The international tax gap, expatriates, and the IRS

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The Internal Revenue Service is giving top strategic priority to the reduction of a very large estimated international tax gap. Its efforts are likely to impact the large and growing population of U.S. expatriates and those moving to the United States, or inpatriates. These expatriates are typically U.S. citizens working or living out of the country for extended periods of time and the inpatriates are typically employees of foreign employers sent to the United States to work for a time period (also called “recently resident” persons). Many members of these two groups will be involved in an expanding effort that the IRS is conducting as part of the activities being undertaken by its newly organized Global High Wealth Task Force (“task force”). At Baker Tilly, we fully support the due administration of the tax laws and the collection of all properly owed taxes. To that end, we are taking the lead in addressing our populations of the “recently resident” and “expatriate groups” in a variety of positive ways to enhance their ability to stay compliant with the U.S. tax law while being able to legitimately conduct their myriad range of foreign activities.

The task force’s mission is to take a closer look at global financial transactions and reporting behaviors of high wealth U.S. citizens and residents living in the United States or overseas. Their scrutiny extends to U.S. citizens moving overseas, investing overseas, having closely-held family investments, or running businesses overseas. While once only wealthy individuals and large corporations had the means to make those types of investments, diminished legal barriers and technological advances have provided opportunities for offshore investments to a broader spectrum of the population, with the same being true of foreign companies and individuals who see the United States as fertile ground for business and personal investments. As companies expand their global reach and engage cross-border employees to manage business activities, their international tax picture becomes increasingly complex and, under increased IRS international scrutiny, companies and their employees can easily run afoul of U.S. tax laws.

Why the increased IRS effort and involvement? There are a number of reasons and one is certainly the potential for legitimately collecting increased tax revenue. International business investments in the United States grew from nearly $188 billion in 1978 to more than $14.5 trillion in 2007. In the same period, U.S. business and investment overseas grew from nearly $368 billion to nearly $15 trillion. The international tax gap mentioned above is defined as taxes owed – but not collected on time, or ever—from a U.S. person or a foreign person whose cross-border transactions are subject to U.S. taxation. The international tax gap encompasses all revenue losses resulting from noncompliance with the U.S. tax laws due to international transactions. These include taxpayer error, conflicting legal interpretations, misinterpretation of the facts, and outright tax evasion. Non-IRS estimates place the total international tax gap at a range of $40 to $123 billion annually.

In addition, in a post 9/11 world there is an increased need to properly report overseas bank account activity. The federal government has a legitimate interest in money coming into the United States as it watches for money-laundering schemes or money being sent to the United States for other criminal purposes. It is monitoring money movement much more closely and the IRS is one of the tools that it is using to help protect U.S. citizens and their interests.

The UBS scandal provided a third reason for enhanced efforts. United States tax law requires that U.S. citizens or residents report annually any foreign based investment, bank, or brokerage accounts on a “Foreign Bank Account Report Form” (form FBAR 90-22.1). The interest and dividends from such accounts also are subject to U.S. income tax. In the UBS scandal, U.S. citizens investing or living abroad created foreign bank accounts with the Swiss bank and did not disclose the existence of these accounts or interest earned on them to the IRS. UBS admitted responsibility in the case and in helping U.S. taxpayers conceal more than $20 billion in offshore accounts from the U.S. government in an effort to avoid paying U.S. income tax. In the agreement reached between the IRS, the U.S. Department of Justice, and the Swiss government, UBS turned over information on thousands of offshore accounts and names of account holders. The IRS offered an amnesty program, which ended last year, to those who came forward to make voluntary disclosures and may criminally prosecute those who did not.

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If you're wondering what all this might have to do with you or your employees then remember that the United States stands alone in taxing its citizens on a global basis, U.S. income tax, as applied to residents, is also global in reach, and unlike many countries around the globe, there are few loopholes for offshore deferral of income under U.S. tax law. Many American expatriates don't know they need to report accounts held in foreign countries and pay taxes on them and on their worldwide income. And foreign nationals who have become recently resident in the United States do not know that significant reporting is required of foreign employees who come here to work. These people – innocent of wrongdoing – are nonetheless still subject to the IRS's legitimate scrutiny and investigation efforts.

