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### Submission of Articles

We welcome the submission of articles and recent developments for publication in the *TTLQ*. Authors may wish to check with the Editor about preemption of their topic. Articles should be approximately three to ten double-spaced pages inclusive of endnotes. Generally, citations should conform to the Bluebook form of citations. All articles should be submitted by email to [Andrew.Melsheimer@tklaw.com](mailto:Andrew.Melsheimer@tklaw.com).

### Section Membership

If you are aware of attorneys who are not members of the International Law Section of the State Bar of Texas or who may have failed to renew their membership, please give them the membership information that is included in the back of the *TTLQ*.

### Online

Access this and past issues of the *TTLQ* at <http://www.ilstexas.org/ttlq.htm>.

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To the International Law Section Membership:

It was good to see so many of you at the 21<sup>st</sup> Annual International Law Institute at the Hyatt Regency in March. Attendees were rewarded with presentations on timely topics for this new and challenging global economic landscape. I would like to thank all of our outstanding organizers and speakers, and especially the keynote speakers, Duaine Priestley, Cody Sutton, and Owen Tobias. Your contributions were invaluable to making this event a success.

Please continue to share your ideas with us on topics you'd like to see covered at next year's Institute. Your participation is vital to keeping the Institute's annual program stimulating and focused on current issues across our many practice areas. Also, do not hesitate to contact me or any ILS Officer or Council Member to make a suggestion on a new program or CLE topic, or on any ILS issue of interest to you.

As you know, our annual Section Meeting and CLE event will be held in conjunction with the State Bar's Annual Meeting on the afternoon of June 25 at the Hilton Anatole in Dallas. Please make plans to join us for the meeting and CLE.

As always, I would encourage you to participate in our law student outreach program, where we visit Texas law schools and talk with students about a career in international law. Visit the webpage at: [http://www.ilstexas.org/Student\\_Outreach.htm](http://www.ilstexas.org/Student_Outreach.htm) or contact George Humphrey at [georgehumphrey@andrewskurth.com](mailto:georgehumphrey@andrewskurth.com).

We continue to welcome section members to submit articles on international legal issues for publication in the *Texas Transnational Law Quarterly*.

Again, thank you for your support of the International Law Section. With your continued participation, we can make it more valuable to each of you.

Finally, I am grateful for the privilege of serving as the Section's Chair this past year and have enjoyed working with all of you. I look forward to seeing everyone in Dallas soon!

Joe A. Rudberg  
Chair, International Law Section

## Resolution of Commercial Disputes in Russia

By  
Stanislav A. Bobkov

### Introduction

Those who engage in business activities in Russia or have dealings with Russian customers, clients, business partners, or authorities, should be prepared when their commercial conflicts cannot be amicably resolved. When a commercial dispute is submitted to an arbitration tribunal or a Russian state court, it is important to anticipate what proceedings will be involved and how a final award or decision may be enforced. This article provides a general overview of the process for resolving commercial disputes in Russia.

The court system in Russia is divided in two major levels: (1) the federal courts and (2) the regional courts. The federal courts include the Constitutional Court of Russia, which has the authority to decide whether a law complies with the Russian Constitution; the courts of general jurisdiction, which try civil, labor, administrative, criminal and other cases; and the state commercial courts, called "*arbitrazhnye*" courts, which try commercial disputes. The regional courts include the constitutional courts of Russian regions, which are authorized to decide whether regional legislation complies with the constitution of the region; and the magistrate courts, which act as courts of general jurisdiction and try minor civil, administrative, and criminal cases.

Commercial disputes in Russia are typically resolved through the state commercial courts, although non-governmental, arbitration tribunals or "*treteyskiye*" courts also exist. Disputes settled through the latter process may be executed voluntarily or through the simplified state court procedure described later in this article.

The Russian state commercial courts have jurisdiction over cases in which two conditions are met. First, the case must be connected with some commercial, entrepreneurial or economic activity and, second, each party in the case must be a legal entity or a natural person having the status of an individual entrepreneur. Typically, if

even one of the parties is a natural person without the status of individual entrepreneur, the case must go to a court of general jurisdiction, instead. However, the state commercial courts will have exclusive jurisdiction over cases between shareholders of a company and the company, even if a shareholder is a natural person without the status of individual entrepreneur. Similarly, the state commercial courts will also have exclusive jurisdiction over cases involving complaints alleging the unjust refusal to incorporate a legal entity or to grant a natural person the status of an individual entrepreneur, even if the natural person involved in the dispute does not presently have the status of an individual entrepreneur.

There are four instances of the state commercial courts in Russia. The regional commercial courts are courts of first instance. There are twenty appellate courts of second instance, which review decisions of courts of first instance that have not come into force. Each appellate court is authorized to review decisions of certain group of courts depending on their geographical location. In the third instance, there are ten courts of cassation, which have the authority to review decisions of the courts of first instance that came into force as well as the rulings of appellate courts. Each court of cassation may review decisions of certain group of courts and rulings of appellate courts depending on their geographical location. The Russian Supreme Commercial Court holds the highest level of review and is authorized to review decisions and rulings of any lower court that came into force. The Supreme Commercial Court's principal function is to provide unification and consistency of the commercial court practice within Russia.

### First Instance Proceedings

Legal proceedings before the state commercial courts in Russia are governed by the Code of Arbitration Proceedings of Russia (hereinafter the "Code"). There are three types of proceedings. The first and most common type, action proceedings, include matters such as the collection of debts, the enforcement of contracts,

and so forth. The second type includes proceedings that arise out of administrative or other public relations, such as complaints alleging unlawful acts of state bodies and officials, cases regarding administrative violations, actions concerning the collection of taxes, etc. The third type includes special proceedings, such as cases regarding bankruptcy or the recognition and enforcement of arbitration tribunals and foreign courts, among other particular matters.

Action proceedings commence when a claimant files a complaint against a defendant. As a general rule, the claim must be filed with the court located in the jurisdiction of the defendant's domicile. However, sometimes the parties may agree to resolve their dispute through some other state commercial court of first instance. In other circumstances, the jurisdiction may be prescribed by the Code; for example, disputes regarding real estate may be tried only in the court in the same jurisdiction where the real estate is found. Each claim must contain the name of the court with which it is filed, the name of the claimant and its official address, the name of the defendant and its official address, the subject matter of the claim containing references to the provisions of law on which the claim is based, the basis of the claim and references to the evidences confirming the claim, and the monetary amount claimed (if applicable). Prior to filing a claim, the claimant must send a copy of the complaint to the defendant and pay a stamp duty. The amount of stamp duty varies from US\$20.00 to US\$4,000, depending on the subject matter and the amount of the claim.

Provided that the filed claim complies with all formal requirements, the commercial court will open a case, arrange for a preliminary hearing, and summon the parties. If a decision of the court may influence the rights of third parties, such third parties may be also invited into the case. At the preliminary hearing, the parties may clarify their claims and objections, present and request evidence, call witnesses, and so forth. When the preliminary hearing is over, the court will schedule the final hearing. Court hearings are attended by representatives of the parties. Currently, any person (not only attorneys-at-law) may act as a representative of a party at the state commercial court on the basis of the power of attorney. If a party was duly informed about the date, time, and place of

hearing, the hearing may be held in absence of the party's representative.

At the close of the proceeding, the court will issue a decision sustaining or dismissing a claim in full or in part. It is prescribed by the Code that a commercial court of the first instance shall hear a case and shall render a decision within one month after the final hearing is scheduled. Normally, a commercial court of first instance will issue its decision between two and six months after the claim was filed. As a general rule, a decision comes into force one month after it is rendered if it is not appealed. If a decision is appealed, it will come into force if an appellate court upholds it, as described below.

### **Appellate and Cassation Proceedings**

Any decision that has not come into force may be appealed within one month. To initiate appellate proceedings, an interested party must file an appeal, which shall be considered by the appellate court within one month after filing. The appellate court may conduct hearings and may uphold the decision in whole or in part, overturn or modify the decision in full or in part, issue a new decision, and/or cease further proceedings. A decision may be overturned or changed if the court of first instance did not duly ascertain circumstances of the case, if conclusions made by the court are not duly proved or do not correspond to the circumstances of the case, or if the court violated or improperly applied material or procedural law.

Decisions of courts of the first instance that come into force and rulings of appellate courts may be reviewed by courts of cassation. The cassation claim may be brought within three months of the first-instance decision or the appellate court ruling. The court of cassation has the same authorities as the appellate court but also has authority to overturn a ruling and to return a case to the court of the first instance. When reviewing decisions and rulings, the courts of cassation will focus mainly on whether the lower courts duly applied the law.

### **Supreme Commercial Court Proceedings**

The Supreme Commercial Court has the authority to review decisions and rulings of lower courts. To commence proceedings before the Supreme Commercial Court, an interested party must file a review claim, but the Supreme

Commercial Court may decide whether to review the case at its sole discretion. In reviewing a case, the Supreme Commercial Court has the same authorities as the court of cassation and will focus on the unification of commercial court practice, protection of public order and fundamental human rights.

### **Enforcement**

After a judicial decision comes into force, the court that made the decision will issue an enforcement order. A decision that comes into force is enforceable against all legal entities, natural persons, authorities and officials in Russia. If the obligor or any third party refuses to execute the decision voluntarily, the decision can be enforced via the Russian Bailiff's Service.

With respect to arbitral awards, if the defeated party refuses to execute the award voluntarily, a claimant may file an application with the Russian state commercial court for issuing an enforcement order based on the arbitration award. Russia is a signatory to the U.N. Convention on Recognition and Enforcement of Arbitral Awards (New York, 1958). Therefore, awards of foreign arbitration tribunals are normally enforceable in Russia. Nonetheless, the state commercial court may refuse to issue the enforcement order if there were certain violations during the proceeding at the arbitration tribunal, if the award of the arbitration tribunal was later dismissed, if the arbitration tribunal did not have jurisdiction over the case, and/or if the award contravenes fundamental principles of Russian law.

Decisions of foreign national courts may be recognized and enforced in Russia provided that there is an international treaty between Russia and that state on the mutual recognition and enforcement of judicial decisions. As of the date of this article, Russia has such treaties with only a few countries, most of which are former members of the former Union of Soviet Socialist Republics (USSR).

### **Conclusion**

In order to avoid proceeding before the Russian state commercial court, parties doing business in Russia or with Russian counterparties should consider including an arbitration clause in their agreements, specifying that all disputes arising

out of the agreement or in connection with such agreement shall be tried by a certain arbitration tribunal and identifying which substantive laws shall apply.

While this article has provided a brief overview of the commercial dispute resolution process in Russia, it is not a substitute for legal advice from qualified Russian counsel on the subject matter contained herein.

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## The Transportation Worker Identification Credential Card System

By  
Amy Donnelly Ashby

As part of the Department of Homeland Security's (DHS) effort to improve security procedures in maritime areas, two agencies within the DHS, the Transportation Security Administration (TSA) and the U.S. Coast Guard, developed the Transportation Worker Identification Credential (TWIC) card system.<sup>1</sup> The new TWIC card system will require all workers, U.S. citizens and foreign nationals alike, needing unescorted access to secure and/or restricted maritime areas, facilities and vessels to apply for a TWIC card and pass a threat assessment.<sup>2</sup>

To understand fully the impact that this requirement will have on workers and businesses, it is important to point out that most areas in the country's ports, waterways, maritime facilities and vessels are secure areas. For example, the entire footprint of all Outer Continental Shelf (OCS) facilities is a secure area and some parts of the OCS facility are also classified as restricted areas. The secure area includes all sleeping quarters and bathroom facilities.<sup>3</sup> Moreover, it should be noted that there are hundreds of thousands of maritime workers who must regularly access secure and/or restricted areas. Most businesses and industries situated in the onshore and offshore maritime regions, including interior waterways, oil and gas platforms and related projects in the United States' OCS will be subject to this DHS security effort.<sup>4</sup> A recent commentary appearing on CNN's website underscored the impact and scope of the TWIC program. The author explained that even employees at historical parks who work as "mule skimmers" guiding the mules as they pull tourist-type boats must obtain TWIC cards.<sup>5</sup>

This article will provide a brief overview of the TWIC program and the application process. It will primarily discuss the impact of the TWIC card system as it relates to foreign national employees and their employers. The article will also summarize the TSA adjudication procedures and the appeal and waiver options that the TSA offers to applicants. Finally, the

article will alert the reader to unresolved issues that will continue to affect foreign national employees and their employers.

### Overview of Transportation Worker Identification Credential Program

In 2002, Congress passed the Maritime Transportation Security Act (MTSA) and in 2006, the Security and Accountability for Every Port Act (SAFE Port Act).<sup>6</sup> These laws require the DHS to promulgate regulations for a biometric identification credentialing system for individuals who need unescorted access to secure and/or restricted areas of maritime facilities and vessels.<sup>7</sup>

As mentioned above, the TSA and the U.S. Coast Guard are the two agencies within the DHS charged with developing, implementing and enforcing the TWIC card system. The TSA is charged with the adjudication and issuance of the TWIC cards and the U.S. Coast Guard is charged with enforcement and compliance.<sup>8</sup> The TWIC card application process will serve as a means of obtaining information to conduct security threat assessments on individuals who will require unescorted access to secure and/or restricted areas of maritime facilities and vessels. The TSA will conduct the security threat assessment for all TWIC applicants, prior to issuing the TWIC card.<sup>9</sup>

Initially, the TWIC card will be used as a visual identification badge or a "flash pass."<sup>10</sup> However, in the future, vessel and facility owners and operators will be required to install biometric card readers to verify the electronic features on the TWIC card at points of entry to secure and/or restricted areas.<sup>11</sup> When this occurs, the TWIC card will be used for more than just a "flash pass"; a TWIC card holder will be required to insert the card through the card reader to obtain access to secure or restricted areas each and every time he or she enters these areas.

