

Renouncing Your U.S. Citizenship: Failed Amendment May Signal That Now Is The Time To Get Out!

By: Alexander F. Marino, JD, LLM (U.S. Tax)

A. INTRODUCTION

If you are one of the many U.S. citizens contemplating renouncing your U.S. citizenship, Congress has sent fairly clear messages that now, as opposed to later, may be the right time to get out of the club. On June 12, 2013, U.S. Senators Jack Reed (D-RI) and Chuck Schumer (D-NY) attempted to add yet another hurdle to the ongoing saga for those individuals looking to renounce their U.S. citizenship when they filed an amendment to an immigration reform bill. This amendment would have ensured that the U.S. Department of Homeland Security could exclude certain individuals from re-entry into the United States. The proposed amendment was never voted on in the House of Representatives and died before reaching the floor. But if it had made its way into law, it would have excluded from re-entry not only former U.S. 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 U.S. citizenship remains on Congress’s radar and, moving forward, potential changes seem likely to make getting out harder rather than easier. The 2017 calendar year witnessed one of the highest number of U.S. citizens renouncing in history.¹ This record number of U.S. citizens getting out represents substantial losses in the number of U.S. taxpayers and tax dollars collected by the IRS, during life and at death. Congress is clearly aware of this fact and appears poised to at some point put the brakes on the mass exodus. Indeed, when in December 2017 they undertook the largest reform of U.S. tax law in over three decades, U.S. lawmakers did not to change to a residence-based tax system for U.S. individuals or take any steps to make renouncing easier. If U.S. immigration reform becomes a reality—and Donald Trump has hinted that this is high on his list of priorities—it is not difficult to imagine that something like the 2013 proposal becoming law.

Under the failed 2013 amendment, a renouncing individual who was classified as a Covered Expatriate under § 877A would have had to prove to the U.S. 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 United States.

So how does a renouncing U.S. 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 U.S. citizen as a Covered Expatriate if he or she meets one or more of the following criteria:

- i. has an average annual net tax liability for the five preceding years of more than \$168,000 USD (2019 amount);
- ii. has a net worth of over \$2,000,000 USD (never inflation-adjusted); or
- iii. fails to certify compliance with U.S. tax obligations for the prior five years (discussed in further detail below).²

¹ 5,133 renouncers in total for 2017 (a number that is likely understated). Complete 2018 numbers are not yet available.

² There are two limited exceptions provided for dual citizens at birth and persons under 18 ½ years of age. These two exceptions in effect make eligible individuals Covered Expatriates if they fail to certify compliance with U.S. tax obligations for the prior 5 years. Thus, these two exceptions can eliminate the applicability of the tax liability test (I.R.C. § 877(a)(2)(A)) and the net worth test (I.R.C. § 877(a)(2)(B)) in for individuals who could otherwise be classified as Covered Expatriates (discussed further infra).

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 U.S. citizenship in the near future, the fact that influential senators have attempted to make the penalties associated with renouncing even more severe should send a loud and clear message to all those looking to renounce their U.S. citizenship...“GET OUT NOW.”

B. WHERE THE LAW WAS HEADED UNDER THE FAILED REED-SCHUMER AMENDMENT

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

- i. Automatically excluding any Covered Expatriate who triggered the “exit tax” of § 877A;
- ii. Creating a mechanism to allow a Covered Expatriate (i.e., an individual caught under § 877A) to petition the U.S. Department of Homeland Security for a determination that tax avoidance was not one of the principal purposes of expatriation; and
- iii. Allowing the Department of Homeland Security to make that determination if the Covered Expatriate could establish through clear and convincing evidence that tax avoidance was not one of 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 U.S. government to show that the renouncing U.S. citizen did so to avoid U.S. 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 U.S. citizen (whether a Covered Expatriate or not) as it can be very difficult for the U.S. government to meet its burden of proof regarding tax avoidance motives. Under the failed Reed-Schumer Amendment, however, the advantage would have been squarely with the U.S. government.

