GUEST FEATURE

ACCIDENTAL AMERICANS

We are delighted to present a guest article by two leading practitioners in Private Wealth at global law firm Stephenson Harwood LLP, Erik Wallace, a Partner based in Hong Kong, and Emily Osborne, a Senior Associate based in London. They provide a fascinating insight into why people who may have an unwitting connection to the USA are liable to US taxes.

Introduction

US Persons are subject to worldwide taxation and reporting obligations, regardless of their residence. They also may experience difficulties opening bank accounts and investment accounts, and are subject to penal tax regimes on non-US investments. Of course this is not news to most of those who know they are US Persons, but there are a growing number of "Accidental Americans" who are unaware of their US status and resulting obligations.

US Persons

The issue arises because of the wide definition of "US Persons". Principally this means US citizens, but others also fall into the definition. In respect of citizenship, this can be acquired either by being born in the US, or by having a parent who is a US citizen.

In addition, "resident aliens" are also US Persons. These are individuals who either hold a green card or meet a day count test known as the substantial presence test. Although the substantial presence test is a bright line test, it can be difficult and cumbersome in application. Quite often individuals who thought they were not US Persons are surprised to find that they are, in fact, resident aliens because they either failed an exception or their days of presence in previous years counted towards their current year calculation.

Taxpayers Living Abroad

All US Persons, wherever resident, must file income, estate, and gift tax returns and pay any tax due, even if they have never lived in the US and have no US income.

Reporting Obligations

In addition, where a US Person is not in receipt of income, there may still be filing requirements where they hold other assets. There are substantial penalties for failure to comply with any of the following:

Report of Foreign Bank and Financial Accounts (FBAR) – where a US Person has a financial interest in or signature authority over foreign financial accounts which had an aggregate value in excess of $10,000 during the calendar year, an FBAR form must be filed.

Statement of Specified Foreign Financial Assets – where a US Person has specified financial assets with a total value of more than the appropriate reporting threshold, they must file Form 8938 detailing those assets.

Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts – reportable events include creation of foreign trusts by US Persons, transfer of any money or property to a foreign trust, and gifts or bequests exceeding $100,000 received from a foreign person.

Information Return by a Shareholder of a Passive Foreign Investment Company - if a US Person is a direct or indirect shareholder of a passive foreign investment company (PFIC) he or she is subject to a special tax and interest regime and must report when he or she receives income or recognises a gain from disposition of shares. This includes investments in non-US Unit Trusts and Mutual Funds.

Foreign Account Tax Compliance Act (FATCA)

As if all of those reporting obligations were not sufficient, US Persons are also subject to FATCA. Foreign financial institutions are obliged to report details of foreign financial accounts held by US Persons to the IRS. This may include financial accounts held by individuals, partnerships or corporations organised under US law or trusts where a US Person has authority to control the main decisions. There is a 30% withholding tax on many types of money flow to non-compliant foreign financial institutions.

If the foreign country has entered into an Intergovernmental Agreement with the US then the disclosure may be made to the foreign country's relevant tax authority, which then passes the information on to the IRS.

Getting Compliant

Understandably, there are a number of US Persons who are unaware of their position and their obligations as explained above. Such individuals may be able to use either the Offshore Voluntary Disclosure Program (OVDP) or the Streamlined Program to regularise their position. The OVDP requires filing of tax returns for 8 years and also making FBAR reports for 8 years. A 27.5% offshore penalty (imposed on the highest value of the non-compliant assets during the 8 year period) is normally payable in addition to outstanding tax liabilities and late filing penalties. The offshore penalty is increased to 50% where the foreign financial institution holding the US Person's account has been publicly identified as being under investigation.

The Streamlined Program requires the filing of 6 years of FBARs and only 3 years of returns. In addition, the taxpayer must explain his or her facts to the IRS and certify that his or her failure to file was not willful. So long as the IRS accepts the taxpayer's Non-Wilfulness Certification Statement there is no additional penalty.

Expatriation

Once compliant, the US Person must continue to file returns and meet their other filing obligations, unless they decide to expatriate by giving up their citizenship or green card. However, "covered expatriates" will find that there is a US tax cost to doing so.

US citizens and those persons who have held a US green card for at least 8 years are subject to special US federal tax rules when they expatriate from the United States. Under this regime, a person is treated as a "covered expatriate" if (i) his or her net worth is US$2 million or more, (ii) he or she paid on average more than US$161,000 (indexed for inflation) in US federal income taxes annually during the 5 year period preceding expatriation, or (iii) he or she fails to certify that he or she is fully compliant with his or her US federal income tax and reporting obligations during the 5 year period preceding expatriation.

These covered expatriates will be treated as selling their worldwide assets (often called an "exit tax" or "mark-to-market tax") and any resulting deemed gains and income in excess of a certain amount will be subject to current taxation at whatever rates would have applied if the assets had actually been sold. In addition, any future gifts or bequests from the covered expatriate to a US Person are subject to US transfer tax at the highest estate and gift tax rates then in place (currently 40%). Moreover, distributions from certain trusts to the covered expatriate will be subject to a 30% withholding tax. Finally, these rules now apply for the rest of the covered expatriate's life, not just 10 years as with the previous regime. As a result of these additional lifelong tax burdens, it is now more important than ever to take legal advice when giving up US status.

Conclusion

It is all too easy to be an Accidental American as MP Boris Johnson discovered when he sold his London home. Mr Johnson was born in New York and accordingly held US citizenship, meaning his expected tax free (in the UK) gain on the disposal was subject to US capital gains tax. If you are worried about your US status or have any queries on US tax issues, please get in touch.

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