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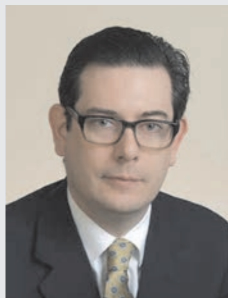
FATCA and the Road To Expatriation

By Matthew A. Morris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In this article, Morris suggests ways to fix the expatriation tax so that it better targets bad actors rather than benign actors. He proposes requiring taxpayers to certify that they have not willfully structured their affairs or assets to fall below the applicable net income and net worth thresholds and adding an exception to the expatriation tax for individuals who have returned to compliance with U.S. income tax and reporting requirements.

A. Introduction

Expatriation is a controversial term laden with heavy political implications. In the United States, the standard definition of the verb "expatriate" is to relinquish one's U.S. citizenship, but the political connotation is best captured by the term "expatriot," referring to a former patriot who has renounced his political allegiance to the United States. Also, the verb expatriate can easily be confused with the noun expatriate, which refers to a U.S. citizen living abroad. The common association of an expatriate in the United States may be either that of a wealthy American living a life of luxury in a foreign country or a 20-something college student or recent graduate who opts for the peripatetic backpacker experience before finally returning to his permanent home in the United States. Because of images like these, the verb expatriate has picked up a host of unjustified assumptions and associations.

Perhaps the most widely shared assumption regarding expatriation is that relinquishing or renouncing one's citizenship expresses an underlying political belief — the desire to dissociate from the United States because of a political disagreement or because of allegiance to another country. However, despite this common assumption, there are several nonpolitical reasons U.S. citizens may wish to relinquish or renounce their citizenship. For example, some countries outlaw dual citizenship, which makes it impossible for residents of those countries — some of whom reside there for economic or social (family) reasons rather than political reasons — to remain legal residents there without formally renouncing or relinquishing their U.S. citizenship.[1]

Other U.S. citizens relinquish or renounce their citizenship to avoid the burdensome U.S. income tax and information reporting requirements under the Foreign Account Tax Compliance Act. The problem here is threefold:

1. FATCA — and the IRS disclosure initiatives designed to encourage compliance with FATCA before the IRS's announcement of the streamlined filing compliance procedures in June 2014 — does not distinguish between "bad actors" who intentionally failed to disclose foreign income and assets from "benign actors" who did not know about the U.S. income tax and reporting requirements (discussed in Section B);

2. FATCA and the United States' citizenship-based taxation system have made it prohibitively expensive for expatriates and "accidental" U.S. citizens to become compliant and meet the U.S. income tax and information reporting requirements (discussed in Section C); and

3. the expatriation tax, or "exit tax," under section 877A imposes a harsh mark-to-market regime on taxpayers who meet the applicable net worth or net income threshold or who fail to certify under penalty of perjury that they have met U.S. income tax and reporting requirements for the five tax years preceding the tax year in which they renounce their U.S. citizenship, regardless of whether the taxpayers are benign actors or bad actors (discussed in Section D).

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[1]The countries that either ban or impose significant restrictions on dual citizenship include (but are not limited to) Andorra, Austria, Bahrain, China, El Salvador, Estonia, India, Indonesia, Japan, Lithuania, Malaysia, Montenegro, the Netherlands, Norway, Panama, Poland, Singapore, Slovakia, Thailand, Ukraine, the United Arab Emirates, and Venezuela. Andrew Henderson, "Which Countries Allow Dual Citizenship?" Nomad Capitalist, Apr. 25, 2014.

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B. An Overview of FATCA

The most significant nonpolitical reason for renouncing one's U.S. citizenship can be summarized in five letters. FATCA, which became law in the United States in 2010,[2] imposes comprehensive reporting requirements on individuals[3] with foreign accounts, on foreign financial institutions, and on foreign governments.[4] The basic premise of the law is that (1) foreign governments that enter into intergovernmental agreements to implement FATCA agree to report to Treasury information regarding accounts held by U.S. citizens in that country, and (2) FFIs that agree to register with the IRS and provide the names of their U.S. account holders will avoid an automatic withholding tax of 30 percent on any U.S.-source payments made to the FFIs. This means that individuals with accounts in foreign countries that have signed on to FATCA — or holders of accounts at FFIs that have registered with the IRS — can no longer shield these accounts from U.S. income tax and disclosure requirements.[5] FATCA is rapidly becoming a worldwide disclosure regime, and U.S. citizens who maintain accounts in foreign countries without disclosing them to Treasury on Financial Crimes Enforcement Network Form 114 (foreign bank account reports) or reporting the income on their Forms 1040 may seek to avoid harsh civil or criminal penalties by renouncing their U.S. citizenship before their names and account information are turned over to the IRS.

An ancillary consequence of FATCA is that millions of benign actors — a term originally coined by National Taxpayer Advocate Nina Olson in her 2012 Report to Congress[6] — have been swept into FATCA's net despite the original purpose of FATCA to identify and investigate bad actors evading their U.S. income tax requirements.[7] For example, there are thousands of "accidental" U.S. citizens who were born in the United States but moved at a young age with their families to a foreign country and became citizens there. These U.S. citizens by birth may have never set foot in the United States since childhood or may have returned to the United States after many years living and working in what they consider to be their home countries. Most accidental U.S. citizens, especially those who never returned to the United States, are unaware that the United States imposes tax on its citizens, permanent residents, and substantial presence residents[8] on their "worldwide income," regardless of whether that source of income is subject to tax in their country of residence. This particular class of benign actors may not have complied with U.S. income tax and reporting requirements for many years or may have been minimally compliant with these requirements by filing returns reporting only U.S.-source income without filing other necessary information returns such as FBARs. This means that many benign actors are forced to choose between two equally unappealing alternatives: either (1) comply with the United States' exceedingly complex international income tax and information reporting regime or (2) relinquish or renounce their U.S. citizenship to avoid these burdensome tax and disclosure requirements, a process that involves its own complex set of tax procedures (discussed in Section D, below).

Benign actors who sought to retain their U.S. citizenship and come into U.S. tax compliance were

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[2]FATCA was enacted as subtitle A (sections 501 through 541) of title V of the 2010 Hiring Incentives to Restore Employment (HIRE) Act. *See* P.L. 111-147, title V, subtitle A, sections 501-547 (Mar. 18, 2010).

