Puedes Correr pero No Te Puedes Esconder - El Costo Tributario de la Ciudadanía o Residencia Americana Sin Importar Adonde Residas

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Worldwide Income Taxation

- U.S. citizens, resident aliens ("RA") and domestic corporations ("U.S. Persons") are taxed in the U.S. on a world wide basis.
- This rule applies regardless of being taxed in a foreign jurisdiction.
- Section 911 exclusion minimizes U.S. income tax for certain eligible individuals.
- U.S. Foreign Tax Credit rules help minimize double taxation. Direct and Indirect Foreign Tax Credits may be available.
- Income Tax Treaties must be considered with respect to which jurisdiction has the right to tax income and and applicable withholding tax rates.
- NOTE: 15% U.S. dividend rate only applicable for dividends from Qualified Foreign Corporations. See Notice 2011-64, 2011-37 IRB 8/18/2001 (updating the prior Notices on this issue).

Section 911 Exclusion

- Qualified individuals may elect to exclude both their foreign earned income and a housing cost amount from gross income, subject to certain limitations.
- The sum of the amounts that a qualified individual excludes as foreign earned income and as foreign housing costs may not exceed the individual's foreign earned income for the taxable year.
- The maximum amount of foreign earned income that an individual may exclude is currently limited to $92,900 annually (subject to an annual inflation adjustment, with this amount being for 2011).
- Be aware of new limitations (floor and ceiling) applicable to the housing exclusion and Notice 2006-87 relating to increased amounts for particular countries / cities.
- Consider Forms 2555 and 2555EZ.

Foreign Tax Credit: In General

- U.S. citizens, income tax residents and domestic corporations are taxed on their worldwide income. In order to prevent the double taxation that could result on income derived from foreign sources, the United States allows a credit for foreign taxes paid or accrued.
- Consider Form 1116.

Foreign Tax Credit: Indirect Credit

- In certain circumstances, a U.S. corporate shareholder of a foreign corporation (an "FC") is entitled to a foreign tax credit for foreign taxes paid by the foreign corporations that are "deemed paid" by the shareholder.
- This indirect credit is available with respect to dividends (including §1248 dividends) and subpart F inclusions to U.S. corporate shareholders that own 10% or more of the voting stock of the FC.
- U.S. shareholders that are entitled to an indirect foreign tax credit must include the amount of the indirect credit in their income (the "gross-up").
- See §902.

Choice of Entity: What does it mean?

- How an entity is classified will determine how the entity or its shareholder is taxed, including with respect to:
  - Foreign Tax Credits / Double Taxation.
  - Controlled Foreign Corporation ("CFC") status.
  - Passive Foreign Investment Company ("PFIC") status.
  - Branch Profits Tax.
  - Partnership or Trust status.
  - Conduit Financing Arrangements.
  - Treaty under an Income Tax Treaty.
  - Hybrid Entities.

Choice of Entity: Domestic Entities

- A "C" corporation is a per se entity.
- A Limited Liability Company may choose to be classified as a corporation. Otherwise its default classification is that of a 'tax nothing" or branch if it has a single member or a partnership if it has more than one member.
  - A Limited Liability Company might want to elect corporate status in order to make an "S" corporation election (if otherwise eligible to make such an election).

Section 482: Outbound Concept

- The §482 rules for "outbound transactions" are the same as those presented earlier in this presentation.
- Possible outbound situation:
  - FC is engaged in a U.S. trade or business and makes payments to a related FC for its services. If the payments for those services are an amount in excess of what would be paid to an unrelated third party, the IRS could utilize §482 to adjust the deduction allowed for such services (thereby increasing the U.S. income tax due).
- Also consider Forms 5471 and 5472.

U.S. Trade or Business

- Watch out for using an FC to engage in a U.S. trade or business.
  - Potential for three levels of U.S. income tax!
  - Corporate tax.
  - Branch Profits Tax.
  - Tax on Dividend to U.S. Person shareholders (possibly at capital gains rates if a Qualified Foreign Corporation).

Anti-Deferral Regimes in General

- Over the years, Congress has successfully closed various "loopholes." For instance, where a U.S. Person (i.e., U.S. citizen or RA) shareholder would attempt to utilize an FC to defer, avoid, or evade U.S. taxes.
- A classic example of this would be an FC owned 100% by a single U.S. Person shareholder who contributes $1,000,000 to the FC that in turn invests the $1,000,000 in a passive interest-bearing account. Assuming a 5% yield, this passive investment would give rise to $50,000 of interest income per year.
- Because: (a) the FC could be located in a no or low tax jurisdiction; and (b) specific investments made by the FC can possibly avoid U.S. income taxation at the FC's level, Congress decided that the earnings of certain FC's owned by U.S. Persons should be taxed currently, regardless of whether or not such earnings are distributed.

