
Expatriation: The American's Tax Experience in Canada

Kevyn Nightingale and David Turchen*

PRÉCIS

Seuls deux gouvernements dans le monde — les États-Unis et l'Érythrée — soumettent leurs citoyens à une imposition mondiale complète indépendamment du lieu où ils vivent. Il y a plus d'Américains qui vivent au Canada que dans tout autre pays étranger. Bien que les deux pays aient des régimes fiscaux semblables, il y a tout de même un certain nombre d'incompatibilités. En conséquence, les citoyens américains qui vivent au Canada rencontrent plusieurs obstacles majeurs pour exercer leurs activités ou planifier leurs affaires, comparativement aux citoyens non américains. En outre, la charge administrative imposée par l'Internal Revenue Service des États-Unis est lourde et ne cesse de s'accroître. Une politique d'application de la loi plus musclée ces dernières années a conduit un nombre croissant d'Américains vivant à l'étranger à abandonner leur citoyenneté américaine ou leur statut associé à la carte verte. Cet article traite de l'histoire de ce phénomène et des conséquences fiscales pour les Américains vivant au Canada qui abandonnent leur statut de citoyen des États-Unis.

ABSTRACT

Only two governments in the world—the United States and Eritrea—subject their citizens to comprehensive worldwide taxation regardless of where they live. There are more Americans living in Canada than in any other foreign country. While the two countries have generally similar income tax systems, there are a number of areas of incompatibility. As a result, US citizens living in Canada encounter significant limitations on their ability to carry on their activities or plan their affairs, compared with non-US citizens. In addition, the reporting burden imposed by the US Internal Revenue Service is heavy, and growing. A more aggressive enforcement policy in recent years has induced increasing numbers of Americans abroad to relinquish their US citizenship or green-card status. This article discusses the history of this phenomenon, and the tax consequences for Americans in Canada who give up their US status.

KEYWORDS: EXPATRIATION ■ EXPATRIATES ■ CANADA-US ■ UNITED STATES ■ REPORTING ■ INDIVIDUAL

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INTRODUCTION

It is estimated that about a million US citizens currently live in Canada, as well as an unknown number of people who have US green-card status (that is, are “lawful permanent residents” of the United States).¹

In most countries, citizenship comes with both benefits and obligations. Many of these American-Canadians are cognizant of the benefits of their ability to live and

1 Roma Luciw, “U.S. Tax Crackdown Hits Canadian Residents,” *Globe and Mail*, June 20, 2011.

work in the United States. From our experience, we would hazard a guess that until recently, only a small minority knew that one of their obligations, as US citizens or green-card holders, is an ongoing duty to comply with US tax rules. In addition, there are many individuals who do not even know that they are US citizens, so they *certainly* have no idea that US tax rules apply to them.

The United States and Eritrea are the only two countries that tax their citizens on their worldwide income regardless of where they live. Strange, one would think, that this unique approach has been adopted by the most powerful and richest nation in the world, and one of the smallest and least developed. It helps to understand the essential nature of tax. Governments tax because they can, and they tax what they can, be it income, sales, property, salt, or windows installed in buildings. They also impose tax on all who fall under their jurisdiction; thus, the US Internal Revenue Service (IRS) has a longer effective reach than, say, HM Revenue & Customs in the United Kingdom or the Canada Revenue Agency (CRA).

The United States can tax more broadly than other nations because—as all roads once led to Rome—the United States is the centre of the financial world. It is hard to do business or invest effectively without participating in US markets. The case of Eritrea is obviously different. The Eritrean government enforces its 2 percent “diaspora” tax by withholding birth, death, and marriage certificates. There are also reports that Eritreans abroad have been told that relatives who are still in the country will be mistreated or even disappear if the expatriates fail to pay up.²

While the consequences to an American abroad for failure to comply are not so draconian, the obligations are often onerous. Since everything that a US expatriate does in Canada is “foreign” to the United States, the filings required to ensure compliance are voluminous, even for ordinary people, not just the wealthy and those engaged in diverse business and investment activities.

While US and Canadian tax laws are similar in many respects, they are not the same. Different ways of measuring income and US anti-avoidance rules in respect of foreign entities can create additional taxation.

As a consequence of increasing awareness of their US tax obligations, many Americans in Canada are now wondering whether to retain their US status. This article discusses the background to this dramatic change, and the issues faced by such individuals who are considering relinquishing their status.

TAX OBLIGATIONS FOR AMERICANS LIVING IN CANADA

Each US citizen and resident must file a US tax return annually, reporting worldwide income, so long as the taxpayer's income exceeds a *de minimis* amount.³ For a single

2 Stewart Bell, “Eritrea’s ‘Extortion,’” *National Post*, November 5, 2011.

3 Section 6012(a)(1)(A) of the Internal Revenue Code of 1986, as amended (herein referred to as “the IRC”). Unless otherwise stated, statutory references in this article are to the IRC.

person under age 65 who is not eligible to be claimed as a dependant by another person, for 2013 this amount is US\$10,000.⁴

It may seem odd to think of a US resident living in Canada, but the US definition of residence is different than the Canadian one. A lawful permanent resident of the United States—that is, a green-card holder—is deemed to be a US resident, even if he or she never enters the United States.⁵ It is also possible to be a US resident simply by spending more than a limited amount of time in the United States.⁶ The Canada-US tax treaty has tie-breaker rules for residents, but these rules do not restrict the United States' ability to tax its citizens.⁷ The treaty in some cases mitigates double taxation, but it does not eliminate the requirement to file.

A US person⁸ living in Canada likely needs to file an FBAR (“Report of Foreign Bank and Financial Accounts”).⁹ This form is not part of the income tax return and is filed separately. An individual is required to file an FBAR reporting each foreign account in which he or she has a financial interest or over which he or she has signature authority, where the total in all such accounts exceeds US\$10,000 in total at any time during the year. Where an individual owns over 50 percent of a foreign corporation by votes or value, the individual is deemed to have a financial interest.

This \$10,000 threshold may have seemed high when it was enacted in 1970, at a time when there were relatively few Americans living abroad, and very few living in the United States who had access to foreign accounts. Given the explosion in international migration and commerce, along with inflation, the threshold is now ludicrously low, catching virtually every US adult abroad.

For 2011 and subsequent years, Americans with larger balances in foreign accounts are also required to file form 8938 (“Statement of Specified Foreign Financial Assets”) providing far more detailed information about those accounts along with other “foreign assets” that are not reported on the FBAR.¹⁰ The threshold for a US couple filing jointly and living abroad is \$600,000 at any time during the year, or

4 All figures cited are in US dollars for 2013.

5 IRC section 7701(b)(1)(A)(i).

6 IRC sections 7701(b)(1)(A)(ii) and 7701(b)(3).

7 Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as “the Canada-US treaty”), articles IV(2) and XXIX(2).

8 All references in this article to a “person” mean a “natural person,” and not a corporation, trust, partnership, or other entity.

9 Department of the Treasury form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts.” The legislative authority for the FBAR reporting requirements was originally introduced in conjunction with the Bank Secrecy Act of 1970, 31 USC 1051 et seq. It is currently set out in 31 USC section 5314 and implemented by regulation 31 CFR 1010.350.

10 IRC section 6038D.

\$400,000 at the end of the year.¹¹ Form 8938 is quite complicated, and reporting is expected to significantly increase many individuals' accounting fees.

The United States has a number of mechanisms to limit double taxation. For most Americans resident in Canada, the foreign earned-income exclusion of up to \$97,600¹² will effectively eliminate their US tax. For individuals with higher incomes or more complicated income streams, the foreign tax credit will, in most cases, fully offset the tax¹³ because Canadian tax rates are generally higher than US rates.

The vast majority of Americans abroad live in advanced countries with robust tax systems utilizing higher effective tax rates than current US rates; consequently, it is rare for such persons to owe US tax.¹⁴ However, even individuals with modest incomes normally need to file FBARS. Those who fail to do so are exposed to "ordinary" civil penalties of up to \$10,000 per account per year; penalties for wilful failure to file can be much higher.

For individuals higher up the food chain, the United States has rules around foreign corporations and trusts that parallel the objectives of Canada's foreign accrual property income and non-resident trust rules. However, by comparison, the US rules generally have broader application, and the reporting requirements are more extensive.¹⁵

For people with complex affairs, the Canadian and US tax systems do not always dovetail well. It is quite common to see corporate structures in Canada that are tax-efficient in a purely domestic scenario, but when a US person is an owner of such a structure, double taxation can easily result. This will often be the case, for example, with investment companies and trusts. These vehicles are very common in Canadian owner-manager tax planning, but the United States often views them as suspect.

When set up in low-tax jurisdictions, such structures can be used to avoid US tax, defer US income or gain recognition, or divert income to other taxpayers who may be taxed at lower rates, or not at all, by the United States. Consequently, the United States has very robust controlled foreign corporation (CFC) rules that largely parallel

11 Pending regulations announced in Notice 2011-55, 2011-29 IRB 53; currently Internal Revenue Service, "Instructions for Form 8938: Statement of Specified Foreign Financial Assets," November 2011.

12 IRC section 911; Rev. proc. 2012-41, 2012-45 IRB 539. The foreign earned-income exclusion applies to employment and business income.

13 IRC section 901.

14 For years prior to 2005, high-income individuals often owed alternative minimum tax (AMT) as a result of an arbitrary restriction on the AMT foreign tax credit.

15 For example, see IRS forms 926 ("Return by a U.S. Transferor of Property to a Foreign Corporation"), 3520 ("Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts"), 3520-A ("Annual Information Return of Foreign Trust with a U.S. Owner"), 5471 ("Information Return of U.S. Persons with Respect to Certain Foreign Corporations"), 8621 ("Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund"), and 8865 ("Return of U.S. Persons with Respect to Certain Foreign Partnerships").

Canada's controlled foreign affiliate rules. "Mobile" income, such as investment income, earned inside a CFC is included in the US shareholder's income even if the income is not distributed by the CFC to the US shareholder.¹⁶ Income earned by a trust can be attributed back to the person who funded the trust¹⁷ in a manner analogous to Canada's reversionary trust rules.¹⁸ Income distributed from an investment company to a minority US shareholder (a passive foreign investment company, or PFIC) can be subject to onerous taxation at high rates, plus an interest charge in respect of the presumed deferral of US tax.¹⁹ These charges can reach the total amount of the distribution. Incidentally, the PFIC rules were the model for the now-abandoned Canadian foreign investment entity proposals.

Owner-managers who provide their own services may incorporate in order to take advantage of Canadian small-business tax rates, but they may find that for US tax purposes, their corporate income is deemed to be personal income, even without distributions to them.²⁰ If the income is distributed to the owner-manager, the US tax may be higher than the Canadian tax, notwithstanding the generally higher Canadian tax rates. Such income (known as "subpart F" income) is taxed at full rates, up to 39.6 percent (plus surtaxes), rather than the lower rates applicable to "qualified" dividends.²¹ This rate is often higher than the equivalent Canadian tax rate on dividends.

