By **Barbara R. Hauser**

Offshore (But Still U.S.) Taxpayers

The IRS is here to "help"

"The time has come the Walrus said, to speak of many things, of shoes and ships and sealing wax, of cabbages and kings." (Alice in Wonderland)

In September 2012, the Internal Revenue Service began another "amnesty/voluntary disclosure" program—this time to help U.S. taxpayers who reside in other countries, many of whom are dual citizens living in the country they consider to be home. The IRS has had several programs to encourage the reporting of offshore income or accounts of U.S. taxpayers who live in the United States. Now, there's a complementary program focused on U.S. taxpayers who live overseas to encourage their reporting of global income and accounts.

Basics

Every U.S. citizen owes U.S. taxes on any income earned anywhere in the world.[1] This is true even if they never live in the United States. Because this policy is nearly unique in its geographic breadth (most countries tax only those who live within their borders), those who don't live in the United States—particularly those with a nationality of the place where they do live—don't know this or simply don't believe it.

In the short-hand jargon of immigration law, the United States applies both of the common tests for citizenship: "blood" and "dirt." So, individuals born in the United States, or born anywhere (but from U.S. parents), in general, will have U.S. citizenship, even if they're not aware of it.[2] (And, even if they haven't obtained a U.S. passport. A common myth that there's then no U.S. citizenship is wrong: They're U.S. citizens for all tax purposes.) The basic rule is that children can formally give up that citizenship before age 18½ without penalty.[3] After that, the exit tax provisions apply.

Delinquencies

What have these offshore U.S. taxpayers failed to file? First, of course, is the basic U.S. income tax form (and payment). Many offshore U.S. taxpayers believe they're exempt from all filing requirements if they earn less that the foreign earned income exclusion. However, to claim that exclusion, they're required to file a return.

They also believe that children don't need to file. But, there's no age limit for the IRS. If the parent isn't required to file a U.S. income tax return, but the child is a U.S. citizen, the child's age doesn't matter; only the minimum amount of income matters.[4] If the child is too young to sign a return, a parent can sign for the child. Some home tax advisors have (incorrectly) advised offshore U.S. taxpayers that if they work only for a home-country-based company, they don't owe U.S. taxes. Others advise taxpayers that if they don't use their U.S. passport when they open Swiss bank accounts, they don't owe any U.S. tax on those accounts. As onshore U.S. taxpayers know well, the IRS penalties can be severe. This also surprises those who live in countries where the residents may have a more casual attitude toward the payment of taxes.

In addition to income tax returns, the next most common delinquencies are: (1) the information returns, such as the Report of Foreign Bank and Financial Accounts (FBAR), required if there was more than $10,000 at any time during the year in any foreign financial account in which the U.S. taxpayer had an interest or over which the U.S. taxpayer had certain signing authority;[5] and (2) the new Form 8938 (Statement of Specified Foreign

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Financial Assets), which is required for accounts that had more than $50,000 on the last day of the tax year or $75,000 at any time during the tax year for a U.S. taxpayer living in the United States or for a U.S. taxpayer living elsewhere, if there was more than $200,000 on the last day or more than $300,000 at any time.[6]

In addition to the income tax and the informational returns, occasionally, a U.S. taxpayer (especially a dual national) will start a business in the home country, without giving a thought to the U.S. tax consequences, such as the complex controlled foreign corporation rules.

IRS Procedure

The IRS issued a press release in 2012, saying that it's "aware that some U.S. taxpayers living abroad have failed to timely file U.S. federal income tax returns or Report of Foreign Bank and Financial Accounts (FBARs)."[7] The IRS was concerned: "Some of these taxpayers have recently become aware of their filing requirements and want to comply with the law."[8] The IRS announced a new procedure for current non-residents including, but not limited to, dual citizens who haven't filed U.S. income tax and information returns to file their delinquent returns. The procedure went into effect on Sept. 1, 2012.

