taxation of the nonresident alien versus the tax-motivated expatriate. I.R.C. § 877 must therefore be examined in light of changes in taxation of the nonresident alien which were brought about by FITA.

III. I.R.C. SECTION 877: DETAILED ANALYSIS

A. *General Provisions and Tax Consequences*

Essentially, I.R.C. § 877 is an alternative tax[82] imposed on former United States citizens classified as tax-motivated expatriates.[83]

76. 8 FED. TAXES (P-H) ¶ 42,001 (1982).

77. I.R.C. § 894 (1982).

78. I.R.C. § 7852(d) (1982). Exception to this general policy exists within the Revenue Act of 1962, which provided in § 31 that provisions of the Act take precedence over treaties. However, the Treasury Department stated in ¶ 2654 H of the Act that none of the provisions within the Act were in conflict with existing tax treaties. *See also* Roberts, *Is Revenue Ruling 72-152, Which Taxes an Expatriate's Gain, Consistent With the Code*?, 51 J. TAXATION 204 (1979).

79. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 110, 80 Stat. 1575.

80. *See supra* text accompanying notes 76-79.

81. See generally textual discussion in Section IV *infra*.

82. *See supra* note 6 and accompanying text.

83. A United States citizen who renounces citizenship, thereby avoiding federal income, estate or gift tax may fall within this classification. See *infra* notes 107-09 and accompanying text regarding burden of proof. See also companion legislation under I.R.C. § 2107 (estate tax), and I.R.C. § 2501 (gift tax). I.R.C. § 877 does not apply when loss of citizenship obviously is not tax-motivated. For example, I.R.C. § 877 does not apply when a prolonged absence has resulted in loss of citizenship for an individual who acquired dual citizenship at birth. *See* I.R.C. § 877(d) (1982). *See also* B. BITTKER, *supra* note 21, at 65-10.

These individuals will be taxed at domestic rates[84] for ten years following loss of citizenship.[85] I.R.C. § 877 applies only to United States source income,[86] and only when the tax rate imposed by I.R.C. § 877 exceeds the tax rate normally applied to nonresident aliens.[87]

Recently, I.R.C. § 877 has been applied in a manner which extended the taxing jurisdiction of the code provision. I.R.C. § 877 applies to tax-motivated expatriates residing within countries other than the United States. Presumably, some of these expatriates are residing in non-treaty countries[88] while others are residing in treaty countries. Congress did not intend for I.R.C. § 877 to apply to those individuals residing in treaty countries.[89] However, despite the clarity with which Congress stated its position,[90] this code section has been expanded to include the latter category of individuals.[91]

Only United States source income which is *not* "effectively connected"[92] will be taxed under I.R.C. § 877.[93] In addition, I.R.C. § 877 provides special rules regarding sources of income.[94] Included within the confines of United States source income are "[g]ains on the sale or exchange of property . . . located within the United States . . . . [and] stock issued by a domestic corporation or debt obligations of United States persons . . . ." or governmental authorities.[95] Such income will be taxed under I.R.C. § 877 regardless of where the sale is consummated.[96] Normally, income from such sales or exchanges would not be considered United States

84. *See supra* note 6 and accompanying text.

85. I.R.C. § 877(a) (1982).

86. See *infra* notes 94-97 and accompanying text for special rules regarding source of income under I.R.C. § 877. See also I.R.C. § 872 (a) as referred to by I.R.C. § 877 (b) (1982).

87. I.R.C. § 877(a) (1982).

88. "Non-treaty countries" refers to countries with which the United States is not a party to a tax convention.

89. *See supra* text accompanying notes 74-78.

90. *See supra* text accompanying note 75.

91. *See, e.g.*, Rev. Rul. 79-152, 1979-20 C.B. 14. *See generally* textual discussion in Section IV *infra*.

92. See *supra* notes 56-60 and accompanying text regarding determination of income as not "effectively connected." I.R.C. § 877 does not apply to "effectively connected" income because such income is already taxed at domestic rates. *See supra* note 59 and accompanying text. Because I.R.C. § 877 also taxes at domestic rates, tax consequences would not be affected.

93. I.R.C. § 872(a) (1982).

94. I.R.C. § 877(c) (1982).

95. I.R.C. § 877(c) (1982).

96. Ness, *supra* note 69, at 397.

source income unless the sale were physically completed within the United States.[97]

Special tax consequences are imposed by I.R.C. § 877 on capital gains from sources within the United States.[98] The code section provides for taxation of such capital gains at domestic rates regardless of whether the tax-motivated expatriate was present within the United States during the taxable year.[99] Normally, a nonresident alien will be taxed on capital gains only if (s)he is present within the United States for 183 days or more during the taxable year.[100] If the presence requirement is not met, capital gains are not taxed.[101] I.R.C. § 877 may also be applied to the individual who seeks to avoid capital gains on proceeds due to the liquidation of a corporation.[102]

In order to determine the tax consequences imposed by I.R.C. § 877, it is necessary to undertake a two-step analysis. First, the tax imposed on the nonresident alien individual is fixed pursuant to I.R.C. § 877.[103] Second, taxation of this individual under I.R.C. § 877 must be determined. Once the tax consequences under each situation are calculated, a comparison of the two is necessary. If the tax consequences under I.R.C. § 877 impose a harsher tax on this individual, the code section will be applied as an alternative tax.[104] Otherwise, the individual will be taxed as a nonresident alien.[105] Generally speaking, the tax burden on nonresident aliens is less onerous than the tax imposed on tax-motivated expatriates

97. Treas. Reg. § 1.861-7(c) (1957).

98. I.R.C. § 877 affects only income which is *not* "effectively connected." *See supra* note 92 and accompanying text. "Capital gains" herein refer to *not* "effectively connected" capital gains.

