What to Consider When Deciding to Renounce U.S. Citizenship for Tax Purposes - The Globe and Mail Article (Featuring Quotes from Alexander Marino, Leader of the US Tax Practice)

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June 22, 2022

For Americans looking to give up their U.S. citizenship, the decision isn't just about national identity but also how much taxes they might have to pay when leaving the country officially.

While an American who renounces their citizenship will no longer have to pay U.S. taxes on their worldwide income, they could be forced to pay an expatriation tax, also known as an exit tax, upon departure, depending on their net worth and other rules the Internal Revenue Service (IRS) has laid out.

"You can't just hand your passport to the border agent and say, 'I'm done,'" says Darren Coleman, senior portfolio manager with Portage Cross Border Wealth Management at Raymond James Ltd. in Toronto. "There's a lot more to it than that."

Mr. Coleman says advisors should be discussing with their American-citizen clientele the various steps of renunciation – and ensuring they have the proper legal and tax expertise when going through the process.

"You really can't make any mistakes when you do it," he says.

For advisors looking to help clients make the move, the goal is to not be considered what's known as a "covered expatriate" in order to avoid paying the exit tax – a U.S. federal tax on assets with unrealized gains at the time someone cuts ties with the U.S.

Additional U.S. withholding taxes can apply later to payments from some types of deferred compensation arrangements, accounts and trusts, says Steven Flynn, a partner and Canadian and U.S. cross-border tax expert at Andersen LLP in Vancouver.

Americans can avoid the exit tax if they meet three conditions on the official date of expatriation:

1.Their average annual net income tax over the past five years is less than US$172,000 (as of 2021, the rate changes annually with inflation);
2.They're fully compliant with their U.S. tax obligations for those five years;
3. Their net worth is US$2-million or less.

With some planning, Mr. Flynn says the first two conditions are relatively easy to meet for those looking to avoid the exit tax.

However, the third condition on net worth can be a hurdle for many Americans, especially those who are older and whose assets have increased in value over the years.

Mr. Flynn also notes that since the conditions were put in place in 2008, the US$2-million threshold hasn't increased with inflation.

He adds that Americans can still use strategies to lower their net worth, such as gifting assets to family members while they're still U.S. citizens. Although the U.S. has a gift tax, he notes the exemption is currently about US$12-million, which is set to be reduced significantly by 2026.

Still, Americans who renounce their citizenship successfully but as a covered expatriate may not be done with the U.S. tax system, Mr. Flynn says. Any U.S. person who receives a gift or is a beneficiary of a former U.S. citizen who is a covered expatriate in their will is still subject to a 40-per-cent tax on the value of those assets.

"That's pretty significant," he says, "and a real concern for people with U.S. citizen or resident children."

Importance of reason for renunciation
Alexander Marino, leader of the U.S. tax practice at Moodys Tax Law in Calgary who runs the firm's renunciation group in Canada, saw a record number of people looking to renounce during the pandemic, in part because people more had time to go through the lengthy process.

The steps include not only working with experts to determine if renouncing is the right decision but also filing and addressing reams of paperwork before the final step of meeting in person with a consular officer at a U.S. embassy or consulate to officially renunciate.

In addition, Mr. Marino says U.S. persons need to ensure they're communicating their reasons for renunciation properly, especially if they have plans to return as a visitor.

He points to the Reed Amendment, also known as the Expatriate Exclusion Clause, which bans certain former U.S. citizens from re-entering the country if they're considered to have renounced for a tax avoidance motive or purpose.

"Knowing what to say in the interview is critical," he says.

Mr. Marino says advisors also need to be aware of these issues to protect their clients – and themselves. He notes advisors have an obligation to identify who their U.S. citizen clients are under the Foreign Account Tax Compliance Act in Canada (FATCA), an international agreement signed between Canada and the U.S.

His team at Moodys works with advisors to help them determine if clients are U.S. citizens, particularly as some may not realize it or understand the impact of not disclosing it. For example, he says some people may have lived in Canada their entire lives but have American parents, which means they're also U.S. citizens.

"You need to be asking the right questions," he says.

Once it's clarified if a client is a U.S. citizen, Mr. Marino says advisors can work with them – with the help of their U.S. legal professionals – to decide the pros and cons of renunciation. The process includes strategies to reduce or avoid the U.S. exit tax altogether when cutting ties with "Uncle Sam" properly.

Mr. Flynn adds that there are also non-tax implications to renunciation.

"If you change your mind years later, you're not going to get any special status just because you were a U.S. citizen before," he says. "You'll go to the back of the line, like everyone else trying to become a

U.S. citizen."

The U.S. government publishes the names of Americans who renunciate, he adds.

Mr. Flynn also says that Americans who renunciate are still subject to taxes on assets or income made in the U.S., similar to a Canadian who works or owns assets in the U.S.

"The difference is that you avoid the bigger net, which is on your worldwide income and worldwide assets because you're no longer a U.S. citizen," he says.