The United States subscribes to two basic tax law concepts that govern how the IRS tracks employees and income. The first is the concept of citizenship which it borrowed from the Roman Empire: If you are a citizen of the United States, no matter where you reside, you have to pay U.S. tax on your worldwide income. In addition, foreign persons are taxed on their U.S. source income when they are connected to a U.S. trade or business, for instance. The second concept is that of domicile (or extended residency intention) which the United States modeled after the British Empire: Where you are intending to live is where you have to pay taxes. Income tax is governed by the concept of citizenship and residency (e.g., 183 days in the United States in any given year) and estate taxes (which will be effective again in 2011) and gift taxes are governed by citizenship and domicile making individuals subject to estate and gift tax on a global basis. In this way, the United States has a unique global tax perspective that isn't replicated anywhere else in the world.

This above described uniqueness has a significant impact on recently resident employees in the United States. Here are the top five surprises that typically confront them:

1. United States income tax is globally assessed on residents irrespective of the source of their income or where the resident of the United States lives. This is particularly true for green card holders who are deemed to be residents of the United States for tax purposes even though they may live abroad and have numerous sources of foreign income.
2. The United States has a death tax (again effective in 2011) assessed on domiciles and citizens of the United States and that death tax is assessed on global assets irrespective of where the U.S . citizen or domicile dies.
3. The United States has a gift tax which is assessed on U.S . citizens or domiciles globally.
4. Our anti-deferral rules, (aka, the controlled foreign corporation or passive foreign investment company rules), apply to many interests in foreign corporations that are privately held and can produce current income to the shareholder even in the absence of actual distributions.
5. Holding a green card for eight of the last fifteen years can result in a global exit tax assessed on all global assets worldwide on a deemed sale basis if one gives up the green card after seven years and moves back to one's original foreign country of residence.

In an effort to help clients avoid unexpected penalties, Baker Tilly's international tax professionals ask a series of questions of recently resident persons in the United States or persons considering a move to the United States for any period of time as an employee or an entrepreneur:

1. Do you have any foreign bank accounts? Failure to report on them annually can lead to a penalty of $10,000 per year per bank account.
2. Do you have interests in any foreign privately-held corporations? Failure to report the presence of such interests, for instance in the case of controlled foreign corporations, can lead to a $10,000 per year penalty for failure to file a Form 5471.
3. Have you received any gifts from abroad in excess of $100,000 in any one year from any one donor or any one estate?
4. Have you received any distributions from any foreign trusts?
5. Have you created or settled any foreign trusts?

A "yes" answer to any of the last three questions requires the filing of IRS Form 3520 to report the transactions or gifts. Though no actual tax may be due, failure to report the transactions or gifts can result in severe penalties. The penalty for failure to report the creation of a foreign trust is 35 percent of the transfer to the trust. Failure to report a distribution from a foreign trust results in a penalty of 35 percent of the value of any distribution. And failure to report a foreign gift can be up to 25 percent of the value of the gift.

U.S. international tax laws address a multitude of potentially taxable transactions that are engaged in by millions of entities worldwide, including large multinational enterprises, U.S.-based companies operating internationally, foreign-based companies operating in the United States, nonresident individual investments in the United States, individual U.S. investors' international investments, individual U.S. residents residing abroad, and non-resident aliens residing in the United States. That's a pretty all-encompassing list and Baker Tilly international tax professionals encourage all – individuals or companies, employers or employees, expatriates or the recently resident – to seek the best advice they can to be in compliance with U.S. international tax laws. In an increasingly complex world where borders are indeed vanishing, it is incumbent that U.S. tax advisors understand the unique U.S. tax compliance and planning needs (and world views) of their expatriate and recently resident clients. It is certain that the IRS's legitimate and good-faith efforts at enhancing the level of compliance from such globally situated individuals will soon directly impact their lives.

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