# A RUNDOWN OF THE TOP 10 INTERNATIONAL TAX TRAPS: A PRACTICAL GUIDE TO TROUBLESHOOTING INTERNATIONAL COMPLIANCE ISSUES

Deidra W. Hubenak, JD, CPA, Gray Reed & McGraw, P.C., Houston, Texas
Austin C. Carlson, JD, CPA, Gray Reed & McGraw, P.C., Houston, Texas

This outline and associated presentation is meant to be a primer on common issues arising from international tax compliance requirements. It is not meant to be exhaustive, but rather hit the some of the biggest areas of tax compliance issues we see with clients. International tax compliance issues are becoming increasingly more common, and with the IRS continuing to tighten its enforcement on international issues, compliance with the law is as important now as ever. This outline's goal is to give you the tools so you know enough to spot these issues when they arise with a client so you can handle them before they end up with a delinquent return or unreported income.

Each of the 10 issues starts with a scenario, which is loosely taken from issues we have encountered with clients.

## List of Issues

1. **FBAR Reporting: Options for Resident Non-Filers**

2. **FBAR Reporting: Opting Out of the OVDP**

3. **FBAR Reporting: Signatory Authority**

4. **Reporting Gifts or Bequests from Foreign Persons**

5. **Income Tax Residency Status: When a Non-Resident Becomes a Resident under the Substantial Presence Test**

6. **Income Tax Residency Status: Treaty Tie-Breaks**

7. **Estate Tax Residency Status: When a Non-Resident Becomes a Resident**

8. **Form 5471 Reporting**

9. **Unreported Interest on Related Party Loans**

10. **Withholding on Payments to Foreign Persons**

## 1. FBAR Reporting: Options for Resident Non-Filers[1]

a. Scenario. A client (dual citizen of the U.S. and a foreign country) spent the last ten years living and working primarily abroad, even though the company she worked for was headquartered in the U.S. At the advice of a bank advisor, the client made a deal with her company to make all of her salary payments to foreign accounts. These accounts are now valued over $10MM and provide over $400,000 per year in interest income and dividends. The client has since moved back to the U.S. but has not closed the accounts. The client hired a CPA firm to file her returns over the last 10 years and timely filed returns and paid U.S. tax due on her salary, but has never reported the foreign interest and dividend income and has never filed an FBAR. She did not disclose the foreign accounts and income to her tax advisor.

b. Issue. The client is a U.S. person with foreign accounts and thus is required to file an annual FBAR to report the accounts. Additionally, since U.S. tax residents are taxed on their worldwide income, the client should have reported the foreign income on her U.S. tax return.

c. Basic Rule[2]. A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year.

d. U.S. Person. United States person means United States citizens; United States residents; entities, including but not limited to, corporations, partnerships, or limited liability companies created or organized in the United States or under the laws of the United States; and trusts or estates formed under the laws of the United States.

e. Financial Interest. A United States person has a financial interest in a foreign financial account for which:
   i. the United States person is the owner of record or holder of legal title, regardless of whether the account is maintained for the benefit of the United States person or for the benefit of another person; or
   ii. the owner of record or holder of legal title is one of the following:
      1. An agent, nominee, attorney, or a person acting in some other capacity on behalf of the United States person with respect to the account;
      2. A corporation in which the United States person owns directly or indirectly: (i) more than 50 percent of the total value of shares of stock or (ii) more than 50 percent of the voting power of all shares of stock;
      3. A partnership in which the United States person owns directly or indirectly: (i) an interest in more than 50 percent of the partnership's

[1] Note, there is are streamlined procedures available for non-resident non-filers with low amounts of tax due on unreported income. More information can be found here: http://www.irs.gov/uac/Instructions-for-New-Streamlined-Filing-Compliance-Procedures-for-Non-Resident-Non-Filer-US-Taxpayers

[2] See FBAR Instructions.

