

## IRS PROVIDES MORE SENSIBLE OFFER IN ITS INCREASED ENFORCEMENT OF OFF-SHORE ACCOUNTS AND ASSETS OF U.S. TAXPAYERS RESIDING OVERSEAS; SPECIAL OFFER MADE TO U.S. TAXPAYERS WITH UNREPORTED FOREIGN INCOME

By: *Patrick W. Martin, Procopio, Cory, Hargreaves & Savitch LLP*

The IRS announced on 8 February 2011 a specific program for U.S. taxpayers who have unreported foreign accounts and other foreign assets that have not been previously reported and/or taxed.<sup>1</sup> The IRS Commissioner's Statement on the 2011 Offshore Voluntary Disclosure Initiative (referred to as the "2011 OVDI" throughout this article) can be reviewed online at <http://www.irs.gov/newsroom/article/0,,id=235728,00.html>.

**This offshore initiative is part of the longstanding voluntary disclosure program ("VDP"), and provides specific terms for participation.**

The time for participation is very short (i.e., August 2011) and the terms of the IRS offer are rigorous and are explained further in this article. Taxpayers who participate will need to have completed all of the paperwork and tax returns by August of this year.

Time is of the essence.

The IRS has finally acknowledged and provided a more sensible approach for U.S. citizens residing overseas as part of its 2011 OVDI. The U.S. is the only major country in the world that taxes individuals not only based upon physical presence in their country, but also based upon citizenship when residing outside the country of residence. This comes as a big surprise to many individuals not living in the United States. No one seems to know how many U.S. citizens actually live overseas for several reasons. First, many people are simply not aware they are U.S. citizens. The 14th Amendment automatically grants citizenship to anyone born in the U.S. and many foreign families give birth to children in the U.S. before returning to their home country. Second, many foreign born persons are automatically U.S. citizens under a complex web of immigration laws that grants derivative citizenship depending upon a number of factors (e.g., date of birth, nationality of one or both parents, number of days one or more parent spent in the U.S. or a U.S. territory). The U.S. census data does not try to effectively track U.S. citizens residing overseas.

In the mid-1990s, "The State Department estimates that there are approximately 3 million U.S. citizens living abroad, although thousands of these individuals may not even know that they are U.S. citizens." See Joint Committee on Taxation Report, J.C.S. 12-96: General Explanation of Tax Legislation Enacted in The 104th Congress (Expatriation Tax Provisions (Secs. 511-513)).

Current estimates seem to be 4.1 million. See, ESTIMATION OF EMIGRATION FROM THE UNITED STATES by Jason P. Schachter, Ph.D. "There is currently no reliable estimate of the number of U.S. citizens living abroad. The U.S. State Department occasionally publishes data about U.S. nationals living abroad based on registrations at embassies and missions, but there are major questions concerning its validity.

According to U.S. State Department data there were 4.1 million U.S. citizens living abroad in 1999 (see Table 1). Nearly one-quarter (1 million) of these people lived in Mexico, while 687,000 were in Canada. Other countries with large numbers of Americans included the United Kingdom (224,000), Germany (211,000), Israel (184,000), Italy (169,000), Philippines (105,000), Australia (103,000), France (102,000), and Spain (95,000). In fact, according to these State Department data, these ten countries contain about 70% of all U.S. citizens living abroad.

However, when State Department figures are compared to international Census data huge discrepancies are found. State Department estimates of U.S. citizens seem to be on average about two to three times larger than the enumerated population. For example, from the 2000 round of Censuses or population registers, among countries with the largest number of U.S. citizens from State Department data, all had far fewer U.S. born or U.S. citizens. Mexico only counted 344,000 U.S. born residents, Canada 238,000 U.S. born permanent resident (and 208,000 U.S. citizens, 68,000 of whom were dual US-Canadians citizens), the United Kingdom 158,000 U.S. born (and 109,000 U.S. citizens estimated from their Labor Force Survey), Germany 112,000 U.S. citizens, Israel up to 124,000 citizens from the "Americas," Italy 33,000 U.S. citizens, Australia 54,000 U.S. born, France 39,000 U.S. born, and Spain 21,000 U.S. born (15,000 U.S. citizens)."

<sup>1</sup> See, IRS FAQs on 2011 OVDI - 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html>

These numbers do not try to include or count foreign born citizens. Whatever the number, it is several million.

