Leaving it all Behind
The Expatriation Tax

Summary

While the reasons that individuals seek to forfeit their US citizenship or long-term residency status may be unique to the thousands that choose to expatriate each year, many hope to escape the onerous consequences of our citizenship-based tax system in favor of less green(back) pastures. But it may be easier said than done as the US tenaciously imposes income, gift and estate taxes on those who attempt to flee. This course will help practitioners determine who is subject to the exit tax, how it is computed, when it must be reported, and when it must be paid.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

Instructor

Monica Haven, E.A., J.D. will happily address follow-up questions. You may contact her at:

(310) 286-9161 PHONE
(310) 557-1626 FAX
mhaven@pobox.com
www.mhaven.net

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I. We're outta here![1]

Writer T.S. Eliot of St. Louis, Missouri moved to the United Kingdom and relinquished his US citizenship in 1927. Entertainer Josephine Baker gave up her citizenship in 1937 disgusted by the overt racism against blacks she experienced. German-born artist Max Ernst immigrated in 1941 but turned in his American passport to become a French citizen in 1958, the same year that Earl Tupper (Tupperware) renounced. Film director John Huston emigrated to Ireland in protest over the activities of the House Committee on Un-American Activities and renounced US citizenship in 1964. Actor Yul Brynner relinquished in 1965; opera singer Maria Callas renounced in 1966; Christina Onassis renounced in 1975 and donated the American portion of her holdings in her father's company to the American Hospital of Paris in 1975. Queen Noor forfeited her US citizenship and became a Jordanian citizen when she married King Hussein in 1978. Financier John Templeton left Wall Street behind in 1986. Martial artist Jet Li moved to Singapore and renounced his US citizenship in 2009. Born in Brazil but naturalized in 1996, Eduardo Saverin (Facebook) renounced his US citizenship in 2011. Tina Turner, Rock and Roll Hall of Famer, relinquished her US citizenship and became a Swiss citizen in 2013. Current British Prime Minister, American-born Alexander Boris de Pfeffel Johnson relinquished his US citizenship in anger when the IRS demanded tax on the sale of his London home in 2016.

Elizabeth Taylor renounced her citizenship not just once but twice; first in 1965 and again a year later. Famous for her many marriages, Taylor's first divorce from Richard Burton in 1974 was followed by remarriage in the next year and a second divorce in 1976; similarly, Taylor became a US citizen a second time in 1977 – one of only a handful of ex-citizens granted the opportunity to repatriate. In fact, Roger Ver (the "Bitcoin Jesus") renounced in 2014, obtained a passport from the Caribbean islands of St. Kitts and Nevis, and was denied entry into the US a year later when he merely wanted to attend a conference in Miami, not repatriate.

As it turns out St. Kitts and Nevis – officially known as the Federation of Saint Christopher and Nevis – offers foreigners the option to become citizens-by-investment. The program established in 1984 and revamped in 2016, offers citizenship for life that can be passed on to future generations in exchange for a $400K purchase of real estate or a $250K contribution to the Sugar Industry Diversification Fund. It seems that poker player Adam Bilzerian (son of accused market manipulator Paul Bilzerian) did just that in 2008.

Chess grandmaster Bobby Fischer became a man without a country when he violated US economic sanctions against Yugoslavia to reclaim his championship title against Boris Spassky in 1992. Thereafter, Fischer lived abroad in relative obscurity until he was detained in Tokyo for using a US passport that had been revoked due to an outstanding arrest-warrant issued by the US government. When Japan sought to deport Fisher, Iceland came to his rescue and offered him citizenship in 2005.

The list of US citizens who have chosen to expatriate is long but hardly exclusive. Just shy of 3,000 individuals renounced their US citizenship or terminated long-term US residency in the first quarter of 2020, a 40% increase from the prior year and a 90% increase from a decade ago, potentially foretelling of ever escalating numbers.[2] Reasons vary; including everything from a desire to return to family roots, marry a foreign national, accept a diplomatic appointment, pursue a political career, represent an athletic team at the Olympics, avoid deportation from a foreign country, evade the draft,

[1] The author has borrowed the phrase from the title of The Ramones' fourth live album (released on November 18, 1997).

[2] Federal Register, *Quarterly Publication of Individuals, Who Have Chosen to Expatriate, as Required by Section 6039G* (85 FR 27507, May 8, 2020) [available at https://www.federalregister.gov/documents/2020/05/08/2020-09814/quarterly-publication-of-individuals-who-have-chosen-to-expatriate-as-required-by-section-6039g, last accessed May 16, 2020].

or because dual citizenship is not an available option.[3] Some expatriates have publicly stated their desire "to be free from the silly US laws" [Vince Cate, encryption expert, 1994][4], to protest America's participation in the Korean War [Stefan Heym, WWII refugee from Germany, 1953][5], to obtain release from detention as an enemy combatant [Yaser Hamdi, American detained since by the US-allied Northern Alliance in Afghanistan, 2004][6], or to become a citizen of the world [Garry Davis, activist, 1948].[7]

Many have not given a reason; they don't have to. But those of us left behind may collectively speculate. *Forbes* reports that some Americans have left because they "say that the US tax and disclosure laws are downright oppressive."[8] US taxpayers living abroad are particularly hard-hit as they must file US tax returns on worldwide income, which may already be taxed by their resident countries. While US citizens may avail themselves of treaty benefits or claim the Foreign Earned Income Exclusion and/or the Foreign Tax Credit, the effect of double taxation is not always fully mitigated; most certainly, the reporting requirements are not eliminated.

Additionally, foreign account reporting has become ever more onerous, along with incredibly steep penalties for failure to comply. And, as financial institutions throughout the world discover that *they* must comply with the complex and burdensome rules of the Foreign Account Tax Compliance Act (FATCA), Americans abroad often become personae non gratae for even the simplest of banking activities. Sometimes it's just easier to say goodbye!

II. History of Citizenship Taxation

With the exception of Eritrea,[9] the US is the only other country in the world that relies on a system of citizenship- rather than residency-based taxation. Under the US tax regime, US citizens – regardless of where they reside and regardless of the geographic source of income – are subject to US taxation.

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[3] American-born, Japanese ice dancer Cathy Reed was asked to relinquish her US citizenship as dual citizenship is not permitted under Japanese law after the age of 22.

[4] Wayner, *Encryption Expert Says US Laws Led to Renouncing of Citizenship*, Technology CyberTimes, September 6, 1998 [available at http://partners.nytimes.com/library/tech/98/09/cyber/articles/06encrypt.html, last accessed May 16, 2020].

[5] Binder, *Stefan Heym, Marxist-Leninist Novelist, Dies at 88 on Lecture Tour in Israel*, The New York Times, December 18, 2001 [available at https://www.nytimes.com/2001/12/18/arts/stefan-heym-marxist-leninist-novelist-dies-at-88-on-lecture-tour-in-israel.html?pagewanted=all, last accessed May 16, 2020].

[6] *Hamdi voices innocence, joy about reunion*, CNN.com, October 14, 2004 [available aat https://www.cnn.com/2004/WORLD/meast/10/14/hamdi/index.html?_s=PM:WORLD, last accessed May 16, 2020].

[7] Fox, *Garry Davis, Man of No Nation Who Saw One World of No War, Dies at 91*, The New York Times, July 28, 2013 [available at https://www.nytimes.com/2013/07/29/us/garry-davis-man-of-no-nation-dies-at-91.html?pagewanted=all&_r=0, last accessed May 16, 2020].

[8] Wood, *Americans Renouncing Citizenship up 221%, All Aboard the FACTA Express*, Forbes, February 6, 2014 [available at http://www.forbes.com/sites/robertwood/2014/02/06/americans-renouncing-citizenship-up-221-all-aboard-the-fatca-express/ , last accessed May 16, 2020].

[9] Eritrea – located on the horn of Africa – charges Eritreans who live overseas a flat tax of 2% on all income earned. Outraged by the practice, the UN Security Council condemned Eritrea for "using extortion, threats of violence, fraud and other illicit means to collect taxes outside of Eritrea from its nationals" [Resolution 2023] and Canada even expelled the head of the Eritrean consulate to protest the practice. [Giambruno, *Only Two Countries Do This Appalling Thing – And the US is One of Them* [available at https://internationalman.com/articles/this-appalling-practice-is-only-used-in-two-nations-and-the-us-is-one-of-th/, last accessed May 16, 2020)].