profits (e.g., distributive share of partnership income taking into account any special allocation agreement) or (ii) an interest in more than 50 percent of the partnership capital;

4. A trust of which the United States person: (i) is the trust grantor and (ii) has an ownership interest in the trust for United States federal tax purposes. See 26 U.S.C. sections 671-679 to determine if a grantor has an ownership interest in a trust;
5. A trust in which the United States person has a greater than 50 percent present beneficial interest in the assets or income of the trust for the calendar year; or
6. Any other entity in which the United States person owns directly or indirectly more than 50 percent of the voting power, total value of equity interest or assets, or interest in profits.

f. Foreign Financial Account. A foreign financial account is a financial account located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.

g. Options for Non-Filers

i. Do Nothing

If the IRS investigates and finds a non-filer, it can assert the following civil and criminal penalties, including the possibility of jail time:

1. Civil Penalties: Willful violations are assessed at the greater of $100,000 or 50% of the total balance of the foreign account for every year an FBAR was not filed[3]. This can result in a penalty many times greater than the account balance. For example, if a taxpayer sold his company overseas and held $2,000,000, the entire proceeds of the sale, in the account even just for a week, the penalty for the year could be $1,000,000, even if the account has a zero balance at the end of the year.
2. Criminal Penalties: The IRS can recommend prosecution under several criminal statutes including tax evasion, filing a false return, failure to file an income tax return, and willfully failing to file an FBAR, which would result in additional financial penalties and or jail time.

ii. File all Delinquent FBARs in a Quiet Disclosure if No Unreported Income

The IRS has released a FAQ relating to voluntary disclosures of unreported foreign income. The IRS has provided guidance for taxpayers that did not file

[3] 31 U.S.C. § 5321(a)(5)

FBARs but had no unreported foreign income. For those taxpayers who reported, and paid tax on, all their taxable income for prior years but did not file FBARs, the taxpayer should file delinquent FBARs according to the FBAR instructions and include a statement explaining why the FBARs are filed late[4]. The IRS will not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities and you have not previously been contacted regarding an income tax examination or a request for delinquent returns.

iii. File all Delinquent FBARs in a "Noisy" Disclosure

Many tax professionals are advising their clients with some unreported foreign income to follow a procedure similar to FAQ 17, and file amended returns, FBARs, a check for past due tax, standard penalties and interest and a statement explaining the reason for non-filing.

It is important to note that if the Taxpayer has any unreported foreign income or any unpaid U.S. tax, the IRS can assert the same penalties on delinquent filers filing this type of noisy disclosure as non-filers. If you have even one dollar of unreported interest or other income from a foreign account, the IRS could penalize you with the penalties described above on your delinquent FBARs.

iv. Enter the Offshore Voluntary Disclosure Program

The IRS has created a voluntary disclosure program for non-filers to disclose their previously unreported foreign accounts, foreign income, and unpaid U.S. tax. The program provides for significantly reduced civil penalties and no criminal prosecution for taxpayers that come to the IRS before the Justice Department initiates an investigation. To participate in the program, a taxpayer must submit FBARs and amended returns for the prior eight years showing previously unreported income and foreign accounts. The taxpayer will also have to pay the following:

1. Tax on unreported foreign income;
2. Standard statutory 20% accuracy penalty on unreported foreign income;
3. Interest on unpaid tax and penalties; and
4. Offshore Penalty – Instead of the severe civil penalties for non-filers, the Program asserts a 27.5% penalty on the highest value of all foreign assets with associated unreported income. For example, a foreign apartment with unreported rental income would be included in the penalty calculation. This penalty is only asserted once even if the failure to file FBARs was for multiple years.

[4] 2012 OVDP FAQ #17

v. Conclusion. This fact pattern is a prime example of an excellent candidate for the OVDP. The client worked with a foreign tax advisor to help shield foreign income. There is a significant amount of unreported income and high account balances. The client should enter into the OVDP to ensure lower civil penalties and no criminal exposure.