Fortunately, the IRS' recent modification to the 2011 OVDI program has provided a more sensible approach to these millions (however many millions there are) of U.S. citizens residing overseas. These terms do not expressly extend to LPRs, but presumably the IRS would extend these terms to LPRs too.

The new terms of the 2011 OVDI reduce the "25% in lieu of FBAR penalty" explained below to 5% for persons who meet each of the following three categories:

- 1.- They reside overseas outside of the United States;
- 2.- They have less than US\$10,000 of income from sources from the United States; and
- 3.- They can demonstrate a good faith effort of timely filing and paying their tax obligations in their country of residence.

These terms are worthy of consideration and should be analyzed in each particular case. They presumably also apply to non-U.S. citizens who are lawful permanent residents ("LPRs") who also reside overseas. The U.S. Homeland Security estimates there are about 12.5 million LPRs at the end of 2008, but does not indicate how many live outside the U.S.

Importantly, if a U.S. taxpayer (which includes U.S. citizens and presumably LPRs residing outside the U.S.) has no U.S. income tax liability, they can generally not be liable for any of the following penalties:

i) late payment penalty, (ii) understatement penalty, (iii) negligence penalty, (iv) late filing penalty, or (v) fraud penalty, etc. All of these penalties are calculated with reference to the amount of income tax owed.

Time is of the essence in analyzing these new terms.

### WHO IS AFFECTED (WHO CAN BENEFIT)?

The off-shore initiative applies to three general categories of individuals, all of whom are generally U.S. income tax residents who may have foreign accounts or assets where the income from them has not been reported and previously subject to U.S. income taxation.

#### 1. U.S. Citizens

U.S. citizens are U.S. income tax residents irrespective of where they might reside. U.S. citizens with dual or multiple nationalities are also U.S. income tax residents. Unfortunately, U.S. income tax treaties with various countries do not provide any treaty protection to somehow avoid U.S. income tax residency to any U.S. citizens. U.S. citizens are U.S. income tax residents even if they live exclusively overseas.<sup>2</sup>

#### 2. Lawful Permanent Residents

Also, lawful permanent residents (i.e., "green card" holders) are also generally U.S. income tax residents.

#### 3. Non-U.S. Citizens Who Live Predominantly in the U.S.

Finally, non-U.S. citizens who reside predominately in the U.S. are also generally U.S. income tax residents.

There are many U.S. citizens who are citizens merely by virtue of their birth.<sup>3</sup> The total non-U.S. citizens who come to the U.S. is a very large number annually and out of those non-immigrants, there are inevitably numerous births, and hence U.S. taxpayers. According to the April 2010 Annual Flow Report, prepared by the Department of Homeland Security ("DHS"), there were 163 million nonimmigrant admissions to the U.S. in 2009, including tourists and business travelers from Canada and

**U.S. taxpayers include:  
(i) U.S. citizens, and generally  
(ii) lawful permanent residents; and  
(ii) non- U.S. citizens who live  
predominantly in the U.S.**

<sup>2</sup> While the U.S. system of income taxation based upon citizenship, regardless of physical residency may seem unfair or somehow inequitable, the U.S. Supreme Court concluded it constitutional in the 1920s. See *Cook v. Tait*, 65 US 47 (1924) where a U.S. citizen resided permanently and was domicile in Mexico City with his Mexican citizen wife and the Court found that U.S. taxation of his Mexican source income was indeed constitutional. The basic rationale of the Court was that the U.S. federal government provides, or at least can provide, much protection and benefits to U.S. citizens residing abroad.

<sup>3</sup> See, the 14<sup>th</sup> Amendment of the U.S. Constitution, which provides in relevant part:

**Section 1.** All persons **born** or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. [*emphasis added*]

Mexico with specific border crossing cards.<sup>4</sup> According to this report, approximately 36 million of these 2009 admissions required I-94 Arrival/Departure Record admissions while Mexico, the UK and Japan are the primary countries of I-94 admissions.<sup>5</sup>

The vast majority of these total 36 million (90 percent) were (a) visitors, such as tourists and business travelers, while (b) the remaining 3.4 million were temporary residents including specialty workers and students.<sup>6</sup>

The principle countries for non-immigrant visa entries were citizens from Mexico, India, Japan, Canada, China, the UK, South Korea, Germany, France and Brazil in more or less that order for the years 2007, 2008 and 2009.

