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Expats Live in Fear of Malevolent Time Machine

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It's a large world out there. People move from the United States to many different countries with a variety of different customs, languages and cultures. But however different their circumstances may be, many expatriates of the United States have one thing in common. Having relinquished their U.S. citizenship long ago, they now live in fear. They wake up in a cold sweat worrying that the IRS will effectively pull the lever on a time machine, rewriting history so that their relinquishment of U.S. citizenship never happened, and exposing them to decades worth of taxes, plus, of course, interest and draconian penalties. As discussed in greater detail below, this article is written in the hope that the IRS will issue written guidance putting their fears to rest.

BACKGROUND: HOW CITIZENSHIP IS LOST

In very general terms, section 349(a) of the Immigration and Nationality Act, P.L. 82-414, provides that an individual may lose his or her citizenship by voluntarily performing any of the following acts with the intention of relinquishing U.S. nationality:[1]

1. becoming naturalized in another country;

2. formally declaring allegiance to another country;

3. serving in a foreign army;

4. serving in certain types of foreign government employment if the individual is a national of the foreign country or takes an oath of allegiance to that foreign country;

5. making a formal renunciation of nationality before a U.S. diplomatic or consular officer in a foreign country;

6. making a formal written renunciation in the United States during a time of war;

7. committing any act of treason or similar act against the United States.

As should be evident, some of these actions inherently involve the provision of a notice to the U.S. Government (*e.g.*, formal renunciation to a diplomatic or consular officer), but many do not (*e.g.*, obtaining naturalization in a foreign country). Consequently, absent some additional notice requirement, many years may go by following an individual's loss of citizenship before the IRS learns (if it ever does learn) about an individual's expatriation.

OVERVIEW OF INDIVIDUAL EXPATRIATION RULES

Taxation of Nonresident Aliens vs. U.S. Citizens and Residents

Residents of the United States are subject to income tax on their worldwide income.[2] And, unlike virtually all other countries, the United States taxes its nonresident citizens in the same manner. In contrast, nonresident aliens are subject to U.S. federal income tax only on (1) income that is "effectively connected" with the conduct of a trade or business in the United States,[3] and (2) certain fixed or determinable annual or periodical income from sources within the United States.[4] For nonresident aliens who do not have U.S. investments, U.S. income taxes do not apply.

Similarly, U.S. citizens and residents are subject to U.S. gift and estate tax on worldwide assets, whereas nonresident aliens are subject to U.S. gift and estate tax solely with respect to certain assets considered to be situated within the United States.[5]

Given the disparity in the tax treatment between U.S. citizens on the one hand, and nonresident aliens on the other, there has long been a feeling in Congress that special rules (collectively referred to herein as "expatriation rules") are needed to address situations where individuals relinquish their U.S. citizenship for tax purposes.

The Foreign Investors Tax Act of 1966

The first expatriation rules were enacted in 1966. The Foreign Investors Tax Act of 1966, P.L. 89-809 (the "1966 Act"), enacted Code Sec. 877, pursuant to which an alternative tax regime generally was prescribed for every nonresident alien individual who lost his or her U.S. citizenship at any time after March 8, 1965, unless such loss of citizenship "did not have for one of its principal purposes the avoidance of tax under this subtitle or subtitle B[.]"[6] Under the alternative tax regime, certain gains (*e.g.*, from dispositions of stock issued by a domestic corporation and debt obligations of a U.S. person) that would otherwise have a foreign source were deemed to have a U.S. source, and thus were rendered taxable, during the 10-year period following expatriation.

There was not at that time any rule that could in any circumstance cause a former citizen to continue to be treated as a citizen for tax purposes. The status of an individual for immigration purposes was determinative for federal tax purposes.

The Health Insurance Portability and Accountability Act of 1996

As it turns out, the expatriation rules enacted under the 1966 Act were rarely invoked. Proving a taxpayer's subjective intent can be quite difficult, and most taxpayers could present at least some plausible non-tax reason for having expatriated. Accordingly, Congress determined that changes to strengthen the expatriation rules were needed.[7]

As part of the Health Insurance Portability and Accountability Act of 1996 P.L. 104-191 (the "1996 Act"), Code Sec. 877 was modified to add a presumption of tax avoidance in cases where an expatriate's net worth equaled or exceeded $500,000 (net worth test), or the expatriate's average federal income tax liability over a specified five-year period exceeded $100,000 (tax liability test), with both figures adjusted for inflation in subsequent years.[8] A taxpayer to whom the presumption applied could, if certain requirements were satisfied, submit a ruling request asking the IRS for a determination that the alternative tax regime does not apply because he or she did not have a principal purpose of tax avoidance.[9]