Controlled Foreign Corporations

- The primary objectives of Congress when enacting the CFC provisions were to
  - prevent unintended tax deferral through the use of an FC; and
  - attack avoidance transactions such as shifting income by or among related parties to a low or no tax jurisdiction through an intermediary FC.

Controlled Foreign Corporations (Cont.)

- Another important U.S. income tax provision intended to stop deferral through the use of an FC is §1248. To the extent a U.S. Person Shareholder of a CFC is not required to include in his or her income under the subpart F rules certain post-1962 earnings and profits ("E&P") of the FC, such deferred E&P may eventually be taxed as a deemed dividend in lieu of capital gain when the U.S. Person Shareholder sells, exchanges or distributes the shares of a CFC.

Controlled Foreign Corporations (Cont.)

- Where a CFC makes certain investments in U.S. property, the lesser of: (a) the average amount of such U.S. property (subject to reductions for amounts previously taxed under this rule); or (b) the E&P of the CFC, may be taxed to the U.S. Person Shareholders. See §956.
- In general, and subject to certain exceptions, U.S. property includes:
  - tangible property located in the United States;
  - stock of domestic corporations;
  - an obligation of a United States person; or
  - any right to the use in the United States of
    - a patent or copyright,
    - an invention, model, or design (whether or not patented),
    - a secret formula or process, or
    - any other similar property right, which is acquired or developed by the controlled foreign corporation for use in the United States.

Passive Foreign Investment Company

- Because certain of the provisions discussed above did not always apply to FCs with a broader ownership base (e.g., a public FC), Congress enacted the PFIC provisions.
- The PFIC rules ensure that U.S. Persons with smaller ownership interests are taxed, as these rules do not rely on a specific ownership percentage test for the provision to apply to a U.S. Person shareholder.
- See §§1291-1298.

Passive Foreign Investment Company (Cont.)

- An FC constitutes a PFIC if either 75% or more of its gross income is passive or the average percentage of its assets held for the taxable year that produce passive income is at least 50%.
- Subject to certain exceptions, passive income includes dividends, interest, royalties, annuities, rents, net gains from the sale of property yielding passive income (e.g., stock), and other passive income.
- Passive assets are generally assets that derive passive income.
- See §1297.

Passive Foreign Investment Company (Cont.)

- The PFIC provisions apply to actual or constructive distributions made to a U.S. Person shareholder.
- A U.S. Person shareholder, for purposes of the PFIC rules, is any U.S. Person who directly or indirectly (through corporations, partnerships, trusts, and other entities, but not through other family members) owns the stock of a PFIC.
- A U.S. Person shareholder of a PFIC may be subject to additional tax on the amount of the distribution that constitutes an "excess distribution."
- An excess distribution is the excess of the amount of the distributions received by the U.S. Person shareholder during the taxable year over 125% of the average amount received in respect of such stock by the U.S. Person shareholder during the 3 preceding taxable years.
- See §§1291 and 1298.

Pulling It All Together (Example 1)

- U.S. citizen taxpayer wants to use an FC located in an offshore "tax haven jurisdiction" to invest in passive assets (whether offshore or in the U.S.) because he or she "heard that no U.S. income tax would have to be paid."
  - The FC will be a CFC and/or PFIC, depending upon the exact facts.
  - Deferral opportunities will likely not be present.
  - Watch out for U.S. investment, as no FTC available for U.S. tax paid, resulting in double tax!
  - No 15% U.S. dividend rate!

Pulling It All Together (Example 2)

- U.S. citizen taxpayer wants to use an FC in an offshore "tax haven jurisdiction" to operate a business overseas because he or she "heard that no U.S. income tax would have to be paid."
  - Depending upon the nature of the business (e.g., rental, sales, manufacturing, etc.), as well as with whom the FC does business (related versus unrelated parties), U.S. income tax deferral might be available.
  - Watch out for how accumulated earnings are invested. Passive income may not receive deferral.
  - Watch out for U.S. trade or business and possible triple tax!
  - No 15% U.S. dividend rate.

Pulling It All Together (Example 3)

- U.S. citizen taxpayer wants to use an FC to operate a business in an offshore "high tax jurisdiction."
  - Even if U.S. income tax deferral is obtainable, income tax will be paid in the high tax jurisdiction.
  - Use of an FC will likely result in a second level U.S. income tax (possibly at the beneficial 15% rate) on the dividends received by the U.S. shareholder.
  - An FTC will not be available for the tax paid by the FC unless the indirect FTC is applicable; however, and FTC should be available for any tax on the dividends.
  - Consider using a "Check-the-Box" entity and electing "tax nothing" or partnership status. Although income will be currently taxable in the U.S., the U.S. FTC should minimize the potential for double tax.