The sheer number of non-U.S. citizens who arrive to the U.S. for a partial stay, necessarily means that the birth of their children in the U.S. will create U.S. citizenship and hence U.S. income tax residency.

U.S. citizens who reside overseas and see no benefits of U.S. citizenship should certainly consider whether renouncing their U.S. citizenship is in their best interest; although there are important U.S. tax considerations for so doing, if the taxpayer's assets or income thresholds are sufficiently high.

These are some of the key considerations all U.S. citizens and lawful permanent residents should analyze, when contemplating the U.S. tax consequences of U.S. citizenship or lawful permanent residency, for otherwise "foreign persons" or "foreign families."

### IRS ENFORCEMENT EFFORTS

The world in 2011 is one of increased international tax enforcement, particularly in the U.S. regarding foreign assets and income.

<sup>4</sup> See, R. Monger and M. Barr, Nonimmigrant Admissions to the United States: 2009, p. 1 (April, 2010), DHS Office of Immigration Statistics.

<sup>5</sup> See Supra, footnote 4, page 1.

<sup>6</sup> See Supra, footnote 4, page 3, Table 1 recreated below:

**Table 1.**  
**Nonimmigrant Admissions (I-94 only) by Category of Admission: Fiscal Years 2007 to 2009**

Category of admission	2009		2008		2007	
	Number	Percent	Number	Percent	Number	Percent
Total	36,231,554	100.0	39,381,928	100.0	37,149,651	100.0
Non-residents	32,544,098	89.8	35,434,175	90.0	33,301,754	89.6
Temporary visitors for pleasure .	27,800,027	76.7	29,442,168	74.8	27,486,177	74.0
Temporary visitors for business	4,390,888	12.1	5,603,668	14.2	5,418,884	14.6
Transit aliens .	346,695	1.0	387,237	1.0	396,383	1.1
Commuter students .	6,488	--	1,102	--	310	--
Short-term residents .	3,438,276	9.5	3,688,167	9.4	3,566,367	9.6
Temporary workers and families	1,703,697	4.7	1,949,695	5.0	1,932,075	5.2
Students	951,964	2.6	917,373	2.3	841,673	2.3
Exchange visitors	459,408	1.3	506,138	1.3	489,286	1.3
Diplomats and other representatives	323,183	0.9	314,920	0.8	303,290	0.8
Other .	24	--	41	--	43	--
Expected long-term residents .	53,019	0.1	59,097	0.2	76,158	0.2
Alien fiancé(e)s of U.S. citizens and children .	32,009	0.1	34,863	0.1	38,507	0.1
Alien spouses of U.S. citizens and children, immigrant visa pending	15,515	--	15,694	--	18,495	--
Alien spouses of U.S. permanent residents and children, immigrant visa pending	5,445	--	8,478	--	19,099	0.1
Other .	50	--	62	--	57	--
Unknown	196,161	0.5	200,489	0.5	205,372	0.6

Note: Excludes the majority of short-term admissions from Canada and Mexico. See Appendix A for classes included in each category.

Source: U.S. Department of Homeland Security, Customs and Border Protection (CBP), TECS, Arrival File, Fiscal Years 2007 to 2009.

The following is an excerpt from IRS Commissioner Doug Schulman's testimony before the Senate Finance Committee, in 2009, that reflects the increased efforts and resources committed by the IRS in identifying unreported income in foreign accounts:

#### **IRS Enforcement: Tightening the Net**

*Mr. Chairman, I am also pleased to be here today to describe the unprecedented focus that the Internal Revenue Service has placed on detecting and bringing to justice those who unlawfully hide assets overseas to avoid paying tax.*

*In today's economic environment, it is more important than ever that citizens feel confident that individuals and corporations are playing by the rules and paying the taxes that they owe.*

**The point of the U.S. immigration law discussion is to highlight the impact of how the U.S. taxation system affects individuals, wherever they may reside.**

*When the American public is confronted with stories of financial institutions helping US citizens to maintain secret overseas accounts involving sham trusts to improperly avoid US tax, they should be outraged, as I am. But they should also know that the US government is taking new measures, and there is much more in the works.*

