Akin Gump
STRAUSS HAUER & FELD LLP

Tax Alert

January 13, 2016

If you read one thing…

- Enacted on December 4, 2015, as part of the FAST Act, a new law provides for the revocation or denial of U.S. passports to individuals with unpaid U.S. federal taxes of more than $50,000, including penalties and interest.
- The revocation or denial of a U.S. passport under the FAST Act does not impact the individual's citizenship status, nor does it relieve the individual from his or her prior, current, or future tax reporting and payment obligations.
- Individuals who have not complied fully with their U.S. tax and reporting obligations should consider making a voluntary disclosure, possibly under the amnesty program (before it is terminated by the IRS).

Game Changer: Losing U.S. Passport for Unpaid Taxes

The United States has enacted a new law authorizing the revocation or denial of U.S. passports to individuals with certain tax delinquencies. Enacted on December 4, 2015, as part of the Fixing America's Surface Transportation Act ("FAST Act"), Pub. L. No. 114-94 (2015), the new law provides for the revocation or denial of U.S. passports to applicants with certain tax delinquencies considered "seriously delinquent" tax debt (i.e., more than $50,000 of unpaid federal taxes, including penalties and interest). While there is little guidance, it appears that the Internal Revenue Service ("IRS") can work through the Department of the Treasury to transmit a certification of a "seriously delinquent" tax debt to the Department of State for the actual revocation or denial. The new law provides for a humanitarian and emergency exception, and issuance of a limited passport or limit of an existing passport solely to allow the individual to return to the United States.

Importantly, note that the revocation or denial of a U.S. passport under the FAST Act does not impact the individual's citizenship status, nor does it relieve the individual from his or her prior, current, or future tax reporting and payment obligations. Rather, the new law seeks to penalize non-compliant individuals by denying them the benefit of traveling on a U.S. passport while preserving tax liabilities. Note that an individual wishing to renounce his or her U.S. citizenship must voluntarily and with intent to relinquish U.S. citizenship, appear in person before a U.S. consular or diplomatic officer in a foreign country (normally at a U.S. Embassy or Consulate), and sign an oath of renunciation. Renunciations that do not meet the conditions described above have no legal effect.

With the enactment of the new law, the IRS has added another “power tool” to its arsenal of tax enforcement in addition to the Foreign Bank Account Report (“FBAR”) and the Foreign Account Tax Compliance Act. The practical implication of the new law is to broaden the reach of the IRS into the uncharted territory of impacting the mobility of U.S. citizens for tax delinquencies. About two weeks after enactment of the FAST Act, the IRS publicly confirmed that it plans to end the current amnesty program for certain taxpayers with unreported assets overseas.

U.S. Income Taxation of Citizens and IRS Enforcement

The United States is unusual among nations in that it imposes an income tax on the basis of citizenship. The rules that govern an individual’s obligation to file a tax return and pay taxes in the United States are exceedingly complex, but the “simple” rule is that, no matter where in the world they reside, U.S. citizens are subject to U.S. income tax on all of their income from sources within or without the United States. In addition to complex rules governing tax obligations generally, there are special sets of rules addressing the taxation and reporting of certain offshore assets and activities of U.S. persons. For example, U.S. citizens and residents are required to file an FBAR annually to identify their direct or indirect ownership interest in, or signatory authority over, foreign financial accounts with value, in the aggregate, exceeding $10,000, and should file information returns regarding their interests in foreign companies, partnerships and trusts, or the receipt of large foreign gifts or bequests.

Failure to comply with U.S. tax rules can result in substantial civil penalties and, in certain circumstances, criminal penalties. Civil penalties for failure to file and report income tax returns are generally based on a percentage of actual taxes due. However, civil penalties for failure to disclose the receipt or transfer of certain foreign assets can result in monetary penalties based on a percentage of the value of the assets received or transferred. For example, a U.S. person’s failure to disclose the receipt of an otherwise nontaxable foreign gift could result in a civil penalty of up to 25 percent of the value of the foreign gift imposed on the U.S. recipient. Additionally, the failure to file an FBAR can result in a penalty of $10,000 for non-willful failure or the greater of $100,000 or 50 percent of the value of all unreported foreign accounts for a willful failure. Ultimately, each U.S. person must devise the best strategy to deal with his or her potential noncompliance in the most effective manner.

Over the past several years, the U.S. government has aggressively prioritized enforcement of its international tax rules, particularly regarding the reporting of offshore financial interests held by U.S. persons and the reporting of income from such offshore interests. The enforcement efforts are targeted at what the government believes to be a substantial problem of tax avoidance by shifting assets overseas.

