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Look Before You Leap: When Renouncing U.S. Citizenship May Not Be a Good Idea

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For those advising U.S. citizens living and domiciled abroad, renouncing United States citizenship may appear a no-brainer. With a life firmly planted outside the United States, continued U.S. tax compliance is often seen as something between a costly inconvenience and a much-resented nightmare. The publicity surrounding offshore voluntary disclosure programs since 2009, passage of FATCA[1] in 2010 and increased enforcement of foreign account disclosures and other offshore compliance obligations have compelled many (although likely not a majority) of U.S. citizens living abroad to take advantage of either the streamlined filing compliance procedure or the various incarnations of the offshore voluntary disclosure program since 2009 to become U.S. tax compliant.[2] For some who have taken this step, the silver lining in their coerced compliance is the opportunity to renounce U.S. citizenship and thereby escape the U.S. tax web.

Regardless of the other indicia, covered expatriate status and potential imposition of the exit tax under §877A is automatic for individuals who have not filed U.S. tax returns for the five years prior to the year in which expatriation occurs.[3] For those who have satisfied this compliance requirement, covered expatriate status is avoided if the taxpayer's net worth is less than $2,000,000 and the average annual net U.S. income tax liability shown on the five prior years' tax returns is less than $162,000 for those renouncing citizenship in 2017.[4]

For those who are able to avoid covered expatriate status, neither the exit tax nor the tax imposed by §2801 on the heirs of those taxpayers will be a consideration in determining whether to expatriate. In contrast, for those individuals whose net worth or average annual U.S. income tax liability exceeds the thresholds permitted to escape the exit tax, the tax deterrents to expatriating go beyond characterization as a covered expatriate and potential exposure to the exit tax.

Many covered expatriates find they have no exit tax exposure or the exit tax exposure can be minimized. The pleasures and resources of United States citizenship include a meaningful gift and estate tax exemption which allow transfers of wealth with a cumulative value up to $5,490,000 in 2017 without payment of any gift or estate tax.[5] This opportunity is used by many to avoid covered expatriate status by making gifts sufficient to reduce the taxpayer's net worth in the year of expatriation to an amount less than $2,000,000. For those who cannot avoid covered expatriate status by such pre-expatriation transfers, the gift and estate tax exemption remains a huge window through which gain-laden assets may be transferred so

[1] Foreign Account Tax Compliance Act.

[2] *See generally* Robert E. Ward, *2012 Off-Shore Voluntary Disclosure Program (Issues and Opportunities)*, 41 Tax Mgmt. Int'l J. 548 (Oct. 12, 2012); and *Off-Shore Voluntary Disclosure Program Round 4: IRS Announces Further Changes to Encourage Better Compliance*, 43 Tax Mgmt. Int'l J. 604 (Oct. 10, 2014).

[3] *See* §877(a)(2)(C). All section references are to the U.S. Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated. Section 877A(g)(1) defines the term ''covered expatriate'' to refer to an individual who (1) relinquishes United States citizenship or ceases to be a lawful permanent resident and (2) meets one of the conditions of §877(a)(2)(A), §877(a)(2)(B), or §877(a)(2)(C).

[4] *See* §877(a)(2)(A), §877(a)(2)(B).

[5] Rev. Proc. 2016-55, 2016-45 I.R.B. 707, §3.32, §3.35.

as to minimize the gain realized on the deemed sale of the covered expatriate's assets as a result of application of the exit tax.[6] The gift and estate tax exemption may also be used strategically to make pre-expatriation transfers of any U.S. situs property to avoid U.S. estate tax exposure at the covered expatriate's death.[7]

The fly in the ointment for this strategic use of the gift and estate tax exemption in pre-expatriation planning to avoid or mitigate U.S. exit and estate tax is §2801. While the covered expatriate successfully escaped the U.S. income, gift, and estate tax system by renunciation of U.S. citizenship, the heirs of such individual who are U.S. persons are not so fortunate.[8] Proposed Treasury regulations under §2801 disadvantage covered expatriates by creating impediments to the tax-free transfer of wealth while alive and at death, where such impediments are not suffered by those who retain citizenship.[9]

Section 2801 imposes a tax at the highest marginal rate in effect under §2001(c) on any U.S. person who receives a direct or indirect transfer of anything of value from a covered expatriate. The tax is imposed on the fair market value of the gift or bequest at the time received.[10] This will include post-expatriation appreciation on the transferred assets. This is particularly problematic in the case of testamentary and other trust planning inasmuch as delays in the transfer of wealth invite the opportunity for that wealth to appreciate, and thereby increase the asset value on which the §2801 tax is imposed. Individuals who renounce U.S. citizenship are far more likely to live outside the U.S. at the time they expatriate than to be a U.S. resident, and the few who may reside in the United States are compelled to change their residence and domicile in order to derive any benefit from renouncing their U.S. citizenship. Consequently, most of these individuals who use trusts as part of their estate planning will frequently establish those trusts as foreign trusts. Unless the foreign trust makes an election to be treated as a domestic trust per Prop. Reg. §28.2801-5(d)(3), the §2801 tax will be imposed not at the time a gift or bequest is made to the foreign trust but, instead, when distribution is made from the foreign trust to the U.S. recipient.[11] In the case of a trust with multiple transferors, any distribution (whether of income or principal) from the foreign trust to the U.S. recipient will be determined on a proportional basis taking into account the appreciation and accumulated income of the entire trust corpus.[12]