The 1996 Act also enacted Code Sec. 6039F (redesignated as Code Sec. 6039G in 1997) requiring expatriates to file an information statement (eventually taking the form of Form 8854) with the IRS by a specified date, extended application of the expatriation rules to "long-term residents,"[10] and added additional categories of income treated as U.S.-source under the alternative tax regime.[11]

Notwithstanding these important changes, the basic approach from 1966 was largely retained. More to the point, as of 1996 there continued to be no rule that could in any circumstance cause a former citizen to continue to be treated as a citizen for tax purposes. The status of an individual for immigration purposes remained determinative for federal tax purposes.[12]

2003 JCT Report

In 2003 the Joint Committee on Taxation conducted a Review of the Present Law Tax and Immigration Treatment of Relinquishment of Citizenship and Termination of Long-Term Residency, (JCS-2-03), February 2003 (the "2003 JCT Report"). The 2003 JCT Report is useful, because it outlines the state of the law immediately prior to the 2004 legislation described below.

In the background section describing then-present law, the 2003 JCT Report provides in part as follows:[13]

> Under present law, the Immigration and Nationality Act governs the determination of when a U.S. citizen is treated for U.S. Federal tax purposes as having relinquished citizenship. Similarly, an individual's U.S. residency is considered terminated for U.S. Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive benefits of such treaty). In view of this reliance on immigration-law status, it is possible in many instances for a U.S. citizen or resident to convert his or her Federal tax status to that of a nonresident noncitizen without notifying the IRS.

The 2003 JCT Report further observes that, although individuals who relinquish their citizenship or terminate their residency are required to provide tax information statements on Form 8854, "difficulties have been encountered in enforcing this requirement, and in many cases the IRS does not receive information that it needs to enforce the alternative tax regime. In these cases, an individual may become a non-resident non-citizen of the United States for Federal tax purposes—and enjoy reductions in U.S. taxes from such tax status—despite failing to provide the tax information statements necessary for the IRS to monitor and enforce compliance with the alternative tax regime."[14]

Accordingly, the Joint Committee on Taxation recommended that an individual should continue to be treated as a citizen or long-term resident for U.S. federal income tax purposes until such individual: (1) notifies the Department of State or the INS, and (2) files a complete and accurate tax information statement with the IRS on Form 8854.

The Joint Committee on Taxation also made a number of other recommendations, including (1) replacing the subjective intention-based test with an objective test for determining whether the alternative tax regime applies; (2) imposing full U.S. taxation on individuals who are otherwise subject to the alternative tax regime and who return to the United States for extended periods; (3) imposing U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situs assets; and (4) imposing an annual return-filing requirement for individuals subject to the alternative tax regime, during the 10-year post-expatriation period.[15]

The American Jobs Creation Act of 2004

Consistent with the recommendations of the Joint Committee on Taxation, the American Jobs Creation Act of 2004, Pub. L. 108-357 (the "2004 Act"), made a number of significant changes to the expatriation rules. First and foremost, the 2004 Act enacted Code Sec. 7701(n), which for the first time untethered the citizenship status of an individual for federal tax purposes from the status of such individual for immigration purposes.

Code Sec. 7701(n) provided as follows:

(n) Special rules for determining when an individual is no longer a United States citizen or long-term resident. For purposes of this chapter—

> (1) United States citizens. An individual who would (but for this paragraph) cease to be treated as a citizen of the United States shall continue to be treated as a citizen of the United States until such individual—
>
> (A) gives notice of an expatriating act (with the requisite intent to relinquish citizenship) to the Secretary of State, and
>
> (B) provides a statement in accordance with section 6039G (if such a statement is otherwise required).
>
> (2) Long-term residents. A long-term resident (as defined in section 877(e)(2)) who would (but for this paragraph) be described in section 877(e)(1) shall be treated as a lawful permanent resident of the United States and as not described in section 877(e)(1) until such individual—
>
> (A) gives notice of termination of residency (with the requisite intent to terminate residency) to the Secretary of Homeland Security, and

(B) provides a statement in accordance with section 6039G (if such a statement is otherwise required).