Interestingly, the US did not always rely upon citizenship-based taxation. In fact, the first income tax enacted in 1861, specifically excluded overseas income. The Revenue Act was designed to fund what was expected to be a short-lived Civil War and imposed a 3% tax on annual income in excess of $800. The following year, Congress introduced a progressive tax, a standard deduction and employer withholdings to fund the protracted war effort.[10]

The civil war tax passed quietly into oblivion ten years later. A new version of the income tax was introduced in 1894 but was declared unconstitutional within a year.[11] Fourteen years later, the income tax was reincarnated under the 16th Amendment of the US Constitution and it seems to have withstood the test of time, surviving more than a century of Congressional tinkering and judicial challenges since 1913.

A. The Modern Income Tax

In 1916, the original language of the 16th Amendment was changed from a tax on "lawful income" to "income from whatever source derived", thereby including the income of every US citizen, whether residing at home or abroad. Despite inevitable challenges to the broad nature of the law, the Supreme Court upheld the constitutionality of the taxation of Americans on foreign-source income.

> *"…the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, if being in or out of the United States, and was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen."*[12]

Although Congress has never since made any attempt to rescind the taxation of US citizens abroad, various provisions have been enacted to mitigate the deleterious effects upon taxpayers subject to multiple taxing authorities. The Foreign Tax Credit introduced in 1918 allowed Americans to claim a credit for taxes paid to a foreign government[13] and in 1926, the Foreign Earned Income Exclusion allowed taxpayers to shield an unlimited amount of foreign earnings (but not investment income) from US taxation if they lived abroad for at least six months in any calendar year.[14] The exclusion was later limited to $20,000 per year, rising to $35,000 annually for those still living abroad after three years.[15] The limitation was raised in fits in starts during the next several decades and finally adjusted for inflation beginning in 2005.[16] It is currently set at $107,600 in 2020.

[10] In the same year (1862), the Office of Commissioner of Internal Revenue was established.

[11] In *Pollock v Farmers' Loan & Trust Co.,* the court held that the 1894 tax law was unconstitutional since it imposed taxes on personal income derived from real estate investments, stocks, and bonds. Deemed to be a direct tax, it violated the requirement that the income tax must be apportioned among the states. Language of the 16th Amendment later gave Congress the "power to lay and collect taxes on incomes… without apportionment" [157 US 429 (1895)].

[12] In *Cook v. Tait,* a US citizen living in Mexico challenged the tax assessed on rental income derived from his foreign real estate holdings. The court reasoned that "government, by its very nature, benefits the citizen and his property wherever found" and that an American who carried the protection of his country's citizenship with him, should not be allowed to escape the burdens of said citizenship [265 US 47(1924)].

[13] Revenue Act of 1918, Ch. 18, 40 Stat. 1057, §240(c).

[14] Revenue Act of 1926, Ch. 27, §213(b)(14), 44 Stat. 9 (1926).

[15] Revenue Act of 1962, P.L. 87-834, Ch. 11, 76 Stat. 960 (196).

[16] Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, §911.

Alas, neither the Foreign Tax Credit nor the Foreign Earned Income Exclusion serve to make the taxation of US citizens abroad entirely fair or even comparable to that of US residents. Non-resident citizens, for example may not claim deductions for contributions made to charities in their host countries and cannot make tax-free transfers of their estates to non-citizen spouses.

B. A Punitive Tax

As our world becomes smaller – or at least ever-more accessible – an increasing number of Americans are living and working abroad. Indeed, the growth of foreign earnings of US citizens has outpaced the growth of domestic earnings by roughly four to one.[17]

Whether those who have chosen to reside overseas or those who are merely "accidental" Americans born into unwanted citizenship, the diaspora of US taxpayers remains shackled to a tax regime that was once designed to punish Civil War draft dodgers but today penalizes those who seek to be economically mobile. Whether in protest or out of economic necessity, ever more US citizens have renounced their citizenship.

To stem the flow or at a minimum introduce a deterrent to expatriation, Congress in 1966 enacted a ten-year tax on US-source income of individuals whose motive for expatriation was tax avoidance.[18] The law, however, was unenforceable since the IRS was not informed of expatriations and was unable to objectively determine whether the taxpayer's departure was motivated by "tax avoidance." Thirty years later, the law was revised to *presume* that high net worth individuals chose to expatriate for no other reason than to avoid the payment of US taxes.[19] With yet another revision in 2004, this presumption became a definition which held that all departing taxpayers who met legislated income or net worth thresholds were incontrovertibly leaving for no other reason than that of tax avoidance![20]

To add insult to injury, Congress mandated that the IRS publish the names of all who renounce citizenship to publicly shame those "that America has given so much to" but who "care so little about citizenship that they would flee in order to avoid taxes."[21] Indeed, the data is readily available on a quarterly basis in the Federal Register.[22]

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[17] *Background and History of Tax on U.S. Expatriation*, Taxes for Expats (available at https://www.taxesforexpats.com/expat-tax-advice/Background-and-History-of-Tax-On-Expatriation.html, last accessed May 16, 2020).

[18] The Foreign Investors Tax Act of 1966, P.L. 89-909, §877(a).

[19] Health Insurance Portability and Accountability Act of 1996, P.L. 104-91, §511(a)(2).

[20] American Jobs Creation Act of 2004, P.L. 108-357, §804(a).

[21] Rep. Charles Rangel (D-NY), 1995.

[22] A daily publication of the US government available at https://www.federalregister.gov/ (last accessed May 16, 2020).

III. The Expatriation Tax[23]

But leaving is not easy and does not come cheaply. Knowing that it would likely be difficult if not impossible to collect tax from afar, Congress has enacted laws to ensure that US citizens and residents pay their fair share long before they escape the collection clutches of the US Treasury. The Expatriation Tax is an asset-based tax designed to discourage US citizens from taking assets and their attendant income streams out of the federal system of taxation.

The tax is onerous, just as it is intended to be. But, it seems, it is not yet onerous enough as we hear news story after news story of US taxpayers packing it up and moving out with all of their wealth in tow. *The Huffington Post*, for example, reports that super-rich Democratic donor Denise Rich "gave up her passport to permanently move to Europe" in an attempt to avoid US taxation.[24] Apparently for some, it is cheaper to leave and pay an exit tax than it is to stay and pay the income tax.

A. Pay to Leave

In 2008, Congress unanimously approved a new tax designed to raise revenues to fund increased veterans' benefits authorized by the Heroes Earnings Assistance and Relief Tax Act (HEART). Dubbed the "Billionaires' Amendment" by Senator Edward Kennedy (D-Mass.), this tax was designed to nab the super-rich but in actuality applies to all "covered expatriates", defined as US citizens or long-term permanent residents who leave the US and meet one of the following tests:[25]

- Income Tax Test – the average annual US income tax liability during most recent 5 years prior to expatriation must be over $157,000 [in 2020];[26]
- Net Worth Test – net assets must exceed $2 million on the date of expatriation;[27] OR
- Compliance Test – the expatriate must be able to certify that he has met all US tax filing obligations for the most recent five years prior to expatriation.

NOTE: The reason for leaving no longer matters.[28] As per IRC §877A,[29] the tax will apply to all covered expatriates, so classified based on one of these three objective tests.

[23] IRC §§877 and 877A.

[24] *American Expat Taxpayers Would Rather Ditch Citizenship than Face New IRS Rules*, Huff Post, April 27, 2013 [available at http://www.huffingtonpost.com/2012/11/09/american-expat-taxpayers-would-rather-ditch-citizenship-than-face-new-irs-rules_n_2094559.html, last accessed May 16, 2016].

[25] Different rules apply depending upon the date of expatriation – details are available at http://www.irs.gov/Individuals/International-Taxpayers/Expatriation-Tax (last accessed May 16, 2020).

[26] This amount has since been indexed for inflation – the applicable amounts for each year are: $145,000 (2009 & 2010), $147,000 (2011), $151,000 (2012), $155,000 (2013), $157,000 (2014), $160,000 (2015), $161,000 (2016), $162,000 (2017), $165,000 (2018), $168,000 (2019), and $171,000 (2020).

[27] If assets are denominated in a foreign currency, they must be converted to US dollars on the date of expatriation using the exchange rate published by the US Treasury or any other verifiable exchange rate.

[28] Billionaire Kenneth Dart renounced his US citizenship in 1994, became a citizen of Belize and then was promptly appointed by the Belizean government to become a consular officer in Sarasota, Florida, allowing him to continue to live his lavish lifestyle right where he had begun without paying any tax to the US government. In retaliation, (now)-Senator Jack Reed (D-RI) introduced the Expatriate Exclusion Clause (a.k.a. Reed Amendment) that denied re-entry into the US to any former citizen who renounced for the purpose of tax avoidance [8 USC §1182(a)(10)(E)]. The law stands to this day but remains unenforceable a taxpayer's motive cannot be objectively ascertained. In fact, "tax avoidance" is neither mentioned nor considered under current law which instead relies upon incontrovertible criteria by which to determine whether an expatriate is "covered" and, therefore, subject to the exit tax.