Summary of Filing Considerations

- Form 926 applies to certain transfers to FCs.
- Form 5471 applies to U.S. Persons that own interests in certain FCs, and has 4 Categories of people to which it can apply.
- Form 8621 is for PFICs and QEFs.
- Form 5472 is used to report certain information about: (i) a domestic corporation that is 25% foreign owned (as defined below); and (ii) a foreign corporation that is 25% foreign owned (as defined below) and is doing business in the United States.
- Form 8865 applies to U.S. Persons that own interests in certain foreign partnership, and has 4 Categories of people to which it can apply.
- TD F 90-22.1 is required to be filed by each U.S. Person who has a "financial interest in or signature authority or other authority over a bank, securities, or other financial account in a foreign country, which exceeded $10,000 in aggregate value at any time during the calendar year." See the IRS FAQ for good overview of the issues relating to this form. Also be prepared for a revised TD F 90-22.1 to be released.
- Consider the specific questions on Form 1040, Schedule B, Part III.
- Form 8858 is required to be filed with respect to certain disregarded entities.
- IMPORTANT: Civil and Criminal penalties may be imposed for the failure to file the above mentioned forms!

Form TD F 90-22.1—Report of Foreign Bank and Financial Accounts "FBAR"

- FBAR law under U.S.C. Title 31 (not the I.R.C.—Title 26) is the primary weapon in the government's arsenal regarding unreported offshore accounts—a U.S. Treasury form, rather than an IRS form.
- See, for example, Form 1040, Schedule B, Part III, Question 7—the IRS plays "Battleship"!
- New 03/11 form was issued and Final Regulations apply effective March 28, 2011 (see the discussion herein).

FBAR— Filing Requirements

- Under the Bank Secrecy Act, each "United States person" must file a FBAR if :
  - The person has financial interest in, signature authority <u>or</u> "other authority" over one or more accounts in a foreign country, and
  - The <u>aggregate value</u> of the accounts exceeds $10,000 at <u>any time</u> during the calendar year.

FBAR— Filing Requirements

- FBAR must be filed whether or not the foreign account generates any income.
- The FBAR is due by 6/30 of the following calendar year—it is not filed with federal income tax return, no applicable extensions, no "mailbox rule".
- If an account holder does not have all the available information to timely file the return, file as complete a return as possible and then amend it (check the "Amended" box) when the additional or new information becomes available, attaching a copy of the previously-filed report.

FBAR— Account Reporting

- Must report the maximum value of the account during the calendar year being reported.
- “Maximum value” will generally be the largest amount of currency or non-monetary assets appearing on an account statement, using the official end-of-year foreign currency exchange rate.
- The value of stock, other securities or other non-monetary assets is the fair market value at the end of the calendar year—if withdrawn from the account, the value is the fair market value at the time of the withdrawal.

FBAR—Penalties

- Civil penalties for a non-willful violation can range up to $10,000 per violation.
- Civil penalties for a willful violation can range up to the greater of $100,000 or 50% of the amount in the account at the time of the violation.
- Civil penalties can be assessed for up to six years.
- Criminal penalties range from up to a $500,000 fine or 10 years imprisonment or both.
- Civil and criminal penalties may both be imposed.

FBAR—Other Issues

- Records of accounts required to be reported on an FBAR must be retained for a period of 5 years .
- Attach explanatory statements to late FBARs.
- No penalty will be assessed if "reasonable cause" and balance in the account is properly reported.
- Consult with <u>both</u> civil and criminal tax attorneys before filing late FBARs (and related amended tax returns), <u>especially important</u> if the amounts in question exceed $1 million—6 years of back returns is the general standard.

Penalties for Underpayments Attributable to Undisclosed Foreign Financial Assets: New §6662(b)(7) and §6662(j)

- Code §6662(j) imposes a 40% penalty on any understatement attributable to an undisclosed foreign financial asset.
- The term "undisclosed foreign financial asset" includes all assets subject to certain information reporting requirements (e.g., under Code §§6038, 6038B, 6038D, 6046A or 6048) for which the required information was not provided by the taxpayer as required under the applicable reporting provisions.
- These provisions are effective for taxable years beginning after March 18, 2010 (the date of enactment).

Modification of Statute of Limitations for Significant Omission in Connection with Foreign Assets: Code §6501(c)(8) and §6501(e)(1)

- Code §6501(e)(1) provides for a six (6) year limitations period for assessment of tax on understatements of income attributable to foreign financial assets where: (1) there is an omission of gross income in excess of $5,000; and (2) the omitted gross income is attributable to an asset with respect to which information reports are required under Code §6038D (applied without regard to the dollar threshold, the statutory exception for nonresident aliens and any exceptions provided by regulation).
- Also, Code §6501(c)(8) (which suspends the limitations period for assessment to the date which is 3 years after the date on which the IRS is furnished the information required to be reported) was amended to apply where a taxpayer fails to provide timely information returns required with respect to passive foreign investment corporations and reporting of foreign financial assets, and was "clarified" to apply to "any tax return" not just items relating to these information returns.
- This is effective for returns filed after March 18, 2010 (the date of enactment) as well as for any other return for which the assessment period specified in Code §6501 has not yet expired as of March 18, 2010.

