Navigating the latest US tax maze

Some US persons living abroad face penalties of up to 50% of value of unreported accounts

- By Virginia La Torre Jeker, Special to Gulf News
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New York: The US tax authorities (IRS) are using every possible means to detect tax avoidance by Americans overseas. The Obama administration has phenomenally expanded the IRS arsenal of weaponry to combat tax cheats. We have seen a surge in the hiring of international revenue agents, new tax laws mandating increased reporting by foreign financial institutions about their US clients, expanded reporting rules imposed on taxpayers holding foreign assets and steep increases in penalties for non-compliance.

In addition to these gargantuan efforts, we've seen an increase in stolen bank data being handed over to revenue authorities (rewards usually given) and now, WikiLeaks' Julian Assange was given two CDs reputedly containing the details of up to 2,000 tax evaders from various countries, including the US.

Most US persons living overseas have now become painfully aware of the need to file the so-called FBAR (Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts) with regard to their own foreign financial accounts or those over which they have signature authority. Some may have gotten their FBAR education the hard way — by paying penalties as high as 50 per cent of the value of the unreported account and risking criminal prosecution. With the advent of new tax laws in March 2010, taxpayers need to learn much more if they want to avoid harsh consequences.

The so-called HIRE Act of 2010, which contains the Foreign Account Tax Compliance Act of 2009 (FATCA) made dramatic changes to the tax landscape for Americans overseas; some being generally described in this article. Overall, the FATCA rules render the hiding of assets offshore even more susceptible to discovery, and make the punishment upon discovery even harsher.

FATCA provisions will force non-US financial (and certain non-financial) institutions to provide the IRS with information about accounts held by Americans, or suffer a 30 per cent withholding tax on US-source payments (generally effective January 1, 2013). Broadly, a "financial institution" is one that accepts deposits in the ordinary course of a banking or similar business, or that is in the business of holding financial assets for the account of others, or that is engaged in the business of investing, reinvesting, or trading in securities, partnership interests, commodities etc. Obvious target institutions are foreign banks, funds and brokerage firms.

A trust company will also be considered a foreign financial institution (FFI) under IRS guidance. Even "a small family trust" can be so categorised. Many FFIs have taken an active decision not to invest in the US market in order to avoid FATCA, but many will continue such investments and will be reporting to the IRS about their US clients.

Reporting requirements

Reporting will include the name, address and taxpayer identification number of each US account holder; the account number; account balance and value; the account's gross receipts and gross withdrawals or payments; and other account related information requested by the IRS.

Commencing on January 1, the HIRE Act expands the reporting requirements for individuals with an interest in "specified foreign financial assets" (SFFAs) exceeding a $50,000 (Dh183,900) aggregate. Some of the information required under the new rules is similar to that for FBAR, but they are not identical and constitute an additional reporting requirement that does not replace the FBAR. Failure to make the required disclosures can result in a $10,000 penalty for the tax year (maximum penalty is $50,000). The penalty can be waived if the individual can establish reasonable cause for not filing. Reliance on a tax professional should assist a taxpayer in establishing "reasonable cause".

SFFAs on which detailed information reporting is mandated include:

• Depository, custodial, or other financial accounts maintained by a foreign financial institution;

• Foreign stocks or securities;

• Any financial instrument or contract held for investment that has an issuer or counterparty other than a US person; and

• Any interest in a foreign entity.

Generally this covers overseas bank and brokerage accounts, foreign funds, debt or equity interests in foreign entities etc. — even if held only in a nominee capacity.

A new 40 per cent penalty will be imposed on any tax understatement attributable to undisclosed foreign financial assets.

Generally, the IRS has only three years from the date the taxpayer files his tax return to assess further taxes or challenge the return. The HIRE Act made two changes.

First, in the case of returns filed after March 18, 2010, and those that are filed before this date but for which the statute of limitation has not yet expired, the statute of limitation for the entire tax return is suspended for failure to provide certain information related to foreign assets/transactions. If a taxpayer fails to report information about foreign

financial assets, certain foreign entities (including corporations and trusts), or interests in and transfers to foreign entities that must be disclosed on any of numerous tax forms, the statute of limitation for the entire tax return does not begin until the omitted information is provided to the IRS. Prior to the new law, the statute was extended only for the portion of the return related to the missing information.

Second, the statute is increased from three to six years if there is an omission of income exceeding $5,000 from undisclosed foreign financial assets. These changes mean at a minimum, there will be an extension of time for the IRS to catch any problems with your tax return and, even worse, a complete lack of closure to one's tax transactions if any information is missing from the return relating to foreign assets or transactions.

Higher prices

The price for tax noncompliance, already very high, just keeps escalating. Just ask any of the 14,700 taxpayers who have entered into the IRS Voluntary Disclosure Programme (VDP) for offshore accounts and assets. Even higher prices are being paid by those who have not entered into VDP but who are getting caught with unreported offshore holdings; penalties can involve criminal prosecution.

The offshore VDP expired in October 2009, although many taxpayers are still coming forward under the IRS' general VDP (even though penalties are not as clearly set out as they were in the now-expired offshore VDP).

The IRS recently announced it is considering another special offshore VDP although no details have been released. Taxpayers with undisclosed assets should seek professional advice about their particular situation, understand the options and related risks. The increase incidence of stolen bank data, increased enforcement efforts and powerful new weapons for the taxman embodied in FATCA mean hiding one's head in the sand is simply no longer an option.

The writer, based in Dubai, specializes in US taxation and international taxation planning. She can be reached at vjeker@eim.ae The information provided does not constitute tax or legal advice and is of a general nature only.

Cheating

FATCA will:

- Impose a 30 per cent tax withholding on payments to 1) foreign financial institutions (can include trusts) that fail to identify US accounts, their owners and assets to the IRS, or 2) foreign corporations that do not supply the name, address, and tax identification number of any US individual with at least 10 per cent ownership;

- Impose penalties up to $50,000 on US taxpayers owning at least $50,000 in offshore accounts / assets who fail to annually report them as part of their US income tax return;
- Impose a 40 per cent penalty on the amount of any understatement of tax attributable to undisclosed foreign assets;
- Extend the statute of limitations (perhaps indefinitely) in certain cases involving offshore holdings.

US persons should:

- Review all foreign asset holdings with a tax professional;
- Determine the tax information and other reporting that is required;
- Ensure proper filings are up-to-date;
- Monitor the continuous IRS guidance being rendered in the foreign area;
- Seriously consider whether "green cards" or "second" US passports are truly necessary and worth the tax and compliance price tags.