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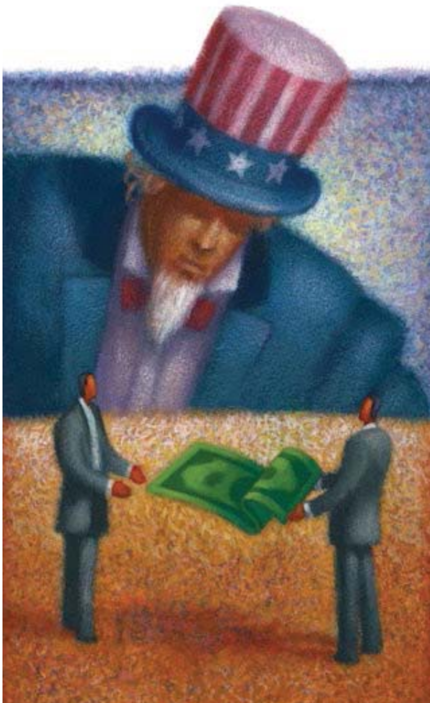

FATCA's Perfect Storm for Offshore Accounts

The United States taxes its citizens and permanent residents on their worldwide income. It does not matter in which country one resides, where the income is earned, or where else one might also pay tax. Every U.S. citizen or permanent resident must report worldwide income to the Internal Revenue Service.

Of course, the taxpayer may receive foreign tax credits for taxes paid elsewhere, which may offset some of the burden of paying tax in multiple jurisdictions. Tax treaties may help too, but treaties and tax credits rarely serve as a complete fix. These rules are not new, but enforcement is a different matter.

It isn't only U.S. worldwide tax reporting that is causing a stir. The related Report of Foreign Bank and Financial Accounts (known as FBAR) foreign account disclosures have become big business for U.S. enforcement. If you live overseas, you may not regard your local accounts as "foreign," but they are to the IRS. With draconian civil penalties and the risk of criminal prosecution, the "everyone does it" mentality about foreign accounts has faded quickly.

Finally, of course, there is FATCA, the Foreign Account Tax Compliance Act. FATCA puts the frosting on a U.S. enforcement policy that is sweeping and harsh. FATCA requires foreign banks to reveal American depositors with accounts of over $50,000. Noncompliant institutions could be frozen out of U.S. markets, so everyone is complying.

The U.S. worldwide tax reporting requirements are not new and have been a part of U.S. law for decades, as have FBAR filing requirements. FBARs date to 1970 and require filing for all non-U.S. accounts having a combined value of more than $10,000 at any time during the year. But compliance with all these rules was fairly low until the last five years or so.

Not anymore. In 2009, the IRS struck a groundbreaking deal with UBS (Switzerland's largest bank) for $780 million in penalties and disclosure of the names of American depositors. FATCA was enacted in 2010 as related enforcement developments were unfolding. But it took four years of ramp-up before FATCA's impact took hold.

The idea behind FATCA was to cut off companies' access to critical U.S. financial markets if they failed to pass along American data. More than 100 nations have agreed to the law, as have over 77,000 financial institutions. Even notoriously difficult China and Russia are on board.

Foreign Financial Institutions (FFIs, a term defined in FATCA) must report account numbers, balances, names, addresses, and U.S. identification numbers. For U.S.-owned foreign entities, FFIs must report the name, address, and U.S. Taxpayer Identification Number of each substantial U.S. owner. Some characterize this as a kind of global witch hunt. American indicia will likely mean a letter from the bank asking about U.S. compliance and stating the need to verify the information so the bank can be compliant with the United States as well.

FBARs Still Required

FATCA adds to the burden by including the filing of IRS Form 8938, but it does not replace FBARs. The latter have taken on huge importance since 2009. U.S. persons with foreign bank accounts exceeding $10,000 must file an FBAR by June 30. These forms are serious, as are the criminal and civil penalties.

FBAR failures can mean fines up to $500,000 and prison terms up to 10 years. Even a non-willful civil FBAR penalty can result in a $10,000 fine. Willful FBAR violations can draw the greater of $100,000 or 50% of the account for each violation – and each year is separate. The numbers can add up fast.

Republicans have mounted a FATCA repeal effort, although many observers think the likelihood of repeal is small. Meanwhile, Canadians have filed suit to block FATCA and to prohibit the handover of U.S. names to the IRS.[1] The suit claims the Inter-Governmental Agreement, under which

Canada can turn over private bank account information, is illegal.

