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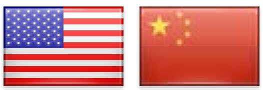
US Tax Law Worries for Chinese Families and Companies



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The U.S. and China enjoy increasingly strong connections. Yet virtually no Chinese family or business relishes dealing with the Internal Revenue Service (IRS). American tax laws are famously complex, and dealing with the IRS can be like quicksand. Of course, whether they like it or not, U.S. citizens and green card holders (U.S. permanent residents) must deal with the IRS.

They must file their tax returns with the IRS on a worldwide basis, even if they are resident and paying taxes elsewhere. There was a time when the only Chinese persons worrying about such issues were U.S. citizens and permanent residents. Increasingly, though, many others having more attenuated connections with the U.S. must also now consider these rules and their IRS exposure.

For example, Chinese companies with U.S. shareholders now face increasing reporting and disclosure rules. FATCA, the Foreign Account Tax Compliance Act, has expanded America's tax reach into many foreign countries, including China. And the U.S. is enforcing its tax laws more vigorously than ever.

FATCArequires foreign banks to reveal Americans with accounts over $50,000. Non-compliant institutions can be frozen out of U.S. markets, so institutions worldwide are complying.Despite the uptick in enforcement, U.S. worldwide tax reporting has been a part of U.S. law for decades.

FBARs date to 1970, requiring filing for any non-U.S. account(s) having a combined value of more than $10,000 at any time during the year. Compliance with all these rules was fairly low until the last 6 or 7 years. In 2009,the IRS struck a groundbreaking settlement with UBS for $780 million in penalties and the disclosure of thousands ofAmericans with UBS accounts.

FATCA was enacted in 2010, as related enforcement developments were unfolding.

FATCA's idea was to cut off companies from access to critical U.S. financial markets if they failed to pass along American data. More than 100 nations have agreed to the law, including China. 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, they must report the name, address, and U.S. Taxpayer Identification Number of each substantial U.S. owner. American indicia will likely mean a letter from the bank asking about U.S. compliance and the need to verify that so the bank can also be compliant with the U.S.

FBARs Still Required

FATCA does not replace FBARs. U.S. persons with foreign bank accounts exceeding $10,000 must file an FBAR by each June 30.These forms are serious, and so are the criminal and civil penalties.

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

Form 5471 filing

Currently, there are four categories of persons that must file Form 5471, ranging from Category 2 through Category 5. Category 1 was eliminated in 2004. A Category 2 filer includes a U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person acquires shares representing 10 percent or more of the aggregate voting power or value of the corporation.

A "U.S. person" is a citizen or a resident of the U.S., a domestic partnership or corporation, or a domestic estate or trust. A corporation or partnership is considered "domestic" if it was organized in the U.S. or under the laws of the U.S. or of any state.

A trust is considered "domestic" if a court within the U.S. is able to exercise primary supervision over the administration of the trust or one or more U.S. citizens or residents have the authority to control all substantial decisions of the trust. An estate is usually considered "domestic" if the income of the estate is subject to U.S. income tax.

Generally, a Category 3 filer is a U.S. person who during the year:

- Acquires 10 percent of the voting or participating shares in a foreign corporation;

- Acquires voting or participating shares that, when added to the shares owned on the date of acquisition, equals or exceeds 10 percent or more of the voting or participating shares; or

- Disposes of voting or participating shares in a foreign corporation that reduces ownership to less than 10 percent.

A Category 4 filer is a U.S. person who owned more than 50 percent of the aggregate voting power or value of a foreign corporation for at least 30 days during the foreign corporation's year. While Form 5471 is required for Category 2 and 3 filers only for the year in which the relevant transactions occur, a U.S. person should file Form 5471 for each year in which the more than 50 percent ownership threshold is met.

Generally, a Category 5 filer is a "U.S. shareholder" (as defined herein) who owned stock in a foreign corporation that is a controlled foreign corporation

(CFC). The stock must have been owned for at least 30 days during the year, as well as owned on the last day of the year. A U.S. shareholder is generally defined as a U.S. person who owns 10 percent or more of the voting shares of a CFC.

Generally, a CFC is a foreign corporation that has persons qualifying as U.S. shareholders that own more than 50 percent of the voting or participating stock of the corporation on any day of the year. As with Category 4 filers, a U.S. person should file Form 5471 for each year in which the Category 5 requirement is met.