### **Unescorted Access versus Escorted Access**

Unescorted access to secure and/or restricted areas allows workers to conduct employment related duties and move around a facility or vessel without someone “accompanying” them or “monitoring” their activities.<sup>12</sup> Escorted access requires owners and operators to “monitor” or “accompany” workers without a TWIC card at all times when they are in secure areas. A secure area is defined as the area on board a vessel or at a facility or OCS facility over which the owner/operator has implemented security measures for access control in accordance with a Coast Guard approved security plan.<sup>13</sup> The designated secure area does not include passenger access areas, employee access areas, or public access areas.<sup>14</sup>

Restricted areas are those areas on board a vessel or at a port facility or OCS facility over which the owner/operator has outlined as such in the Coast Guard approved security plan.<sup>15</sup> These restricted areas on maritime vessels or facilities require a higher degree of security protection than secure areas.<sup>16</sup>

In order to meet the “accompany escort” standard in a secure area, the ratio of TWIC to non-TWIC personal may be no greater than one TWIC employee to ten non-TWIC employees or personnel and may even be less depending upon the nature of the site’s secure area and the project.<sup>17</sup>

Monitoring of non-TWIC personal in a secure area may be performed via a close circuit camera surveillance system, increased lighting, automatic intrusion-detection devices, providing the facility or vessel’s monitoring is conducted by a TWIC holder. Moreover, the vessel or facility owner/operator must ensure that TWIC security personnel are able to respond immediately if the non-TWIC worker deviates from prescribed work duties or enters prohibited areas.<sup>18</sup>

As mentioned above, those areas of a maritime vessel or facility, which the vessel owner or operator outlined in the Security Plan as restricted areas, require a higher level of security protection and security measures. As a consequence, non-TWIC workers in these restricted areas must be physically accompanied on a side-by-side basis by a TWIC holder with a

ratio of no more than five non-TWIC holders to one TWIC holder. Mere “monitoring” through close circuit camera surveillance is not sufficient in restricted areas.<sup>19</sup>

### **Obtaining the TWIC Card**

All facility and vessel owners and/or operators should have submitted by now a Security Plan, which outlines the secure and/or restricted areas on the facility or vessel. By doing so, with limited exceptions, employers, facility or vessel owners and/or operators indirectly determined the workers who need unescorted access to secure areas and who need to apply for a TWIC. In order to be eligible to apply for the TWIC, the applicant must assert that as part of the individual’s employment duties, the applicant is required or is likely to be required to have unescorted access to secure areas of the maritime facility or vessel.<sup>20</sup>

As part of this application process, the applicant will be required to provide biographic information, original identity documents and must disclose prior convictions and criminal records, including warrants, indictments or pending indictments.<sup>21</sup> The applicant will also need to provide information on prior military service, if any, and current immigration status, if applicable.<sup>22</sup> Naturalized U.S. citizens must provide the date of naturalization.<sup>23</sup>

### **Who May Apply for a TWIC**

The MTSA’s implementing regulations allow all U.S. citizens who do not pose a security threat to apply for a TWIC card. However, the regulations limit TWIC eligibility to certain foreign nationals.<sup>24</sup> All applicants must appear in person at a TWIC enrollment center, complete the TWIC Disclosure and Certification application and bring original identity document(s) and supporting documentation if needed to establish eligibility for the TWIC.<sup>25</sup> The applicant is required to pay the applicable enrollment fee, and have a complete set of fingerprints taken along with a digital photograph.

### **The Security Threat Assessment and Appeals and Waivers of TSA Determination**

Pursuant to the terms of the MTSA, the TSA must conduct a threat assessment of all TWIC applicants. The TSA assesses an applicant’s

criminal history, mental capacity and immigration status by obtaining the applicant's fingerprints and then submitting the fingerprints to the FBI and Criminal Justice Information Services (CJIS).<sup>26</sup> The TSA also conducts a search of both national and international government databases, including the United States Citizenship and Immigration Services (USCIS) and Interpol's resources, to obtain information on an applicant's eligibility for a TWIC.<sup>27</sup>

### ***Criminal History and Mental Capacity***

There are certain criminal offenses, which render applicants, both U.S. citizens and foreign nationals, permanently ineligible for a TWIC and permanently ineligible for an appeal and/or a waiver. These criminal offenses include: (1) espionage or conspiracy to commit espionage; (2) sedition, or conspiracy to commit sedition; (3) treason, or conspiracy to commit treason; or (4) a federal crime of terrorism, or conspiracy to commit the crime of terrorism.<sup>28</sup> All other criminal offenses may cause an applicant to receive an Initial Determination of Threat Assessment. However, all applicants, including foreign nationals, who have a disqualifying criminal record, but not a permanently disqualifying criminal record, may file an appeal or request a waiver from the qualifying standards.<sup>29</sup> Likewise, all applicants, including foreign nationals, who have or had a disqualifying mental condition, may file an appeal or request a waiver from the qualifying standards.<sup>30</sup>

### ***Immigration Status***

All foreign nationals must demonstrate that they have one of the select immigration statuses. If a foreign national applicant receives an Initial Determination of Threat Assessment because the TSA determined that the foreign national did not meet the immigration status requirements, the foreign national may appeal the TSA determination. Once the foreign national applicant has submitted the relevant immigration documents with the written appeal, the TSA Assistant Administrator, after reviewing the documentation, will issue either a Final Determination of Threat Assessment or a Withdrawal of Initial Determination of Threat Assessment.<sup>31</sup>

A Final Determination of Threat Assessment by the TSA Assistant Administrator, based on the

foreign national's inability to demonstrate a qualifying immigration status, is final. The foreign national's only recourse is to file a claim in the federal court system. There is no further appeal or waiver process for most foreign national applicants within the TSA.<sup>32</sup> However, the regulations do provide additional provisions for foreign national applicants who have temporary protected status (TPS).<sup>33</sup>

### ***Special Provisions for Foreign Nationals in Temporary Protected Status***

TPS is a temporary immigration status granted to eligible nationals who are temporarily not able to return to their home countries because of continuing armed conflicts, environmental disasters or other extraordinary conditions. Currently, the Department of Homeland Security has provided TPS to certain eligible foreign nationals from El Salvador, Honduras, Nicaragua, Somalia and the Sudan.<sup>34</sup>

A foreign national applicant in TPS who receives an Initial Determination of Threat Assessment may either file an appeal or request a waiver from the qualifying immigration standards.<sup>35</sup> In almost all cases, it will be futile for foreign nationals in TPS to file an appeal because they will not have one of the qualifying immigration statuses mentioned above and will risk receiving a denial and a Final Determination of Threat Assessment. Instead, they should immediately file a waiver request of the qualifying immigration statuses.

Foreign national aliens in TPS requesting a waiver of the qualifying immigration statuses should be prepared to submit documentation demonstrating that they meet the country specific TPS criteria, that they have continuously registered for TPS and have a valid unexpired Employment Authorization Document authorizing actual employment. If the foreign national in TPS receives a denial of the waiver request, he or she may then file an appeal for review of the Assistant Administrator's determination with an administrative law judge (ALJ).<sup>36</sup>

It should be noted that when reviewing all appeals of waiver requests, including appeals for waiver requests based on criminal records, mental incapacity or immigration statuses for TPS foreign nationals, the ALJ will only consider evidence and information that was originally presented to the TSA with the initial waiver

request. If any applicant, including the foreign national in TPS, has new evidence to submit with the appeal, he or she must begin the entire waiver request all over again with the TSA Assistant Administrator.<sup>37</sup>

After receiving the ALJ's determination either to sustain or withdraw the TSA Assistant Administrator's Final Determination of Threat Assessment, an applicant or the TSA may file an appeal for review of the ALJ's determination with a TSA Final Decision Maker.<sup>38</sup> The TSA Final Decision Maker's determination is final, and no further TSA appeal procedures are available.<sup>39</sup>

### **Issuance of the TWIC Card and Post Issuance Responsibilities**

Once the TSA has completed the threat assessment and concluded that the foreign national applicant does not pose a security threat, the TSA will notify the applicant to retrieve the TWIC card.<sup>40</sup> The applicant must then return to the same enrollment center that he or she submitted the initial application to retrieve and activate the TWIC card for a period of five (5) years.<sup>41</sup> Currently, the TSA is reluctant to issue TWIC cards for a lesser validity period; however, TWIC regulations authorize the TSA to issue cards for less than five (5) years to match a foreign national applicant's visa expiration date.<sup>42</sup>

A TWIC card remains the property of the TSA.<sup>43</sup> The regulations strictly forbid transferring the TWIC card to another person or allowing another person to use the card. A foreign national with a TWIC card must surrender the card to the TSA if he or she no longer meets the qualifying TWIC standards. This is particularly true in situations where an alien TWIC card-holder ceases to maintain one of the qualifying nonimmigrant statuses. In fact, the TSA deems the TWIC card to have expired as of the date the foreign national's nonimmigrant status ceases, even though the foreign national is still lawfully present in the United States. Likewise, if an employer terminates the foreign national TWIC card-holder's employment, the TSA deems the TWIC card to have expired as of the date the employment ceases.<sup>44</sup> A TWIC card-holder with a work restricted nonimmigrant alien status whose status expires is obligated to surrender the TWIC card to his or her employer.<sup>45</sup> This applies to TWIC card holders with work

restricted nonimmigrant statuses, such as H-1B, L, E, etc. It is unclear whether the foreign national, who is the beneficiary of a petition to extend his or her status, must surrender the TWIC card to the employer during the petition's frequently prolonged adjudication period.

Further, during the five-year validity of a TWIC card, all TWIC card-holders, including U.S. citizens and foreign nationals, are obligated to disclose to the TSA all convictions, findings of not guilty by reason of insanity, a disqualifying crime, or any commitment to a mental health institution or adjudication of lacking mental capacity. TWIC card-holders who denounce their U.S. citizenship, lose permanent resident status, or who no longer have a qualifying immigration status must surrender their TWIC card to the TSA.<sup>46</sup>

Moreover, the TSA regulations impose additional responsibilities on employers that employ foreign national TWIC card-holders. If an employer terminates a TWIC card-holder's employment who is working under a restricted nonimmigrant status, such as an H-1B, E, L employee, etc., or the TWIC card-holder ceases working for the sponsoring employer, the employer must notify the TSA within five business days and surrender the TWIC card, if possible.<sup>47</sup> Failure to comply with this requirement or violations of any of the provisions of the regulations, can subject the employer and/or the TWIC holder to civil, criminal or administrative actions.<sup>48</sup>

### **Unresolved Issues**

The TSA and the U.S. Coast Guard appear to be striving to make the TWIC implementing regulations straight forward. However, this new initiative involves complex criteria and considerable delegation of discretionary authority. There are many subjective issues that arise, which are not easily addressed with objective administrative directives. Frequently, many such issues are not contemplated and solutions take considerable patience and negotiations. Moreover, the sheer magnitude and scope of the TWIC's provisions, the complicated appeal and waiver processes and the perennial and persistent lack of government resources are causing and will likely continue to cause major problems and delays with the TWIC issuance.

### ***Delay Issues and New Hires***

Many TWIC applicants, who have no criminal backgrounds and are U.S. citizens, are waiting for up to ninety days or more to receive authorization for the TWIC card. Prior to established compliance dates, the delayed adjudication and issuance was not problematic. However, in April 2009 all maritime and navigation areas in the United States and the country's various OCS areas will be within the compliance date timeframe. Consequently, this long delay will be burdensome on employers and applicants waiting for the TWIC card.<sup>49</sup>

In an effort to compensate for the delays, the TWIC final rule provides alternative procedures for "new hires."<sup>50</sup> However, the procedures are very complicated and the benefits are very limited. Moreover, the "new hire" provisions rule out the possibility of foreign nationals in TPS and their employers from participating in the limited benefits. All "new hires" and their employers wishing to partake in the limited benefits must assert there are no issues that would result in the need for the "new hire" to file an appeal or a waiver.<sup>51</sup> Because all foreign nationals in TPS must submit a waiver request of the qualifying immigration statuses, this prohibits these individuals and their employers from partaking in the "new hire" provisions.

### ***Immigration Issues***

Problems also arise from the exceeding restrictive language of the MTSA concerning TWIC eligibility for lawful foreign national workers. The section of the MTSA that addresses the determination of a terrorism security risk provides that an individual may not be denied a transportation security card *unless* the individual may be denied admission to the United States or removed from the United States under the Immigration and Nationality Act or otherwise.<sup>52</sup> The Immigration and Nationality Act puts the burden of proof on demonstrating admissibility to the United States on all alien nonimmigrants and proving immigrant status on all immigrants each time they apply for admission to the United States.<sup>53</sup> As a legal and practical matter, every nonimmigrant or immigrant alien who is unable to meet the burden of proof may be denied admission to the United States and therefore under a strict interpretation of the law may be denied eligibility for a TWIC card.

Fortunately, in its implementing regulations, the TSA broadened TWIC eligibility to include certain immigration categories. However, there are several nonimmigrant categories that were not included. For example, omitted from the list of nonimmigrant statuses eligible to apply for a TWIC is the R Religious Worker classification.<sup>54</sup> A foreign national Priest, Minister, Rabbi, etc. may not apply for a TWIC; if they do apply, they will fail the security threat assessment and be served with a Final Determination of Threat Assessment. Consequently, foreign national Priests, Ministers, Rabbis, etc. will not be granted unescorted access to a secure area. Foreign national religious leaders providing guidance on facilities on the OCS will be monitored or accompanied at all times. Privacy of the confessional will now be replaced with monitoring of the confessional.

In addition, only alien visitors with B-1 OCS visas are eligible to apply for a TWIC.<sup>55</sup> At this time, neither B-1/B-2 visa holders nor Mexican nationals with BBBCV visas are eligible to apply for a TWIC, even if they have a U.S. Coast Guard Letter of Exception from OCS employment restrictions. This poses a separate problem for such nonimmigrant aliens because, according to Department of State policy, an individual may not be in possession of more than one valid visa of the same classification in the same type of passport at the same time.<sup>56</sup> The Department of State considers a B-1 OCS visa and a B-1/B-2 visa to be of the same classification, notwithstanding, the considerable differences between a B-1 OCS visa and a B-1/B-2 visa.

For example, typically, a B-1 OCS visa may be valid from one to five years and is limited for use for admission to the United States to perform specialized and technical services on the OCS. Conversely, a B-1/B-2 visa may be valid up to ten years and may be used to apply for admission to the United States for many purposes, such as visiting family, tourism, business meetings, even performing services on the OCS with special U.S. Coast Guard authorization.<sup>57</sup>

The TSA has demonstrated that they are diligently attempting to reconcile the B-1 visa problem. However, until this matter is resolved, the U.S. Consulate must cancel the foreign national's multi-purpose ten-year B-1/B-2 visa and issue a one to five year limited purpose B-1

OCS visa for the foreign national to obtain TWIC eligibility.

Of considerable concern are foreign nationals who are in the process of adjusting their temporary nonimmigrant status to permanent immigrant status. Frequently, these foreign nationals no longer have any of the qualifying nonimmigrant classifications. Nevertheless, these foreign nationals remain lawfully present in the United States with work authorization pursuant to a valid Employment Authorization Document. Notwithstanding their lawful presence in the United States and valid work authorization, it will be very burdensome and difficult for these foreign nationals to apply for a TWIC. Based on current United States Citizenship and Immigration Services (USCIS) adjudication timeframes, these foreign nationals must wait for eighteen (18) to twenty (20) months or more to obtain permanent resident alien status according to their eligibility to apply for a TWIC.<sup>58</sup> Foreign nationals in this situation should definitely seek the assistance of legal counsel to guide them through the TWIC application process and the likely Initial Determination of Threat Assessment that they will receive from the TSA.

### ***Waiver and Appeal Issues***

Another problematic area is the extremely complicated, time sensitive and convoluted waiver and appeal process. The TSA describes the waiver and appeal process as very straightforward, and advises applicants that appeals and/or waiver requests may be typed or handwritten.<sup>59</sup> Both the TSA and the U.S. Coast Guard claim that in order to prepare an appeal or request a waiver no legal knowledge is needed, nor is legal representation necessary.<sup>60</sup> However, it is advisable that a TWIC applicant, at a minimum, elicit the assistance of an attorney to clarify timeframes, review any prior criminal history, and interpret and assess the impact of any such criminal act on the TWIC application process. Likewise, a foreign national appealing an Initial Determination of Threat Assessment based on an immigration issue should retain legal counsel to review immigration documents, applicable TWIC regulations and the limited appeal procedure. Foreign nationals should retain legal counsel prior to beginning the TWIC application process.