The Proposed Regulations create a rebuttable presumption that every living expatriate is a covered expatriate. U.S. persons who receive gifts from family members and others may not know the citizenship status of those transferors. Many of those recipients will not know whether the particular transferor was a covered expatriate. Despite these difficulties, the Proposed Regulations make it clear that the recipient of any gift or bequest has the obligation to ascertain "whether the transferor is a covered expatriate and whether the transfer is a covered gift or covered bequest."[13] The rebuttable presumption that every living expatriate is a covered expatriate applies unless the transferor authorizes the disclosure of relevant returns or information shown on those returns to the recipient. Presumably because of the difficulty in obtaining information regarding the status of the transferor and the source of distributions from foreign trusts, U.S. citizens and residents receiving gifts and bequests may file Form 708 United States Return of Tax for Gifts and Bequests from Covered Expatriates on a protective basis in order to avoid accruals of interest and penalties for failures to pay the §2801 tax.[14]

While §2801(e)(1) provides that property reported on a timely filed gift or estate tax return will not be subject to the §2801 tax, the Proposed Regulations carve back this relief.

- Amounts within the annual exclusion of §2503(b) are subject to the §2801 tax because annual exclusion gifts are excluded from the definition of taxable gifts under §2503(a) by §2530(b).[15]
- By the same logic, the covered expatriate's payment of medical or educational expenses of a U.S. person who would otherwise qualify for the exclusion under §2505(e) is not available.[16] (Prop. Reg. §28.2801-3(a).)
- Similarly, the requirement imposed by the Proposed Regulations that a tax be paid appears to

[6] Taxpayers' enthusiasm for pre-expatriation transfers may be diminished when they learn that such transfers must be reported on Form 8854, Initial and Annual Expatriation Statement. Form 8854 requires disclosure of "significant changes in. . .assets and liabilities" for the period that began five years before expatriation.

[7] *See generally* §2104.

[8] Section 2801 applies to U.S. citizens or residents. §2801(a). Prop. Reg. §28.2801-2(b) takes the position that residency for purposes of determining who is liable for the §2801 tax is based upon the gift and estate tax concept of domicile. REG-112997-10, 80 Fed. Reg. 54,447 (Sept. 10, 2015).

[9] REG-112997-10.

[10] §2801(a).

[11] §2801(e)(4)(B); Prop. Reg. §28.2801-4(d)(4), §28.2801-5(a).

[12] Prop. Reg. §28.2011-5(c).

[13] Prop. Reg. §28.2801-7(a). *See also* Prop. Reg. §28.2801-5(c)(3).

[14] Prop. Reg. §28.2801-7(b)(2).

[15] Prop. Reg. §28.2801-3(a).

[16] *Id.*

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also subject the first $60,000 of wealth exempted from U.S. estate tax by the exemption for nonresidents under §2102(b)(1) to the §2801 tax.

- Non-U.S. situs property (which because of pre-expatriation planning explained above, is likely to be most of what the covered expatriate owns at death) cannot benefit from filing a U.S. estate tax return because transfers of life insurance proceeds, bank deposits and portfolio debt obligations, and RIC stock are excepted by §2105 from inclusion in the gross estate of a noncitizen nonresident.[17]

U.S. persons who receive gifts or bequests from covered expatriates are also disadvantaged in at least three other respects in contrast to those who receive gifts and bequests from U.S. citizens and domiciliaries.

- In the case of gifts that are brought back into the covered expatriate's gross estate by §2036, §2037 or §2038, gift tax paid with respect to those transfers will not be credited against the estate tax due, as would otherwise be the case under §2012.[18]
- Code provisions such as §6159, §6161, §6163, and §6166, which permit deferred payments of estate taxes, apparently are not applicable to §2801.[19]
- Section 1015(d) does not apply to the tax imposed by §2801 to increase the basis of the recipient of a gift from a covered expatriate by the amount of §2801 tax paid.[20]

Conclusion

Individuals who renounced U.S. citizenship prior to June 17, 2008, were subject to an alternative tax regime under §877(b) for 10 years following the year of expatriation.[21] With the advent of §877A, the 10-year reporting regime of §877 no longer applies. However, the exit tax of §877A and the §2801 tax on U.S. persons receiving gifts and bequests from covered expatriates will be viewed by many expatriating taxpayers and their heirs as just as onerous, if not more. Any hopes or expectations that repeal of the U.S. estate tax system may spare the beneficiaries of covered expatriates' wealth from the ravages of §2801 should be tempered by recognition that the estate tax provisions of the Internal Revenue Code are found in Chapter 11, but §2801 is found in Chapter 15.

[17] Prop. Reg. §28.2801-3(c)(2).

[18] Prop. Reg. §28.2801-4.

[19] The Regulations are silent as to whether elections to defer payment of estate taxes are applicable to the §2801 tax.

[20] Prop. Reg. §28.2801-6.

[21] Pub. L. No. 110-245, §301(a). See §877.

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