Bloomberg BNA

Tax Management International Journal™

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Considerations in Relying On CLN as an Alternative to The OVDP and SFOP

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INTRODUCTION

For most U.S. citizens residing outside the United States who have not been totally tax compliant, the Offshore Voluntary Disclosure Program (OVDP) and Streamlined Filing Offshore Procedure (SFOP) offer opportunities to address a broad range of past non-compliance.[1] The OVDP and SFOP were initiated by the Internal Revenue Service to process large numbers of somewhat similarly situated taxpayers. The stated objective of these programs is to "bring taxpayers that have used undisclosed foreign accounts and assets, including those held through undisclosed foreign entities, to avoid or evade tax into compliance with United States tax and related laws."[2] Even taxpayers who have failed to file U.S. income tax returns are eligible to participate in either program.

Taxpayers who are reasonably confident that their non-compliance was non-willful will in most cases take advantage of the SFOP by filing U.S. income tax and information returns for the three most recent years and foreign bank account reporting forms (FBARs)[3] for the six most recent years under Form 14653, Certification by U.S. Person Residing Outside of the United States for Streamlined Foreign Offshore Procedures. Nonresident taxpayers who successfully take advantage of the SFOP escape penalties and are solely liable for taxes and interest on the unreported income. In contrast, taxpayers participating in the OVDP are required to file U.S. income tax returns, information returns, and foreign bank account reports for the eight most recent years and pay taxes, interest, a variety of tax-based penalties, and, most significantly, an offshore penalty of 27.5% or 50% of the high value of foreign assets and accounts during the eight-year OVDP period.

Not all U.S. persons residing outside the United States find the OVDP or SFOP desirable options to address past non-compliance. The offshore penalty regime under the OVDP is often severe. Even taxpayers who are eligible to take advantage of the SFOP may nonetheless have substantial U.S. tax liabilities on income reported on the three years' returns required by that procedure. Significant U.S. income tax liabilities are likely to arise in circumstances in which the U.S. person's country of residence exempts or favors certain types of income that are nonetheless subject to U.S. income taxation. For residents of Canada, this commonly arises on sale of a principal residence which is exempt from Canadian income taxation by §40(2)(b) of the Income Tax Act. The anti-deferral rules of the U.S. controlled foreign corporation or

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[*] The author would like to thank Bridget A. Alzheimer of Ward Chisholm, P.C., for her assistance in the research for this article.

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

[2] Offshore Voluntary Program Frequently Asked Questions and Answers (2014) Effective for OVDP Submissions Made on or After July 1, 2014, posted to irs.gov (July 15, 2015).

[3] FinCEN Report 114, Report of Foreign Bank and Financial Accounts.

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ISSN 0090-4600

passive foreign investment company regimes will often subject business and investment income to tax at a different time or higher rates than the country in which the taxpayer resides.[4]

Even in the absence of significant offshore penalties or U.S. income tax liabilities, the U.S. person may be deterred by the professional costs (legal and accounting fees) incurred to participate in the OVDP or SFOP. Some U.S. persons residing abroad may simply be uncomfortable with filing U.S. income tax returns for reasons political, nefarious, or otherwise. In addition, once past non-compliance has been addressed, future compliance costs continue in order to file U.S. income tax and information returns and FBARs until death or renunciation of U.S. citizenship.

Renunciation of U.S. citizenship may be attractive to taxpayers who do not wish to deal with an ongoing tax compliance burden. Some would-be expatriates may have already relinquished U.S. citizenship as the result of certain actions taken in the past. For those taxpayers, U.S. tax compliance obligations — past, current, and future — simply may not exist. However, the more compelling reason to confirm prior relinquishment of U.S. citizenship is to avoid the U.S. exit tax either in its current incarnation in §877A or its prior incarnation in §877.