The significance of this cautionary recommendation is underscored by the realization that the TWIC regulations do not indicate the standard of review, which the TSA will apply when reviewing an appeal and/or waiver request. It is unclear whether an applicant seeking a waiver or filing an appeal will need to demonstrate eligibility by preponderance of the evidence (a lesser standard), clear and convincing evidence (a greater standard), or beyond a reasonable doubt (an even greater standard).

The only standard of review mentioned in the regulations is that which the ALJ will use when reviewing an appeal of the Assistant Administrator's Final Determination of Threat Assessment. That standard of review for the appealing party is "substantial evidence on the record," defined as such relevant evidence as a reasonable person might accept as adequate to support a conclusion.<sup>61</sup> Because the ALJ will only review evidence and information previously submitted to the TSA and because most TWIC applicants have no idea what the standard of review "substantial evidence on the record" really requires, legal counsel is essential. Attempting to defend against a TSA Initial Determination of Threat Assessment or a Final Determination of Threat Assessment without proper legal assistance appears to be an open invitation to a no win "Catch 22" situation. The government's advice to forgo legal counsel and just "send hand written responses" fails to disclose that the ALJ's final decision, which will likely impact the applicant's livelihood, actually will be made on the hand written response.

### ***Damage Control and the Impact of a Final Determination of Threat Assessment***

Based on the current regulations and policy, there is no procedure in place for an applicant to withdraw a TWIC application. Employers and foreign national employees should only begin the TWIC application process after consulting legal counsel to ascertain if the foreign national employee is eligible to apply for the TWIC card and to determine the supporting documents needed for the application process. Further, foreign national applicants should not begin the TWIC application process until the USCIS approves the petition and the foreign national is admitted to the United States. If the USCIS adjudication is lengthy or if the applicant's visa application is subject to the Department of

State's "administrative processing," the applicant may not be able to establish the qualifying immigration status and may likely receive a Final Determination of Threat Assessment.

This is particularly troublesome because there is no indication what impact a Final Determination of Threat Assessment may have on foreign national applicants' ability to obtain other government benefits in the future. For example, it is unclear what impact a Final Determination of Threat Assessment would have on a foreign national's ability to successfully reapply for a TWIC. Moreover, it is unclear whether a Final Determination of Threat Assessment will adversely impact the foreign national's ability to obtain a visa, to be admitted to the United States, to obtain work authorization, to obtain a driver's license, to pursue a study program, to visit the U.S. or become a U.S. citizen after marrying a lawful permanent resident or a U.S. citizen. This uncertainty, coupled with the reality that a foreign national's immigration status, or the lack thereof, really does not have any bearing on whether the applicant poses a security threat, may lead to much frustration for foreign national applicants.

Although Congress' objective with the MTSA was to improve and increase rigorous security standards and procedures in the maritime areas both on and offshore, the MTSA may in fact have created more problems than it solved. By focusing on immigration status instead of all individuals who regularly enter maritime secure areas, the MTSA may not adequately address the threat assessment of the applicant. By broadening the scope of the TWIC program to enforce employment authorization for foreign nationals, the DHS may have veered from its focus to improve and increase rigorous security standards. In so doing, the DHS actually created issues where none existed previously. U.S. employers, the TSA and U.S. Coast Guard personnel are now left to sort through these entangled directives to carry out their respective responsibilities.

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<sup>1</sup> See generally Final Rule, Transportation Worker Identification Credential (TWIC) Implementation in the Maritime Sector; Hazardous Materials Endorsement for a Commercial Driver's License [9110-05-P] (2006), available at [http://www.tsa.gov/assets/pdf/1652-AA41\\_twic\\_fr.pdf](http://www.tsa.gov/assets/pdf/1652-AA41_twic_fr.pdf) (last visited Mar. 9, 2009) [hereinafter *Final Rule*].

<sup>2</sup> TSA Credentialing and Security Threat Assessments, 49 C.F.R. § 1572.3(b)(2) (2008); Final Rule, *supra* note 1, at 2; Navigation and Vessel Inspection Circular No. 03-07, COMDTPUB 16700.40, at 3, (July 2, 2007), available at [http://homeport.uscg.mil/cgi-in/st/portal/uscg\\_docs/MyCG/Editorial/20070706/FINAL%20TWIC%20NVIC%2007-02-07\\_2.pdf?id=17cced63a000001887cdf00744d75e9fe0bfe0a7](http://homeport.uscg.mil/cgi-in/st/portal/uscg_docs/MyCG/Editorial/20070706/FINAL%20TWIC%20NVIC%2007-02-07_2.pdf?id=17cced63a000001887cdf00744d75e9fe0bfe0a7) (last visited Mar. 9, 2009) [hereinafter *NVIC No. 03-07*].

<sup>3</sup> NVIC No. 03-07, *supra* note 2, at Enclosure 3 § 3.3b(4).

<sup>4</sup> U.S. flag vessels, operating under a waiver provided by 46 USC 8103(b)(3)(A) or (B), such as offshore supply vessels, which operate in foreign ports and foreign waters, and mobile offshore drilling units, which operate in waters beyond the U.S. Outer Continental Shelf (OCS) and are engaged in support of exploration, exploitation or production of offshore mineral energy resources, do not have secure areas until and unless the vessels enter U.S. waters. These vessels, while in foreign waters or beyond the OCS, are not required to comply with TWIC regulations. TWIC regulations do not apply to vessels and ships owned and operated by the U.S. government. Finally, the TWIC regulations do not apply to foreign flag vessels and mariners are allowed to access port facilities immediately adjacent to a vessel when they are conducting supportive operations for the vessel, such as attaching shore ties, attend to maintenance, etc. without a TWIC card. See Navigation and Vessel Inspection Circular No. 03-07, Enclosure 3, 3.1a(1-5).

<sup>5</sup> Mike M. Ahlers, *TSA: Mule skimmers need background checks, too* Feb. 25, 2009, available at <http://www.cnn.com/2009/US/02/25/mule.skinner.blues/index.html?iref=mpstoryview> (last visited Mar. 9, 2009).

<sup>6</sup> Maritime Transportation Security Act, 46 U.S.C. § 70105 (2006), (*amended by* SAFE Port Act H.R. 4954, 109<sup>th</sup> Cong. (2006)).

<sup>7</sup> *Id.*

<sup>8</sup> NVIC No. 03-07, *supra* note 2, at 6.

<sup>9</sup> 49 C.F.R. § 1572.5; Final Rule, *supra* note 1, at 15; NVIC No. 03-07, *supra* note 2, at 3.

<sup>10</sup> NVIC No. 03-07, *supra* note 2, at 4.

<sup>11</sup> Final Rule, *supra* note 1, at 17 & 64.

<sup>12</sup> NVIC 03-07, *supra* note 2, at 4.

<sup>13</sup> Coast Guard Maritime Security, 33 C.F.R. § 101.105 (2008); see also Final Rule, *supra* note 1, at 29; NVIC No. 03-07, *supra* note 2, at 4.

<sup>14</sup> *Id.*

<sup>15</sup> 33 C.F.R. § 101.105.

<sup>16</sup> *Id.*

<sup>17</sup> NVIC 03-07, *supra* note 2, at Enclosure 3 § 3.3(c).

<sup>18</sup> 33 C.F.R. §§ 104.285(a) 105.275(a), 106.275(a); *see also* NVIC 03-07, *supra* note 2, at Enclosure 3 § 3.3c.(2)(b).

<sup>19</sup> NVIC 03-07, *supra* note 2, at Enclosure 3 § 3.3c(3).

<sup>20</sup> 49 C.F.R. § 1572.17(e); TWIC Disclosure and Certification, *available at* [http://www.tsa.gov/assets/pdf/twic\\_form\\_2212\\_english.pdf](http://www.tsa.gov/assets/pdf/twic_form_2212_english.pdf), (last visited February 2009).

<sup>21</sup> 49 C.F.R. § 1572.17(b).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> (1) a U.S. lawful permanent resident; (2) a refugee; (3) an asylee; (4) M-1 enrolled in U.S. Merchant Marine Academy or a comparable State maritime academy; (5) non-immigrant aliens admitted pursuant to the Compact of Free Association between the U.S. and Federated States of Micronesia, the Marshall Islands and Palau; (6) a commercial driver licensed in Canada or Mexico under NAFTA provisions; (7) an applicant in nonimmigrant status who has unrestricted employment authorization, (such as spouses of E-1, E-2, L-1 who are allowed to apply for work authorization) except for an applicant with S-5, S-6, K-1, K-2 nonimmigrant status, (please note, an applicant in Temporary Protective Status (TPS), V and T nonimmigrant status **with employment authorization** may apply for a TWIC); or (8) a foreign national applicant in one of the following nonimmigrant statuses: (a) B-1 OCS, (b) C-1/D, (c) H-1B, (d) H-1B1, (e) E-1, (f) E-2, (g) E-3, (h) L-1, (i) O-1, or (j) TN. 49 C.F.R. § 1572.105 (emphasis added).

<sup>25</sup> TSA Frequently Asked Questions, Transportation Worker Identification Credential (TWIC™), *available at* [http://www.tsa.gov/what\\_we\\_do/layers/twic/twic\\_faqs.shtm#twic\\_process](http://www.tsa.gov/what_we_do/layers/twic/twic_faqs.shtm#twic_process) (last visited February 17, 2009) [hereinafter TSA Q&A].

<sup>26</sup> 49 C.F.R. § 1572.21(b).

<sup>27</sup> *Id.* at § 1572.21(c).

<sup>28</sup> *Id.* at § 1572.103(a)(1)-(4).

<sup>29</sup> *Id.* at §§ 1515.5(a), 1515.7(a).

<sup>30</sup> *Id.*

<sup>31</sup> 49 C.F.R. § 1515.5(b)(6).

<sup>32</sup> *Id.* at § 1515.5(g).

<sup>33</sup> *Id.* at § 1515.7(a).

<sup>34</sup> Temporary Protected Status, *available at* <http://www.uscis.gov/portal/site/uscis/menuitem.eb1d4c2a3e5b9ac89243c6a7543f6d1a/?vgnextoid=609d3591ec04d010VgnVCM10000048f3d6a1RCRD&vgnnextchannel=609d3591ec04d010VgnVCM10000048f3d6a1RCRD>.

<sup>35</sup> 49 C.F.R. § 1515.7(a)(ii).

<sup>36</sup> *Id.* at § 1515.11(a)(1).

<sup>37</sup> *Id.* at § 1515.11(b).

<sup>38</sup> *Id.* at § 1515.11(g).

<sup>39</sup> *Id.* at § 1515.11(h).

<sup>40</sup> *Id.* at § 1572.21(d)(1); TSA Q&A, *supra* note 24.

<sup>41</sup> TSA Q&A, *supra* note 24; NVIC 03-07, *supra* note 2, at Enclosure 2 §2.6(5).

<sup>42</sup> 49 C.F.R. §1572.23(b); Final Rule, *supra* note 1, at 44 footnote 4.

<sup>43</sup> 49 C.F.R. § 1572.19(c).

<sup>44</sup> *Id.*

<sup>45</sup> 49 C.F.R. § 1572.105(c); Final Rule, *supra* note 1, at 232.

<sup>46</sup> NVIC 03-07, *supra* note 2, at Enclosure 2 § 2.6(5).

<sup>47</sup> 49 C.F.R. § 1572.105(d).

<sup>48</sup> Final Rule, *supra* note 1, at 64.

<sup>49</sup> To obtain the most current TWIC compliance information visit: [http://www.tsa.gov/what\\_we\\_do/layers/twic/twic\\_faqs.shtm#required\\_twic\\_date](http://www.tsa.gov/what_we_do/layers/twic/twic_faqs.shtm#required_twic_date).

<sup>50</sup> 33 C.F.R. §§ 104.267, 105.257, 106.262; NVIC 03-07, *supra* note 2, at Enclosure 3 § 3.3(h).

<sup>51</sup> *Id.*

<sup>52</sup> 46 U.S.C. § 70105(c)(C) (2006).

<sup>53</sup> 8 U.S.C. §§ 1181, 1184 (2007).

<sup>54</sup> 49 C.F.R. § 1572.105; Final Rule, *supra* note 1, at 50.

<sup>55</sup> 49 C.F.R. § 1572.105.

<sup>56</sup> 9 FAM 41.113 N2.1 (2008).

<sup>57</sup> 9 FAM 41.31 *et seq.* (2009).

<sup>58</sup> For current processing times for USCIS petitions and application visit the USCIS website at [www.uscis.gov](http://www.uscis.gov).

<sup>59</sup> Final Rule, *supra* note 1, at 230.

<sup>60</sup> Final Rule, *supra* note 1, at 230; NVIC 03-07, *supra* note 2, at Enclosure 2 § 2.7; TSA Q&A, *supra* note 24, *available at* [http://www.tsa.gov/what\\_we\\_do/layers/twic/twic\\_faqs.shtm#disqualifying\\_offenses](http://www.tsa.gov/what_we_do/layers/twic/twic_faqs.shtm#disqualifying_offenses) (last visited March 9, 2009).

<sup>61</sup> 49 C.F.R. § 1515.11(e)(4).

## Uruguay's Call for Upstream Investment: The 2009 Offshore Round

By  
María Victoria Vargas

The *Administración Nacional de Combustibles, Alcohol y Portland* (“ANCAP”), the entity in charge of granting hydrocarbon exploration and production rights in Uruguay, recently launched its first offshore bid round (the “2009 Uruguay Round”). The 2009 Uruguay Round, currently underway, seeks to award eleven offshore blocks on the Uruguayan continental shelf. This article provides a general background of Uruguay's hydrocarbon sector and discusses the main aspects of the bidding and the exploration and production contracts to be awarded.