Thus, pursuant to Code Sec. 7701(n)(1), an individual who relinquished citizenship by, for example, becoming naturalized in another country with the intention to no longer be a U.S. citizen, would remain a citizen, solely for federal tax purposes, until he or she (1) notified the Secretary of State, and (2) if required under Code Sec. 6039G, filed a certain statement (Form 8854) with the IRS.

The 2004 Act also: (1) replaced the subjective intention-based test with objective standards for determining whether former citizens or former long-term residents were subject to the alternative tax regime;[16] (2) imposed full U.S. taxation on individuals who were otherwise subject to the alternative tax regime and who return to the United States for extended periods;[17] (3) imposed U.S. gift tax on gifts of stock of certain closely-held foreign corporations that hold U.S.-situated property; and (4) required Form 8854 to be filed annually during the relevant 10-year period by individuals subject to the alternative tax regime.

The effective date of Code Sec. 7701(n) is particularly noteworthy. As expressly provided under section 804(f) of the 2004 Act, Code Sec. 7701(n) (and the other expatriation-related provisions of the 2004 Act) "shall apply to individuals who expatriate after June 3, 2004."[18] Thus, there's no question that individuals who successfully relinquished their citizenship for immigration purposes on or prior to June 3, 2004, continued to be respected as noncitizens for federal tax purposes after the 2004 Act.

The Heroes Earnings Assistance and Relief Tax Act of 2008

The next major change to the expatriation rules came in 2008 with The Heroes Earnings Assistance and Relief Tax Act of 2008 P.L. 110-245 (the "2008 Act"). The 2008 Act completely overhauled the expatriation rules by replacing the alternative tax regime (which had been in existence in some form or other since 1966) with an exit tax, set forth in new Code Sec. 877A. Subject to important exceptions, the new exit tax generally treats a "covered expatriate" as if he or she had sold all of his or her property for fair market value on the day preceding the "expatriate date." The 2008 Act also enacted Code Sec. 2801 (imposing a transfer tax on gifts received by U.S. persons from "covered expatriates") and repealed Code Sec. 7701(n).[19] Code Sec. 877A is effective (and, pursuant to new Code Sec. 877(h), Code Sec. 877 is ineffective) for any individual whose "expatriation date" is on or after June 17, 2008.

For all relevant purposes, Code Sec. 877A(g)(3) defines the term "expatriation date" as

(A) the date an individual relinquishes United States citizenship, or

(B) in the case of a long-term resident of the United States, the date on which the individual ceases to be a lawful permanent resident of the United States (within the meaning of section 7701(b)(6)).

So far, so good. But Code Sec. 877A(g)(4) provides as follows:

(4) Relinquishment of citizenship. A citizen shall be treated as relinquishing his United States citizenship on the earliest of—

(A) the date the individual renounces his United States nationality before a diplomatic or consular officer of the United States pursuant to paragraph (5) of section 349(a) of the Immigration and Nationality Act (8 U.S.C. 1481(a)(5)),

(B) the date the individual furnishes to the United States Department of State a signed statement of voluntary relinquishment of United States nationality confirming the performance of an act of expatriation specified in paragraph (1), (2), (3), or (4) of section 349(a) of the Immigration and Nationality Act (8 U.S.C. 1481(a)(1)-(4)),

(C) the date the United States Department of State issues to the individual a certificate of loss of nationality, or

(D) the date a court of the United States cancels a naturalized citizen's certificate of naturalization.

Subparagraph (A) or (B) shall not apply to any individual unless the renunciation or voluntary relinquishment is subsequently approved by the issuance to the individual of a certificate of loss of nationality by the United States Department of State.

In case it's not obvious, Code Sec. 877A(g)(4) was designed in part to take the place of old section 7701(n), by treating a former citizen (or long-term resident) as a U.S. citizen (or resident) for federal tax purposes until one of the above-specified "notice events" takes place.

WHY PEOPLE ARE UP AT NIGHT

So, let's consider the application of the above rules to a specific example.

Example. John Doe is a natural-born U.S. citizen who naturalized in Canada on January 1, 1975, with the intention of no longer being a U.S. citizen.[20] Pursuant to section 349(a)(1) of the Immigration and Nationality Act, he ceased to be a citizen on that date. Recently, Mr. Doe spoke with an immigration lawyer who advised him to get a certificate of loss of nationality ("CLN"). On January 1, 2013, the Department of State issued a CLN to Mr. Doe, confirming that he ceased to be a citizen on January 1, 1975.