Clearly, these rules were not set up with Canadian-resident US shareholders in mind. Canada is no tax haven, and Canadian entities are rarely vehicles for Canadian residents to avoid US tax.

Upon the sale of a closely held corporation, a Canadian resident is generally entitled to an effective exemption of up to Cdn\$750,000 of the gain for Canadian tax purposes.²² A US citizen resident in Canada is still subject to US tax on the entire gain (generally at a rate of 20 percent).²³ There is no parallel exemption for the United States.

Reorganizations of Canadian entities are often accomplished in a manner that defers Canadian tax.²⁴ Even though there are US provisions that are meant to parallel most of these objectives, the same transactions can create gain recognition or gift tax

16 IRC section 951.

17 IRC section 671.

18 Subsection 75(2) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the ITA").

19 IRC sections 1291 and 1297; elections can be made to mitigate the interest charge.

20 IRC section 954(c)(1)(H).

21 IRC section 1(h)(11); and *Oswaldo and Ana M. Rodriguez*, 137 TC no. 14 (2011), citing Notice 2004-70, 2004-2 CB 724.

22 ITA subsection 110.6(2.1).

23 IRC section 1(h)(1)(C).

24 For example, pursuant to ITA sections 85 through 88, 97, and 98.

where the individual owner is a US person.²⁵ As a result, a US person in Canada will find the scope of tax-planning opportunities significantly limited, compared with those available to similarly situated non-Americans.

For many years, the IRS and US Treasury paid, at best, only muted attention to international tax compliance. Then, beginning in 2008, a number of events occurred that changed the compliance environment.

IMPACT OF 2008 EVENTS—INCREASED FOREIGN ENFORCEMENT EFFORTS

The financial crisis of 2008 delivered a series of shocks to the US economy: the stock market crashed, the housing bubble popped, and unemployment increased significantly. To deal with the crisis, the newly elected Obama administration, with some support in Congress, proposed a substantially expanded role for government in managing the economy. Meanwhile, ongoing military commitments, notably in Afghanistan and Iraq, continued to consume a huge share of federal revenues. The US budgetary deficit expanded dramatically.

In February 2008, it came to light that several Swiss and Liechtenstein banks had allegedly been marketing tax-evasion schemes to wealthy Americans and other foreign accountholders. An employee of one bank stole data on German, American, and other depositors, and sold this information to a number of governments.²⁶ Following an investigation into the allegations, a US Senate subcommittee estimated that “offshore abuses were costing U.S. taxpayers about \$100 billion a year,” and urged Congress to legislate “strong penalties” on tax haven banks that engaged in such “deceptive banking practices.”²⁷

This combination of events prompted the US government to increase its foreign enforcement efforts. There were several prongs to this strategy: voluntary disclosure, publicity, the use of foreign (including Canadian) financial institutions to gather information, connection to passport renewal, and penalties.

2009 Offshore Voluntary Disclosure Program

In response to the offshore account revelations, the IRS created the offshore voluntary disclosure program (OVDP) to encourage tax evaders to come forward. The targets were principally residents of the United States, but other US taxpayers were welcome to participate. The program would remain in effect from March 23 to October 15, 2009.

25 See, for example, IRC sections 367, 954(c)(1), and 2701.

26 “Massive Tax Evasion Scandal in Germany: The Liechtenstein Connection,” *Spiegel Online International*, February 16, 2008.

27 “UBS, Liechtenstein Aided US Cheats: Senate,” *Associated Press*, July 17, 2008 (www.cnn.com/id/25713850).

The participants were required to file or amend their tax returns for the preceding five years (2003-2008). The penalty imposed was generally equal to 20 percent of the value of assets located outside the United States.²⁸

Approximately 18,000 people participated in the OVDP. Despite the IRS's efforts, the program was not well advertised in Canada. Of the Canadians who participated, a significant number chose to do so as a result of informal IRS representations that penalties would be applied lightly. In many cases, the penalty applied was higher than the taxpayers had been led to expect.²⁹

Foreign Account Tax Compliance Act

The next arrow in the IRS's quiver was enhanced detection through reporting on foreign accounts. The Foreign Account Tax Compliance Act³⁰ (FATCA), passed in 2010, requires foreign (including Canadian) financial institutions to determine whether their clients are US persons. For those individuals, the institution must report their banking activities to the IRS. Failure to do so will result in 30 percent withholding at source on every US transaction—interest, dividends, and even sales of US securities.³¹ FATCA reporting is required for brokerages as well as banks and other entities in the financial services sector.

Few Canadian banks or brokerages could afford to do business when subject to this kind of tax, and as far as we are aware, all the major ones are complying with FATCA. As a result, many accountholders who have (intentionally or not) neglected their US tax obligations in the past are about to be reported to the IRS.

The IRS has delayed implementation of most provisions of FATCA until January 1, 2014.³²

Japan and several European countries have negotiated agreements, or frameworks for agreement, with the United States whereby those countries will collect FATCA information from their own financial institutions and supply the IRS with that information through existing tax information exchange agreements.³³ Accordingly, financial institutions in those countries would not have to report to the IRS directly. Canada is in the process of negotiating such an agreement.³⁴

28 Internal Revenue Service, "Authorization To Apply Penalty Framework to Voluntary Disclosure Requests Regarding Unreported Offshore Accounts and Entities," March 23, 2009 (www.irs.gov/pub/newsroom/memorandum_authorizing_penalty_framework.pdf).

29 Scott D. Michel and Mark E. Matthews, "OVDI Is Over—What's Next for Voluntary Disclosures," *Tax Analyst*, October 17, 2011.

30 Foreign Account Tax Compliance Act, subtitle A of title V of the Hiring Incentives To Restore Employment Act of 2010, Pub. L. no. 111-147, enacted on March 18, 2010.

31 IRC section 1471(a).

32 Notice 2011-53, 2011-32 IRB 124, at section I.

33 United States, Department of the Treasury, "Foreign Account Tax Compliance Act (FATCA)" (www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx).

34 Canada, Department of Finance, "Negotiation of an Information Exchange Agreement with the United States," November 8, 2012.

2011 Offshore Voluntary Disclosure Initiative

The official IRS line was that the 2009 OVDP was successful.³⁵ In reality, the IRS was not satisfied with the response; it believed that there were many non-compliant taxpayers who had chosen not to come forward. Accordingly, in 2011, it created a new program, the offshore voluntary disclosure initiative (OVDI). In order to be fair to the people who had come forward in 2009, this program also required the filing or amendment of returns back to 2003. The general penalty was increased to 25 percent.³⁶

The OVDI was announced on February 8, 2011, and would remain in effect until August 31, 2011. As in the case of the 2009 OVDP, the original objective was to attract US residents who had been hiding money abroad.

The reality is that most Americans with accounts abroad are, unsurprisingly, Americans who live abroad. The vast majority of such people live in countries like Canada, with higher effective income taxes than the United States. These countries tend to have robust tax systems, so evasion is limited. In the vast majority of cases, these people have no US tax liability. Lumping them together with Americans who were shipping suitcases of cash to Switzerland made no sense.

Consequently, throughout the operation of both the 2009 OVDP and the 2011 OVDI, many tax advisers—ourselves included—complained to the IRS that the penalty regime was too onerous for Americans living overseas. We told the IRS that we knew many people who wanted to “come in from the cold,” but were unwilling to pay a penalty of 25 percent of (in most cases) of all of their assets, after already paying foreign-country income taxes of up to 50 percent. These people did not think of themselves as scofflaws—in most cases, they had no idea of their US filing obligations.

On June 8, 2011, less than three months before the OVDI deadline, the IRS announced a new, reduced penalty for Americans living abroad. In most cases, the penalty was reduced to 5 percent, and the base was narrowed to undisclosed financial accounts.³⁷ From recent discussions, it appears that the IRS is exempting at least some Canadian-registered plans, such as registered retirement savings plans (RRSPs), from this penalty.

Now the IRS was offering a carrot (the reduced OVDI penalty, which was small enough for many Americans in Canada to consider participation in the program) to soften the impact of the stick (FATCA). The combination of the two caught the attention of the media. The OVDI was, from that point on, publicized much more

35 Internal Revenue Service, “IRS Reminds Taxpayers That the Aug. 31 Deadline Is Fast Approaching for the Second Special Voluntary Disclosure Initiative of Offshore Accounts,” *News Release IR-2011-84*, August 8, 2011.

36 Internal Revenue Service, “2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers,” August 29, 2011 (www.irs.gov/businesses/international/article/0,,id=235699,00.html), at question 8.

37 *Ibid.*, at questions 52-53.

widely in Canada. This publicity introduced to many people the notion that Americans in Canada had to file US tax returns and possibly pay US tax.

Still, the potential cost of disclosure (professional fees), plus taxes and penalties, kept many Americans in Canada from coming forward under the OVDI.

2012 Enforcement Initiatives

2012 OVDP

On January 9, 2012, the IRS reopened the voluntary disclosure program, going back to the 2009 name, OVDP, but keeping most of the 2011 OVDI provisions. The main penalty was increased from 25 percent to 27.5 percent, but this change affected few Americans in Canada, who continued to qualify for the 5 percent rate.³⁸ The 2012 OVDP remains in effect.

Streamlined Program for Americans Living Abroad

In June 2012, the IRS announced that there will be a new program to allow Americans living abroad to come into compliance on more favourable terms than those set out in the OVDP.³⁹ Individuals will be allowed to file tax returns for only three years (2009-2011) and FBARs for six years (2006-2011).

To be eligible, a US citizen or resident must meet the following criteria:

- The individual must have resided outside the United States continuously from January 1, 2009 to December 31, 2011. (It is likely that this requirement will change for filings that include tax years 2012 or later.)
- The tax owed for each of 2009, 2010, and 2011 must be under US\$1,500. (It is not known whether this is tax owing after withholding at source and estimated tax payments, or instead is gross tax.)
- The individual has not previously filed a return for 2009 or 2010. (The instructions provided could be read as excluding individuals who have filed for 2011, but the IRS has assured us, and others, that a 2011 filing is not a bar to participation.)

An exception to the last requirement is provided for amendments regarding retirement plans. Individuals will be allowed retroactive treaty relief with respect to such

38 Internal Revenue Service, "IRS Offshore Programs Produce \$4.4 Billion To Date for Nation's Taxpayers; Offshore Voluntary Disclosure Program Reopens," *News Release* IR-2012-5, January 9, 2012.

39 Internal Revenue Service, "IRS Announces Efforts To Help U.S. Citizens Overseas Including Dual Citizens and Those with Foreign Retirement Plans," *News Release* IR-2012-65, June 26, 2012. More details were released on August 31, 2012: Internal Revenue Service, "Instructions for New Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer U.S. Taxpayers" (www.irs.gov/uac/Instructions-for-New-Streamlined-Filing-Compliance-Procedures-for-Non-Resident-Non-Filer-US-Taxpayers).

plans⁴⁰ without having to go through the expensive and complex private letter ruling process (as was previously required).⁴¹

Submissions to participate in the program will be divided into low-risk and high-risk categories. To determine the risk, a US individual living in Canada must answer questions about entities and financial accounts located outside Canada.⁴² It does not appear that an interest in an entity or a financial account located in Canada is likely to be a meaningful risk factor for such a person.