Under the procedure, taxpayers are required to file delinquent tax returns (with payments, including any interest) and any related information returns, for the past three years and to file delinquent FBARs for the past six years. The only taxpayers who may use this procedure are non-resident U.S. taxpayers, who've resided outside of the United States since Jan. 1, 2009 and haven't filed a U.S. tax return during the same period.

The new procedure will allow offshore taxpayers who are "low compliance risks" to get current with their tax requirements without facing penalties or additional enforcement action. The low risk filers are defined as people who generally will have simple tax returns and owe less than $1,500 in tax for any of the covered years.

The IRS will review some filings more thoroughly than others, depending on how it views the level of compliance risk. The risk level rises as the income rises, and also "[i]f there are indications of sophisticated tax planning or avoidance." There's a 20-question form[9] to fill out, with questions such as, "Did you rely on the advice of a tax professional for not filing required U.S. tax returns? If yes, is your tax advisor located in the U.S.?" Someone who chooses this route isn't allowed to participate in the voluntary disclosure program (which is another option to "catch up").[10]

FATCA

The U.S. legislative practice of adding revenue-producer sections to unrelated legislation that will have a cost resulted in the Foreign Account Tax Compliance Act (FATCA) being added to the Hiring Incentives to Restore Employment Act of 2010 to encourage employers (by giving tax incentives) to hire certain unemployed

> FATCA will require foreign financial institutions to report directly to the IRS.

persons. After 30 pages relating to the hiring incentives, there are some 20 pages containing the requirements for foreign financial institutions (FFIs) to report accounts that have presumed U.S. taxpayers. FATCA adds a new Chapter 4 to the Internal Revenue Code, entitled "Taxes To Enforce Reporting On Certain Foreign Accounts." It contains a number of new defined terms and extensive provisions (and penalties).

FATCA contains new reporting requirements for two groups. One is the U.S. taxpayers with foreign interests, who are getting used to having a variety of reporting requirements for their foreign interests. The second, however, is all FFIs that have accounts held, directly or indirectly, by U.S. taxpayers. As the IRS described it:

> Under FATCA, certain U.S. taxpayers holding financial assets outside the United States must report those assets to the IRS. In addition, FATCA will require foreign financial institutions to report

directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.[11]

FATCA was originally written to go into effect Jan. 1, 2013, but now has phase-in dates.

FATCA requires "foreign financial institutions" to enter into an agreement with the IRS:

(A) to obtain such information regarding each holder of each account maintained by such institution as is necessary to determine which (if any) of such accounts are United States accounts,
(B) to comply with such verification and due diligence procedures as the Secretary may require with respect to the identification of United States accounts,
(C) in the case of any United States account maintained by such institution, to report on an annual basis . . .[12]

The penalty for the failure to enter into the agreement is that:

In the case of any withholdable payment to a foreign financial institution which does not meet the requirements of subsection (b), the withholding agent with respect to such payment shall deduct and withhold from such payment a tax equal to 30 percent of the amount of such payment.[13]

FATCA also requires individuals to report "foreign assets":

(a) In General.—Any individual who, during any taxable year, holds any interest in a specified foreign financial asset shall attach to such person's return of tax imposed by subtitle A for such taxable year the information described in subsection (c) with respect to each such asset if the aggregate value of all such assets exceeds $50,000 (or such higher dollar amount as the Secretary may prescribe).

(b) Specified Foreign Financial Assets.— For purposes of this section, the term "specified foreign financial asset" means—

(1) any financial account (as defined in section 1471(d)(2)) maintained by a foreign financial institution (as defined in section 1471(d)(4)), and
(2) any of the following assets

which are not held in an account maintained by a financial institution (as defined in section 1471(d)(5))—

> **(A)** any stock or security issued by a person other than a United States person,
> **(B)** any financial instrument or contract held for investment that has an issuer or counterparty which is other than a United States person, and
> **(C)** any interest in a foreign entity (as defined in section 1473).[14]

FATCA was originally written to go into effect Jan. 1, 2013, but now has phase-in dates (see below). In the meantime, there are numerous questions about the scope of the provisions. In September 2010, the IRS published Notice 2010-60, which contains some 31 pages of clarification. In May 2011, the IRS published an additional 46-page notice, Notice 2011-34, as a supplement to Notice 2010-60, in which the IRS also "requests guidance." In 2012, proposed FATCA regulations were issued—at a length of 388 pages.