### Background

Less known in the international oil and gas circles, Uruguay has not been a major target for energy companies looking for prospects abroad. This small South American country, neighboring Argentina and Brazil, has no current oil or gas production<sup>1</sup> and has been meeting its energy needs through imports, particularly natural gas from Argentina, to which Uruguay is connected by two natural gas pipelines, the *Gasoducto del Litoral* and the *Gasoducto Cruz del Sur*.<sup>2</sup> Since Argentina started cutting its exports, Uruguay has been exploring alternative sources to cover its energy needs. These alternatives include a proposed liquefied natural gas (LNG) regasification facility (the “Montevideo LNG Plant”). Earlier this year, the Uruguayan Ministry of Industry, Energy and Mines (“MIEM”) announced that a tender will be launched for the construction of the Montevideo LNG Plant, which would use a floating LNG tanker with an initial capacity of around 3M-4M m<sup>3</sup>/d.<sup>3</sup> The Uruguayan government seems keen to pursue this project to fruition and continues studying its feasibility and most suitable structure. On the commercial front, Uruguay is a party to Mercosur, a regional trade agreement with Argentina, Brazil and Paraguay, and has signed numerous bilateral investment treaties, including those with the United States, Canada, United Kingdom, France and Spain. From a country risk perspective, Uruguay is very stable, ranking

within the top 75 to 90 percentile range for political stability according to the World Bank Governance Indicators.<sup>4</sup>

### The Bidding Process

Pursuant to Decree No. 239 of May 12, 2008, the President of the Republic of Uruguay authorized ANCAP to call interested parties to submit bids for the award of contracts for the exploration and exploitation of hydrocarbons in the Uruguayan continental shelf. Interested parties must purchase the terms of reference (the “Bid Terms”) from ANCAP for a price of US\$5,000. To participate in the bidding, companies must first prequalify by April 30, 2009 evidencing compliance with certain legal and financial requirements, plus certain technical qualifications for operators. In terms of legal requirements, companies must present evidence of their legal existence and representation and a statement that they are not affected by any incompatibility or inability to bid. Companies interested in bidding under a consortium structure must also submit a copy of the corresponding consortium agreement. From a financial point of view, the interested entity must either (i) be within the Top 100 oil companies of the most recent edition of “Petroleum Intelligence Weekly”; (ii) have a credit rating of either BBB of Standard & Poors, Baa of Moody's or BBB of Duff & Phelps; or (iii) submit independently audited financials for the last three years demonstrating a market capitalization of minimum US\$2,000,000,000 or a minimum net worth of US\$1,000,000,000, and submit projected financial statements for five years. Additionally, operators must either (i) be within the list of the Top 100 oil companies referred above or (ii) evidence levels of production of at least 5,000 Boepd during the last three years, deep water operations ( $\geq$  300 mts), exploration in frontier and environmentally sensitive areas, and experience in international operations for at least five years. The financial and technical requirements can be met through credentials of a parent company or

controlling entity provided such entity delivers a parent company guaranty becoming principally and directly liable for the performance of its subsidiary under the contract and any damages arising from the breach thereof.

### The Areas

ANCAP is offering eleven blocks, comprising a total surface of approximately 74,000 square kilometers located in the Punta del Este Basin and the Pelotas Basin in the Uruguayan continental shelf. These areas have been the subject of geological, geophysical and geochemical study through various surveys commissioned by ANCAP. The available Areas are listed in Annex A to the Bid Terms and are classified as “Areas A” and “Areas B”. According to ANCAP’s technicians many leads and plays have been identified located in bathymetries from shallow to ultra depth analogous to some productive systems in the Atlantic<sup>5</sup> and some bright spots may indicate the presence of natural gas.<sup>6</sup> Interested companies may bid for any number of areas provided an independent bid is submitted for each. The information package for the Areas is available from ANCAP only for prequalified companies at a cost of US\$25,000.

### Bid Submission and Award

The term for submission of bids by prequalified companies is currently scheduled to take from June 14 to July 1, 2009. The bids must have a 180 validity term counted from the bid opening date (July 1, 2009). The awarding criteria for the areas comprises the following factors: (i) the minimum work program offered by each bidder; (ii) the economic terms offered, including: (a) the maximum percentage of production requested for cost recovery, (b) the profit sharing percentages per kind of hydrocarbon and levels of accumulated production, and (c) the increase of ANCAP’s sharing percentage for hydrocarbons price increments; and (iii) the maximum participation allowed to ANCAP in case it opts for participating with the Contractor in any exploitation lot, ranging from 20% to 40%. With its bid, the interested entity must deliver a guaranty in the form of a bank guaranty, cash deposit, or other guaranty acceptable to ANCAP, for an amount equal to 5% of the minimum work program offered for the relevant area.

### Main Contract Terms

The contract proposed under the 2009 Uruguay Round is a Production Sharing Contract (“PSC”), whereby the Contractor must carry out at its sole risk, cost, expense and liability exploration, and eventually exploitation, activities in the particular area being entitled, upon a commercial discovery, to take production in kind to recover the costs of petroleum operations and to a percentage share of the remaining production.

*Contract Term.* The PSC has a total thirty-year term but may be extended per the Contractor’s reasoned request for up to ten additional years, with the prior approval of the Executive Power, provided the Contractor has duly complied with its obligations. Such extension request may be submitted after the initial twenty-five years but before two years of the PSC’s scheduled termination.

*The Contractor’s Rights and Obligations.* Under the PSC, the Contractor is given the exclusive right to conduct petroleum operations in the Contract Area, having to act efficiently and diligently, observing the prudent practices of the oil industry, and assuming total and exclusive liability for damages or losses caused by its personnel or subcontractors. The Contractor must comply with all applicable Uruguayan statutes and regulations regarding the protection of the environment, particularly regarding sea and water pollution. Likewise the Contractor must take all appropriate measures to prevent hydrocarbon spills and adopt adequate mitigation measures to avoid atmospheric pollution. The Contractor is also subject to local content obligations to use Uruguayan goods, materials, and services, as long as they are comparable and competitive with foreign ones in terms of price and quality. The PSC further requires the Contractor to employ Uruguayan technical and non-technical personnel, to the extent possible, and to provide training to local workers. In addition, the Contractor must deliver to ANCAP the amount of US\$100,000 per year for training purposes throughout the contract term. The Contractor bears the cost and responsibility of obtaining all the required permits and licenses to conduct its operations, and has to indemnify ANCAP for any claim by third parties that suffer damages as a result of the Contractor’s activities. All technical and economic information obtained from the performance of the contract must be delivered

by the Contractor to ANCAP and the Contractor is subject to confidentiality with respect thereof.

*ANCAP's Rights and Obligations.* ANCAP has the right to use all data relative to the Contract Area obtained by the Contractor and has broad authority to control and oversee the operations performed under the PSC. ANCAP is also entitled to conduct audits and inspections of the accounts kept by the Contractor relative to the PSC. On the other hand, ANCAP must cooperate and assist the Contractor in obtaining all applicable permits, and must process the required environmental permits with the information and data provided by the Contractor.

*Exploration Period.* The PSC contemplates a basic exploration period ("Basic Subperiod") of four years with an optional two year additional period ("Complementary Subperiod") and a two year extension period ("Extension Subperiod") at the Contractor's option. The Minimum Work Program offered by the Contractor should be completed within the Basic Subperiod. The Contractor may opt for entering the Complementary Subperiod provided it assumes the obligation to drill at least two exploratory wells during such Complementary Subperiod and relinquishes at least 20% of the Contract Area. However, if the Contract Area corresponds to an "Area B" the 20% relinquishment obligation does not apply. The Extension Subperiod is also at the election of the Contractor, but is subject to the relinquishment of 50% of the remaining Contract Area and the obligation to drill other two new exploration wells during such subperiod. The relinquishment obligation excludes evaluation and exploitation lots.

*Commercial Discovery.* In the event of a discovery, the Contractor must notify ANCAP and submit an Evaluation Program for approval of the Management Committee formed by two representatives of ANCAP and two representatives of the Contractor. The Contractor must perform the activities set forth in the approved Evaluation Program within one year from the date of approval. Upon completion of the Evaluation Program, the Contractor should declare whether the discovery is commercial. In the event of a commercial discovery, the Contractor must submit the corresponding Exploitation Work Program and Budget to ANCAP for its consideration, thereafter entering into the Exploitation Period. If the discovery is

not commercial, the corresponding evaluation lot shall be withdrawn from the Contract Area and ANCAP will have the right to dispose of it as it sees fit. Regardless of a commercial discovery, the Contractor must continue conducting an active exploration program on areas outside the exploitation lots retained by the Contractor.

*Relinquishment.* In addition to the mandatory relinquishments required for the Contractor's entry into the Complementary and/or Extension Subperiods, as applicable, the Contractor must also relinquish the areas outside the exploitation lots if it fails to conduct an active exploration program therein, as well as any evaluation lots, if the discovery is not commercial. In addition, the Contractor has the right to relinquish voluntarily any portion of the Contract Area after full compliance with the agreed work program with thirty days' notice to ANCAP.

*Exploitation Period.* Upon a declaration of commerciality, the Contractor has a maximum term of twenty-five years for the development and production of each exploitation lot (subject to the maximum thirty year PSC term and maximum ten year extension discussed above). During the Exploitation Period, the Contractor must carry out its activities in accordance with the development programs approved by the Management Committee, which will include the rate of production, which in turn will be the Maximum Efficient Rate according to standard operational and conservation practices of the oil industry, unless otherwise agreed by the parties. The Contractor must provide all the facilities that may be necessary for the storage, measuring and delivery of the hydrocarbons to the relevant fiscalization points at its cost and expense.

*Hydrocarbon Production.* The Contractor is entitled to use the hydrocarbons produced in the Contract Area as required for its operations, but must deliver all remaining production at the corresponding fiscalization points. The Contractor is entitled to receive a share of the hydrocarbon production in kind comprising a cost recovery element and a profit sharing element. The cost recovery portion is meant to reimburse all exploration, development and production costs incurred by the Contractor in the performance of operations under the PSC. These costs are determined according to a procedure to be approved by the Management Committee. The remaining profit hydrocarbons are shared between the Contractor and ANCAP

in the percentages offered by the Contractor in its bid, ranging between 20% and 40%. ANCAP's percentage is subject to increase by X percentage points (X being in each case the percentage offered by the Contractor in its bid) per dollar increment in the price of oil or natural gas over a pre-set base price. The Contractor is entitled to dispose freely of and export its share of production subject, however, to ANCAP's preferential right to purchase all or part of the hydrocarbons as necessary to satisfy the country's domestic needs. ANCAP may, at its option, request that the Contractor takes care of selling ANCAP's share of hydrocarbons, in which case the Contractor shall submit and offer to ANCAP on which basis both parties will agree the commercialization terms.

*Sole Risk Operations.* Under the PSC, ANCAP is allowed to undertake sole risk secondary or tertiary recovery operations, provided such operations were proposed as regular operations under the PSC but failed to reach the required Management Committee approval. ANCAP's sole risk operations shall be conducted by the Contractor as operator but for ANCAP's sole risk and cost. Any such ANCAP sole risk project should not substantially interfere with the regular PSC operations approved by the Management Committee. All existing facilities, wells and equipment can be used for ANCAP's exclusive operations as long as there is no interference with other PSC operations. An ANCAP sole risk project shall cease to exist once the cash flow from sole risk production reaches 500% of the sole risk investment. The Contractor has the option to reinstate its rights into an ANCAP sole risk operation by making a lump sum cash payment to ANCAP equal to the balance resulting from taking five times (500%) the sole risk investment minus the cash flow from such sole risk production as of such date. Thereafter the sole risk project shall cease to exist and the PSC will continue its regular course.

*Association.* ANCAP has the right, at its discretion, to participate with the Contractor in the exploitation of any exploitation lot. Any such decision must be notified by ANCAP to the Contractor within 120 days from the date of approval of the exploitation lot. If ANCAP decides to participate, its notice to the Contractor must include the actual percentage ANCAP will bear, ranging between 20% and the maximum percentage indicated by the Contractor in its bid. ANCAP's participation is

subject to ANCAP's payment to the Contractor of an amount equal to ANCAP's participating interest in the direct drilling and completion costs of the exploration wells in production. Regarding appraisal wells, ANCAP must pay the Contractor its participating interest share of all direct expenses but no costs will be reimbursed for appraisal wells that are less than 25% productive. In addition, a 15% will be added to such costs to cover indirect expenses incurred by the Contractor. The total payment must be made in cash within 180 days from the date when the corresponding association contract is signed between the parties.

*Assignments.* Total or partial assignments of the PSC by the Contractor require ANCAP's prior written approval. If the Contractor is a Consortium, any changes to the consortium or association agreement also require ANCAP's prior written approval. No exceptions are contemplated for assignments to the Contractor's affiliates. On the other hand, if in the future ANCAP is replaced by other government entity, the PSC shall be deemed transferred to such new entity.

*Events of Termination.* The PSC terminates at the Contractor's decision at any time during the Exploration Period if the Minimum Work Program is satisfied. If the Contractor decides to terminate otherwise, it must pay ANCAP to cover the amount of the remaining works. The PSC also terminates in the following circumstances: (i) if no commercial discovery has been made during the Exploration Period; (ii) upon the expiration of the contract term; (iii) per the mutual agreement between the Contractor and ANCAP; (iv) on account of certain events attributable to, or affecting, the Contractor, including (a) failure to commence operations within the stated deadlines, (b) cessation or abandonment of operations, (c) failure to deliver required information and to facilitate inspections and audits, (d) material breach of PSC obligations, (e) total or partial assignment without prior ANCAP approval, (f) bankruptcy or restructurings for the benefit of creditors, (g) if the Contractor or any of the entities comprising the Contractor is merged into or bought by other entity, and (h) change of the Contractor's corporate structure without ANCAP's prior consent. In the foregoing situations affecting the Contractor, ANCAP must give prior termination notice and the Contractor has a sixty-day cure period to remedy the

default, subject to extension if the Contractor is diligently pursuing its cure. However, no cure period applies in the event of bankruptcy or pursuant to an agreement for the benefit of creditors, nor if the Contractor is bought by or absorbed by other companies or changes its corporate structure without ANCAP's prior written consent. In the latter events, ANCAP may at its sole discretion terminate the PSC at any time without prior notice to the Contractor. In the termination events attributable to the Contractor, the Contractor shall be liable for damages or losses resulting from its default and ANCAP shall be entitled to retain the performance guaranty until the Contractor has satisfied such liability. Upon termination of the PSC for whatever cause, the Contractor must transfer to ANCAP all the wells, facilities, buildings, equipment, gathering and storage facilities, platforms, water plants, power plants and electricity grids, well equipment and any other goods of similar nature required for petroleum operations. During the term of the PSC, the Contractor may not transfer, encumber or withdraw any such assets, except with ANCAP's express consent and as required for regular maintenance, repair or replacement duly authorized by ANCAP.

*Abandonment.* The Contractor is responsible for all activities required for the abandonment of the Contract Area, including shutting wells, decommissioning production and transportation facilities and restoring the Contract Area, all in accordance with the laws and regulations then in effect. To this end, the Contractor must appropriate a reserve to cover the abandonment cost, to be included in the annual budgets, which will be considered as part of the Petroleum Operations Expenses for cost recovery purposes. The corresponding funds must be deposited in a bank account in Uruguay; if the funds so reserved are not enough, the Contractor must assume the deficit. Upon termination of the PSC, the Contractor must transfer to ANCAP any remaining unused funds.

*Taxes.* The PSC is exempt from taxes and levies of any nature, national or municipal, excluding the tax on the income from business activities ("TIBA"). However, if new taxes or levies are imposed on the activities under the PSC or there is a change making the TIBA more onerous for the Contractor after the effective date of the PSC, the Contractor may charge such increase as a recoverable cost under the

PSC.

