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Expatriation and compliance: What you need to know now

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OWNERS AND ENTREPRENEURS

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Although the United States is the land of opportunity to millions worldwide who are willing to risk their lives to come, there are others who are eager to depart. In fact, although small in comparison with those arriving, the number of people giving up their US citizenship or US lawful permanent resident card (the "green card") has risen significantly over the last several years.

Considering how many people want to come to the United States, why, you may ask, would someone wish to surrender US citizenship or a green card? What is so unappealing about being an American? And if one wishes to cease being a US citizen or green card holder, what are the steps to take?

While US citizenship (and, to some extent, green card status) provides many rights — including the right to live in the United States, to travel widely around the world, and to vote in US elections — US citizenship obligations are less numerous. There is no requirement, for example, for US citizens to vote in presidential or local elections, and there is no required military service. There is, however, a seemingly endless number of tax forms to file and taxes to pay.

Tax Compliance Burden

The key obligation accompanying US citizenship and green card status (US citizens and green card holders hereinafter collectively referred to as "US persons") is the requirement to file US tax returns and pay US income taxes, regardless of where the US person lives, earns income, or places assets. In addition, US persons are subject to gift tax on worldwide gifts of their assets and estate tax on their worldwide estate. For both taxes, the rate is 40 percent on transfers exceeding the unified lifetime exemption of US$11.2 million (in 2018).

In addition to filing income tax returns and related forms, US persons are required to file Financial Crimes Enforcement Network Form 114, generally referred to as a foreign bank account report. On FBARs, US persons must report all foreign bank and financial assets if the total value in all accounts exceeds US$10,000 at any point during the calendar year. Reportable accounts include bank accounts, investment accounts, life insurance, pensions, credit accounts, safe deposits at banks, and any similar accounts or arrangements. All ownership types are subject to reporting: accounts owned separately, jointly, under powers of attorney, signature authority, nominee accounts, bare title, and so forth.

Accounts owned by trusts, corporations, partnerships, and other entities may be subject to reporting if, in general, the US person's interest exceeds 50 percent. Starting in 2017, the FBAR is due with the US tax return. There is no tax associated with the form, but the failure to file it accurately and in a timely manner carries severe civil and potentially criminal penalties — as high as 50 percent of the total account value if the failure is deemed willful.

Furthermore, there are the arduous US and international compliance and know-your-customer rules. These have proven to be a great impediment to the everyday banking activities of US persons living outside the United States.

US persons living outside the United States face significant compliance requirements resulting from their status as US citizens. Just opening a checking account outside the United States has become a daunting task. The Foreign Account Tax Compliance Act requires non-US financial institutions to collect information from their US clients, including a fully completed US IRS Form W-9 (containing name, address, and US tax identification number). The financial institutions are then required to forward a report on their US clients to US tax authorities, creating massive administrative compliance burdens.

Further complicating the process is the fact that many non-US banks have difficulty applying these rules and are not sure how to complete or process forms for US persons opening or maintaining non-US financials accounts. Many non-US financial institutions have therefore become reluctant to accept US citizen clients, limiting US citizens' banking and investment options. Over the course of the last few years, many US citizens living abroad have made the decision to renounce their US citizenship for this reason alone.

A US person desiring to expatriate must consider both his US immigration status and his financial circumstances. For two US persons of identical financial means, the results can be quite different depending on the US Treasury's precise definitions of their immigration status.

The process of renouncing US citizenship involves making an appointment at a US embassy, appearing for an interview, completing various Department of State forms, and surrendering the US passport either at the appointment or when receiving the Certificate of Loss of Nationality. For green card holders, the process involves handing in the green card. It is imperative that a US person thinking about expatriating consider the entire process, both from a US immigration and a US tax perspective, before taking *any* steps to renounce citizenship or surrender a green card.

For tax purposes, US expatriation rules are generally set forth in IRC sections 877 and 877A. An expatriate deemed to be a "covered expatriate" can be subject to a mark-to-market tax referred to as the exit tax, generally imposed before the expatriate leaves the United States.

Expatriate Definition

Under IRC section 877A, an expatriate is:

- any US citizen who relinquishes US citizenship; and
- any long-term US resident who ceases to be a lawful permanent resident.

