A Top 10 Rundown of International Tax Compliance: A Practical Guide for Troubleshooting Issues

Austin C. Carlson, JD, CPA, Gray Reed & McGraw, P.C.


on-Filers
FBAR Reporting
3. Power of Attorney
The Situation
Issue
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.
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FBAR.
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.

1. FBAR Reporting: Options for Non-Filers

The Situation

- A client (dual citizen of the U.S. and a foreign country) spent the last ten years living and working primarily abroad.
- Company paid salary to foreign account, now valued over $10MM and and generates 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.
- Filed returns over the last 10 years 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.

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.
- Client has both civil and criminal exposure on FBARs and unreported income.

Basic Rule and Penalties

Basic Rule

- 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.

- **U.S. Person** – Citizens, Residents, and Entities. [illegible]
- **Financial Interest** – 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
- **Foreign Account** – Physically located outside the U.S.

Penalties

- **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.
  - This can result in a penalty many times greater than the account balance.
- **Criminal Penalties:** The IRS can recommend prosecution under several criminal statutes which would result in additional financial penalties and/or jail time.

Options for Non-Filers

1. Do Nothing

- If the IRS starts an investigation on a taxpayer, the taxpayer is no longer eligible for a voluntary disclosure.
- Civil and Criminal Penalties
- Increasing Risk: Bilateral Treaties and FATCA
- Balance with Resources of the IRS

2. Quiet/Noisy Disclosure

- No unreported foreign income - OVDP FAQ 17: No penalties
- "Noisy" Disclosure - unreported foreign income. Risks - Same penalties.
- Streamlined procedures for non-resident non-filers with minimal unreported income

3. Enter the OVDP

File 8 years of amended returns and FBARs. No criminal prosecution and reduced civil penalties, must pay:
- Tax on unreported foreign income;
- Standard statutory 20% accuracy penalty on unreported foreign income;
- Interest on unpaid tax and penalties; and
- 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.

Conclusion

Strongly consider the OVDP

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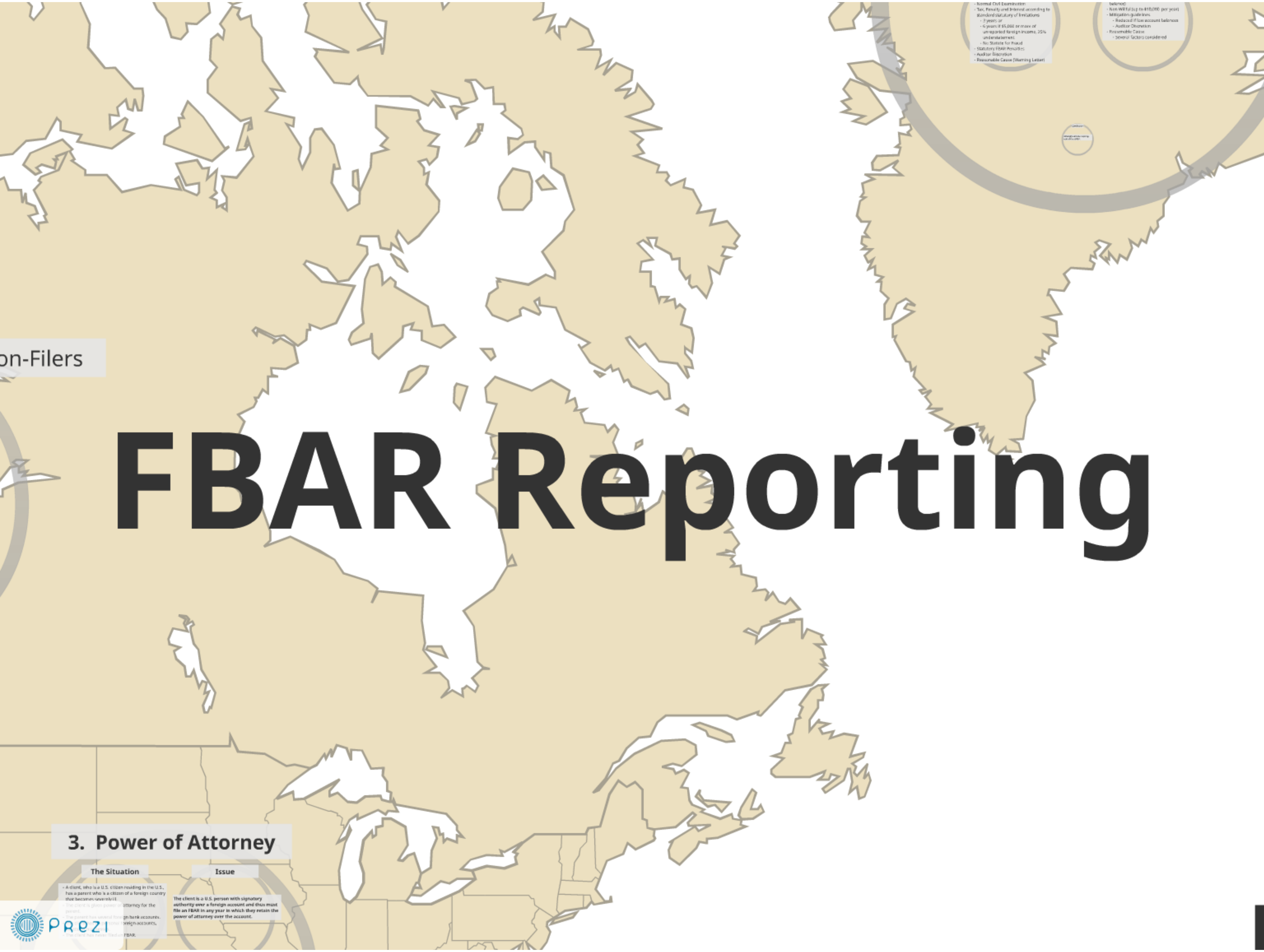