The taxpayer's level of tax compliance in Canada is relevant, as is advice that the taxpayer has received from tax advisers.

US-source income and employment by a US company are risk factors.

In a strange twist, claiming a refund of US tax is a risk factor. Most of the refunds that would arise from a person's entry into this program are the making work pay and child tax credits. We have not been able to determine how this would constitute a risk factor.

All submissions will be reviewed, but low-risk submissions will be subject to a lower-intensity review. These taxpayers will pay only the tax and interest owing for 2009 through 2011; no penalty will be charged; and the IRS will not ask for prior-year returns.

A more intensive review will be applied for higher-risk submissions. These taxpayers may be subject to penalties, as well as taxes and interest owing; and they may be asked to file additional returns for years prior to 2009, which would also be subject to review.

Visiting the United States

When a US citizen or green-card holder crosses the border from Canada into the United States, he or she is required to present a valid US document (passport or green card).⁴³ It is common for dual Canadian-US citizens to use a Canadian passport alone when crossing, since in many cases they do not hold US passports. A number of our clients in this position have recently been hassled by US Homeland Security, and told to get one. Some have been told that without a passport, they will be denied entry.

The rules for renewing a passport have also been changed. When a person applies for renewal of a passport, he or she will be required to provide identifying information

40 For example, under article XVIII(7) of the Canada-US treaty.

41 Treas. reg. section 301.9100-3: see, for example, Private Letter Ruling (PLR) 201226010, March 30, 2012.

42 Internal Revenue Service, "Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer Taxpayers Questionnaire" (www.irs.gov/pub/irs-utl/non-resident_questionnaire.pdf). All applicants must complete the questionnaire.

43 United States, Department of State, *Foreign Affairs Manual*, vol. 9 (Washington, DC: Department of State), section 41.104.

that is supposed to be conveyed to the IRS.⁴⁴ Previously, the applicant only had to indicate whether he or she had filed tax returns for the previous three years.⁴⁵ However, that requirement was only spottily enforced.

Penalties

The IRS is applying penalties in situations where in the past it has been lenient. For instance, it recently upheld quite significant penalties for failure to file where a US person had established a foreign trust.⁴⁶ What is especially interesting is the IRS's lack of accommodation in a case where tax avoidance was not a motivating factor. The penalties applied were not merely a single \$10,000 penalty, but multiple penalties for multiple years, and additional penalties for not responding quickly enough. In addition, the penalties were applied to the taxpayer's estate.

IMPLICATIONS OF EXPATRIATION FOR AMERICANS LIVING IN CANADA

Immigration Status

Publicity about the US government's intensified enforcement initiative led many people who thought they might be affected to seek advice from immigration lawyers. Many needed to know whether they were in fact US citizens. Until 1980, it was thought that merely accepting Canadian citizenship and swearing an oath to the Crown would void US citizenship. Ultimately, that was held not to be the case. The act of renunciation of US citizenship had to be an affirmative one.⁴⁷ Congress codified this principle in 1986,⁴⁸ and subsequently affirmed that it applied even for prior years.⁴⁹

With respect to the recent surge of inquiries about immigration status, a common question was whether the fact that a person's parents or grandparents were US citizens conferred US citizenship upon that person. This question is outside the scope of this article.

Green-card holders who have moved back to Canada, or have never settled in the United States, often believe that the mere expiry of the card implies expiry of their status. This is not true. To cease to be a green-card holder, the individual must actively relinquish it, or have it withdrawn judicially.⁵⁰

44 Prop. Treas. reg. section 301.6039E-1.

45 Former prop. Treas. reg. section 301.6039E-1, INTL-978-86, 1993- CB 822.

46 Internal Revenue Service, Chief Counsel Advice 201208028, November 2, 2011.

47 *Afroyim v. Rusk*, 387 US 253 (1967); and *Vance v. Terrazas*, 444 US 252 (1980).

48 Immigration and Nationality Act Amendments of 1986, Pub. L. no. 99-653, enacted on November 14, 1986, section 18.

49 Immigration Technical Corrections Act of 1988, Pub. L. no. 100-525, enacted on October 24, 1988, section 8(r).

50 *Foreign Affairs Manual*, supra note 43, at section 42.22, note N3.2.

For individuals who were able to confirm their status as US persons, and those who knew it all along, the next step was to consult an accountant about potential tax concerns. Often, the first reaction upon learning of the tax issues (and especially the penalties) was “Well, then I’ll just give up my citizenship/green-card.” In our experience, spanning some 23 years in the area of cross-border tax, it was very rare to hear a US citizen utter those words until 2011, when it became commonplace.

According to the IRS, in the fiscal year ending September 30, 2008, 146 individuals renounced their US citizenship. This figure rose to 1,534 in 2010, and 1,781 in 2011.⁵¹ In January 2012, the US consulate in Toronto began conducting mass renunciation gatherings because of the demand.

And this is where we get to the meat of the matter.

The Politics Behind the US Expatriation Regime

The United States, like most empires, is rather chauvinistic about membership. A person who renounces citizenship is not well regarded. And politics being what it is, a citizen who chooses to renounce for tax purposes is an easy tool for politicians looking to score points. Consequently, such people have been targets for a long time—since 1966, in fact.⁵² From that time through 2004, the law specifically addressed the tax treatment of former US citizens where one of the principal purposes of expatriation was the avoidance of US taxes.⁵³

In 1996, the target group was expanded to include individuals who had been lawful permanent residents (green-card holders).⁵⁴ Part of the impetus for these changes was the expatriation of some very wealthy business persons.

The regime for expatriates has been modified several times since, as politicians have tried to score points for cracking down on “unpatriotic” behaviour.

Despite the number of revisions to the US expatriation rules, Congress has seen previous attempts as unsuccessful in either forcing Americans to retain citizenship, or in extracting sufficient revenue from them as they became expatriates. Of particular note is the so-called Reed amendment to the Immigration and Nationality Act,⁵⁵ which barred expatriates from entry into the United States if their expatriation was motivated by tax avoidance.

One of the major difficulties for the IRS in utilizing the law effectively was proving a tax-avoidance motivation. As a purpose test, the law was always vulnerable on this

51 Federal register 02/02/2012, 10/26/2011, 08/03/2011, 05/10/2011, 02/11/2011, 11/10/2010, 05/24/2010, 02/26/2010, 11/19/2009, 07/21/2009, 02/05/2009, 10/31/2008, 07/24/2008, 05/08/2008, 02/08/2008, and 11/08/2007.

52 IRC section 877; and the Foreign Investors Tax Act of 1966, Pub. L. no. 89-809, enacted on November 13, 1966.

53 IRC section 877(a), prior to its amendment in 2004 (see *infra* note 58).

54 IRC section 877, as amended by the Health Insurance Portability and Accountability Act of 1996, Pub. L. no. 104-191, enacted on August 21, 1996, section 511(f)(1).

55 Immigration and Nationality Act, 8 USC, section 212(a)(10)(E).

front. Virtually all expatriates argued that their main ties were to other countries, and they no longer had need of US citizenship. The tax issues were secondary. Since most expatriates did not retain meaningful residential ties to the United States, this position was often credible. Consequently, the IRS was often unsuccessful in applying the purpose test.⁵⁶ In the few cases where it was successful, it had very convincing evidence.⁵⁷

There is no recorded case in which the immigration portion of the Reed amendment has ever been used, and owing to changes in the tax law over that time, it probably can never be used. This is true despite the significant rise in the number of people who have renounced their citizenship since 2008.

As a result of the IRS's lack of success in applying the purpose test, in 2004, for tax purposes, the subjective purpose test was removed and solely objective tests were put in its place.⁵⁸ For immigration purposes, the intent requirement was left untouched, but the Reed amendment still has not been successfully used.

In the subsequent four years, there was no great crisis surrounding expatriation. But the issue remained a political football. In 2008, the United States brought in a new regime designed to tighten the handcuffs further.

The 2008 Expatriation Regime

The current regime became effective on June 17, 2008. Under the new rules, there are three major potential adverse impacts for an individual leaving the US tax net:

1. an exit tax, modelled on Canada's deemed disposition rules;⁵⁹
2. increased withholding on certain US-source income items; and
3. an excise tax on future gifts and bequests to US persons.

These are discussed in detail below, under the heading "Consequences of Expatriation."

The tax rules surrounding expatriation are numerous and complex. The US Treasury is expected to draft regulations,⁶⁰ but the regulation time frame is often measured in years (and sometimes decades). To allow taxpayers to comply in the meantime, the IRS has issued a notice to provide guidance.⁶¹

56 For example, *Di Portanova v. US*, 82-2 USTC 9598 (Ct. Cl. 1982); *Tedd N. Crow*, 85 TC 376 (1985); and *Cecil B. Furstenberg*, 83 TC 755 (1984).

57 For example, *Max Kronenberg*, 64 TC 428 (1975).

58 IRC section 877(a), as amended by the American Jobs Creation Act of 2004, Pub. L. no. 108-357, enacted on October 22, 2004, section 804.

59 ITA subsection 128.1(4).

60 Notice 2009-85, 2009-45 IRB 598, at section 1, postamble.

61 *Ibid.*

The political game continues, as readers will see when they come to the final pages of this article.

Targets

The main targets of the regime remain expatriate “rich” Americans. The unstated (formerly explicit) objective is to penalize the members of that group who choose expatriation for tax purposes.

An “expatriate” is a US citizen who renounces US citizenship,⁶² or a long-term resident of the United States who ceases to be taxed as a US resident.⁶³ A “long-term resident”⁶⁴ is an individual who held a green card and was taxed as a US resident for at least 8 of the 15 tax years ending with the year in which

- the status is relinquished, or
- the individual becomes a resident of another country under the provisions of a US tax treaty and does not waive the benefits of the treaty (that is, files as a non-resident alien).

It is possible for an individual to hold a green card without being taxed as a US resident. For instance, a Canadian citizen could obtain a green card and subsequently move back to Canada. While resident in Canada, the individual could subsequently elect to file a return as a US non-resident alien, paying US tax only on US-source income.⁶⁵ The years subject to that election would not count toward the eight-year threshold.

In the absence of a re-entry permit or a returning resident visa,⁶⁶ such a course of action may expose the person to a risk of loss of the green card for failure to comply with the conditions, one of which is to reside in the United States.⁶⁷ Importantly, even if the holder fails to meet the obligations, as noted earlier the green card is not void until it is surrendered or judicially withdrawn.⁶⁸ Consequently, unless the individual makes the treaty election described above, he or she will still be considered a US resident for US tax purposes.