For individuals renouncing U.S. citizenship prior to June 17, 2008, §877 imposed continued U.S. income taxation on U.S.-source income determined on the basis of special sourcing rules set forth in §877(d) for 10 years after the year of expatriation. For individuals who renounced citizenship on or after June 17, 2008, §877A marks to market assets owned by such individuals and treats items of deferred compensation as accelerated to the date of expatriation.[5] Before February 6, 1995, the exit tax regime of §877 applied only to individuals whose renunciation of U.S. citizenship had as one of its principal purposes the avoidance of U.S. income, gift, or estate taxes. For individuals expatriating on or after February 6, 1995, and before June 3, 2004, the tax avoidance test was made conclusive if the individual had an average annual net income tax liability for the five preceding taxable years of $100,000 or a net worth of $500,000. Both amounts were indexed for inflation.[6]

Since 2004 the tax avoidance purpose has been deleted from the statute and a three-part test applied to determine if an individual renouncing U.S. citizenship will be subject to some form of exit taxation. An individual will be regarded as a ‘‘covered expatriate’’ if *any* of the following tests are met:

(1) the individual's average annual net taxable income for the five years preceding the year of expatriation is greater than $124,000 (indexed for inflation; 2016 amount $161,000);[7]

(2) the individual's net worth is more than $2 million; or

(3) the individual fails to certify full U.S. tax compliance for the five years prior to the year in which expatriation occurred.[8]

For those individuals who renounce U.S. citizenship on or after June 17, 2008, and satisfy the test for covered expatriate status, the exit taxes come with a bonus. Heirs of covered expatriates who are U.S. citizens or residents are subject to a gift or estate tax under §2801. The tax is imposed on the fair market value of the gift or bequest and computed at the highest marginal gift or estate tax rate (currently 40%).[9] Proposed regulations clarify that residency for purposes of §2801 is determined on the basis of domicile.[10] The statute is unique in its imposition of the gift and estate tax on the recipient instead of the transferor.[11] Customary gift and estate tax exemptions available to transferors under §2010 and §2505 do not apply. In the case of intervivos gifts, the annual exclusion of §2503(b) does not apply nor does the exclusion for medical and education expenses under §2503(e).[12]

U.S. CITIZENSHIP

The first question before enlisting tax professionals to assist the client in addressing past non-U.S. compliance should be to determine whether the client is, in fact, a U.S. citizen. Short of naturalization, U.S. citizenship is typically acquired in two ways: either an individual is born in the United States or the individual is the offspring of one or more parents who are U.S. citizens at the time of the individual's birth outside the United States.[13] In the case of individuals born within the geographical boundaries of the United States and its outlying possessions, the nationality of the child's parents does not matter. In the case of individuals born outside the geographical limits of the United States and its outlying possessions, the child is a U.S. citizen if both parents are U.S. citizens and one of those parents has had a residence in the United States or one of its outlying possessions prior to the birth of the child.[14] In the case of an individual born outside the geographical limits of the United States and its outlying possessions to parents only one of

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[4] *See generally* §951–§965 and §1291–§1298.

[5] *See* §877A(a), §877A(d). *See generally* Robert E. Ward, *Advising U.S. Citizens and Longterm Residents on Expatriating*, 9 Trust Qtrly. Rev., No. 3 (Sept. 2011).

[6] §877(a) (1996), Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, §511(a).

[7] Rev. Proc. 2015-53, §3.30, I.R.B. 2015-44.

[8] §877(a)(2).

[9] *See* §2801; Prop. Reg. §28.2801-0 through §28.2801-7, I.R.B. 2015-39.

[10] *See* Prop. Reg. §28.2801-2(b).

[11] *See* §2801(b); Prop. Reg. §28.2801-4(a).

[12] Prop. Reg. §28.2801-2(c), §28.2801-3(a), §28.2801-3(b).

[13] *See* INA §301(a); 8 U.S.C. §1401(a).

[14] *See* INA §301(c); 8 U.S.C. §1401(c).