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2. Opting out of the OVDP

The Situation

- A client used another professional to help him enter into the OVDP.
- Only $75 per year of unreported foreign income on interest on a modest sized bank account.
- The standard penalty calculation resulted in a $50,000 penalty.
- The client has now come to you to ask if there are any options other than to pay this penalty.

Issue

The client must accept the penalty or opt-out of the OVDP.

What a Client Faces

- Maintains Protection from Criminal Prosecution
- Normal Civil Examination
- Tax, Penalty and Interest according to standard statutory of limitations
  - 3 years or
  - 6 years if $5,000 or more of unreported foreign income, 25% understatement
  - No Statute for Fraud
- Statutory FBAR Penalties
- Auditor Discretion
- Reasonable Cause (Warning Letter)

The Penalties

- Willful (50% of highest account balance)
- Non Willful (up to $10,000 per year)
- Mitigation guidelines
  - Reduced if low account balances
  - Auditor Discretion
- Reasonable Cause
  - Several factors considered

Conclusion

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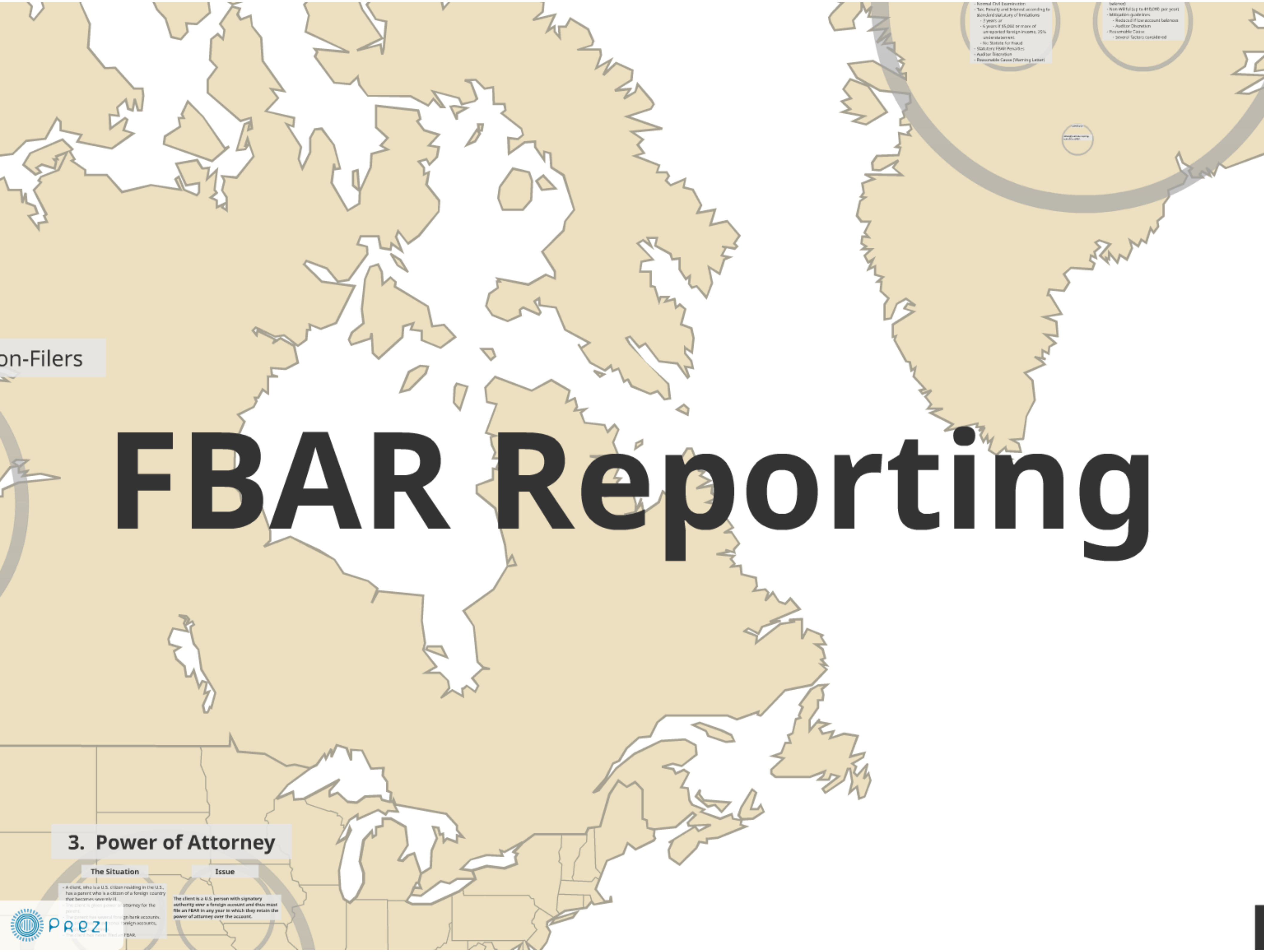