[29] Effective June 18, 2008.

US Citizens

It is critical to note the distinction between citizenship for nationality purposes versus tax purposes. Richardson distinguishes the two in this manner:

> *"Americans have always been proud of their U.S. citizenship. Most U.S. citizens regard their U.S. citizenship as the most valuable thing they have. Most Americans will fight for their citizenship. They will die for their citizenship. They believe that their U.S. citizenship gives them rights and privileges that citizens of other nations simply do not have."*[30]

There are but few actual rights bestowed on citizens; these include the right to enter the US (with a valid passport), the right to work, and the right to vote (subject to state regulations). Then in 2014, Congress conferred an additional right on US citizens – the right to pay taxes.[31] Ever since, the IRS distinguishes between national and tax citizenship and it has become possible to relinquish one without the other.

To give up tax citizenship requires specific affirmative actions by the taxpayer; it cannot simply be forfeited by allowing a passport to expire or by travelling and remaining abroad. Prior to 2004, a citizen by nationality was also a tax citizen. In those olden days, an individual could give up his nationality and, thereby, automatically and simultaneously terminate his citizenship for tax purposes.

Regulations since proscribe complex methodologies by which to relinquish tax citizenship depending upon the date of the relinquishment and applicable law on that date:

- Relinquishments prior to the enactment of IRC §877A on or before June 3, 2004.
- Relinquishments after June 3, 2004 and prior to June 17, 2008.[32]
- Relinquishment on or after June 17, 2008.

Long-term Permanent Residents (LPRs)

LPRs are individuals who are not US citizens but have been lawful residents of the US in at least eight of fifteen taxable years ending in the year of expatriation. LPRs do not include those who are treated as residents of a foreign country under applicable treaty provisions.[33]
NOTE: A taxpayer deemed to be a "dual resident" under a tax treaty and who is a resident of a foreign country, should file **Form 1040-NR US Nonresident Alien Income Tax Return** and attach **Form 8833**.

Since expatriation rules apply only to US citizens and some but not all US residents, it is crucial to determine if the non-citizen taxpayer is in fact an LPR. If the individual does not satisfy the long-term residency requirement, he cannot – be definition – expatriate and is therefore not subject to the burdensome rules imposed by the expatriation regime.[34]

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[30] Richardson, John, *Understanding "Exit Taxes"* (November 20, 2015) [available at https://www.taxconnections.com/taxblog/part-12-understanding-exit-taxes/, last accessed May 17, 2020].

[31] American Jobs Creation Act amended IRC §877 to provide for an alternative tax regime for certain, expatriated individuals.

[32] IRC §7701(n) mandates that individuals will continue to be treated as US citizens or long-term residents until they have notified both the IRS and the Department of State (for former US citizens) or the Department of Homeland Security (for LPRs) of their expatriation or termination of residency [Heroes Earnings Assistance and Relief Tax Act of 2008, §301].

[33] IRC §877(e)(2).

[34] IRC §877A(g)(2).

Exempt Individuals
Individuals who have held dual citizenship from birth and have not lived in the US more than ten of the most recent fifteen years are exempt from the expat tax requirements; as are persons younger than 18½ who have not lived in the US more than ten years.[35]

B. A Closer Look at the Defining Tests

1. Income Tax Test

This presumptive test relies upon a threshold that today is hardly representative of a high-income taxpayer, let alone a billionaire or even someone thought to be "super-rich." Even so, code provisions allow for the reduction of the tax liability before applying the expatriation standard.

To calculate the tax liability for purposes of the threshold, the taxpayer must first determine the applicable years. For example, a taxpayer who chooses to expatriate in 2020, must look back to the five tax years that ended *before* the year of expatriation; in this case, 2015 – 2019. The net tax liability from each of these years is computed after the taxpayer's Alternative Minimum Tax (AMT) liability is added to his regular tax liability and certain – but not all – tax credits are subtracted. For US taxpayers living abroad, the Foreign Tax Credit (FTC) is often sufficient to reduce the countable tax liability to near-zero (or at least low enough, to fall below the expatriation threshold amount).[36]

Once the countable taxable liability[37] for each of the five years has been determined, the liabilities are averaged and matched against the threshold test amount in effect for the year of expatiation.

NOTE: While the net tax liability for each year must be entered on **Form 8854, Initial and Annual Expatriation Statement** Part II, Line 1, the computed average is not entered on the form.

2. Net Worth Test

To reduce the value of countable assets, a taxpayer may create an expatriation trust or make strategic gifts prior to his planned expatriation date. For example, a non-resident beneficiary of a foreign non-grantor trust funded exclusively with overseas assets could conceivably enjoy non-US taxable income from that trust, although the foreign trustee would – at least in theory – be required to submit mandatory withholdings which the taxpayer could reclaim if a return is filed.

NOTE: As per IRS instructions for **Form 8854**, Part II, Section B, the taxpayer is required to disclose "if there have been significant changes in [a]ssets and liabilities for the period that began 5 years**"** the date of expatriation.

[35] IRC §877A(g)(1)(B).

[36] If additional credits are needed to further reduce the countable tax liability, the taxpayer may apply those credits enumerated in IRC §§21 – 30D.

[37] If married and filing jointly, the net tax liability of each joint return in the previous five years is used to compute the average liability, *without* any adjustment or allocation to split the liabilities between spouses.

3. Compliance Test

Past compliance must be certified under penalties of perjury. Compliance is not limited to the mere filing of prior year income tax returns along with associated schedules, but also to the filing of requisite information returns under the mandates of the Bank Secrecy Act of 1970 (BSA)[38] and the Foreign Account Tax Compliance Act of 2010 (FATCA).[39] There appears to be no reasonable cause or de minimis exception.[40]

As a result, even the smallest incidences of non-compliance can cause a taxpayer who might otherwise not qualify as a covered expatriate under the income and net worth tests, to be deemed covered based on filing omissions in prior years. **WARNING:** The taxpayer must weigh the risks of becoming compliant for purposes of expatriation against the costs and penalties associated with the correction of his failures.

C. How to Expatriate

Leaving or exiting the US is of course a prerequisite to the imposition of the tax, so it becomes critical to determine whether in fact a US citizen or long-term resident has jumped through the requisite hoops. Merely handing over or surrendering a passport to a customs agent at the airport will hardly satisfy the IRS' criteria. The traveler who presumes to have declared his "freedom" in this manner, will soon discover the near-limitless reach and tenacity with which the IRS will undertake pursuit.

Expatriation is a personal right that cannot be exercised on behalf of another (e.g. a parent renouncing the citizenship of a minor child).[41] The burden – by a preponderance of the evidence – is upon the expatriate to prove that all the proper steps have been taken.

While it is possible to relinquish US citizenship by serving in the armed forces of an enemy state, accepting policy-level employment with a foreign government or being convicted of treason, the quickest and most unequivocal way to give up US citizenship is by swearing an oath of renunciation before a diplomatic or consular officer abroad.[42] **NOTE:** The expatriating act must occur overseas (except during wartime).

An individual seeking to renounce his citizenship must do so voluntarily. He will be required to complete a questionnaire,[43] have an interview with a US diplomatic officer abroad, and must

[38] Currency and Foreign Transactions Reporting Act, P.L. 91-508.

[39] Hiring Incentives to Restore Employments ACT (HIRE), §501(a).

[40] IRS Notice 2009-85.

[41] The US Department of State presumes that a minor under the age of 16 is insufficiently mature and cannot have knowing intent to renounce citizenship; the minor will only be allowed to renounce pending approval by a consular officer who has conducted an extensive interview with the child outside of his parents' presence. If the minor is permitted to renounce, he will automatically be granted a 6-month window following his 18th birthday to reclaim his citizenship [8 USC §1483(b)].

[42] 8 USC §1481(a).

[43] **Form DS-4079** Request for Determining Possible Loss of US Citizenship.

receive official approval by the Department of State.[44] The fee charged by consular offices for renunciation services were increased from $450 to $2,350 (!) effective September 12, 2014.[45]

US Citizens

A citizen will be treated as relinquishing his US citizenship on the earliest of four possible dates:

- the date the individual renounces his US nationality before a US diplomatic or consular officer,[46]
- the date the individual furnishes to the US Department of State (DOS) a signed statement of voluntary relinquishment of US nationality,[47]
- the date on which the DOS issues a certificate of loss of nationality to the individual, or
- the date a US court cancels a naturalized citizen's certificate of naturalization.[48]

US Residents

A long-term resident ceases to be an LPR if:

- the individual's immigration and residency status has been revoked or has been administratively or judicially determined to have been abandoned, or
- the individual is treated as a resident of a foreign country under the provisions of a tax treaty between the US and the foreign country, does not waive the benefits of the applicable treaty, and notifies the IRS of such treatment on **Form 8833 Treaty-Based Return Position Disclosure,** as well as **Form 8854**, or[49]
- by formally abandoning his status.