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ISSN 0090-4600

whom is a U.S. citizen, that parent must have been physically present in the United States or its outlying possessions prior to the birth of the child for periods totaling not less than five years, at least two of which must have been after attaining age 14, in order for the child to be a U.S. citizen.[15]

RELINQUISHING U.S. CITIZENSHIP

The Immigration and Naturalization Act of 1952, as amended (''INA'') establishes that an individual may renounce his U.S. citizenship by taking a formal oath of renunciation.[16] Citizenship may also be lost by an act of relinquishment.[17] In the case of individuals who acquired dual citizenship as a result of being born abroad, former INA §350 provided that U.S. citizenship could be lost if the individual ''voluntarily sought or claimed the benefits of the nationality of any foreign state'' and continued to reside in the foreign country of dual citizenship for at least three years after attaining age 22.[18] Further, under INA §349(a) as originally enacted, citizenship could be lost as a result of eight other acts:

(1) becoming a naturalized citizen of another country;[19]

(2) taking an oath of allegiance to a foreign government;[20]

(3) serving in the armed forces of another country;[21]

(4) ''accepting, serving in, or performing the duties of any office, post, or other employment under the government of a foreign state'' if the individual acquired citizenship in the foreign state or took an oath of allegiance to the foreign state;[22]

(5) voting in a political election in a foreign state;[23]

(6) deserting from U.S. armed forces during a time of war;[24]

(7) committing an act of treason against the United States;[25] and

(8) departing from or remaining outside the United States during a time of war so as to avoid military service.[26]

Any of the foregoing actions were ''conclusively presumed'' to have been undertaken voluntarily if the individual was a citizen of the foreign country and physically present in that country for periods totaling at least 10 years immediately prior to the expatriating act.[27] In 1954 the INA was amended to expand the scope of treasonous acts.[28] Subsequent amendments in 1961 added advocating for the forceful overthrow of the United States government.[29]

Starting in 1958, four decisions of the U.S. Supreme Court held certain expatriating provisions of the INA unconstitutional. *Trop v. Dulles*[30] invalidated desertion in a time of war as a basis for loss of citizenship, declaring INA §349(a)(8) unconstitutional. *Kennedy v. Mendoza-Martinez*[31] invalidated evading military service as a basis for loss of citizenship, declaring INA §349(a)(10) and §401(j) unconstitutional. *Schneider v. Rusk*[32] invalidated residence abroad by a naturalized citizen as a basis for loss of citizenship, declaring INA §352 unconstitutional. *Afroyim v. Rusk*[33] invalidated voting in foreign elections as a basis for loss of citizenship, declaring INA §349(a)(5) and §401(e) unconstitutional. *Afroyim* went further to hold that an involuntary loss of citizenship violated section one of the Fourteenth Amendment.[34]

The Supreme Court in *Afroyim* overruled its decision in *Perez v. Brownell*,[35] affirming the ''Fourteenth Amendment while it leaves the power where it was before, in Congress, to regulate naturalization, has

[15] *See* INA §301(g); 8 U.S.C. §1401(g).

[16] INA §349(a)(5); 8 U.S.C. §1481(a)(5).

[17] ''By way of clarification, though all losses of citizenship under INA 349 involve relinquishment of citizenship, for purposes of this FAM chapter (7 FAM 1200), 'renunciation' refers to the expatriating act under INA 349(a)(5) of taking a formal oath of renunciation of citizenship in accordance with law and prescribed procedures, whereas 'relinquishment' refers to the expatriating acts specified under INA 349(a) (1), (2), (3), or (4) voluntarily taken with the intent to relinquish citizenship.'' 7 United States Department of State and Foreign Affairs Manual (''FAM'') 1222d (Aug. 26, 2014).

[18] *See* 66 Stat. 163, 269 (1952); repealed by Pub. L. No. 95-432, §1(d)(20) (Oct. 10, 1978), 92 Stat. 1046.

[19] INA §349(a)(1) (1952).