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- The client is given power of attorney for the parent.
- The parent has several foreign bank accounts.
- The client has no personal foreign accounts, assets, or businesses.
- The client has never filed an FBAR.

Issue

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.

Analysis and Conclusion

- Under FAQ 17, no penalties if no unreported income.

- Use the quiet disclosure discussed in Issue 1.

- File delinquent FBARs (all electronic now) and statement of why the FBARs are delinquent.

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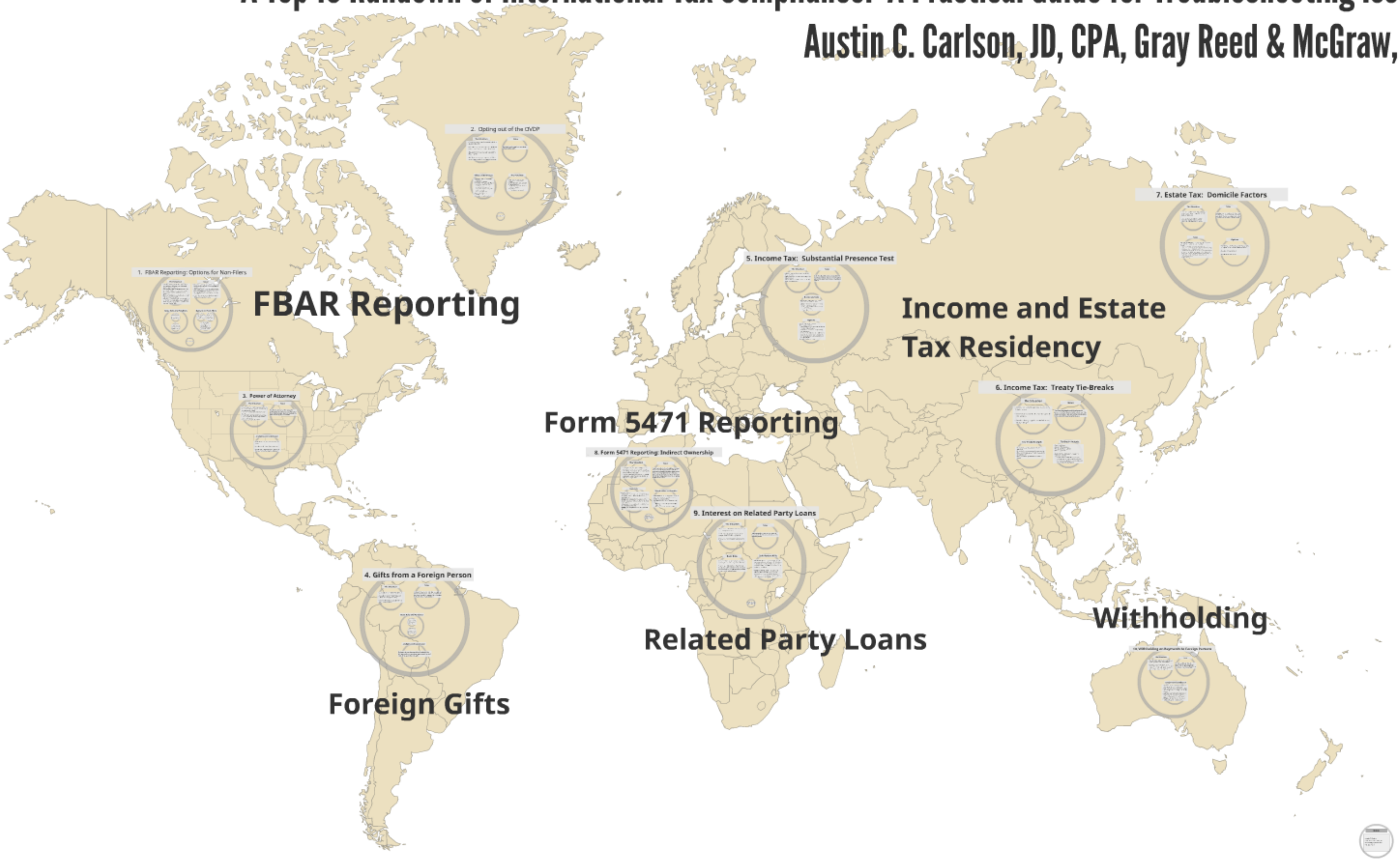