99. I.R.C. § 877(b),(c) (1982).

100. I.R.C. § 871(a)(2) (1982). When capital gains are taxed under this provision, a 30 percent rate is applied.

101. *Id.*

102. *See* Max Kronenberg v. Commissioner, 64 T.C. 428 (1975). This case involved a United States-Swiss citizen who lived with his family in the United States for approximately eighteen years. During that time, he incorporated his own business, of which he was the sole officer. A plan for liquidation was adopted. One day before receiving the assets from the liquidation, he voluntarily renounced his citizenship before the United States Consul in Zurich. (He had been informed by an accountant that he would avoid United States taxation on the assets.) The court held that Kronenberg fell within the purview of I.R.C. § 877, and would therefore be taxed under United States law on capital gains which resulted from the corporation's liquidation.

103. I.R.C. § 877(a) (1982). The code section requires that tax consequences initially be determined according to I.R.C. § 871.

104. I.R.C. § 877(a) (1982). *See generally* textual discussion in Section II(A) *supra*.

105. I.R.C. § 877(a) (1982).

under I.R.C. § 877.[106]

The burden of proof is ultimately on the taxpayer to show that loss of citizenship is not tax-motivated.[107] Initially, the Internal Revenue Service (Service) must make a showing that it is "reasonable to believe" that an individual's expatriation is tax-motivated.[108] By showing that except for possible application of I.R.C. § 877 there would be a substantial decrease in taxes on probable or expected income, I.R.C. § 877 is triggered. The burden of proof is then placed on the taxpayer.[109]

The provision governing burden of proof may result in a dilemma for former citizens classified as tax-motivated expatriates. Many individuals of former citizenship now residing in foreign countries may be taxed under I.R.C. § 877 regardless of whether their loss of citizenship was tax-motivated.[110] An individual who renounces citizenship to reside in a foreign country may receive favorable tax treatment under the taxing laws of this new residence. Such favorable taxation may merely be incidental to the renunciation of one's citizenship. Nevertheless, the Service imposes the burden of proof in these situations on the former citizen.[111] It may be difficult for the former citizen to provide persuasive proof that the renunciation of citizenship was not tax-motivated.[112]

Enforcement of I.R.C. § 877 is impeded due to a lack of regulations within the section.[113] The provisions of the code section are set forth without any amplification as to enforcement. Nor do the congressional committee reports elucidate methods of enforcement for I.R.C. § 877.[114] The following discussion examines various factors which may interfere with enforcement and recent efforts to combat these difficulties.

B. Inherent Problems of Enforcement as Applied to I.R.C. § 877

From the time of its enactment, I.R.C. § 877 has proven to be a difficult code section to enforce. I.R.C. § 877 specifically states that

106. *See supra* notes 3-7 and accompanying text. The example therein illustrates the advantage of being taxed as a nonresident alien as compared to a tax-motivated expatriate.
107. I.R.C. § 877(e) (1982). This is consistent with general policy of the Internal Revenue Service of placing the burden of proof on the taxpayer.
108. I.R.C. § 877(e) (1982).
109. *Id.*
110. Roberts, *supra* note 15, at 225.
111. I.R.C. § 877(e) (1982).
112. Roberts, *supra* note 15, at 225.
113. 340 TAX MGMT. (BNA) Foreign Income A-12 (1977).
114. *Id.*

once the Commissioner has established that there is "reason to believe"[115] that an individual's renunciation of citizenship will afford the individual a "substantial reduction"[116] in taxes, the burden is then upon the individual to show that the loss of citizenship was not tax-motivated.[117]

Despite the specificity of this rule, imposition of taxation under I.R.C. § 877 has been avoided in the past by an expatriate simply taking up residence within a treaty country. Originally, a tax-motivated expatriate residing within a treaty country was not subject to taxation under I.R.C. § 877. These individuals could seek refuge in a treaty country. Such action on the part of taxpayers has been specifically confronted by the Service, thereby raising crucial legal issues and policy considerations, both international and domestic in nature.[118]

Internationally, general apathy has prevailed with regard to methods by which tax evasion may be alleviated and international tax claims enforced.[119] This situation compounds the problem of enforcement. Currently, attempts are being made to remedy the situation.[120] Until recently, treaty partners were unable to draft harmonious provisions within tax conventions to deal with the enforcement of international tax claims between States.[121] A proposed solution is to incorporate the concept of "automatic and spontaneous exchange of information" within tax conventions.[122] Exchange of information provisions would allow tax administrations access to any information which would aid in upholding the tax convention.[123]

The newly proposed Canadian tax treaty[124] has expanded the exchange of information provision.[125] The provision now allows

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115. I.R.C. § 877(e) (1982).