To remedy this problem, the IRS has committed substantial resources to international tax enforcement efforts, highlighting existing mechanisms and also devising new ones to combat the problem of tax avoidance. Many of these efforts have been covered by the worldwide press, including threatened or actual criminal prosecution of U.S. persons with undeclared offshore accounts, their banks and their bankers. The IRS has even partnered with the Department of Justice (“DOJ”) to conduct criminal investigations of foreign banks for their role in helping U.S. persons evade U.S. taxes by hiding assets in non-U.S. accounts. For banks in Switzerland, the

DOJ recently offered a voluntary disclosure program under which Swiss banks that may have had reason to believe that they had committed tax-related criminal offenses in connection with undeclared U.S.-related accounts could enter into a non-prosecution agreement in exchange for disclosing their cross-border activities and providing detailed information on an account-by-account basis for accounts in which U.S. persons have a direct or indirect interest. To date, 76 Swiss banks have entered the program, and the IRS and DOJ are expected to extend their investigations into other jurisdictions.

The IRS enforcement efforts apply equally to individuals who might not consider or recognize themselves as U.S. citizens, including the so-called "accidental Americans."

An "accidental American" is an individual who, in good faith, is unaware that he or she is a U.S. citizen or that he or she is subject to U.S. income, estate and gift taxation on worldwide income and assets. Most individuals become U.S. citizens at birth within the U.S. or its possessions, others by birth abroad to at least one U.S. citizen parent who meets certain U.S. residency requirements at the time of birth. A typical accidental American could be an individual who was born in the U.S. to non-U.S. citizen parents, left the U.S. at an early age, lived his or her entire life in a foreign country of which he or she is a citizen or resident, and does not identify as an American. Such individuals are not exempt from U.S. taxation and reporting, and, thus, an accidental American whose status as a U.S. citizen comes to light may be liable for years of back U.S. income taxes and reporting, as well as related penalties and interest.

Curing Noncompliance

In the current climate, in which international tax enforcement tops the government's "most wanted" list, an effective tax strategy must be supported by proactive compliance work. Thus, it is imperative that taxpayers and their professionals understand the intricacies of international tax compliance.

There are several options available to an individual who may not have fully complied with his or her tax or other information reporting obligations. However, given the significant penalties that may be imposed, it is advisable to make a voluntary disclosure to correct any prior errors in filing.

In making a voluntary disclosure, an individual can (1) enter into the Offshore Voluntary Disclosure Program ("OVDP"), (2) use one of the streamlined filing compliance procedures, or (3) make an alternative disclosure. The OVDP was designed specifically for U.S. persons who failed to file an FBAR, but it is also used to correct past mistakes or failures related to income tax and other information returns. If the individual enters into the OVDP, there is a guarantee of no criminal prosecution, and he or she should receive a closing letter from the IRS to end the process. However, in the OVDP, the individual is subject to a penalty of 27.5 percent of the highest aggregate balance of his or her foreign financial assets (e.g., bank and investment accounts). The OVDP is highly recommended for individuals who may have willfully violated the obligation to file correct and accurate tax returns, especially FBARs.

Alternatively, the individual can use one of the streamlined filing procedures. There are a few versions, depending on whether the individual lives in the United States or abroad, and if the individual has missing information returns only, but has otherwise filed all returns and paid all taxes. For all streamlined filing procedures, the individual must be able to certify that failure to comply with U.S. tax rules was non-willful. Under the streamlined procedure for individuals who live outside of the United States, the requirement is to file three years of amended or original tax returns and all relevant information returns, and six years of past FBARs. There will generally be no penalty, assuming that the individual can certify that his or her noncompliance was not willful. With the streamlined procedures, there is a possibility that the IRS may audit the returns, although, as a practical matter, the intention of the streamlined procedures is to provide an efficient method of coming back into compliance without the burden of a long audit. Finally, the individual can develop his or her own plan of curing the prior noncompliance.

Importantly, the IRS has publicly announced that it intends to end the current version of the streamlined filing procedures. The IRS has not announced when it will end the program, but the IRS Commissioner recently confirmed that the program will end.

For individuals surrendering their U.S. citizenship (even accidental Americans), the cost of noncompliance can be significantly increased vis-à-vis the expatriation tax. Since 2008, the IRS has imposed an expatriation tax on certain individuals who surrender their U.S. citizenship or long-term green card holder status. The expatriation tax is effectively an income tax that is imposed on a fictional sale of all (worldwide) assets owned by the expatriate at the time of expatriation, and on certain items of deferred compensation and tax-deferred accounts. An accidental American can generally avoid the expatriation tax under a special exception for dual-nationals at birth, and by certifying that he has been tax compliant for the prior five years. An individual who does not meet the exception for “dual-national at birth” nevertheless may be able to avoid the expatriation tax through proactive planning. However, in all events, the individual must certify that he or she has been tax compliant for the prior five years.

We are available to advise individual clients in connection with navigating the voluntary disclosure program and, if desired, evaluating the tax implications of expatriation and developing proactive strategies around expatriation.

Contact Information

If you have any questions regarding this alert, please contact:

Lucy S. Lee
llee@akingump.com
202.887.4182
Washington, D.C.

Stuart E. Leblang
sleblang@akingump.com
212.872.1017
New York, NY