62 IRC section 877A(g)(2)(A).

63 IRC sections 877A(g)(2)(B) and 7701(b)(6).

64 IRC section 877(e)(2).

65 Articles IV and XXV(1) of the Canada-US treaty; and Treas. reg. sections 301.7701(b)-7(a)(1) and (2).

66 United States, Department of State, SB-1, “Returning Resident Visa.”

67 *Foreign Affairs Manual*, supra note 43, at section 42.22.

68 Supra note 50.

Tests for “Covered Expatriate” Status

The adverse consequences of expatriation apply only to a person who is a “covered expatriate” (CE). A CE is a person who meets one of the following three tests:

1. The taxpayer’s net worth exceeds US\$2 million on the date of expatriation.⁶⁹
2. The taxpayer’s average annual US income tax for the five years preceding the year of expatriation exceeds US\$155,000.⁷⁰
3. The taxpayer fails to certify full compliance with US tax obligations for each of the five years preceding expatriation. The certification covers filing of all tax and information returns, and payment of all amounts owing. It applies to income, employment, estate, and gift taxes, as well as interest and penalties.⁷¹

Some key considerations in the application of these tests are discussed below.

DETERMINATION OF NET WORTH (TEST 1)

The IRS’s view is that for the purposes of the net worth test, “an individual is considered to own any interest in property that would be taxable as a gift . . . if the individual transferred the interest immediately prior to expatriation.”⁷² The exclusions that would ordinarily reduce the taxable gift amount—a gift to a US citizen spouse,⁷³ an annual gift (of up to US\$143,000 to an alien spouse or up to US\$14,000 to others),⁷⁴ and charitable donations⁷⁵—do not apply.

SCOPE LIMITATIONS (TESTS 1 AND 2)

The net worth and tax liability tests are not applicable to a person who

1. was born a dual citizen of the United States and another country, at the time of expatriation is a citizen and resident for tax purposes of that other country, and has been a resident⁷⁶ of the United States for 10 or fewer years in the 15 years prior to and including the year of expatriation;⁷⁷ or

69 IRC section 877A(g)(1)(A), referring to section 877(a)(2)(A).

70 Ibid., referring to section 877(a)(2)(B).

71 Ibid., referring to section 877(a)(2)(C).

72 Notice 2009-85, supra note 60, at section 2(b); and Notice 97-19, 1997-1 CB 394, at section III.

73 Notice 97-19, supra note 72, at section III; and IRC section 2523.

74 Notice 97-19, supra note 72, at section III; and IRC sections 2503(b), 2513, and 2523(i)(2).

75 Notice 97-19, supra note 72, at section III; and IRC section 2522.

76 IRC section 7701(b)(1)(A)(ii).

77 IRC section 877A(g)(1)(B)(i).

2. becomes an expatriate before age 18½ and has been a resident⁷⁸ of the United States for no more than 10 tax years prior to the date of relinquishment of US citizenship.⁷⁹

Typical examples of the first point would be an individual born in Canada to a US parent and an individual born in the United States to a Canadian parent.

Determination of Residence of a Dual Citizen

For the purposes of the CE tests, the residence of a dual citizen is determined by applying the “substantial presence” test (which otherwise applies only to a non-resident alien).⁸⁰ Under the substantial presence test, to be considered a US resident in a particular year, the individual must be present in the United States for at least 31 days in that year, and the total determined by the following formula must be at least 183:⁸¹

- days present in the current year, plus
- days present in the prior year divided by 3, plus
- days present in the second prior year divided by 6.

A person who spends 122 days (about 4 months) per year in the United States in three consecutive years would be considered a US resident in the third year under this test. A person who spends 183 days in the United States in a single year would be a US resident in that year.

For a non-resident alien, the substantial presence test can be overridden where the person has a closer connection to a foreign country (or to two foreign countries) than to the United States.⁸² Generally, a person will not be considered to have a closer connection to a foreign country if he or she is physically present in the United States for 183 days or more. However, the days of presence in the United States are ignored where the individual

1. has a medical condition that prevents him or her from leaving the United States,⁸³ or
2. is present (in limited circumstances) in the United States as a
 - a. foreign-government-related individual,
 - b. teacher or trainee,

78 IRC section 7701(b)(1)(A)(ii).

79 IRC section 877A(g)(1)(B)(ii).

80 IRC section 7701(b)(1)(A)(ii).

81 IRC section 7701(b)(3)(A).

82 IRC section 7701(b)(3)(B) (referred to as “the closer connection exception”).

83 IRC section 7701(b)(3)(D)(ii).

- c. student, or
- d. professional athlete competing in a charitable sports event.⁸⁴

It is not entirely clear whether the closer connection exception would apply to an expatriate, but it appears likely.

In practice, however, very few expatriate Americans in Canada would meet the substantial presence test and not meet the closer connection exception. Such a person would have to spend 183 days or more per year in the United States, or have a closer connection to the United States than to Canada. In our experience, it would be unlikely that such a person would consider renouncing US citizenship or green-card status. The right to live and work in the United States would simply be too important.

Usefulness of Scope Limitations

With a few exceptions, every person born in Canada automatically receives Canadian citizenship. Individuals born in Canada to parents who are US citizens and have lived in the United States long enough will obtain “derivative” US citizenship as well. (The rules vary depending on the date of birth.) Other individuals may be born in the United States to Canadian citizens (typically working or studying there temporarily). All of these individuals will be dual citizens from birth. Hence, the first scope limitation will be helpful to many.

The second scope limitation is probably of limited use. It is possible, although very difficult, to renounce US citizenship prior to age 18,⁸⁵ so the window is short. In addition, renunciation may not seem beneficial to a young person. US citizenship conveys the right to live and work in the United States. Since these rights are potentially valuable to a teenager who has not yet determined where he or she will live, it is unlikely that the option to renounce will be exercised often.

On the other hand, many children who hold dual Canadian-US citizenship have grown up in Canada and self-identify as Canadian. Their emotional attachment to the United States will likely be weaker than that of people who have lived in the United States in their formative or adult years. Parents may suggest to their children in this circumstance that the compliance burden described above makes citizenship not worthwhile. This is particularly likely to occur where the parents’ tax situation is complex (involving, for example, interests in certain corporations, partnerships, or trusts) and where restrictions under US tax law may have a material effect on tax-planning opportunities.

In circumstances where the parents are relatively well off, the children are more likely than average to obtain a post-secondary education. Individuals with this level of education are the ones for whom access to the United States is potentially more

84 IRC section 7701(b)(5).

85 *Foreign Affairs Manual*, supra note 43, volume 7, at section 1290.

important, and they are generally able to obtain US visas (for example, a TN-1) fairly easily.

COMPLIANCE WITH PRIOR TAX OBLIGATIONS (TEST 3)

Scope

The legislation mandates only compliance with all requirements under title 26 of the US Code (that is, the IRC). The FBAR requirement is in title 31. Consequently, the failure to file FBARS should not prevent certification of compliance.

Discussions with the IRS indicate that, in its view, FBAR filing is required. However, this position is not consistent with the law.

Failure to file an FBAR may not mean failure to meet test 3; however, there are independent penalties for failure to file the form. What is likely is that the IRS will target expatriates for review of FBAR filing, and application of those penalties in cases of non-compliance.

There is a statute of limitations for FBAR filing (unlike the filing of tax returns), which applies even if the form is not filed. The assessment period is six years for civil penalties and five years for criminal penalties.⁸⁶

Timing

To avoid becoming a CE under test 3, the taxpayer must file a form 8854 (“Initial and Annual Expatriation Statement”) certifying compliance with all US tax obligations for the preceding five years. There are two timing issues relating to this certification:

1. *What is the effective certification date?* The certification date has an impact on the date on which an individual chooses to expatriate. To avoid becoming a CE, the taxpayer must be compliant as of the certification date. As noted above, many individuals contemplating expatriation are not compliant. So the question is whether the taxpayer must become compliant prior to expatriation or merely prior to the filing date.

Form 8854 can be filed as late as December 15 of the year following the year of expatriation. If the certification date is the date of filing of the form, then (aside from tests 1 and 2), the taxpayer may expatriate first and comply later.

There is no guidance as to the certification date, so the implication is that the certification is made as of the date on which form 8854 is filed.

2. *Which years are covered by the five-year certification?* The law says the certification of compliance is made in respect of the “5 preceding taxable years.”⁸⁷ What is not clear from the law is the year that these five precede.

⁸⁶ 31 USC section 5321(b)(1); and 18 USC 3282.

⁸⁷ IRC section 877(a)(2)(C).

One would ordinarily think that the five years would be those ending before the year of certification. Since form 8854 is filed in the year *after* expatriation,⁸⁸ one would think that the five years should be those ending with the year of expatriation. However, the IRS's interpretation is that certification is in respect of the five years *preceding* the year of expatriation.⁸⁹

Accordingly, an individual who became an expatriate in 2012 must file form 8854 in 2013, certifying compliance for tax years 2007 through 2011.

Consequences of Expatriation

A person who is a CE under any of the tests described above will be subject to certain adverse tax consequences. As noted earlier, these include liability for an exit tax, increased withholding on certain US-source income, and the imposition of an excise tax on future gifts and bequests. These and other tax-related concerns are discussed below.

Exit Tax

The most immediate impact of being a CE is immediate taxation of virtually all accrued but unrecognized gains and income.

In general, the individual is treated as having sold all of his or her assets for their fair market (mark to market, or MTM) value on the day before the date of expatriation.⁹⁰ The first US\$668,000 of gain from the deemed disposition is exempt from tax.⁹¹ For those individuals who have limited accrued but unrealized gains, this exemption will eliminate the exit tax. But for many high net worth individuals, the deemed disposition under the MTM regime will have quite a substantial impact.

Some assets are subject to a separate regime (an alternative exit tax), which yields a similar result, except that the gain and income from the assets are not generally eligible for the reduced tax rates that apply to qualified dividends and long-term capital gains, or for the MTM exemption. These assets fall into three categories:

1. deferred compensation,
2. specified tax-deferred accounts, and
3. interests in non-grantor trusts.

We will discuss the tax treatment of these assets later. First, we will outline the principles that govern the taxation of other assets under the MTM regime.

88 See below under the heading "Reporting Obligations."

89 Notice 2009-85, *supra* note 60, at section 2A(3); IRS form 8854, "Initial and Annual Expatriation Statement," at part IV, line 6; and Internal Revenue Service, "2012 Instructions for Form 8854," at 4.

90 IRC section 877A(a)(1).

91 IRC section 877A(a)(3); and Rev. proc. 2011-52, 2011-45 IRB 701, at section 3.27.

Taxation Under the MTM Regime

INCLUSION AND VALUATION

In determining which assets are included in the MTM regime, and the valuation of those assets, generally US estate tax principles apply as though the expatriate had died on the date of expatriation.⁹² Interestingly, in this respect, the MTM regime differs from the approach used to determine an individual's net worth for the purposes of the CE test discussed above. Specifically, the latter is based on gift tax, rather than estate tax, principles.

