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Streamlined Filing Compliance Procedures

Using the residency rules, you could avoid the penalties on failure to disclose foreign financial account ("FFA"), also known as foreign bank accounts reporting ("FBAR").

Wealthy Europeans and Japanese have avoided FBAR and FATCA reporting requirements, by not becoming US residents. Foreigners, who are not U.S. citizens or U.S. permanent residents, can still own and conduct businesses in the US, including real estate ventures. As such for this reason, many wealthy Europeans and Japanese do not want US citizenship or permanent residency. They avoid US residency by carefully following the non-residency rules within U.S. income tax law, which are mechanical, as such easily avoidable.

For those contemplating becoming U.S. resident, splitting residency between the spouses can help in avoiding penalties on failure to disclose FFA. In this strategy, the U.S. income tax exposures are isolated to family members in the US, who are U.S. resident, generally with little or no FFAs and foreign income, thus avoiding penalties related to failure to disclose FFA.

Some have feared that disclosing FFAs will bring double taxation in estate/gift taxes on worldwide assets. Their fear is based on the fact that their country of residency's estate/gift taxes are imposed on the recipient of property, while U.S. estate/gift tax is imposed on the giver of property. However, US residents may choose to apply either the local country estate/gift tax law or U.S. estate/gift tax law. As such, making such election will avoid double taxation of estate/gift tax. Many have chosen U.S. estate/gift tax law over local country estate/gift tax law, due to higher exemption level ($5,340,000 in 2014 and $5,430,000 in 2015).

If you are US permanent resident or have been present in the US for more than 183 days during the past three years, and with more than $10,000 of FFAs, you should consider the benefits of Streamlined Filing Compliance Procedures ("SFCP"), if FFAs had not been previously disclosed. If you can demonstrate that your failure in reporting worldwide income and disclosing your FFA was not willful, then you may qualify for SFCP. To demonstrate non-willfulness, you must not be under an IRS audit or contacted by the IRS. The amount of unreported worldwide income also is a factor, in determining whether or not you were willful, in not disclosing FFA.

There are two different types of SFCP. The first for U.S. taxpayers residing outside the United States, and the second for U.S. taxpayer residing in the United States.

If you are a U.S. taxpayer residing outside the United States, then you will not be penalized for late filing of FFA, if you do the following:

1. File delinquent original or amended U.S. tax returns for the most recent three taxable years, and all required international informational returns.
2. File delinquent FFAs for the most recent six years.
3. Certify that all required FFAs have now been filed, and that taxpayer's prior failure to file tax returns, pay all tax and file FFAs was non-willful, and
4. Pay all tax and interest due on the tax returns submitted.

If you are a U.S. taxpayer residing in the United States, you will only need to pay a miscellaneous offshore penalty equal to 5% of the highest aggregate value of the taxpayer's FFAs at any time during the most recent three taxable years, for late filing of FFAs, if you do the following:

1. File amended tax returns for the three most recent taxable years for which the tax return due date has passed, together with all required international information returns,
2. File delinquent FFAs for the most recent six years,
3. Certify that all required FBARs have now been filed and that taxpayer's prior failure to report all income, pay all tax and submit all required information returns was non-willful, and
4. Pay all tax and interest due on the tax returns submitted.

The key qualifier for SFCP is proving that you were not willful in not disclosing FFAs. If there are more evidence of willfulness, then you should consider Offshore Voluntary Disclosure Program (OVDP), which carries 27.5% penalty on highest aggregate value of FFAs. OVDP will avoid criminal prosecution (carrying jail time), which is the main reason for selecting this program.

So how do you define willfulness? As it depends on facts and circumstances, pinning down this definition is difficult. The most objective indicator of willfulness is the amount of foreign income, previously not reported. In my next column, I will discuss case studies, which provided some guidance on the range that IRS has accepted as being non-willful.

In prior column, I have written about using residency to avoid penalties on failure to disclose foreign financial accounts. In addition, the determination of willfulness is an important factor to determine whether Streamlined Filing Compliance Procedures ("SFCP") should be pursued or Offshore Voluntary Disclosure Program ("OVDP").

According to the IRS, willfulness involves a voluntary, intentional violation of a known legal duty. Although the IRS had hard time proving willfulness in breaking tax law, the IRS regardless asserts willfulness on all cases that even hints of intentional violation.

In the case of foreign financial asset (FFA), the immigrants coming to U.S. had the benefit of doubts when it came to willfulness in the past, due to their lack of knowledge of U.S. tax law. However, that appears to have changed due to the wealth of recent Korean immigrants coming to U.S. With the increased in wealth, a higher standard of knowledge is now being attributed on FFA cases. The failure to learn of filing requirements, with efforts to conceal the existence of the accounts, can be viewed as willfulness.