116. Max Kronenberg. v. Commissioner, 64 T.C. 428 (1975).

117. I.R.C. § 877(e) (1982).

118. *See generally* textual discussion in Sections IV and V *infra*. Recent action has been taken to impose taxing power of I.R.C. § 877 on individuals residing in treaty countries.

119. Trelles, *Double Taxation/Fiscal Evasion and International Tax Treaties*, 12 IND. L. REV. 341, 363 (1979).

120. *See infra* text accompanying notes 122-27.

121. Trelles, *supra* note 119, at 363.

122. See Article 26 of the OECD Model Double Taxation Convention, 1 TAX TREATIES (CCH) ¶ 151 (1980).

123. *Id.* at art. 26.

124. For full text of the newly proposed treaty, see 1 TAX TREATIES (CCH) ¶ 1301-1317 (1982).

125. Smejda, *The Proposed Canadian Tax Treaty: Trends and Policies*, 7 INT'L TAX J. 165, 168 (1981).

exchange of information to be "furnished to the same extent and in the same manner as under domestic law, as if that country's own taxes are involved."[126] Implementation of such provisions within tax conventions is a plausible solution for States unable to tax an individual who collects all of his assets and escapes tax liability by permanently exiting the country. Though perhaps not accomplishing "multilateral harmonization," exchange of information provisions promote a "workable agreement" between treaty countries.[127]

A major impediment to a workable agreement has been attributed to the fact that differences exist among countries in the definitions of certain tax terms. For example, various countries differ on the interpretation of the terms "tax evasion" and "tax avoidance." In the United States, the distinction is usually drawn between "evasion" as breaking the law, and "avoidance" as a method of lessening taxes.[128] In some countries, there is no clear distinction.[129] Such inconsistency between various countries regarding terminology impedes progress towards harmonious enforcement of international tax conventions.[130]

The Organization for Economic Cooperation and Development (OECD), cognizant of this problem, formed a Working Party on Tax Avoidance and Evasion.[131] The OECD, an inter-governmental organization with representatives from national tax administrations, particularly supports exchange of tax information between countries in order to discourage tax avoidance and evasion.[132] In addition, the OECD seeks to reduce misuse of tax havens and encourage better relations and communication between taxpayers and tax administrations.[133] Ultimately, the OECD works to promote more effective means of curtailing tax avoidance and evasion while protecting the "liberty and privacy" of the taxpayer.[134]

The enforcement of tax laws within the international arena poses significant difficulties. This is illustrated by an examination of recent application of I.R.C. § 877. Conflicts regarding latitude

126. *Id.*
127. Trelles, *supra* note 119, at 378.
128. *OECD: Work on Tax Avoidance and Evasion*, 1980 INTERTAX 9, 10.
129. *Id.*
130. *Id.*
131. *Id.*
132. *Id.* at 9.
133. *Id.* at 13.
134. *Id.* at 14.

of enforcement have arisen due to recent measures employed in order to uphold I.R.C. § 877. Specifically, the means which have been applied deviate from the original legislative intent.

IV. I.R.C. SECTION 877: RECENT APPLICATION: FOCUS ON REV. RUL. 79-152

With the legislative intent clearly defined by Congress,[135] it is difficult, if not impossible, to reconcile this intent with recent application of I.R.C. § 877. In particular, this conflict is illustrated in Rev. Rul. 79-152,[136] a Revenue Ruling handed down in 1979.

Rev. Rul. 79-152 has generated criticism, particularly in regard to its enforcement of I.R.C. § 877 as applied to an individual residing in a treaty country. Further criticism centers on treaty interpretation within the ruling, particularly with regard to the "saving clause."[137]

The issue raised by Rev. Rul. 79-152 is whether I.R.C. § 877 will apply to the extent of taxing an expatriate who is a resident of a treaty country when the treaty concerned does not "specifically preserve the right of the United States to tax under I.R.C. § 877."[138] In other words, the issue is whether I.R.C. § 877 will be applied contrary to the terms of an existing treaty, thereby resulting in a deviation from the legislative intent of Congress.

Rev. Rul. 79-152 involved an individual who renounced his United States citizenship. The loss of citizenship was deemed tax-motivated due to the following facts. The individual's domestic corporation, of which he was the sole shareholder, was undergoing liquidation. Immediately preceding completion of the liquidation, this citizen took up residence within a treaty country and voluntarily renounced his citizenship. On the following day, the company was liquidated and he received the proceeds from the liquidation. As a nonresident alien residing in a treaty country, this individual met the requirements stated within the applicable tax treaty for exemption from such taxes. His intent was thereby to avoid capital

135. *See generally* textual discussion in Section II *infra*.