There are exceptions to the use of estate tax principles for the purposes of the MTM regime:⁹³

- The credits (unified, state death tax, gift tax, etc.) do not apply.⁹⁴
- Certain non-grantor trust interests that would not ordinarily be included under the estate tax rules are included for this purpose.⁹⁵
- Life insurance policies are included, and are valued as though the expatriate had made a gift of the policy.⁹⁶
- The alternate valuation date election (which allows the use of the value on the day that is six months after the date of death, instead of the value on the date of death)⁹⁷ is not available.⁹⁸
- The special-use valuation (which allows certain real estate passed to a family member to be valued on the basis of its actual use, rather than the highest and best use)⁹⁹ is not available.¹⁰⁰
- To ensure that the value of a corporation is fully recognized, the anti-freeze gift tax provisions are applied as though interests in the corporation were transferred to family members.¹⁰¹
- The exemptions for transfers to a charity, a spouse, or a qualified domestic trust, and for a family-owned business are not taken into account.¹⁰²
- Because the exit tax is an income tax, no relief is provided for US gift tax paid in connection with a previous transfer.¹⁰³

92 Notice 2009-85, supra note 60, at section 3A.

93 Ibid.

94 IRC sections 2010 through 2016.

95 Notice 2009-85, supra note 60, at section 3A, referring to Notice 97-19, supra note 72, at section III, under the heading "Special Rules for Determining Beneficial Interests in Trusts."

96 Treas. reg. section 25.2512-6.

97 IRC section 2032.

98 Notice 2009-85, supra note 60, at section 3A.

99 IRC section 2032A.

100 Notice 2009-85, supra note 60, at section 3A.

101 IRC sections 2701 through 2704

102 IRC sections 2055 through 2057.

103 As it would ordinarily be in an estate tax context: IRC section 2012.

Ordinarily, a decedent is treated as owning assets transferred prior to death if he or she retained control over the property or the income therefrom, unless the control or income was relinquished more than three years prior to death.¹⁰⁴ It is not clear whether an asset that was transferred by a CE less than three years prior to expatriation would be subject to the same rule.

PRINCIPAL RESIDENCE

The principal residence exemption, which would normally exclude the first US\$250,000 of gain,¹⁰⁵ is not available for asset valuation purposes under the MTM regime.¹⁰⁶

ANNUITIES AND LIFE INSURANCE

Annuities and life insurance policies are generally valued at their replacement cost.¹⁰⁷

GRANTOR TRUSTS

Under US tax law, where a trust is considered to be a grantor trust, the individual who settled the trust (the grantor) is treated as the owner of the underlying assets.¹⁰⁸ Typically, the individual has transferred funds into a trust, and has the right to receive distributions out of the trust, but there are other circumstances that can cause a trust to be a grantor trust.

Where a CE is treated as the owner of assets under the grantor trust rules, the trust assets will be subject to the MTM rules;¹⁰⁹ it will be as though the trust did not exist.

There is an important anti-avoidance rule here. Expatriation would ordinarily cause a grantor trust to be converted from a US trust to a foreign trust. For a trust to be a US person, "one or more US persons [must] have authority to control all substantial decisions of the trust."¹¹⁰ When a US person is a grantor (who typically has this power) and he or she becomes a CE, the trust will cease to be a US person. There are substantial restrictions on the treatment of a non-resident alien as the grantor of a trust;¹¹¹ accordingly, it is possible that a trust that previously qualified

104 IRC sections 2035 through 2038.

105 IRC section 121(a).

106 IRC section 877A(a)(2)(A).

107 Notice 2009-85, *supra* note 60, at section 3A; and Treas. reg. section 25.2512-6.

108 IRC sections 671 through 679.

109 United States, Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 6081, the "Heroes Earnings Assistance and Relief Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on May 20, 2008*, JCX-44-08 (Washington, DC: Joint Committee on Taxation, May 20, 2008), at 43.

110 IRC sections 7701(a)(30)(E)(ii) and (31)(B).

111 IRC section 672(f).

as a US domestic grantor trust could become a foreign non-grantor trust. In this event, the assets might be viewed as not being owned by the CE.

The IRS has considered this possibility. It has said that it will treat this effect as a transfer from a domestic to a foreign trust.¹¹² This type of transfer has for some time created gain recognition (outside the expatriation rules). An “immigration trust”¹¹³ set up as part of tax plan to move to Canada would generally be caught under this provision.

Because this gain recognition rule is not part of the expatriation rules, the MTM exemption is not applicable in this situation.

CANADIAN INDIVIDUAL REGISTERED PLANS

There is no guidance on Canadian retirement plans that are specific to an individual (RRSPs, registered retirement income funds, life income funds, and annuities into which these plans may be converted). US tax law treats such plans as distinct from pension funds or plans, which are group retirement arrangements.

Individual retirement plans are not “deferred compensation items” (discussed below) because they are not “foreign pension plans.” They have previously been described as grantor trusts in earlier guidance unrelated to expatriation.¹¹⁴ For this reason, the difference between the tax basis and the fair market value of the assets would be taxable.

The taxpayer has “basis” in the underlying assets, because they were purchased with after-US-tax funds. On expatriation, the exit tax would apply only to the unrecognized income and gains, not to the entire value of the plan.

The basis is usually equal to the contributions. This is the result where (as is usually the case) the taxpayer has always elected to defer income recognition inside the fund.¹¹⁵ If the taxpayer did not make this election, the basis would be increased by net gains and income recognized over the time that the RRSP was held.

WASH SALES

The United States has “wash sale” rules¹¹⁶ similar to Canada’s “superficial loss” rules.¹¹⁷ They are designed to limit a taxpayer’s ability to accelerate losses on properties that are repurchased close to the sale date. These wash sale rules do not apply in an expatriation context. Losses arising on expatriation can be fully utilized.¹¹⁸

112 Notice 2009-85, *supra* note 60, at section 4; and IRC section 684.

113 ITA subclause 94(1)(b)(i)(A)(III).

114 Rev. proc. 89-45, 1989-2 CB 596 and implicitly in Notice 97-34, 1997-1 CB 422.

115 Article XVIII(7) of the Canada-US treaty; and IRS form 8891, “U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.”

116 IRC section 1091.

117 ITA paragraph 40(2)(g) and the definition of “superficial loss” in ITA section 54.

118 IRC section 877A(a)(1)(2)(B).

DEFERRAL OF PREVIOUSLY REALIZED GAINS

There are a number of circumstances in which an individual may have previously completed a transaction but the resulting gain has been deferred. An example may be a like-kind exchange¹¹⁹ (similar to Canada's replacement property rules).¹²⁰ The deferrals are terminated as of the day before expatriation.¹²¹

ASSETS PREVIOUSLY TRANSFERRED TO A FOREIGN CORPORATION

Because of the numerous tax-deferred reorganization methods endemic to both the Canadian and US tax systems, it is easy to forget that a US citizen who transfers appreciated assets to a foreign (Canadian) corporation is ordinarily subject to tax on the gain at that time.¹²² It is, however, possible in many cases to file a gain recognition agreement (GRA) with the IRS to defer application of the rules to the time of actual sale.¹²³

The IRS's position is that expatriation creates a deemed disposition, and this disposition may cause the individual to fail to meet his or her obligations under the GRA. As a result, the deferred gain may be taxable. The IRS's view is that any gain recognized as a result of the failure to meet the obligations under the GRA is taxable for that reason, and not under the expatriation rules. Consequently, the MTM exemption is not available.¹²⁴

DEEMED BASIS FOR A PERSON NOT BORN WITH US STATUS

For a non-resident alien who moved to the United States, any pre-immigration gain in respect of property owned at that time can be ignored. Property owned on the residence starting date¹²⁵ is deemed to have a basis equal to the fair market value of the property on that date.¹²⁶ This mechanism is very similar to Canada's deemed adjusted cost base for an immigrant,¹²⁷ except that the US rule applies only in the expatriation context.

The IRS recognizes two significant exceptions to this treatment.¹²⁸ The step-up in basis is not available in respect of US real property or in respect of any property

119 IRC section 877A(h)(1)(A); Notice 2009-85, *supra* note 60, at section 4; and, for example, IRC section 1031.

120 ITA section 44.

121 IRC section 877A(h)(1)(A); and Notice 2009-85, *supra* note 60, at section 4.

122 IRC sections 367(a) and (d).

123 Treas. reg. section 1.367(a)-8.

124 Notice 2009-85, *supra* note 60, at section 4.

125 The date on which the individual first became a resident of the United States: IRC section 7701(b).

126 IRC section 877A(h)(2).

127 ITA paragraph 128.1(1)(b).

128 Notice 2009-85, *supra* note 60, at section 3D.

held in connection with the conduct of a US trade or business on the residence starting date unless

- there was a treaty between the United States and the foreign country at that time, and
- the US trade or business was not carried on through a permanent establishment under the terms of that treaty.

It is possible for a CE to elect out of the deemed basis treatment. An individual might want to do so where the original cost of an asset is higher than the value at the residence starting date, or where it is difficult to establish the fair market value as of that date. The election is made on an item-by-item basis, and is irrevocable.¹²⁹

Assets Subject to the Alternative Exit Tax

As noted above, there are three categories of assets that are not subject to the MTM regime: deferred compensation, specified tax-deferred accounts, and interests in non-grantor trusts. Because these assets are taxed differently, the MTM exemption is not applicable. The exit tax rules that apply to these types of assets are described below.

DEFERRED COMPENSATION¹³⁰

“Deferred compensation items” include interests in

1. US deferred income plans, where the trust administering the fund is exempt from tax, including¹³¹
 - a. pensions,
 - b. annuities,
 - c. retirement plans for government employees (federal, state, and local),
 - d. simplified employee pensions, and
 - e. simple retirement accounts;
2. foreign (non-US) pension plans;¹³²
3. any other item of deferred compensation;¹³³ and
4. any property, or right to property, that the individual is entitled to receive in connection with the performance of services, but has not received as of the date of expatriation.¹³⁴

129 IRC section 877A(h)(2); and Notice 2009-85, supra note 60, at section 3.

130 IRC section 877A(d).

131 IRC sections 877(d)(4)(A) and 219(g)(5); and Notice 2009-85, supra note 60, at section 5B(1).

132 IRC section 877A(d)(4)(B).

133 IRC section 877A(d)(4)(C).

134 IRC section 877A(d)(4)(D).

Property or a right to property under point 4 includes stock options, stock appreciation rights, and restricted stock units (RSUs).¹³⁵ Ordinarily, where RSUs are not transferable and are subject to a substantial risk of forfeiture, the value of such units is not included in income until realization.¹³⁶ However, for the purposes of the exit tax, they are deemed to be both transferable and not subject to a substantial risk of forfeiture on the day before expatriation.¹³⁷

The time at which tax is payable in respect of deferred compensation depends on whether the particular item of compensation is “eligible” or “ineligible,” as described below.

Eligible Deferred Compensation

An item of deferred compensation is “eligible” where the following conditions are met:¹³⁸

- The amount is payable by a US person or a person who elects to be treated as a US person for this purpose.
- The taxpayer notifies the payer of his or her status as a CE.
- The taxpayer waives reduced withholding provided by any treaty.