## 2. FBAR Reporting: Opting-Out of the OVDP

a. Scenario. A client used another professional help him enter into the OVDP. The client had only $75 per year of unreported foreign income on interest on a modest sized bank account that contained the client's inheritance from a foreign parent. The standard penalty calculation resulted in a $50,000 penalty. The client has no come to you to ask if there are any options other than to pay this penalty.

b. Issue. The client has the option to opt-out of the OVDP and, instead of the standard penalty, face a normal civil examination and statutory FBAR penalties.

c. Basic Rule. The IRS offers taxpayers the right at any time to opt-out of the standard 27.5% penalty and face a normal audit and statuary FBAR penalties. Taxpayers that opt out of the standard penalty:

1. Will not face criminal prosecution just like in the OVDP;
2. Will only owe tax, interest, and standard return penalties on the statuary statute of limitation rules instead of the prior eight years; and
3. Can receive a reduced FBAR penalty or no FBAR penalty if reasonable cause can be shown for the failure to file the FBAR.

d. Types of Penalties. Upon opting out of the OVDP, the taxpayer will face a normal civil examination. At the conclusion of the examination, the taxpayer will face one of three types of penalties: (1) Willful FBAR Penalty, (2) Non-Willful FBAR Penalty, or (3) No Penalty (Warning letter). Note, unlike the OVDP standard penalty, the IRS agent has discretion to adjust the amount of the penalty, subject to guidelines for each type of penalty.

e. Willful FBAR Penalty. For violations occurring prior to October 23, 2004, a penalty up to the greater of $25,000 or the amount in the account (up to $100,000) may be asserted for willfully violating the FBAR requirements[5]. For violations occurring after October 22, 2004, a willfulness penalty may be imposed up to the greater of $100,000 or 50% of the amount in the account at the time of the violation[6].

i. The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty.
ii. A finding of willfulness under the BSA must be supported by evidence of willfulness.

[5] 31 U.S.C. § 5321 (a)(5).
[6] *Id.*

iii. The burden of establishing willfulness is on the Service.
iv. If it is determined that the violation was due to reasonable cause, the willfulness penalty should not be asserted.
v. Willfulness is shown by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements. In the FBAR situation, the only thing that a person need know is that he has a reporting requirement. If a person has that knowledge, the only intent needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR.
vi. Under the concept of "willful blindness", willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements.
    1. An example that might involve willful blindness would be a person who admits knowledge of and fails to answer a question concerning signature authority at foreign banks on Schedule B of his income tax return. This section of the return refers taxpayers to the instructions for Schedule B that provide further guidance on their responsibilities for reporting foreign bank accounts and discusses the duty to file Form 90-22.1. These resources indicate that the person could have learned of the filing and recordkeeping requirements quite easily. It is reasonable to assume that a person who has foreign bank accounts should read the information specified by the government in tax forms. The failure to follow-up on this knowledge and learn of the further reporting requirement as suggested on Schedule B may provide some evidence of willful blindness on the part of the person. For example, the failure to learn of the filing requirements coupled with other factors, such as the efforts taken to conceal the existence of the accounts and the amounts involved may lead to a conclusion that the violation was due to willful blindness. The mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness.
vii. Willfulness can rarely be proven by direct evidence, since it is a state of mind. It is usually established by drawing a reasonable inference from the available facts. The government may base a determination of willfulness in the failure to file the FBAR on inference from conduct meant to conceal sources of income or other financial information. For FBAR purposes, this could include concealing signature authority, interests in various transactions, and interests in entities transferring cash to foreign banks.

f. Non-Willful FBAR Penalty. For violations occurring after October 22, 2004, a penalty, not to exceed $10,000, may be imposed on any person who violates or causes any violation of the FBAR filing and recordkeeping requirements in a manner that is not considered to be willful. The penalty should not be imposed if the violation was due to reasonable cause.

