

Renouncing your US citizenship: Failed amendment may signal that now is the time to get out!

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Introduction

If you are one of the many US citizens contemplating renouncing your US citizenship, Congress sent a fairly clear message that now, as opposed to later, may be the right time to get out of the club. On June 12, 2013, US Senators Jack Reed (D-RI) and Chuck Schumer (D-NY) attempted to add yet another hurdle in the ongoing saga for those individuals looking to renounce their US citizenship in filing an amendment to the immigration reform bill, which attempted to ensure that the US Department of Homeland Security could exclude certain individuals from re-entry into the US. The proposed amendment was never voted on in the House and died before reaching the floor. If the proposed amendment had made its way into law, it would have excluded from re-entry not only former US citizens who renounce for tax avoidance purposes (as is the current law), but also renouncing individuals who are considered “*Covered Expatriates*” under Internal Revenue Code Section 877A.

What is most important to take away from this failed passage of legislation is that the issue of renouncing one’s US citizenship is again front and center on Congress’s radar and the only guarantee moving forward is that any potential changes will not make things any easier to get out. The 2016 calendar year witnessed the highest number of US citizens renouncing in history.¹

This record number of US citizens looking to get out represents substantial losses in the number of taxpayers and tax dollars collected on behalf of the IRS (during life and at death). Congress is clearly aware of this fact and appears poised to put the brakes on the mass exodus.

Under the failed amendment, a renouncing individual who was classified as a Covered Expatriate under §877A, would have had to prove to the Department of Homeland Security by “clear and convincing” evidence that he or she did not renounce for tax avoidance purposes. The burden of proving this negative would have fallen on the renouncing Covered Expatriate if he or she desired to ever re-enter the US.

So how does a renouncing US citizen become a Covered Expatriate under § 877A? Section 877A defines a Covered Expatriate as an individual who meets the requirements of subparagraph (A), (B), or (C) of § 877(a)(2). Section 877(a)(2) classifies a renouncing US citizen as a Covered Expatriate if he or she meets one or more of the following criteria:

1. has an average annual net tax liability for the five preceding years of more than \$162,000 USD (2017 amount adjusted for inflation);
2. has a net worth of over \$2,000,000 USD; or
3. fails to certify compliance with USD tax obligations for the prior five years (discussed in further detail *infra*).²

When questioned regarding the proposed amendment, Senator Reed stated:

“American citizenship is a privilege. But it seems that a privileged few are trying to game the system by accumulating wealth and benefiting from the greatness of the United States and then renouncing their citizenship to avoid paying their fair share of taxes. They are welcome to leave our country, but they should not be welcomed to return without playing by the rules and paying what they owe.”

While the failed passage of this amendment is a clear victory for those looking to renounce their US citizenship in the near future, the fact that Congress has already attempted to bring legislation before the floor in an effort to make the penalties associated with renouncing even more severe, should send a loud and clear message to all those looking to renounce their US citizenship...“GET OUT NOW”.

Where the law was headed under the failed Reed-Schumer Amendment

The original Reed Amendment and current law (discussed below) was passed in the 1990’s. Fast forward almost two decades and the same issues regarding the lost US tax revenue of expatriates still exist today. The proposed and rejected Reed-Schumer Amendment would have changed the current law governing the renunciation of US citizens by:

1. Automatically excluding any Covered Expatriate that triggers the expatriate exit tax under § 877A;
2. Creating a mechanism to allow a Covered Expatriate (individual caught under § 877A) to petition the US Department of Homeland Security for a determination that tax avoidance was not one of the principal purposes of expatriation; and
3. The Department of Homeland Security may make that determination if the Covered Expatriate can establish through clear and convincing evidence that tax avoidance was not one the principal purposes for the expatriation.

