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4 Tax Tips For Counseling Clients On US Expatriation

By **Ama Sarfo**

Law360, New York (January 27, 2014, 11:30 AM ET) -- Last year witnessed the largest number of U.S. expatriations in history — an exodus so large that figures from the third quarter of 2013 exceeded total expatriations from the previous record-holding year, 2011, by roughly one-third. Media reports often characterize expatriates as mega-rich individuals seeking to avoid stiff U.S. taxes, but reality tells a different story, attorneys say.

While some expatriates certainly are guided by tax evasion motives, many more are normal citizens who live abroad and have become frustrated by the expensive and time-consuming process of filing annual U.S. tax returns, experts say. And the process will only become more costly and complex with the implementation of the Foreign Account Tax Compliance Act, which requires foreign banks to report tax information about U.S. account holders to U.S. or foreign governments.

"The tax complexity has become burdensome," said Philip Hodgen, an international tax attorney with Hodgen Law PC. "If you're a U.S. citizen living abroad, it costs about $3,000 or $4,000 to have your taxes prepared by a reputable source, and if you don't get them right, you pay $10,000 in fines. Many are finding that it just isn't worth it," he said.

Below are four tips attorneys say are indispensable when guiding clients who want to get rid of their U.S. passports for good.

Figure Out If Expatriation Is Right for Your Client

The ideal expatriation candidate is someone who has strong international ties, experts say. For example, a U.S. citizen who has dual citizenship or a long-term resident who plans to return to his or her home country likely will have a less complicated expatriation process, attorneys say.

"You have to have an alternate citizenship," said Dianne Mehany, a Caplin & Drysdale Chtd. associate who focuses on international tax planning. "There are some clients who think you can be stateless, and that's not right."

Many individuals with dual citizenship are unaware they are U.S. citizens until they reach legal age and encounter red tape with banks, for example, that makes renunciation appealing, according to Kenneth Vacovec, a tax partner with Vacovec Mayotte & Singer LLP.

"Perhaps they were born in the U.S. because their parents were working here, and returned to their native country when they were little, so they don't have any real ties to the U.S.," Vacovec said. "Once they reach their 18th birthday, they try to open a bank account, are asked for their birth certificate and are told the bank doesn't handle U.S. clients. It makes sense for those people."

Mehany added that an individual whose net worth is less than $2 million is an ideal candidates for expatriation, since such a person will miss the income threshold that would otherwise obligate them to pay an expatriation tax to the IRS.

On the other hand, high-wealth individuals whose assets are mainly rooted in the U.S. or whose children intend to stay in the U.S. should probably reconsider expatriation, since they will have to pay taxes on their U.S.-source income and their children will pay estate taxes, according to Mehany.

"At the end of the day, the U.S. will get their money," she said.

Determine If Your Client Is a Covered Expatriate

The Internal Revenue Service requires certain individuals — known as covered expatriates — to pay an expatriation tax before they leave the country. The tax applies to U.S. citizens whose net worth is $2 million or higher on the date of their expatriation, as well as individuals who had to pay an average $155,000 income tax for the five years preceding their expatriation. It also applies to individuals who fail to certify that they complied with their U.S. federal tax obligations for a five-year period before expatriation.

"The design is that you were a U.S. citizen when you made your millions, you enjoyed the benefits of citizenship, and now you should share that," Mehany said of the reasoning behind the exit tax.

Individuals can also evade the "covered expatriate" label by conducting some pre-exit planning that reduces their net worth, like fulfilling their $5 million estate tax exemption, according to Hodgen.

And they can make sure they've paid their federal tax debts for the preceding five years. Dual citizens who've lived outside the U.S. for 10 out of the past 15 years avoid the exit tax, unless they fail to show that they met their U.S. income tax obligations for the five years before expatriation, according to IRS rules.

Generally, expatriate candidates with U.S. tax debt have to pay penalties on the money they owe — unless they qualify for a new IRS review that eliminates penalties for low-risk taxpayers who have been living abroad since 2009 and haven't paid U.S. income taxes since then, according to Mehany.

Regardless, the amount of money that expatriate candidates have to pay to the government often is manageable, Vacovec says.

"Quite often the income is all foreign-source income and clients wind up getting a tax credit, so the tax liability in the U.S. usually is low," Vacovec said.

For this reason, Hodgen believes the exit tax is motivated more by political reasons than by any economic benefits. "It does not bring in any significant revenue at all, according to figures I've seen," he said.

Calculate Any Exit Tax

Individuals who qualify for the exit tax are treated as though they sold all of their worldwide property on the day before they expatriated, and are taxed on the gain from the sale. Although, the IRS currently excludes the first $663,000 from taxation, there are no exceptions to the tax, attorneys say.

"Some clients think you can avoid it if you turn everything into cash before you leave, but you've sold everything anyway, so you've paid taxes on it," Vacovec said.

However, permanent residents who have lived in the U.S. for less than eight out of 15 years aren't liable for the exit tax, according to the IRS.

And exit tax payments on some assets, like retirement assets, can be deferred, attorneys say.

Consider Post-Expatriation Liabilities

Just because you've successfully expatriated and are happily living abroad doesn't mean your tax obligations to Uncle Sam are done, attorneys say.

"You have three years to be audited, so the IRS could audit a client's exit year tax," Hodgen said. But he added that such audits are rare and normally occur when an individual commits a horribly blatant error.

"People want to get out, and so we do it correctly so there is a clean break," he added. "You don't poke the bear with a pointed stick."

More importantly, any income with a U.S. source will continue to be taxed by the federal government, regardless of the expatriate's new country of residence or citizenship status, attorneys say.

"If a client was teaching here and has expatriated, but has a TIAA-CREF, when he starts drawing on that, he'll pay taxes on that," Vacovec said.

--Editing by Kat Laskowski and Katherine Rautenberg.