136. Rev. Rul. 79-152, 1979-20 C.B. 14. As stated within the Code, a revenue ruling is an official interpretation by the Internal Revenue Service which is published for information and guidance. Revenue rulings are limited, however, to application as precedent to facts which are substantially the same as those within the ruling. *See* 8 FED. TAXES (P-H) ¶ 41, 457 (1982).

137. *See infra* note 141 and accompanying text.

138. Rev. Rul. 79-152, 1979-20 C.B. 14.

gains taxes.[139]

The analysis applied by the Service to justify taxation of this individual has been criticized. The Service's reasoning revolved around I.R.C. § 877 and the "saving clause" within the tax treaty.[140] The purpose and tax consequences of the "saving clause" warrant examination to aid in the analysis of Rev. Rul. 79-152.

A "saving clause" is a provision typically contained within tax conventions between the United States and treaty partners, which reserves the right for the United States to tax its citizens as if the treaty never came into effect.[141] An individual classified within the purview of the "saving clause" will be taxed according to revenue laws of the United States, just as if the treaty did not exist.

The "saving clause" within the treaty concerned in Rev. Rul. 79-152 reserved the right for the United States to tax its citizens under domestic law.[142] However, the Service interpreted the "saving clause" to allow domestic taxing power over former citizens. The justification for such interpretation of the "saving clause" has been criticized as erroneous.[143] The analysis within the ruling is nebulous, despite the following step-by-step approach.

Initially, the analysis within Rev. Rul. 79-152 concluded that the loss of citizenship was tax-motivated. Second, the applicable treaty was examined for purposes of interpretation. The Service acknowledged that the treaty reserved the right for the United States to tax its citizens, notwithstanding any other treaty provisions. The Service then examined the provisions within I.R.C. § 877, concluding that the code section was applicable because the loss of citizenship was deemed to be tax-motivated.[144]

Conflicts develop at this point in the analysis. In Rev. Rul. 79-152, the Service imposed domestic taxation under I.R.C. § 877

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139. *Id.*

140. *Id.* at 15. *See infra* note 141 and accompanying text.

141. Ness, *supra* note 38, at 395. Within the analysis of Rev. Rul. 79-152, reference to the "saving clause" is limited to the taxing power of the United States over its own citizens. The express language of the "saving clause" within the treaty concerned in Rev. Rul. 79-152 reserved taxing power over citizens only, not former citizens. This is consistent with the "saving clause" contained within the majority of the United States tax conventions. However, it has been proposed that the "saving clause" be expanded to expressly include former citizens. *See infra* text accompanying notes 178-79.

142. Rev. Rul. 79-152, 1979-20 C.B. 14.

143. Roberts, *Is Revenue Ruling 79-152, Which Taxes an Expatriate's Gain, Consistent With the Code?*, 51 J. TAXATION 204 (1979) [hereinafter cited as *Code*].

144. Rev. Rul. 79-152, 1979-20 C.B. 15.

upon an individual residing within a treaty country,[145] which is in "sharp conflict" with the legislative intent of I.R.C. § 877.[146] Within Rev. Rul. 79-152, the Service interpreted the legislative intent behind I.R.C. § 877. The analysis addressed the attempt of Congress to discourage tax-motivated expatriation.[147] However, the ruling is void of a comprehensive interpretation of the legislative intent.[148] Congress did not intend for I.R.C. § 877 to be applied in abrogation of treaty law.[149] Rev. Rul. 79-152 directly violates this intent by essentially rewriting rather than interpreting the congressional statute.[150]

Of even greater consequence is the Service's interpretation of the "saving clause," which compounds the erroneous analysis within the ruling.[151] The Service justifies its taxing jurisdiction over the former citizen by applying the "saving clause." However, the "saving clause" was expressly limited to tax citizens under domestic law — not former citizens.[152] The ruling defines the "saving clause" as a means of preserving domestic taxing power "on the basis of citizenship."[153] The ruling analogized this "basis" for taxation to the taxing power of I.R.C. § 877, defining both to be "on the basis of citizenship."[154] The analysis concludes that since I.R.C. § 877 taxes individuals who are former citizens, the "saving clause" should be interpreted to include former citizens also.[155]

This conclusion fails to take into account the following factors. The term "citizen" within treaties is to be interpreted according to the confines of domestic law.[156] In applying domestic law to interpret the term "citizen," the Service's inclusion of former citizens is distorted.[157] The ruling construed the term "citizen" according to its interpretation of I.R.C. § 877 as "taxation on the basis of citizen-

145. *Id.*

146. *Code, supra* note 143, at 204; Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 110, 80 Stat. 1575.

147. Rev. Rul. 79-152, 1979-20 C.B. 14-15.

148. *Code, supra* note 143, at 205.

149. *See supra* text accompanying notes 74-78.

150. *Code, supra* note 143, at 205.

151. *Id.*

152. Rev. Rul. 79-152, 1979-20 C.B. 14.

153. *Id.*

154. *Id.* at 15.

