Born in the USA

Large Corporate

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Jeff Levin and Helen McGhee outline the options available to individuals who have been forced to address their US tax compliance obligations

Key Points

What is the issue?

With the effect of FATCA felt worldwide in an era of increased global transparency of tax affairs, many individuals, with perhaps seemingly tenuous US links, may find themselves entirely innocently and unwittingly in difficulty with the IRS

What does it mean for me?

The problem is more widespread than contemplated because many individuals would not think that holding a US passport would leave them exposed. Individuals may even consider relinquishing US citizenship

What can I take away?

Timely advice on the best method of bringing up to date any lapsed US tax obligations might result in penalty mitigation

With the recent increase in international enforcement activities undertaken by the US Internal Revenue Service (IRS) and the enforcement of the US Foreign Account Tax Compliance Act (FATCA), numerous seemingly or self-perceived non-US individuals have been forced to address their US tax compliance obligations.

For those in Europe, who are dealing with those obligations for the first time, may face paying substantial costs for their past non-compliance. Often, such persons (including Mayor of London Boris Johnson) have had limited or even no contact with the US for many years and have erroneously considered themselves exclusively taxpayers and residents of another country with no US tax compliance responsibilities.

US persons

Someone is considered a US person for income tax purposes if he or she is either a US citizen or a US tax resident. US tax residents tend to know that they may have a tax obligation because they spend significant time in the US or have obtained permanent resident status. However, the position for US citizens who live outside the US is less clear.

A person can acquire US citizenship in several ways. The most obvious is through birth in the US, but citizenship is also acquired if a person born outside the country has two parents who are US citizens or has one US citizen parent if born after 23 December 1952. US citizenship can also be acquired by naturalisation.

US citizens and residents are subject to US income tax on their worldwide income (and gains), regardless of both the source of that income and the tax home of the taxpayer (unless an exemption is available, such as under a double tax treaty).

Tax and filing obligations of US persons

US persons who live outside their home country are generally subject to the same reporting obligations as persons living in it. Those who own certain types of foreign assets have distinct annual tax reporting obligations to both the IRS and the US Treasury Department. These vary depending on the type and value of the asset.

US persons who are the beneficial owners of (or have signature authority over) a foreign bank or investment account with an annual aggregate balance of more than $10,000 are required to file a Report of Foreign Bank and Financial Accounts (FBAR) with the Treasury Department. Reporting is also required for non-US bank or investment accounts owned by entities, regardless of nationality, if a US person owns more than a 50% interest in the corporation, partnership or trust. The relatively new form for this reporting is electronic filing form FinCEN Report 114.

US income tax consequences apply to US persons with respect to passive income, generally interest, dividends, rent, and certain capital gains earned by foreign entities that have a US owner, even though the income is not distributed to the US taxpayer owner. These rules, which differ depending on the percentage of US ownership and known as the controlled foreign corporation (CFC) and passive foreign investment company (PFIC) rules, can act as a trap for the unwary.

Options for regularisation

So what should a US person living in the UK do if they unwittingly have US tax obligations unearthed by FATCA? Currently, a non-compliant US person has three ways to regularise their US tax affairs. First is the route (before the introduction of the Offshore Voluntary Disclosure Programs (OVDP)) known as Quiet Disclosure, which will tend to look back three to six years after the IRS receives the information return. Taxpayers will prepare and file initial tax returns or amended ones reporting income or assets previously omitted and pay additional taxes and interest. Depending on the facts, a taxpayer may be able to negotiate with the IRS a reduction in penalties. This ability to negotiate down potentially very high penalties (particularly in relation to late-filed FBAR forms) is not available under the OVDP route.

For foreign income tax non-compliance issues there are two other options: the 2014 OVDP and the 2014 OVDP Streamlined Filing Alternative. To date, the OVDPs have raised $6.5 billion in back taxes for the IRS.

2014 Offshore Voluntary Disclosure Programs

In 2009, the IRS announced its first Offshore Voluntary Disclosure Initiative to provide an incentive for US taxpayers to comply with their income tax obligations with respect to foreign situs assets and income. This was followed by two OVDPs: for 2011 and 2012, both of which have since been modified and expanded into the present 2014 OVDP.

The 2014 OVDP has several advantages over Quiet Disclosure, particularly if the penalties cannot be waived for reasonable cause. One advantage of the 2014 OVD over both Quiet Disclosure and the 2014 OVDP Streamlined Filing Alternative is that the IRS will issue a formal closing agreement to the taxpayer that will limit the IRS from reopening any of the tax years covered by the 2014 OVDP. The 2014 OVDP is limited to a maximum of eight years and, under this, it is possible that no FBAR penalties will be imposed.

The 2014 OVDP Streamlined Filing Alternative offers different procedures for persons who are resident outside the US (foreign filing). The taxpayer is required to certify under penalty of perjury that their non-compliance was due to 'non-wilful conduct'. The IRS defines this as conduct due to negligence, inadvertence, mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law. Any intentional conduct to ignore or circumvent US reporting would not be considered 'non-wilful'. To take advantage of this route, as is the case for the 2014 OVDP Streamline Filing Alternative, the taxpayer must not be subject to a civil or criminal examination by the IRS.

For foreign filing, the taxpayer must be a 'non-resident' of the US. This is defined as a person who, in at least one of the previous three years for which a due date for a US income tax return has passed, has not had a US abode and was physically outside the US for at least 330 full days. Under foreign filing, the taxpayer must file all delinquent tax and information returns, and pay the full amount of tax and interest due for those three tax years. The taxpayer must also file all delinquent FBARs for the previous six years.

What about expatriation?

Once a US person abroad becomes fully compliant, the individual has the option of expatriation to relinquish US citizenship or long-term permanent resident status. There are potential US income, and possibly transfer, tax implications of expatriation. In particular, care must be taken regarding time spent in the US after expatriation.

If an individual has (broadly) a net average US taxable income tax liability in the five years before expatriation of less than about $160,000 a year, net worth as of the date of expatriation of less than $2,000,000, and can certify that the individual has fulfilled their filing obligations for the previous five years, the taxpayer could expatriate (filing a Form 8854) from the US without additional tax consequences there. The fee for processing a renunciation of US citizenship is now $2,350.

If the expatriate individual acquired dual US and non-US citizenship at birth and, as of the expatriation date, continues to be a citizen of, and is taxed as a resident of their other country (and has been a US resident for not more than 10 of the 15 taxable years prior to expatriation), expatriation could occur without additional US tax consequences.

Otherwise, under most circumstances, the expatriate will be considered a ‘covered expatriate’ and subject to a US exit tax on their appreciated worldwide assets beneficially owned on the day immediately before expatriation. All property of a ‘covered expatriate’ is treated as sold on the day before expatriation and any gain or loss on the deemed disposal must be paid on a US income tax return for the year of expatriation.

As well as this exit tax, a form of inheritance tax, currently 40%, may be payable on gifts or bequests made by a ‘covered expatriate’ to US persons subsequent to expatriation – if not otherwise exempted. The US expatriate may want to use their available lifetime US transfer exemption to make gifts before expatriation.

Conclusion

For US citizens or US tax residents living and working in the UK and are delaying a decision or believe that the IRS will not learn of them or their offshore assets, this is a matter of urgency. The taxpayer could be in a far worse situation if the IRS discovers them or their foreign assets first. However, prompt action now on their US obligations might mitigate any monetary penalties.