*Applicable Law and Dispute Resolution.* The PSC is governed by Uruguayan law and any disputes that cannot be directly settled by the parties shall be submitted to the courts of Uruguay in Montevideo. However, any of the parties may demand that technical and/or financial matters be submitted to consultation or arbitration. In the event of consultation, the consultant shall be appointed by mutual agreement of the parties, and in lieu thereof it will be selected by drawing the name from lists of three candidates prepared by each party. The opinion of such consultant shall have the force and effect previously agreed by the parties. All expenses for such proceeding shall be assumed by both parties in equal shares. Arbitration is allowed only for technical and/or financial matters and cannot include any legal issues, which are reserved exclusively to the courts of Montevideo. Any such arbitration shall take place also in Montevideo and be conducted according to the rules of international arbitration of the International Chamber of Commerce. The PSC is silent as to what dispute resolution procedure applies in the event the parties fail to agree on the nature of the dispute and in practice it is difficult to isolate completely financial or technical matters under a contract to avoid involving legal issues.

*Guaranties.* The PSC requires three categories of guaranties. First, it requires a Performance Guaranty, whereby the Contractor's parent company becomes jointly and severally liable with the Contractor for the performance of all its obligations under the contract. Second, the PSC requires Guaranties for the Exploration Period, which are bank guaranties or similar instruments of guaranty acceptable to ANCAP to ensure compliance with the work program. During the Basic Subperiod the amount of this guaranty must be equal to 5% of the Minimum Work Program for the areas classified as "Areas A", and to 10% of the Minimum Work Program for "Areas B." For the Complementary Subperiod the amount shall be equal to 5% of the investments estimated to be done during such subperiod, and for the Extension Subperiod shall also be of 5% of such subperiod's estimated investments. Finally, the PSC requires a Guaranty for the Exploitation Period, which is also in the form of a bank guaranty or similar guaranty acceptable to ANCAP for an amount equal to 5% of the estimated investments for the

first five years of the Exploitation Period. This last guaranty can be yearly reduced up to 50% of the original amount during the first five years of exploitation in proportion to the work done by the Contractor and the projected investments. ANCAP may enforce the guaranties if the Contractor breaches the PSC, but enforcement of the guaranties does not exonerate the Contractor from its obligation to indemnify ANCAP fully against all damages and losses caused.

### **Closing Remarks**

Given the country's history of political and legal stability, Uruguay may be an attractive destination for foreign investment in the energy sector. ANCAP has been actively promoting the 2009 Uruguay Round, including road shows in London and Houston, which have been well attended by key oil and gas industry players. The biggest challenge for the 2009 Uruguay Round stems from the dire situation of the world's economy and falling oil prices, which are forcing some companies to cut their budgets for new investments. However, in times of crisis, companies that take advantage of good investment opportunities can position themselves to fare better than their competitors in the long term.

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<sup>1</sup> Energy Information Administration, Country Analysis Briefs, [www.eia.doe.gov](http://www.eia.doe.gov).

<sup>2</sup> Energy Information Administration, Country Analysis Briefs, [www.eia.doe.gov](http://www.eia.doe.gov).

<sup>3</sup> BNamericas, Oil & Gas News, January 13, 2009.

<sup>4</sup> World Bank Worldwide Governance Indicators., 1996-2007, [http://info.worldbank.org/governance/wqi/sc\\_country.asp](http://info.worldbank.org/governance/wqi/sc_country.asp).

<sup>5</sup> ANCAP.

<sup>6</sup> Worldoils.com press release, December 28, 2008.

## Avoiding the Common Legal Pitfalls Associated with an Indian Workforce

By  
Nicole Gewinner and Sue Snyder

### I. Introduction

India is a popular destination for U.S. companies seeking labor abroad due to the size, education and cost-efficiency of its workforce. Finance and technology companies are increasingly turning to India for their human resourcing needs and, by 2019, it is estimated that in excess of three million white collar jobs will move from the United States to India and primarily in the high tech industry.<sup>1</sup> Although an Indian workforce is many times sought to be beneficial to a company's bottom line, there are a number of legal pitfalls and unexpected sources of trouble and expense associated with that workforce. Common problems that arise for U.S. companies employing or contracting with Indian nationals include certain prohibitions on the termination of employees, the payment of certain benefits without U.S. equivalents and the non-enforceability of non-competition provisions in employment contracts. This article highlights some of the legal issues most frequently encountered by U.S. companies that enter the Indian workforce.

The Indian workforce is attractive to U.S. employers, and information and technology companies in particular, for numerous reasons, most of which relate to the education, language skills and the perceived cost of Indian labor. India has a large English-speaking population and one of the world's largest pool of scientific and technical personnel. Twenty-two million people in India have graduated from college and over seven million of those persons have a degree in science and engineering.<sup>2</sup> Due to many factors, including a high rate of domestic unemployment, wages are considered relatively low for all categories of workers, including managers and skilled labor.

No matter how attractive the outsourcing and employment opportunities in India may appear, it is nonetheless important to understand the legal environment when entering the Indian labor market. A company must enter the employment field in India with care and ample legal advice

concerning not only Indian law, but also U.S. and international law.

### II. Choosing a Business Model in India

One of the first matters of consideration for a U.S. company interested in engaging an Indian workforce is how to structure its business operations abroad. It may be entirely unnecessary for a U.S. company to form any sort of corporate presence in India, instead managing its interaction with Indian nationals by simple independent contract. However, for U.S. companies with a substantial and long-term presence in India, it may be legally necessary or practically advantageous to engage employees or independent contractors through Indian entities. A company's choice of entity should be based on what advantages certain entities provide under Indian law as aligned with a company's business concerns, including productivity and transition costs, taxes and required talent. The business operations of a U.S. company in India could also take the form of a joint venture with an Indian entity, a branch or liaison office, or the acquisition of an Indian entity.<sup>3</sup>

As does the United States, India provides flexibility to foreign business operations and there are a number of corporate structures from which a U.S. company may choose. The Partnership Act of 1932 provides for the formation of partnerships, though it may not be advisable to choose such a structure, as partnerships in India do not provide limited liability to their partners.<sup>4</sup> Public or private companies are formed under the Companies Act of 1956 and are alike in structure to a U.S. corporation, with similar form, registration and disclosure requirements.<sup>5</sup> A U.S. company may form a branch or liaison office with the consent of the Reserve Bank of India. A branch office is generally restricted from engaging in activities outside of providing certain services to the parent company and a liaison office is further restricted to representative and promotional activities.<sup>6</sup>

A U.S. company may also define its presence in India so as to be able to advantage themselves certain tax exemptions and subsidizations. For example, a U.S. company could locate in certain spaces created by the Indian government to incentivize foreign business operations, such as Free Trade Zones, Electronic Hardware Technology Parks, Software Technology Parks and Software Export Zones. Companies exporting goods or computer software from these designated areas are allowed exemption from local taxes, as well as subsidized utilities, lessened import restrictions and tax holidays.<sup>7</sup>

An understanding of the legal and economic implications of a chosen business structure is imperative for successful operation abroad. The business structure of a U.S. operation in India will, in part, determine the Indian laws, and of particular interest to most companies, the taxes, which are applicable to the operation.

### III. Hiring Employees

A U.S. company looking to employ from the Indian workforce must first determine whether to engage an Indian national or entity as a full or part-time employee or as an independent contractor. The employment of Indian nationals is not always the most practical solution, and an alternative to employment for many is to enter into a relationship with an Indian national as an independent contractor.

The relationship between an employer and employee in India is primarily governed by the written agreement between the parties and applicable employment law. Employment law in India can be characterized as generally pro-labor and the rights of employees are broadly protected.<sup>8</sup> Because an employer cannot contract out of the minimum protections provided to employees under Indian law, it is important for any employer to be familiar with the laws applicable to its workforce.<sup>9</sup> Not only is there ample legislation governing the rights of workers in general, but there are also a number of laws aimed at specific industries, including plantations, mines, construction, transportation, and sales.<sup>10</sup>

#### A. Workman v. Non-Workman

Prior to undertaking any discussion of Indian labor law, it is important to note that Indian employees are divided into two categories under

the law: workmen and non-workmen. The laws apply differently to these two categories, especially those applicable to termination of employment. Under the Industrial Disputes Act of 1947, a workman is defined as a person that is employed to do any manual, clerical, skilled, unskilled, technical, operation or supervisory work.<sup>11</sup> A non-workman is a person that performs managerial, supervisory or administrative work or whose wages are in excess of 1,600 rupees per month.<sup>12</sup> In the United States, a workman might be described as a blue-collar worker, and a non-workman might be described as a white-collar worker.<sup>13</sup> The employment laws explored below most always apply to workmen and are generally protective of the workman's rights. Non-workmen are not provided the same amount of protection under Indian employment law, in part because non-workmen are often able to negotiate the terms of their employment by way of an employment contract. For the most part, the terms of a non-workman's employment contract will govern his or her employment relationship.<sup>14</sup>

#### B. Concurrent Regulation

Not only do employment laws differ according to the category or industry of the employee, but Indian employment laws may also differ from state to state. Pursuant to Schedule II of the Indian Constitution, labor is a matter of concurrent power and may, therefore, be regulated by all of the twenty-eight states as well as the central government.<sup>15</sup> Some state's laws are more protective of employees than others, and a company should consider which states have employer-friendly laws prior to choosing a location of establishment in India, if applicable.<sup>16</sup> Whether the a company is an employer of or in an agency relationship with an Indian national, it should seek out legal advice specific to the state in which it is doing business or the state in which its contractor is a resident.

#### C. Termination of Employment

The laws applicable to the termination of employees in India are starkly different from those of the United States. In certain industries, there are substantial legal barriers to firing employees.<sup>17</sup> Instead, a number of different methods of involuntary termination must be delicately navigated by Indian employers, over time and in accordance with law. The two primary statutes governing termination of

employees in India are the Industrial Disputes Act and the Industrial Employment (Standing Orders) Act of 1946, which requires employers to set forth standard employment terms.

Pursuant to Indian law, termination of employment is categorized into (1) dismissal for misconduct; (2) discharge; and (3) retrenchment.<sup>18</sup> In some circumstances, employers are restricted from retrenchment, which is defined under the Industrial Disputes Act as the termination of an employee for any reason other than (1) punishment for bad behavior; (2) voluntary retirement; (3) retirement at a certain age; (4) non-renewal of a contract; or (5) the bad health of the employee.<sup>19</sup> Retrenchment is prohibited by the Industrial Disputes Act unless an employer has first complied with certain notice and approval requirements. An employer must give a workman one month's written notice of termination or give the workman one month's wages in lieu of providing notice. An employer must also pay a retrenched workman fifteen days of payment for every year of employment and provide the governmental authorities with notice of retrenchment.<sup>20</sup> In order to terminate certain factory, mine, plantation or industrial employees, the employer must give notice of the desired termination to the government, wait for the government's approval and then provide certain compensation to the terminated employee.<sup>21</sup>

An employer may not be able to avoid prohibitions on retrenchment by entering into a written contract with an employee. Depending on the circumstances, the termination provisions of a contract between an employer and employee may even be unenforceable. In the case of an employee with a written employment contract, in *Central Inland Water Corp. Ltd. v. Brojo Nath Gnaguly*, the Supreme Court of India found that an employment agreement that provided for termination of the employee with notice, but without reason, was void under the Indian Contract Act of 1872.<sup>22</sup> The holding of the above case, however, does not apply to non-workmen in managerial and executive positions in the private sector.<sup>23</sup> Indian employment law does not, in general, prohibit employers from involuntarily terminating non-workmen. The employment of a non-workman is most often regulated by the employment contract, rather than employment law.

Related to restrictions on the termination of employees are laws that restrict businesses from dismissing their employees in connection with the termination of the business. Indian law, and the Industrial Disputes Act, in particular, generally requires companies to seek government approval to close a business and terminate employees, especially in the case of companies with a large number of employees. The Industrial Disputes Act requires an employer with fifty or more employees to provide the government with sixty days notice prior to closure.<sup>24</sup>

It is of utmost importance that an attorney advising a U.S. company asks the following questions prior to the termination of an Indian employee: Is the employee a workman or a non-workman? Is there a written contract with the employee? What are the laws applicable to the particular industry or the state in which the business or employee is located? Indian law may strictly prohibit the simple termination of an employee, and any legal advice must be tailored to the circumstances and causes of the desired termination.

#### **D. Wages and Benefits<sup>25</sup>**

Indian law provides for payment of certain wages and benefits that do not have counterparts in the U.S., for example, dearness allowances. A number of separate laws regulate the payment of wages and the provision of benefits, including the Payment of Wages Act of 1936, the Minimum Wages Act of 1948, the Payment of Bonus Act of 1965 and the Equal Remuneration Act of 1976. Indian employees generally receive a basic salary in addition to a "dearness allowance." A dearness allowance is either linked to the cost of living or calculated at a flat rate. In addition to the above, the Payment of Gratuity Act of 1972 provides that employers pay certain of their long-standing employees a gratuity in connection with retirement or disability.<sup>26</sup> The Payment of Bonus Act of 1965 applies to employers with twenty or more employees and requires that every employee is entitled to a bonus of a minimum percentage of the wages earned for each accounting year worked.<sup>27</sup>

Certain other benefits may be mandatory under Indian law, including paid vacation, severance pay, sick leave, personal leave, and maternity

leave. Employers may also be required to contribute to provident funds, pension funds and insurance funds, as applicable.<sup>28</sup> Pursuant to the Employee's State Insurance Act of 1948, employers must provide certain benefits in connection with sickness, maternity or work-related injury.<sup>29</sup> Vacation leave includes three national holidays and may also include certain religious or festival vacation days.<sup>30</sup>

In order to determine what wages and benefits are due to employees, an employer must consider the categories of employees, any written agreements and the applicable industry. The above-described laws apply differently depending on the circumstances of employment. Much like determining how to involuntarily terminate an employee, legal counsel is necessary to determine wages and benefits due to employees.

#### **E. Non-Enforceability of Non-Competes**

While U.S. courts generally uphold non-competition provisions with narrowly tailored restrictions, Indian courts have found that non-competition provisions in employment contracts are an unfair restraint of trade and therefore void and unenforceable.<sup>31</sup> As an exception to this rule, Indian courts have found that non-compete clauses that are effective only during the period of employment are enforceable. Non-compete provisions that become effective after an employee's employment has terminated, however, may be void under the Indian Contract Act.<sup>32</sup> Agreements in restraint of trade are prohibited under Section 27 of the Contract Act.<sup>33</sup> In *Niranjan Shankar Golikari v. Century Spinning and Mfg. Co. Ltd.*, the Supreme Court of India found that an exclusivity covenant in an employment contract binding only for the duration of employment was not a restraint of trade.

Employers have found alternatives to non-compete provisions that offer similar protection. Some companies require their employees to enter into a bond agreement that acts as a sort of replacement for a non-competition agreement. If the company provides the employee with professional training and the employee subsequently leaves the company after a short period of time, the bond provides that the employee is required to reimburse the company

for the cost of his or her training. These bonding arrangements have been held to be enforceable by Indian courts.<sup>34</sup>

#### **F. Other Applicable Employee Related Laws**

*Health and Safety.* Indian law covers the health and safety of its employees extensively under the Factories Act of 1948, the Mines Act of 1952, and the Dock Workers Act of 1986. The government agencies that direct and supervise employee health and safety are the Directorate General of Mines Safety and the Directorate General of Factory Advice Service and Labour Institutes.

