ExPat Tax Guide

2017 EDITION

Premier Offshore Investor
Services for the Offshore Entrepreneur

Premier Offshore
International Tax & Business Guide

2017 Edition

The Complete Guide to U.S. Taxes for Americans
Living, Working & Investing Abroad

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INTRODUCTION

The biggest challenge facing Americans living and/or working abroad is the Internal Revenue Service. The U.S. is one of the few countries that tax its citizens abroad, and the only one that regularly locks up its people up in prison cells for violations of the tax code.

The Service's hostility to foreign tax planning and attacks on international business has become legendary over the last five years. Criminal penalties aside, the financial risks for failing to file a report or form on time are extraordinary…some include penalties of up to $50,000 per year, per form. For this reason, many Americans are afraid to hold funds or assets abroad.

Even after determining what forms are required, an ever moving target, figuring your tax liability is like learning a foreign language. "IRS speak" is unique and convoluted…and a distant cousin to the business English you speak every day.

And, once you learn the lingo, applying that language to your situation requires advanced training in accounting and finance.

How much time will it take an average business person to learn the language, organize the accounting, and prepare the forms for a standard foreign corporation return? The IRS estimates you should spend 174 hours to complete Form 5471 and its schedules! That's about 22 days, working 8 hours per day, while completely ignoring your business, employees, and other obligations.

> Note: Time estimates are contained in the instructions for each form. For Form 5471, see page 14 of 17 at http://www.irs.gov/pub/irs-pdf/i5471.pdf

As few international entrepreneurs have the time or energy required to learn this language, some give up and stay onshore and others hand the entire mess over to their accountants and hope for the best. Those who really like to gamble, place their bets on off the shelf software costing anywhere from $25 to $150, with the expectation that the software will guide them through the maze and costly traps safely.

Think about that. Spending $25 to protect yourself from risks of $50,000+ is quite a gamble. Would you do that in any other area of your life or business?

With that in mind, the objectives of this tax guide are to 1) give you the tools to maximize profits and minimize taxes while working and living abroad, 2) provide a road map to the U.S. forms and reporting requirements, and 3) to point out the landmines of international taxation – costs and risks of failing to keep up with tax compliance.

Armed with this guide, you will be able to structure your business and plan your life abroad to your advantage…and those advantages can be significant. For example, a business owner may be able to reduce or completely eliminate U.S. income tax on his ordinary income while taking a salary tax free from an offshore active business of up to $102,100 for 2017. This means no Federal income taxes, no State income taxes, and no employment taxes (payroll, FICA, etc., which add up to 15% in the U.S.).

While you might not become a U.S. tax expert by the end of this guide, you will be better prepared to deal with your tax attorney, CPA or accountant. You will have an understanding of the options available, the forms required, and the questions that must be asked. You will be able to determine if your current preparer is capable of handling your new and more complex tax reporting and, by being better prepared, you should cut down on the time—and fees—spent with your advisor.

In addition to this guide, there are resources available on the IRS website at www.irs.gov. For example, IRS Publications 593 and 54 should be reviewed by all U.S. ExPats (anyone living and/or working outside of their home country). Publication 54 is a lengthy document, which goes into the nitty-gritty of overseas taxation—for a summary of the highlights, use Publication 593. Publication 593 can be viewed at http://www.irs.gov/publications/p593/index.html and Publication 54 is at http://www.irs.gov/publications/p54/index.html.

If you have been living abroad, or had an offshore account, for several years and not been filing your U.S. forms, this guide can help you get in to compliance. However, a complete analysis of your situation should be undertaken by a qualified tax attorney before you file any amended or delinquent tax returns or forms. I suggest you start with the section of this report entitled "2014 IRS Offshore Compliance Program," then review the IRS website for any new information. After you understand your options, read the rest of this guide to become familiar with your filing obligations and future planning options.

- At the time of this update, October of 2016, the 2014 Offshore Compliance Program is still in effect. That may change any day.

Finally, this guide is focused on your U.S. Federal Taxation issues. It is not meant to help you with (1) liability for state income taxes; (2) estate and probate matters; (3) local taxes of a foreign country; or (4) the community property laws of the U.S. states or foreign countries.