In a nutshell, all Covered Expatriates would have had the burden of proving that tax avoidance was not a primary purpose of their renunciation. Under the original Reed Amendment, the burden is with the US government to show that the renouncing US citizen did so to avoid US tax. This shifting of the burden of proof is enormously important and greatly increases what is at stake for a Covered Expatriate. Under the original Reed Amendment, the advantage was clearly with any renouncing US citizen (whether a Covered Expatriate or not). It can be very difficult for the US government to meet its burden of proof regarding tax avoidance motives. Under the failed Reed-Schumer Amendment, the advantage would have been squarely with the US government when dealing with a Covered Expatriate.

If similar legislation to the failed Reed-Schumer Amendment later becomes law, the importance of avoiding the US exit tax under § 877A will be even more important than before. Not only would the repercussions of being classified as a Covered Expatriate under § 877A result in a deemed disposition of the renouncing individual’s worldwide assets under the exit tax rules, but the burden to prove that a primary purpose of the renunciation was not to avoid US tax, would have fallen on the Covered Expatriate and not the US government.

This automatic presumption of having renounced for tax avoidance purposes would have resulted in the Covered Expatriate having to retain counsel and present evidence before the Department of Homeland Security to prove that he or she did *not* renounce for tax avoidance purposes. The burden of proving a negative is extremely difficult in any situation. The result would be that the Covered Expatriate would

have been required to spend time and resources fighting an uphill battle of proving through “clear and convincing evidence” that a principal purpose in their renunciation was not to avoid US tax. The Covered Expatriate would have been forced to make a circumstantial argument before the Department of Homeland Security in hopes that the governing body involved sees the facts in the taxpayer’s favor. If not, the Covered Expatriate would have been denied re-entry into the United States in addition to being hit with the exit tax.

Where the law stands today: The original Reed Amendment

In the early 1990’s, a highly publicized renunciation case involving Mr. Kenneth Dart was at issue. Mr. Dart was a billionaire who decided to renounce his US citizenship in an effort to avoid paying US tax, became a citizen of Belize, and was then appointed by the Belizean government to be a consular officer in Sarasota, Florida. These strategic decisions allowed Mr. Dart to continue to live and work in the US, without paying any tax on the hundreds of millions of dollars he had accumulated in the US, as a US citizen.

As a result, in 1996 Senator Reed proposed and passed into law the original Reed Amendment, further governing the treatment of expatriates who renounce their US citizenship for the primary purpose of tax avoidance.³ The law still stands today and allows the Executive Branch⁴ the ability and authority to determine which US citizens have renounced for tax avoidance purposes. If it is determined that the US citizen renounced for the primary purpose of avoiding US tax, that person will be denied re-entry into the US.⁵ While the law currently governing this issue gives the Executive Branch the ability to make the determination of tax avoidance, its successful application is very rare.

The reason so few expatriates are classified as having done so for tax avoidance purposes under the original Reed Amendment is because the burden to establish the renouncing expatriates tax avoidance motives falls squarely on the Consular Officer assigned to conduct the exit interview. The exit interview is the final stage of the renunciation process and is done at a US Consulate location. Under the original Reed Amendment, the burden is on the Executive Branch to prove that the US citizen is renouncing with the primary purpose of tax avoidance.

However, in the practical application of the original Reed Amendment, the renouncing individual is rarely denied re-entry to the US unless he confesses during his exit interview to be renouncing for tax avoidance purposes. Needless to say, very few expatriates renouncing their US citizenship confess to having tax avoidance purposes. Consequently, identifying those expatriates who renounce for tax avoidance purposes is nearly impossible. Congress knows this and is attempting to tighten the screws on the renunciation program through the proposed Reed-Schumer Amendment.

Section 877A: Avoid being a "Covered Expatriate"

Avoiding being classified as a Covered Expatriate under § 877A will take on an even greater importance if future legislation similar to that of the failed Reed-Schumer Amendment ever becomes law in the weeks, months, or years to come. As the law currently stands, avoiding § 877A and the US exit tax is very important. Standing alone, the exit tax can have devastating tax consequences to a renouncing US citizen who is not prepared accordingly. Assuming a variation of the Reed-Schumer Amendment one day becomes law, the scope and effect of not being labeled a covered expatriate under § 877A cannot be understated.

