NEWS ANALYSIS

For Sale: Foreign Citizenship, Maybe Diplomatic Posts

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2013 is looking like another year full of compliance complexity in U.S. international tax laws. Final regulations for the Foreign Account Tax Compliance Act are on the books, and the Justice Department and the IRS are ratcheting up offshore account enforcement.

Playing hide-and-seek with the U.S. government is increasingly futile. Treasury is likely to sign dozens of intergovernmental agreements over the next few years, and major FATCA provisions will take effect during that period, making it all but certain that rogue nations will be the only place left to hide money from the IRS.

If taxpayers can't hide money, can they escape tax by simply leaving the United States? Maybe, but there are tax provisions affecting expatriates, too.

A Brief History

The so-called exit tax imposed by the United States affects only covered expatriates, or those who have average annual net income tax exceeding $155,000 for the five years before expatriation and a net worth in excess of $2 million, and who fail to certify that they have been tax compliant for the past five years. Under section 877A, a covered expatriate must mark all of her property to market before leaving the United States. Section 2801 covers gifts and bequests by covered expatriates to U.S. persons and imposes a tax equal to the product of the highest marginal tax rate under section 2001(c) and the value of the gift or bequest, as long as the value exceeds the statutory exclusion amount under section 2503(b).

The Foreign Tax Investors Act of 1966 targeted those who relinquished their U.S. citizenship for the principal purpose of avoiding U.S. tax. It created an alternative tax regime whereby the former citizen would be subject to tax only on U.S.-source income at rates applicable to U.S. citizens.

Thirty years later, as part of the Health Insurance Portability and Accountability Act of 1996, Congress passed significant changes to the alternative tax regime, partly in response to reports of expatriated persons maintaining ties to the United States. It included section 6039G, which requires the State Department to provide a list of expatriated individuals to Treasury, which must then publish them quarterly in the *Federal Register*. That was important because it linked the State Department, which is attuned to problems of expatriation, and the IRS.

In October 1999 House Ways and Means Committee Chair Bill Archer tasked the Joint Committee on Taxation with reviewing the effectiveness of the legislation. In 2003 the JCT issued its long-awaited, 550-page report, noting that there was ''little or no enforcement of the special tax and immigration rules applicable to tax-motivated citizenship relinquishment and residency termination.'' The key reason for the inefficiency in enforcing the alternative tax regime was the government's inability to obtain the necessary information from individuals both when they relinquished citizenship and over the 10 years before. As an alternative to the alternative, the JCT recommended a mark-to-market system.

Congress didn't act on that recommendation for five years, eventually passing the Heroes Earnings Assistance and Relief Tax Act of 2008 that included section 877A, the mark-to-market approach that taxed gains in excess of $600,000 (indexed for subsequent years) from a deemed sale of an individual's worldwide assets on the day before the individual's expatriation date. (Prior coverage: *Tax Notes*, July 28, 2008, p. 296.)

Citizenship by Investment

The recent economic downturn was a good time for the very wealthy to expatriate, according to Michael G. Pfeifer of Caplin & Drysdale. With asset values depressed, marking to market meant some individuals recognized very little gain, he said.

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The number of U.S. individuals who have expatriated has increased significantly since 2008, when 231 individuals renounced their U.S. citizenship. In 2009, 742 individuals expatriated from the United States. The number peaked in 2011 at 1,781; last year, it dropped to 932. And every year, another high-profile American defects. Last year it was Facebook billionaire Eduardo Saverin (to Singapore) and socialite Denise Rich (to Austria). This year, it's Tina Turner (to Switzerland). But for every celebrity, there are dozens of less prominent expatriates. (Prior coverage: *Tax Notes*, May 21, 2012, p. 925.)

For some, it's an easy decision: They were born in the United States, but have spent their entire lives in a different country and have no plans to take advantage of their birthright. They've never been back to the United States and have burdensome reporting requirements each year — hiring a U.S. tax return preparer in their home country is expensive.

For others, the decision is more complicated. They have built lives in the United States and succeeded beyond their wildest expectations, building a fortune so great that no rule against perpetuities could keep their descendants from living a life of leisure. But the government needs revenue and will get it from the people who can afford to pay. (Prior analysis: *Tax Notes*, Feb. 11, 2013, p. 703.)

Some individuals in the second group have approached, or have been approached by, foreign jurisdictions with preferable tax rates. A select few have been offered diplomatic status with their new country, enabling them to travel freely. Tax Analysts spoke with several practitioners, many on the condition of anonymity, about advising the very rich in their quest to give up U.S. citizenship for greener pastures.

One practitioner said a high-net-worth client recently expatriated to St. Kitts and Nevis, where he owned significant amounts of real estate. To sweeten the deal, the country, which is not subject to the State Department's visa waiver program, offered the individual a diplomatic post that would allow him to travel to the United States without a visa, the practitioner said.

St. Kitts and Nevis — whose motto, "Country Above Self," may be lost on its newest inhabitants — was the first to offer a citizenship-by-investment (CBI) program, which the government says is intended "to attract investors of good character to make a substantial contribution to the development of the Federation." Applicants must make a big investment, and visiting the islands, let alone living on them, is not necessary. The investment can be a contribution to the Sugar Industry Diversification Foundation, which begins at $250,000 for a single applicant, exclusive of a $7,500 background check. Or an applicant can make a minimum $400,000 investment in approved real estate projects, which are almost exclusively resorts. In either case, the total application cost can be pricey. A retired U.S. person seeking economic citizenship and taking the real estate option for his spouse and two children can anticipate administrative fees greater than $100,000.

