Current Issues in U.S. Succession Planning for International Families

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The United States is one of the few countries in the world that taxes its citizens and "residents" including green card holders on their world wide income and gains regardless of their residence or domicile. U.S. citizenship, once prized is now falling into disfavour as the costs associated with the passport begin to outweigh the benefits once associated with the passport. Similarly green cards have become a burden for many people who held the card for convenience and do not need the economic opportunities once promised by the United States.

My presentation will cover a broad range of subjects relevant to succession planning for families in the region. However this document discusses the two tax issues that arise most frequently: compliance with U.S. tax obligations and renunciation of U.S. citizenship, referred to as expatriation.

I. Compliance with U.S. Tax Obligations – The New Offshore Voluntary Disclosure Initiative – Compliance Required by 31 August 2011

It is unthinkable to individuals who have never lived in the United States that the U.S. Internal Revenue Service could expect them to pay U.S. income tax. However the U.S. government is now enforcing severe financial sanctions against U.S. citizens and green card holders who have not complied with their U.S. tax obligations.

On 8th February 2011, the U.S. Internal Revenue Service announced a new overseas voluntary disclosure initiative ("OVDI"). Individuals who enter the initiative minimise their risk of criminal prosecution and have "certainty" that fixed civil penalties, which are lower than the maximum penalties allowable under law, will be levied in connection with their disclosures. The IRS has increased its focus on "foreign facilitators" and taxpayers participating in the OVDI will be required to provide information regarding the financial institutions and advisors who assisted them with the unreported assets and income.

The 2011 OVDI closes on 31st August 2011. According to the guidance issued yesterday, taxpayers who make disclosures under the OVDI MUST submit all returns, Foreign Bank and Financial Account Reporting Forms ("FBARs") and other forms *completed and filed by 31st August 2011, including copies of foreign account statements for all relevant years.* This is a very short time frame for taxpayers who must collect bank statements and other records dating back 8 years from a variety of jurisdictions and financial institutions. The program is also open to trusts and other entities.

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Any U.S. taxpayer with unreported or underreported U.S. assets or income should consider whether to participate in the OVDI immediately.

A. **OVDI Considerations To Enter or Not to Enter**

As from 2013, most non-US financial institutions will be required to “report” their U.S. customers to the IRS under the FATCA provisions of the HIRE Act (enacted in March 2010). This means that staying under the IRS radar is not a viable alternative for noncompliant U.S. citizens, green card holders and other individuals who are resident in the United States for U.S. income tax purposes.

U.S. citizens and individuals who have held green cards for more 8 or more of the past 15 years must file with the IRS when renouncing their citizenship or abandoning their green cards. Thus U.S. tax compliance issues are raised if they attempt to exit the U.S. tax net by ceasing to be U.S. citizens or long term permanent residents. In essence if a U.S. taxpayer is not compliant, it is now time to come forward.

Some taxpayers will prefer to make a “quiet” disclosure. This may be preferable if the individual has “reasonable cause” for his or her failure to file or to report certain foreign income or assets.

The United States is one of the few countries in the world that taxes its citizens regardless of their residence or domicile. Many U.S. citizens who born in the United States spent the majority of their lives overseas, may have had a U.S. passport but no knowledge of the fact that they had any U.S. tax obligations. They would never have had any reason to contact a U.S. tax advisor, nor would their non US advisors necessarily have known that their clients had any U.S. obligations. Nonetheless, the IRS is taking the position that this very common scenario does not constitute “reasonable cause” for failure to comply with U.S. tax and reporting obligations. My personal opinion is that this is wrong and that individuals who are ready for the fact that they may have to appeal an unfavourable IRS penalty determination may be better off making a “quiet disclosure” outside of the OVDI. This is however a personal decision which is dependent on the facts of each case and the taxpayer’s appetite for risk.
The IRS has stated that individuals who make quiet disclosures and do not have “reasonable cause” will be subject to penalties higher than those applicable to the OVDI if their returns are randomly audited and are at greater risk of criminal prosecution.

The IRS’s rigid approach is not uniformly followed by the U.S. courts. For example in *U.S. v. Williams,* (E.D. Va. 2010) the court determined that what the IRS penalised as a wilful failure to disclose foreign accounts was in fact an “understandable omission” given the circumstances of that case. Each case must be determined on its own individual facts and

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circumstances as the cost of proving a case in court, and the uncertainty of the outcome may weigh in favour of participating in the OVDI.