Section 877A was enacted in 2008 under the Heroes Earnings Assistance and Relief Act and established a more stringent exit tax regime applicable to a Covered Expatriate. Section 877A classifies

an expatriate as a “Covered Expatriate” when the individual meets any one portion of a three-part test and renounces their US citizenship or loses US residency⁶ after June 17, 2008. A Covered Expatriate subject to the exit tax under § 877A will face a mark to market exit tax regime in which the provision treats the covered expatriate as having sold all of their property the day before the “expatriation date” for its fair market value.⁷ The “expatriation date” is the date that the taxpayer renounces citizenship or ceases to be a lawful permanent US resident.⁸ The mark to market exit tax regime applies to unrealized net gains in excess of \$699,000 USD in 2017 (adjusted annually).⁹ The mark to market rules deviate in application to any deferred compensation items,¹⁰ specified tax deferred accounts,¹¹ and to interests in non-grantor trusts.¹² The three part test of the statute, as discussed above, will classify an individual as a “Covered Expatriate” if any of the following statements are true:

1. The individual has a net worth of \$2,000,000 US or more at the time of renunciation (Net Worth Test);
2. The individual had an average annual net income tax liability of more than \$162,000 USD in the five years ending before the date of expatriation (Tax Liability Test);¹³ or
3. The individual failed to certify on Form 8854 that he or she had complied with all US Federal tax obligations for the five years preceding the date of expatriation (Compliance Test).

There are two main exceptions to the exit tax regime for US citizens looking to renounce and not be considered Covered Expatriates. The first exception is largely limited to dual citizens who live in the country of their other nationality. The second is even narrower and is limited to citizens who did not live in the US for more than ten years before the age of eighteen and a half. As minors are generally not allowed to renounce their US citizenship, it effectively allows only a six-month window for such individuals to avoid the imposition of § 877A’s exit tax regime. The following are the two exceptions to § 877A’s exit tax regime:

1. An individual is exempt from the exit tax regime if he or she:
 - a. Files Form 8854;
 - b. Became a dual citizen at birth and continued to be a citizen and tax resident of the other country (Canada) at the time of renunciation of citizenship; and
 - c. Was a resident of the US for no more than ten of the fifteen tax years ending with the tax year during which the renunciation of citizenship occurred.¹⁴
2. An individual is exempt from the exit tax regime if he or she:
 - a. Files Form 8854;
 - b. Renounces his or her US Citizenship before the age of 18 and a half; and
 - c. Was a resident of the US for no more than ten years before the age of 18 and a half.¹⁵

In the practical application of these two exceptions, a renouncing individual who qualifies under either will not be subject to the Net Worth Test or the Tax Liability Test only. Every renouncing individual, whether qualifying under the exceptions or not, will always be subject to the Compliance Test. Form 8854 is filed with a renounced individual’s final year return. On Form 8854, the renouncing individual must affirm under penalties of perjury, that he is compliant with US tax and filing obligations for the period of five years preceding expatriation. Thus, taking the proper steps to avoid the exit tax regime of § 877A requires that the renouncing individual is US tax compliant in all circumstances.

With every renouncing individual being required to be five years US compliant in order to avoid the classification of a Covered Expatriate under § 877A, a brief review of some potential filing and reporting

obligations facing an expatriate looking to get US tax compliant is useful. Appended to this article is a table that summarizes most of the filing and reporting obligations required by US citizens residing in Canada.