IRS Voluntary Disclosure Programs

Starting in 2009, with changes in 2011, 2012, and 2014, the IRS has given taxpayers a way to resolve their noncompliance with these rules, and over the last five years, tens of thousands of people have done so. Since June 18, 2014, there are now several programs from which to choose.

The IRS has kept the Offshore Voluntary Disclosure Program (OVDP), involving eight years of amended tax returns and FBARs. You pay taxes, interest and a 20% penalty on whatever taxes you owe. Often, the amount of unreported income from the undisclosed accounts is fairly modest. However, for most people, there is also a 27.5% penalty on your highest offshore account balance.

In some cases, that penalty may be 50% depending on whether the taxpayer has accounts at a dozen or so already identified banks. Notably, this list of "bad banks" includes UBS and Credit Suisse, both of which settled charges with the United States. But even with the penalties, the OVDP is still highly attractive and better than the risk of higher penalties or even prosecution.

The Streamlined program can also be attractive, although it provides fewer assurances than the OVDP. The OVDP protects you from prosecution, while the Streamlined program does not. The OVDP costs more, but you get more. And if the taxpayer has bad facts, the OVDP absolves them.

In contrast, the Streamlined program hinges on the taxpayer certifying under penalties of perjury that he or she was non-willful. Caution is in order here, since the IRS can examine the taxpayer. If there are signs your tax missteps were willful, the IRS may be harsh.

The Streamlined program actually consists of a Domestic Streamlined program for people in the United States, and a Foreign Streamlined program for those living abroad. Both Streamlined programs involve three years of tax returns, not eight. Both Streamlined programs require FBARs for six years instead of three, to match the six-year FBAR statute of limitations.

The Foreign Streamlined program has no penalty. The Domestic Streamlined program applies a 5% penalty to the highest year-end balance in the offshore accounts over the six FBAR years. It is inevitable that taxpayers may gravitate to the Streamlined program.

Indeed, if you are not worried about the willfulness element of your facts, comparing the 27.5% OVDP penalty with the 5% Domestic Streamlined penalty seems like a no-brainer. Yet as it turns out, there are differences in how the 5% and the 27.5% penalties are computed. The Domestic Streamlined penalty is calculated on the year-end account balances and year-end asset values.

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This is different from the OVDP which typically requires you to take the highest value of the account during the year.[2] More important than what goes into the penalty is what you can take out. For the 27.5% OVDP penalty, you can typically remove accounts that are tax compliant but were not reported.[3] The Domestic Streamlined base is broader. For the 5% Domestic Streamlined penalty, you must include all accounts that were either unreported or tax non-compliant.

For those people already in the OVDP process before July 1, 2014, but who still have open cases, the IRS has a Transitional Relief program. You still go through eight years of tax returns and FBARs, and you also make a non-willful certification. The result is a kind of blend: the security of the OVDP, but instead of the 27.5% penalty, you can get a 5% Streamlined penalty.[4]

Clients who reported all of their income and paid all of their taxes but forgot to file FBARs may be able to escape the penalties entirely by sending in their delinquent paperwork. This used to be covered under OVDP FAQs #17 and #18, but the IRS has rebranded them under the Delinquent FBAR and Delinquent International Information Return procedures.[5] However, you should be careful with these too, as the IRS can be harsh if it thinks you are willful.

To get beyond the reach of the IRS, a citizen must give up U.S. citizenship. A permanent resident (green card holder) must give up that status. It is also relevant to distinguish between residents and long-term residents. That is, how long has the person had a U.S. green card?

A long-term resident is a non-U.S. citizen who has been a lawful permanent resident of the United States for at least eight years during the 15-year period before that person's residency ends. Nevertheless, a person is not treated as a lawful permanent resident for purposes of this eight-year test in a year in which that person is treated as a resident of a foreign country under a tax treaty, and who does not waive the treaty benefits applicable to the residents of that country. However, as a word of caution: holding a green card for even *one day* during a year will taint the whole year.

Tax Avoidance and Exit Tax

The U.S. tax law on expatriating changed multiple times over the last few decades. For example, in 2004, Congress discarded tax avoidance motives altogether. In 2008, Congress made further changes. A law generally known as the Heroes Act changed the method of taxation for those who became expatriates on or after June 17, 2008, adding more complexity and, usually, higher U.S. taxes.

