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Should I stay or should I go? US taxpayers, international families and the question of expatriation

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INTRODUCTION

Members of international families are renouncing their US citizenship in record numbers, and for some the decision to renounce requires them to weigh complex considerations. US income tax rates are lower than those in numerous other jurisdictions, yet it is common for clients to be advised to renounce their US citizenship.

The 2010 Foreign Account Tax Compliance Act (FATCA) is no longer unique to the US: the world is becoming increasingly transparent and many other countries have adopted the Organisation for Economic Co-operation and Development's (OECD's) 2014 Common Reporting Standards (CRS) (a regime the United States has declined to adopt). Nonetheless, a US passport, once considered a prized possession by many, has become less attractive to many international families.

Individuals with no ties to or interest in the United States may view the decision to renounce their US citizenship as straightforward where there are obvious tax benefits. However, tax is not the only factor to be considered in connection with the decision to renounce US citizenship. In many cases, issues unrelated to tax can be equally compelling and may require a more nuanced decision-making process.

This article will therefore:

- Provide a summary of how individuals acquire US citizenship.
- Provide an overview of the US expatriation tax regime.
- Consider some of the issues associated with renouncing US citizenship for international families.

ACQUISITION OF US CITIZENSHIP

US citizenship can be acquired through naturalisation or at birth, either because individuals are born in the United States or under the principle of "derivative citizenship".

Citizenship by birth

US citizenship is conferred at birth on individuals who are born in the United States under the principle of jus soli (right of the soil: the right of anyone born in the territory of a state to nationality or citizenship). In such case US citizenship will be conferred regardless of whether their parents are US citizens or domiciliaries (*8 USC §1401(a)*).

Children who are born in the United States to two non-US citizen parents and later return to their parents' home country are often referred to as "accidental Americans." Indeed, the US State Department's Foreign Affairs Manual notes that State Department offices are occasionally contacted by parents of accidental Americans protesting "involuntary" acquisition of US citizenship (*7 FAM 1292(a)*).

Legislation proposed in 2017 would restrict the acquisition of citizenship by individuals born in the United States. Under the proposals, citizenship would only be conferred on a child if one of the child's parents is a US citizen, a green card holder residing in the United States or a non-citizen performing active service in the US Armed Forces (*Birthright Citizenship Act 2017, HR 140, 115th Cong (2017)*). However, this proposed legislation is unlikely to become law.

It is understandable that parents may assume they have the right to determine whether their children will be US citizens. However, this is an offer that cannot be refused: parents cannot renounce citizenship on behalf of children who acquire US citizenship at birth (*7 FAM 1292(e)*).

Derivative citizenship

Individuals born outside of the United States derive citizenship from a US citizen parent who has been present in the United States for five years prior to a child's birth, if two of those years of presence occurred after the parent reached 14 years of age (*8 USC §1401(g); see also 8 USC §1401(c)-(e)(birth in outlying US possessions*).

OVERVIEW OF THE US EXPATRIATION TAX REGIME

For many years, individuals subject to the expatriation tax regime were required to report their US source income and gains (as defined for expatriation tax purposes) to the US Internal Revenue Service for ten years after the initial date of their expatriation (*see IRC §877 (originally enacted in 1966 as part of the Foreign Investors Tax Act 1966, PL 89-809, 80 Stat 1541, §103(f)*). Resourcing rules applied to treat certain income and assets as US source specifically for the purposes of the expatriation tax regime, which impacted certain gifts and bequests (*see IRC §§877(b), 2501(a)(3), 2107*). However, individuals that did not hold US situs assets could transfer their assets to their families free from US gift and estate tax.

In 2008, the US Congress enacted an expatriation exit tax regime (*IRC §877A*). While some welcomed the end of the ten-year reporting requirement, the exit tax significantly changed the scope of the expatriation tax for those covered by the regime (Covered Expatriates) in two key aspects:

- First, it imposed an exit tax on the expatriate's worldwide assets. A Covered Expatriate is deemed to have sold his/her worldwide assets as of the day before his/her expatriation date (*IRC 877A sale*). This can be particularly onerous for individuals expatriating as adults who own significant assets that are not subject to tax in their home country. Exceptions do apply, however, to trusts that are characterised as "non-grantor trusts" and certain deferred compensation arrangements.
- Second, Covered Expatriates can no longer freely transfer their assets to their US citizen descendants free from US gift or estate tax. US citizens and US domiciliaries who receive gifts and bequests from Covered Expatriates will therefore be subject to tax on the gift unless:

- the gift qualifies for the US gift or estate tax marital deduction; or
- the gift is subject to US gift or estate tax (*see IRC §2801*).