A long-term resident may abandon his status voluntarily, willingly and affirmatively by submitting **Form I-407 Abandonment of Lawful Permanent Resident Status** to a consular officer.[50] A long-term resident may also forfeit his residency status inadvertently if (1) tie-breaker rules determine that he is a resident of a treaty country and not the US, (2) no waiver of the applicable treaty is made, and (3) the LPR notifies the Secretary of such treatment under a treaty.

44 **Form DS-4083** Certificate of Loss of Nationality of the United States.

45 Federal Register, *Schedule of Fees for Consular Services, Department of State and Overseas Embassies and Consulates-Visa and Citizenship Services Fee Changes* (79 FR 51247, August 28, 2014) [available at https://www.federalregister.gov/documents/2014/08/28/2014-20516/schedule-of-fees-for-consular-services-department-of-state-and-overseas-embassies-and#p-amd-2, last accessed May 16, 2020].

46 **Form DS-4080,** Oath/Affirmation of Renunciation of Nationality of United States.

47 **Form DS-4081**, Statement of Understanding Concerning the Consequences and Ramifications of Renunciation or Relinquishment of U.S. Nationality.

48 IRC §877A(g)(4).

49 IRC §877(e)(2).

50 A German citizen and holder of a US Green Card was held liable for US taxes on installment sale proceeds collected between the date he claimed to have (informally) abandoned his US residency and the date on which he finally submitted **Form I-407** seven years later, as he was also not treated as a German resident for tax purposes during that period [*Topsnik v Comm*, (143 T.C. No. 12].

Whether a US citizen or LPR, individuals seeking to expatriate must follow these five steps:

1. Obtain citizenship (and a passport) in another country.[51] This step is crucial since the DOS will otherwise deny the renunciation application.

2. Leave the US.

3. Appear before the US Consul in the new host country.

4. Attach **Form 8854** to the final US income tax return which must cover both the period of residency and the period of non-residency in the year of expatriation. If expatriation occurred on any date other than December 31st, the taxpayer will be required to file **Form 1040-NR**, attach **Form 1040 US Individual Income Tax Return** (or a comparable statement) to account for the tax liability accrued during the period of residency and note "Dual Status Return" at the top of the form.

5. Pay any Exit Tax due.

IV. Crunching the Numbers

The exit tax is an asset-based tax that is assessed against US citizens who have renounced their citizenship and long-term residents who have ended their residency status. Different rules and rate structures apply depending on the date of expatriation. This manual will examine the rules in effect for expatriations after June 16, 2008.

A. Subject Property

The exit tax is based on a mark-to-market regime (the MTM) which deems that all of the expatriate's property has been sold on the day before the expatriation. The resulting phantom gains and losses[52] from the deemed sales are reportable in the taxable year of expatriation.

Property subject to the MTM includes all property that would be taxable as part of the individual's gross estate if the individual were subject to the federal estate tax on the day before his expatriation date,[53] without deductions for the Unified Credit or credits for state death taxes, previously paid gift taxes, and prior taxes on transfers and remainder interests.[54] An individual's beneficial interest in a trust – even if not part of his gross estate – is also counted for purposes of the MTM.

[51] The DOS allows US passport holders who have renounced their citizenship to keep their US passports until a Certificate of Loss of Nationality (CLN) has been issued since these expatriates might otherwise not be able to travel during the processing period.

[52] The wash sale loss provisions of IRC §1091 do not apply.

[53] IRC §2031.

[54] IRC §§2010 – 2015.

In simple terms, the MTM tax basis includes the individual's worldwide assets; all except:

- Deferred compensation items[55] including foreign retirement accounts, foreign pension plans and retirement arrangements, and any property transferred in connection with the performance of services;[56]
- Tax-deferred accounts, including individual retirement plans, qualified tuition programs (§529 plans), Coverdell education savings accounts (ESAs), health savings accounts (HSAs), and Archer medical savings accounts (MSAs); and
- Interests in non-grantor trusts.[57]

Exempt from the MTM, these assets are subject to a separate 30% withholding tax regime [discussed later].

B. Exclusion Amount

The tax basis is reduced (but not below zero) by an exemption amount that is adjusted annually for inflation.[58] The exclusion amount is currently set at $737,000 [in 2020].[59]

Each individual is eligible for only *one* lifetime exclusion[60] which must be allocated amongst all of the built-in gain properties subject to the MTM by multiplying the exclusion amount by the ratio of each asset's built-in gain divided by the total built-in gain of all assets. The exclusion amount allocated to each gain asset may not exceed the amount of that asset's built-in gain. **NOTE:** The exclusion amount is not allocated to any asset with a built-in loss.

A covered expatriate relinquished his citizenship on November 1, 2019. On October 31, 2019, the individual owned the following assets with a total built-in gain of $2,000,000:

Asset	FMV on 10/31/19	FMV at Purchase (Basis)	Built-in Gain (Loss)
X	2,000,000	200,000	1,800,000
Y	1,000,000	800,000	200,000
Z	500,000	800,000	(300,000)

Step 1: Determine the portion of the exclusion amount allocable to each gain asset by multiplying the exclusion amount [$725,000 for 2019] by the ratio of the built-in gain on each gain asset over the total built-in gain on all gain assets.

Asset X: (1.8 million ÷ 2 million) X 725,000 = $652,500
Asset Y: (200,000 ÷ 2 million) X 725,000 = $72,500

[55] IRC §877A(d)(4).

[56] IRC §83.

[57] §877A(f)(3).

[58] IRC §877A(a)(3).

[59] Exclusion amounts previously in effect: $600,000 (2008), $626,000 (2009), $627,000 (2010), $636,000 (2011), $651,000 (2012), $668,000 (2013), $680,000 (2014), $690,000 (2015), $693,000 (2016), $699,000 (2017), $711,000 (2018), $ 725,000 (2019), and $737,000 (2020).

[60] If a covered expatriate repatriates at a later time and once more loses his citizenship or ceases to be a lawful permanent resident, the exclusion amount with respect the second expatriation is limited to the unused portion of the first expatriation, as adjusted for inflation.

Step 2:	Determine the amount includible in gross income with respect to each gain asset by subtracting the exclusion amount allocated to each asset from the amount of built-in gain deemed realized. Asset X: 1.8 million – 652,500 = $1,147,500 Asset Y: 200,000 – 72,500 = $127,500
Step 3:	The taxpayer must report all includible amounts in gross income with respect to Assets X and Y, as well as the loss with respect to Asset Z on **Form 1040** for the portion of the taxable year that includes the day before the expatriation date. **Form 1040** and all attendant schedules should be attached as supplementary schedules (exhibits) to **Form 1040-NR** for the remainder of that taxable year.

NOTE: Deemed IRC §877 losses and gains are subject to the usual netting rules and limitations[61] but are exempt from the wash sale rule.[62]

C. Future Sales

Any amount of gains or losses realized upon actual sale of assets after the date of expatriation will be adjusted for gains and losses already recognized under the deemed sale.

> The taxpayer in the foregoing example now lives abroad and sells Asset X for $3,000,000 and Asset Z for $700,000 on October 15, 2020. His taxable gain is computed as follows:
>
> Asset X: 3 million sales proceeds – 2 million adjusted basis = $1,000,000
> Asset Z: 700,000 sales proceeds – 500,000 = $200,000
>
> **NOTE:** Taxpayer's basis is adjusted to reflect the fair market value of each asset on the day before expatriation without regard to the allocated exclusion amount.

D. Basis Step-up

In general, non-resident aliens (NRAs) who own foreign property when they become resident aliens of the US do not get a stepped-up basis when residency begins.

> NRA bought land in Europe for the equivalent of US $100,000 in 2002. He becomes a US resident in 2005 when the land was valued at $150,000 and eventually sells the land in 2020 for $400,000. He capital gain of $300,000 will be reportable in full on his US tax return.

However, a special exception applies for the purpose of the MTM *only*. As per the exception, an NRA who became a US resident but then expatriates must – solely for purposes of determining the tax imposed under the expatriation regime – adjust the basis of all assets to the fair market value on the date that he became a US resident.[63] The taxpayer may make an irrevocable election on a property-by-property basis to be exempt from this rule.[64]

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[61] IRC §1211.

[62] IRC §1091.

[63] IRC §877A(h)(2).