Notice is provided by filing form W-8CE (“Notice of Expatriation and Waiver of Treaty Benefits”) with the payer¹³⁹ by the earlier of

- 30 days following the expatriation date, and
- 30 days before the first distribution on or after the expatriation date.

Eligible deferred compensation is not subject to US taxation until actually paid. As a result of the treaty waiver, payment of the deferred compensation to the CE will be subject to 30 percent withholding tax at source, not a treaty-reduced rate.¹⁴⁰

If tax is not withheld at source, the CE must file a US return and pay the tax.¹⁴¹

Ineligible Deferred Compensation

Any item of deferred compensation items that is “ineligible” is taxable in the year of expatriation as though it had been paid on the day before expatriation.¹⁴² The

135 Notice 2009-85, supra note 60, at sections 5B(6) and (7).

136 IRC section 409A(a)(1).

137 Notice 2009-85, supra note 60, at section 5C; and Treas. reg. section 1.83-3(c).

138 IRC section 877A(d)(3).

139 Notice 2009-85, supra note 60, at section 8D.

140 IRC section 877A(d)(1)(A); and Notice 2009-85, supra note 60, at section 5C.

141 IRC section 877A(d)(6); and Notice 2009-85, supra note 60, at section 5F.

142 Notice 2009-85, supra note 60, at section 5B(3).

treatment is similar to that for a deemed disposition, except that in this case the amount is ordinary income (and, as mentioned before, the MTM exemption does not apply).

The taxpayer must provide form W-8CE to the payer. Within 60 days of receipt of the form, the payer must provide a statement indicating the present value of the accrued benefit on the day before the expatriation date.¹⁴³ For an entitlement under a defined benefit plan, the present value is determined using prescribed methodology.¹⁴⁴

From a practical perspective, it may be difficult to force a non-US payer to provide this information. The individual will likely have no contractual right to it, and the IRS will rarely have any enforcement ability.

For an interest in a foreign pension plan, the present value is determined by any reasonable method.¹⁴⁵

The United States levies additional taxes upon withdrawal of many types of income before age 59½.¹⁴⁶ These charges do not apply to the deemed income inclusion as a result of expatriation.¹⁴⁷

The value of unexercised stock options, stock appreciation rights, RSUs, and similar types of deferred income¹⁴⁸ is determined as of the day before the expatriation date, assuming that there is no risk of forfeiture and that the item is fully transferable by the individual. (According to usual valuation principles, risk of forfeiture and transferability are factors that would normally create discounts to the value.)

Deferred compensation items attributable to services performed outside the United States while the CE was not a US citizen or resident are not subject to US tax.¹⁴⁹ Any reasonable method can be used to determine what portion is exempt.

SPECIFIED TAX-DEFERRED ACCOUNTS¹⁵⁰

The US tax system provides for a number of individual tax-deferred savings accounts. Funds held in “specified” tax-deferred accounts are treated as having been distributed on the day before expatriation.¹⁵¹ Again, no early distribution taxes apply.¹⁵²

143 *Ibid.*, at section 5D.

144 *Ibid.*; and Rev. proc. 2004-37, 2004-26 IRB 1099, at section 4.02.

145 Prop. Treas. reg. section 1.409A-1; and Notice 2009-85, *supra* note 60, at section 5D.

146 IRC section 72(t).

147 IRC section 877A(d)(2)(B).

148 Notice 2009-85, *supra* note 60, at section 5D; inclusions under IRC section 83.

149 IRC section 877A(d)(5); and Notice 2009-85, *supra* note 60, at section 5E.

150 IRC section 877A(e).

151 IRC section 877A(e)(1).

152 IRC section 877A(e)(1)(B); Notice 2009-85, *supra* note 60, at section 6; and IRC sections 72(t), 220(f)(4), 223(f)(4), 409A(a)(1)(B), 529(c)(6), and 530(d)(4).

The accounts covered by this treatment include the following:¹⁵³

- individual retirement accounts or annuities,¹⁵⁴
- qualified tuition (“529”) plans,¹⁵⁵
- Coverdell savings accounts,¹⁵⁶
- health savings accounts,¹⁵⁷ and
- Archer medical savings accounts.¹⁵⁸

Simplified employee pension plans¹⁵⁹ and simple retirement accounts¹⁶⁰ do not qualify as specified tax-deferred accounts.¹⁶¹

INTERESTS IN NON-GRANTOR TRUSTS¹⁶²

A CE’s interest in a non-grantor trust is not subject to the deemed disposition rules in the same way as an interest in a grantor trust.¹⁶³ Instead, the following rules apply:

- Distributions are subject to a 30 percent withholding tax.¹⁶⁴ Generally, neither treaty relief nor a foreign tax credit is available. (Withholding tax is applied in the normal way, as it would be for any US-source income item, even though the distribution may not be income from a US source.)¹⁶⁵
- The IRS views this tax as applicable to a distribution of foreign (non-US)-source income from a foreign trust.¹⁶⁶
- For distributions of appreciated property, the trust must recognize the gain.¹⁶⁷
- The CE must file form W-8CE with the trustee of the non-grantor trust annually to inform the trustee of the above requirements.¹⁶⁸

153 IRC section 877A(e)(2).

154 IRC section 7701(a)(37), referring to IRC sections 408(a) and (b), subject to certain exclusions (see *infra* notes 159 and 160, and the related text).

155 IRC section 529.

156 IRC section 530.

157 IRC section 223.

158 IRC section 220.

159 IRC section 408(k).

160 IRC section 408(p).

161 IRC section 877A(e)(2).

162 IRC section 877A(f).

163 IRC sections 877A(c)(3) and (f)(3).

164 IRC section 877A(f)(1)(A).

165 IRC section 877A(d)(6)(B).

166 Notice 2009-85, *supra* note 60, at section 7A.

167 IRC section 877A(f)(1)(B).

168 Notice 2009-85, *supra* note 60, at section 7C.

- The unrealized gain on assets held by a non-grantor trust will be recognized if the trust subsequently becomes a grantor trust after expatriation.¹⁶⁹ The assets held by the trust will be deemed to have been distributed to the grantor.¹⁷⁰
- The CE must also file form 8854 each year to report distributions from the trust.

This system of taxation is clearly a treaty override, in at least two ways. Most US treaties, including the treaty with Canada, contain a “saving clause” whereby the United States retains the right to tax its former citizens and long-term residents for up to 10 years after expatriation.¹⁷¹ However, the expatriation rules have no time limit. Furthermore, the entitlement to a US foreign tax credit for Canadian tax survives the saving clause.¹⁷²

Unlike Canada, the United States does not automatically give primacy to treaties (post-1954) over domestic law. Instead, it has enacted later-in-time rules.¹⁷³

With respect to the MTM election, the IRS will administratively allow a CE who has an interest in a non-grantor trust to make an election to have the entire value of the trust treated as having been distributed to him or her on the day before the expatriation date.¹⁷⁴ To make the election, the CE must obtain a letter ruling as to the value of the interest in the trust. The letter ruling must be provided to the trustee, along with a certification, under penalties of perjury, that the MTM tax has been paid to the IRS. Only with such an election will the IRS respect the CE’s treaty rights.

The system of taxation for interests in non-grantor trusts is difficult to comprehend, because expatriation necessarily happens in a foreign (non-US) context. As a result, many such trusts will be foreign, and the underlying income will be foreign-source. Without allowing a credit for foreign tax, the United States is attempting to exercise a first right of taxation on income that will generally be foreign-source.

The compliance requirements are still more perplexing. The United States requires action not only by the CE, but also by financial institutions, trustees, and other payers, which in many cases will be foreign. Sometimes the payers will be members of the CE’s family. Foreign payers (not to mention family members) may not have systems in place to facilitate compliance with US tax law. There is no meaningful way that the IRS can enforce compliance in this scenario, where a particular institution does not deal with US persons or securities.

This may be a classic case of American legislative overreach. The objective is not really to ensure substantial compliance; rather, it is to obtain spotty compliance

169 Ibid., at section 7A; and IRC section 877A(f)(2).

170 Notice 2009-85, supra note 60, at section 7A; and IRC section 877A(f)(1).

171 Article XXIX(2)(b) of the Canada-US treaty.

172 Article XXIX(3)(a) and, in general, article XXIV of the Canada-US treaty.

173 IRC section 7852(d). In this regard, see *Chae Chan Ping v. United States* (sub nom. *The Chinese Exclusion Case*), 130 US 581 (1889).

174 Notice 2009-85, supra note 60, at section 7D.

from those who feel an exposure to the long arm of the IRS—wealthy expatriates, major foreign financial institutions, professional trustees, and the like. It seems that the law is intended to be enforced haphazardly.

Deferral of Exit Tax Payment

In some cases, the CE will not have sufficient liquidity to pay the exit tax. For assets subject to the MTM regime, the CE may elect to defer payment of the tax¹⁷⁵ until the earliest of

- the date on which a property is actually sold,
- the date on which a gain would otherwise be recognized, and
- the date of the taxpayer's death.

However, in contrast to Canada's system,¹⁷⁶ the deferral is elected on an asset-by-asset basis.¹⁷⁷

Once made, the election is irrevocable.¹⁷⁸

The deferral is elected on a property-by-property basis. The amount of tax attributable to each property is the deferred tax described above, proportionately allocated on the basis of the deemed gain.¹⁷⁹ The tax deferred is the incremental amount that would be payable as a result of the deemed disposition. It is not a prorated portion of the overall tax liability.¹⁸⁰

The deferral may not last beyond the due date of the tax return for the taxpayer's year of death.¹⁸¹

Following Canada's example, the United States requires the CE to post security acceptable to the IRS in order to make the election.¹⁸² The IRS has indicated that security will generally be required to be "hard"—that is, a bond, letter of credit, or the like.¹⁸³

Furthermore, an electing taxpayer must waive treaty rights that would preclude assessment or collection of the tax.¹⁸⁴ It is not clear how this would affect someone who was a Canadian citizen at the time of expatriation. We hazard a guess that US

175 IRC section 877A(b)(1); and Notice 2009-85, *supra* note 60, at section 3E.

176 ITA paragraph 128.1(4)(d).

177 IRC section 877A(b)(2); and ITA subsection 220(4.5).

178 IRC section 877A(b)(6).

179 *Ibid.*

180 IRC section 877A(b)(2).

181 IRC section 877A(b)(3).

182 IRC section 877A(b)(4).

183 IRC sections 877A(b)(4)(B) and 6235.

184 IRC section 877A(b)(5).

collection efforts on Canadian soil would still fail. The prohibition against enforcement of US tax laws in Canadian courts is a Canadian domestic rule, not a treaty rule.¹⁸⁵

One major difference between the Canadian and the US regimes is that the US deferred tax is subject to interest.¹⁸⁶ Interest is applied at the normal underpayment rate, which is the applicable federal short-term rate, plus 3 percentage points.¹⁸⁷ The rate changes every calendar quarter. As of January 2013, it was 3 percent.