[3]FATCA also imposed a reporting requirement on U.S. citizens, resident aliens (who meet the green card or substantial presence test under section 7701(b)(1)(A)), and specific nonresident aliens (those who elect to be treated as resident aliens and bona fide residents of American Samoa or Puerto Rico) to report specified foreign financial assets on Form 8938 to be filed with their Form 1040 annually. *See* IRS "FATCA Information for Individuals" (Apr. 2, 2015); section 6038D (mandating the disclosure of information regarding foreign financial accounts required by Form 8938).

[4]*See* IRS, Foreign Account Tax Compliance Act. FATCA added sections 1471 to 1474 to the code, which set forth the withholding requirements for nonsignatory foreign governments and FFIs.

[5]As of July 15, 2015, 68 countries have signed IGAs to implement FATCA, and 44 countries have reached agreements in substance with the United States to implement FATCA. Treasury Resource Center, FATCA-Archive.

[6]National Taxpayer Advocate, "2012 Annual Report to Congress," at 134 (Dec. 31, 2012).

[7]The State Department estimates that as of May 2014, 7.6 million U.S. citizens live abroad. State Department, Bureau of Consular Affairs, "Who We Are and What We Do: Consular Affairs by the Numbers" (May 2014). Foreign accounts maintained by these estimated 7.6 million expatriate U.S. citizens — not to mention foreign accounts owned by dual citizens and other taxpayers with substantial connections to foreign countries — are subject to the same reporting requirements under FATCA as foreign accounts owned by bad actors who specifically intend to evade U.S. income tax and reporting requirements.

[8]*See* section 7701(b)(3) (setting forth the number of days of physical presence in the United States required to treat noncitizen, nonpermanent residents as U.S. citizens or permanent residents for federal income tax purposes).

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initially encouraged to participate in the IRS offshore voluntary disclosure program (OVDP).[9] This program was originally designed to offer bad actors the opportunity to come forward without the threat of criminal prosecution to file their delinquent or amended returns for an eight-year lookback period, pay the additional income tax plus interest, pay a substantial understatement penalty equal to 20 percent of the additional income tax, and pay an ''offshore'' or miscellaneous penalty (originally 20 percent but currently equal to 27.5 percent of the highest aggregate account balance during the eight-year lookback period for most foreign accountholders).[10] Faced with significantly more OVDP applications than originally expected,[11] the IRS focused primarily on the administrative complexity of processing, assigning, reviewing, and closing these OVDP cases within a reasonable amount of time. In consideration of these administrative burdens, the IRS was not well-equipped to address the specific nuances of each case that tended to establish non-willfulness or the larger questions of fundamental fairness in the OVDP process as a whole. The standard IRS party line regarding the OVDP was (and to a large extent still is) that it is a settlement initiative, and thus it affords taxpayers no statutory appeal rights or any of the other procedural protections found in the code.[12]

Once benign actors committed to participating in the OVDP, they had only one way out — a process referred to as an ''opt-out'' in which they would forgo the OVDP penalty structure for a much more ambiguous, open-ended scenario involving the full gamut of civil penalties (including the draconian willful failure-to-file FBAR penalty equal to 50 percent of the highest aggregate balance of the taxpayer's foreign accounts for the years under investigation).[13] Even though benign actors constituted the vast majority of OVDP applicants, very few opted out because of the risk of these potentially devastating FBAR penalties.[14]

Since the first OVDP in 2009, the program has been substantially revised and expanded to account for non-willful tax and information return compliance problems. In June 2014 the IRS announced the streamlined filing compliance procedures, which offer both residents and nonresidents of the United States the opportunity to resolve their compliance issues simply by filing the delinquent tax returns for the past three tax years and FBARs for the past six calendar years, paying the additional income tax and interest thereon, paying a miscellaneous offshore penalty equal to 5 percent of the highest balance of their year-end balances in their foreign accounts over a six-year lookback period (for residents only — nonresidents are not responsible for paying a miscellaneous offshore penalty), and filing a certification of non-willful conduct.[15]

C. The Rising Costs of Compliance

Despite the significant progress the IRS has made in simplifying the compliance process for benign actors, accidental U.S. citizens with few connections

[9] *See, e.g.*, National Taxpayer Advocate, *supra* note 6, at 136 (''The IRS 'strongly encouraged' everyone with an FBAR violation and unreported income (including benign actors) to participate in its OVD programs and initially discouraged them from opting out.'').

[10] *See* Matthew A. Morris, ''One Size Does Not Fit All: Unintended Consequences of the Offshore Voluntary Disclosure Program,'' *Int'l Tax J.* (CCH) (2013) (summarizing the terms of the 2009, 2011, and 2012 programs).

[11] *Compare* IR-2012-89 (''In a typical year, we used to get 100 or so taxpayers who used our voluntary disclosure program. When we first set up our new program in 2009, we thought that figure would rise to maybe 1,000.''), *with* IR-2011-14 (''The first special voluntary disclosure program closed with 15,000 voluntary disclosures on Oct. 15, 2009. Since that time, more than 3,000 taxpayers have come forward to the IRS with bank accounts from around the world.'').

[12] *See, e.g.*, IRS Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers, at A27 (July 15, 2015) (''The certification process is less formal than an examination and does not carry with it all the rights and legal consequences of an examination. For example, the examiner will not send the usual taxpayer notices . . . [and] the taxpayer will not have appeal rights with respect to the Service's determination.'').

[13] *See* 31 U.S.C. section 5321(a)(5)(C) (establishing a maximum penalty of the greater of $100,000 of 50 percent of the amount reportable for any willful failure to file an FBAR — a penalty that can be imposed for each unfiled FBAR rather than for each individual nonfiler). The IRS recently issued guidance stating that ''in most cases, the total penalty amount for all years under examination will be limited to 50 percent of the highest aggregate balance of all unreported foreign financial accounts during the years under examination'' rather than a cumulative penalty of 50 percent of the highest account balance for each year in which an FBAR violation (*i.e.*, non-filing) occurred. *See* SBSE-04-0515-0025, ''Interim Guidance for Report of Foreign Bank and Financial Accounts (FBAR) Penalties'' (May 13, 2015). This interim guidance reverses the IRS's previously held position that a willful failure-to-file FBAR penalty should apply for each year in which an FBAR violation occurred. *See, e.g.*, *United States v. Zwerner*, Dkt. No. 1:13-cv.22082-CMA (S.D. Fl., June 11, 2013) (The IRS assessed a willful FBAR penalty equal to approximately 200 percent of the highest aggregate account balance — 50 percent of the highest aggregate account balance for four consecutive calendar years; the jury found Zwerner liable for three years of willful penalties, equal to approximately 150 percent of the highest aggregate account balance.).