4. Gifts from a Foreign Person

The Situation

- 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.

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.

Basic Rule and Penalties

Basic Rule

Filing Deadline and Penalties

Analysis and Conclusion

If the gift is over the reporting threshold, the U.S. person has a reporting requirement by April 15th of the year after the gift.

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Basic Rule and Penalties

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- A U.S. person must report on Form 3520 any gift from a foreign person if:
  - 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
  - The gift is valued at more than $13,258 (adjusted annually for inflation) from foreign corporations or foreign partnerships (including foreign persons related to the foreign corporations or foreign partnerships).

- Aggregation of Gifts from Related Parties
- Reclassification of Gifts from Foreign Partnership and Corporations

Filing Deadline and Penalties

- **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.

- **Penalty**: 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%.

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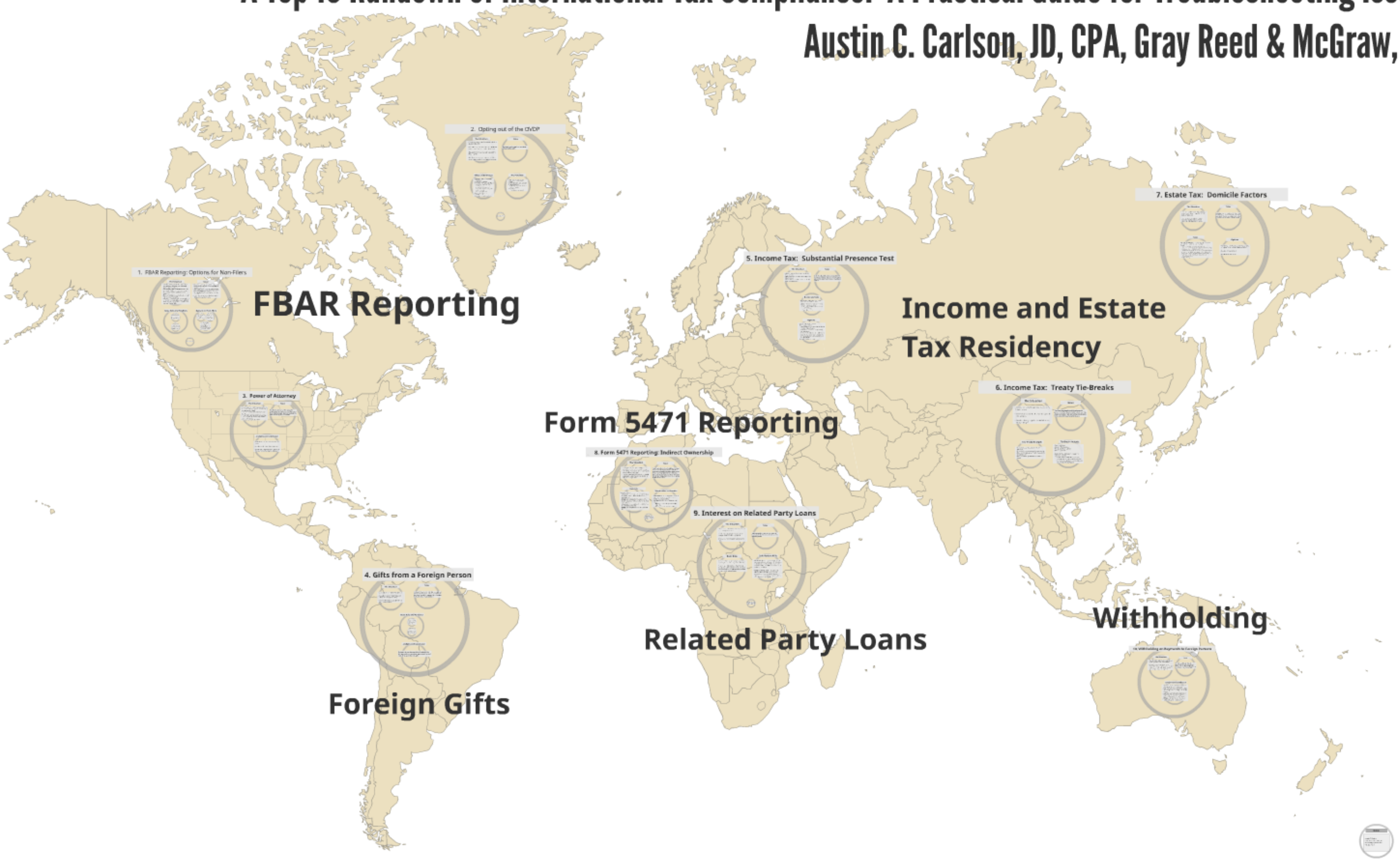