*In the wake of some recent well-publicized cases, the media has been full of speculation from those who are advising US taxpayers who have undeclared offshore accounts and income.*

*My advice to those taxpayers is very simple. The IRS has been steadily increasing the pressure on offshore financial institutions that facilitate concealment of taxable income by US citizens. That pressure will only increase under my watch. Those who are unlawfully hiding assets should come and get right with their government through our voluntary disclosure process*

The 2011 OVDI is of course one of the responses by the IRS to its policy of identifying U.S. taxpayers with unreported income in foreign accounts. It follows a well publicized 2009 initiative for foreign accounts and a specific offer for voluntary disclosure program participants. The Commissioner of the IRS announced that over 18,000 taxpayers participated in the 2009 voluntary disclosure program regarding foreign accounts.<sup>7</sup>

#### **WHAT IS THE LATEST IRS 2011 OVDI NOT ABOUT?**

First, it is not an "amnesty" as much of the popular press has reported it. It does not guaranty a taxpayer will not be criminally prosecuted. However, it lessens the risk significantly that the IRS and the Justice Department will pursue a criminal indictment against a taxpayer who participates in good faith in the 2011 OVDI.

Second, the IRS has expressed their interest in learning more about the promoters (e.g., bankers, lawyers, accountants, financial advisors, banks, etc.) of off-shore undisclosed accounts. The government has and will continue to pursue criminal actions against these persons. The IRS has expressed their focus of criminal prosecutions is generally not against individual taxpayers who participate in the 2011 OVDI.

Third, U.S. tax lawyers are promoting the VDP offshore initiative with great fervor, since they see significant legal work arising from assisting taxpayers file and participate directly in this latest initiative. The initiative was not established to benefit U.S. tax lawyers, but that is certainly one of the side-effects of this 2011 OVDI and the 2009 initiative where apparently more than 18,000 taxpayers participated. Imagine the legal fees generated in these 18,000 cases.

#### **WHAT IS THE LATEST IRS 2011 OVDI ABOUT AND WHAT ARE ITS BASIC TERMS?**

The 2009 initiative had more favorable terms than the 2011 OVDI. The following summarizes some of the key terms of the 2011 OVDI:

- Taxpayers must report the income for the last eight years, starting in 2003 and ending with the latest tax year 2010 (the "Tax Years") and of course pay income tax on the unreported income ("Income").
- The base penalty amount to be owed by the taxpayers is 25% ("25% Account Balance Penalty") and is measured by the highest amount of the foreign account balance during any of the Tax Years. This "penalty" (which has no direct correlation to the law) is often times erroneously referred to as the "FBAR penalty". This 25% Penalty has no correlation to the unreported income or income tax liability of the taxpayer; as it merely is based upon the balance in the foreign account.

<sup>7</sup> See, IRS Commissioner Doug Shulman's Statement on UBS / Voluntary Disclosure Program, 16 Nov. 2010 <http://www.irs.gov/newsroom/article/0,,id=231520,00.html>

- The 25% Account Balance Penalty can be reduced to 12.5% or 5% depending upon the specific facts of the taxpayer.
- The 12.5% lesser Account Balance Penalty applies to certain accounts where the maximum balance was US\$75,000 in the foreign accounts.
- The 5% lesser penalty applies to certain inherited accounts where the U.S. taxpayer had minimum contacts with the foreign accounts.
- In addition to the “25% Account Balance Penalty”, the taxpayer is required to pay the so-called accuracy related penalty of 20%<sup>8</sup> with reference to the income tax liability owed by the taxpayer.<sup>9</sup>

Taxpayers who wish to participate in the 2011 OVDI must provide extensive and detailed information prior to the August 31, 2011 deadline as follows:

- Copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure;
- Complete and accurate amended federal income tax returns (for individuals, Form 1040X, or original Form 1040 if delinquent) for all tax years covered by the voluntary disclosure, with applicable schedules detailing the amount and type of previously unreported income from the account or entity (e.g., Schedule B for interest and dividends, Schedule D for capital gains and losses, Schedule E for income from partnerships, S corporations, estates or trusts).
- Complete and accurate original or amended offshore-related information returns (see FAQ 29 for certain dissolved entities) and Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, commonly known as an “FBAR”) for calendar years 2003 through 2010;
- Cooperation in the voluntary disclosure process, including providing information on offshore financial accounts, institutions and facilitators, and signing agreements to extend the period of time for assessing tax and penalties;
- Full payment of all tax, interest, accuracy-related penalty, and, if applicable, the failure to file and failure to pay penalties with the required submissions set forth in FAQ 25 or make good faith arrangements with the IRS to pay in full, the tax, interest, and these penalties (see FAQ 20 for more information regarding a taxpayer’s ability to fully pay) (the suspension of interest provisions of IRC § 6404(g) do not apply to interest due in this initiative); and
- Execute a Closing Agreement on Final Determination Covering Specific Matters, Form 906.