Conclusion

The Reed-Schumer Amendment recently failed to become US law, but the danger of inadvertently being barred from the US while also being hit with the US exit tax may still be of real concern for those considering renouncing in the near future and beyond. It is fairly safe to say that Congress is aware of the renunciation problem they are facing, and smart money would be on another amendment or bill attempting to become law in the near future. This fact, accompanied with the Foreign Account Tax Compliance Act (FATCA) now in effect, may make now the best time to renounce one's US citizenship. The magnitude of what could be at stake when an individual looks to renounce their US citizenship in the future has the potential to be exponentially greater if Congress continues on its path to curb the record number of renunciations in 2017 and beyond. Any US citizen who renounces their citizenship under the current Reed Amendment, or a potential future variation of the failed Reed-Schumer Amendment, needs to understand the repercussions and timing of this decision moving forward.

Click [here](#) for a summary of filing and reporting obligations required by US citizens residing in Canada.

For questions or inquiries please contact Alexander Marino at amarino@moodysgartner.com or 403-693-5114.

If you're considering renouncing your U.S. citizenship, join us for a complimentary [informative session](#).

Appendix

Situation	Form	Due Date	Failure to File Penalty
Ownership or signatory authority over non-U.S. accounts with an aggregate value in excess of \$10,000	TD F 90-22.1 (FBAR)	<ul style="list-style-type: none"> • Must be <u>received</u> on or before June 30, with no extensions • May be filed electronically 	<ul style="list-style-type: none"> • <u>Non-willful penalty</u> is \$10,000 per year • <u>Willful penalty</u> is: <ul style="list-style-type: none"> ◦ Greater of 50% of the account or \$100,000 ◦ Not more than 5 years in prison <p>31 U.S.C. 5321(a)(5)</p>
Individual has "Specified Foreign Assets". Market value of which exceeds certain	8938	If reside outside of U.S. must be filed with individual tax return (form 1040), June 15. Additional 4 month	Required beginning in 2012 Attached to U.S. income tax return (form 1040)

Situation	Form	Due Date	Failure to File Penalty
thresholds.		extension to file if form 4868 is timely filed	<ul style="list-style-type: none"> • Failure to file penalty is \$10,000 if form is not “accurate and complete” • If account is disclosed and tax is unreported on the account, penalty is 40% of the tax owed • NOTE, no distinction between “willful” and “non-willful” <p>26 U.S.C. 6038D</p>
Transfer money or other property to trust (including TFSA, RDSP, RESP)	3520	If reside outside of U.S. due date is same as individual tax return (form 1040), June 15. Additional 4 month extension to file if form 4868 is timely filed	<p>Failure to file penalty is 35% of the value of the property transferred</p> <p>26 U.S.C. 6048</p>
Receipt of distribution from non-U.S. trust (including TFSA, RDSP, RESP)	3520	If reside outside of U.S. due date is same as individual tax return (form 1040), June 15. Additional 4 month extension to file if form 4868 is timely filed	<p>Failure to file penalty is 35% of the value of the property transferred</p> <p>26 U.S.C. 6048</p>
Ownership of non-U.S. trust (including TFSA, RDSP, RESP) or trustee of non-U.S. trust, or executor of non-U.S. estate	3520-A	<p>15th day of the 3rd month after the trust’s tax year (including extensions per form 7004)</p> <p>Note the due date is not automatically extended by filing an extension with the income tax return</p>	<ul style="list-style-type: none"> • Failure to file penalty is greater of \$10,000 or 5% of the amount “owned” by person <p>26 U.S.C. 6677(b)</p> <ul style="list-style-type: none"> • Criminal Penalties may apply for failure to file if fraudulent or willful <p>26 U.S.C. 7203, 7206, 7207</p>
Receipt of gift from non-U.S. Person or distribution from a non-U.S. estate	3520	If reside outside of U.S. due date is same as individual tax return (form 1040), June 15. Additional 4 month extension to file if form	<p>Failure to file penalty is 5% of the amount of the gift or distribution, not to exceed 25%</p>