To aid in the analysis, let's separately consider Mr. Doe's situation before and after the 2008 Act. As of 2008, when Code Sec. 877A was enacted, Mr. Doe's relinquishment of U.S. citizenship had been effective for federal tax purposes for 33 years and counting. As noted above, and confirmed by the 2003 JCT Report, the immigration rules were controlling prior to the enactment of Code Sec. 7701(n) in 2004, and that provision clearly applied solely on a prospective basis.

But then came the 2008 Act, and the successor provision to Code Sec. 7701(n) found in Code Sec. 877A(g)(4). Since the issuance of Mr. Doe's CLN on January 1, 2013, is the first "notice event" set forth in Code Sec. 877A(g)(4), that is arguably the first date on which Mr. Doe is considered to have relinquished his U.S. citizenship within the meaning of Code Sec. 877A(g)(4) (as well as the "expatriation date" as defined in Code Sec. 877A(g)(3)). And if that is indeed the case, then (gosh it seems silly to say) it arguably follows that Mr. Doe must retroactively be considered to have remained a U.S. citizen for the entire 38-year period beginning on January 1, 1975. Under this view, Mr. Doe would be retroactively responsible for taxes, plus interest and a plethora of life-altering penalties for each year during the 1975-2012 period. And, of course, to add the final insult (or perhaps the final injury), he would be subject to mark-to-market treatment under Code Sec. 877A(a) as of December 31, 2012.

But, wait a second, you say. Can Code Sec. 877A really be effective for an individual, such as Mr. Doe, who expatriated 33 years prior to the date of enactment? Don't these rules have effective date provisions? Yes, they do. But in this instance, the provision is very poorly drafted.

Section 301(g) of the 2008 Act provides (with specified exceptions not here relevant) that "the amendments made by this section [including section 301(a) of the 2008 Act, which enacted Code Sec. 877A] shall apply to any individual whose expatriation date (as so defined) is on or after the date of the enactment of this Act." Under a literal reading of this provision, Code Sec. 877A applies to Mr. Doe, because his expatriation date, as defined under Code Sec. 877A(g)(3) is January 1, 2013, which is on or after June 17, 2008.

It should be self-evident, however, that such a result is absurd, and cannot have been intended. Congress cannot possibly have meant to treat individuals who had long since relinquished their U.S. citizenship, and whose expatriations had always been respected for federal tax purposes, as if they had been citizens all along.

Undoubtedly, Code Sec. 877A was meant to apply solely to individuals that, on (or after) the date of enactment, were otherwise treated as citizens (or long-term residents) for federal tax purposes. Any individual who took all steps required to successfully terminate citizenship for federal tax purposes, under the tax laws as in effect immediately prior to enactment of the 2008 Act, would not again need to *relinquish* U.S. citizenship and thus could not be within the intended scope of Code Sec. 877A(g)(4).

Furthermore, since the 2004 Act quite deliberately included a "grandfather rule" for individuals who expatriated (within the general meaning of that term) on or prior to June 3, 2004, it's extraordinarily difficult to imagine that the 2008 Act would have been intended to reverse that treatment. And, indeed, if Congress truly had intended to take a figurative crowbar to the settled expectations of expatriates whose status as aliens had been carefully preserved under the 2004 Act just four years earlier, the legislative history certainly would have included some explanation of why Congress considered this appropriate. But, of course, the legislative history contains no such explanation, because Congress had no such intention.

Finally, if one were to cast all common sense aside, and to apply Code Sec. 877A in accordance with a literal reading of its effective date, where would it all end? Suppose that Mr. Doe had naturalized in Canada in 1956 and died in 1965, prior to enactment of the first expatriation rules as part of the 1966 Act. Should his children (or grandchildren) now file 10 years of income tax returns and an estate tax return to boot? Any different answer if he naturalized in Canada in 1910 and died in 1917? Once you enter Wonderland, it's tough to find your way out.

In all fairness, it must be admitted that dealing with a poorly drafted statute can be challenging. The authors are mindful that the IRS cannot take it upon itself to ignore the clear meaning of a statute, and that it is the role of Congress (not the IRS) to make tax-policy decisions. It is well established, however, that a statute must not be interpreted to compel absurd results.[21] Moreover, application of section 877A to Mr. Doe would appear to raise serious Constitutional issues under the Due Process Clause,[22] and there is "a well recognized doctrine that doubtful statutory construction involving possible unconstitutionality should always be rejected in favor of a reasonable construction by which the constitutional conflict can be avoided."[23]

CONCLUSION

More than a few expats find themselves in the same position as John Doe from the example above. They're understandably terrified that the IRS will pull the lever on a time machine, altering the past so that their relinquishment of U.S. citizenship never happened, with grossly inequitable and devastating consequences. The authors can only hope that the IRS will relieve their suffering by issuing favorable written guidance as soon as possible.