[64] The election is made on **Form 8854** which must be filed with the covered expatriate's income tax return for the taxable year that includes the day before the expatriation date. An individual may choose to remain exempt from the basis step-up rule if the expense and inconvenience of the requisite appraisal dictate.

In the foregoing example, the NRA who became a US resident, later abandoned his residency and returned to his native country. Unless the taxpayer makes an affirmative election,[65] the basis of the land will be automatically stepped-up to $150,000; the resulting deemed gain for purposes of the exit tax will be reduced to $250,000.

NOTE: Property used in connection with a US trade or business is not eligible for the inbound basis step-up. On the other hand, basis step-up would apply to any asset held in connection with a foreign trade or business entity if, prior to becoming a US resident, the NRA was a resident of a country which had a tax treaty with the US.

NRA obtained his Green Card in 2010 and relinquished it ten years later. At the time of expatriation, he owned two non-business assets that he had purchased abroad while he was still an NRA decades earlier:

	Purch. Price	**FMV (2010)**	**FMV (2020)**	**Expat Basis**	**G/L (no elctn)**	**G/L (elctn)**
X	400,000	700,000	1,300,000	700,000[a]	600,000	900,000
Y	500,000	300,000	800,000	500,000[b]	300,000	300,000

[a] As per the default rules, basis is stepped-up to the date that NRA obtained residency in 2010. If the taxpayer makes the election to forego the basis step-up, he must use his original purchase price as the basis when computing his expat tax liability.

[b] In the case of an asset that has decreased in value between the purchase date and the time that the NRA obtains his Green Card, rules prohibit a downward basis adjustment. Therefore, for expat tax computations, the individual must use the purchase price as his basis, whether he claims the election or not.

E. Currency Fluctuations

The MTM rules of the expat tax regime are themselves costly, requiring that taxpayers compute a tax on unrealized gains. But that cost may be amplified when rates of exchange go against the taxpayer, creating taxable phantom gains.

Since US tax law requires that all amounts entered on a US return be reported in US dollars, a fluctuating exchange rate may alter both the expatriate's net worth (potentially raising net asset values above the defining threshold for covered expatriates subject to the exit tax), as well as generating phantom gains calculated under the MTM. For example, as the value of a foreign currency rises relative to the US dollar, less of the foreign currency would be required to purchase the dollar but capital gains measured in dollars would increase.

[65] Individual taxpayers may have differing reasons for electing to forego what appears to yield a significant tax benefit; for example, a taxpayer may not wish to incur the expense and inconvenience of obtaining an appraisal to establish valuation on the date of residency.

A Canadian resident seeking to renounce his US citizenship may in one year be deemed a covered expatriate and, in another year, fly below the radar. Presuming that the individual held assets worth 2.4 million C$ in 2012 when the exchange rate was roughly one to one, his net worth of $2.4 million would subject him to the expat tax. But in 2015 when the Canadian dollar fell, his net worth when converted to US dollars would equate to only $1.92 million. So, without any change in financial status and due only to a fluctuating currency rate, this individual would find it preferable to expatriate in 2015 rather than in 2012. Now, if only his crystal ball could accurately forecast exchange rates!

V. The Expat Tax Regime – Parts 2 and 3

So far, this text has focused on the Exit Tax assessed on covered expatriates – the tax that is computed on gains resulting from deemed sales of assets held on the date of expatriation in excess of the annual exclusion amount. But covered expatriates are subject to two additional taxes: Those assessed on deferred compensation and non-grantor trusts, and those assessed on gifts and bequests to US citizens. Under the latter, an expatriate may find that he remains obligated to the US Treasury for life!

A. The Withholding Tax

Exempt assets not deemed to be subject property are not marked to market and are not subject to the deemed sale computations of the MTM. Instead, such assets (if "eligible") are subject to automatic withholdings at a rate of 30% each time a distribution is made to the covered expatriate.[66] **NOTE:** The recipient is required to notify the payer of his ex-citizenship status using **Form W-8CE Notice of Expatriation and Waiver of Treaty Benefits**.

A deferred compensation item is eligible if (a) paid by a US person or a non-US person[67] who elects to be treated as a US person and (b) that US person withholds 30% of any amount distributed to an expatriate who would otherwise have included the payment as part of his gross income had he not expatriated. **NOTE:** If the plan is "ineligible," the 30% withholding tax will be applied to the present value of the accrued benefit on the day before the expatriation date (rather than each time a distribution is made).

Similarly, the (in)direct distribution of any property from a non-grantor trust[68] is subject to the 30% withholding tax if such disbursement would have been includable in gross income on a US return had the individual not expatriated. Expatriates subject to the 30% tax are deemed to have waived the right to claim any tax reductions as per an applicable tax treaty. Alternatively, the individual may elect to include the value of his trust interest in total assets subject to the MTM. **NOTE:** If the fair market value of the distributed property exceeds its adjusted basis, the trust will be required to recognize a gain as if the property had been sold (rather than distributed) to the expatriate.[69]

[66] These withholdings replace all taxes that would otherwise apply to deferred compensation.

[67] A non-US person is an NRA, a partnership or corporation organized under the laws of a foreign country, or a foreign estate or trust.

[68] Non-grantor trust means the portion of any trust, whether domestic or foreign, of which the covered expatriate is not considered the owner on the day before the expatriation date [IRC §877A(f)(3)].

[69] IRC §877A(f).

In the case of a tax-deferred account (e.g. IRA, §529 plan, HSA or MSA), the expatriate is treated as receiving a distribution of his entire interest on the day before expatriation.[70]

Taxpayer relinquishes his citizenship on December 17, 2019 and becomes a covered expatriate. On December 16, 2019, Taxpayer was an employee of Corporation Z, a US corporation, for which Taxpayer performed all services in the US. On the day before his expatriation, Taxpayer had restricted stock units which had been granted in 2018 that entitled him to 100 shares of the company's common stock if he continued to provide substantial services to the company until December 16, 2023. Although Taxpayer's restricted stock units do not provide for a deferral of compensation for purposes of IRC §409A since he *no longer works* for the company, the units are deferred compensation items within the meaning of IRC §877A(d)(4)(D). As a result, the units will be treated as substantially vested on the day before expatriation and their fair market value will be includible in the computation of the exit tax. If, however, Taxpayer *continues to perform services* for Corporation Z, timely notifies the company of his status as a covered expatriate and irrevocably waives any right to claim any withholding reduction under any treaty with the US, the restricted stock units will be deemed "eligible deferred compensation". Taxpayer, therefore, will have no income inclusion on the date of expatriation but will instead be subject to 30% withholding tax on the pro-rated portion of payout that is allocable to his earnings while in the US. If, for example, Taxpayer can reasonably determine that 80% of the value of the stock that is eventually transferred to him December 16, 2023 is attributable to services performed outside the US when he was no longer a US citizen or resident, then only 20% of the distribution will be includible in gross income and subject to withholding.

B. Gifts and Bequests to US Citizens[71]

Alas, a former US citizen or long-term resident is subject not only to the *one-time* exit tax as well as the ongoing 30% withholding tax but may also be *forever* subject to gift and estate taxes for any gifts or bequests made to US citizen and resident donees and beneficiaries. **NOTE:** Gifts and bequests made to non-US citizens are exempt from the expat gift and estate tax regime.

The expat gift and bequest tax regime was instituted in 2008 but implementation and enforcement was suspended pending the issuance of IRS guidance and final regulations. Proposed regs were issued in 2015[72] but to date, have not yet been finalized. Once implemented, a US recipient who receives a covered gift or bequest will be required to file **Form 708, US Return of Gifts or Bequests from Covered Expatriates** on or before the 15th day of the 18th calendar month following the close of the calendar year in which the covered gift or covered bequest was received. **Form 7004** may be used to request a six-month extension of time to file (but not pay).

Here's what to expect… Gifts – whether made with assets acquired before or after expatriation – and bequests made by a covered expatriate are valued as they would be under the estate tax regime, then reduced by the applicable annual gift tax exclusion [$15,000 in

[70] IRC §877A(e).

[71] IRC §2801.

[72] REG-112997-10 (September 10, 2015).

2020], and taxed at the highest marginal bracket of gift or estate tax in effect during the year of the gift. The resulting tax becomes the liability of the receiving transferee.

NOTE: If, instead, the gift was made while the donor was still a US citizen, the donor would remain eligible for the lifetime exclusion; the gift would only be taxable in the event that it exceeded that amount [$11.58 million in 2020]. Additionally, it would be the donor (not the donee) who would be liable for the resulting gift tax. Similarly, a US citizen transferring assets to US beneficiaries at death may use his available lifetime exclusion to reduce or even eliminate the estate tax, whereas non-citizen decedents may not benefit from this exemption.

