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Stay on top of changing U.S. rules

Now that the IRS has new powers to track taxpayers who live outside their country, it is especially important to track changes in the U.S. tax code that relate to these taxpayers. This can include both more tax relief and additional burdens

By Rudy Mezzetta | Mid-October 2014

If you have clients who are American citizens or green-card holders, you know that they often require expert cross-border tax advice.

That's because the U.S. bases its tax system on the right to permanent residence: American citizens and permanent residents must file a U.S. tax return annually on their worldwide income, regardless of where in the world they live. For the estimated one million Americans in Canada, that means filing a U.S. tax return every year as well as a Canadian tax return.

Here are three recent tax developments your American clients should be aware of:

- ***Kinder amnesty program***

In July, U.S. tax authorities offered an olive branch to Americans living abroad who haven't been filing U.S. tax returns or otherwise keeping up with their U.S. tax obligations. There now is a more forgiving amnesty program through which these individuals can become compliant.

"It is very good news," says Jamie Golombek, managing director of tax and estate planning with ***Canadian Imperial Bank of Commerce's wealth advisory services division***. "This is about as easy [a program] as you're possibly going to get."

The changes to the existing streamlined voluntary-disclosure program (VDP), originally introduced in 2012, include eliminating both the requirement that the taxpayer have less than US$1,500 of taxes owing in each of the previous three years and the need to fill out a risk-determination questionnaire. For all Americans abroad who are eligible for the streamlined VDP, penalties related to offshore non-compliance will be waived.

As part of this revised program, an American taxpayer still has to file three years of U.S. tax returns, plus six years of U.S. foreign bank and financial account information, using FinCEN Form No. 114. Finally, the individual would have to self-certify, using IRS Form No. 14653, that he or she didn't wilfully fail to file their tax information.

However, while the U.S. Internal Revenue Service (IRS) has made the VDP more lenient, it also made the Offshore Voluntary Disclosure Program (OVDP) stricter. The OVDP is for taxpayers whom the IRS considers to be wilfully non-compliant and who aren't eligible for the streamlined VDP. Under the OVDP, the IRS now requires more information from a taxpayer and will impose higher penalties in some circumstances.

- ***Health-care surtax***

Beginning in the 2013 taxation year, American taxpayers faced a new surtax - a net investment income tax (NIIT) for high-earning taxpayers - designed to help fund the provisions of the U.S. Patient Protection and Affordable Care Act, the new health-care legislation. This surtax also affects American taxpayers living abroad; but, unlike other U.S. tax liabilities, there is no relief in the form of foreign credits that can be claimed against the surtax.

"It was a bit of a surprise this year for some on their 2013 tax filings," says Terry Ritchie, director of cross-border wealth services with Toronto-based ***Cardinal Point Wealth Management LLC*** in Calgary, who adds that he alerted his clients in advance to the surtax.

How the NIIT works: couples who file jointly and who earn more than US$250,000 combined - as well as married individuals filing separately who earn more than US$125,000, or single individuals who earn more than US$200,000 - must pay a 3.8% surtax on their net investment income, which includes interest, dividends and capital gains. The NIIT is levied upon either the taxpayer's investment income or the excess of total income above the threshold, whichever is lower.

American taxpayers in Canada typically don't pay U.S. taxes because of the Canada/U.S. tax treaty. These individuals can apply foreign tax credits in the U.S. against the income taxes they pay in Canada. As Canada's tax rates tend to be higher than those of the U.S., American taxpayers in Canada usually don't have U.S. taxes owing.

The troubling issue with the NIIT is that because of where it appears in the U.S. Internal Revenue Code, there is no foreign tax credit that can be applied against this surtax. As a result, some American citizens living abroad found themselves owing money to the IRS in 2013, even if all their income was earned outside the U.S.

"People are angry," Ritchie says. "They don't like the fact that they're subsidizing a [health-care] system that they don't benefit from, and may never benefit from."

- ***Expatriations rise, as does the fee***

The number of Americans living abroad who are choosing to give up their American citizenship to avoid U.S. taxes continues to rise steadily, even as the costs and barriers to renouncing citizenship also increase.