If similar legislation to the failed Reed-Schumer Amendment eventually becomes law, the importance of avoiding the U.S. exit tax under § 877A will be even more important than before. Not only will 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 U.S. tax will fall on the Covered Expatriate.

This automatic presumption of having renounced for tax avoidance purposes would likely result in many Covered Expatriates having to retain counsel and present evidence before the Department of Homeland Security to prove that they did *not* renounce for tax avoidance purposes; the burden of proving a negative is extremely difficult in any legal situation. The result would be that Covered Expatriates would have been required to spend time and resources fighting an uphill battle of proving through “clear and convincing evidence” that a principal purpose of their renunciation was not to avoid U.S. tax. Covered Expatriates would have been forced to make circumstantial arguments before the Department of Homeland Security in hopes that the governing body involved saw the facts in the taxpayer's favor. If not, a Covered Expatriate would have been denied re-entry into the United States in addition to being hit with the exit tax.

C. WHERE THE LAW STANDS TODAY: THE ORIGINAL REED AMENDMENT

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

As a result, in 1996 Senator Reed proposed the original Reed Amendment, which was made law.³ The law still stands today and gives the Executive Branch⁴ the ability and authority to determine which U.S. citizens have renounced for tax avoidance purposes. If the U.S. government determines that a former citizen renounced for the primary purpose of avoiding U.S. tax, that person will be denied re-entry into the United States.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 expatriate's tax avoidance motives falls 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 U.S. Embassy or Consulate General.

Thus, in the practical application of the original Reed Amendment, the renouncing individual is rarely denied re-entry to the United States unless he or she confesses during his or her exit interview to be renouncing for tax avoidance purposes. Needless to say, very few individuals renouncing U.S. citizenship confess to having tax avoidance purposes. Consequently, identifying those expatriates who renounce for tax avoidance purposes is nearly impossible. Congress knows this and may thus eventually tighten the screws on the renunciation program through the proposed Reed-Schumer Amendment or something like it.

D. 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 becomes law. As the law currently stands, avoiding § 877A and the U.S. exit tax is very important as, by itself, the exit tax can have devastating tax consequences to a renouncing U.S. citizen who is not prepared. Assuming a variation of the Reed-Schumer Amendment one day becomes law, the scope and effect of not being labelled 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 Covered Expatriates. Section 877A classifies an expatriate as a “Covered Expatriate” when the individual meets any portion of a three-part test and renounces his or her U.S. citizenship or loses U.S. residency⁶ after June 17, 2008. A Covered Expatriate subject to the exit tax under § 877A will face a mark-to-market exit tax regime under which the covered expatriate is treated as having sold for fair market value all of his or her property the day before the “expatriation date.”⁷ The “expatriation date” is the date that the taxpayer renounces citizenship or ceases to be a lawful permanent U.S. resident.⁸ The mark-to-market exit tax regime applies to unrealized net gains in excess of \$725,000 USD in 2019 (the amount is adjusted annually for inflation).⁹

³ I.R.C. § 877A(g)(2) provides that an “expatriate” means any U.S. citizen who relinquishes his or her citizenship and any U.S. long-term resident who ceases to be a lawful permanent resident of the U.S. Long term resident is defined in I.R.C. § 877A(g)(5).

⁴ I.e., the U.S. 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 U.S. citizenship and who is determined by the Attorney General to have renounced U.S. citizenship for the purpose of avoiding taxation by the United States is inadmissible.

⁶ I.R.C. § 877(e)(2). An individual is deemed a long term permanent resident if he or she held a U.S. green card for 8 of the previous 15 years.

⁷ I.R.C. § 877A(a)(1).

⁸ I.R.C. § 877A(g)(3) and (g)(4).

⁹ I.R.C. § 877A(a)(3).

Renouncing Your U.S. Citizenship: Failed Amendment May Signal That Now is the Time to Get Out!