Decedent A – a US citizen at death – has an estate valued at $17 million on the date of death in 2020. Presuming the full lifetime exclusion was available and the estate was taxed at the highest marginal rate currently in effect [40% in 2020], the net estate after tax that would pass to beneficiaries would total $2,168,000.

In contrast, Decedent B – a non-US citizen at death – could reduce his taxable estate by only $15,000 per beneficiary. Presuming that the decedent had two beneficiaries, the net estate after tax that would pass to those beneficiaries would total $10,014,000, almost $5 million less than Decedent A's estate!

Married US citizens who have $3M cash and no other assets when they renounce citizenship, will have no MTM tax to pay since there can be no phantom income on cash. However, if these expatriates then grow a successful business while living overseas, such that all wealth of this business was created as non-US persons outside the US, any future gifts or bequests to US persons would be subject to a 40% tax at current tax rates [in 2020]. For instance, if the estate had grown to a value $10 million and was bequeathed to three US citizen children, the children would have to pay $4 million in taxes [under current rates]; even if none of the children lived in the US!

NOTE: A foreign trust which is funded by a covered expatriate who has named US citizen or resident beneficiaries is subject to these same rules.

Blog author Martin warns that this "forever taint" could live on for multiple generations if trust beneficiaries include children, grandchildren and even great-grandchildren who are US citizens or have dual citizenship with the US.[73]

<u>Exempt Gifts & Bequests</u>
Taxable gifts reported on a covered expatriate's timely filed gift tax return (**Form 709**) and property included in a covered expatriate's gross estate on a timely filed estate tax return (**Form 706**) is exempt from the expat gift & bequest tax regime.[74] In other words, if the expatriate or his personal representative pay the taxes due with **Form 709** and **706**, the tax liability will be computed using applicable tax brackets and will not be transferred to the recipient legatee.

[73] Patrick Martin, *The "Hidden Tax" of Expatriation – Section 2801 and its "Forever Taint",* Tax Expatriation blog, April 10, 2014 [available at http://tax-expatriation.com/2014/04/10/the-hidden-tax-of-expatriation-section-2801-and-its-forever-taint/, last accessed May 18, 2020].

[74] IRC §2801(e)(2).

VI. Reporting the Tax

Gain or loss on the deemed sale of each asset – albeit not actually realized – is recognized and reported on the relevant form or schedule of the individual's **Form 1040** for the year that includes the day before the expatriation date.

The gain or loss is reported in the same manner as if the property had actually been sold. For example, gain recognized from the deemed sale of a rental property that has been depreciated is reported on **Form 4797 Sale of Business Property** as if it had been sold. Gain recognized from the deemed sale of personal property (such as stock or a personal residence) is reported on **Form 8949 Sales and Other Dispositions of Capital Assets** as if it had been sold. A capital gain retains its character as a capital gain (whether short- or long-term); an ordinary gain retains its character as ordinary income.[75]

A. Payment of the Expat Tax

The MTM exit tax is computed as part of the income tax due with the tax return that covers the calendar year which includes the date of expatriation. Recognized gain from the MTM deemed sales is computed on **Form 8854**, Section C, Line 2 and cross-referenced with the appropriate form or schedule of the individual's income tax return to which the 8854 is attached.

Line 2 provides space enough for only seven assets; the expatriate is expected to add continuation statements if needed. Line 2 also appears deceptively simple and merely provides columns to enter the fair market value (b), cost basis (c), computed gain or loss (d), and the net gain after the exclusion amount has been subtracted (e). But, as the reader already knows from examples provided earlier in this manual, the allocation is complicated. IRS instructions ask the taxpayer to attach explanatory statements.

The tax may be deferred on an asset-by-asset basis until the due date (plus extensions) of the expatriate's income tax return for the year in which the asset is actually sold.[76] Taxpayers seeking to make the irrevocable election to defer payment must enter the amount of deferred tax on Section C, Line 2(g), as well as complete Section D of **Form 8854** and furnish a bond to the Secretary of the Treasury[77] or another satisfactory security (e.g., letters of credit) as prescribed by the Secretary.

The taxpayer requesting to defer payment must complete two hypothetical individual income tax returns using **Form 1040-NR**; the first must include all income (including MTM gains and losses); the second return must include all income (without the MTM gains and losses sought to be deferred) so that the amount of the deferred tax can be derived from the difference in tax liabilities reported on each return. Both returns must be attached to **Form 8854**.

The original deferral agreement request along with **Form 8854** must be sent to the Department of the Treasury in Philadelphia. A copy should be attached to the income tax return that is due for the year that includes the expatriation date.

75 Instructions for **Form 8854**, Department of Treasury, Internal Revenue Service.

76 IRC §877A(b)(1).

77 IRC §6325(a)(2).

If the deferral agreement[78] is accepted by the IRS, the taxpayer may not extend the due date for payment of the deferred tax beyond the earlier of either:

- The due date of the return required to report the disposition of the asset by sale, non-recognition transaction, gift, or other means; or
- The due date of the return required for the year that includes the date of death; or
- The date that the posted collateral is no longer considered adequate by the IRS (unless the taxpayer increases his collateral within 30 days after notification).

NOTE: Interest on any unpaid liability resulting from the MTM tax will accrue until the balance due is paid in full.

B. Filing Requirements

Form 8854 must be filed with a US consular office or federal court at the time of expatriation.[79] Until the taxpayer files the form and notifies either the DOS or Homeland Security of his expatriation or termination of long-term residency status, the taxpayer will continue to be treated as a US citizen or resident for tax purposes.[80] Failure to file **Form 8854** is subject to a $10,000 penalty (unless failure was due to reasonable cause).

The taxpayer must be able to certify that he has complied with all federal tax filing requirements for the five years prior to expatriation.[81] Expatriates should file all tax returns that are due, regardless of whether or not full payment can be made at the time of filing since a payment plan may be arranged for any outstanding tax liability.

If the taxpayer has mistakenly omitted income from a prior-year return, he should file an amended return prior to submitting **Form 8854.**

<u>Annual Reporting</u>

Individuals who have expatriated after June 16, 2008 and prior to the current tax year, must file **Form 8854**, Part III each year after expatriation if:

- Payment of tax was deferred in any prior year;
- The individual reported an eligible deferred compensation item in a previous year; or
- The individual reported an interest in a non-grantor trust in any prior year.

The form is due on April 15th of each subsequent year.

Expatriates – like NRAs – must file **Form 1040-NR** for each year after expatriation in which they have received US-sourced effectively connected income and have not satisfied their tax obligations through automatic withholdings.[82] Additionally, if an asset subject to the MTM is sold or a distribution subject to the withholding tax is received, the expatriate must submit **Form 8854** to Philadelphia. If

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[78] A sample agreement is available in Appendix A of IRS Notice 2009-85.

[79] IRS Instructions for **Form 8854** specify how individuals should certify that they have met their federal tax obligations for the five preceding taxable years and what constitutes notification to the DOS or the Department of Homeland Security.

[80] IRC § 7701(n).

[81] Even taxpayers who otherwise do not meet the §§ 877 and 877A filing thresholds must satisfy the 5-year compliance requirement – if they fail to meet this requirement, they will be treated as though they met the §§ 877 and 877A thresholds and will be subject to all expat tax provisions.

[82] Treas. Reg. §1.6012-1(b).

Form 1040-NR is required to be filed, a copy of the 8854 must be attached to the income tax return, which should be submitted in its usual and timely manner.

VII. Expat Tax Strategies

While circumstances may dictate and leave most US citizens or long-term residents little choice with regards to the timing of their expatriation, some covered expatriates may be able to plan for that day when they can put the IRS in their rearview mirror. With proper legal guidance and sufficient time, several strategies may be used to minimize or even eliminate the expatriation tax that would otherwise be incurred.

A. Reducing Taxable Income

Since the income limitation is applied to the average annual net taxable income reported on five prior-year tax returns without regard to the filing status employed, married taxpayers may elect to file separately in all affected years prior to the anticipated expatriation date. On the assumption that taxable income can thereby be allocated between spouses, lesser amounts would be reported on each spouse's tax return if not filing jointly. The lesser amounts might allow one or both spouses to fall below the taxable income threshold at which they would be deemed to be covered expatriates subject to the exit tax.

NOTE: Taxpayers residing in community property states would, of course, have to adhere to the proper income split as dictated by state law.

REMINDER: Married couples can change their filing status from married filing separately to married filing jointly. However, they cannot change their filing status from married filing jointly to married filing separately once an original return is filed.