g. Reasonable Cause Exception to Non-Willful Penalty. If the taxpayer can establish reasonable cause, no FBAR penalty will be issued. Reasonable cause is a facts and circumstances test. Among the facts and circumstances that will be considered in determining whether reasonable cause exists are:

i. The taxpayer's education;
ii. Whether the taxpayer has previously been subject to the tax;
iii. Whether the taxpayer has been penalized before;
iv. Whether there were recent changes in the tax forms or law that the taxpayer could not reasonably be expected to know;
v. The level of complexity of a tax or compliance issue;
vi. Reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account;
vii. Evidence that the foreign account was established for a legitimate purpose;
viii. Evidence that there was no effort to intentionally conceal the reporting of income or assets; and
ix. Evidence that there was no tax deficiency related to the unreported account.

h. <u>Conclusion</u>. Considering the very small amount of tax due, moderate size of the bank account, and other facts showing that the client is not intentionally hiding income overseas, opting out offers an attractive option to receive potentially receive a lower penalty than the one assessed in the OVDP.

## 3. FBAR Reporting Example: Signatory Authority

a. <u>Scenario</u>. A client, who is a U.S. citizen residing in the U.S., has a parent who is a citizen of a foreign country that becomes severely ill. The client is given power of attorney for the parent. The parent has several foreign bank accounts. The client has no personal foreign accounts, assets, or businesses. The client has never filed an FBAR.

b. <u>Issue</u>. The client is a U.S. person with signatory authority over a foreign account and thus must file an FBAR in any year in which they retain the power of attorney over the account.

c. <u>Basic Rule</u>. As described in Issue 1 above, U.S. persons with signatory authority or a financial interest in a foreign account must report the account on an annual FBAR. A power of attorney would count as signatory authority.

d. <u>Conclusion</u>. This is a classic example we often see that would fall into 2012 OVDP FAQ 17 with no unreported foreign income. The taxpayer should file delinquent FBARs according to the FBAR instructions and include a statement explaining why the FBARs are filed late. The taxpayer will not face any FBAR penalties for the failure to file FBARs.

## 4. Reporting Gifts or Bequests from Foreign Persons

a. Scenario. A client, who is a U.S. citizen living in the U.S., has a distant foreign family member from Taiwan that recently passed away. The client will receive a sizable gift from the family member's estate.

b. Issue. Although there is no tax due on gifts or bequests from foreign persons, depending on the size of the gift or bequest, the U.S. person may have a reporting requirement.

c. Reporting Requirement.
   i. Basic Rule. A U.S. person must report on Form 3520 any gift from a foreign person if:
      1. The gift or bequest is valued at more than $100,000 from a nonresident alien individual or foreign estate (including foreign persons related to that nonresident alien individual or foreign estate); or

      2. The gift is valued at more than $13,258 (adjusted annually for inflation[7]) from foreign corporations or foreign partnerships (including foreign persons related to the foreign corporations or foreign partnerships).

   ii. Aggregation of Gifts. You must aggregate gifts received from related parties. For example, if you receive $60,000 from nonresident alien A and $50,000 from nonresident alien B, and you know or have reason to know they are related, you must report the gifts because the total is more than $100,000. Report them in Part IV of Form 3520. Treat gifts from foreign trusts as trust distributions you report in Part III of Form 3520.

   iii. Trap - Reclassification as Income. Make sure this is actually a gift. The IRS may re-characterize purported gifts from foreign partnerships or foreign corporations as items of income that must be included in gross income. Just like with domestic corporations, expect the IRS to closely scrutinize whether the foreign corporation or partnership actually gave this as a gift or is merely allowing the U.S. citizen to avoid recognition of income, particularly in related party situations

d. Filing Deadline. File Form 3520 separately from your income tax return. The due date for filing Form 3520 is the same as the due date for filing your annual income tax return, including extensions. You file an annual Form 3520 for all reportable foreign gifts and bequests you receive during the taxable year.

