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IRS streamlined offshore procedures may be used to rectify delinquent US reporting obligations

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Introduction

US tax and information reporting obligations have become an increasing concern for international families and their succession planning structures. Missed or late filings can result in steep penalties, even when no tax is due. The Foreign Account Tax Compliance Act (FATCA) is alerting the Internal Revenue Service (IRS) to income and accounts held by US citizens and green card holders (US persons). To help bring delinquent individuals into compliance, the IRS offers streamlined filing compliance programmes. For family members not living in the United States who have missed reporting deadlines, the streamlined offshore procedures should be considered.

Background

Non-US source income, distributions from foreign trusts, non-US bank and financial accounts, and investments in foreign corporations, can all trigger US reporting requirements (for further details please see "2023 US reporting checklist and deadlines"). When US family members live abroad for many years, US reporting can sometimes slip off the radar (for further details please see "US citizens living abroad still face US tax and reporting obligations"). It is also not unusual to discover that the family member's US tax accountant is not familiar with the many additional forms required to report non-US income and assets. Non-US individuals may not realise that they are required to file US returns to report income effectively connected with a US trade or business.

As a result, family advisers may become aware of international investments or assets, such as international bank or investment accounts, and business interests or other income, that have not been timely reported on a US tax or information return. Streamlined procedures are available only to certain individual taxpayers, both those residing outside the United States (streamlined foreign offshore procedures) and those residing in the United States (streamlined domestic offshore procedures).

Streamlined offshore procedures available to certain delinquent individuals

The streamlined offshore procedures allow individuals to voluntarily submit themselves to the IRS through this simplified programme if they:

- have not yet been contacted or are under audit by the IRS;
- meet the applicable non-residency requirement (in the case of the streamlined foreign offshore procedures); and
- failed to report foreign financial assets or accounts due to non-wilful conduct.

Instead of submitting all delinquent income tax returns, the streamlined offshore procedures only require that the US person submit the previous three years of original or amended tax returns (eg, for the 2022 tax year, this would include calendar years 2019, 2020 and 2021) and the previous six years of foreign bank account reports (FBAR), if any are due (eg, years 2016 through 2021) (for further details on FBAR please see "US Treasury Department publishes final rule for foreign bank account reports").

Applicant must not be resident in United States

Individuals will meet the non-residency requirement for the streamlined foreign offshore procedures if, in any one or more of the last three US tax years:

- the individual was a US person who did not have a US abode and was physically outside the United States for at least 330 full days; or
- the individual was not a US citizen or green card holder and did not meet the substantial presence test (for further details on tax residency under the substantial presence test, please see the "Overview (August 2022)").

Failure to file must be result of non-wilful conduct

To be eligible for the streamlined offshore procedure, the failure to report income from foreign financial assets and pay tax must result from "non-wilful conduct". As part of the submission, the individual must certify that their conduct was not wilful and, as such, may qualify for no penalties.

Generally, non-wilful conduct is conduct that is:

- due to negligence, inadvertence, or mistake; or
- the result of a good faith misunderstanding of the requirements of the law. For example, a non-wilful failure to file could be the result of bad advice obtained from tax professionals.

Non-wilful conduct could also arise in situations where a US citizen:

- left the US shortly after birth or was born outside the US;
- has not had any connection to the US since; and
- had no way of knowing that they had a US filing obligation.

There have been several recent cases, some conflicting, as to what constitutes "reasonable cause" and "wilful conduct" and how to compute a related penalty.

The explanation presented to the IRS during the streamlined offshore procedures is very important and will be judged, to a certain extent, subjectively. Thus, the IRS agent could simply disqualify the individual from using this programme based on finding the individual's conduct to be "wilful" and, thus, requiring use of the regular administrative tax submission process, which could be a much longer process requiring additional professional fees and potential penalties.

Relinquishing US citizenship or green card will not solve current problem

Is it possible for a US person to relinquish their US citizenship or green card rather than pursue the streamlined offshore procedures or risk a potential IRS audit? There are two main problems with this approach. First, the IRS has demonstrated that it is more than capable of freezing the individual's non-US accounts if it suspects tax evasion or certain degrees of wilful noncompliance.

Second, the IRS may impose an exit tax on such an individual. The exit tax applies if the expatriating individual's global net worth exceeds $2 million, but it also applies if the US person cannot affirmatively declare that they have been compliant with the previous five years of US tax filings. If the exit tax is imposed, it essentially treats the individual as if they had sold their entire global estate and imposes a tax on the total gain, in excess of certain thresholds. Further, an individual subject to the exit tax will not be able to make gifts or bequests to US family members in the future without subjecting such US persons to US transfer tax of about 40% (for further details on expatriation, please see the "Overview (August 2022)").

Evaluating situation and identifying solutions

Advisers assisting family members who need to rectify US tax compliance issues should work with an attorney and accountant to:

- understand the overall ownership structure, noting that determinations as to the US treatment of entities and trusts will need to be made;
- determine annual US filing obligations of the overall ownership structure;
- identify missed and incomplete filings, along with potential risks and penalties;
- explore solutions and eligible reporting options or IRS disclosure programme; and
- engage in the chosen solution to rectify compliance.

Comment

In a world of increasing reporting and compliance initiatives, attention to possible US filing obligations for US family members or US investments cannot be understated. Family advisers should be sure to engage professionals who have substantial experience working with multinational families and their tax needs. Engaging with the IRS through a streamlined programme can lay to rest the risk of a time-consuming and costly audit.

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