*Worker's Rights & Unions.* Workers' rights are generally addressed by the conventions of the International Labour Organization, of which India is a founding member.<sup>35</sup> The conventions are aimed at eradicating and regulating unfair labor practices. The Industrial Disputes Act also regulates labor practices and relations and provides for freedom of association and collective bargaining rights.

Unions are an active part of the Indian workforce and the right to "form associations or unions" is a fundamental right to freedom under the Constitution of India.<sup>36</sup> The Trade Unions Act of 1926 and the International Labour Organization's conventions protect and regulate the activities of the unions.

#### **IV. Independent Contractors**

In the event that employment of Indian nationals is not practical, necessary or economical for a U.S. company, a common alternative is the use of independent contractors. In general, Indian law permits the use of independent contractors and also allows the parties to agree to the terms of the arrangement, including termination. The advantage to a U.S. company of having an independent-contractor relationship rather than an employment relationship with an Indian worker is that the more labor-friendly Indian employment laws described above generally will not apply. Such labor-protective laws generally apply only to employees and independent contractors are generally not included in the common law or statutory definitions of employees.

### A. Independent Contractor Defined

Much like U.S. common law, Indian law employs a number of tests to distinguish an independent contractor from an employee. Traditionally, Indian common law uses a “control test” to determine if an individual is an independent contractor or an employee. As articulated by the Indian Supreme Court in the 1955 decision *Shivnandan Sharma v. The Punjab National Bank, Ltd.* “the test is the existence of a right of control over the agent in respect of the manner in which his work is to be done.”<sup>37</sup> The more control that a company has over the independent contractor, the more likely it is that the independent contractor will be deemed to be an employee of the company.

Recently, the Supreme Court of India lessened the importance of the control test, finding instead that control is one of a number of factors to be considered in distinguishing an employee from an independent contractor. In the 2003 decision in *Ram Singh and Ors. v. Union Territory, Chandigarh and Ors.*, the court found that “it is necessary to take a multiple pragmatic approach weighing up all the factors for and against an employment instead of going by the sole test of control.”<sup>38</sup> The court held that it would utilize the “integration test” in determining whether an individual is an employee. Under the integration test, a court will examine whether individuals are “fully integrated into the employer’s concern” or if they remain apart or independent from it.<sup>39</sup>

Because an independent contractor who is folded into the larger, internal operations of an enterprise may be characterized as an employee, a U.S. company should not treat that individual as they might treat an employee in the ordinary course of business. Rather, companies should conduct business with contractors as they would any other outside service provider. Contractors should maintain a separate business operation from the U.S. company, and all transactions between the contractor and the company should be made at arm’s length.

In addition to the control and integration tests described above, an Indian court will consider a number of other factors, including the following: (a) the terms and conditions of any contract between the parties; (b) where the individual performs the services; (c) who provides the machines and equipment required to perform the services; and (d) a party’s right to reject non-

conforming goods or services.<sup>40</sup> As held in the *Silver Jubilee Tailoring House and Others* decision, a court should consider factors such as the above and “perform a balancing operation weighing up the factors which point in one direction and balancing them against those pointing in the opposite direction.”<sup>41</sup>

### B. Avoiding a Permanent Establishment

A U.S. company with employees and a permanent establishment in India will have to abide by a host of Indian employment and tax laws and will be subject to corporate tax. The relevant law to consider here is the Indo-US Double Tax Avoidance Convention – the main purpose of which is to prevent double taxation of corporate entities operating in the United States and India.<sup>42</sup> Under the convention, corporate entities with a permanent establishment in India are subject to Indian corporate tax and are required to make certain tax withholdings. If a U.S. company has enduring, substantial business in India, such that the business and operations of the company are taking place in India, then the company has a permanent establishment in India and its operations will be subject to Indian taxation.<sup>43</sup>

In general, a U.S. company will not incur Indian corporate tax liability in connection with the use of an independent contractor as long as the U.S. company does not have a permanent establishment in India. A U.S. company is at risk of establishing a permanent establishment in India when the independent contractor is so dependent upon or so integrated into the operations of the U.S. company that he could be deemed to have established an outpost of the U.S. company in India. An agent has an independent status if he is independent both legally and economically and if he acts in the ordinary course of his business when acting on behalf of an enterprise. For example, an agent that acts almost exclusively for one enterprise may have difficulty maintaining the independent status required to prevent being deemed having a permanent establishment. An independent contractor agreement that is “independent” is negotiated at arm’s length and all terms and payment are at market terms and rates.

In summary, if a U.S. company does not have a permanent establishment in India, and enters into an independent contractor agreement with an agent in India, the U.S. company will not be

subject to Indian corporate tax and will not be required to make withholdings from payments made to the independent contractor. In the event that a U.S. company has a permanent establishment in India, then it will be subject to corporate tax and required to make withholdings. If a U.S. company has a permanent establishment in India and an employee in India, then it will be subject to corporate tax, required to make withholdings and will also have to comply with Indian labor laws.

## V. Additional Considerations

### A. Venue and Jurisdiction

India recognizes the parties' right to decide the governing law of an agreement and venue for disputes. While Indian law generally allows parties to decide in which courts a dispute will be decided, there are many exceptions to this rule. For instance, India's civil procedure codes and other legislation provide that local courts have inherent territorial jurisdiction in some matters that cannot be taken away. For example, in the event that a U.S. company desired to have a court grant an injunction against a contractor while the contractor was in India, that injunction would have to be obtained from an Indian court. Since one of the parties to the contractor agreement is in India, working in India and receiving payments in India, no agreement can exclude the inherent jurisdiction of the Indian courts.<sup>44</sup>

To avoid the applicability of the inherent jurisdiction of an Indian court, the parties may choose arbitration for resolving disputes. An arbitration provision could set forth the jurisdiction, arbitrators, law and venue of the parties' choice. However, the parties shall have to approach the courts situated in the jurisdiction of the concerned party in order to enforce any decree that may be passed in such arbitration.

### B. Protecting Intellectual Property Rights

Intellectual property rights are of great concern to any company contracting with foreign nationals, as the company takes the risk that it may lose the protection afforded to it under U.S. law once the property is created by or in the hands of a foreign national. A company must ensure, first, that it will have full ownership of any intellectual property created by a contractor

or its employees and, second, that it will be protected or able to seek remedy in the event that its intellectual property is misappropriated. Intellectual property rights are protected in India under the Patents Act of 1970, the Designs Act of 2000, the Copyright Act of 1957 and the Trade Marks Act of 1999, among other legislation. In addition to domestic intellectual property legislation, India is a party to the Agreement on Trade Related Aspects of Intellectual Property Rights (commonly known as the TRIPS Agreement), which was negotiated at the Uruguay Round of the General Agreement on Tariffs and Trade in 1994 and is administered by the World Trade Organization. The TRIPS Agreement mandates its parties to protect the intellectual property of the nationals of the other parties to the TRIPS Agreement as extensively as they protect the intellectual property of their own nationals. Notwithstanding the broad intellectual property protection provided under Indian and international law, trade secrets are not afforded legal protection in India.

Confidentiality and intellectual property provisions in contracts with Indian nationals may provide adequate trade secret protection for U.S. companies. Such contract provisions must prohibit both the disclosure of confidential information and trade secrets as well as misappropriation by the employee or contractor. The contract must also allow for the enforcement of the employer's rights under the contract, as well as remedies, including damages and injunctive relief. It appears that such contract provisions will be upheld by Indian courts, as demonstrated in *Niranjan Shankar Golikari v. Century Spinning and Mfg. Co. Ltd.*, a case in which the Supreme Court of India upheld an injunction issued against an employee to restrain him from exposing the information and documents of his former employer.<sup>45</sup>

Much like U.S. law, the "works made for hire" doctrine in India, which provides that an employer has ownership of any intellectual property made by an employee in the course of his employment, does not extend to intellectual property created by an independent contractor.<sup>46</sup> A U.S. company should therefore cause its independent contractor to execute a separate agreement assigning all intellectual property created in the course of his engagement to it.

There are a few differences in the intellectual property rights protection provided under Indian

law worth noting. First, unless an intellectual property assignment agreement states otherwise, the term of a copyright assignment is five years and the assignment is confined to India.<sup>47</sup> Assignment agreements should therefore provide that the assignment is perpetual and worldwide. Second, if the assignee under an intellectual property assignment agreement does not use those intellectual property rights within the first year of an assignment, the assignment lapses.<sup>48</sup> Assignment agreements should therefore provide that the rights shall not lapse if the company does not make use of them within one year.

### C. Foreign Corrupt Practices Act

The U.S. Foreign Corrupt Practices Act (the “FCPA”), the United Nations Convention Against Corruption and the Organization for Economic Cooperation and Development Bribery Convention relate to U.S. companies operating abroad and seek to generally prohibit bribery, corruption and undue influence in international business practices.

The FCPA bars companies within the United States from bribing foreign officials. Companies found to have violated the FCPA may be fined up to \$200,000 and are subject to a civil penalty of up to \$10,000.<sup>49</sup> Officers, directors, employees, and agents of these companies who “willfully violate” the FCPA are also subject to fines up to \$100,000, a civil penalty of up to \$10,000, and up to five years in prison.<sup>50</sup> These amounts, however, are based on each incident. Most cases include multiple incidents as noted by the recent multi-million dollar settlements and multiple years of imprisonment recently imposed.<sup>51</sup>

A company may have liability under the FCPA for the actions taken by its independent contractors. The FCPA prohibits not only payments made directly by a company to a foreign official, but also improper influence that is exerted indirectly by the company. Such indirect influence may include payments or bribes made by the independent contractors of U.S. companies. Companies are therefore responsible for educating their agents on what behavior violates these laws, as well as prohibiting their agents from engaging in such behavior by contract.

FCPA planning and compliance strategies are becoming more and more essential to businesses that operate abroad. Since 2007, there has been a markedly increased number of FCPA cases filed by the government. In fact, there have been more FCPA enforcement actions initiated by the Department of Justice and the Securities and Exchange Commission in the last three years than were brought in all prior years combined since the FCPA was enacted in 1977.<sup>52</sup>

### D. Deemed Exports

Companies that turn to the Indian workforce for their information and high tech needs may be unaware that U.S. export laws apply where companies make their technology available to foreign nationals, including their employees and contractors. Technology is defined under such deemed export laws as any information required to develop, produce or use a product.<sup>53</sup> Pursuant to the U.S. Export Administration Regulations, a U.S. company is deemed to have exported technology when it is “released” to a foreign national.<sup>54</sup> A release takes place where technology is made available to foreign nationals to look at, talk about or use.<sup>55</sup> Certain technology, as defined under these regulations, is “controlled” and, as such, is subject to export restrictions. A U.S. company and its attorneys must determine whether the company’s products or technology appear on the Commerce Control List as controlled.<sup>56</sup> Technology appearing on that list may not be exported and as such, a U.S. company would be restricted from making such technology available in any way to its Indian employees or independent contractors. A complete deemed export analysis should be conducted by any company prior to engaging in international export.

### E. Currency Fluctuations

The risk of currency fluctuation is increasingly of concern to U.S. companies operating abroad and contracting with foreign individuals or entities. In the past, companies have not hesitated to contract with foreign nationals in U.S. dollars, but as the dollar weakens against other currencies, such a practice may not be sustainable. The last two to three years have witnessed volatile fluctuation in currency value and the devaluation of the U.S. dollar against the Indian rupee.<sup>57</sup>

In the event that an Indian national is paid in rupees and the dollar weakens against the rupee, the amount paid to the Indian national will increase. If an Indian national is paid in rupees and the dollar strengthens against the rupee, the amount paid to the Indian national will decrease. As long as the exchange rate is favorable to the dollar, such an arrangement is advantageous to the U.S. company and the employee. However, if the exchange rate between the dollar and the rupee experiences fluctuation, U.S. employers and outsourcers may experience a large increase in the cost of Indian labor.

Companies may be able to hedge the risk of currency fluctuation by carefully planning ahead based on expected currency values or by contracting around the issue. Employment and other contracts with Indian nationals may include provisions providing for flexibility or amendment at the employer's option in the event of currency fluctuation. Currency exchange is regulated in India, however, and a U.S. company must comply with exchange control regulation notwithstanding any contract. The Reserve Bank of India is the primary regulator of currency exchange and the Foreign Exchange Management Act of 1999 controls the movement of currency in and out of India.<sup>58</sup>

## VI. Conclusion

The laws discussed in this article are specific to India; however, the legal issues could apply to any foreign workforce. The basic roadmap for any company considering the use of foreign labor is first to determine the shape and structure of its business operations abroad and second to design employment contracts and arrangements that address the legal issues specific to the country. Narrowly-tailored legal advice, documentation and compliance are necessary for any U.S. company in order to assure that the benefits associated with a foreign workforce outweigh any liability.

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<sup>1</sup> Daniel H. Pink, *The New Face of the Silicon Age*, *Wired Magazine* (February 2004), available at [http://www.wired.com/wired/archive/12.02/india\\_pr.html](http://www.wired.com/wired/archive/12.02/india_pr.html).

<sup>2</sup> Ames Gross and John Minot, *Workforce Issues in India HR Needs to Understand*, SHRM India, (2007), available at [http://www.shrm.org/India/o7\\_understand.asp](http://www.shrm.org/India/o7_understand.asp).

<sup>3</sup> Bijesh Thakker, *Services Offshoring to India*, in *Practising Law Institute, Patents, Copyrights, Trademarks, and Literary Property Course Handbook Series*, 48, 43-55, (2008).

<sup>4</sup> Shardul S. Shroff, *Perspectives on Doing Business in India; Issues for U.S. Companies*, in *Practising Law Institute Corporate Law and Practice Course Handbook Series*, 248-249, 278-279, (2008).

<sup>5</sup> *Id.* at 249.

<sup>6</sup> *Id.* at 250.

<sup>7</sup> Thakker, *supra* at 52.

<sup>8</sup> Shroff, *supra*, at 276.

<sup>9</sup> *Id.* at 250.

<sup>10</sup> See the Factories Act of 1948, the Plantation Labour Act of 1951, the Mines Act of 1952, the Contract Labour (Regulation and Abolition) Act of 1970, the Building & Other Construction Workers (Regulation of Employment & Conditions of Service) Act of 1996, the Motor Transport Workers Act of 1961, the Sales Promotion Employees (Conditions of Service) Act of 1976 and the Shops and Establishments Act of 1953, as cited in Priya Khanna and Rekha Daniel, *Employment Law*, in *Corporate Counsel's Guide to Doing Business in India* § 10:2 (2d ed. 2008).

<sup>11</sup> Industrial Disputes Act, § 2(s) at India Code, 1947, Act No. 14.

<sup>12</sup> *Id.*

<sup>13</sup> Thakker, *supra* at 52.