[20] INA §349(a)(2) (1952).

[21] INA §349(a)(3) (1952).

[22] INA §349(a)(4) (1952).

[23] INA §349(a)(5) (1952).

[24] INA §349(a)(8) (1952).

[25] INA §349(a)(9) (1952).

[26] INA §349(a)(10) (1952).

[27] INA §349(b) (1952).

[28] *See* Act of September 3, 1954, §2, 68 Stat. 1146;

[29] *See* Act of September 26, 1961, §19, Pub. L. No. 87-301, 75 Stat. 650, 656 (adding INA 401(c), 8 U.S.C. 1481(c)). Act of September 26, 1961 also added INA 349(c) — burden to prove loss of citizenship by preponderance of the evidence.

[30] 356 U.S. 86 (1958).

[31] 372 U.S. 144 (1963).

[32] 377 U.S. 167 (1964).

[33] 387 U.S. 253 (1967).

[34] ''All persons born or naturalized in the United States and subject to jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.'' *See* 387 U.S. at 268.

[35] 356 U.S. 44, 78 S. Ct. 568 (1958).

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ISSN 0090-4600

conferred no authority upon Congress to restrict the effect of birth, declared by the Constitution to constitute a sufficient and complete right to citizenship.''[36] Because the statute was declared to be unconstitutional, the holding of *Afroyim* applied retroactively. As a consequence of *Afroyim*, Congress passed Pub. L. No. 95-432, which repealed INA §350 effective October 10, 1978. Pub. L. No. 95-432 did not restore U.S. citizenship to dual nationals who remained in the foreign country for three years after attaining the age 22 but did eliminate presence in the foreign country as a grounds for loss of citizenship for individuals who had not yet completed the three years of continuous residence in the country of nationality prior to the date of enactment.[37] In 1986 Congress passed the Immigration and Nationality Act Amendments of 1986, amending INA §349(a) to insert the requirement of ''voluntarily performing any of the following acts with the intention of relinquishing United States nationality'' in order for an act of relinquishment to be effective.[38]

The current state of law is that U.S. citizenship can be voluntarily relinquished through performance of any of the following acts:

(1) becoming a naturalized citizen of another country after age 18;[39]

(2) taking an oath or otherwise affirming allegiance to another country after attaining age 18;[40]

(3) serving in the armed forces of another country if those forces are engaged in hostilities against the United States or the individual served as a commissioned or non-commissioned officer;[41]

(4) accepting ''any office, post, or employment under the government of a foreign state or political subdivision thereof'' after age 18 if the individual became a citizen of the country in whose government the individual served;[42]

(5) accepting ''any office, post, or employment under the government of a foreign state or political subdivision thereof'' after attaining age 18 if an oath or other affirmation of allegiance is required as a condition for such position;[43]

(6) formally renouncing U.S. citizenship before a diplomatic or consular officer of the United States situated in another country;[44]

(7) formally renouncing U.S. citizenship before an officer designated by the Attorney General of the United States whenever the United States is ''in a state of war'';[45]

(8) committing various acts of treason or attempting to overthrow the United States government.[46]

All of the acts of expatriation listed above must be performed voluntarily.[47] And many of them must have been undertaken with the intent to relinquish U.S. citizenship. However, motivation is not a relevant inquiry in the determination as to whether citizenship has been relinquished.[48]

Although current renunciation of U.S. citizenship is not a solution to address past non-compliance, the particular individual confronting U.S. tax compliance obligations may have lost U.S. citizenship sufficiently far in the past as a result of an act of relinquishment so as to obviate the need for any U.S. filing obligations.[49] Individuals who believe their U.S. citizenship has been lost as a result of an act of relinquishment can request a Certificate of Loss of Nationality (CLN) from the U.S. Department of State. The U.S. Department of State Foreign Affairs Manual recognizes there have been an increasing number of requests for CLNs and speculates that the increase in volume may be ''due to perceptions of the U.S. citizen (which may or may not be accurate) regarding the tax consequences, cost, or visa inadmissibility consequences, of relinquishment of citizenship. . . .''[50]