155. *Id.*

156. *Code, supra* note 143, at 205. Terms contained within treaties are to be analyzed according to domestic law, unless the term is specifically defined within the treaty.

157. *Id.*

ship."[158] However, I.R.C. § 877,though imposing domestic tax rates, actually taxes according to rules applied to nonresident aliens.[159] Specifically, the code section refers to tax-motivated expatriates as nonresident aliens rather than former citizens.[160] Domestic law does not reflect the ruling's interpretation of the term "citizen" within the "saving clause" to include former citizens.[161]

It is the position of critics that Rev. Rul. 79-152 is in direct conflict with the Code, the legislative history of I.R.C. § 877 and the treaty as interpreted within the ruling.[162] Concern has been generated as to the influence such application of I.R.C. § 877 will have over the interpretation of other existing tax treaties.[163] In addition, the "saving clause" as construed in Rev. Rul. 79-152 is likely to be highly objectionable to treaty partners in that such interpretation would result in an expansion of United States taxing power over residents of treaty countries.

Such expansion of United States taxing power is likely to be met with resistance by treaty partners for the following reasons. First, most countries wish to uphold benefits provided for their residents by tax treaties.[164] Second, treaty partners are likely to object to the possible loss of revenue which would result through the granting of credit to residents against taxes paid to the United States.[165] Third, expansion of the present system of United States taxation of its citizens on the basis of worldwide income[166] to in-

158. Rev. Rul. 79-152, 1979-20 C.B. 15.

159. *Code, supra* note 143, at 205. Sources of income to be taxed under I.R.C. § 877 are determined according to code provisions which apply to nonresident aliens. *See* I.R.C. § 877(b) (1982).

160. I.R.C. § 877(a) (1982).

161. *Code, supra* note 143, at 205.

162. *Id.* at 204.

163. *Id.* Here, the author points out an additional concern. Revenue rulings are retroactive unless otherwise indicated within the ruling. There was no provision within Rev. Rul. 79-152 limiting its application. The result has been criticized from the standpoint of administrative policy. Contemporary critics argue that an application of law to the detriment of taxpayers should not be applied without advice of such action. Otherwise, the taxpayers "suffer retroactive legislation through administrative fiat." This is particularly disturbing due to serious questions which have been raised by the analysis of Rev. Rul. 79-152. In addition, the author notes that no regulations have been issued with regard to I.R.C. § 877. Nor do any of the regulations which have come down under the companion provisions for gift and estate tax even suggest the outcome of Rev. Rul. 79-152. *See Code, supra* note 143, at 204-05.

164. *Code, supra* note 143, at 205.

165. *Id.* Such credits or exemptions are typical of tax conventions. *See supra* text accompanying notes 29-30.

166. *See supra* text accompanying note 21. See also *Code, supra* note 143, at 204,

clude former citizens is likely to spawn resistance.[167]

Recently, this expansion of United States taxing power has been sought through revision of treaty language. Essentially, the taxing provisions of I.R.C. § 877 have been integrated into the "saving clause" contained within certain United States tax conventions by expressly including former citizens within the purview of the clause.[168] Treaty partners do not appear anxious to adopt the "saving clause" in its newly revised form.[169]

This Comment suggests that treaty partners are placed in a precarious situation. On the one hand, if a treaty partner adopts the revised "saving clause," the result is that tax-motivated expatriates residing in a treaty country will be taxed under United States tax laws.[170] If, on the other hand, a treaty partner refuses to adopt the revised "saving clause," the Treasury has the prerogative of imposing identical tax consequences by applying enforcement measures as were utilized in Rev. Rul. 79-152. In either case, treaty partners may be subjected to tax encroachment.

V. THE EXPANDED SAVING CLAUSE: TAX CONSEQUENCES AND INTERNATIONAL CONSIDERATIONS

The U.S. Model Income Tax Treaty (1977 U.S. Model),[171] as published by the Treasury in 1977, includes a revised version of the "saving clause" which allows for an expansion of United States taxing power.[172] The OECD[173] is responsible for the draft which was ultimately adopted by the Treasury.[174] The Treasury announced

wherein it is emphasized that the United States taxation of citizens and residents on worldwide income is unique among developed countries.

167. *Code, supra* note 143, at 204.

168. Patrick, *supra* note 17, at 618.

169. *See infra* text accompanying note 186.

170. See *supra* text accompanying notes 164-67 regarding the disadvantage imposed upon treaty partners.

171. *See* Treasury Dept. News Release B-235 (May 17, 1977). For full text, see 1 TAX TREATIES (CCH) ¶ 153 (May 17, 1977).

172. *Id.* at art. 1. The newly revised "saving clause" within art. 1 of the 1977 U.S. Model includes former citizens to be subject to domestic tax laws.

173. *See supra* text accompanying notes 131-34.