B. Reducing Net Worth

A high net worth individual planning to expatriate may have the option to reduce his net worth by gifting some of his assets prior to the expatriation date. If both spouses are US citizens at the time of the gift, the donor can take advantage of the unlimited marital exclusion to transfer sufficient assets to bring him below the expatriation threshold. **BEWARE:** If the recipient spouse is not a US citizen at the time of the gift, the donor's exclusion will be limited to $171,000 [in 2020].[83]

Rather than making an outright gift, it may be possible to convert direct ownership of assets into indirect ownership. Garcia and Qian suggest that "an expatriate might create and fund an expatriation trust such as an irrevocable self-settled, non-grantor US discretionary trust under the laws of a jurisdiction that has asset protection legislation." They caution that the terms of the governing instrument must ensure that the trust is not classified as a grantor trust for US tax purposes and that the settlor renounces any retained powers of appointment to ensure that trust assets are not counted as part of the expatriate's net worth. To further bolster the claim of non-inclusion, the expatriate should attempt to eliminate any potential beneficial interest.[84] **BEWARE:** US citizen and resident beneficiaries may be required to file **Form 3520 Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain**

[83] Gifts to non-citizen spouses are subject to an annual exclusion, indexed for inflation: $136,000 (2011), $139,000 (2012), $143,000 (2013), $145,000 (2014), $147,000 (2015), $148,000 (2016), $149,000 (2017), $152,000 (2018), $155,000 (2019) and $157,000 (2020) [IRC §2523(i)].

[84] Garcia & Qian, *Exiting the US tax system*, AICPA The Tax Adviser (April 1, 2018) [available at https://www.thetaxadviser.com/issues/2018/apr/exiting-us-tax-system.html, last accessed May 18, 2020].

Foreign Gifts and **3520-A Annual Information Return of Foreign Trust With a U.S. Owner** under the FATCA regime.

An intending expatriate might consider the use of a family limited partnership, taking advantage of valuation discounts for minority interests, illiquidity and the lack of control that would result after asset contribution.

While these and other creative options may be explored, taxpayers should be prepared to defend their strategies since the IRS will inevitably attempt to discredit many as tax avoidance schemes.

C. Fixing Compliance Issues

Individuals who have not been compliant with IRS filing requirements in each of the five years prior to expatriation will automatically be subject to the expat tax regime and may wish to consider submitting or amending prior-year returns. As a reminder, the statute of limitations for claiming a refund is limited to the later of three years after the original due of the return or two years after payment of the tax. But the expatriate's purpose is not, of course, to obtain a refund but to come into compliance with all tax obligations so that he will not be deemed a covered expatriate subject to the onerous expat tax regime.

D. Accidental Americans

As per the 14^{th} Amendment of the US Constitution, "all persons born or naturalized in the US" are citizens of the US. With the limited exception of individuals born in the US to parents who hold diplomatic immunity, all others born in the US or born abroad to a US citizen parent acquire US citizenship at birth. As citizens, these individuals are forever subject to the US citizenship-based tax regime unless they expatriate.

However, it is not uncommon that many such individuals are entirely unaware of their citizenship status and only learn of their US reporting obligations inadvertently; possibly when alerted by an overseas bank seeking to comply with the FATCA mandate to report US account holders to the IRS.

Kevan Earl of Manchester, England was born in Nashville, Tennessee, to British parents.[85] He lived in the US for about a year before moving to the United Kingdom (UK), where he has lived ever since. He has an American birth certificate and a registered document of live birth from the British consulate." He claims, "I've always considered myself British." His problems began when he indicated "Nashville" as his place of birth while opening a bank account in England. The bank promptly asked the new customer for his Social Security Number (SSN). To comply with his newly unearthed US tax filing requirements and obtain an SSN, Earl was required to visit the US embassy in London, provide an official birth certificate along with additional documents to prove that he'd been living abroad for most of the 54 years of his life. Only then, could Earl begin to address the issue of unfiled tax returns and unreported income, as well as non-compliance – in fact, total ignorance – of the FATCA and BSA filing mandates! The time and expense to come into compliance quickly mounted into the tens of thousands of dollars.

[85] Darla Mercado, *Why 'accidental Americans' have an uphill battle with the IRS*, Personal Finance (October 3, 2019) [available at https://www.cnbc.com/2019/10/03/why-accidental-americans-have-an-uphill-battle-with-the-irs.html, last accessed May 20, 2020].

The IRS has recently developed a program intended to allow individuals of lesser means to come into compliance and begin their lives as expatriates without a looming debt owed to the IRS. The IRS has not set a termination date for the program at this time.

Relief Procedures for Certain Former Citizens[86]

Only individuals – not estates, trusts or any business entity – who have[87] or will renounce their citizenship after March 18, 2010 are eligible for this program. Such individuals must have net assets less than $2 million and the prior non-compliance must have been non-willful. **NOTE:** Non-willful conduct is conduct that is due to negligence, inadvertence, mistake, or a good faith misunderstanding of the law. Willfulness is a legal term interpreted differently by the IRS, the courts and lay members of the public. Taxpayers should consult with legal counsel to determine eligibility for the relief program.

Eligible individuals may file outstanding tax returns, including all required schedules and information returns,[88] for the five years preceding and the year of expatriation. If the tax liability does not exceed a total of $25,000 for the six years filed, the taxpayer's entire tax obligation is forgiven. No taxes, penalties or interest will be due!

John was born in the US while his NRA parents were attending university for post-graduate studies. Almost immediately after his birth, the family returned to their native country. John renounced his citizenship on October 1, 2019 and received a Certificate of Loss of Nationality. John has never filed a US income tax return and never applied for or received an SSN. John had various sources of income, including small amounts of income from foreign mutual funds that are passive foreign investment companies. His net worth is minimal.

As per the relief program, John must report his worldwide income for 2019 and the preceding five tax years. He may claim all applicable available deductions and credits, including the Foreign Earned Income Exclusion and the Foreign Tax Credit, to determine his tax liability for each year. John must submit **Form 1040** for 2014 – 2018 and **Form 1040-NR** (with **Form 1040** attached as an information return reporting worldwide income through October 1, 2019). He must compute the income from his foreign mutual funds and report them as ordinary income on the "other income" line of each 1040. Although John did not submit **Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund** as he would have been required to do, he nevertheless is eligible for relief if his aggregate tax liability totals less than $25,000.[89]

[86] IR 2019-151 (September 16, 2019).

[87] Any individual who previously relinquished his citizenship after March 18, 2010 but was not tax compliant and did not become tax compliant in the interim, may use the relief procedures.

[88] Returns that must be filed include **Form 1040** (of course), **Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return** (if applicable), as well as **Form 8938, Statement of Specified Foreign Financial Assets** and other information returns. The procedures do not *require* the submission of delinquent FBARs (**FinCEN 114, Report Foreign Bank and Financial Accounts**) but, if filed contemporaneously with the prior-year returns, the IRS will not assert FBAR penalties.

[89] The apparent inconsistency with regards to the omitted **Form 8621** was addressed in an IRS instructional video in which the presenter explained, "So, John should have reported his PFIC on a **Form 8621** with some special computation, but he didn't. He tried his very best. He knew it was a special category of income and he reported it as other income. Now, implicit in this Hypothetical is that John explained what he did in his submission, so that the IRS could understand that he used his best efforts." It appears that the IRS seeks to accommodate eligible taxpayers and make this program as user-friendly and inexpensive as possible. [Video is available at https://www.irsvideos.gov/Individual/education/ReliefForFormerCertainCitizens, last accessed May 20, 2020.]

> **NOTE:** If John's total tax liability exceeds the threshold amount, the IRS will process the returns in the usual manner. John may request removal of penalties under the IRS' First Time Abatement Penalty Policy[90] for 2014 and for reasonable cause for all other years. If unable to pay the tax liability, he may qualify for an Offer in Compromise.[91]

Taxpayers seeking relief should note the following:

- The program is not available to individuals under the age of 18.
- A program applicant may file even if he does not have an SSN and does not have to request an SSN to submit his returns. He may, instead, simply leave any box requesting an SSN blank. If the applicant previously (and mistakenly) obtained an Individual Taxpayer Identification Number (ITIN), he should include that number with his submission.
- All returns filed under this program must be mailed to the IRS at the Austin campus; not e-filed. Each return should be marked "Relief for Certain Former Citizens."
- Tax withholdings relating to any year of the individual's submission are not considered and will not be refunded.
- An individual who has filed **Form 1040-NR** n(not **Form 1040**) in the most recent five years prior to expatriation is generally ineligible for relief under the program unless the returns were mistakenly filed based on the taxpayer's good faith belief that he was not a US citizen.
- Failure to timely file **Form 8854** does not disqualify the applicant from relief, presuming all other criteria have been satisfied. Instead, the form should be filed as soon as possible along with a statement providing reasonable cause for late filing.
- Individuals who file pursuant to the relief procedures but are deemed ineligible will be liable for all taxes, as well as associated penalties and interest.