CERTIFICATE OF LOSS OF NATIONALITY

Although the process to obtain a CLN is initiated through diplomatic and consular offices of the United States, actual approval of the finding of loss of nationality can be given only by the Secretary of State or his designee.[51] A preliminary recommendation regarding a finding of loss of citizenship is typically prepared by

[36] 387 U.S. at 267 quoting *United States v. Wong Kim Ark*, 169 U.S. 649, 703 (1898).

[37] 7 FAM 1230c, d.

[38] Pub. L. No. 90-653, §18, 100 Stat. 3655.

[39] INA §349(a)(1), 8 U.S.C. §1481(a)(1).

[40] INA §349(a)(2), 8 U.S.C. §1481(a)(2).

[41] INA §349(a)(3), 8 U.S.C. §1481(a)(3).

[42] INA §349(a)(4)(A), 8 U.S.C. §1481(a)(4)(A).

[43] INA §349(a)(4)(B), 8 U.S.C. §1481(a)(4)(B).

[44] INA §349(a)(5), 8 U.S.C. §1481(a)(5).

[45] INA §349(a)(6), 8 U.S.C. §1481(a)(6).

[46] INA §349(a)(7), 8 U.S.C. §1481(a)(7).

[47] INA §349(b), 8 U.S.C. §1481(b).

[48] 7 FAM 1211c (Dec. 19, 2014).

[49] In the case of individuals who have filed U.S. tax returns, the statute of limitations may have run on the omitted income. *See generally* §6501. In the case of unfiled FBARs, the statute of limitations is six years. *See* 31 U.S.C. §5321(b)(1). In the case of taxpayers who have never filed U.S. income tax returns, the statute of limitations does not run. However, it is common practice to only file six to eight years of prior income tax returns in the case of domestic nonfilers.

[50] 7 FAM 1222d (Aug. 26, 2014).

[51] INA §104(a)(3), 8 U.S.C. §1104(a)(3); INA §358, 8 U.S.C.

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ISSN 0090-4600

an officer at a U.S. embassy or consulate and then transmitted to the Office of American Citizen Services and Crisis Management (''CA/OCS/ACS'') for approval.[52] The Secretary of State has delegated authority to approve or disapprove the recommendation of consulate officers to CA/OCS/ACS division chiefs in the Directorate of Overseas Citizens Services, Bureau of Consular Affairs of the U.S. Department of State.[53] Division chiefs may also designate appropriate senior consular officers in CA/OCS/ACS to approve or disapprove applications for CLNs.[54]

The analysis to determine whether a CLN should be granted is described by the United States Department of State and Foreign Affairs Manual (FAM) as a four-part test:

> (1) Was the person a U.S. citizen at the time of the potentially expatriating act?
>
> (2) Did the person perform an act which the relevant U.S. statute defines as a potential basis for expatriation?
>
> (3) Was the act performed ''voluntarily,'' i.e., as a product of the individual's free will (free of the undue influence of another) with an understanding of the nature of the act and a good general knowledge of its consequences? . . . .
>
> (4) Was the act performed with the intention (though not necessarily the motive or desire) to relinquish U.S. citizenship?[55]

The first two tests (citizenship and performance of an act of relinquishment or renunciation) are objective based upon the facts. The second two tests (voluntariness and intent) are far less objective. Consequently, administration presumptions are important.