e Test

Income and Estate Tax Residency

6. Income Tax: Treaty Tie-Breaks

The 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
- Client has already stayed in the United States 190 days this year.

Issue

The client has already met the substantial presence test for the year (and cannot meet the closer connection test) and will be considered a U.S. resident for income tax purposes.

Tax Treaty Analysis

Tie-Break Analysis

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5. Income Tax: Substantial Presence Tes

The 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
- Client is planning on staying in the U.S. for 200 days in the current year.

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.

Residency Tests

- **Green Card Test** - Lawful permanent residents are U.S. resident aliens for U.S. income tax purposes.

- **Substantial Presence Test** - To meet the test, the alien must:
  - Be present 31 days in the current year
  - Be present 183 days during the 3 year period, current year and prior two years counting:
    - All days in current year
    - 1/3 of days in prior year
    - 1/6 of days two years prior

Options

- Stay less than 132 days this year
- **Closer connection test**:
  - Are present in the United States for less than 183 days during the year,
  - Maintain a tax home in a foreign country during the year.
  - Have a closer connection during the year to one foreign country in which you have a tax home than to the United States (similar to treaty tie-break)
- **Treaty Tie-Break** (next issue)

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Tax Treaty Analysis

- Is the client a U.S. resident alien for tax purposes?
- Is the client a tax resident of a foreign country?
- Does the U.S. have an income tax treaty with the foreign country?
- Can the client treaty-tiebreak under that tax treaty?

Tie-Break Analysis

- Permanent Home
- Center of Vital Interests
- Habitual Abode or National
- Mutual Agreement

- **Center of Vital Interests**: "Personal and economic relations"
  - Relevant facts include: family and social relations, occupations, political, cultural or other activities, place of business, the place of administration of property

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7. Estate Tax: Domicile Factors

The Situation

- 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.

Issue

Depending on a number of facts and circumstances, the client could be considered domiciled in the U.S. and subject to the U.S. estate tax on her worldwide assets upon death.

Issue

- **Basic Rule**- Domiciled in the U.S. at the time of death or gift. "no definite present intention of later leaving the U.S"
- **Factors**
  - the length of time spent in the U.S. and abroad
  - the value, size, and locations of the donor's or decedent's homes and whether he or she owned or rented them;
  - whether the alien spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.;
  - the situs of valuable or meaningful tangible personal property;
  - where the alien's close friends and family are situated;
  - visa/green card status
  - income tax filing

Options

- Do nothing - fall under U.S. citizen/resident alien exemption (note, martial deduction issues)
- Estate tax treaty tie break
- Establish domicile factors