<sup>14</sup> *Id.* at 53.

<sup>15</sup> India Const. Schedule II.

<sup>16</sup> Kerry R. Weinger and Dominika Korytek, *Offshoring and Outsourcing: A Roadmap for the Employer*, in *International HR Journal*, Volume 17, Issue 2 (Spring 2008).

<sup>17</sup> Shroff, *supra*, at 247.

<sup>18</sup> International Labour Organization, *India* (2007), available at [www.ilo.org/public/english/dialogue/ifpdial/info/termination/countries/india.htm#\\_ftn3](http://www.ilo.org/public/english/dialogue/ifpdial/info/termination/countries/india.htm#_ftn3).

<sup>19</sup> Industrial Disputes Act, §2(oo) at India Code, 1947, Act No. 14.

<sup>20</sup> *Id.* at § 25F.

<sup>21</sup> Khanna and Daniel, *supra*, at § 10:48.

<sup>22</sup> A.I.R. 1986 S.C. 1571.

<sup>23</sup> Khanna and Daniel, *supra*, at § 10:50.

<sup>24</sup> Industrial Disputes Act, § 25FFA at India Code, 1947, Act No. 14.

<sup>25</sup> Again, it is important to note that wage and benefits requirements under Indian law may vary depending on whether the employee is a workman or a non-workman.

<sup>26</sup> Khanna and Daniel, *supra*, at § 10:36.

<sup>27</sup> Khanna and Daniel, *supra*, at § 10:37.

<sup>28</sup> Stephen Mathias, *Outsourcing and Offshoring to India*, in Corporate Counsel's Guide to Doing Business in India § 21.8 (2d ed. 2008).

<sup>29</sup> Shroff, *supra*, at 278.

<sup>30</sup> *Id.* at 277.

<sup>31</sup> *Id.* at 278.

<sup>32</sup> Shroff, *supra*, at 278-279.

<sup>33</sup> 1967 A.I.R. 1098, 1967 S.C.R. (2) 378.

<sup>34</sup> Mathias, *supra* at § 22:26.

<sup>35</sup> Thakker, *supra* at 52.

<sup>36</sup> INDIA CONST. art. 19.

<sup>37</sup> A.I.R. 1955 S.C. 1439.

<sup>38</sup> J.T. 2003(8) S.C. 345.

<sup>39</sup> *Id.*

<sup>40</sup> 1974 A.I.R. 37.

<sup>41</sup> 1974 A.I.R. 37.

<sup>42</sup> Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, December 18, 1990, TIAS.

<sup>43</sup> Thakker, *supra* at 52.

<sup>44</sup> Section 20 of the Civil Procedure Code of 1908 states that: "Every suit shall be instituted in Court within the local limits of whose jurisdiction - (a) the defendant, or each of the defendants where there are more than one, at the time of the commencement of the suit, actually and voluntarily resides, or carries on business, or personally works for gain; or (b) any of the defendants, where there are more than one, at the time of the commencement of the suit actually and voluntarily resides, or carries on business, or personally works for gain, provided that in such case either the leave of the Court is given, or the defendants who do not reside, or carry on business, or personally work for gain, as aforesaid, acquiesce in such institution; or (c) the cause of action, wholly or in part, arises."

<sup>45</sup> 1967 A.I.R. 1098, 1967 S.C.R. (2) 378.

<sup>46</sup> Shroff, *supra* at 275.

<sup>47</sup> Copyright Act, § 19 at India Code, 1957, Act No. 14.

<sup>48</sup> *Id.*

<sup>49</sup> 15 U.S.C. § 78dd-2(g)(1).

<sup>50</sup> *Id.* § 78dd-2(g)(2).

<sup>51</sup> Recently, for example, Willbros Group, Inc. agreed to pay a \$22 million fine for violations of the FCPA. See May 14, 2008 Agreement between the DOJ and Willbros Group, Inc., which can be found at [http://lawprofessors.typepad.com/whitecollarcrime\\_blog/files/willbros\\_deferred\\_agreement.pdf](http://lawprofessors.typepad.com/whitecollarcrime_blog/files/willbros_deferred_agreement.pdf). Further, jail terms, including those exceeding five years,

have been imposed for individual employees found to have violated the FCPA. See generally *United States v. Kay*, 513 F.3d 432 (5th Cir. 2007) (upholding a 63-month jail sentence of the president of American Rice, Inc. stemming from FCPA violations in Haiti).

<sup>52</sup> Securities and Exchange Commission, *SEC Announces Fiscal 2008 Enforcement Results* (2008), available at <http://www.sec.gov/news/press/2008/2008-254.htm>.

<sup>53</sup> See Export Administration Regulations 15 C.F.R. Part 772.

<sup>54</sup> See 15 C.F.R. § 734.2(b)(2)(ii).

<sup>55</sup> See 15 C.F.R. § 734.2(b)(3).

<sup>56</sup> The Commerce Control List may be accessed at the U.S. Government Printing Office's website at [www.access.gpo.gov/bis/ear/ear\\_data.html](http://www.access.gpo.gov/bis/ear/ear_data.html).

<sup>57</sup> Juliana Gidwani, *Currency Risk: Overcoming the Dollar's Demise*, in Global Services Insights Research Report, Volume 5, Issue 6 (July 2007) available at [www.neolT.com](http://www.neolT.com).

<sup>58</sup> Thakker, *supra* at 48.

## Expatriation After I.R.C. Sections 877A and 2801

By  
Jin Long Zheng

### I. Introduction

“Taxes are what we pay for civilized society. . . .”<sup>1</sup> However, “there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible . . . . [N]obody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contribution.”<sup>2</sup> Expatriation – renunciation of U.S. citizenship or long-term permanent U.S. resident status – has become an important strategy for many wealthy U.S. citizens and long-term permanent residents desiring to avoid federal tax.<sup>3</sup> Faced with the challenge of revenues loss, in June of 2008, President Bush signed the Heroes Earning Assistance and Relief Tax Act (the “Heart Act”), which amended the 1986 Internal Revenue Code by replacing section 877 with 877A and adding a new section 2801.<sup>4</sup> This article discusses the tax implications of the Heart Act (more specifically the impact of sections 877A and 2801) on expatriates.

### II. Driving Force behind Expatriation – Disparity of Tax Treatment

The United States has been one of the most aggressive countries in asserting its taxing jurisdiction over its citizens and residents<sup>5</sup> by taxing their worldwide income regardless of the source of income or where one lives.<sup>6</sup> In contrast, a nonresident alien is only subject to U.S. income taxation on the income that effectively connects with business or trade in the United States and on certain passive investment income from U.S. sources.<sup>7</sup> For example, if a nonresident alien sells his stock in a corporation, and recognizes gain from the sale, such gain is generally not subject to United States income taxation even if the stock is of a U.S. domestic corporation.<sup>8</sup>

In addition to the disparity in the income tax treatment, nonresident aliens are treated very differently from U.S. citizens and residents with respect to U.S. estate and gift taxes.<sup>9</sup> First, the United States currently imposes on its citizens and residents a estate and gift tax with a maximum rate of 45 percent<sup>10</sup> regardless of the

source of the estate or where the death occurred.<sup>11</sup> On the other hand, a nonresident alien is only subject to an estate tax if the assets of the estate are within the United States.<sup>12</sup> Second, U.S. citizens and residents have to pay a gift tax on tangible or intangible assets, no matter where the assets are located, or where the donor lives.<sup>13</sup> On the other hand, a nonresident alien is only subject to gift tax on certain inter vivo transfers of tangible assets situated in the United States.<sup>14</sup> Because of these disparities in treatment between U.S. citizens or residents and nonresident aliens, the temptation to choose expatriation for tax purpose can be significant.<sup>15</sup>

### III. U.S. Government Efforts in Stopping Tax-Motivated Expatriation

The Expatriation Act of 1868 allowed U.S. citizens to renounce their citizenship.<sup>16</sup> The 1868 act was followed by Foreign Investors Tax Act of 1966, which gave favorable tax treatment to nonresident aliens in order to encourage foreign investment in the United States.<sup>17</sup> Aware that the change might induce some U.S. citizens to expatriate for tax purpose, Congress added section 877 to the Internal Revenue Code.<sup>18</sup> Section 877 created an alternative tax regime, which applies to tax-motivated expatriates for ten years after the expatriation date.<sup>19</sup> However, after ten years, no special tax consequences attach to these expatriates any more.<sup>20</sup>

Thirty years after its enactment, IRC section 877 was amended by the Health Insurance Portability and Accountability Act of 1996, and subsequently further amended by American Jobs Creation Act of 2004.<sup>21</sup> The alternative tax regime under American Jobs Creation Act of 2004 has made significant improvements on the original alternative tax regime.<sup>22</sup> First, in addition to subjecting tax motivated expatriates who renounced their citizenship or long-term permanent residence status to an alternative tax regime ten years following the renunciation,<sup>23</sup> the new alternative tax regime created a presumption of tax avoidance, which will be applicable to the expatriates if they meet certain

requirements. There are only two exceptions to this presumption: dual citizenship and minor.<sup>24</sup> Second, it added to section 7701 a subsection (n),<sup>25</sup> which provides that the date of expatriation should be the date when the expatriates (1) give notice to the Secretary of State or the Secretary of Homeland Security, and (2) provide an information statement under section 6039G.<sup>26</sup> Third, it added to section 877 a new subsection (g), which, with certain exceptions, subjects expatriates to full U.S. taxation if they are physically present in the United States for more than 30 days within any alternative taxable year following the expatriation date.<sup>27</sup> Lastly, it amended section 6039G by requiring an annual information return on the expatriates on their annual income, assets and liabilities as well as the number of days they are physically present in the United States for each taxable year without regard to whether they owe tax to United States or not.<sup>28</sup> Despite these improvements on the original alternative tax regime, the new alternative tax regime was still viewed as a “tiger with no teeth,”<sup>29</sup> primarily for failing to address the concern over patient tax-motivated expatriates who were willing to wait for ten years before selling their assets and the administrative burden of monitoring those expatriates for ten years after the expatriation.<sup>30</sup>

At the time American Jobs Creation Act was being passed, the Treasury Department already recognized that a mark-to-market regime would be more effective in deterring tax motivated expatriation than the alternative tax regime.<sup>31</sup> However, a mark-to-market regime was not adopted in 2004.<sup>32</sup> Instead such a regime was adopted under the Heart Act of 2008 in section 877A, which replaced section 877.<sup>33</sup> The goal of section 877A was to move the alternative tax regime under section 877 to a mark-to-market regime that ensures the tax-motivated expatriates pay their fair share of income tax on the appreciation of their assets.<sup>34</sup> In addition, under the Heart Act of 2008 there is also a newly added section 2801, which imposes transfer tax on U.S. citizens and residents who receive certain gifts or bequests from the covered expatriates under section 877A.<sup>35</sup>

#### **IV. Covered Expatriate under Section 877A**

The right to expatriate is “a natural and inherent right of all people indispensable to the enjoyment of the rights of life, liberty and the pursuit of happiness.”<sup>36</sup> Therefore, the goal of

expatriation provisions is only to deter tax-motivated expatriation while allowing those individuals who truly want to sever their ties with the United States to do so.<sup>37</sup> Therefore, only certain expatriates fall under the framework of section 877A’s mark to market regime.<sup>38</sup> An “expatriate” is defined as any U.S. citizen who relinquishes U.S. citizenship or any long-term U.S. permanent resident who ceases to be a lawful permanent U.S. resident under section 7701(b)(6).<sup>39</sup> If such an expatriate (1) has an average annual net income tax liability exceeding \$124,000<sup>40</sup> for the five taxable years preceding expatriation; (2) has a net worth of \$2 million or more on the date of expatriation; or (3) fails to certify under penalties of perjury that he or she has complied with all Federal tax law for five years preceding expatriation or fails to submit proof of compliance as required by the Secretary of Treasury, then such expatriate will be considered covered expatriate to whom the mark to market rule will apply.<sup>41</sup>

However, in determining whether an expatriate is a covered expatriate, there are two exceptions to the annual income and net worth tests described above.<sup>42</sup> First, an expatriate is not a covered expatriate if he or she became at birth citizen of the United States and another country, but was taxed as a resident in the other country as of the expatriation date, and he or she has not been considered a U.S. resident under the substantial presence test of section 7701(b)(1)(A)(ii) for more than ten taxable years during the fifteen taxable year period ending on the year of expatriation.<sup>43</sup> Second, an expatriate is not covered expatriate if the expatriation occurs before he or she becomes eighteen and half years old, provided that he or she has not been a U.S. resident determined under the substantial test referred to above for more than ten taxable years before the expatriation date.<sup>44</sup>

#### **V. Determination of Covered Expatriate’s Expatriation Date**

The expatriation date for a U.S. citizen is the date when he or she relinquishes his or her U.S. citizenship,<sup>45</sup> which is the earliest of the following: (1) the date on which citizenship is renounced before a consular or diplomatic officer of the United States in accordance with the Immigration and Nationality Act; (2) the date the U.S. Department of State is provided with a signed statement of voluntary relinquishment of citizenship confirming the performance of an act

of expatriation; (3) the date the U.S. Department of State issues a loss of citizenship certificate; or (4) the date a U.S. court cancels a naturalized citizen's certificate of naturalization.<sup>46</sup> The first and second dates mentioned above are effective only if the renunciation and voluntary relinquishment is subsequently approved by the U.S. Department of State by issuance of a certificate of loss of nationality.<sup>47</sup> This is different from section 7701(n) adopted under the American Jobs Creation Act of 2004, which required the expatriation date for tax purpose to be determined not only by Department of State under the nationality law, but also in accordance with Internal Revenue Code section 6039G.<sup>48</sup>

The expatriation date determination provision under section 7701(n) was challenged for violating Congress' prescriptive taxing jurisdiction under customary international law and its constitutionality was questioned.<sup>49</sup>

A long-term U.S. permanent resident is any individual who is lawful permanent resident<sup>50</sup> of the United States in at least eight taxable years during the period of fifteen taxable years ending with the year of the cease of lawful permanent residence status.<sup>51</sup> Such long-term permanent resident will be considered a covered expatriate if he or she terminated lawful permanent residence status and meets the requirement under subparagraph A, B, or C of section 877(a)(2), the same as for the relinquishment of citizenship, but without any exceptions.<sup>52</sup> The expatriation date will be the date when any long-term permanent resident ceases to be a lawful permanent resident of the United States.<sup>53</sup> An individual shall cease to be treated as a U.S. lawful permanent resident for all tax purposes if (1) he or she begins to be treated as a resident of foreign country that the United States has tax treaty with, (2) does not waive the benefits of the treaty applicable to him or her as a resident of the treaty state, and (3) informs the Secretary of Treasury of the starting of such treatment.<sup>54</sup> Here, such lawful permanent resident can take advantage of the tax treaty as long as he or she is not considered a long-term permanent resident, and thus the mark-to-market regime will not apply.