174. For the text adopted by the Treasury, see 1 TAX TREATIES (CCH) ¶ 153 (May 17, 1977). The progression leading up to the Treasury's publication of the 1977 U.S. Model which, except for a few changes, adopts the model drafted by the OECD, developed as follows. The changes made in the 1977 U.S. Model were necessary in order to align the treaty provisions of the model with United States tax laws, such as the fundamental rule of United States taxation on the basis of worldwide income. *See* B. BITTKER, *supra* note 21, at 65-5. The OECD was originally formed in order to draft a model convention which would avoid double taxation. *See* Pearson, *The OECD Draft Double Taxation Convention and Recent*

its intent to utilize the 1977 U.S. Model as a basis for the drafting of future tax conventions, thereby achieving greater uniformity of provisions within various tax treaties.[175] The primary advantage of more uniform drafting is the promotion of recognition of decisions over tax disputes by the authority of one State as valid and binding over other States.[176] Such uniformity of drafting also encourages the development of possible multilateral conventions.[177] Though the 1977 U.S. Model ultimately serves to further fiscal harmony, this Comment suggests that the expanded text of the "saving clause" may cause conflict.

Within the 1977 U.S. Model, the "saving clause," which is present in all existing United States tax treaties, has been expanded.[178] Article I of the 1977 U.S. Model states within its "saving clause" that the term "citizen" is to include all former citizens.[179] Article I specifically includes "former citizens whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of ten years following such loss."[180] This language corresponds precisely with the language contained within I.R.C. § 877. Therefore, all persons classified as tax-motivated expatriates, including those residing within a treaty country, are subject to tax consequences imposed by I.R.C. § 877. These individuals will be deprived of treaty benefits which would otherwise be provided due to their residence within a treaty country.

Prior to the adoption of the 1977 U.S. Model as set forth by the

United States Treaties, 48 TAXES 426 (1970). The OECD has remained particularly active in attempting to alleviate this problem, as well as drafting a model tax treaty that will hopefully resolve differences between various taxing jurisdictions. As a means of accomplishing this harmonization, the OECD considered tax conventions from the League of Nations, as well as approximately seventy tax conventions previously entered into by various OECD members. Prior to the publication by the Treasury of the 1977 U.S. Model, which adopted much of the OECD model, the United States had always been reluctant to accept previous treaties as drafted by the OECD. With the acceptance of the OECD as a model, the Treasury Department recognized the superior drafting of the OECD Model in dealing with complex tax issues. *See* Patrick, *A Comparison of the United States and OECD Model Income Tax Conventions*, 10 LAW & POL'Y INT'L BUS. 613 (1978).

175. Bissell, *The Treasury's Model Income Tax Treaty: An Analysis and Appraisal*, 3 INT'L TAX J. 8 (1976).

176. Trelles, *supra* note 119, at 363.

177. Lazerau, *OECD Draft Influence on United States Tax Treaties*, ARK. L. REV. 115, 117 (1972).

178. Bissell, *supra* note 175, at 9.

179. Patrick, *supra* note 174, at 613.

180. 1 TAX TREATIES (CCH) ¶ 153 (May 17, 1977). This text excerpt is contained within art. 1 of the 1977 U.S. Model.

OECD, the Treasury altered certain provisions contained within the original OECD draft. The expanded "saving clause" within the 1977 U.S. Model is a major distinction between the 1977 U.S. Model and the OECD draft.[181] The OECD draft simply states, "[t]his convention shall apply to persons who are residents of one or both of the Contracting States."[182] There is no reference to taxing power over former citizens.

Two factors operate as possible obstacles to application of the expanded "saving clause" contained within the draft as altered and adopted by the Treasury. First, within the 1977 U.S. Model, residency is determined according to Article 4 entitled Fiscal Domicile. If an individual is deemed to be a resident for treaty purposes under Article 4, the former citizen provisions in the "saving clause" will not apply.[183] Second, the provision is likely to be received unfavorably by treaty partners.[184] The reasons behind treaty partners' resistance are identical to those concerns raised by the expansion of taxing power under Rev. Rul. 79-152.[185]

This unfavorable reception by treaty partners is evident in several recent treaties which exclude the expanded "saving clause."[186] However, the newly proposed United States-Canadian Tax Convention includes the expanded version of the "saving clause."[187] The United States' purpose behind including the new "saving clause" is to eliminate tax evasion.[188] Furthermore, the newly proposed treaty contains provisions for exchange of information in order to deter tax evasion.[189] Similar expatriate provisions have been included in proposed treaties with Cyprus and Denmark. These

181. Patrick, *supra* note 174, at 618.

182. 1 TAX TREATIES (CCH) ¶ 151, art. 1 (1980).

183. Patrick, *supra* note 174, at 619.

184. *Id.*

185. *See supra* text accompanying notes 164-67.

186. *Code, supra* note 143, at 204. The provision was not included in treaties with Korea (6/4/76), Phillippines (10/1/76) or Moracco (8/1/77).

187. 1 TAX TREATIES (CCH) ¶ 1301-1317. The text of the newly proposed treaty was signed September 26, 1980.