Many tax practitioners have complained about the lack of clear guidance in the definition of willfulness, as it relates to FFA. However, the lack of clear guidance is by design. U.S. government is well aware of the fact that there are a lot of bad people out there and the IRS wants to get them. If too specific guidance is given, many of these bad people would try to take advantage of loopholes. Leaving the rules vague enough, while providing leniency to truly non-willful taxpayers, appears to the goal of the IRS.

That still doesn't help many who want to come forward but are afraid of being labeled as criminal, as their actions can be viewed as willful. SFCP is designed to help those who want to come forward and be in compliance with U.S. tax law. To this goal, SFCP will not impose penalty for the U.S. taxpayers, residing outside of U.S.

This is where an opportunity exists to avoid penalties on failure to disclose FFAs. Many U.S. permanent residents (green cardholders) live in foreign countries and only visit U.S. less than four months per year. For these U.S. green cardholders, there may be a provision in U.S.Income Tax Treaty, to claim non-resident status for tax purposes, if there is a closer tie to local country, as long as all FFAs are disclosed.

SFCP has been developed from the past accepted FFA cases , which are outside of OVDP. A look of past cases can shed some lights into what the IRS views as non-willful, thus qualifying for SFCP.

Let's take a look at a 2011 case, pre-SFCP case, where a doctor, with a medical clinic in foreign country, has U.S. green card. He spends most of his time working in foreign country and only come to visit U.S. twice a year for vacation, usually to warm states, such as Hawaii for less than one month. This doctor mistaken filed as resident of U.S. (Form 1040) since 2000, only reporting U.S. rental income on his U.S. condo. This doctor had significant foreign assets and foreign income (in the million dollar range).

The problem, that this doctor faced, is the fact he did not report worldwide income to the U.S. government, when claiming to be a resident of U.S. He received a wrong tax advice that as a green cardholder, he is only required to report US source income and not worldwide income. If this doctor was treated as non-resident for tax purposes, he could have only reported his U.S. condo rental income (his only U.S. source income).

On this doctor's case, the IRS has accepted the amended tax returns, claiming non-residency status to the U.S. and late filing of past Foreign Bank Account Reports ("FBARs"), with an explanation that previous returns (claiming resident of U.S.) were a mistake and the correct returns, which should have been filed, were non-resident tax returns (Form 1040NR).

The significance of this case is that as long as income is properly reported, there is no penalty for late filing of FBARs. Even if mistakes were made in the past filings, which would have resulted in higher taxes, if worldwide income is properly reported, as would be required to all resident U.S. taxpayers, the penalty can be avoided. In the U.S., mistakes are forgiven but covering up these mistakes will be considered to be a willful act. Additionally, green cardholders or permanent non-residents could elect to be treated as non-resident for tax purposes. The lesson to be drawn from this case is that proper reporting of income is the start of determination of willfulness. In addition, the actions taken by the taxpayer, to correct the mistakes (as opposed to covering up), determines whether a failure to disclose FFA is or is not willful.

Another way to view this case is that the purpose of requiring FFA disclosure is forcing reporting worldwide income reporting by US taxpayers. If worldwide income is properly reported and corrective actions are properly taken (instead of covering up), then late filing of FBARs would not result in penalty. Even a green cardholder can be considered to U.S. non-resident for tax purposes. FBAR penalty can be avoided by simply reporting only the U.S. source, if considered to U.S. non-resident.

Taking this view one step further, the IRS now allows even U.S. citizens, if residing outside of U.S., from penalty, if three years of worldwide income is reported to the U.S. government and six prior years of FBARs are filed, under SFCP. However, this leniency is only offered if you have not been discovered either through IRS audit or through FATCA process.

If a U.S. taxpayer lives in the U.S. and had failed to disclose FFAs, then as long as worldwide income is reported to U.S. government, then the penalty is reduced to 5% of FFAs highest balance. To qualify for this lower penalty rate, three years of worldwide income must be properly reported to the U.S. government and six prior years of FBARs must be filed, under SFCP. Again, to qualify for SFCP, you must have not been discovered either through IRS audit or through FATCA process.

Using the residency rules, you may be able to meet U.S. income tax reporting requirement with minimal income tax cost. This is significant! As we can see from SFCP, meeting income tax reporting, regardless of the positions that you take, is the starting point for SFCP, which may eliminate or minimize your penalty on failure to disclose FFAs.