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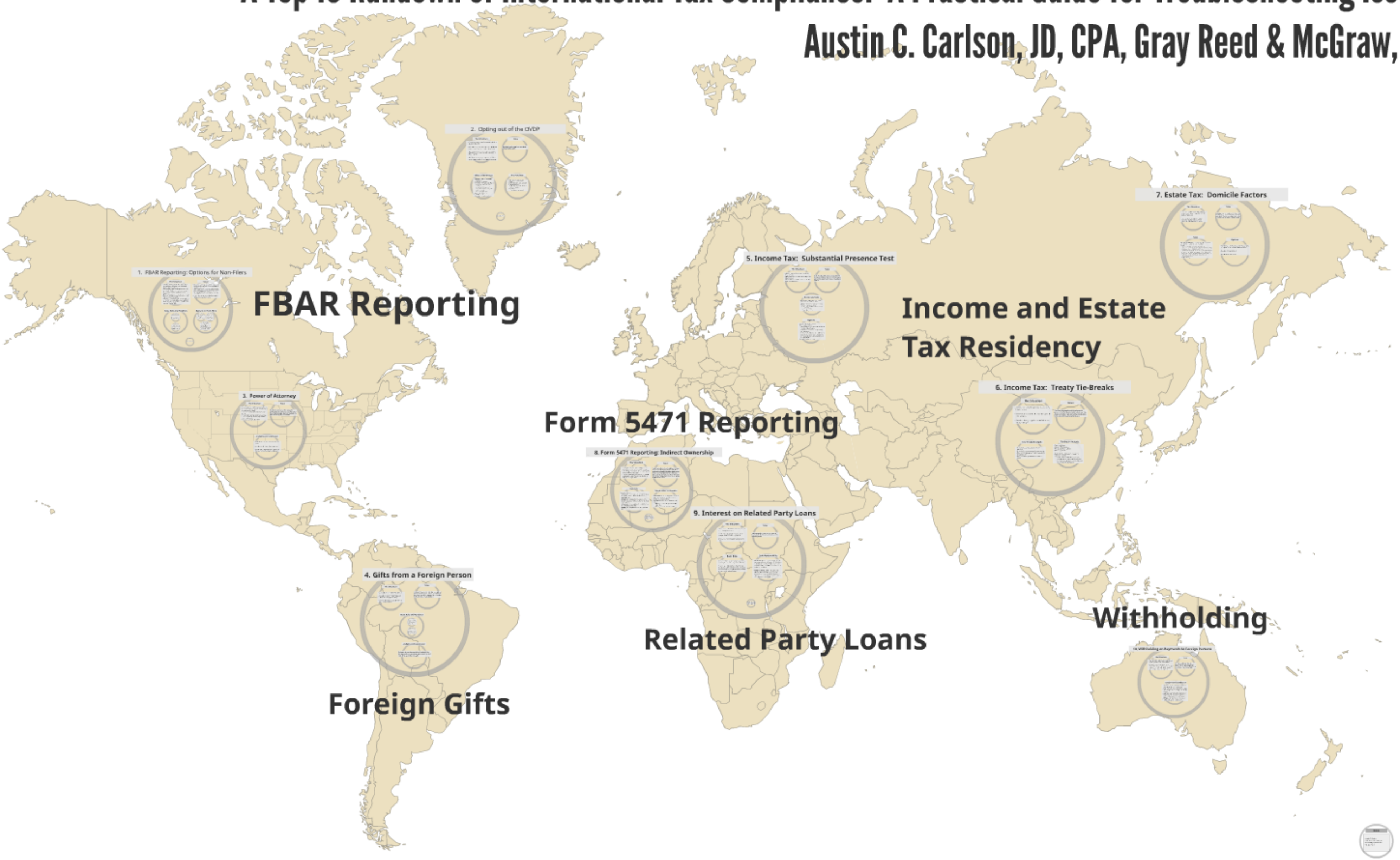

8. Form 5471 Reporting: Indirect Ownershi

The Situation

- 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.

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.