[14] The Internal Revenue Manual acknowledges the potential for confiscatory FBAR penalties. *See, e.g.*, IRM section 4.26.16.4 (''FBAR civil penalties have varying upper limits, but no floor. . . . Examiner discretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation.'').

[15] *See generally* IRS, ''Streamlined Filing Compliance Procedures'' (Oct. 9, 2014).

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to the United States may feel that their U.S. citizenship is not worth the costs of participating in the streamlined foreign offshore procedures and the annual costs associated with preparing "true, correct, and complete" U.S. income tax and information returns. For many nonresident U.S. citizens, the annual tax and information returns required to be filed are exceedingly complex and in most cases cannot be prepared without some form of professional assistance.

Example 1: Geoffrey was born in the United States in 1962. His father was a U.S. citizen only, and his mother was an Australian citizen only. Under Australian law at the time of Geoffrey's birth, it was not possible to obtain Australian citizenship at birth in a country outside of Australia unless the child (or the parent on behalf of the child) applied for and was granted citizenship.[16] Geoffrey's parents did not apply for Australian citizenship on his behalf. Geoffrey moved to Australia with his mother when he was 7 years old and acquired Australian permanent residency status. He has worked in Australia as a self-employed attorney since he was 25 years old and has made contributions to his Australian retirement account (referred to as a superannuation account in Australia) since that time. He became a citizen of Australia in 1997. When he was 50 years old, in 2012, he inherited his father's shares of a closely held Australian software company, becoming a 25 percent owner. The company was valued at USD $1 million as of the date of his father's death. Geoffrey is now 53 years old. He has never filed a U.S. income tax return or information return (such as an FBAR). To come into compliance with his U.S. income tax and information reporting requirements, Geoffrey must prepare and file the following forms:

- *Forms 1040 for tax years 2012, 2013, and 2014*. The Forms 1040 must include the following tax and information forms:
  - Form 3520 for tax year 2012, reporting his receipt of shares from a foreign estate;[17]
  - Form 3520 and Form 3520-A for tax years 2012 to 2014, reporting his Australian superannuation account as a foreign grantor trust for U.S. income tax purposes;[18]
  - Forms 5471 for tax years 2012, 2013, and 2014, reporting the balance sheet information regarding the Australian software company (required because he owns more than 10 percent of the total value of a foreign corporation's stock);[19]
  - Forms 8621 for tax years 2012, 2013, and 2014, reporting the passive foreign investment company gains and losses on his Australian superannuation account;[20]
  - Forms 8938 reporting his specified foreign financial assets in Australia;[21] and
  - Form 8275, "Disclosure Statement," claiming an exemption from the requirement to report self-employment tax to the United States because he is already contributing to the Australian social security system under an Australia-U.S. Social Security Agreement (including a letter from the U.S. Social Security Administration indicating that his wages are not covered by the U.S. Social Security system).[22]

[16]Another barrier to Geoffrey obtaining dual Australian-U.S. citizenship at birth is that the United States did not allow dual citizenship before the Supreme Court decision in *Afroyim v. Rusk*, 387 U.S. 253 (1967), which held that Congress has no power under the Constitution to divest a person of U.S. citizenship under the Fourteenth Amendment without that person's voluntary relinquishment thereof.

[17]*See* section 6039F (requiring the disclosure of foreign gifts and bequests from foreign persons or estates); Form 3520, Part IV, at 6 (2014); and Instructions to Form 3520, at 12 (2014).

[18]The U.S. income taxation of earnings on Australian superannuation accounts is far from a settled area, but there is some authority within the international tax practitioner community to suggest that these accounts should be treated as foreign grantor trusts subject to information reporting on Form 3520 and Form 3520-A and that any foreign mutual funds held in these superannuation accounts should be taxed as PFICs. *See, e.g.*, LTR 200807003 (concluding that Australian superannuation funds should be treated as trusts for U.S. income tax purposes under reg. section 301.7701-4(a), which provides that an "arrangement will be treated as a trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility"). Some tax law practitioners agree that superannuation accounts might qualify as trusts (and more specifically, grantor trusts) for U.S. income tax purposes. *See, e.g.*, Phil Hodgen, "Form 3520-A Filing Deadline Is March 15, 2011," HodgenLaw PC International Tax Blog (Mar. 11, 2011) ("Australian citizen sticks money into a superannuation account. Immigrates to the United States. Same result: Form 3520-A . . . will be required.").

[19]*See* section 6046 (requiring the disclosure of information regarding foreign corporations when a U.S. citizen or resident becomes a 10 percent shareholder of the foreign corporation); Form 5471 (rev. Dec. 2012).

[20]*See generally* sections 1291-1297 (containing the PFIC rules); Form 8621 (rev. Dec. 2014); Instructions to Form 8621 (rev. Dec. 2014).

[21]*See supra* note 3 (discussing the Form 8938 requirement under FATCA).

[22]*See* IRS, "Social Security Tax Consequences of Working Abroad" (Nov. 2, 2014) (explaining that an individual working in a foreign country must continue to pay Social Security tax to

(Footnote continued on next page.)

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- *FBARs for calendar years 2009, 2010, 2011, 2012, 2013, and 2014*. Geoffrey will need to prepare and file these FBARs for the six previous calendar years for which the FBAR deadline has already passed under the terms of the streamlined foreign offshore procedures and will need to prepare and file these FBARs by June 30 of each subsequent calendar year to remain in compliance with his requirements under FATCA.

