Podcast Transcript

Estate and Tax Planning for Globally Mobile Clients: U.S. Tax Reporting for Americans That Live Overseas and Voluntary Disclosure

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Lee: The United States has a complex tax system that applies to Americans who live in the U.S. and also those who live abroad. Many American expats are not aware that when they leave the U.S., they are still subject to U.S. taxation. This can lead to significant problems including steep penalties imposed by the IRS. I'm Leanne Lee and you're listening to BakerHosts.

On today's episode, we'll discuss tax compliance for Americans who live abroad. We're joined by Private Wealth partner George McCormick, who is located in our New York office. In his practice, George focuses on tax and estate planning for international clients with a connection to the United States. Welcome to the show, George.

McCormick: Hi Leanne, thanks for inviting me today.

Lee: So, to start us off, how do the U.S. tax rules apply for Americans who live abroad?

McCormick: Americans that live abroad are subject to U.S. income tax on their worldwide assets. So, if you're American citizen and you live in England, or you live in China or Australia, the income that you earn while you live overseas is subject to U.S. taxation. It is also important to note that many types of assets that Americans that live abroad are also reportable on U.S. tax information returns. So, these are primarily non-us financial assets that have to be reported each year in forms that typically go with the Americans income tax return. I'll also note that while I'm talking about Americans that live abroad, this rule generally applies to any assets that an American owns abroad. So, if you're an American that lives in the U.S. and you earn income from overseas, or you own assets overseas, those are also reportable annually with your U.S. tax return.

Lee: Okay. So, you mentioned two types of reporting, income reporting and information reporting. Could you discuss these in more detail?

McCormick: Sure. So, all types of income that an American earns overseas are reported on their U.S. tax return. So, that could be wages or salary, interest income, short term or long term capital gain, dividends, royalties, income from crypto, any type of income that American can earn is reportable annually on their U.S. tax return. Information return reporting is generally for reporting American's ownership or interest in non-us financial assets primarily. So, these are non-us bank accounts, shares of a non-U.S. corporation, partnership interest or other types of ownership interest in foreign partnerships or foreign disregarded entities, also interest in foreign trust. So, any distribution from a foreign trust, income tax ownership of a foreign trust or any other type of interest in a foreign trust may be reportable on an information return. Also, something that sometimes overlooked is large gifts from foreign persons are also reportable. So, a gift that a U.S. person receives from a non-U.S. person, more than $100,000 in a year, is reportable on a U.S. tax information form. I just used the term U.S. person and if you listen to a prior podcast in this series, you've heard me define who is a U.S. person and it is just worth clarifying for a moment who is a U.S. person. So, a U.S. person who is a U.S. tax resident who is required to report their worldwide income and also their non-U.S. financial assets on these information forms includes a U.S. citizen, a U.S. permanent resident, informally known as a green card holder, and a person who is deemed to be a U.S. resident for a given year based on a day count test of days of physical presence in the U.S.

Lee: That makes sense. So, what are the consequences of failing to report your income in the information returns?

McCormick: Failure to report income and information returns on a timely basis or accurately can result in a range of penalties that can accumulate and become quite severe. So, penalties can arise if income is not reported timely, which is generally reporting your income and paying taxes due by April 15 if you live in the U.S., or June 15 if you live outside of the U.S., though, you typically can get an extension to October 15. If you can't meet your filing deadline, or you don't pay the taxes on time, or you don't pay them accurately, there is generally a penalty of 20 to 25% on the unreported tax amount and interest can accrue not only on the unpaid taxes, but also on the unpaid penalties.

For the information returns potential penalties vary widely based on this specific type of form. There are several different types of forms for the different types of foreign assets a person may own. The most notable information return, I would say is the Foreign Bank account report, form FINCEN 114, and that is for reporting non-U.S. bank accounts if the aggregate value of the non-us bank accounts exceeds $10,000 in a year, which can be quite easy for a American who lives abroad if, for example, their employer doesn't withhold taxes from their paycheck. So, on a given monthly basis, could be quite easy to exceed $10,000, in which case they have an FBAR filing requirement.