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[1] In certain instances, additional requirements apply, such as having achieved the age of 18 at the time of the specified action.

[2] *See* Code Sec. 1; Treas. Reg. § 1.1-1(b). Except as may otherwise be indicated, all "section" and "sec." references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. sec." references are to the Treasury Regulations promulgated thereunder.

[3] Pursuant to Code Sec. 897, gains from dispositions of United States real property interests are taxed in the same manner as income that is considered to be "effectively connected" with the conduct of a trade or business in the United States.

[4] *See* Code Sec. 872.

[5] Note that the definition of resident for gift and estate tax purposes differs from the definition that applies for income tax purposes.

[6] Certain exceptions (not relevant to this discussion) were set forth in Code Sec. 877(d).

[7] In 1994, Forbes magazine published an article, "The New Refugees" touting the benefits of expatriating to avoid U.S. estate and income taxes, and listed the names of many rich individuals who had managed to escape U.S. taxation with their fortunes intact. The 1996 legislation described herein may have been due in part to the publicity generated by that article.

[8] *See* Code Sec. 877(a)(2) (1996).

[9] See Code Sec. 877(c) (1996); Notice 97-19, 1997-1 CB 394, obsoleted by Notice 2005-36, 2005-19 IRB; Notice 98-34, 1998-2 CB 29, obsoleted by Notice 2005-36, 2005-19 IRB.

[10] In very general terms, an individual who held a green card for at least eight taxable years during a specified 15-year period (without invoking the benefits of a treaty "tie-breaker" rule) was considered a long-term resident. *See* Code Sec. 877(e) (1996).

[11] *See* Code Sec. 877(d) (1996).

[12] And, while Code Sec. 6039F (later redesignated as Code Sec. 6039G) introduced the requirement to file an information statement on Form 8854, there was no suggestion that noncompliance would affect the expatriate's status as a nonresident alien.

[13] 2003 JCT Report at 209 (emphasis added; footnotes omitted).

[14] Id. (footnotes omitted).

[15] Id. at 205-215.

(continued)

[16] Following the 2004 Act, a former citizen (or long-term resident) was subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless s/he: (1) (a) established that his or her average annual net income tax liability for the five preceding years did not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth did not exceed $2 million, or (b) satisfied certain limited exceptions for dual citizens and minors with no substantial contact with the United States; and (2) certified under penalties of perjury that he or she had complied with all U.S. federal tax obligations for the preceding five years.

[17] Pursuant to Code Sec. 877(g), an individual who was physically present in the United States for more than 30 days during any calendar year within the above-described ten-year period was treated as a U.S. citizen or resident for all purposes of the Internal Revenue Code.

[18] No special definition of expatriation was provided for this purpose.

[19] Conforming changes to the information-reporting provisions of Code Sec. 6039G were made as well.

[20] He did not acquire a green card or reside in the United States at any time thereafter.

[21] *See, e.g.*, *United States v. American Trucking Associations, Inc.*, 310 U.S. 534 (1940) (footnotes omitted) ("There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act.").

[22] As observed by the Supreme Court in *United States v. Carlton, 512 U.S. 26 (1994)*, a number of the Court's decisions "have stated that the validity of a retroactive tax provision under the Due Process Clause depends upon whether 'retroactive application is so harsh and oppressive as to transgress the constitutional limitation.' *Welch v. Henry*, 305 U.S. at 147, quoted in *United States v. Hemme*, 476 U.S. at 568-569." Thus, for example, as noted in *Milliken v. United States*, 51 S. Ct. 324 (1931) the Court has on several occasions held certain attempts to tax gifts on a retroactive basis to be "so palpably arbitrary and unreasonable as to infringe the due process clause. *Nichols v. Coolidge*, supra; *Untermyer v. Anderson*, 276 U. S. 440, 48 S. Ct. 353, 72 L. Ed. 645; *Coolidge v. Long*, 282 U. S. 582, 51 S. Ct. 306, 75 L. Ed.—, decided Feb. 24, 1931." The due process questions in this case seem even more severe.

[23] *See, e.g.*, *Independent Life Insurance Co. of America*, 17 BTA 757 (1929) (citations omitted).