e. Penalties. A U.S. person who fails to make the required report within the prescribed time, including extensions, is subject to a penalty of 5% of the amount of the gift for each month that the failure continues, up to a maximum penalty of 25%. The penalty

[7] The inflation adjusted amount for 2014 is $14,000.

must be paid on notice and demand by IRS in the same manner as tax[8].

f. Other Issues to Consider. Is the asset a U.S. or foreign asset? For example, if the gift was 100% of the stock of a foreign corporation, valued at $500,000, the taxpayer would have to file the following:
   i. Form 5471 to report the Foreign Corporation;
   ii. Form 8938 to report the Foreign Corporation; and
   iii. If the Client and the Foreign Corporation has foreign bank accounts that aggregate over $10,000, the client will have to file an FBAR to report the corporation's accounts starting in the year he received the corporation's stock.

**5. Income Tax Residency Status: When a Non-Resident Becomes a Resident under the Substantial Presence Test.**

a. Scenario. Client is citizen of a foreign country and a U.S. E-2 visa holder. Client was present in the U.S. for 100 days in the prior two years and is planning on staying in the U.S. for 150 days in the current year.

b. Issue. Under the substantial presence test, Client will be considered a U.S. tax resident for the current year and be subject to U.S. tax on his worldwide income.

c. Residency Tests. The rules for income tax residency are found in I.R.C. § 7701(b). Under these rules, any alien (non U.S. citizen) who is not considered a resident alien is a non-resident alien. An alien is considered a resident alien if the alien meets one of the three tests:
   i. Green Card Test - Admitted to the U.S., or changing status to, a Lawful Permanent Resident under the immigration laws[9];
   ii. Substantial Presence Test - Meeting the substantial presence test based on number of days in the U.S[10]: or
   iii. First-Year Choice - Making what is called the "First-Year Choice" (a numerical formula under which an alien may pass the Substantial Presence Test one year earlier than under the normal rules)[11].

d. Substantial Presence Test Formula – To meet the substantial presence test, an alien must be physically present in the United States on at least:
   i. 31 days during the current year, and
   ii. 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting:
      1. All the days you were present in the current year, and
      2. 1/3 of the days you were present in the first year before the current year, and
      3. 1/6 of the days you were present in the second year before the current

[8] I.R.C. § 6039F.
[9] I.R.C. §7701(b)(1)(A)(i).
[10] I.R.C. §7701(b)(1)(A)(ii).
[11] I.R.C. §7701(b)(1)(A)(iii).

year.

e. Conclusion: Dealing with the Residency Issue. If the client being considered a U.S. resident for income tax treatment results in an unfavorable tax income, as it usually does, there are two options for the client:
    i. Stay few enough days to not meet the substantial presence test. Since the client stayed 100 days each over the last two years, he will need to stay 132 days of less this year to not meet the substantial presence test.
    ii. Qualify as a non-resident under a tax treaty between the U.S. and the client's country of citizenship (See next issue).

**6. Income Tax Residency Status: Treaty Tie-Breaks**

a. Situation. Client is citizen of a foreign country and a U.S. E-2 visa holder. Client was present in the U.S. for 100 days in the prior two years and has already stayed in the United States 190 days this year.

b. Issue. The client has already met the substantial presence test for the year and will be considered a U.S. resident for income tax purposes.

c. Tax Treaty Analysis. The U.S. has entered into double taxation treaties with over 65 countries.[12] Under these treaties, residents of foreign countries are taxed at a reduced rate, or are exempt from U.S. taxes on certain items of income they receive from sources within the United States. These reduced rates and exemptions vary among countries and specific items of income.