This set of reporting requirements has led many FFIs to refuse to hold any accounts for U.S. taxpayers. U.S. taxpayers are finding it increasingly difficult to maintain non-U.S. bank accounts, even in their non-U.S. country of residence. Offshore U.S. taxpayers are alarmed that their home banks will start reporting all of their accounts to the IRS.

On July 14, 2011, the IRS announced that in response to the various complaints it had received, there would be a phase in of FATCA, with the actual withholding not beginning until 2014.

Notice 2011-53 (the Notice) provides "a workable timeline for FFIs and U.S. withholding agents to implement the various requirements of FATCA." The Notice phases in the implementation of FATCA as follows:

- An FFI must enter an agreement with the IRS by June 30, 2013, to ensure that it will be identified as a participating FFI in sufficient time to allow withholding agents to refrain from withholding beginning on Jan. 1, 2014.
- Withholding on U.S. source dividends and interest paid to non-participating FFIs will begin on Jan. 1, 2014, and withholding on all withholdable payments (including on gross proceeds) will be fully phased in on Jan. 1, 2015.
- Due diligence requirements for identifying new and pre-existing U.S. accounts (including certain high-risk accounts) will begin in 2013. Reporting requirements will begin in 2014.
- For purposes of the Notice, high risk accounts include private banking accounts with a balance of $500,000 or more.

According to the Notice, the Treasury Department and IRS will "continue to work closely with businesses and foreign governments to implement FATCA effectively."

(For more information on FATCA's reporting regime, see "The Foreign Account Tax Compliance Act," by Eric van Aalst, in this issue, p. 52.)

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In 2012, the Treasury Department announced that it had developed a model agreement together with five significant countries:

> The model agreement … was developed in consultation with France, Germany, Italy, Spain, and the United Kingdom and marks an important step in establishing a common approach to combatting tax evasion based on the automatic exchange of information. These five countries, along with the United States, will, in close cooperation with other partner countries, the Organization for Economic Cooperation and Development, and, when appropriate, the European Commission, work towards common reporting and due diligence standards in support of a more global approach to effectively

combatting tax evasion while minimizing compliance burdens.[15]

The head of Treasury commented that:

> We appreciate that France, Germany, Italy, Spain and the United Kingdom were among the first jurisdictions to join us in this important effort and we look forward to quickly concluding bilateral agreements based on today's model.[16]

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As part of the agreement, there was a separate endorsement by the five countries, calling for a speedy conclusion of bilateral agreements based on the model.

The Treasury Department also negotiated separate agreements with Japan and Switzerland. Those agreements would allow banks in Japan and Switzerland to report directly to the IRS. (The agreement with France, Germany, Italy, Spain and the United Kingdom would have the financial institutions report to their local governments, which in turn would automatically send the information to the IRS.)

Exiting the U.S. Tax Regime

So, taken together, these requirements are increasing the interest of offshore U.S. taxpayers (especially dual citizens living in their home country) in opting out of the system. There's an impression that this is easier for dual nationals closer to, and living in, their home country, but in practice that may not be true.

The exit tax applies, as described on the IRS website, if any one of these conditions is met:

1. Your average annual net income tax for the 5 years ending before the date of expatriation or termination of residency is more than a specified amount that is adjusted for inflation ($151,000 for 2012); or
2. Your net worth is $2 million or more on the date of your expatriation or termination of residency; or
3. You fail to certify on Form 8854 that you've complied with all U.S. federal tax obligations for the five years preceding the date of your expatriation or termination of residency.[17]

Under two exceptions, discussed below, the first two tests will be waived, but the third test will still apply. This means that individuals must always certify that they've complied with all U.S. federal tax obligations for the previous five years, or they won't be able to use one of these two exceptions.