188. *See generally*, Bissell, *The New Canadian Tax Treaty: Impact on Individuals*, 7 INT'L TAX J. 379 (1981). *Compare* Tax Convention, Mar. 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983, 989; Supplementary Tax Convention, June 12, 1950, United States-Canada, 2 U.S.T. 2235, T.I.A.S. No. 2347; Supplementary Tax Convention, Aug. 8, 1956, United States-Canada, 8 U.S.T. 1619, T.I.A.S. No. 3916; Supplementary Tax Convention, Oct. 25, 1966, United States-Canada 18 U.S.T. 3186, T.I.A.S. No. 6415. The existing treaty's "saving clause" refers only to citizens.

189. Smedja, *The Proposed Canadian Tax Treaty: Trends and Policies* 7 INT'L TAX J. 165 (1981).

treaties are awaiting ratification.[190]

The effects of the Treasury's attempt to include such provisions within recent tax conventions will soon be realized. One certain result is a "substantial increase in taxing jurisdiction."[191] The question remains as to whether this expansion of United States taxing power will interfere with international treaty relations.

VI. CONSIDERATIONS OPPOSING THE EXPANSION OF UNITED STATES TAXING POWER

The primary concern regarding such expansion of United States taxing power[192] is twofold. First, inconsistencies within domestic law result from the application of statutes contrary to legislative intent. I.R.C. § 877, as applied in Rev. Rul. 79-152, has generated criticism in this regard.[193] Second, the expanded power may impede harmonious international relations. The increase of United States taxing power under I.R.C. § 877, as evidenced by both the ruling and the expanded "saving clause," poses particular disadvantages for treaty partners. Resistance by treaty partners currently exists and is likely to continue.[194]

The following proposed solutions are aimed at maintaining consistency within domestic law, as well as promoting amicable relations with our treaty partners. This Comment proposes the following: (1) I.R.C. § 877 should be repealed, and (2) the language contained within the expanded "saving clause" should be altered to reinstate the policy of United States taxation on the basis of citizenship only.[195] These solutions must be examined in light of both international and domestic law as they exist and may develop.

A. Prospect of Repealing I.R.C. § 877

The primary motivation behind the enactment of I.R.C. § 877 was to deter expatriation for tax purposes. Within the context of congressional intent, I.R.C. § 877 was to apply only to persons residing within non-treaty countries. This restriction was stipulated in

190. *Id.* at 169.

191. *Id.*

192. The expanded taxing power as referred to herein is limited specifically to the taxing power discussed in this Comment. *See generally* textual discussion within Section IV and V *supra*.

193. *See supra* text accompanying notes 146-50.

194. *See supra* text accompanying note 186.

195. *See generally* textual discussion in Sections IV and V *supra*.

order to avoid interference with existing treaties.[196]

The concern for upholding existing treaty law is consistent with the general policy of both the Code and FITA.[197] The Service, however, has enforced I.R.C. § 877 in derogation of legislative intent.[198] The result is interference with treaty law,[199] which is precisely what Congress had intended to avoid.[200]

Enforcement of I.R.C. § 877, even if accomplished within the confines of legislative intent, poses several difficulties.[201] Individuals may seek refuge from taxation imposed by I.R.C. § 877 by simply taking up residence in a treaty country. In addition, I.R.C. § 877 is void of any regulations regarding methods of enforcement. The code section does not provide any assistance in this regard. The congressional committee reports do not offer any enlightenment.[202]

Enforcement of I.R.C. § 877, to the extent of abrogating treaty law,[203] disrupts international treaty relations. Treaty partners are uneasy over further expansion of United States taxing power. They are aware of possible deprivation of revenue. Moreover, treaty partners are thereby deprived of taxing jurisdiction over residents who are potentially subject to the expanded United States taxing power.[204]

Additionally, application of I.R.C. § 877 to residents of treaty countries increases the possibility of harsh tax consequences for expatriates classified as tax-motivated expatriates, while in actuality, their reasons for relinquishing citizenship were not tax-related. As a

196. See *supra* text accompanying notes 74-78 regarding legislative intent.

197. *See supra* text accompanying notes 74-78.

198. *See generally* textual discussion in Section IV *supra*.

199. Such results were the product of applying I.R.C. § 877 to an individual residing in a treaty country. Thereby, this individual was deprived of treaty benefits which would otherwise be afforded under the treaty.

200. *See supra* text accompanying notes 74-78.

201. In addition to the problems addressed in the text, the enforcement of I.R.C. § 877 raises a constitutional question of equal protection. *See* B. BITTKER, *supra* note 21, at 65-10 n.2. I.R.C. § 877 taxes these expatriates differently from other nonresident aliens. But tax-motivated expatriates are nonresident aliens of former citizenship. The discrimination of nonresident aliens on the basis of former citizenship imposes serious tax consequences upon these individuals. By imposing domestic tax rates on certain sources of income, the tax-motivated expatriate is effectually held to duties of a citizen, but without enjoying any rights to which United States citizens are entitled. Nor does the individual enjoy the full benefits of nonresident alien status. *See* Ness, *supra* note 69, at 394. *See generally* L. TRIBE, AMERICAN CONSTITUTIONAL LAW § 16-22 (1978).