Many times a person will be considered a resident of two different countries under each country's tax laws. In order to avoid double-taxation, the tax treaties provide a set of rules that determines the person to be a resident of only one of the countries, overriding the tax law tests. For example, a Mexican citizen who meets the Mexican definition of residency, and is also a U.S. visa holder that meets the substantial presence test, could "treaty tie-break" under the U.S.- Mexico tax treaty and be considered a resident for Mexican tax purposes and a non-resident for U.S. Income tax purposes.

d. Residency Tie-Breaker Rules. Most of the treaties have a similar article for residency tie breakers. The following article is from the U.S. Mexico Tax Treaty. Article 4 of the treaty provides the residency tie breaker rules:

ARTICLE 4
Residence

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein

[12] http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z

by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. However, this term does not include any person who is liable to tax in that State in respect only of income from sources in that State.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his residence shall be determined as follows:

a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);

b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

d) in any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, such person shall not be treated as a resident of either Contracting State for purposes of this Convention.

e. Residency Tie-Breakers - "Permanent Home" Test. Article 4 gives preference to the country in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one country and has only made a stay of some length in the other country. The residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration. As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).

f. Residency Tie-Breakers: "Center of Vital Interest" Test. If the individual has a permanent home in both countries, it is necessary to look at the specific facts in order to determine which of the two countries his "personal and economic relations" are closer. Pers The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention.[13] If a person who has a home in one country sets up a second home in the other country while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his "center of vital interests" in the first State.[14] Some commentaries on the "center of vital interest" test (as it is applied internationally among many income tax treaties) have referred to the foregoing factors, as well as an intention of a person to spend their old age at a certain place, possession of an identity card, membership in a club, the exercise of a hobby, location of person friends, and even the location of family pets.[15]

g. Residency Tie-Breakers: Habitual Abode, Nationality, Mutual Agreement. If the individual has a permanent home in both countries, paragraph 2 of Article 4 gives preference to the country with which the personal and economic relations of the individual are closer: the "center of vital interests". In the cases where residency cannot be determined by reference to this rule, paragraph 2 of Article 4 provides as further criteria each of "habitual abode"[16], and then "nationality". If the individual is a national of both States or of neither of them under the foregoing tests, the question shall be solved by mutual agreement between the States concerned according to the procedure in Article 25.

h. Conclusion – Pay close attention to U.S. immigration status and the number of days stayed in the U.S. Even if the client is considered a U.S. resident for income tax purposes, you may be able to tie-break the client under a treaty to be a non-resident for U.S. income tax purposes.

**7. Estate Tax Residency Status: When a Non-Resident Becomes a Resident**

a. The Scenario. The client is a citizen of a foreign country on a temporary visa to visit family and suffers a serious medical issue. The client applies for lawful permanent residence (her green card) to allow for continued medical treatment in the U.S.

b. Issue. Depending on a number of facts and circumstances, the client could be

---

[13] Under the U.S. Model Treaty, "'Center of vital interests' considers the individual's family, employment, friends, personal possessions, and other similar criteria." Surviving a Heart Attack: Expatriation and the Tax Policy Implications of the New Exit Tax, Stephen A. Arsenault, 24 Akron Tax J. 37, 40 (2009).

[14] The words "personal and economic relations" were selected to pick up pecuniary and non-pecuniary interests. In the creation of the first model tax treaty by the OEEC (forerunner of the present OECD) in 1963, its drafters chose from among formulations which would have included only the stronger economic relations, only the stronger personal relations, and both economic and personal relations together. See Understanding the OECD Model Tax Convention: The Lesson of History, John F. Avery, 10 Fla. Tax Rev. 1, 18-19 (2009). Advice Memoranda of the IRS have referred to both the OECD model tax treaty and the US Model Treaty in interpreting particular income tax treaties, including for the "permanent home" and "center of vital interests" tests. See, e.g., IRS Memorandum to Charles Prince, May 1 1995, IRS Memorandum to Rosemary Sereti, April 18, 2012.