The individual requesting the CLN bears the burden of proof in establishing the loss of citizenship.[56] The burden is satisfied by a preponderance of the evidence; ''that is, it is more likely than not that the individual intended to relinquish citizenship.''[57] An individual who has committed a potentially expatriating act is presumed to have done so voluntarily, subject to rebuttal of this presumption by a preponderance of the evidence.[58] The constitutionality of the provision of the INA on which the presumption is based is questionable in light of Supreme Court decisions in *Vance v. Terazas*[59] (1980) and *Afroyim v. Rusk* (1967).[60] Consistent with those decisions, in 1990 the State Department adopted an administrative presumption that a U.S. citizen intends to retain citizenship when committing certain otherwise expatriating acts.[61] However, the FAM notes that the administrative presumption is in the process of being revised.[62] The current administrative standard appears to require one of two conditions in order for:

(1) naturalization in a foreign state;

(2) exercise of an oath of allegiance to a foreign government;

(3) service in the armed services of another country not engaged in hostilities against the United States; or

(4) acceptance of non-policy level employment with a foreign government

to result in a loss of citizenship. There must also be:

(1) an unequivocal assertion that the act was performed with the intent to relinquish U.S. citizenship; or

(2) the individual has engaged in conduct inconsistent with retention of U.S. citizenship.[63]

Accordingly, the administrative presumption of intent to retain U.S. citizenship is inapplicable when the individual unequivocally asserts the expatriating acts listed above were performed with the requisite intent to relinquish U.S. citizenship.[64] Actions consistent with an intent to, instead, retain U.S. citizenship include travel using a U.S. passport[65] or resuming residence in the United States without applying for a visa.[66]

Tax Citizenship

Loss of U.S. citizenship for immigration and naturalization purposes is not necessarily a loss of U.S. citizenship for U.S. tax purposes. Since at least 1974 Treasury regulations have required an individual who renounces U.S. citizenship during the taxable year to

§1501, 7 FAM 1214a.

[52] 7 FAM 1213a(3) (Dec. 19, 2014).

[53] 7 FAM 1213b(1) (Dec. 19, 2014).

[54] 7 FAM 1213b(2) (Dec. 19, 2014).

[55] 7 FAM 1221b (Aug. 26, 2014).

[56] INA §349(b), 8 U.S.C. §1481(b); 7 FAM 1224.4c (Sept. 19, 2014).

[57] 7 FAM 1224.4d.

[58] INA §349(b), 8 U.S.C. §1481(b); 7 FAM 1224.4e (Sept. 19, 2014).

[59] 444 U.S. 252.

[60] 387 U.S. 253.

[61] *See* 22 CFR 50.40.

[62] *See* 7 FAM 1222a (Aug. 26, 2014).

[63] 7 FAM 1222b (Aug. 26, 2014).

[64] 7 FAM 1222c (Aug. 26, 2014).

[65] *See Action S.A. and Deltamar Establishment v. Marc Rich & Co., Inc.* 951 F.2d 504 (2d Cir. 1991); 7 FAM 1227(e)(4) (Feb. 24, 2015). *Accord* 7 FAM 1223a(3)(a) (Sept. 19, 2014). Form DS11 Application for a U.S. Passport requires an affirmation by the applicant that the applicant has not committed any of acts set forth in INA §349(a)(1) through §349(a)(5) or §349(a)(7). If such acts were performed the application requires an explanation of those actions.

[66] 7 FAM 1211f(4).

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ISSN 0090-4600

file a Form 1040NR which includes a separate schedule showing the income tax computation for the part of the taxable year when the individual was a citizen or resident of the United States.[67]

The Health, Insurance, Portability, and Accountability Act of 1996 (''HIPAA'') made several amendments to the tax provisions of §877 as that statute existed at the time of enactment.[68] HIPAA also enacted §6039F (later recodified as §6039G) requiring individuals subject to §877 to provide the Secretary of Treasury certain information regarding the expatriate's identity and assets.[69] In the case of individuals expatriating before February 6, 1995 (the effective date of HIPAA), §511(g)(3)(A) of HIPAA provides the 10-year expatriation tax regime of §877 will be deferred until a statement is furnished to the U.S. State Department confirming voluntary relinquishment of U.S. citizenship by performance of an expatriating act described in subparagraphs (1) through (4) of INA §349(a).[70] The statute defers application of the expatriation tax regime until notice is communicated to the State Department. However, the statute's application is limited by §511(g)(3)(B) of the Act. That provision expressly states that the deferral does not apply if the expatriating individual establishes that the loss of U.S. citizenship occurred before February 6, 1994.[71] Consequently, for individuals relinquishing citizenship before February 6, 1994, the 10-year expatriation tax regime commenced with the year citizenship was relinquished (but only if the expatriate satisfied one of the conditions for its application at that time).[72]

