Am I still a US citizen? Confusion regarding loss of US citizenship for tax purposes

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Unlike virtually every other developed country, the United States bestows upon its citizens the unique pleasure of being taxed on their worldwide income, regardless of where that income is earned. To sweeten the pot, Uncle Sam also imposes estate and gift taxes on the value of property transferred by a US citizen by gift or upon death regardless of the location of those assets.[1] Even if a US citizen in Canada (and elsewhere abroad) has a limited amount of income or pays foreign taxes such that the US tax returns to be filed would show zero tax liability owing, citizens must file a complex web of income and informational returns or potentially face severe penalties.[2] These intricate and confusing requirements often result in substantial and burdensome tax compliance costs for US citizens living in Canada, and create ongoing risks of harsh penalties due to noncompliance.

What can a US citizen abroad do to bring the party to a halt? US citizens abroad are faced with three options:

1. ignore US filing obligations;
2. continue with annual tax and compliance obligations; or
3. leave the party altogether by terminating US citizenship.[3]

I. Ignore US tax filing obligations

While the first option of simply ignoring US filing obligations appears the simplest, it is wrought with potential dangers, particularly with the enactment of the Foreign Account Tax Compliance Act ("FATCA").[4] Generally under FATCA foreign financial institutions are obligated to relay information with respect to accounts held by United States persons (including citizens) to the IRS, either directly or through their respective government. This new information reporting regime has heightened the IRS's awareness of accounts held outside the United States by United States persons, greatly simplifies ferreting out noncompliance, and enhances their ability to impose penalties. Now more than ever the IRS is cracking down on noncompliance by United States persons living abroad, and the risks associated with ignoring filing obligations continue to mount. In other words, ignorance may be bliss, but the risk of detection is high.

II. Continue with US tax filing obligations

Attempting to become fully compliant also has its pitfalls. The complex maze of filing requirements created by the US tax system can trip up even the most experienced tax professional without careful attention. This is particularly true for US citizens in Canada and elsewhere, as most foreign tax professionals develop their expertise based on that jurisdiction's tax laws, not the United States law. As a result, a taxpayer may find themselves in the unenvious position of not only paying high fees for compliance services, but also facing stiff penalties imposed by the IRS due to their preparer's failure to file the necessary forms.

Take the garden variety US citizen living in Canada with a simple portfolio of assets including a Canadian Registered Retirement Savings Plan ("RRSP"), a Canadian Tax Free Savings Account ("TFSA"), savings in a bank account of $75,000, and annual income of $60,000. Such an individual must file the following IRS forms at a minimum: 1040, 3520, 3520-A, 8621,nd FBAR. The IRS estimates that completion of these forms will take approximately *sixty hours*, not including any schedules required to be attached to Form 1040 (e.g. Schedule A for itemized deductions) and the FBAR. Without specialized knowledge and training, many tax professionals neglect to file all of these forms among several others that may arise depending upon an individual's circumstances. Correcting these errors can result not only in doubling up on compliance costs, but also swallowing the bitter pill of failure-to-file penalties.

III. Terminate US citizenship

Terminating US citizenship is a difficult and important decision. Individuals exploring this potential route should seek professional advice and weigh all relevant factors before moving forward. US citizens are afforded many privileges and have access to benefits that non-citizens do not enjoy, including protection abroad, consular services, the right to vote, and easy access to the US job market.[5] Once an individual loses their United States citizenship their US reporting and filing obligations by virtue of being a citizen terminate after filing a final year return. In addition, non-resident non-citizen individuals are not subject to the US estate tax except as to "US situs property" (generally property situated within the U.S.).

So how does an individual terminate US citizenship? In the past, US immigration law and tax law were on the same page: once you stopped being a US citizen under immigration law, your tax filing obligations stopped as well. However under current law, tax filing obligations continue until certain factors have been met *regardless* of the date the individual stopped being a US citizen for immigration purposes. Thus, the current "mark-to-market" exit tax regime imposed by US tax law creates a trap for the uninformed.

IV. US immigration law

Under current US immigration law, an individual loses their US citizenship by voluntarily performing an expatriating act with the intention of relinquishing their citizenship.[6] An expatriating act includes: (1) naturalizing in a foreign country after the age of eighteen; (2) taking an oath of allegiance to a foreign country after the age of eighteen; (3) serving in the armed forces of a foreign country as an officer or if such forces are engaged in hostility with the US; (4) working for a foreign government after the age of eighteen if having or acquiring that nationality; (5) renouncing your US citizenship before a diplomatic or consular office of the United States; (6) making a formal written renunciation of US citizenship in the US during a time of war; or (7) conviction for an act of treason or similar offence.[7] Unfortunately in a bizarre twist the US tax law restricts loss of citizenship for tax purposes further than immigration law. Unwary individuals could potentially lose their citizenship under immigration law and still be treated as a US citizen for tax purposes.