Not only must Geoffrey file the above income tax and information returns for previous tax years to come into U.S. tax compliance, he needs to continue filing these forms annually to remain in compliance. Because it would be very difficult for Geoffrey to prepare all of the necessary returns and information returns on his own, even with the assistance of a software program such as TurboTax, this could result in significant annual tax and information return preparation fees.

More importantly, however, the U.S. tax on PFIC income from the Australian mutual funds in his Australian superannuation account provides a major disincentive to retaining U.S. citizenship. Although his superannuation account is a qualified tax-deferred investment and retirement vehicle under Australian law, the account becomes a significant annual drain on his net income for U.S. tax purposes under the mark-to-market regime of section 1296 or the ''excess distribution'' deferred tax and interest regime under section 1291. After application of the foreign tax credit, Geoffrey's U.S. income tax on his Australian self-employment income and family business dividend income is de minimis. However, the income generated by the foreign mutual funds in his Australian superannuation account is likely subject to U.S. tax because (1) this category of income is not addressed in the Australia-U.S. income tax treaty, (2) no specific exception applies to the general rule that ''gross income means all income from whatever source derived,''[23] and (3) no U.S. FTC is available to offset the U.S. income tax liability even though the contributions to the superannuation account (and the annual earnings on those contributions) are taxed in Australia at a 15 percent rate, as these taxes are paid at the fund level rather than at the shareholder level.[24] Subjecting the PFIC earnings within Geoffrey's superannuation account to both U.S. and Australian income taxes undermines the central purpose of the Australian superannuation system, which is to provide an adequate source of retirement savings for Australian citizens.

For Geoffrey and other U.S. expatriates, accidental U.S. citizens, and U.S. citizen-residents with accounts and investments abroad, the professional and tax costs of complying with U.S. income tax and information return requirements has become prohibitively expensive. Taxpayers like Geoffrey — with minimal connections to the United States, no present or future plans to return to the United States, and an overwhelming tax and information return compliance burden — might therefore conclude that expatriation is the only prudent option from a practical, economic, and tax standpoint.

D. The Expatriation Tax Under Section 877A

The expatriation tax rules set forth in section 877A apply to (1) U.S. citizens who renounced their citizenship on or after June 17, 2008,[25] and (2) ''long-term residents'' who ended their U.S. resident status for federal tax purposes on or after June 17, 2008. Long-term resident is defined in section 877(e)(2) as any individual who is a lawful permanent resident of the United States (green card holder) in at least eight of the 15 tax years ending with the tax year in which the individual gives up resident status for federal tax purposes.[26] An individual will be treated as relinquishing or renouncing U.S. citizenship on the earliest of the following: (a) the date the individual ''renounces his United States nationality before a diplomatic or consular officer of the United States,'' (b) the date the individual provides to the State Department ''a signed statement of voluntary relinquishment of United States nationality,'' (c) the date the State Department issues to the individual a

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the United States unless an exception applies or there is a Social Security totalization agreement between the United States and that country); Social Security Administration, ''U.S. International Social Security Agreements'' (listing the countries with Social Security agreements currently in force).

[23]Section 61(a).

[24]This assumes that Geoffrey's contributions to his superannuation account were ''concessional'' (pretax) contributions. If Geoffrey made ''non-concessional'' (after-tax) contributions, the earnings on those contributions would not be subject to tax while they remain in the superannuation account. *See* Australian Taxation Office, ''Super and Tax.'' Geoffrey's inability to claim a U.S. FTC for the Australian income taxes paid on his concessional contributions results from the lack of proper documentation regarding the tax payment. Because the fund pays the tax, rather than the individual accountholders, the trustee of the superannuation account cannot provide Geoffrey with any documentation regarding the amount of taxes paid. Although U.S. mutual funds or other regulated investment companies can pass the amount of the fund-level taxes paid on to individual shareholders by issuing a Form 1099-DIV or similar statement, Australian superannuation accounts are not designed with U.S. tax compliance in mind and therefore are not equipped to pass this information on to individual accountholders. *See* IRS Publication 514, *Foreign Tax Credit for Individuals*, at 6 (2014) (summarizing the rules for foreign taxes paid by U.S. mutual funds and passed on to shareholders).

[25]The rules for expatriations before June 17, 2008, which are not discussed in this article, are set forth in section 877.

[26]Section 877(e)(2).

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"certificate of loss of nationality," or (d) the date that a U.S. court "cancels a naturalized citizen's certificate of naturalization."[27]

Assuming that the individual who relinquishes or renounces U.S. citizenship meets the definition of a "covered expatriate" under section 877A(g)(1)(A) (see discussion below), the mechanics of the expatriation tax under section 877A are as follows. The expatriating taxpayer must file three tax returns for the year of renunciation of U.S. citizenship (to be filed on or before April 15 of the calendar year following renunciation, or by June 15 if the taxpayer is living outside of the United States):

1. Form 1040 from January 1 to the day on which the individual renounces U.S. citizenship (reporting the individual's worldwide income and assets);

2. Form 1040NR for the day after the renunciation of U.S. citizenship until December 31 (reporting only U.S.-source income); and

3. Form 8854, "Initial and Annual Expatriation Statement" (to determine whether the renouncing taxpayer is a covered expatriate and, if so, whether any expatriation tax or exit tax is due).

The expatriation tax or exit tax is a mark-to-market tax. The mark-to-market regime under section 877A treats all *worldwide* property of a covered expatriate as sold for its fair market value on the day before the expatriation date.[28] Standard rules of gain and loss then apply — the FMV of the property on the day before expatriation is treated as the amount realized, and the taxpayer compares the amount realized with his basis in the property to determine if there is any taxable gain or loss. Both gains and losses on the deemed sales are recognized, but the wash sale rules of section 1091 are inapplicable.[29] The amount that would be includable by reason of the deemed sale rules is reduced by an exclusion amount ($690,000 for expatriations in tax year 2015).[30]

These mark-to-market rules do not apply to the following types of property:

1. *Deferred compensation items*.[31] Eligible deferred compensation items (such as qualified U.S. retirement accounts) are not marked to market, but the payer of these items must withhold 30 percent of any taxable distribution to a covered expatriate. All other items of deferred compensation are treated as having been distributed to the covered expatriate to the extent of the expatriate's accrued benefit (or the amount that the individual is entitled to transfer without a substantial risk of forfeiture) on the day before the expatriation date.[32] No early distribution tax will apply by reason of the deemed distribution of non-eligible deferred compensation items, and adjustments must be made to subsequent distributions from the plan to reflect the tax impact of the deemed distribution on the covered expatriate (that is, the expatriate will get a step-up in basis for the amount deemed distributed on the day before expatriation).[33]

2. *Specified tax-deferred accounts*.[34] The amount of a specified tax-deferred account is treated as having been distributed to the covered expatriate on the day before expatriation. No early distribution tax will apply by reason of the deemed distribution of non-eligible deferred compensation items, and adjustments must be made to subsequent distributions from the plan to reflect the tax impact of the deemed distribution on the covered expatriate (that is, the expatriate will get a step-up in basis for the amount deemed distributed on the day before expatriation).[35]

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[27] *Id.* Section 877A(g)(4).