The distinction between loss of citizenship for immigration and naturalization purposes and the loss of citizenship for tax purposes was made explicit by the American Jobs Creation Act of 2004 (the ''2004 Act'').[73] The 2004 Act enacted §7701(n) which expressly required notice of an expatriating act to be given to the Secretary of State or the Secretary of Homeland Security and an appropriate statement be filed in accordance with §6039G in order for an individual who renounced citizenship to no longer be treated as a resident or citizen of the United States for U.S. tax purposes.

Section 7701(n) was repealed by the Heroes Earnings, Assistance, and Relief Tax Act of 2008[74] and replaced with §7701(a)(50). That statute provides, ''An individual shall not cease to be treated as a United States citizen before the date on which the individual's citizenship is treated as relinquished under §877A(g)(4).''[75] Section 877A(g)(4) provides citizenship will not be treated as relinquished until the earliest of:

(1) renunciation before a diplomatic or consular officer of the United States;

(2) furnishing a signed statement of voluntary relinquishment confirming performance of an expatriating act specified in INA §§349(a)(1) through (4) to the Department of State;

(3) the date on which the U.S. Department of State issues a CLN; or

(4) the date a naturalized citizen's certificate of naturalization is canceled by a U.S. court.

Motivated by concern and skepticism that someone who relinquished citizenship prior to 2004 could continue to be subject to U.S. income taxation until notification is given to the State Department, members of the American Bar Association Section of Taxation's sub-committee on U.S. Activities of Foreigners and Tax Treaties requested clarification and guidance in correspondence to IRS Commissioner John Koskinen on March 2, 2015.[76]

CONFRONTING A DELAYED LOSS OF TAX CITIZENSHIP

Until the IRS provides further guidance, individuals obtaining a CLN must consider possible application of §7701(a)(50) and §877A(g)(4). If applied literally, individuals who seek a CLN continue to be subject to U.S. income tax reporting and information filing requirements until the date the CLN is issued by the State Department. Individuals who have received a CLN are liable for any failures to file prior to issuance of the CLN.

In response to the literal language of §7701(a)(50) and §877A(g)(4), individuals who have obtained a CLN have four potential courses of actions:

(1) ignore the statutes and their application;

(2) file Form 8854 with a Form 8275 disclosure statement explaining §7701(a)(50) and §877A(g)(4) do not apply and consequently no disclosures are being made regarding the expatriate's assets as required by Form 8854;

(3) file only Form 8854; or

(4) file Form 8854 along with U.S. income tax and information returns (including FinCEN Form 114 FBAR Report of Foreign Bank and Financial Accounts) for the five years prior to the issuance of the CLN.

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[67] *See* Reg. §1.6012-1(b)(2)(ii)(*b*).

[68] Pub. L. No. 104-191, §511.

[69] HIPAA §512(a). The information required by §6039G is provided using Form 8854.

[70] The notice requirement is imposed on individuals relinquishing U.S. citizenship before February 6, 1995. It is reasonable to infer that, but for §511(g)(3)(A), the customary compliance obligations of a U.S. citizen no longer apply once a potentially expatriating act is performed with the requisite intent.

[71] *See* HIPAA §511(g)(3)(B).

[72] *See* text at n. 77, below.

[73] Pub. L. No. 108-357.

[74] Pub. L. No. 110-245.

[75] §7701(a)(50)(A).

[76] Tax Analysts Doc. 2015-5159.