A separate regime applies to impose gift tax on distributions received from foreign trusts created by Covered Expatriates (regardless of whether the trust qualifies as a foreign grantor trust). Broadly, this means that if the parents are Covered Expatriates but their children remain US citizens (or domiciliaries), they cannot pass their assets to their children free from US transfer taxes.

Under the 2008 expatriation exit tax regime, an individual that renounces his/her US citizenship will be a Covered Expatriate where all of the following are applicable:

- He/she has assets in excess of US$2 million.
- He/she has an average US income tax liability of US$165,000 or less over the five years prior to expatriation.
- He/she is compliant with their US income tax obligations (*see IRC §2801(e)(4)*). An income tax deduction may be available for the gift tax paid if the distribution is subject to US income tax).

However, despite the above criteria, the following persons will not be Covered Expatriates (*IRC §877A(g)(1)(B)*):

- **Minors.** Individuals who expatriate prior to reaching 18 years of age who have not been residents in the United States for more than ten years.
- **Dual nationals.** Individuals who became nationals of the US and another country at birth and:
  - continue to be citizens of the other country as of the date of expatriation;
  - are taxed as residents of the other country as of the date of expatriation; and
  - have not been residents of the US for more than ten taxable years during the 15-year period ending with the taxable year including the expatriation date.

Green card holders are not eligible to claim any of these exceptions.

Example: Ming

Ming became a dual national of China and the US at birth. She has not resided in the United States since she was six months old. Her net worth is greater than US$2 million. Ming is participating in an internship in Paris while she is preparing to renounce her US citizenship. If she is between the age of 18 and 18 and six months, she will not be a Covered Expatriate. If she is over 18 years and six months, she will be a Covered Expatriate, unless she is tax resident in China in the year in which she renounces her US citizenship. If Ming was a citizen of a country that permitted dual nationality and she was naturalised as a US citizen, she would not be eligible for any of the exceptions to covered expatriate status.

RENOUNCING US CITIZENSHIP

Will you marry me and renounce your US citizenship?

When a marriage between the members of two families with significant wealth is contemplated, one can assume that both parties will have sophisticated advisers. The tax consequences and family governance issues that can arise in connection with the couple's choices such as where to live and how to structure their finances, as well as the impact of US citizenship on these issues, will be the subject of careful consideration.

However, in other cases, expatriation is presented as a pre-ordained conclusion (for example, where it is imperative (for the good of the family) that one of the spouses renounces their US citizenship).

If the couple's assets are segregated, the US information reporting requirements imposed on a US citizen will not need to be extended to the spouse's non-US family members and their enterprises. However, the notion that the US spouse will produce a US citizen heir may be unacceptable, regardless of whether the child renounces her US citizenship in the future.

There are numerous arguments in favour of expatriation, for example:

- There are countries that prohibit dual citizenship and others where anti-American sentiment makes holding a US passport a disadvantage.
- From a practical perspective, many financial institutions do not accept US citizens as clients and in some countries US citizens find it difficult to arrange routine banking relationships.
- Certain investments are not tax efficient for US citizens and a family's trusts, foundations or other vehicles may not be structured in a manner that is tax efficient for US citizens.

The calculus may be different for a US spouse, for example:

- Does the US spouse have aging parents in the United States? If they became critically ill would the US spouse want to spend extended periods of time in the United States with them?
- Does the US spouse have children residing in the United States?
- If the marriage ended, where would the US spouse reside?
- Does the US spouse work in a field where the United States offers greater career prospects?

Renunciation of US citizenship is an irrevocable act. A former US citizen does not have the right to reside in the United States without an appropriate visa. What visas will be available to the US spouse? Does the US spouse have sufficient assets to finance a return to the United States and restart her life? If the US spouse does not have significant assets prior to the marriage and assets are not placed in the spouse's name during the marriage, her options may be limited (subject to the quantum of the assets received in connection with a divorce).