#### **VI. The Mark-to-Market Regime under Internal Revenue Code Section 877A**

The mark-to-market regime imposes income tax on world wide property of the covered

expatriates before the expatriation date for its fair market value over its adjusted basis even if the property was not sold.<sup>55</sup> Covered expatriates have to recognize this gain without regard to other provision of the Internal Revenue Code.<sup>56</sup> However, the first \$600,000 gain does not have to be recognized.<sup>57</sup> In the case of a loss, it is recognized to the extent otherwise provided in the Internal Revenue Code.<sup>58</sup> The mark-to-market regime forces the covered expatriates to recognize the accrual gain during citizenship or long-term permanent residence status right at the time of expatriation.<sup>59</sup> It solves the problem under the alternate tax regime where the patient expatriates could wait for ten years to sell their property to avoid being tax on the gain.<sup>60</sup> It also provides a deterrence effect and administrative ease by not having to keep track of these individuals for ten years after their expatriation.<sup>61</sup> Notwithstanding the mark-to-market regime's above advantages over the alternative tax regime, it was criticized as being unconstitutional and interfering with rights to emigrate under international law.<sup>62</sup>

In order to soften the harshness of realization of gain at the time of expatriation under the mark-to-market regime of section 877A, these covered expatriates are allowed to make election of deferral or installment payment on the tax due after the expatriation.<sup>63</sup> The election can be made on a property by property basis.<sup>64</sup> The tax is deferred until covered expatriates sell the property or death of covered expatriates or if disposed of without recognizing gain, then until a date prescribed by the Secretary of Treasury.<sup>65</sup> But covered expatriates have to pay interest on the deferred tax, and have to post a bond or other security instrument such as letter of credits to the satisfaction of the Secretary of Treasury.<sup>66</sup> The election is irrevocable and when made, the covered expatriates waive any right under any tax treaty of the United States that may preclude the collection of such tax.<sup>67</sup>

#### **VII. Gifts or Bequests from Covered Expatriates under Section 2801**

United States citizens or residents are subject to estate or gift tax wherever property situated.<sup>68</sup> A nonresident alien is only subject to estate tax on property situated in United States such as real estate, tangible property located within the United States, and stocks in U.S. domestic corporations.<sup>69</sup> Nonresident aliens also are generally subject to a gift tax on gift transfer of

U.S. property such as real and tangible property in United States but excluding intangibles like stocks without regard to whether stocks are of U.S. domestic corporations or foreign corporations.<sup>70</sup> Therefore, under such a tax system, covered expatriates could avoid paying gift tax when he wants to give real or tangible property to his or her relatives by simply transferring the property to a U.S. domestic corporation and then giving away the stocks of such corporation to that intended relatives.<sup>71</sup> The gifts and bequests generally are not included in the recipient's income.<sup>72</sup> To stop such abuse, section 2801 imposes tax on the recipient, U.S. citizen or resident, of covered gift or bequest.<sup>73</sup> Covered gift or bequest is any property acquired by gift directly or indirectly from a covered expatriate defined under section 877A at the time of acquisition or any property acquired directly or indirectly from the death of an individual that was a covered expatriate defined under section 877A before death.<sup>74</sup> However, a covered gift or bequest does not include (1) any property shown as taxable gift on a timely filed return of tax imposed by chapter 12 by the covered expatriate, (2) any property shown on a timely filed return of tax imposed by chapter 11 of the covered expatriate's estate and (3) any property that would be allowed deduction under section 2055, 2056, 2522 or 2523 as if the decedent or donor were a United States person.<sup>75</sup>

The covered gift or bequest taxes are to be paid by the recipient of such gifts or bequests.<sup>76</sup> The tax only applies to the amount of gifts or bequests exceeding the amount in effect under section 2503b for that calendar year (which is 12,000 for 2008).<sup>77</sup> The tax is equal to the product of highest marginal tax rate of estate tax under section 2001(c) or if greater, the highest marginal tax rate of gift tax under section 2502(a) on the date of receipt and the value of covered gift or bequest.<sup>78</sup> The recipient is entitled to the deduction of foreign tax paid on the covered gifts or bequests from the U.S. tax.<sup>79</sup>

Regarding the transfer of covered gifts or bequests into a trust, section 2801 distinguishes between U.S. domestic and foreign trusts.<sup>80</sup> In the case of transfer of the covered gifts or bequests to a U.S. domestic trust, the tax should apply to the trust as if the trust were a U.S. citizen, and the trust is liable to pay the covered gift or bequest tax.<sup>81</sup> As in the case of transfer

of covered gifts or bequests to a foreign trust, the distribution of either income or corpus from the foreign trust to a U.S. citizen or resident, the recipient here has to pay the covered gift or bequest tax on the distribution.<sup>82</sup> However, the recipient is entitled to deduction under section 164 for the amount of the tax paid to extent that such distribution is included in the gross income of the recipient.<sup>83</sup> The foreign trust here can elect to be treated as domestic trust, and the election may be revoked with consent of the Secretary of Treasury.<sup>84</sup>

In order for section 2801 to be applicable, the assumption that the covered expatriates do not intend to expatriate as a whole family including their heirs to avoid estate and gift tax has to be valid. The covered gift or bequest does not include gift or bequest from covered expatriates before the enactment of section 877A and 2801, i.e., June 17, 2007.<sup>85</sup>

### VIII. Conclusion

The most effective way to disapprove tax-motivated expatriation is to take away the tax benefit.<sup>86</sup> The mark-to-market regime under section 877A forces the tax-motivated expatriates to recognize gain at the expatriation date without actual sale and, therefore, could significantly deter income tax avoidance expatriates. However, section 877A does not cover estate and gift tax avoidance.<sup>87</sup> Although section 2801 tax on the recipient of gifts or bequests from the covered expatriate helps in deterring estate and gift tax motivated expatriation, it only applies to the recipient who is a U.S. citizen or resident,<sup>88</sup> and therefore will be less useful where the covered expatriate's heirs and donees decide to expatriate as well.<sup>89</sup>

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<sup>1</sup> *Compania General de Tabacos de Philipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

<sup>2</sup> *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, J., dissenting).

<sup>3</sup> Richard A. Westin, *Expatriation and Return: An Examination of Tax-Driven Expatriation by United States Citizens, and Reform Proposals*, 20 VA. TAX REV. 75, 87-89 (Summer 2000).

<sup>4</sup> Internal Revenue Amendments, Pub. L. No. 110-245, § 301, 122 Stat. 1624, 1638-48 (2008) (codified at I.R.C. § 877A and § 2801 (2008)).

<sup>5</sup> There are three ways that an individual can be considered a resident: (1) lawfully admitted for permanent residence so called green card test; (2) substantial presence test; (3) first year election. I.R.C. § 7701(b)(1). An individual is considered a resident under substantial presence test if (A) he stays in the United States for at least 31 days in the current taxable year and (B) the number of days he stays in the United States in the current taxable year, plus the number of days he stays in the United States during the previous two years, is equal to or exceeds 183 days. In calculating days, one day in the current taxable year is equal to one day. One day in the immediately preceding year is equal to one-third of a day, and one day in the year immediately preceding such year is equal one-sixth of a day. I.R.C. § 7701(b)(3). As long as one does not stay more than 122 days for each year in a consecutive three-year period, one will not be considered a U.S. resident for the current year, and there are exceptions in section 7701(b)(2)(B) as well.

<sup>6</sup> Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863, 870 (March 2004). The Supreme Court held that Congress has power to tax income of a U.S. citizen residing abroad even if the income is sourced from abroad because "the government, by its very nature, benefits the citizen and his property wherever found." *Cook v. Tait*, 265 U.S. 47, 56 (1924).

<sup>7</sup> Kirsch, *supra* note 6, at 870.

<sup>8</sup> *Id.* A domestic corporation means a corporation created or organized in the United States or under the laws of the United States or of any State. I.R.C. § 7701(a)(4) (2008).

<sup>9</sup> Michael S. Kirsch, *The Tax Code as Nationality Law*, 43 HARV. J. ON LEGIS. 375, 379 (Summer 2006).

<sup>10</sup> I.R.C. § 2001(c)(2)(B).

<sup>11</sup> Kirsch, *supra* note 6, at 871. "Resident" as defined under Internal Revenue Code for income tax purpose is different from "resident" as defined for estate and gift tax purposes, which is based on domicile. See Kirsch, *supra* note 6, footnote 29.

<sup>12</sup> *Id.* at 871-72.

<sup>13</sup> *Id.* at footnote 31.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 873. For example, a number of billionaires have already left: Michael Dingman, the former chairman of Abex, Inc., who went to Belize; John Dorrance III, heir to the Campbell Soup fortune, who went to Ireland; Kenneth Dart, president of Dart Container Corporation; and Ted Arison, the founder of Carnival Cruise Lines, who returned to his native Israel. See Westin, *supra* note 3, at 87-89.

<sup>16</sup> Elise Tang, Note, 31 BROOK. J. INT'L L. 615, 621 (2006).

<sup>17</sup> Kirsch, *supra* note 6, at 877.

<sup>18</sup> *Id.* at 878.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at 879.

<sup>21</sup> Tang, *supra* note 16, at 622-24.

<sup>22</sup> *Id.* at 629.

<sup>23</sup> *Id.* at 630.

<sup>24</sup> *Id.* at 630-31.

<sup>25</sup> Section 7701(n) is stricken under the Heart Act of 2008. See Internal Revenue Amendment, *supra* note 4, at 1646.

<sup>26</sup> Tang, *supra* note 16, at 632.

<sup>27</sup> *Id.* at 633.

<sup>28</sup> *Id.* 633-34.

<sup>29</sup> *Id.* at 635.

<sup>30</sup> *Id.* at 640.

<sup>31</sup> *Id.* at 636.

<sup>32</sup> *Id.* at footnote 158.

<sup>33</sup> See Internal Revenue Amendment, *supra* note 4.

<sup>34</sup> 154 CONG. REC. S 4772-02, (daily ed. May 22, 2008) (statement of Sen. Baucus).

<sup>35</sup> See Staff of Joint Comm. On Taxation, Technical Explanation of H.R. 6081, The "Heroes Earnings Assistance and Relief Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on May 20, 2008, 36, 40 (Comm. Print JCX-44-08, 2008), available at <http://www.jct.gov/x-44-08.pdf> [hereinafter 2008 JCT Report].

<sup>36</sup> Kenneth D. Heath, *The Symmetries of Citizenship: Welfare, Expatriate Taxation, and Stakeholding*, 13 GEO. IMMIGR. L.J. 533, 543 (Summer 1999).

<sup>37</sup> Tang, *supra* note 16, at 624.

<sup>38</sup> See 2008 JCT Report, *supra* note 35, at 40.

<sup>39</sup> I.R.C. § 877A(g)(2) (2008).

<sup>40</sup> \$124,000 is adjusted for cost of living after 2004, and it is \$139,000 in 2008. See 2008 JCT Report, *supra* note 35, at 40.

<sup>41</sup> I.R.C. § 877A(g)(1)(A); I.R.C. § 877(a)(2); I.R.C. § 877A(a)(1).

<sup>42</sup> I.R.C. § 877A(g)(1)(B).

<sup>43</sup> I.R.C. § 877A(g)(1)(B)(i).

<sup>44</sup> I.R.C. § 877A(g)(1)(B)(ii).

<sup>45</sup> I.R.C. § 877A((g)(3)(A).

<sup>46</sup> I.R.C. § 877A(g)(4).

<sup>47</sup> *Id.*

<sup>48</sup> Kirsch, *supra* note 9, at 383.

<sup>49</sup> Kirsch, *supra* note 9, at 435.

<sup>50</sup> A lawful permanent resident is an individual who having been lawfully accorded privilege of residing permanently in

the United States as immigrant according to immigration law and such status has not been revoked. I.R.C. § 7701(b)(6).

<sup>51</sup> I.R.C. § 877A(5); I.R.C. § 877(e)(2).

<sup>52</sup> I.R.C. § 877A(g)(2)(B).

<sup>53</sup> I.R.C. § 877A(g)(3)(B).

<sup>54</sup> I.R.C. § 7701(b)(6).

<sup>55</sup> I.R.C. § 877A(a)(1). There is exception for certain property. See I.R.C. § 877A(c).

<sup>56</sup> I.R.C. § 877A(a)(2)(A).

<sup>57</sup> I.R.C. § 877A(a)(3)(A).

<sup>58</sup> I.R.C. § 877A(a)(2)(B).

<sup>59</sup> Tang, *supra* note 16, at 644.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* at 654.

<sup>62</sup> The mark-to-market regime was introduced in the Clinton administration. See Kirsch, *supra* note 6, at 883-85. After thorough analysis of the judicial decisions and legal commentaries, the Joint Committee on Taxation noted in their 1995 report that the mark-to-market regime generally will be able to withstand the constitutional challenges of violation of non realization doctrine under the Sixteenth Amendment and the due process violation under the Fifth Amendment. See STAFF OF JOINT COMM. ON TAXATION, ISSUES PRESENTED BY PROPOSALS TO MODIFY THE TAX TREATMENT OF EXPATRIATION, 69-100 (Comm. Print JCS-17-95, 1995), available at <http://www.house.gov/jct/s-17-95.pdf>.

<sup>63</sup> See I.R.C. § 877A(b).

<sup>64</sup> 2008 JCT Report, *supra* note 35, at 41.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 42.

<sup>67</sup> *Id.* at 42; see also I.R.C. 877A(b)(5).

<sup>68</sup> 2008 JCT Report, *supra* note 35, at 36.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> Westin, *supra* note 3, at 94.

<sup>72</sup> Kirsch, *supra* note 6, at 884.

<sup>73</sup> 2008 JCT Report, *supra* note 35, at 45.

<sup>74</sup> *Id.*; I.R.C. § 2801(e)(1).

<sup>75</sup> 2008 JCT Report, *supra* note 35, at 45; I.R.C. § 2801(e)(2).

<sup>76</sup> I.R.C. § 2801(b).

<sup>77</sup> I.R.C. § 2801(c).

<sup>78</sup> 2008 JCT Report, *supra* note 35, at 45; I.R.C. § 2801(a).

<sup>79</sup> 2008 JCT Report, *supra* note 35, at 45; I.R.C. § 2801(c).

<sup>80</sup> I.R.C. 2801(e)(4).

<sup>81</sup> I.R.C. 2801(e)(4)(A).

<sup>82</sup> 2008 JCT Report, *supra* note 35, at 45; I.R.C. § 2801(e)(4)(B)(i).

<sup>83</sup> 2008 JCT Report, *supra* note 35, at 45; I.R.C. § 2801(e)(4)(B)(ii).

<sup>84</sup> I.R.C. 2801(e)(4)(B)(iii).

<sup>85</sup> Internal Revenue Amendment, *supra* note 4, at 1647.

<sup>86</sup> Tang, *supra* note 16, at 646.

<sup>87</sup> Westin, *supra* note 3, at 182.

<sup>88</sup> I.R.C. § 2801(a).

<sup>89</sup> However, newspaper accounts of what happens in the real world report that most heirs and donees of expatriates remain in the United States. See Westin, *supra* note 3, at 184.

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