[28] Section 877(e)(2); section 877A(a)(1).

[29] Section 877(e)(2); section 877A(a)(2)(B).

[30] Rev. Proc. 2014-61, 2014-47 IRB 860.

[31] Deferred compensation items include an item of deferred compensation such as a qualified retirement plan listed in section 219(g)(5) (*e.g.*, section 401(a) or 403(a) plans), any foreign pension plan or similar arrangement, any item of deferred compensation, and any property received in exchange for services to the extent not already included in gross income under section 83. Section 877A(d)(4). Eligible deferred compensation items include deferred compensation items if the payer of these items is a U.S. person (or elects to be treated as one for U.S. tax purposes) and the covered expatriate (i) notifies the payer of his status as a covered expatriate and (ii) makes an irrevocable waiver of the right to claim any treaty benefits associated with the income. *Id.* Section 877A(d)(3).

[32] Section 877A(d)(2)(A). Deferred compensation items other than eligible deferred compensation items are treated as having been distributed to the taxpayer on the day before expatriation. Eligible deferred compensation items are not treated as having been distributed to the taxpayer on the day before expatriation, but the payers of these items must withhold 30 percent of any payment to a covered expatriate.

[33] Section 877A(d)(2)(B) and (C).

[34] *Id.* Section 877A(e)(2) ("'Specified tax-deferred account' means an individual retirement plan (as defined in section 7701(a)(37)) other than any arrangement described in subsection (k) ('simplified employee pension') or (p) ('simple retirement account') of section 408, a qualified tuition program (as defined in section 529), a Coverdell education savings account (as defined in section 530), a health savings account (as defined in section 223), and an Archer MSA (as defined in section 220).").

[35] *Id.* Section 877A(e)(1)(B) and (C).

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3. *Any interest in a non-grantor trust*.[36] For distributions of property from a non-grantor trust, the trustee deducts 30 percent of the taxable portion of the distribution to the covered expatriate.[37] If the FMV of the property distributed exceeds the trust's basis in the property, then the trust will recognize gain as if the property were sold to the covered expatriate for FMV.[38]

Section 2801 (enacted in June 2008)[39] imposes major estate and gift tax consequences if covered expatriates attempt to gift or devise cash or property to U.S. persons after the expatriation date.[40] Unlike the standard rules that impose gift and estate tax on the donor or decedent's estate if the amount of the gift or value of the gross estate exceeds the applicable threshold amount, section 2801 states that the donee of a gift from a covered expatriate or the devisee of cash or property received from a covered expatriate's estate will be responsible for paying tax equal to the product of the highest rate of estate tax under section 2001(c) or the highest rate of gift tax under section 2502(a) times the value of the gift or bequest. The rationale for this rule appears to be that a covered expatriate should not be entitled to repatriate cash or property to the United States by means of a gift or estate planning strategy without incurring a serious tax penalty. Because the covered expatriate is presumably beyond the IRS's reach after expatriation, the gift and estate tax is imposed on the donee or devisee instead of on the covered expatriate or the estate.

As mentioned above, the expatriation tax under section 877A applies only to ''covered expatriates.'' The following individuals are exempted from the definition of a covered expatriate:

A. individuals who (i) ''became at birth a citizen of the United States and a citizen of another country and, as of the expatriation date, continues to be a citizen of, and is taxed as a resident of, such other country,'' and (ii) have ''been a resident of the United States as defined in section 7701(b)(1)(A)(ii)'' (under the substantial presence test) for not more than 10 of the prior 15 tax years;[41] or

B. individuals who (i) relinquish their U.S. citizenship before age 18½ and (ii) have been U.S. residents (under the substantial presence test of section 7701(b)(1)(A)(ii)) for not more than 10 tax years before the date of relinquishing their U.S. citizenship.[42]

If neither of the above exceptions under (A) and (B) applies, individuals will be considered covered expatriates under section 877A(g)(1)(A) (by reference to section 877(a)(2)) if they meet *any* of the following criteria[43]:

A. The individual's average annual net income tax in the five tax years preceding the renunciation or relinquishment of citizenship is greater than $160,000 (originally $124,000, as adjusted for inflation). The computation of average annual net income tax is determined under section 38(c)(1).[44] That section defines ''net income tax'' as the sum of the regular income tax and alternative minimum tax, reduced by the credits allowable under ''Subparts A and B of this part'' (sections 21 through 30D).[45]

B. The net worth of the individual as of the date of expatriation is $2 million or more (not adjusted for inflation). The net worth test is a standard balance sheet analysis of the taxpayer's assets and liabilities. The values of assets and liabilities are measured according to the valuation principles set forth in section 2512 ''without regard to any prohibitions or restrictions on such interest'' (for example, discounts for marketability and lack of control) as of the date of expatriation.[46]

C. The individual fails to certify on Form 8854 under penalty of perjury that he is compliant with his U.S. income tax and information return compliance responsibilities for the preceding five tax years. The certification says nothing regarding the timing of the compliance, except for the implicit requirement that the taxpayer must meet the requirements before completing the form.[47]

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[36]*See id.* Section 877A(f)(3) (an individual will be treated as holding an interest in a nongrantor trust if the trust does not meet any of the grantor trust rules set forth in sections 671 to 679); sections 671-679 (the grantor trust rules).

[37]*Id.* Section 877A(f)(1)(A).

[38]*Id.* Section 877A(f)(1)(B).