A long-term resident of the United States is any person who has been a US green card holder for at least eight of the last 15 years and was not treated as a nonresident of the US under an applicable income tax treaty. Therefore, a green card holder who is not a long-term resident is not considered an expatriate when they surrender their green card and is not subject to the exit tax. Simply returning the green card — either by mail to a US embassy, in person at a US embassy, or at the US border — completes the expatriation process for these individuals. Treatment of a US green card holder who has held the green card for less than eight years is similar to that of an individual who is a US person only via the substantial presence test.

While long-term residents and US citizens who become expatriates are treated similarly and may be subject to the exit tax, there is a distinct potential benefit available to some US citizens that is not available to US green card holders.

Covered Expatriates

An expatriate is deemed a covered expatriate if the individual does any of the following:

- Has an average annual net income tax liability for the five preceding tax years ending before the expatriation date exceeding US$165,000 (adjusted for inflation in 2018).
- Has a net worth of US$2 million or more as of the expatriation date (aggregate net value of worldwide assets).
- Fails to certify, under penalties of perjury, that all US federal tax obligations have been complied with for the five tax years preceding the tax year that includes the expatriation date. This certification must be made on Form 8854.

However, a covered expatriate will not be subject to the exit tax if the individual certifies compliance with all US federal tax obligations (as noted above) and meets either the dual citizen or minor exception:

- The dual citizen exception requires that the expatriate became a US citizen and a citizen of another country at birth and, as of the expatriation date, continues to be a citizen of (and is taxed as a resident of) the other country; and that the expatriate has been a US resident for not more than 10 tax years during the 15-tax-year period ending with the tax year during which the expatriation date occurs (residency determined under the substantial presence test).
- The minor exception requires that the expatriate relinquishes US citizenship before the age of 18½ and has been a US resident for not more than 10 tax years before the date of relinquishment.

In sum, a dual citizen from birth or a US citizen minor (who is generally a dual citizen at least at the time of expatriation and is often referred to as an "accidental American") are given a pass regardless of their wealth as long as they certify that they are current with their US tax obligations.

The Exit Tax

If a US person is a covered expatriate, the exit tax is computed as if the individual sold all assets on the day before expatriation. The deemed gains are reported on the final US tax return with tax rates varying by asset type (for example, if artwork is deemed sold, it is subject to the special 28 percent rate). The exit tax does not apply to a US person who is not a covered expatriate or who can use one of the exceptions.

For assets deemed sold, section 877A refers to "all property," but does not define the term. To provide further guidance, Treasury released Notice 2009-85, 2009-45 IRB 598, which explains that to determine the tax base for the deemed sale, a covered expatriate is treated as owning an interest in any property that would be subject to federal estate tax as part of the individual's gross estate if the person had died a US citizen on the day before expatriation.

Once the tax base is identified and determined, estate tax valuations are used (although various deductions such as the section 2065 marital deduction are not available). Practically speaking, a covered expatriate's assets include assets such as interests in grantor trusts, as well as section 2035, 2016, and 2038 assets — that is, assets the covered expatriate transferred away within three years of expatriation or retained an interest or power over.

Similarly, deferred compensation items are generally subject to the exit tax, with some important exceptions noted below. Deferred compensation items include:

- any interest in a qualified plan or other retirement arrangement under section 219(g)(5);
- any interest in a non-US pension or retirement or similar arrangement;
- section 83 stock options and related items; and
- any item of deferred compensation.

For a covered expatriate who has non-vested stock options, those options are deemed to vest.

Some deferred compensation items are excluded from the exit tax paid at the time of expatriation. Instead, US income tax is paid on these items when the covered expatriate receives a payment. Income tax is withheld at 30 percent and collected at source. A deferred compensation item is deemed eligible for this if the payer is a US person (withholding obligation) or if the payer elects to be treated as a US person (elects to act as withholding agent — although it is not clear from the notice how such an election could be made). Covered expatriates also have the option of deferring the exit tax by providing adequate security; the IRS's Plantation, Florida, office has supervision over the administration of this option, but the actual process and the frequency of use is unclear.