The IRS has prescribed the form of a deferral agreement into which a taxpayer must enter. This form must be filed by the extended due date of the tax return for the year of expatriation. The taxpayer must also appoint a US agent for service. If the agent resigns, the taxpayer must appoint a new one within 90 days, or the agreement becomes void, and the security is applied to the tax and interest.¹⁸⁸

In light of the security requirement and the interest charge, it is reasonable to expect that only in the most illiquid situations will a CE elect deferral of payment of the tax. The IRS expects that, at most, only 10 taxpayers per year will make the election.¹⁸⁹

US Tax Basis of Assets After the Exit Tax

Since gain or income is required to be recognized, the US tax basis of all assets subject to the exit tax is the value used in that calculation. A subsequent transfer may have US tax consequences, particularly if the asset in question is US real property. The gain recognized on expatriation will not be subject to tax a second time.¹⁹⁰

Transfer Taxes

The final piece of the regime is the transfer tax. The United States applies taxes on gratuitous transfers, both before and upon death.¹⁹¹ These taxes apply to all transfers made by a US person.

For non-US persons, only transfers of US-situs property are subject to transfer taxes.¹⁹² Consequently, there is an incentive for a US person to expatriate in order to avoid such taxes (particularly when that person's assets are largely non-US situs, or could be converted to such property).

The expatriation rules limit a person's ability to accomplish this goal. To capture the "lost" estate tax, the United States imposes a tax on the recipient of a gift or

185 See below under the heading "Collectibility of US Tax and Penalties."

186 IRC section 877A(b)(7).

187 IRC sections 6601(a) and 6621(a)(2).

188 Notice 2009-85, supra note 60, at appendix A.

189 Notice 2009-85, supra note 60, under the heading "Paperwork Reduction Act."

190 Notice 2009-85, supra note 60, at section 3C.

191 IRC sections 2001 and 2501.

192 IRC sections 2103 and 2511.

bequest from a CE.¹⁹³ The tax is imposed at a rate equal to the maximum gift/estate tax rate (40 percent).¹⁹⁴ The tax applies where

- the donor/decedent is or was a CE,¹⁹⁵
- the beneficiary/recipient is a US person,¹⁹⁶ and
- the transfer is not otherwise subject to US gift or estate tax.¹⁹⁷

The following transfers are exempt from the gift tax, presumably because they would have been exempt even if the transferor had remained a US person:¹⁹⁸

- de-minimis gifts (up to US\$143,000 to a non-resident alien spouse and up to US\$14,000 for gifts to others),
- transfers to US charities,¹⁹⁹ and
- transfers to a spouse who is a US citizen.²⁰⁰

The idea behind the last exemption is that the asset (unless depleted) will then ultimately be subject to US estate tax on the spouse's death.

The current rules have some questionable consequences, of which the following are the most egregious:

- They catch a CE who pays a medical or educational expense for a US person. Had the CE retained his or her US status, the payment would not have been considered a taxable gift.²⁰¹
- A transfer from a CE who was previously a long-term resident (not a US citizen) will be caught by this system. However, if such a person had not given up his or her US status, and remained domiciled in Canada, ordinary gift or estate tax would not have been exigible (except in respect of US-situs assets).

A credit is allowed for foreign gift or estate tax.²⁰² However, Canada has no such tax. It is unlikely that the Canadian income tax on the deemed gain on a gift²⁰³ or death²⁰⁴ would qualify for this credit.

193 IRC section 2801(b).

194 IRC section 2801(a)(1), referring to IRC sections 2001(c) and 2502(a).

195 IRC section 2801(e)(1).

196 IRC section 2801(a).

197 IRC section 2801(e)(2).

198 IRC section 2801(c).

199 IRC sections 2801(e)(3), 2055, and 2522.

200 IRC sections 2056 and 2523.

201 IRC section 2503(e).

202 IRC section 2801(d).

203 ITA paragraph 69(b).

204 ITA subsection 70(5).

The form that must be filed by CEs in respect of transfer taxes (form 708) is not yet available. Until it is available, reporting and payment of the tax is not required.²⁰⁵

There is, however, already a reporting requirement for gifts and bequests received by Americans, albeit not specific to the expatriation regime. Receipts from individuals in excess of US\$100,000 must be reported on form 3520 (“Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts”).²⁰⁶

Process of Expatriating

There are several ways to give up US citizenship, but the most common way is to make a formal renunciation of nationality. This must be done before a diplomatic or consular officer of the United States in a foreign state; it cannot be done in the United States.²⁰⁷ The individual must submit the following documents:

- form DS-4079 (“Questionnaire: Information for Determining Possible Loss of US Citizenship”),
- a “Statement of Understanding Concerning the Consequences and Ramifications of Relinquishment or Renunciation of U.S. Citizenship,” and
- a copy of the individual’s US and foreign-country passports.

Generally, two appointments are required. The IRS wants to ensure that US citizens are not being coerced into relinquishing citizenship.

To relinquish green-card status, one must voluntarily return the card, or have it judicially withdrawn. It can be withdrawn for failure to abide by the terms of the status (such as living in the United States), or for committing a crime, among other things. To abandon the status voluntarily, a green-card holder submits form I-407 (“Abandonment of Lawful Permanent Resident Status”), generally to the local US consulate. As a practical matter, the individual can simply take the card to any border crossing and surrender it to a US immigration agent.

Date of Expatriation

For US tax purposes, US citizenship is determined to be relinquished on the earliest of the following dates:²⁰⁸

1. the date on which the taxpayer renounces US nationality;
2. the date on which the taxpayer furnishes the US Department of State with a signed statement of voluntary relinquishment of US nationality confirming at least one of
 - a. naturalization in a non-US jurisdiction,

205 Announcement 2009-57, 2009-29 IRB 158.

206 IRC section 6039E.

207 8 USC section 1481.

208 IRC section 877A(g)(4).

- b. taking an oath or making an affirmation or other formal declaration of allegiance to a non-US jurisdiction,
 - c. serving in the armed forces of a non-US jurisdiction, or
 - d. accepting employment by the government of a non-US jurisdiction;
3. the date on which the US Department of State issues a certificate of loss of US nationality to the taxpayer; and
 4. the date on which a court of the United States cancels a naturalized citizen's certificate of naturalization.

For a green-card holder, the expatriation date is the earlier of the following:²⁰⁹

1. The date on which the individual loses the privilege of residing permanently in the United States. As described above, such privilege may be relinquished voluntarily, or it may be withdrawn by administrative or judicial order.
2. The date on which the individual commences to be a non-resident of the United States pursuant to a tax treaty with a foreign country and does not waive the benefits of the treaty that apply to non-residents. Under the Canada-US treaty, green-card holders living in Canada may elect to be taxed by the United States in the same manner as ordinary Canadian residents.²¹⁰ Making such an election would constitute expatriation.

Reporting Obligations

For US tax purposes, a CE is considered to be a “dual-status” person for the year of expatriation.²¹¹ The concept of a dual-status person is analogous to the Canadian concept of a part-year resident.

Unless the taxpayer's expatriation date is January 1, the CE must file a dual-status return for the year of expatriation. This return is form 1040NR (“U.S. Nonresident Alien Income Tax Return”), with form 1040 (“U.S. Individual Income Tax Return”) attached as a schedule. The 1040NR reports US-source income earned after the date of expatriation, and form 1040 reports worldwide income earned prior to that time.²¹²

The taxpayer must attach form 8854 to this tax return.²¹³ Because of the requirement to account for all of the taxpayer's assets on a US tax basis, and the comprehensiveness of the system, form 8854 is quite complicated. The time, effort, and cost of compliance are substantial.

209 IRC section 877A(g)(3)(B).

210 Article IV(2) (residence) and article XXV(1) (non-discrimination) of the Canada-US treaty.

211 Notice 2009-85, *supra* note 60, at section 8B.

212 Treas. reg. section 1.6012-1(b)(2)(ii)(B); and IRS publication 519, “U.S. Tax Guide for Aliens,” at chapter 6.

213 Notice 2009-85, *supra* note 60, at section 8C; and “2012 Instructions for Form 8854,” *supra* note 89, at 3.

By default, the due date for filing these forms is April 15 of the year following the expatriation year.²¹⁴ In virtually every case, the CE will be living outside the United States, and thus be a non-resident alien. If this is true, and the individual has no wages subject to US withholding at source, the original due date for the return is June 15.²¹⁵ Timely filing of form 4868 (“Application for Automatic Extension of Time To File U.S. Individual Income Tax Return”) will entitle the individual to an extension to October 15. With another request, the IRS will routinely allow an extension to December 15.²¹⁶

A CE must file forms 1040NR and 8854 for each subsequent year for as long as any deferred tax remains to be paid.

As discussed earlier, a CE with assets subject to the alternative exit tax must file form W-8CE with each payer, to inform it of the withholding obligations. In the case of ineligible deferred compensation, a specified tax deferred account, or a non-grantor trust, the form notifies the custodian that it must supply the present value of the account to the taxpayer, so that the amount may be included on the taxpayer's return. This form must be filed²¹⁷ by the earlier of

- the day before the first payment after the expatriation date, and
- 30 days after the expatriation date.

Collectibility of US Tax and Penalties

While the United States may be able to levy significant tax, penalties, and interest in respect of an expatriate, it may be difficult for the IRS to actually collect this money.

Where the individual has assets located in the United States, or if the individual travels to the United States, collection action may be taken in a purely domestic context.²¹⁸ However, when the person's assets are located solely in Canada, such action is not available.

It is possible, though cumbersome and unusual, for the CRA to pursue collection efforts through the US criminal courts. It appears that US criminal statutes can apply to evasion of Canadian tax.²¹⁹ On the other hand, while such a conviction may bring unpleasant sanctions in the United States (fines and prison time), it does not result in collection of tax by the IRS and remittance to Canada.

The reverse is not true. Under Canadian common law (and in most common-law jurisdictions), Canada will not act to collect a foreign nation's tax:

214 IRC section 6072(a).

215 IRC section 6072(c).

216 Treas. reg. section 1.6081-1(b).

217 Notice 2009-85, *supra* note 60, at section 8D.

218 For example, by way of levy: IRC section 6502.

219 *United States v. Pasquantino*, 336 F. 3d 321 (4th Cir. 2003); and David Bishop Debenham, “From the Revenue Rule to the Rule of the ‘Revenuer’: A Tale of Two Davids and Two Goliaths” (2008) 56: 1 *Canadian Tax Journal* 1-66, at 2.

[E]nforcement of a claim for taxes is but an extension of the sovereign power which imposed the taxes, and . . . an assertion of sovereign authority by one State within the territory of another . . . is (treaty or convention apart) contrary to all concepts of independent sovereignties.²²⁰

This convention is called “the revenue rule.”²²¹

Effective November 8, 1995, the Canada-US treaty was amended to override the revenue rule and provide for each government to assist in the collection of taxes owing to the other government.²²² For the CRA to accede to a request by the IRS in respect of US taxes owing by an individual,

- the taxes must be “finally determined” (not subject to further rights of appeal), and
- the individual cannot have been a citizen of Canada during the period in which the tax debt was incurred.