The Rules for Americans Overseas

Foreign Income Must Be Reported

As an American citizen overseas—regardless of where you live or work—you are generally required to file a U.S. tax return, reporting any income generated abroad, in addition to your earnings on the U.S. side.

You are also subject to the same filing requirements that apply to U.S. citizens or residents living in the U.S. As long as you meet the gross income requirement, there's no escaping the IRS.

You are also eligible for just about all of the deductions. You can choose to take the standard deduction, or itemize on Schedule A. If you itemize, you may deduct mortgage interest, property tax, investment interest, etc. The only major issue is charitable contributions made to a non-U.S. church or organization.

In order for a charitable contribution to be deductible, it must be made to an IRS approved organization. In other words, the charity must qualify under Code Section 501(c)(3). Only the largest of international charities have gone through this approval process, thus, it is unlikely that a contribution to your local non-U.S. church or group is deductible on your U.S. tax return.

Certain deductions may also be reduced by the foreign housing exclusion for the foreign earned income exclusion. However, this is rare and you will need to consult with a tax professional for further guidance.

Even if you determine that your federal tax obligation is zero, you must still complete and file the forms. The IRS changes the filing thresholds slightly each year. In general, once you have the following gross income amounts for 2017, the law requires you to file a federal tax return with the IRS:

Filing status	Gross income
Single	$10,300
— 65 or older	$11,850
Head of household	$13,250
— 65 or older	$14,800
Married filing jointly	$20,600
— One spouse 65 or older	$21,850
— Both spouses 65 or older	$23,100
Married filing separately	$4,000
Qualifying widower	$16,600
— 65 or older	$17,850

To determine if you meet the gross income requirement for filing purposes, you must include all income you receive from foreign sources as well as your U.S. income.

This is true even if:

- The income is paid in foreign money.
- The foreign country imposes an income tax on that income.
- The income is excludable under the foreign earned income exclusion.

If you are self-employed, and generate more than $400 of net self-employment earnings in a single year, you must file a U.S. income tax return, regardless of your age. Net earnings from self-employment include the income earned both in a foreign country and in the U.S.

You must pay self-employment tax on your net self-employment income, even if it is earned in a foreign country and is excludable as foreign earned income in figuring your income tax. This is an important point worth repeating: the foreign earned income exclusion helps reduce the income tax—not the self-employment tax. The only way to reduce self-employment tax is with ordinary business expenses incurred in the self-employment activity or to operate the business through a foreign corporation.

The Standard Deductions for tax year 2017 are unchanged from last year and are as follows:

Married, Filing Joint Return. $12,700
Head of Household. $9,350
Single. $6,350
Married, Filing Separate Return. $6,350

Tax Advantages for Americans Overseas

The good news is that you may be able to exclude from your income some or all of your foreign earned income. Earned income includes salary, wages, and self-employment earnings. You may also be able either to exclude or to deduct from gross income a "housing amount." And—depending on your situation—you may qualify for a foreign tax credit or deduction for the local taxes paid to a foreign country. Based on your own particular circumstances, these advantages may reduce—or sometimes eliminate—your federal tax liability.

While exclusions and credits can reduce your tax liability to Uncle Sam, the United States has concluded tax treaties—and other international agreements—with many foreign countries which may help reduce your foreign tax liability, as well.

In theory, the foreign earned income exclusion, the credit or deduction for foreign income taxes, and the application of tax treaty provisions are designed to prevent overseas Americans from paying taxes to both the U.S. and a foreign country on the same income. In other words, they are designed to avoid double taxation. If you are fortunate enough to live in a foreign country that—for one reason or another—doesn't tax your income, and your salary while abroad is less than or equal to the foreign earned income exclusion amount, this exclusion may allow you to escape income taxes altogether

Foreign Earned Income Exclusion

The most important tool in the expat's U.S. tax toolbox is the Foreign Earned Income Exclusion (FEIE or Exclusion). If you qualify, you can exclude up to $102,100 for 2017, up from $101,300 in 2016, of earned income free from U.S. Federal income tax. If you are married, and both spouses qualify for the exclusion, your total exclusion may be $204,200.