This remains the current law. If a U.S. citizen or long-term resident expatriates on or after June 17, 2008, the expatriate is deemed to have sold all of his or her worldwide property

for its fair market value *the day before* leaving the United States. This deemed gain is subject to U.S. tax at the capital gain rate.

However, none of the exemptions, exclusions, non-recognition or rollover provisions in the tax code that might provide tax relief will apply. The exit tax is analogous to an estate tax. Just as all assets that would be part of one's estate would be included in one's gross estate, the expatriate's assets will be subject to income tax on unrealized gains as of the day before the person expatriates.

But there are exceptions to its application. First, there is the net annual income tax threshold. An individual is subject to expatriation tax only if he or she has an average net annual income tax of $160,000 for the five years preceding expatriation or has a net worth of $2 million or more on the date of expatriation. But another way of being hit with this exit tax is if you fail to certify on Form 8854 that you have complied with all U.S. federal tax obligations for the five years preceding the date of your expatriation or termination of residency.

There is also a gain-on-sale threshold. If a taxpayer has less than $600,000 of income from the deemed sale of assets on expatriation, there is no tax due. This exemption amount is adjusted for inflation ($690,000 for 2015 and $680,000 for 2014). If the expatriate's gain exceeds this amount, he or she must allocate the gain pro rata among all appreciated property.

Nonetheless, this exclusion amount must be allocated to each item of property with built-in gain on a proportional basis. This involves a complicated process of multiplying the exclusion amount by the ratio of the built-in gain for *each gain asset* over the total built-in gain of *all gain assets*. The exclusion amount allocated to each gain asset may not exceed the amount of that asset's built-in gain.

Moreover, if the total allowable gain of all gain assets is less than the exclusion amount, the exclusion amount that can be allocated to the gain assets will be limited to that amount of gain. For example, in 2015, if the total allowable gain in an expatriate's assets was $500,000, then that $500,000 would be the limit instead of $690,000. As this suggests, there are traps here, so be careful.

Is anyone exempt? Yes, some people born with dual citizenship who have not had a substantial presence in the United States are exempt, as are certain minors who expatriated before the age of 18½. Still, these people must file an IRS Form 8854 Expatriation Information Statement.

Taxpayers who are subject to the exit tax are entitled to make an irrevocable election to defer the tax until actually selling the property. This election allows people to leave the United States and to expatriate without triggering immediate tax. To qualify, a covered expatriate must provide a bond or other adequate security for the tax liability.

Conclusion

It is unlikely that anyone relishes the prospect of doing paperwork. There is no question that U.S. tax compliance can be daunting. Indeed, most people with their feet in several countries regard the U.S. tax and reporting laws as among the more onerous worldwide.

And if the last five years of IRS, Justice Department and U.S. legislative actions have taught us anything, it is that these rules are nothing to take lightly. In the author's experience, most persons considering giving up a U.S. passport or green card are considering a variety of issues, not the least of which may be family worries. When one adds such uncertainties about family worries to what can be big dollars at stake, the decision can be daunting indeed.

Often, the person considering giving up a U.S. green card or passport is currently not compliant. That can make the decision more complex, since the best way of cutting off all liability in the future is usually to become compliant first and then to expatriate. That can seem like applying to college for the sole purpose of dropping out. Inevitably, some taxpayers who do get compliant with the IRS end up deciding not to expatriate after all.

Regardless of how grave the situation may seem, there is almost always a way to address it. That is far better than the increasingly dangerous approach of ignoring these issues. ■

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1. *See Virginia Hillis & Gwendolyn Louise Deegan v. Attorney Gen. of Can.*, Case No. F1736-14, Federal Court of Vancouver.

2. *See* 2014 OVDP FAQ#31, http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers-2012-Revised.

3. *See* 2014 OVDP FAQ#45.

4. *See* Transitional FAQ#5 and #9, http://www.irs.gov/Individuals/International-Taxpayers/Transition-Rules-Frequently-Asked-Questions-FAQs.

5. *See* IRS Delinquent International Information Return Submission Procedures (updated Oct. 9, 2014), http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-International-Information-Return-Submission-Procedures.