Now, the penalties for filing an FBAR are for first a potential non-willful failure is $10,000 per year. Now this is a somewhat newly understood penalty amount. For many years there was somewhat of a lack of understanding or wasn't clear whether the non-willful penalty was $10,000 per year or not. There was a Supreme Court case though in recent years has said that the non-willful failure to file an FBAR is $10,000 per year. However, there can also be willful FBAR penalties, so that is a willful failure to file, and those penalties can be much steeper. The willful FBAR penalties can be the greater of $100,000 per account per year or 50% of the account balance per year. Now, if you're adding that up in your head, you can see that those penalties can be quite high, and they can actually exceed the aggregate balance of the account and there are cases that say that that is constitutional. The penalties for the willful failure can actually exceed the value of the account. So, it is very important to file the FBAR on a timely basis.

Lee: So, if a U.S. taxpayer is not current with their tax filings, what are their options to become compliant?

McCormick: The disclosure options for reporting their past tax filings very much depend on the taxpayers facts and circumstances. So, where do they live? What are the unreported assets? What are the unreported income? And what is their reason for not filing in the past? Probably the best option is something we call the streamline program. It is the streamlined filing compliance procedures. So, with a streamline filing, a U.S. person files the most recent three years for which the tax return due date has passed, they filed the past six years of FBARs and in exchange for doing that, if the IRS accepts their submission and that taxpayer lives outside of the U.S., there are no penalties. Now they have to pay the taxes and interest, but there are no penalties. If the taxpayer lives in the U.S. but it is reporting their foreign assets or income, there is a 5% penalty on the value of their foreign financial assets. As part of this submission, they have to submit a statement that explains their past filing issues and why their disclosure is based on non-willful behavior.

Now, there are some taxpayers who can't establish to the satisfaction of the IRS that their past filings were based on non-willful conduct. In that case, we would often look at something that is called the voluntary disclosure program, which is another program where you come forward to the IRS and you make your disclosure to the IRS before the IRS has come to you and, for example, audited you. This is a more thorough submission where you are submitting a six years of tax returns, six years of FBARs, and you are more likely to undergo something that feels more like an audit with the streamline program. And of course, when you're doing six years of tax returns and you're paying the penalties, there are obviously more money that is going to be paid to the IRS than under a streamline disclosure.

Another difference with the voluntary disclosure program and a streamlined submission is that one of the goals of a voluntary disclosure or submission is that at the end of the process, you do receive the closing letter from the IRS that closes those tax years for which you've submitted. Now, of course, there are caveats. If you've held back information, if you're not being accurate. But generally, you receive a closing letter that should give you some comfort that those past years are closed. With a streamlined submission, there are potentially no penalties, but very often you don't hear back from the IRS. So, for some taxpayers, they like the idea of getting the comfort of a closing letter at the end of the volunteer disclosure. There are a few other programs calling the delinquent information submission procedures where, for example, maybe a taxpayer needs to file one of these information returns, but they don't need to file admitted tax return report on unreported income.

Lee: Well, clearly there are many reporting issues for American expats to be aware of. Can you recap the main points for them to remember?

McCormick: Sure. So, an American taxpayer, again, U.S. citizen, green card holder, or someone who is a tax resident based on the substantial presence test, is required to report their worldwide income no matter what type of income it is, and no matter where it is earned. They're also required to report certain information reporting forms for reporting non-U.S. financial assets such as bank accounts and also shares of non-U.S. companies. It is very important that the tax return and the information returns are filed on an annual basis because otherwise there can be steep penalties that apply. If an American falls behind on their tax filings, there are certain disclosure options they can utilize to come into compliance and which disclosure option they choose is very much dependent on their facts and circumstances and I suggest that they seek a lawyer like myself to help advise them on the proper disclosure option if that is their situation.

Lee: This has been another great conversation. Thank you, George.

McCormick: Thank you, Leeann.

Lee: If you have any questions for George, his contact information is in the show notes. As always, thanks for listening to BakerHosts. Comments heard on BakerHosts are for informational purposes and should not be construed as legal advice regarding any specific facts or circumstances. Listeners should not act upon the information provided on BakerHosts without first consulting with a lawyer directly. The opinions expressed on BakerHosts are those of participants appearing on the program and do not necessarily reflect those of the firm. For more information about our practices and experience, please visit bakerlaw.com.