The Program

♦ Complete and accurate filing required for 7 years (2003-2010)

♦ Copies of foreign bank and financial statements must be submitted if the highest aggregate balance in foreign financial accounts in any OVDI year was USD 500,000 or more;

♦ A Foreign Financial Institution Statement with regard to each foreign financial institution where accounts were held if unreported foreign financial accounts held USD 1 million or more in the aggregate during any year of the OVDI period. This will be used to identify financial institutions and advisors who assisted in U.S. tax evasion.

♦ Individuals who failed to file FBARs, Form 5471 or Form 3520 but reported all relevant income on their U.S. tax return must submit the relevant form with an explanatory statement but is not required to enter the OVDI.

Penalty Framework:

♦ 25% penalty in lieu of FBAR penalties imposed on highest aggregate balance in foreign financial accounts **and foreign assets purchased with unreported income**

♦ 20% underreporting penalty

♦ Penalty for failure to file in a timely manner

♦ Penalty for failure to pay tax in a timely manner

▲ 25% FBAR penalty reduced to 5% for:

♦ Taxpayers who were *unaware they were U.S citizens*
Ex. Accidental Americans with no U.S. passport or social security number)
▲ Note the reduced penalty does NOT apply to individual who knew they were U.S. citizens (i.e. passport holders) who never inquired about their U.S. tax obligations.

♦ Taxpayers who own an account they did not create if:

▪ The taxpayer did not open or cause the account to be open;

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▪ The taxpayer had minimal infrequent contact with the account;

▪ The taxpayer never withdrew more than USD 1,000 from the account other than to close the account or transfer the funds to the U.S. in any year covered by the OVDI; and;

▪ The taxpayer can establish that U.S. tax has been paid on funds deposited to the account and that only account earnings have escaped U.S. tax.

● Amounts deposited prior to 1991 are presumed to have been taxed if no information is available

▲ 25% penalty reduced to 12.5% if the aggregate value of the account (and undisclosed foreign financial assets) is less than USD 75,000.

The application of the 25% penalty to foreign assets such as art, jewellery and real estate is a new feature of the 2011 OVDI and will mean that individuals who did not otherwise come within the scope of the 2009 OVDI should give careful consideration to the 2011 initiative.

▲ Passive foreign investment companies ("PFICs") – Taxpayers may elect a 20% tax on the mark to market gain for the OVDI years and a 7% interest charge rather than the tax typically applied under the passive investment company regime.

▲ Individuals who did not file FBARs but reported the relevant income and those with signatory authority but no beneficial interest in the account will not be subject to the 25% penalty but must file the FBARs with an explanatory statement by the 31st August deadline.

▲ A "Package Deal". The IRS guidance emphasises that IRS agents will *not* have authority to negotiate penalties or to settle cases for less than the "package" amounts outlined above. It also states that reasonable cause will not be considered in determining penalties.

This is a very brief summary of the 28 pages of guidance issued in February. If you have questions about the program please feel free to contact me.

II. Expatriation.

On 17th June 2008, the US Congress enacted the exit tax it has been proposing for more than 10 years. The exit tax replaces the expatriation tax regime previously in effect. For some US citizens, the rules are a welcome change and a chance to exit the US tax system at no charge. However for the vast majority, and most long term green card holders, the exit tax may be burdensome.

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The exit tax replaces the old regime which imposed tax on US source income, and certain gifts and bequests as well as annual information reporting requirements for 10 years after the date of expatriation. The exit tax regime allows for a clean break for US income tax purposes, except with regard to certain trusts and deferred compensation plans.

A covered expatriate is deemed to have sold all of his assets on the day prior to expatriation, and is taxed at the prevailing capital gains rates on all gain in excess of USD 636,000 in 2011 (indexed annually for inflation). Currently, capital gains are taxed at 15% with respect to the disposition of most property held in excess of one year. Special rules applicable to deferred compensation and trusts are discussed below.

It is important to note that expatriation does not solve the excuse an individual from complying with their outstanding U.S. tax obligations. Outstanding tax obligations should be resolved prior to the date of expatriation.

A. **Who is a Covered Expatriate?**

A covered expatriate is a US citizen or US green card holder who gives up their green card or citizenship on or after 17th June 2008 who:

(a) has a net worth of USD 2 million; or
(b) has an average net US income tax liability over the past 5 years of more than USD147,000 in 2011 (indexed annually for inflation);
(c) has held a green card for 8 or more of the past 15 taxable years and meets the net worth or tax liability threshold set forth above.

