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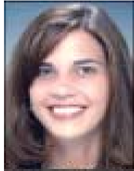
IRS pushes compliance for taxpayers abroad



U.S. TAX LAW

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The Internal Revenue Service has started to focus its attention on tax compliance issues involving U.S. citizens and resident aliens living abroad.

On March 23, IRS Commissioner Doug Shulman announced a settlement program for filers who voluntarily and timely disclose unreported offshore income to the IRS. The IRS also recently announced the addition of a special tax page to its Web site to address the tax issues of U.S. citizens and resident aliens living abroad. The fact sheet is part of the IRS' initiative to improve voluntary compliance with international tax provisions and to reduce the international tax gap.

Furthermore, Congress has proposed legislation addressing perceived offshore tax evasion. These initiatives are likely a response, in part, to the discovery of unreported offshore accounts held by many Americans at Swiss bank UBS AG. On Feb. 28, UBS AG of Switzerland entered into a deferred-prosecution agreement with the U.S. Department of Justice, acknowledging its role in helping U.S. residents evade domestic taxes by using Swiss bank accounts. Under the terms of that agreement, the United States will not criminally prosecute UBS, provided that UBS pays $780 million in restitution and unpaid withholding taxes to the United States, releases information on U.S. account holders and permanently ceases cross-border business for U.S. clients.

Residency tests

Unlike many other countries, the United States taxes U.S. citizens and resident aliens on their worldwide income regardless of where they are living. According to an IRS fact sheet, it is estimated that more than 7 million Americans reside outside the U.S.

A person is considered a resident alien of the United States if he or she meets either the "green-card test" or the "substantial-presence test." Under the green-card test, a person is considered a resident alien if he or she is lawfully admitted to the United States as an immigrant under U.S. immigration laws. This generally requires obtaining a type of visa known as a "green card." Residency continues under this test until lawful permanent-resident status is voluntarily relinquished, revoked or administratively or judicially determined to have been abandoned.

To meet the substantial-presence test, a person must be physically present in the United States on at least 31 days during the current year and on 183 days or more in the aggregate during the current year and two preceding calendar years. Days of presence are weighted as follows: (a.) days of presence in the current year are counted as a full day; (b.) days of presence in the first preceding year are counted as one-third of a day; and (c.) days of presence in the second preceding year are counted as one-sixth of a day. A person is generally considered present in the United States on any day that he or she is physically present in the United States at any time during that day.

There are certain exceptions that may apply to the two residency tests. For instance, a person may be able to claim residence of another country under an applicable income-tax treaty.

Minimizing tax liability

Although U.S. citizens and resident aliens living abroad must pay tax on their worldwide income, there are ways to minimize the tax owing if a person meets certain requirements while living abroad. For instance, she or he may be able to exclude from income a limited amount of foreign earned income, and may also be entitled to a foreign tax credit or itemized deduction for foreign taxes paid to another foreign country. An applicable income-tax treaty that the United States has with many foreign countries may also reduce the person's foreign tax liability.

In addition to filing a U.S. federal income-tax return (Form 1040), U.S. citizens and resident aliens living abroad may also have information-reporting obligations, such as Form 5471 (to report certain interests in foreign corporations) and Form TD F 90-22.1, known as the FBAR, or Report of Foreign Bank and Financial Accounts (to report certain interests in foreign financial accounts).

In October, the U.S. Treasury updated and substantially changed the FBAR form to require more detailed disclosure from a broader base of filers. The FBAR form is generally required to be filed by any U.S. person with a financial interest or signature authority over one or more financial accounts in a foreign country if the aggregate value of the account exceeds $10,000 at any time in a calendar year. The FBAR is due on June 30 following the year in which the filing requirements are met. One of the recent changes to the form modified the definition of a "U.S. person" to include a "person in and doing business in the United States." The definition of a

“financial account” was also expanded to include debit-card and prepaid credit-card accounts. The definition of “financial interest” also now extends to accounts “for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed.”

For instance, a U.S. person has a financial interest in a corporation’s bank or other financial account if he or she owns more than 50 percent of the corporation’s value or controls more than 50 percent of the corporation’s voting power. Similarly, a financial interest in a partnership’s bank or other financial account is now attributed to a person who owns an interest in more than 50 percent of the partnership profits or capital.

Penalties for noncompliance

The IRS can impose harsh penalties for failure to file the FBAR form. A civil penalty may be imposed up to $10,000. For willful violations, the penalty may be $100,000 or 50 percent of the balance in the unreported account, whichever is greater. Criminal penalties may also apply.

As noted above, the IRS recently released a settlement program and a new penalty framework to apply to voluntary disclosure requests involving offshore accounts. The new guidelines apply only to those who come forward on or before Sept. 23, 2009. The IRS has promised reduced penalties and the avoidance of criminal prosecution if taxpayers with unreported foreign accounts come forward now through the voluntary disclosure program.

Given the IRS’ continuing pressure on UBS to disclose the names of its American clients, the IRS hopes that this program will attract more taxpayers to come forward and file.

The settlement program involves filing six years of returns, including information returns, and the FBAR form. The IRS will assess either an accuracy or delinquency penalty for all years; no reasonable-cause exception will be applied. The agency will assess a penalty equal to 20 percent of the amount in foreign bank accounts in the year with the highest aggregate account/asset value. This penalty will take the place of all other penalties that could apply (including FBAR and information return penalties).

In light of the efforts by the IRS, Congress and the Treasury Department, the days of hiding income offshore are numbered. U.S. citizens and resident aliens living abroad should be aware of their U.S. tax filing requirements. Those who have not filed the FBAR form should consider coming forward under the new voluntary disclosure program.

Because it is likely the IRS will continue its international enforcement efforts, it is likely just a matter of time before the IRS discovers those who have not been filing or reporting offshore income.

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