**The 2011 OVDI is available for a very short window of time. Any taxpayer who falls into the category of U.S. taxpayers (including the plethora of U.S. citizens residing overseas by virtue of their birth in the U.S. or otherwise) should seriously analyze and consider participating in the 2011 OVDI.**

The 2011 OVDI is clearly **NOT** for every foreign person who has recently learned they might have a U.S. tax filing obligation merely because of their U.S. citizenship. The costs under the 2011 OVDI are significant and paying 25% of a total account balance, which has no correlation to any income tax liability or penalties, may not be sensible for a foreign person who is a dual or multiple national with U.S. citizenship. For instance, the FBAR penalties (e.g., 50% of account balances) under the law do not apply to everyone. Those who were not aware of the FBAR filing requirements cannot generally be liable for the 50% willful penalty. Also, you may be entitled to foreign tax credits for income taxes paid in your home country of residence and the foreign earned income exclusion. Hence, your actual U.S. income tax liability, even if you earned millions of dollars over time, may be modest or nil. Therefore, a 25% transfer of your account assets (i.e., the “25% penalty” under the 2011 OVDI) to the U.S. Treasury may have no basis under the law, depending upon the specific facts of your case.

The application of the 2011 OVDI program is an important decision that should be carefully analyzed in each particular case.

<sup>8</sup> See, IRC § 6662(a). Commissioner Doug Shulman’s Statement on UBS / Voluntary Disclosure Program, 16 Nov. 2010 <http://www.irs.gov/newsroom/article/0,,id=231520.00.html>

<sup>9</sup> In addition to the 20% accuracy related penalty, taxpayers will also need to pay the so-called “failure to file” penalties and “failure to pay” penalties if applicable in any particular case. See, failure to file penalties under IRC § 6651(a)(1), and failure to pay penalties under IRC § 6651(a)(2).

Mr. Patrick W. Martin is a U.S. lawyer licensed in California and Washington, D.C. and specializes in international tax and related international law matters. Mr. Martin is the partner in charge of the international tax practice group of the Tax Team with the San Diego based law firm of Procopio, Cory, Hargreaves & Savitch LLP. He received his J.D. from the University of San Diego School of Law, has passed the Certified Public Accountant's exam, previously worked for the Internal Revenue Service, and studied postgraduate law studies in international business transactions at the Escuela Libre de Derecho, in Mexico City. In 2010 he received the V. Judson Klein award from the Taxation Section of the California Bar. Reach him at 619.515.3230 or [patrick.martin@procopio.com](mailto:patrick.martin@procopio.com).

For further information about the 2011 OVDI or other international tax issues please contact one of Procopio's international tax attorneys:

Enrique Hernández-Pulido, Esq.	<a href="mailto:enrique.hernandez@procopio.com">enrique.hernandez@procopio.com</a>	619.515.3240
Patrick W. Martin, Esq.	<a href="mailto:patrick.martin@procopio.com">patrick.martin@procopio.com</a>	619.515.3230
Jon Schimmer, Esq.	<a href="mailto:jon.schimmer@procopio.com">jon.schimmer@procopio.com</a>	619.525.3805
Eric D. Swenson, Esq.	<a href="mailto:eric.swenson@procopio.com">eric.swenson@procopio.com</a>	619.515.3235
Abel F. Mejia Consenza	<a href="mailto:abel.mejia@procopio.com">abel.mejia@procopio.com</a>	619.525.3861
Liliana Menzie, Esq.	<a href="mailto:liliana.menzie@procopio.com">liliana.menzie@procopio.com</a>	619.525.3834
Artemiza Schumacher	<a href="mailto:Artemiza.schumacher@procopio.com">Artemiza.schumacher@procopio.com</a>	619.525.3860