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ISSN 0090-4600

Form 8854 is used not only to report relinquishment of U.S. citizenship to the IRS but also to compute the exit tax which may apply in such circumstances. Since June 17, 2008, the United States has imposed an exit tax on individuals who relinquish U.S. citizenship or terminate their status as lawful permanent residents (in lieu of the 10-year reporting regime of §877). Application of the exit tax to such individuals is not universal and applies only if one of three conditions is met:

(1) the individual's average annual U.S. income tax liability for the five years prior to the year of expatriation exceeded a certain indexed threshold ($161,000 for individuals expatriating in 2016);

(2) the individual's net worth exceeded $2 million on the date of expatriation; or

(3) the individual fails to certify on Form 8854 that the individual has filed U.S. income tax returns for the five years prior to the year of expatriation.[77]

If any of the foregoing conditions are met, the individual is subject to an exit tax computed as if all of the individual's assets had been sold for fair market value and all items of deferred compensation were received on the date of expatriation (the date of the CLN).

Even those individuals who satisfy one of the three tests for covered expatriate status and are consequently subject to the exit tax may be effectively exempt from its application. The exit tax applies only to gains in excess of an indexed threshold ($693,000 in the case of individuals whose expatriation is effective in 2016). Thus, unless the net gains realized on the deemed sale of an individual's assets exceed $693,000 or there are items of deferred compensation deemed accelerated by §877A(d)(2), the expatriate will owe no exit tax to the United States.[78] Consequently, for some individuals the most conservative and least costly response to the literal language of §7701(a)(50) and §877A(g)(4) will be to prepare and submit Form 8854 reporting the gains realized on the deemed sale of the expatriate's assets, especially if the result of doing so is to owe little or no tax after application of the exemption. In such a case Form 8854 could be submitted on a protective basis with an explanation as to why relinquishment of citizenship was effective for both tax as well as immigration purposes as of the date of the expatriating act confirmed by the CLN.

For individuals whose expatriation occurred prior to February 6, 1994, the most compelling argument as to why the exit tax of §877A, and, in fact, any other form of U.S. tax compliance does not apply is that they were subject to the 10-year expatriation tax regime of §877 as it existed in the year citizenship was relinquished. As explained above, the individuals who expatriated before February 6, 1994, did not have to give notice in order for their obligations as expatriates to commence. That express exemption should provide conclusive relief from current application of §7701(a)(50) and §877A(g)(4). Nothing in the legislative history of those Code provisions suggests an intention on the part of Congress to repeal the enabling provisions of the prior legislation.

CONCLUSION

For those individuals who are able to satisfy the requirements of the Streamlined Filing Offshore Procedure and will owe little or no U.S. tax for the three years reported under the SFOP, filing returns for an additional two years and then renouncing citizenship (when the individual is able to avoid covered expatriate status) will be the simplest and most straightforward way to avoid ongoing obligations. However, for those taxpayers who may be confronting a significant offshore penalty under the OVDP or who will be treated as covered expatriates on renunciation (especially if their heirs may be exposed to an estate or gift tax under §2801), consideration should be given to obtaining a CLN. Obviously, this will require meeting the burden of proof to establish an act of relinquishment was performed with the requisite showing of voluntariness and intent. For those individuals who successfully obtain a CLN, particularly if the expatriating act occurred prior to February 6, 1994, a compelling argument is available in HIPAA's effective date provisions to render irrelevant the provisions of §877A(g)(4) which extend tax citizenship until the date the CLN is issued.

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[77] *See* §877A(g)(1)(A) cross-referencing §877(a)(2). Since enactment by the Foreign Investors Tax Act of 1966, Pub. L. No. 89-191, the determination of which expatriates would be subject to special treatment as a result of their expatriation has been governed by §877(a).

[78] Rev. Proc. 2015-53, 2015-44 I.R.B. 615, §3.31.

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ISSN 0090-4600