202. *See supra* text accompanying notes 113-14.

203. *See generally* textual discussion in Section IV *supra*.

204. *See supra* text accompanying notes 163-66.

result, the expatriate may be placed in an unfair position due to provisions governing burden of proof.[205] It may be difficult to show that expatriation was not tax-motivated.

By repealing I.R.C. § 877, all nonresident aliens would be taxed alike, depending on whether their income is "effectively connected" to a trade or business.[206] Therefore, tax rates imposed would be the same as those imposed by I.R.C. § 877 upon individuals with "effectively connected" income.[207] As applied to these individuals, the United States would suffer no loss of revenue. On the other hand, individuals whose income is deemed *not* "effectively connected" would be taxed at a more favorable rate of 30 percent.[208] As applied to these individuals, the United States would endure some loss of revenue which would otherwise be acquired under I.R.C. § 877. This Comment suggests that maintaining consistency within domestic law and harmony within international law are paramount in this regard.

B. Taxing Power Defined Within the "Saving Clause"

The "saving clause" contained within all United States tax treaties should be restricted to allow domestic taxation of citizens only. Expansion of the "saving clause" to include former citizens is essentially an incorporation of I.R.C. § 877 into the "saving clause." The result is that tax consequences of I.R.C. § 877 thereby would be imposed upon former citizens now residing within treaty countries.[209]

Certain considerations oppose the expanded version of the "saving clause." First, treaty countries are confronted with the same restrictions on taxing power and deprivation of revenue which occurred as a result of Rev. Rul. 79-152.[210] Second, treaty partners are placed in an awkward position: whether the treaty partner adopts the revised "saving clause" or not, identical tax consequences may ultimately result. If the Service chooses to enforce I.R.C. § 877 in accordance with Rev. Rul. 79-152, the taxing power over tax-motivated expatriates residing within treaty countries is one and the same.[211]

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205. *See supra* text accompanying notes 110-12.
206. *See supra* notes 57-64 and accompanying text.
207. *See supra* note 59 and accompanying text.
208. *See supra* text accompanying notes 61-64.
209. *See generally* textual discussion in Section V *supra*.
210. *See supra* text accompanying notes 163-66.
211. *Id.*

It is recommended that the "saving clause" reinstate the policy of United States taxation on the basis of citizenship. In light of relevant considerations, expansion of taxing power to include former citizens within the "saving clause" will inevitably result in disturbance of harmonious treaty relations.

VII. CONCLUSION

I.R.C. § 877 was enacted to deter tax-motivated expatriation. The code section was included within FITA, which brought about a more favorable tax treatment for nonresident aliens. I.R.C. § 877 was enacted to discourage contemplation by United States citizens to take advantage of the favorable tax changes brought about by FITA.[212]

Congress was explicit in defining the intent of the Legislature regarding enforcement restrictions upon I.R.C. § 877. The code provision was not to apply to individuals residing within treaty countries. The purpose of this restriction was to uphold existing treaty law.[213]

Recently, expansion of domestic taxing power has resulted in enforcement of I.R.C. § 877 contrary to the intent of Congress. In particular, Rev. Rul. 79-152 violates legislative intent by applying I.R.C. § 877 to a resident of a treaty country.[214] Application of this code section to a resident of a treaty country is deemed by "most commentators" to be a faulty position.[215] Though the power exists for Congress to override treaty law, whether it is in the United States' best interests to enact such legislation is a crucial issue of international impact. "Our treaty partners might be very upset if the United States unilaterally enacted legislation overriding treaties."[216]

Enforcement of I.R.C. § 877 in accordance with Rev. Rul. 79-152 is inconsistent with domestic tax law as defined by Congress. International conflicts are likely to arise in response to interference of the valid protected interests of our treaty partners.[217] Similar application of I.R.C. § 877 manifested in the expanded "saving clause" reserves for the United States the right to apply domestic

212. *See generally* textual discussion in Section II A *supra*.
213. *See generally* textual discussion in Section II B *supra*.
214. *See generally* textual discussion in Section IV *supra*.
215. *See, e.g.*, Bissell, *supra* note 31, at 381.
216. Langer, *The Need for Reform in the Tax Treaty Area*, 3 TAX'N INDIVIDUALS 99, 106 (1979).
217. *See supra* text accompanying notes 163-66.

tax laws to certain former citizens.[218] The valid protected interests of treaty partners are further threatened by the expanded version of the "saving clause."[219]

Specifically, such expansion of United States taxing power interferes with not only the revenue interests of our treaty partners, but also their taxing power over residents within their boundaries.[220] Such interference imposed by the United States on treaty partners can hardly be categorized as promoting amicable treaty relations.

In consideration of the consequences, both domestically and internationally, it is recommended that restraint over the expansion of United States taxing power be exercised. By engaging in consistent domestic taxation and policy, harmonization and consistency within international law will be advanced.

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218. *See generally* textual discussion in Section V *supra*.
219. *See supra* text accompanying notes 163-66.
220. *See supra* text accompanying notes 164-66.