Is the US spouse receiving independent advice? If the US spouse is simply being assisted with the mechanics of the expatriation process (for example, ensuring his/her US tax obligations are up to date, completing State Department forms), who is working with her to reach an informed and independent decision regarding the renunciation of her citizenship?

The US spouse's concerns can be addressed using a pre-nuptial agreement. However, the desire to prove that the US spouse is not interested in the family's money may need to be balanced against the reality that the US spouse has made a significant sacrifice by renouncing his/her citizenship.

Example: Rania

Rania was born and raised in Chicago. She meets Ahmed at university in New York. Ahmed's family lives in Jeddah where they have a significant family business with operations throughout the Middle East and Asia. Rania and Ahmed have been working in Dubai for two years and now plan to marry. Rania comes from a family of modest means and is working as a teacher. She has the right to obtain an Irish passport but she has never visited Ireland. The law firm representing Ahmed's family advises Rania that she must renounce her US citizenship after obtaining her Irish passport. They offer to hire a US lawyer to assist her with the process.

Rania does not want to upset Ahmed's family, nor does she want it to appear that she is interested in the family's assets. She is happy to sign a pre-nuptial agreement, but is uncomfortable with the idea of giving up her US citizenship. She does not believe that the ability to live in Ireland or elsewhere in the EU is a suitable substitute for the ability to return to her country of origin. Should she ensure that the pre-nuptial agreement provides her with the ability to obtain an appropriate visa so that she can reside in the United States should she wish to do so?

Expatriating children

When children who reside outside of the United States acquire US citizen at birth, their parents often assume that, as soon as it is feasible for them to do, so they will renounce their US citizenship. The US State Department is sensitive to the role parents play in these decisions and the impact on voluntariness and intent. The Foreign Affairs Manual specifically addresses this issue:

"Minors who seek to renounce citizenship often do so at the behest of, or under pressure from, one or more parent. If such pressure is so overwhelming as to negate the free will of the minor, it cannot be said that the statutory act of expatriation was committed voluntarily. The younger the minor is at the time of renunciation, the more influence the parent is assumed to have. Even in the absence of any evidence of parental inducements or pressure, Consular Affairs personnel must make a judgement as to whether the individual minor manifested the requisite maturity to appreciate the irrevocable nature of expatriation. Absent that maturity, it cannot be said that the individual acted voluntarily. Moreover, it must be determined if the minor lacked intent because he/she did fully understand what he/she was doing. Children under 16 years are presumed to not have the requisite maturity and knowing intent". (*7 FAM 1292(i)(2)*).

Although children under the age of 18 years can expatriate if they demonstrate the requisite maturity and intent, the decision is not final and the Foreign Affairs Manual provides that parents should not be present while children are being interviewed by the State Department. A minor who has expatriated may reclaim her citizenship within six months of reaching 18 years of age (*7 FAM 1292(i)(3)*).

Many teenagers raised outside of the United States have no attachment to their US citizenship and their decision to expatriate is a simple one. However, in other cases, young adults fulfil a familial duty by renouncing their US citizenship. Some clients question the necessity of giving up their US passports.

Children who are educated in the United States may forge strong, and in some cases primary, social ties in the United States. They may plan to work in the United States after graduation. It is possible for individuals who have expatriated to obtain a student visas and visas to work in the United States. However, it is far easier (typically) for young graduates to obtain internships and to enter the US job market as US citizens because their employers are not required to obtain visas for them. It is also not unusual for these individuals to meet their future spouses while they are in the United States. If they marry Americans, the cycle repeats itself. Sometimes they decide to remain in the United States as long-term residents.

Young adults who are being asked to renounce their US citizenship must weigh these issues against the issues that weigh in favour of expatriation, for example:

- What duties do family members undertake as custodians of family wealth?
- Are they required to relinquish their US passports or reside in particular jurisdictions to facilitate the family's business and succession planning?
- Do other members of the family have the appetite to modify their arrangement to accommodate the issues facing US citizens?

These issues are exacerbated for clients who work in a family business. Other family members may be concerned about the extensive information reporting required of US citizens. As a matter of principle and privacy, they may not want the details of their business and its financial accounts to be reported to a foreign government. This may limit a US citizen's ability to advance or to hold significant shareholdings or financial power in a family business.

These are of course intensely personal issues and there is no right or wrong answer to many of the questions raised in this article. Each client should weigh the opportunity costs associated with keeping or relinquishing a US passport from his/her own vantage point.

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