V. US tax law

Despite having lost US citizenship for immigration purposes, the individual's tax and filing obligations only stop on the earliest of: (1) the date they renounce before a diplomatic or consular officer of the United States; (2) the date they furnish a signed statement of voluntary relinquishment to the US Department of State confirming an expatriating act; (3) the date the State Department issues the individual a certificate of loss of nationality ("**CLN**"); or (4) the date a US court cancels an individual's certificate of naturalization.[8] Section 7701(a)(50) of the Internal Revenue Code makes clear that an individual is treated as a US citizen for tax purposes until the foregoing requirements are met, regardless

of the individual's status under immigration law.[9]

Current US tax law imposes an exit tax on certain individuals seeking to terminate their US citizenship.[10] If an individual is considered a "covered expatriate," all of the property they own is treated as sold on the day before relinquishing US citizenship at fair market value, and the individual is taxed on the hypothetical gains from the sale above $680,000 USD (indexed for inflation).[11] A covered expatriate is defined as an individual who relinquishes their citizenship *within the meaning of the US tax code* and meets any one of the following three triggers:

1. has a net worth of $2,000,000 USD or more the day before renouncing;
2. has an average annual net income tax liability of more than $157,000 USD in the five years ending before the date of expatriation; or
3. fails to certify on Form 8854 that he or she has complied with all US federal tax obligations for the five years ending before the date of expatriation.[12]

The intersection between immigration law and tax law can have potentially disastrous results: absent a formal proceeding before a court or the consulate, or furnishing or receiving the proper paperwork from the State Department, an individual that has expatriated for immigration law purposes is still deemed a US citizen for tax purposes and therefore is not relieved of their US federal tax law filing obligations. An individual that thought they lost their US citizenship years ago (e.g. by taking an oath to a foreign country with the intent to relinquish US citizenship) may still have continuing US tax filing obligations (and thus be subject to massive penalties) because they have not yet relinquished their citizenship for tax purposes.

Although the tax law permits a US citizen to relinquish their citizenship in a few different ways, practically speaking affirmative renunciation before a diplomatic or consular officer provides the most certain results. Furnishing a signed statement of voluntary relinquishment (i.e. Form DS-4079) involves a difficult process of proving you performed an expatriating act pursuant to immigration law at some point in the past. Form DS-4079 submissions alone are routinely rejected by the State Department. Moreover, the State Department does not issue CLNs lightly; attempting to get a CLN without affirmative renunciation faces many of the same obstacles that the DS-4079 submission does.

Offshore activity by US citizens and residents continues to garner increased attention by lawmakers in the United States. As a result, the laws and restrictions imposed upon relinquishing one's citizenship, and reporting and filing obligations of those living abroad continue to increase in complexity and burden. Just recently, the State Department increased the fee for processing renunciation applications by over four hundred percent. The forecast suggests that these problematic issues will only continue to grow, and the IRS has greatly bolstered their ability to identify noncompliant citizens abroad.

[1] I.R.C. §§ 2001, 2501.

[2] *See, e.g.*, § 6038D (requiring any individual who holds an interest in specified foreign financial assets the aggregate of which exceed $50,000 to provide information with respect to those assets). The penalty for failure to furnish such information is $10,000 per year.

[3] Removing your status as a United States person may not completely eliminate all of your U.S. filing obligations. For example, nonresident aliens (non-U.S. persons) may still be required to file returns with respect to U.S. source income.

[4] *See* §§ 1471-74.

[5] This list is by no means exhaustive. Consult with an experienced professional to ensure that you fully understand all the consequences of losing your citizenship.

[6] U.S.C. § 1481(a) (2012).

[7] *Id.*

[8] § 877(a)(g)(4). The first two dates are not considered proper relinquishment unless subsequently approved via the issuance of a certificate of loss of nationality by the State Department (flush language).

[9] Note, under § 7701(a)(50)(B) the IRS has the authority to issue regulations that exempt people who were dual citizens at birth, however to date there have been no regulations proposed or issued.

[10] § 877A

[11] *Id.*; Rev. Proc. 2013-35.

[12] § 877(a)(2).