General Overview of U.S. Tax Rules, Why Expatriate?

- As discussed earlier, subject to certain exceptions, limitations and credits, U.S. citizens and income tax residents ("RAs") generally are subject to U.S income taxation on their worldwide income. As will be discussed later in the program, U.S. citizens and U.S. estate tax resident alien domiciliaries ("RADs") subject to U.S. estate tax on their worldwide assets.
- In contrast, U.S. income tax nonresident aliens ("NRAs") are taxed at a flat rate of 30% (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of U.S. nonresident alien domiciliaries ("NRADs") generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Similarly, NRADs are generally subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States, but excluding intangibles, such as stock, regardless of where they are located).

Who is an Expatriate?

- Pursuant to §877(a), a U.S. citizen who relinquishes his or her U.S. citizenship, or a long-term lawful permanent resident who relinquishes his or her lawful permanent resident status will be considered to be "Expatriates."
- For this purpose, a "long-term lawful permanent resident" means any individual who is a lawful permanent resident of the U.S. in at least 8 taxable years during the period of 15 taxable years ending with the taxable year in which such individual gives up his lawful permanent resident status.
- Watch out! Certain actions, such as election to be a resident of a treaty country, can result in expatriation! Consider the changes to §7701(b)(6).

The Expatriate Tax Regime- The Tests

- An Expatriate will be subject to the Expatriation Tax Regime (which generally includes, but is not limited to, the rules of Code §§877A, 2107, 2501, 2511 and 2801) if, either:
  - such individual's average annual U.S. Federal income tax liability for the five taxable years ending before the date of expatriation (i.e., if an individual expatriates in 2011, the taxable years from 2006-2010) is greater than $147,000 (which represents the 2011 taxable year inflation adjusted amount);
  - such individual's net worth as of the date of expatriation is $2,000,000 or more; or
  - such individual fails to certify under penalty of perjury that he or she has met the requirements of all U.S. tax laws for the five (5) preceding taxable years or fails to submit such evidence of such compliance as the U.S. Secretary of the Treasury may require.

The §877A "Exit Tax"

- **§877A(a): General Rules.**
  - **Deemed Sale**. Most property of a covered expatriate is deemed to be sold for its fair market value on the day before expatriation. This applies to U.S. real property interests, accelerating the recognition of gain that would be taxed in any event under FIRPTA. It also applies to assets held in grantor trusts (see below with respect to non-grantor trusts). Some assets are not marked-to-market, but they are otherwise taxed (see below).
  - **Losses**. Losses are taken into account from the deemed sale (to the extent otherwise provided in the Code), except that §1091 (relating to wash sales) will not apply to the loss.
  - **Adjustments**. Proper adjustments will be made for any gain or loss taken into account under this rule for purposes of determining gain or loss on a subsequent disposition.
  - **Exclusion**. Covered expatriates must recognize gain on the deemed sale and pay U.S. income tax on gains over $600,000 (adjusted for inflation this number is $636,000 in 2011).
  - **§877A(h)(2): Special Basis Step-up**. U.S. residents receive the benefit of a step up in basis in the property to the fair market value at the time the individual first became a U.S. income tax resident.

The Exit Tax Regime – Exceptions

- Two very limited exceptions to the definition of a covered expatriate exist, and they are:
  - Dual nationals (from birth) who continue to be a citizen and tax resident of such other country, but only if they have not lived in the United States as a U.S. income tax resident (as determined under the so-called Substantial Presence Test) for more than 10 of the last 15 years before the date of expatriation.
  - Persons under 18½ years old, but only if they have not lived in the United States as a U.S. income tax resident (as defined above) for more than 10 years before the date of expatriation.
- In the case of any covered expatriate who is subject to tax as a citizen or resident of the U.S. for any period beginning after the expatriation date, such individual shall not be treated as a covered expatriate during such period for purposes of §877A(d)(1) (relating to deferred compensation items) and §877A (f) (relating to non-grantor trusts), as well as §2801 (relating to gifts and inheritances).

The Exit Tax Regime – Final Considerations

- The IRS released Notice 2009-85, 2009-45 IRB 598, with respect to numerous details of the rules mentioned herein. A thorough review of this Notice must be performed before advising any client.
- Consider Form 8854, which must be filed by all expatriates in order to certify compliance with the U.S. tax laws.