Basic Rule

Categories of Filers:

- **Category 2**: U.S. person is a officer of CFC where U.S. person has acquired 10% stock or an additional 10%
- **Category 3**: U.S. person who acquires 10% stock or disposes of sufficient stock to not meet ownership req.
- **Category 4**: U.S. person who has control of CFC for uninterrupted 30 days
- **Category 5**: U.S. person owns 10% or more of CFC

Filing Deadline and Penalties

- **Filing Deadline** - Form 5471 is due at the same time as the filing taxpayer's U.S. income tax return, including extensions.
- **Penalties** (includes substantially incomplete filing)
  - Monetary - $10,000 per year per foreign corporation
  - Foreign Tax Credit - Reduction in FTC

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. (FAQ 17)

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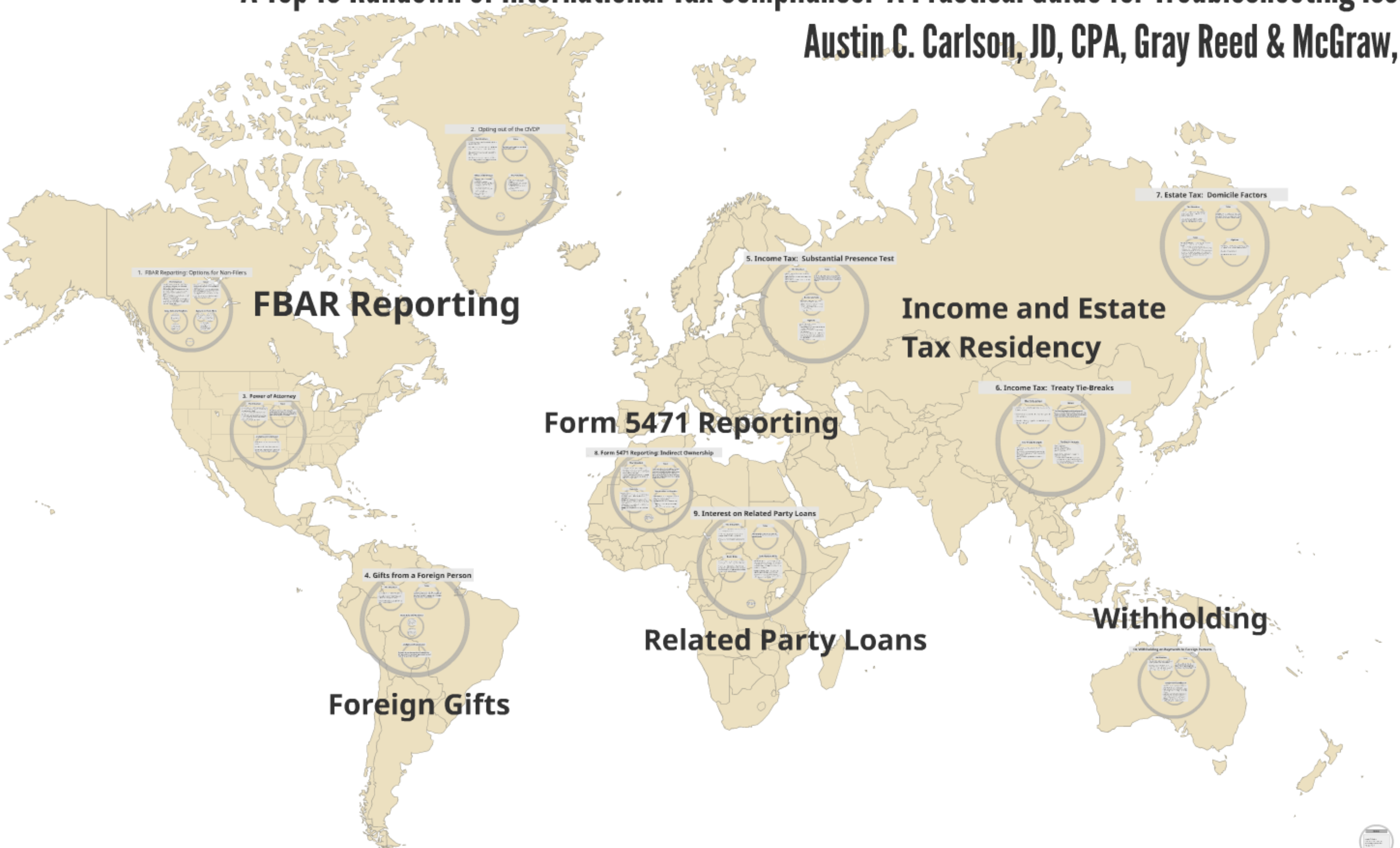

9. Interest on Related Party Loans

The Situation

- Client is the 100% owner of a U.S. corporation and a foreign corporation.
- The foreign corporation has made an inter company loan to the U.S. corporation.
- Interest has not been paid or accrued on the loan.

Issue

Interest must be charged on inter company loans at rates that would be charged between unrelated parties.

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 .