IRS Audit Periods and Penalties

When a U.S. shareholder holds more than 50 percent of the vote or value of a foreign corporation, the company is a controlled foreign corporation or CFC. A U.S. shareholder is a U.S. person who owns 10 percent or more of the foreign corporation's total voting power.That triggers reporting, including filing an annual IRS Form 5471.

It is an understatement to say this is an important form. Failing to file it means penalties, generally $10,000 per form. A separate penalty can apply to each Form 5471 filed late, and to each Form 5471 that is incomplete or inaccurate.

What's more, this penalty can apply even if no tax is due on the return. That seems harsh, but the next rule—about the statute of limitations—is even more surprising.

The IRS normally gets three years to audit. But if you have a CFC and fail to file a required Form 5471, your tax return remains open foraudit indefinitely.

This statutory override of the normal IRS statute of limitations is sweeping. The IRS not only has an indefinite period to examine and assess taxes on items relating to the missing Form 5471. In fact, the IRS can make any adjustments to the entire tax return with no expiration until the required Form 5471 is filed.

You might think of a Form 5471 like the signature on your return. Without a signature under penalties of perjury, a tax return really isn't a tax return. Similarly, without a required Form 5471, the tax return will remain open.

What if there is no CFC because U.S. shareholders do not own over 50 percent? Forms 5471 are not only required of U.S. shareholders in CFCs. They are also required when a U.S. shareholder acquires stock that results in 10 percent ownership in any foreign company.

The harsh statute of limitation rule for Form 5471 was the result of the HIRE Act passed March 18, 2010. Not coincidentally, this was the same law that brought us FATCA. Bottom line: be careful with CFCs and with Form 5471.

IRS Voluntary Disclosure Programs

The presence of all of these tough rules may cause some U.S. citizens and residents to consider how to correct their past failings. Starting in 2009, with changes in 2011, 2012, and 2014, the IRS has given taxpayers a way to resolve their noncompliance with these rules. SinceJune 18, 2014, there are now several programs from which to choose.

The IRS has kept the Offshore Voluntary Disclosure Program or OVDP, involving 8 years of amended tax returns and FBARs. The OVDP involves paying taxes, interest and a 20 percent penalty on any unreported income, plus a 27.5percent penalty on the highest offshore account balance. The Streamlined program is far less expensive, and provides fewer assurances than the OVDP.

The Streamlined programhinges on the taxpayer certifying under penalties of perjury that he or she was non-willful. Caution is in order, since the IRS can examine the taxpayer. The Streamlined actually consists of a Domestic Streamlined program for people in the U.S., 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 percent penalty to the highest year-end balance in the offshore accounts over the six FBAR years.

Some U.S. citizens and residents may think more about getting out of these rules than about correcting their filing history. Yet it can be difficult to exit without addressing the past.

Expatriation

To put oneself 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.

In general, a long-term resident is a non-U.S. citizen who is a lawful permanent resident of the U.S. in at least eight years during the 15-year period before that person’s residency ends. Holding a green card for even one day during a year will taint the whole year.

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.

The U.S. tax law on expatriating changed multiple times over the last few decades. In 2004, Congress discarded tax avoidance motives altogether. In 2008, Congress made further changes.

If a U.S. citizen or long-term resident expatriates on or after June 17, 2008, he is deemed to have sold all of his worldwide property for its fair market value the day before leaving the U.S. This deemed gain is subject to U.S. tax at the capital gain rate. Fortunately, there are exceptions from its application.

First, an individual is subject to the exit tax only if he has an average net annual income tax for the five years preceding expatriation of $160,000, or if he has a net worth of $2 million or more on the date of expatriation. However, 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).

Plan Ahead

If the last five years of IRS, Justice Department and U.S. legislative actions have taught us anything, it is that U.S. tax rules are nothing to take lightly.Families and companies with U.S. interests and U.S. shareholders and members need to consider them and their application to their facts.

Whether the appropriate strategy is to correct past filings, to restructure a company, to have a family member give up a U.S. passport or green card, planning is important. Of course, it is not just taxes at stake. When one adds uncertainties about family worries, and what can be big dollars at stake, these can be daunting issues.

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.