[15] See, e.g., Klaus Vogel on Double Taxation Conventions, Third Edition, Kluwer Law International 1997; ATO Interpretive Decision (ID 2011/53) (Australia), June 17, 2011.

considered domiciled in the U.S. and subject to the U.S. estate tax on her worldwide assets upon death.

c. Basic Rule. For purposes of the U.S. estate and gift taxes, an alien is considered a U.S. resident if he or she is domiciled in the U.S. at the time of his or her death or at the time of a gift. If an alien enters the U.S. for even a brief period of time, with no definite present intention of later leaving the U.S., he or she is deemed to be domiciled in the U.S. and, therefore, is considered a U.S. resident for estate and gift tax purposes.[17] Thus, an alien may be considered a nonresident for estate tax purposes and a U.S. resident for income tax purposes, or the opposite, since the estate tax residency test is the more subjective domicile test just described, while the income tax residency test is met if the alien satisfies an objective day count test known as the "substantial presence test" or holds a green card (*i.e.*, is a lawfully admitted permanent resident of the U.S.).[18]

d. Domicile Test. Some of the factors on which the IRS and courts focus[19] are:

e. Options to Avoid Residency Determination. The client has two options to avoid determination as a U.S. resident for estate tax purposes:
   i. Establish that she is a non U.S. domiciliary based on the factors above.
   ii. Tie-break under a U.S. Estate Tax treaty.

f. U.S. Estate Tax Treaties. The U.S. has estate and gift tax treaties with the following countries: Australia, Austria, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland, and the United Kingdom. Each of these treaties alters in some respect the rules discussed above with respect to the application of the estate and gift taxes to nonresident aliens who reside in these countries. A discussion of treaty tie-breaking is beyond the scope of the article, however the analysis is similar to the treaty tie-breaking in the income tax treaties.

## 8. Form 5471 Reporting

a. The Scenario. A client, who is a U.S. citizen, wholly owns several foreign corporations and has been timely filing his income tax return and required Form 5471s for the entities. The client acquired a 25% interest in a foreign corporation last year but did not file a Form 5471 for the corporation.

b. Issue. In any year a client owns or acquires an interest in a foreign corporation, the Form 5471 filing requirements should be looked at closely to see if there is a filing requirement. In this case, when a U.S. person acquires a greater than 10% interest in a foreign corporation, the U.S. person must file a Form 5471.

---

[17] Treas. Reg. §§ 20.0-1(b) and 25.2501-1(b).
[18] *See* Code § 7701(b)(1)(A).
[19] *See* Heimos, 837-2nd T.M., *Non-Citizens – Estate, Gift and Generation-Skipping Taxation*, Part III.C.4

c. Background. Form 5471 is required to be filed by U.S. persons to satisfy reporting requirements under I.R.C. Sections 6046 (acquisitions or dispositions of foreign corporate stock) and 6038 (information reporting in connection with certain foreign corporations). A U.S. person with reporting requirements for more than one foreign corporation must file a Form 5471 for each entity. The type of information required for a filer is based on which of the four categories of filers the filer meets[20]. If a U.S. person falls into multiple categories, the U.S. person must file all of the information required for each of the respective categories.

d. Filing Deadline. Form 5471 is due at the same time as the filing taxpayer's U.S. income tax return, including extensions.

e. Penalties for Non-Filing or Substantially Incomplete Filing. A taxpayer who fails to file a required Form 5471 can be subject to two different types of penalties for non-compliance:
   i. Monetary Penalties – A monetary penalty of up to $10,000 per year, for each foreign corporation[21].
   ii. Foreign Tax Credit Reduction – The failure to file may also result in a reduction of foreign tax credits[22].

f. Conclusion. If the taxpayer has no unreported foreign income and only failed to file the information return, the taxpayer should file the delinquent Form 5471, with an amended return with a statement explaining the reason for the late filing[23]. The taxpayer should file the amended return even if there are no changes to report other than the Form 5471.