In the first six months of 2014, 1,577 Americans renounced their citizenship. That was on pace to surpass last year's record total of 2,999 expatriations, which itself represented a huge increase from 2012, when just 932 Americans took the step.

Two key factors for this trend appear to be the onerous and ongoing compliance burden of keeping up with U.S. tax obligations, and the advent of the U.S. Foreign Account Tax Compliance Act, a law that effectively compels banks around the world to report on their American clients to the U.S. government. (See sidebar, above right.)

Expatriation is a difficult process. It involves taking a formal oath of the intention to renounce citizenship at a U.S. consulate or embassy. The expatriate also must file the previous five years of tax returns and other tax filings, if he or she hasn't already done so, and pay any taxes and penalties owing. The U.S. government also publishes the names of citizens who expatriate.

For wealthy would-be expatriates, there also may be significant "departure" taxes. And last month, the U.S. raised the fee to expatriate to US$2,350, up from US$450.

New rules add clarity to FATCA

Now that Canadian financial services institutions have begun collecting financial data about their American clients as part of an agreement between the two countries to exchange information, Americans in Canada will find it increasingly difficult to stay off the radar of the U.S. Internal Revenue Service (IRS).

"Three years ago, you might have gotten away by saying, 'I didn't know I had to file [a U.S. return]'," says Veronika Chang, who specializes in U.S. tax law with Toronto-based ***Morris Kepes Winters LLP***. "Now, that will be a harder argument to make."

Since July 1, Canadian financial services institutions have been following new compliance procedures that require them both to identify instances in which an American citizen, green-card holder or resident of the U.S. for tax purposes is opening a new account and to collect information about these clients, such as name, address, account balance and account number. These data are reported to the Canada Revenue Agency (CRA) for exchange with the IRS.

This process represents just the first stage in a three-year phase-in period of the Intergovernmental Agreement (IGA), through which the U.S. Foreign Account Tax Compliance Act (FATCA) will be implemented in Canada.

FATCA, passed into law in the U.S. in 2010, is aimed at preventing offshore tax evasion by American taxpayers. The law compels non-U.S. foreign financial services firms to report on their American clients or face a 30% withholding tax on all U.S.-source income paid to the institution or its clients. American taxpayers must file a tax return annually on their worldwide income, regardless of where they reside.

In February, Canada and the U.S. signed the IGA, which softens some of the more draconian elements of FATCA and provides greater clarity regarding the new regime's implementation.

Under the IGA, Canadian firms will collect and report information on American accountholders who have an aggregate balance of US$50,000 or more with the firm. However, balances in some tax-sheltered accounts, such as RRSPs and tax-free savings accounts (TFSAs), will not be reportable. The exclusion of these accounts from FATCA does not alter their tax treatment under the Canada-U.S. tax treaty. For example, while the U.S., in general, does recognize the tax-deferred status of the RRSP, it does not recognize the tax-exempt status of the TFSA, meaning that income earned in a TFSA by an American could be taxable in the U.S.

"A lot of people are getting tripped up over this distinction," says Jamie Golombek, managing director, tax and estate planning, with ***CIBC's wealth advisory services division***.

The first phase of implementation, the identification of new U.S.-reportable accounts, is followed by a second phase of identifying these accounts that existed prior to July 1, with a particular compliance priority on so-called "high-value" accounts, defined as those with an aggregate value greater than US$1,000,000. That second phase will be implemented between 2014 and 2016. The final stage involves the actual reporting of the information to the CRA, which will begin in May 2015 and be fully implemented by 2017.

There are some bumps as the result of the pre-existing system for keeping track of American taxpayers in Canada. That system uses so-called "U.S. qualified intermediaries" - usually non-U.S. banks that have agreements with the IRS - to withhold taxes owing by their clients on U.S. income.

"There is still some work that needs to be done to figure out how to make sure that [Canada's financial sector] meets the documentation requirements of two regimes," says Andrea Taylor, managing director of the Toronto-based ***Investment Industry Association of Canada***.