[39]*See* P.L. 110-245, section 301(b)(1) (June 17, 2008).

[40]Section 2801.

[41]*Id.* Section 877A(g)(1)(B)(i).

[42]*Id.* Section 877A(g)(1)(B)(ii).

[43]The criteria for covered expatriate status under section 877A(g)(1)(A) are objective standards rather than rebuttable presumptions: If an expatriating taxpayer meets either the net income, net worth, or noncompliance criteria, then he is a covered expatriate even if U.S. income tax avoidance has nothing to do with his decision to expatriate.

[44]*Id.* Section 877(a)(2)(A).

[45]*Id.* Section 38(c)(1).

[46]Notice 97-19, 1997-1 C.B. 394, section III, ''Tax Liability and Net Worth Tests,'' at 2.

[47]Form 8854 is required to be filed with the expatriating taxpayer's final Form 1040 for the year that includes the

(Footnote continued on next page.)

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Each of the criteria for covered expatriate status listed in section 877(a)(2) is intended to determine whether the taxpayer's decision to renounce is motivated by tax avoidance. Until the statute was amended under the American Jobs Creation Act of 2004, section 877 also contained a subjective test to determine whether a taxpayer was motivated by tax avoidance.[48] Before the 2004 amendment, section 877(a)(1) stated that an individual renouncing citizenship is responsible for the expatriation tax under section 877 ''unless such loss [of citizenship] did not have for one of its principal purposes the avoidance of taxes.''[49] Section 877(a)(2) also stated before the 2004 amendments that an individual ''shall be treated as having a principal purpose to avoid such taxes'' if either the net worth or the annual net income tests are met.[50] The 2004 act removed all references to subjective intent in the statute, opting instead for the objective standards of (a) annual net income, (b) net worth, and (c) failing to certify tax compliance.[51]

The first two criteria of the amended statutory definition of covered expatriate are based on unjustified assumptions regarding net worth and annual income. For example, if an individual's net worth and average annual net income for the past five tax years exceed the thresholds set forth under section 877(a)(2)(A) and (B), the IRS assumes that the individual's motivation to renounce was tax avoidance. Notice 97-19 states that under section 877(a)(2), a former citizen is considered ''to have lost U.S. citizenship with a principal purpose to avoid U.S. taxes if the former citizen's tax liability or net worth exceeded specific amounts on the date of expatriation.''[52] Although the notice is referring to a now-superseded version of section 877(a)(2), the general presumption remains that a taxpayer's decision to expatriate is motivated by a tax-avoidance purpose if the taxpayer exceeds the tax liability or net worth thresholds in the current version of the statute. If there is any doubt that the purpose of sections 877 and 877A is to discourage expatriation to avoid U.S. income tax, one need only look to the title of section 877: ''Expatriation to Avoid Tax.''

individual's expatriation date. Instructions to Form 8854, at 3 (rev. 2014). Thus, for U.S. citizens or residents living outside the United States and renouncing their citizenship on October 1, 2015, the due date for Form 8854 is the same due date as for the taxpayers' 2015 Form 1040 (June 15, 2015, which is the standard April 15 due date plus an automatic two-month extension of time to file for U.S. citizens and resident aliens living abroad).

[48]P.L. 108-357, section 804(a)(1) (Oct. 22, 2004).

[49]Section 877(a)(1).

[50]*Id.* Section 877(a)(2).

[51]P.L. 108-357, section 804(a)(2) (Oct. 22, 2004).

[52]Notice 97-19, section I, at 1.

The assumption that high-income and high-net-worth taxpayers are necessarily motivated by a tax-avoidance purpose is problematic. As described in Sections B and C, above, the taxpayer's decision may be more closely related to the duplicative burden and professional costs of complying with two countries' tax laws. In Example 1 (Section C) above, Geoffrey has little if any U.S. income tax liability on his Australian wage and dividend income after the application of the U.S. FTC. Even assuming for the sake of argument that Geoffrey's superannuation account were not subject to U.S. income tax, he would still need to hire a qualified international tax professional to prepare all of the complex information returns reporting his foreign accounts and assets each year. Attorney Phil Hodgen perfectly summarizes this problem: ''Imagine what it is like to [pay] $2,000, $3,000, or more for tax return preparation, with a zero tax bill. It is a pointless [and] expensive exercise.''[53]

The third criterion for covered expatriate status — failing to certify U.S. tax compliance under section 877(a)(2)(C) — also targets a tax-avoidance motive: The IRS assumes that a taxpayer who cannot certify compliance with tax and information return obligations must have renounced for tax-avoidance purposes. The assumption is problematic not only because expatriation may be related to the burdens of compliance (as discussed above), but also because it is unclear whether filing amended or delinquent returns for the five years preceding expatriation meets the compliance requirement. Form 8854 simply requires taxpayers to certify that they have ''complied with all of [their] tax obligations for the 5 preceding tax years'' and not that they have timely filed true, correct, and complete income tax and information returns for those years. Thus, it appears (although it is not entirely clear) that taxpayers can restore compliance for previous years by filing amended or delinquent information returns for the past five tax years and paying any additional income tax due (assuming that all returns and forms are filed and all taxes are paid before completing the Form 8854).

Further, taxpayers who are compliant with their U.S. income tax and information return requirements may still be motivated by a tax-avoidance purpose to renounce or relinquish their U.S. citizenship.

Example 2: Jack, a wealthy businessman, was born in the United States to American parents and has lived his entire life in the United States. Starting in the mid-1980s, Jack opened

[53]Hodgen, ''Why People Expatriate,'' HodgenLaw PC International Tax Blog (June 5, 2012).

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several bank accounts in offshore tax havens such as Switzerland and the Cayman Islands. Jack's sole reason for opening these foreign accounts was to shield his considerable assets from U.S. income tax. Jack married Jill, also a lifetime U.S. citizen, approximately 20 years ago. Fully aware of the expatriation tax rules, Jack liquidated the assets in these foreign accounts 10 years ago (in 2005) and gifted the proceeds and other assets to Jill (who became the sole owner, not a joint or co-owner with Jack). Jack also started to file his U.S. income tax returns as ''married filing separately.'' As a result of Jack's gifts to Jill and his choice to file as ''married filing separately,'' Jack does not meet the net income test of section 877(a)(2)(A) or the net worth test of section 877(a)(2)(B). Further, Jack signed the certification of compliance on Form 8854 under penalty of perjury because he has been fully compliant with his U.S. income tax and reporting requirements for the past five years, despite his noncompliance from the mid-1980s to 2005. Jack renounces his citizenship in 2015 and is not responsible for the mark-to-market expatriation tax under section 877A because he falls under the net income and net worth tests and meets the compliance certification requirement.