Foreign Earned Income

As I said above, only income that is both foreign and earned can be excluded from Federal income tax. Income that is foreign is that which is earned while you are physically present outside of the United States. Income that is earned is wages, salaries, professional fees and other amounts received as compensation for personal services actually rendered when your tax home was located in a foreign country and you meet either the bona fide residence or physical presence test. Wages can come from a U.S. corporation or a foreign corporation, including an offshore corporation, and it does not matter that you are also a shareholder or owner of that corporation.

Earned Income does not include interest, dividends, or other investment or passive income.

To qualify for the exclusion, you must first prove that your "tax home" is outside of the United States. Second, you must meet the requirements of either the residency or 330 day tests.

Your tax home is where your principal place of business is located, regardless of where you maintain your residence. In most cases, if you live and work outside of the United States, your tax home is located there.

The concept of a tax home can become complicated in a few, specific instances, such as when someone works in Mexico and lives in the U.S. (ie. commutes from the U.S. to Mexico each day). In that circumstance, your tax home is the U.S. and the FEIE is not available.

In the vast majority of cases, one's tax home is not a major consideration, therefore, I will not go in to more detail here. For more information, contact a tax professional or see Code Section 911(d)(3) and the related regulations and examples.

Once you have established that your tax home is outside of the United States, you must meet the requirements of either the 330-day test or the residency test.

1. 330 Day Test: You must be outside of the United States for 330 out of any 365-day period. It does not matter if the 330 days is over two calendar years (example: between November 1, 2016 to October 31, 2017) and a special extension to file your tax return is available to give you time to meet this requirement.

2. Bona Fide Residency Test: Residency is achieved by moving to another country and making it your "home." You can intend to return to the United States in the future, but you must move to the foreign country for an "indefinite" or "extended" period of time, which must include one entire calendar year. This is discussed in detail below.

As you can see, the 330-day test is fact based, while the residency test turns on your intentions and is therefore more difficult to use and prove. I often recommend relying on the 330-day test in the first year you claim the Exclusion, and then moving to the residency test after applying for or gaining residency in your new home.

Also, the exclusion is computed on a daily basis. Therefore, the maximum limit must be reduced for each day during the calendar year that you do not qualify. The exclusion is also limited to the excess of your foreign earned income for the year over your foreign housing exclusion.

Bona Fide Residency Test

The bona fide residency test is one of the most misunderstood and misused sections of the tax code by those working and living abroad...especially by contractors on "temporary" assignments and those in combat zones.

You are a bona fide resident if you move to a foreign country and make it your home. You do this by filing and paying taxes in that country, moving there and planning to stay indefinitely, and generally becoming part of the local community.

The perfect example of a resident is someone who moves to a foreign country, does not intend to return to the U.S., files and pays taxes in that country, is on a long term visa that allows them to work in that country, applies for residency and/or citizenship if possible, sell their U.S. home and buys one in the foreign country, and if they are married or have children, those family members relocate with them.

The problem with the residency test is that very few cases are perfect. For example, a husband might move to France to work indefinitely, leaving his family in California, where he returns to visit for 40 days per year. He also plans on returning to California when it is financially possible. This taxpayer must use the residency test and convince the IRS that his tax home is in France, while his wife's tax home is in the U.S. This can be a challenging tax issue.

Also, being out of the U.S. for one calendar year does not make you a resident of a foreign country. For example, if you go to a foreign country to work on a particular construction job for a specified period of time, say 14 months, you ordinarily will not be regarded as a bona fide resident of that country even though you work there for one tax year or longer. The length of your stay and the nature of your job are only some of the factors to be considered in determining whether you meet the bona fide residence test.

If the residency test is so complex, why use it? Because qualifying under this test, rather than physical presence, allows you to return to the U.S. for a few months each year rather than only 35 days. Second, once you qualify as a resident of a foreign country, you will remain a resident of that country for U.S. tax purposes until you give up your residency. With the 330-day test, you must be out of the country for 330 of each 365-day period.