Situation	Form	Due Date	Failure to File Penalty
		4868 is timely filed	26 U.S.C. 6039F
Shareholder, officer, director of certain foreign corporations	5471	If reside outside of U.S. must be filed with individual tax return (form 1040), June 15. Additional 4 month extension to file if form 4868 is timely filed	Failure to file penalty is \$10,000 and reduction of foreign tax credits 26 U.S.C. 6035, 6038, and 6048
U.S. corporation has 25% or more ownership by non-U.S. person	5472	Must be attached to and filed with the corporation's income tax return (form 1120), which is the 15 th day of the 3 rd month after the end of its tax year	Failure to file penalty is \$10,000 26 U.S.C. 2038A and 2038C
Transfer of property (including money) to certain non-U.S. corporations	926	Must be filed with the transferor's income tax return: (a) For individual residing outside the U.S., June 15. Additional 4 month extension to file if form 4868 is timely filed. (b) For corporations and partnerships 15 th day of the 3 rd month after the end of its tax year	Failure to file penalty is 10% of the value transferred with a maximum of \$100,000 26 U.S.C. 6038B
Ownership of certain non-U.S. partnerships	8865	Must be filed with the income tax return: (a) For individual residing outside the U.S., June 15. Additional 4 month extension to file if form 4868 is timely filed. (b) For corporations and partnerships 15 th day of the 3 rd month after the end of its tax year	Failure to file penalty is \$10,000 26 U.S.C. 6038, and 6046A
Transfer of property (including money) to certain non-U.S. partnerships	8865	Must be filed with the income tax return: (a) For individual residing outside the U.S., June 15. Additional 4 month extension to file if form 4868 is timely filed. (b) For corporations and partnerships 15 th day of the 3 rd month after the	Failure to file penalty is 10% of the value transferred with a maximum of \$100,000 26 U.S.C. 6038B

Situation	Form	Due Date	Failure to File Penalty
		end of its tax year	
Ownership of non-U.S. insurance policy on U.S. individual (or U.S. insurable interest)	720	Must be filed at the end of the quarter that follows the quarter in which premium payments are made	<ul style="list-style-type: none"> • Excise tax of 1% on premiums • No failure to file penalty • Joint and several liability with owner broker and issuer
			26 U.S.C. 4371
Ownership of interest in non-U.S. mutual fund	8621	If reside outside of U.S. due date is same as individual tax return (form 1040), June 15. Additional 4 month extension to file if form 4868 is timely filed	There is currently no penalty for failure to file the 8621

1. 5,411 expatriates published for 2016.

2. There are two limited exceptions provided for dual citizens at birth and persons under 18 ½ years of age. These two exceptions make it so that an expatriate will only be a covered expatriate if he or she fails to certify compliance with US tax obligations for the prior 5 years. Thus, these two exceptions can eliminate the need to comply with the tax liability test (IRC § 877 (a)(2)(A)) and the net worth test (IRC § 877 (a)(2)(B)) in attempting to avoid being classified as a covered expatriate (discussed further infra).

3. IRC § 877A(g)(2) provides that an "expatriate" means any US citizen who relinquishes his or her citizenship and any long term resident of the US who ceases to be a lawful permanent resident of the US Long term resident is defined in IRC § 877A(g)(5).

4. US Department of State.

5. 8 U.S.C. § 1182(a)(10)(E)(2011). (Any alien who is a former citizen of the United States who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States Citizenship for the purpose of avoiding taxation by the United States is inadmissible.)

6. IRC § 877(e)(2). Deemed a long term permanent resident if the individual held a US Green Card for 8 of the previous 15 years.

7. IRC § 877A(a)(1).

8. IRC § 877A(g)(3) and (g)(4).

9. IRC § 877A (a)(3).

10. IRC § 877A(d)(4).

11. IRC § 877A(e)(2).

12. IRC § 877A(c) and IRC § 877A(f)(3).

13. 2017 number. Adjusted annually for inflation.

14. IRC § 877A(g)(1)(B)(i).

15. IRC § 877A(g)(1)(B)(ii).