When these conditions are met, the CRA will collect the US debt as though it were a debt owing to Canada.

The treaty does not allow for assistance in collection of FBAR penalties because this reporting requirement is not a tax provision. The CRA has stated that as a matter of policy, it will not collect these penalties.²²³

Information returns that are required as part of the tax return pose a different problem. The United States requires supplementary filing to report foreign (including Canadian) trusts, corporations, partnerships, and financial accounts. The penalty for failing to file even one of these forms starts at US\$10,000.

As noted previously, an overwhelming majority of Americans in Canada are not fully compliant, so these forms have often not been filed. Still, because Canadian personal tax rates are significantly higher than US rates, it is rare for such individuals to owe meaningful US tax.

The CRA has discretion as to whether to accept an IRS request for assistance in collection. The CRA has stated that it will not collect penalties for failure to file such information returns on behalf of the IRS on the basis that such amounts are not in respect of taxes covered by the treaty.²²⁴ A US taxpayer could argue that such action by the CRA would be unconstitutional.²²⁵

220 *United States of America v. Harden*, [1963] SCR 366, at 370, quoting *Government of India v. Taylor*, [1955] AC 491, at 511 (HL).

221 For a thorough discussion of the revenue rule, see Debenham, *supra* note 219.

222 Article XXVI A of the Canada-US treaty.

223 CRA document no. 2011-0431621M4, March 6, 2012.

224 CRA document no. 2011-0427221E5, July 25, 2012.

225 Andrew Bonham, “FATCA and FBAR Reporting by Individuals: Enforcement Considerations from a Canadian Perspective” (2012) 60:2 *Canadian Tax Journal* 305-54, at 345.

Planning To Avoid Being a CE

With the consequences for a CE being so significant, it is obviously important to avoid this status if reasonably possible.

Because Canadian tax rates are so much higher than US rates, it is rare to see an American living in Canada who has a five-year average US tax liability in excess of US\$155,000. Even very high net worth individuals are rarely in this situation, so normally planning does not need to be done around this test.

It is possible for an individual to make gifts prior to expatriation in order to bring his or her net assets below \$2 million, but care must be taken in doing so. As discussed above, a gift generally attracts US tax of up to 40 percent of the value of the gift. However, there are exceptions:

- Gifts of up to US\$14,000 per year can be made to any one person without triggering gift tax.²²⁶
- Unlimited gifts can be made to a US-citizen spouse without tax.²²⁷ However, because all of the individual's assets, and the income they generate, remain in the US tax net, this strategy is generally effective only when the donor expects to receive substantial future income from assets that are retained, or from services to be provided in the future.
- Where the spouse is a non-resident alien, the individual can make a tax-free gift of up to US\$143,000 per year.²²⁸
- The unified credit provides an effective US\$5.25 million lifetime exemption for gifts.²²⁹

These rules mean that an individual with net assets of up to US\$7.25 million prior to expatriation could easily make gifts to get below the threshold. Having a spouse would make the process easier, because the individual could then avoid the Canadian tax on a deemed disposition of gifted property.²³⁰ Consequently, the individual could transfer assets with accrued but unrealized gains without tax exposure.

Some assets, however, are particularly problematic, such as shares of PFICs. Expatriation and gifting of such shares are both considered dispositions.²³¹ If the donor is elderly or in poor health, this deemed disposition may not be a large obstacle to overcome.

While the US tax on gifts over the US\$5.25 million lifetime exemption limit is 40 percent,²³² the long-term capital gains tax rate for the deemed disposition is usually

226 IRC section 2503(b).

227 IRC section 2523(a).

228 IRC section 2523(i)(2); and Rev. proc. 2013-15, 2013-5 IRB 444, at section 2.13.

229 IRC section 2010(c)(3)(A).

230 ITA section 69.

231 Prop. Treas. reg. section 1.1291-3(b).

232 IRC section 2502(a)(2).

20 percent.²³³ Consequently, in most cases, it will not be advantageous to give away assets above the exemption limit in order to avoid being a CE. An individual might choose to do so where there are minor accrued but unrealized gains, but the individual's future estate is likely to be very large (perhaps as a result of an expected inheritance).

To be effective, gifts can be either direct or in trust. However, care must be taken to ensure that a gift in trust is in fact a "completed" gift.²³⁴ An incomplete gift will not be effective in reducing the value of the estate.

Planning Prior to Expatriation

US-Situs Property

Once an individual is a non-resident alien (no longer a US citizen or resident), the US gift tax ceases to apply except in respect of US-situs property. The main estate and gift tax exposure for a non-resident alien is in respect of US real property, tangible property physically located in the United States, and shares of US corporations.

While the unified credit provides an effective US\$5.25 million exemption for a US person's transfer of property, there is no effective exemption for a non-resident alien who gifts US-situs property. Consequently, it is worth considering the possibility of gifting US real property and tangible property located in the United States prior to expatriation. This decision should be made in light of the fact that a decedent who is a resident of Canada is entitled to a proportion of the US\$5.25 million estate tax exemption (based on the proportion of US assets to all assets).²³⁵

For a non-resident alien, gift tax does not apply to shares of US corporations because such shares are intangible property. Intangible property is not subject to gift tax.²³⁶ For a non-resident alien who is a Canadian and owns assets with a net value of less than US\$1.2 million at the time of death, these shares are generally not subject to US estate tax.²³⁷ Because transfer is possible before death without exposure to gift tax, no special planning is required with respect to such shares prior to expatriation.

Double Taxation

One major problem with expatriation is that under Canadian tax law, the US gain recognition provisions are inapplicable. Consequently, when an asset is later sold, or income realized, Canada will tax the same amount again.

233 IRC section 1(h)(1)(D).

234 Treas. reg. section 25.2511-2(b).

235 Article XXIX B(2) of the Canada-US treaty.

236 IRC section 2511(a).

237 Article XXIX B(8) of the Canada-US treaty.

Canada does not allow foreign tax credit carryforwards except where the foreign tax arose in respect of business income.²³⁸ The vast majority of items subject to the US expatriation tax regime will fall outside this category. Consequently, US tax paid on expatriation will rarely be available in a future year to offset the Canadian tax on an actual disposition or other realization event.

Canada also does not allow a foreign tax credit for tax paid solely by virtue of the taxpayer's foreign citizenship where the tax would not be levied on a non-resident.²³⁹ It is quite likely that the expatriation tax would be ineligible for credit.

The same provision would likely deny a credit for US tax in excess of ordinary treaty rates. If, for example, a CE was subject to 30 percent withholding tax on a US periodic pension payment, Canada would likely allow a credit only at the 15 percent treaty rate.²⁴⁰

For a Canadian resident who is required to recognize gain on assets for US purposes, it may be possible to elect to recognize the same gain for Canadian purposes.²⁴¹ The benefit of the election would be a higher Canadian tax cost (adjusted cost base) on a subsequent disposition of the asset. However, this choice may come at some cost, because, as noted previously, the applicable Canadian tax rates are generally significantly higher than the US rates.

For deferred compensation items and assets such as RRSPs, there may be no mechanism to adjust the Canadian tax basis, and double taxation may be the unfortunate result.

One alternative is to undertake actions to realize or recognize income and gains for both US and Canadian tax purposes prior to expatriation. This choice may accelerate tax, but it will generally ensure that taxes paid in both countries are available for credit in the other. It will often minimize exposure to double taxation.

CONCLUSION

The US tax compliance burden for Americans living in Canada is heavy, and growing more onerous every year. Ordinary Canadian tax planning is often rendered inoperative, or of very limited value, by US tax rules. In addition, compliance is difficult, time consuming, and expensive. Even for "just plain folks," remaining in full compliance is often not realistic. The rules effectively force many to choose between penury and criminality.

These burdens have been inducing Americans in Canada to renounce their citizenship in record numbers. Moreover, as the following case suggests, it appears unlikely that the US government will soon relax its treatment of expatriate Americans.

238 ITA paragraph 126(2)(a); and paragraph (a) of the definition of "unused foreign tax credit" in ITA subsection 126(7).

239 Paragraph (d) of the definition of "non-business income tax" in ITA subsection 126(7).

240 Article XVIII(2)(a) of the Canada-US treaty.

241 Article XIII(7) of the Canada-US treaty.

Continuing Political Exposure

In May 2012, Facebook went public. It came to light that Eduardo Saverin, a Facebook co-founder, was at that time living in Singapore; he had renounced his US citizenship in September 2011. Saverin was estimated to have owned approximately US\$3 billion in Facebook stock as of the date of the initial public offering (IPO).

Although Saverin likely incurred substantial tax upon expatriation, the amount of that tax was probably a good deal less than what he would have owed if he had retained his citizenship and sold the stock as part of the IPO. (The stock price dropped significantly after the IPO, but the political storm arose around the time of the IPO.)

The value of Saverin's interest in Facebook was likely much lower in September 2011 than at the time of the IPO. In September 2011, he owned a minority stake in a private company. Also, his stake was large enough that there would likely be a limited market. Under ordinary valuation principles, the discounts to fair market value for these three factors were probably substantial.

As publicity increased toward the IPO date, the perceived value of the company kept rising, and the IPO price and issuance size increased. Almost immediately, two Democratic senators denounced Saverin's renunciation of US citizenship as "an outrage" and "an insult to middle-class Americans." They introduced the Expatriation Prevention by Abolishing the Tax-Related Incentives for Offshore Tenancy ("Ex-PATRIOT") Act.²⁴² It will reinforce existing legislation by *presuming* that an individual has renounced US citizenship for tax-avoidance purposes if he or she has, at the time of expatriation, a net worth of US\$2 million or an average tax liability over the past five years of US\$148,000.²⁴³ The individual will have an opportunity to disprove the presumption.

If the presumption holds, the bill will impose a 30 percent tax on the expatriate's future gains. This is itself strange, considering that the long-term capital gains tax rate was only 15 percent at the time the bill was introduced. An individual who does not pay this tax will be inadmissible to the United States.

The bill requires the IRS commissioner to evaluate the intent of every CE. At this point, there is no such mandate.

One exceptionally offensive part of the legislation is that it is retroactive; it covers any person who renounced US citizenship as long ago as 10 years prior to enactment of the bill. On principle, every American, no matter what his or her political leanings, and regardless of his or her feelings about Saverin, should be opposed to the legislation, if only for this reason. Retroactive taxation is a fundamental breach of trust by elected representatives. It interferes with taxpayers' ability to plan their affairs, and it opens the door to capricious, politically motivated confiscation of wealth.

One can only hope that the Ex-PATRIOT bill will die a quick death, having served its purpose of generating publicity for the two senators.

242 S 3205, 112th Cong., 2d sess. (2012).

243 At this point, it is not clear whether the legislation, if passed, would match the current indexed amount.