Safe Harbor: AFRs

- **Safe Harbor Rates -** 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 . The AFR to be used depends on the length of loan
- **Foreign Currency Loans** - 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 . *Treas. Reg § 1.482-2(a)(2)(iii)(E).*

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

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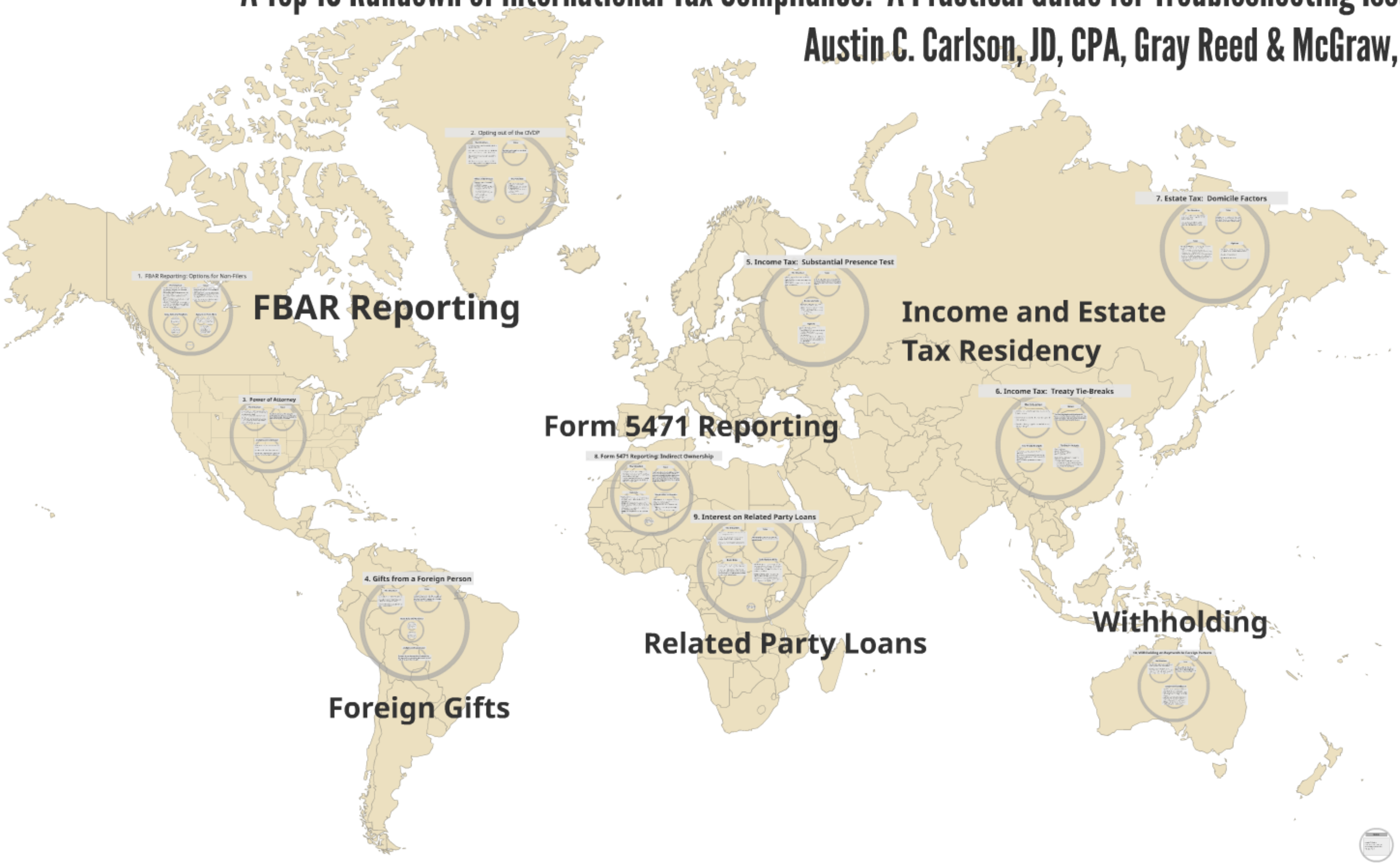

10. Withholding on Payments to Foreign Persons

The Situation

- 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.

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.

Analysis and Conclusion

- Generally, a foreign person is subject to U.S. tax on its U.S. source income.
- Most types of U.S. source income received by a foreign person are subject to U.S. tax of 30% .
- A person that makes such a payment is required to withhold on the payment. Personal liability for not withholding.
- Withhold using Forms 1042 and 1042-S
- Reduced Rates for Treaty Countries

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Questions

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