Page 4 of 8

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:

- i. The individual has a net worth of \$2,000,000 USD or more at the time of renunciation (Net Worth Test, never adjusted for inflation);
- ii. The individual had an average annual net income tax liability of more than \$168,000 USD in the five years ending before the date of expatriation (Tax Liability Test, 2019 amount);¹³ or
- iii. The individual failed to certify on Form 8854 that he or she had complied with all U.S. 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 U.S. 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 U.S. for more than ten years before the age of eighteen and a half. As minors are generally not allowed to renounce their U.S. 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:

- i. 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 (i.e., Canada) at the time of renunciation of citizenship; and
 - c. Was a resident of the United States for no more than ten of the fifteen tax years ending with the tax year during which the renunciation of citizenship occurred.¹⁴
- ii. An individual is exempt from the exit tax regime if he or she:
 - a. Files Form 8854;
 - b. Renounces his or her U.S. citizenship before the age of eighteen and a half; and
 - c. Was a resident of the United States for no more than ten years before the age of eighteen 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 or she is compliant with U.S. 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 be U.S. tax-compliant in all circumstances.

¹⁰ I.R.C. § 877A(d)(4).

¹¹ I.R.C. § 877A(e)(2).

¹² I.R.C. § 877A(c).

¹³ Adjusted annually for inflation.

¹⁴ I.R.C. § 877A(g)(1)B(i).

¹⁵ I.R.C. § 877A(g)(1)B(ii).

With every renouncing individual required to be five years' U.S. tax-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 U.S. tax compliant is useful. Appended to this article is a table that summarizes most of the filing and reporting obligations required of U.S. citizens residing in Canada.

E. CONCLUSION

The Reed-Schumer Amendment failed to become law, but the danger of inadvertently being barred from the United States while also being hit with the U.S. 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 it faces and smart money would be on another amendment or bill eventually becoming law, perhaps as part of Donald Trump's promised immigration reform. This fact, accompanied by the Foreign Account Tax Compliance Act now in effect, may make now the best time to renounce one's U.S. citizenship. The magnitude of what could be at stake when an individual looks to renounce his or her U.S. 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 2019 and beyond. Any U.S. citizen who renounces 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.

For questions or inquiries please contact Alexander Marino via email at amarino@moodytax.com or by phone at 403-693-5114.

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 October 15 • Must 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 thresholds	8938	<p>If reside outside of United States, must be filed with individual tax return (Form 1040), June 15.</p> <p>Additional 4 month extension to file if form 4868 is timely filed</p>	<p>Required beginning in 2012 Attached to U.S. income tax return (Form 1040)</p> <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 RDSP and RESP)	3520	<p>If reside outside of United States due date is same as individual tax return (Form 1040), June 15.</p> <p>Additional 4 month extension to file if form 4868 is timely filed</p>	<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 RDSP and RESP)	3520	<p>If reside outside of United States due date is same as individual tax return (Form 1040), June 15.</p> <p>Additional 4 month extension to file if form 4868 is timely filed</p>	<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 RDSP and 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>

Renouncing Your U.S. Citizenship: Failed Amendment May Signal That Now is the Time to Get Out!
Page 7 of 8

Situation	Form	Due Date	Failure to File Penalty
Receipt of gift from non-U.S. person or distribution from a non-U.S. estate	3520	If reside outside of United States due date is same as individual tax return (Form 1040), June 15. Additional 4 month extension to file if form 4868 is timely filed	Failure to file penalty is 5% of the amount of the gift or distribution, not to exceed 25% 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, or non-U.S. corporation with a U.S. trade or business	5472	Must be attached to and filed with the corporation's income tax return (Form 1120 or 1120-F), which is the 15 th day of the 4 th 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 United States, June 15. Additional 4 month extension to file if form 4868 is timely filed. (b) For corporations, 15 th day of the 4 th month after year-end; for partnerships, 15 th day of the 3 rd month after year-end	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 United States, June 15. Additional 4 month extension to file if Form 4868 is timely filed. (b) For 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 United States, 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

Renouncing Your U.S. Citizenship: Failed Amendment May Signal That Now is the Time to Get Out!
Page 8 of 8

Situation	Form	Due Date	Failure to File Penalty
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 <p>26 U.S.C. 4371</p>
Ownership of interest in non-U.S. mutual fund	8621	If reside outside of United States 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 but taxes associated with ownership of a non-U.S. mutual fund can be high