VIII. How Others Do It

It is important to note that only federal rules have so far been discussed in this manual. As has been repeatedly stated, the US government operates under an extraterritorial system whereby a taxpayer becomes beholden to the IRS based not on the geographical source of his income, his physical presence, or his residency but based on his nationality. Tax citizenship, then, often arises from a mere accident of birth rather than a conscious choice to live and work within jurisdictional boundaries of the US.

It is interesting to compare how other governments – form American states to foreign countries – impose their dominion over taxpayers…

A. State Tax Rules

Most states do not conform to the federal definition of non-resident alien and do not care if the taxpayer they seek to tax is even a US citizen. For state tax purposes, state residency and often domicile are the determinative factors whether the state has jurisdiction to impose its income tax.

A California (CA) tax resident, for instance, is any individual who is either (1) present in the state for a purpose that is not temporary or transitory or (2) is domiciled[92] in California but

[90] IRM 20.1.1.3.3.2.1.

[91] IRC §7122.

[92] California defines "domicile" as the place where a person voluntarily establishes himself and his family, not merely for a special or limited purpose but with a present intention of making it his true, fixed, permanent home and principal establishment. It is the place

located outside CA for a temporary or transitory purpose. The state applies a facts and circumstances test to establish residency. In the FTB Publication 1031 Guidelines for Determining Resident Status the following factors are listed:

- Amount of time spent in versus out of California.
- Location of spouse/RDP, children, and principal residence.
- State that issued driver's license and where vehicles are registered.
- State in which professional licenses and voter's registration are maintained.
- Location of bank accounts, real property, and investments.
- Location of healthcare providers, accountants, and attorneys.
- Location of social ties, including place of worship, social and country clubs.

The CA Franchise Tax Board warns that this is only a partial list and that all the facts of an individual's particular situation must be evaluated to determine residency status.

Massachusetts (MA), on the other hand, states that "[y]ou cannot change your domicile by taking a temporary or longer than expected absence from Massachusetts. You must not intend to return." The tax authority further advises that "[y]ou can't choose to make your home one place for general living purposes and in another for tax purposes." Based on these assertions, it would seem to be difficult to escape the state's clutches for tax purposes without taking overt steps by moving out of state on a permanent basis.[93]

Other states may have other criteria but in all cases, it should be noted that a taxpayer's status established under immigration law, federal tax law, or by application of a tax treaty (to which the US government is a signatory) is determinative for federal purposes only.

B. Looking Overseas

America's system of citizenship taxation is unique in its ability to impose tax on its citizens regardless of their physical presence throughout the world. To escape the long reach of the US tax arm, some individuals feel compelled to renounce their citizenship. Even so, as readers now know, the US has created an alternate tax regime to punish those who choose to expatriate.

No other government would have the need to create a similarly punitive regime since none require citizenship renunciation to escape taxation. Nevertheless, some countries impose an exit tax based not on citizenship forfeiture but on a change of residency, if only to provide a disincentive to move funds offshore and to fill government coffers.

where, whenever absent, he intends to return [available at https://www.ftb.ca.gov/file/personal/filing-situations/military.html, last accessed May 20, 2020].

[93] A former MA resident moved permanently to Florida (FL) and obtained a new driver's license in-state. While she diligently reported MA-source income to MA on a non-resident return, MA auditors determined that she should have filed as an MA resident because she *did not notify Massachusetts Registry of Motor Vehicles* that she now had an FL license [story available at https://www.massachusettstaxalert.com/2015/09/how-taxpayers-are-identified-for-the-massachusetts-domicile-audit/, last accessed May 20, 2020].

Here are a few samples of rules currently in effect:

South Africa
An exit tax much like the American MTM is imposed on individuals who move out of South Africa. On the day immediately before the individual ceases to be a tax resident, the individual's assets are deemed to have been sold at market value. Forty percent of the resulting gain is includible in taxable income and taxed at the individual's marginal tax rate (e.g. a top income tax rate of 45 percent would result in an effective rate of 18 percent). This tax is not assessed against immovable property situated in-country, certain qualifying equity shares from broad-based employee share plans, qualifying equity instruments or rights to acquire certain "marketable securities."[94]

Japan
Enacted to discourage high net worth individuals (100 million JPY[95]) from moving permanently out of Japan, this capital gains tax (15.315%) is assessed on deemed gains of certain financial assets, stocks, bonds and derivative securities, as well as gifts and inheritances. Cash holdings, real estate and insurance policies are exempt. In addition to Japanese nationals, non-Japanese permanent residents and spouses of Japanese nationals are subject to the tax.[96]

Ireland
Ireland's exit tax regime assesses tax on unrealized gains from the deemed disposal of assets when companies migrate or transfer assets offshore. The tax is not applied to those assets that continue to be used in Ireland by a permanent establishment of the company. The rate of tax is 12.5% but may be increased to 33% under an anti-avoidance punitive structure.[97]
NOTE: This tax is charged to business entities, not individual taxpayers.

So, it seems that the US is not alone in its efforts to extract taxes from persons moving abroad. The distinction, however, is that to escape what is perceived to be a burdensome assessment, Americans must not only move overseas but also turn in their US passports. Based on a Bloomberg survey, the US is tied with Slovenia in 35th position for passport desirability. (Sweden is ranked number one.) While the American passport allows for visa-free travel to 174 nations, it "earned low marks because of [our country's] taxation stance toward non-residents."[98]

IX. More Crazy Stuff

The decision to expatriate is fraught with emotional issues. Even if exasperated by the American citizenship-based tax regime or stymied by foreign bankers who do not wish to serve US citizen clients living abroad under the burdensome FATCA regime, many individuals find it difficult to part with the nationality that has identified them since birth. It feels as though they have to give up a part of themselves. A few thousand each year choose to renounce while others miserably accept the oft onerous costs of citizenship in exchange for the privilege of "being an American."

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94 Income Tax Act 58 of 1962.

95 Roughly $820,000 on December 31, 2019 (as per X-Rates currency calculator).

96 Income Tax Act of 2016.

97 The Finance Act of 2018.

98 Justin Bachman, *The Most Desirable Passports On Earth Don't Include America's*, Bloomberg, March 3, 2017 [available at https://www.bloomberg.com/news/articles/2017-03-03/the-most-desirable-passports-on-earth-don-t-include-america, last accessed May 20, 2020].

At least for now. At least until they encounter the proverbial straw that breaks the camel's back. And this may just be it:

Foreign Life Insurance Policies
An innocent – and seemingly fiscally sound – purchase of a policy designed to provide for the family of a US citizen can quickly turn from a conservative estate planning strategy into a compliance nightmare since most offshore policies do not satisfy the IRS definition of "life insurance".[99] Instead, such policies are classified as investments subject to a myriad of reporting requirements, including:

1. **Form 1040**: US owners of non-compliant policies must report income accruals from the contract as ordinary income each year, even if undistributed.[100]

2. **Form 8621**: If the foreign policy invests in mutual funds or similar pooled assets, it will likely be deemed to be a passive foreign investment company subject to a crushing and costly reporting regime. In addition to annual filings and possible tax liabilities, the policy when sold, gifted, paid on death or otherwise disposed will almost assuredly trigger excess distribution rules whereby the tax liability must be annualized over a three-year period and assessed at the highest marginal rate in effect in each year and compounded with accrued interest.[101] If this sounds complicated, it is. If it sounds unfair, it is that too!

3. **Form 720, Quarterly Federal Excise Tax Return**: US citizens and residents must pay an excise tax on premiums paid for policies issued by a foreign insurer or foreign casualty company (1 or 4%, respectively).[102]

4. **Form 8938**: An insurance policy with cash value is a "specified foreign financial account" subject to the FATCA mandate. The 8938 must be attached to the income tax return of the citizen living abroad if the aggregate value of his foreign assets exceeds $200,000 at year-end or $300,000 at any time during the year.[103]

5. **FinCEN 114**: The foreign life insurance policy is an account that must be reported under the FBAR regime if the aggregate value of all foreign accounts exceeds $10,000 at any time during the calendar year.

The IRS estimates the cumulative time to gather the necessary data and complete these forms (not counting the income tax return) averages roughly 55 hours each year. If anyone needed a shove to expatriate, this might just do it!

99 To determine if a foreign policy qualifies as a "life insurance policy" for US tax purposes under IRC §7702, requires a rigorous actuarial and legal analysis so costly that some individuals prefer to simply assume that their foreign policy is non-compliant.

100 IRC §7702(g)(1)(A).

101 IRC §1291(a)(2).

102 IRC §§4371 and 4372.

103 These thresholds are doubled for citizen spouses filing a joint return.