Example 2 illustrates that tax compliance in the five-year period preceding expatriation should not be considered persuasive evidence of the lack of a tax-avoidance motive. Individuals like Jack are free to structure their affairs to shield their assets from the net worth test and keep their incomes below the net income threshold to avoid the expatriation tax,[54] whereas a taxpayer like Geoffrey in Example 1 may not be so lucky because (1) he does not fall under the dual citizen exception to the expatriation tax under section 877A(g)(1)(B)(i),[55] and (2) he never rearranged his assets to fall below the net income and net worth thresholds. As explained further in Section E below, there is a broken link between the requirements in the covered expatriate definition and the question of willfulness.

E. Restoring the Purpose of the Expatriation Tax

Before considering ways to revise section 877A so as to mitigate its impact on benign actors, one must first determine the overarching legislative purpose behind the section 877A mark-to-market regime. Is the goal to discourage expatriation (1) for political reasons (to keep as many U.S. citizens from renouncing their citizenship as possible), regardless of the existence of tax-avoidance motives; (2) for economic reasons (to compensate Treasury for the loss of future tax revenue from the expatriating citizens), regardless of the existence of tax-avoidance motives; or (3) specifically to discourage U.S. citizens from expatriating for purposes of tax avoidance? The legislative history of section 877 — which, as discussed in Section D above, contains a subjective tax-avoidance motive test that was later replaced with the objective tests for net income, net worth, and compliance certification — suggests that its purpose is primarily to discourage expatriation to avoid U.S. income tax.[56]

Proposal 1: Require expatriating taxpayers to certify non-willfullness. If the purpose of the expatriation tax is to discourage or even punish U.S. citizens for renouncing for tax-avoidance purposes, as suggested by the legislative history, this purpose would be better served by requiring taxpayers to certify that they have not willfully (1) structured their affairs to fall below the net income threshold of section 877(a)(2)(A), (2) structured their assets to fall below the net worth threshold of section 877(a)(2)(B),[57] or (3) failed to comply with their U.S. income tax and information return requirements in the five full tax years preceding the expatriation. The specific language regarding non-willfulness

[54]This is not mere academic speculation regarding a loophole that few taxpayers are likely to exploit. Although statistics on the actual number of taxpayers who employ these strategies are impossible to obtain, several tax practitioner websites discuss tax planning strategies for falling below the net income and net worth thresholds of section 877(a)(2). *See, e.g.*, Hodgen, ''How to Compute Net Tax Liability for Form 8854,'' HodgenLaw PC International Tax Blog (''If you are thinking about expatriating at some point in the future, start filing your tax returns using the status 'Married Filing Separately' rather than 'Married Filing Jointly'. You may be able to avoid covered expatriate status that way.''); Chi-Yu Liang, ''A Few Things to Know Before Breaking Up With Uncle Sam,'' Stout Risius Ross Inc. (Spring 2015) (''Accordingly, there are several ways in which a taxpayer may be able to plan in order to fall under the $2 million net worth threshold. The individual may wish to make completed gifts to others by giving annual exclusion gifts, making payments for educational or medical expenses, or making use of his or her $5.43 million federal gift tax exemption.'').

[55]*See supra* text accompanying note 41 (discussing dual citizen exception to covered expatriate status under section 877A(g)(1)(B)(i)). Geoffrey does not qualify for the dual citizen exemption from the expatriation tax under section 877A(g)(1)(B)(i) because he was not a citizen of Australia at birth but acquired Australian citizenship many years later.

[56]*See supra* notes 49-50.

[57]As a public policy matter, the $2 million net worth threshold of section 877(a)(2)(B) should be both increased and indexed for inflation if the purpose is to target the wealthiest echelon of expatriate U.S. taxpayers. For the sake of simplicity, the net worth threshold could track the inflation-adjusted threshold value of the taxpayer's gross estate for federal estate tax purposes ($5,430,000 for tax year 2015). *See* section 2010(c)(3)(A); IRS Form 706 instructions (for decedents dying after December 31, 2014).

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could be borrowed from the certification forms required for participation in the streamlined filing compliance procedures.[58] These new certification forms, which could be titled "Certification by U.S. Person of Non-Willfulness for Purposes of the Expatriation Tax," might require taxpayers to certify something like the following under the penalty of perjury:

> I certify that I have not at any time intentionally structured my affairs and/or assets in order to fall below the applicable net income threshold under section 877(a)(2)(A) of the Internal Revenue Code (the "Code") or the applicable net worth threshold under section 877(a)(2)(B) of the Code in such a way as to avoid the expatriation tax (or "exit tax") under section 877A of the Code. I further certify that any tax non-compliance within the five (5) tax years preceding the date of my expatriation was due to non-willful conduct. I understand that non-willful conduct is conduct that is due to negligence, inadvertence, mistake, or conduct that is the result of a good-faith misunderstanding of the requirements of the law.
>
> I recognize that if the Internal Revenue Service receives or discovers evidence of willfulness, fraud, or criminal conduct, it may open an examination or investigation that could lead to civil fraud penalties, FBAR penalties, information return penalties, or even referral to Criminal Investigation.

As discussed in Section D above, it is not entirely clear whether taxpayers who eventually come into compliance with their U.S. income tax and information return requirements by filing amended or delinquent income tax and information forms after the applicable due dates for these forms but before the date of expatriation are entitled to "certify under penalty of perjury that [they have] met the requirements of this title for the 5 preceding taxable years" under section 877(a)(2)(C). To clarify this point, the IRS should issue guidance to say that taxpayers who have satisfied all the requirements of either the OVDP or the streamlined filing compliance procedures — including taxpayers that have opted out of the OVDP and have paid all applicable taxes, interest, and penalties — are deemed to have met the requirements of this title for the five preceding tax years under section 877(a)(2)(C).