No exit tax is due on deferred compensation earned while the covered expatriate was not a US person and attributed to services rendered outside the United States.

Once assets subject to the exit tax are identified and gains calculated, covered expatriates can shield some of that gain from the exit tax. Specifically, for those expatriating in 2018, up to US$713,000 can be excluded from the taxable amount. If spouses are expatriating together, each has the US$713,000 exclusion amount for 2018 and each must file Form 8854. This exclusion cannot be applied to just one asset, but rather must be prorated among all assets with deemed gain based on the relative amount of built-in gain of each.

The exit tax due is not actually reflected on Form 8854; that form just contains the balance sheet, the income statement, and the very important certification. The exit tax due is calculated as part of Form 1040 and is payable with it, although Form 8854 must be filed with Form 1040. If a US person does not have to file Form 1040 for the year of expatriation (that is, the person has no income of any kind), Form 8854 can be filed by itself. If the US person has no Social Security number (for example, the person was born in the United States, moved from the United States as a child, and never returned), Form 8854 can be filed without a Social Security number, but an explanation should be attached.

Stealth Exit Tax — PFICs

Then there is the passive foreign investment companies exit tax, which some have called the "stealth exit tax." Under proposed regulations, this tax applies to anyone (including those who are US persons only by the substantial presence test), regardless of wealth, who changes status from US person to nonresident. I would argue that the PFIC exit tax does not apply because the regulations have remained in proposed form since 1992 and the expatriation rules of section 877 have been thoroughly revised several times since then. Nevertheless, proposed PFIC exit tax rules are out there and may cause sleepless nights to some covered expatriates.

Failure to Certify

An important point that many taxpayers living outside the United States overlook when planning their expatriation is the requirement of certifying that they have complied with all US federal tax obligations for the five tax years preceding the year in which the expatriation occurs. If a US person wants to renounce citizenship but has not filed US federal tax returns or paid US federal taxes in any of the five years preceding the expatriation, that person must first come into compliance.

There are various options for compliance. One of the most popular is the "streamlined offshore procedure." The streamlined offshore procedure comes in two versions: the foreign streamlined procedure for those who were physically outside the United States for a full 330 days in at least one of the most recent three years for which a US tax return was due (with proper extensions); and the domestic streamlined procedure for those who fail the residency test and have previously filed US federal tax returns. Note that for those who file under the foreign streamlined procedure, the fact that they have not previously filed US federal income tax returns is not an impediment.

Persons filing under the domestic streamlined procedure must have filed US tax returns before but failed to report non-US income. Under both streamlined procedures, the person filing must provide a non-willful statement. Because this program has been around for four years now, one should have rather convincing facts and circumstances to demonstrate a lack of willfulness in the failure to file US federal income tax returns and pay US federal income tax.

Under both streamlined options, the US person must pay the tax due plus interest, but there are no penalties. However, because US persons living in the United States are held to a higher standard and are expected to know US tax laws and requirements, there is a 5 percent miscellaneous offshore penalty assessed on the high balance of those foreign financial assets that should have been reported on an FBAR but were not. Although 5 percent may seem like a lot, it is quite favorable if compared with other possible outcomes outside the streamlined offshore procedure, especially in light of penalties that could otherwise apply.

Another option is participation in the offshore voluntary disclosure program, although this option will soon end. The OVDP has been in place in various iterations and with various levels of penalties since 2009. The IRS announced that it will end the current form of the OVDP on September 28. Under the most recent version, US persons are required to file US tax returns and FBARs for the last eight tax years for which the filing due date has passed (including extensions), pay the US tax due, pay a 20 percent penalty on the tax (instead of other penalties that would otherwise apply), and pay interest on the tax and the penalty. In addition, US persons are required to pay a 27.5 to 50 percent miscellaneous offshore penalty on the high balance in accounts not properly reported. The exact percentage may vary as accounts held at some banks are subject to 50 percent.

US expatriation is a delicate matter requiring thorough analysis and thoughtful consideration of all relevant facts. With potential results of such magnitude, a US person should move forward only after all options are examined and costs and benefits analyzed.

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