The first exception is for someone who became a dual citizen (United States and another) at birth and who continues to be a citizen of the other country (and is taxed as a resident of that country) and has been a resident of the United States for not more than 10 of the previous 15 years.

There's another exception for those who give up

SPOT LIGHT

Proud Parents

"The Alpha Pair" ($21\frac{1}{2}$ in. by $19\frac{1}{2}$ in.) by Bonnie Marris, sold for $25,875 at the Jackson Hole Art Auction in Jackson, Wyo. on Sept. 15, 2012. Marris, who has a degree in zoology and animal behavior, developed a talent for depicting animals "from the inside out." She strives to make the viewer feel the same passion as she does for her animal subjects.

their citizenship prior to age 18½ (provided they weren't a resident of the United States for more than 10 years).

For either of those exceptions to work, however, the individuals must also certify that they have complied with all U.S. federal tax obligations for the previous five years.

Unfortunately, for those unable to use one of the above two exceptions because they can't certify that they've fully complied for the previous five years, the alternative is to enter one of the "voluntary disclosure" programs. The current program requires compliance for the previous eight years. Usually, penalties are reduced (though they still can be significant), but not the past taxes or interest.

Help Wanted

As countries around the world increase their efforts to collect all possible taxes, it's unlikely that offshore U.S. taxpayers will receive much more help from the IRS than the limited policies currently in effect. As FATCA gets implemented, the need for help will dramatically increase, especially for the dual nationality taxpayers living outside the United States.

—The author thanks Brian Bassett, a partner at Ropes & Gray in Boston, for his helpful comments on a prior draft.

Endnotes

1. The income tax rules also apply to green card holders.
2. Children of diplomats aren't considered U.S. citizens if born in the United States during their parent's term of office. The specific rules that apply to birth outside of the United States to a U.S. parent have been changed often, requiring a detailed analysis based on the year of birth.
3. This won't apply if the child has lived in the United States for more than 10 years.
4. The amount in 2011 was $9,500.
5. The Internal Revenue Service says this Report of Foreign Bank and Financial Accounts form must be filed when:

   You are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title, or,

   You have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account.

   See www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements.
6. Those numbers are doubled for couples filing joint returns.
7. IR-2012-65, June 26, 2012.
8. *Ibid.*
9. The form is available at *www.irs.gov/pub/irs-utl/non-resident_questionnaire.pdf.*
10. *www.irs.gov/uac/Instructions-for-New-Streamlined-Filing-Compliance-Procedures-for-Non-Resident-Non-Filer-US-Taxpayers.*
11. *www.irs.gov/Businesses/Corporations/Summary-of-Key-FATCA-Provisions.*
12. Internal Revenue Code Sections 1471 (b)(1)(A)(B) and (C). *www.gpo.gov/fdsys/pkg/USCODE-2010-title26/html/USCODE-2010-title26-subtitleA-chap4.htm.*
13. IRC Section 1471(a).
14. IRC Section 6038D (a) and (b).
15. *www.treasury.gov/press-center/press-releases/Pages/tg1653.aspx.*
16. *Ibid.*
17. *See* IRC Sections 877A(g)(1)(A) and 877(a)(2), *www.irs.gov/Individuals/International-Taxpayers/Expatriation-Tax.*

SPOT LIGHT

Warchief

"Rain-in-the-Face" (20 in. by x 16 1/2 in.) by Charles Schreyvogel, sold for $166,750 at the Jackson Hole Art Auction in Jackson, Wyo. on Sept. 15, 2012. Rain-in-the-Face, the warchief of the Lakota tribe, was one of the Native Americans who defeated George Armstrong Custer and his cavalry at the Battle of Little Big Horn in 1876.