Unfortunately there are no exceptions for "green card" holders, even if they return to their home countries and are fully liable to tax in that jurisdiction. The following exceptions apply to US citizens:

1. The Dual National Exception:

The dual national exception is applicable to individuals who (a) became citizens of the US and another country at birth and (b) have not been resident in the US for US tax purposes in 10 of the last 15 years; and (c) are resident for tax purposes in the "other country" of which they became a citizen at birth.

> Ex. A becomes a citizen of the India and the US at birth. He left the US and returned to India 15 years ago. He is now living in Dubai. He is not eligible for the exception. If he was resident in India he would qualify for the dual national exception.

2. The “Accidental American” Exception.

The accidental American exception is applicable to individuals who: (1) Were born in the US and became a citizen of another country at birth; (2) Who have not lived in the US for more than 10 years; and (3) who are under age 18½ on the date of expatriation.

> Ex. B becomes a Saudi Arabia and the United States at birth. His family left the United States when he was 5 and he has not since lived in the United States. B is now 18 and is living in Abu Dhabi. B is eligible for the “accidental American” exception. Unlike the dual national exception he is not required to live in the other country of which he became a citizen at birth.

B. **Deferral of the Exit Tax.**

The legislation permits a covered expatriate to make an irrevocable election to defer the tax attributable to property subject to the exit tax until it is disposed of by the covered expatriate. Adequate security in the form of a bond or letter of credit is a condition of deferral and interest would be charged annually Deferral is not permitted with respect to certain deferred compensation or interests in “non grantor” trusts.

C. **Trusts and Pension Plans.**

If a covered expatriate is a beneficiary of a trust on the date of expatriation, and the trust is not a “grantor trust” for US income tax purposes, the expatriate will be subject to US withholding tax at a rate of 30% on all distributions that would have been subject to tax if the expatriate were a US taxpayer. Broadly a grantor trust is a trust that the US views as being “owned” by the settler for US income tax purposes. Treaty relief is disallowed.

Similar rules will apply to “eligible deferred compensation” which is defined to exclude payments for services performed outside of the United States. Only a very limited range of US deferred compensation plans qualify as eligible deferred compensation. Similar foreign pension plans may qualify as eligible deferred compensation if the foreign employer elects to be treated as a US taxpayer for purposes of the exit tax withholding rules. Gift and bequests made in trust are also subject to the tax when distributed to the US beneficiary.

Most deferred compensation will not be eligible for withholding tax. In that case, the present value of the deferred compensation is deemed to have been received by the covered expatriate on the day before expatriation. Tax is imposed on this deemed distribution at ordinary income tax rates of up to 35%.

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D. **Estate and Gift Tax Consequences.**

Generally, US gift and estate tax is not paid by the beneficiary, it is paid by the donor. However the general rule does not apply to gifts and bequests made to US citizens or domiciliaries by individuals who are "covered expatriates". The US no longer has the power to tax the expatriate but the beneficiary will be liable for gift or estate tax at the highest marginal rate then in effect (currently 35%), reduced by foreign tax paid on the gift or bequest in another jurisdiction.

Ex. C expatriates in 20011 and is a covered expatriate. In 2012 he makes a gift of USD2 million to his US citizen children. His children are liable for US gift tax at a rate of 35%. Upon his death, if he is still a covered expatriate, his children will be subject to US estate tax at the highest marginal rate then in effect.

Exceptions apply to gifts and bequests that would qualify for the US gift and estate tax marital deductions, the US gift and estate tax charitable deductions. The tax does not apply to gifts that are under the "annual exclusion amount" which is currently USD 13,000 per person per year (indexed annually for inflation).

Finally covered expatriates who become US citizens or residents in the future are not treated as covered expatriates for purposes of the exit tax rules applicable to deferred compensation, trusts and estate and gift tax. It is expected that the US Internal Revenue Service will issue guidance clarifying the application of the exit tax rules to the estate and gift tax rules in the coming months.

Despite the discussion set forth above, I am not an advocate of expatriation solely for tax purposes. Wealth should increase one's options rather than limit them. Individuals with ties to the United States will want to give consider carefully whether expatriation is the proper decision for them, particularly if they have family members in the United States or may plan to settle there in the future. Individuals with U.S. citizen spouses, children and grandchildren can plan their affairs using trusts and other vehicles so that relatives can retain their U.S. citizenship without significant adverse U.S. tax consequences or diminution of family wealth.

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