   The IRS will not impose a penalty for the failure to file the delinquent Forms 5471 if there are no underreported tax liabilities and the client has not previously been contacted regarding an income tax examination or a request for delinquent returns[24]. Note, if there is unreported foreign income, the client will be faced with the issues in Issue 1 above and this procedure and availability of no penalties will not be applicable to the client.

**9. Unreported Interest on Related Party Loans**

a. Scenario. Client is the 100% owner of a U.S. corporation and a foreign corporation.

[20] The definition of "U.S. person" is different depending on the category of filers (2, 3, 4 and 5). Note that prior to 2004 there were five categories of filers; however the "Category 1" requirement was repealed in 2004. The other categories of filers have not been renumbered.
[21] I.R.C. §6038(b)(1)
[22] I.R.C. §6038(c)(1)
[23] The IRS has released a FAQ relating to voluntary disclosures of unreported foreign income. The FAQ also provides guidance on the late filing of Form 5471s. FAQ 18 of the 2012 OVDP FAQs provides the guidance explained above. The FAQ can be found here: http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers
[24] The client should include at the top of the first page of each information return "OVDI - FAQ #18" to indicate that the returns are being submitted under this procedure.

The foreign corporation has made an intercompany loan to the U.S. corporation. Interest has not been paid or accrued on the loan.

b. Issue. Interest must be charged on intercompany loans at rates that would be charged between unrelated parties.

c. Basic Rule. Interest on loans between related parties must be charged at an arm's length rate of interest. Treasury Regulation §1.482-2 states that, for advances or loans between related parties, the IRS may make appropriate allocations to reflect an arm's length rate of interest[25].

d. Safe Harbor. The regulation does provide safe haven rates tied to the applicable federal rate that, if used, would exempt the interest rate from being questioned by the IRS. The safe harbor rates for intercompany loans are between 100% AFR and 130% AFR based on the AFR in the month the loan was created[26]. The AFR to be used depends on the length of loan[27]. There are three lengths of loans, with different interest rates applied to each loan:
    i. Short Term – Three years or less
    ii. Mid-Term – Three to less than 9 years
    iii. Long-Term – More than years

e. No Safe Harbor for Other Currencies. The safe haven interest rates do not apply to any loan or advance that has the principal or interest expressed in a currency other than U.S. dollars[28].

f. Conclusion. The client should determine a safe harbor interest rate to charge retroactively from the beginning of the loan, based on the AFRs from the time the loan was originated.

**10. Withholding on Payments to Foreign Persons**

a. Scenario. The client runs a consulting business in the U.S. providing advice to customers worldwide. For a particular deal, the client hires an independent contractor who is a non U.S. citizen to come to the client's office in the U.S. for a week to help with a particular project.

b. Issue. The income earned by the independent contractor is U.S. source income (personal services income earned in the U.S.) paid to a foreign person. The client must withhold on the payments to the independent contractor.

c. Basic Rule. Generally, a foreign person is subject to U.S. tax on its U.S. source

[25] Treas. Reg. §1.482-2(a)(1)(i)
[26] Treas. Reg. §1.482-2(a)(2)(iii)(B) & (C)
[27] A list of the most current AFR, released by month, can be found here: http://apps.irs.gov/app/picklist/list/federalRates.html
[28] Treas. Reg § 1.482-2(a)(2)(iii)(E).

income. Most types of U.S. source income received by a foreign person are subject to U.S. tax of 30%[29]. A person that makes such a payment is required to withhold on the payment. If they do not withhold, they can personally liable for the tax due.

d. Compliance with Rule. Withholding on a payment of U.S. source income to foreign persons should be made on Form 1042 and related Form 1042-S.

e. Reduction by Treaty. A reduced rate, including exemption, may apply if an Internal Revenue Code Section provides for a lower rate, or there is a tax treaty between the foreign person's country of residence and the United States.

[29] The withholding rules are found in I.R.C. §1441-1443