[58]*See* Form 14653, "Certification by U.S. Person Residing Outside of the United States for Streamlined Foreign Offshore Procedures" (Jan. 2015); Form 14654, "Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures" (Jan. 2015).

Proposal 2: Add a new category of 'restored compliance' taxpayers to the list of taxpayers exempt from covered expatriate status. In this author's opinion, clarifying that participants in the OVDP or the streamlined filing compliance procedures are entitled to certify compliance for the five preceding tax years does not go far enough to further the IRS's objectives of encouraging voluntary compliance and discouraging tax evasion. If the IRS truly wishes to encourage delinquent taxpayers with foreign income and assets to come into compliance with their U.S. income tax and information return requirements, the IRS should ask Congress to add a new exception to the covered expatriate rules under section 877(c). This new section (section 877(c)(4)) might read as follows:

> **(4) Taxpayers who restore past non-compliance.** The Secretary shall prescribe such regulations as may be appropriate to exempt individuals who restore non-compliance with the requirements of this title for the 5 preceding taxable years by satisfying the applicable requirements of the (1) Offshore Voluntary Disclosure Program (either through an executed Closing Agreement or through a completed examination following an opt-out of this Program), (2) Streamlined Filing Compliance Procedures, or (3) similar settlement initiative.

The IRS could promulgate a new regulation under section 877 stating as follows:

> A taxpayer meets the section 877(c)(4) exception from the "covered expatriate" definition of section 877A(g)(1) if:
>
> > 1. the Secretary and taxpayer have fully executed a Form 906 Closing Agreement and the taxpayer has (a) applied for participation in the Offshore Voluntary Disclosure Program or similar settlement initiative, (b) completed that program's certification process, and (c) paid all applicable tax, penalties, and interest in accordance with the terms of that Form 906 Closing Agreement prior to execution of the Form 8854: Initial and Annual Expatriation Statement;
> >
> > 2. the taxpayer has (a) applied for participation in the Offshore Voluntary Disclosure Program or similar settlement initiative, (b) has made an irrevocable election to "opt out" of that Program, and (c) the taxpayer has paid all applicable tax, penalties, and interest assessed by the Internal Revenue Service in a civil examination following the taxpayer's election to "opt out"; or

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3. the taxpayer has completed all of the requirements of the Streamlined Filing Compliance Procedures (either the Domestic or Offshore Procedures), including paying all applicable tax, penalties, and interest in accordance with the terms of those Procedures.

Narrowing the covered expatriate definition could potentially undermine U.S. public policy interests by making it easier to expatriate. Even so, excepting OVDP and streamlined participants from the rules — regardless of those individuals' annual incomes or net worth — is more likely to advance the overarching legislative goals of sections 877 and 877A by more specifically targeting bad actors who seek to expatriate to avoid past, present, and future U.S. tax obligations.

Adding an exception to covered expatriate status for OVDP and streamlined participants would encourage voluntary compliance and facilitate the expatriation process for those taxpayers who have restored compliance through the OVDP or streamlined procedures. Forcing taxpayers who have restored compliance to pay the expatriation tax is particularly unfair because (1) formerly noncompliant taxpayers who have completed the OVDP process have already been punished by paying a miscellaneous penalty as high as 50 percent (but 27.5 percent for most taxpayers in the OVDP)[59] of their highest aggregate offshore account balance over an eight-year voluntary disclosure period (in addition to the additional income tax, substantial understatement penalties, failure-to-file and failure-to-pay penalties (if applicable), and interest on the unpaid tax); (2) noncompliant taxpayers who have opted out of the OVDP have already been punished by paying additional income tax, interest, and (if applicable) civil penalties (including non-willful or willful failure-to-file FBAR and other information return penalties) in the course of a civil examination following the opt out; and (3) noncompliant taxpayers who have completed the streamlined filing compliance procedures have already certified under the penalty of perjury that their compliance problems are attributable to non-willful conduct.[60] This certification in itself should be sufficient to overcome the presumption that the taxpayer expatriated for purposes of tax avoidance.

F. Conclusion

When section 877 was initially enacted, its purpose was clear — to impose a harsh penalty, in the form of an expatriation tax, on those expatriating to avoid U.S. income tax. Unfortunately, the subjective method that the statute initially used to assess the expatriating taxpayer's motivation was too difficult to enforce. To ease the administrative burden on the IRS, Congress replaced the subjective test with an objective one: Under the current version of section 877 (and the newly enacted section 877A), a tax-avoidance motive can be inferred only when a taxpayer meets specific objective criteria such as exceeding the net income or net worth thresholds or failing to certify compliance with U.S. income tax and reporting requirements.

The problem with the new test is that the objective test (1) has lost much of the spirit and intent of the original statute, and (2) is vulnerable to abuse by bad actors who are able to shift their income and assets to fall below the applicable thresholds. Congress and the IRS could help to restore some of the original spirit and intent of section 877 by requiring taxpayers to certify that they have not willfully structured their affairs or assets to fall below the applicable net income and net worth thresholds of section 877(a)(2) and by adding an exception to the expatriation tax for individuals that have completed the OVDP or streamlined filing compliance procedures. This would (a) discourage expatriation for tax-avoidance motives without unnecessarily punishing taxpayers who have voluntarily disclosed and resolved their past noncompliance and (b) encourage compliance for the vast majority of benign actors who want to remain U.S. citizens.

[59]*See* 2014 OVDP FAQs, *supra* note 12, at 7.2 (explaining that a miscellaneous penalty of 50 percent of the highest aggregate account balance will be imposed only when the U.S. government is investigating the FFI in which the account is held or when another facilitator assisted in establishing the offshore account); *id.* at 7 (imposing a default miscellaneous penalty rate of 27.5 percent of the highest aggregate account balance in all other circumstances).

[60]*See supra* note 58 (discussing Form 14653 and Form 14654). Also, participants in the streamlined domestic offshore procedures are required to pay a miscellaneous penalty equal to 5 percent of the highest end-of-year balance over the six-year lookback period. Participants in the streamlined foreign offshore procedures are not responsible for paying a miscellaneous penalty. *See* streamlined filing compliance procedures, *supra* note 15.

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