Pfeifer said the CBI program for St. Kitts and Nevis is "fairly clean," but that Austria is considered the "gold standard" for expatriation. Austria's CBI program, unlike that of St. Kitts and Nevis, requires an active investment in the country. According to Henley & Partners, an international citizenship-planning firm, significant direct investment in the Austrian economy is required for a grant of economic citizenship. Pfeifer estimated that the amount necessary for investment depends on the circumstances but could range from €3 million to €10 million.

That's a lot of money, but Pfeifer said the benefit of Austrian citizenship is that it allows free and unlimited entry to the United States. Austria is a signatory to the Schengen Agreement, a treaty allowing for free travel within the Schengen area, which includes 26 European countries. Another 42 countries have signed agreements with the Schengen area countries for visa-free travel, including St. Kitts and Nevis and Singapore.

While Austria's individual income tax rate is high, it is on a territorial basis. Accordingly, a well-to-do U.S. expat could reside in a tax haven such as Saint Kitts and Nevis and use her Austrian citizenship to visit the U.S. visa-free, Pfeifer said. Austria typically disallows dual citizenship, but it makes an exception for those who obtained their Austrian citizenship economically, enabling someone to take advantage of the low-tax benefits of a tax haven and the travel freedom available with an Austrian passport.

Immigrating to a Schengen country is popular because obtaining a visa is sometimes difficult. It often requires advance planning, including an interview at a U.S. embassy or consulate, and then time to process documentation. Wait times can take more than 90 days in some locations, according to the State Department, and there is always a chance that a visa request could be denied.

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But those who flee the United States for tax reasons risk being barred from reentry, according to Alejandro García-Villalpando of Akerman Senterfitt LLP. Under the Illegal Immigration Reform and Immigrant Responsibility Act of 1996, "if the attorney general determines that an expatriate has renounced his U.S. citizenship in order to avoid U.S. taxes, in theory, that person could be barred entry to the U.S.," García-Villalpando said. "That would apply to a visa-waiver and a non-visa-waiver country," he said, adding that he is unaware of the United States actually enforcing that policy.

Senate Finance Committee member Charles E. Schumer, D-N.Y., said in May 2012 that prior legislation barring entry to tax-motivated expatriates has been difficult to enforce and that no former citizen had ever been denied reentry. He said his own bill, the Expatriation Prevention by Abolishing Tax-Related Incentives for Offshore Tenancy Act (EX-PATRIOT Act), would fix that. (Prior coverage: *Tax Notes*, May 21, 2012, p. 926.)

Despite criticism of those who flee our borders, one fact remains: Money talks. Yes, even the United

States has a CBI regime. In 1990 Congress created the EB-5 Immigrant Investor visa regime, which has two qualifying standards: generally, a $1 million qualifying investment, or a $500,000 qualifying investment in a ''targeted employment area.'' EB-5 investment visas boomed in 2008 and 2009, and according to a September 2012 *New York Times* report, many of those visas went to investors in large hotel projects.

In what could be considered the most significant have-your-cake-and-eat-it-too moment for U.S. expats, one practitioner said a foreign country, which he would not identify, offered one of his clients citizenship and a diplomatic post in the United States. The most convenient part for the individual was that he could live as if he had never renounced his citizenship, the practitioner said.

The wages or salaries of diplomats are tax exempt under section 893(a). Under reg. section 301.7701(b)-3(b)(1)(i), a ''foreign government-related individual'' is considered an exempt individual when calculating substantial presence for determining residency. García-Villalpando said that although the diplomats' days in the United States won't be counted toward calculating substantial presence, meaning they won't be considered U.S. persons for U.S. federal income tax purposes, their U.S. tax liabilities are determined under the same tests used for nonresident aliens. ''Most of the interest income will be exempt, [but] they will have issues with capital gains . . . and U.S. dividends will be subject to withholding,'' he said. ''But all those issues can be cured with proper planning.''

Pfeifer, who in the mid-1990s worked as an adviser to the IRS on expatriate issues, warned that it's not so simple to come back to the United States as a diplomat, no matter how wealthy or powerful the individual is. He used as an example Kenneth B. Dart, the billionaire and former president of Dart Container Co. Dart renounced his U.S. citizenship in the early 1990s and moved to Belize. In 1995 he persuaded Belize to send him back to the United States as a diplomat. The Belize government petitioned the U.S. government to open a consulate in Sarasota, Fla., where Dart lived before he renounced his citizenship. Flummoxed, the State Department wondered why the government of Belize would build a consulate in Sarasota, a place with a limited Belizean population. Someone at the State Department figured it out, Pfeifer said. The U.S. government discovered that Dart would be the consul of the office and that he had offered to pay for the building. Congress urged the State Department to intervene, but the government of Belize withdrew the request before any action was taken.

Wealthy Americans may have reasons other than taxes to flee the United States. Rich reportedly wanted to be closer to her daughters, who live in London, and her partner is an Austrian national. Turner has lived in Switzerland with her longtime partner since 1995.

The world has grown more connected, and with high-speed Internet, an expatriate can connect visually with a relative or friend back in the United States or in any other part of the world. In the past, even telephone service could be spotty, depending on the country.

For motivated millionaires seeking to expatriate, the tax considerations may be an added benefit for something they were going to do anyway. For others, it's the possibility of even higher taxes later, which — fairly or unfairly — tend to fall on top earners. It may have been that the record-keeping burdens of filing annual foreign bank account reporting forms to Treasury and the IRS weren't worth the benefit of remaining citizens of a country they never really called home. ■