Prorate the FEIE

When you first move offshore, you will need to know how to prorate the foreign earned income exclusion. This is because, you will be using the physical presence test in your first year and, presumably, won't move abroad on January 1, so you will need to prorate the foreign earned income exclusion.

Let me take a step back. As you probably know, the Foreign Earned Income Exclusion allows you to exclude $102,100 in salary from your US taxes in 2017. To qualify, you must be a resident of a foreign country (residency test) or be out of the United States for 330 out of 365 days (330-day test or physical presence test).

Under the physical presence test you can choose any consecutive 12-month period for your Foreign Earned Income calculation. So, you might have moved abroad on Mach 15, 2016 and begin your new job on April 1, 2016. Therefore, you will probably want to prorate the Foreign Earned Income Exclusion from April 1, 2016 to April 30, 2017.

In this case, you should be out of the U.S. 330 days from April 1, 2016 to April 30, 2017. You could use March 15th as your start date, but that would mean you lose 15 days of the exclusion and these 15 days can't be recouped when you file your 2017 return.

I note that it is necessary to prorate the Foreign Earned Income Exclusion because most people don't leave the good ole USA on January 1, so they need to prorate in the year they begin their new lives. Also, to qualify as a resident of a foreign country, you must be out of the US for a full calendar year. Therefore, the physical presence test is common in year one.

In the example above, it would be possible to use the 330-day test to qualify for the FEIE from Aril 1, 2016 to December 31, 2016, and then use the residency test to qualify for the exclusion from January 1, 2017 to December 31, 2017. However, this will not affect your exclusion

amount. You will still need to prorate the Foreign Earned Income Exclusion. In other words, there is no financial benefit to converting to the physical presence test, though you will be able to spend more time in the United States. The prorated exclusion amount may not exceed the maximum allowable exclusion.

To prorate the Foreign Earned Income Exclusion, use the number of days you were physically present during the tax year over 365. That is to say, exclusion is calculated by dividing the number of days physically present in the foreign county or countries (numerator) by the number of days in the year (denominator). (See Publication 54, section on part-year exclusion.)

In the example above, your 2016 exclusion is April 1, 2016 to December 31, 2016, or 274 days. Each day is worth $279.72 ($102,100 / 365 = $279.73), so you can exclude up to $76,645 in 2016. If you earned $100,000 in salary from April 1, 2016 to December 31, 2016, you will owe U.S. tax on about $23,355 ($100,000 – $76,645 = $23,355) because of the prorated Foreign Earned Income Exclusion calculation.

Prorating the Foreign Earned Income Exclusion is common in the first year an American move abroad. It is also possible to prorate if you are forced to leave the country due to civil unrest.

According to the instructions for IRS Form 2555, under Waiver of Time Requirements:
If your tax home was in a foreign country, you reasonably expected to qualify for the Foreign Earned Income Exclusion in that country, but were forced to leave because of war, civil unrest, or similar adverse conditions, the time requirements residency test or the 330-day test may be waived. You must be able to show that you reasonably could have expected to meet the minimum time requirements if you had not been required to leave.

To support this rule, the IRS publishes a list of countries and the dates they qualify for the waiver. If you left one of these countries during the period indicated, you can claim a prorated Foreign Earned Income Exclusion on Form 2555 for the number of days you were a resident of or physically present in the foreign country.

As I wrote above, you must reasonably expect to qualify for the Foreign Earned Income Exclusion in the affected country. This is aimed at contractors moving in to dangerous areas. Basically, if you move to a dangerous area, and then decide to leave or are forced to leave, you don’t get the benefit of this rule. If you move to an area after it is listed in the IRS publication, you are on notice that it is dangerous and don’t get the benefit of this section.

Perpetual Traveler

One major issue I see time and time again, especially with retiree’s living abroad, is the “perpetual traveler.” This is someone who is never in any one place long enough to lay down

roots. They travel from place to place, possibly residing in one city for a few days, or a few months.

As stated above, the residency test is based on your intent to move to a particular place and make it your home. If you have no home base, or are not a part of any community in particular, you may not be eligible to use the residency test.

In my opinion, the perpetual traveler is forced to use the 330-day test. Therefore, they must be outside of the U.S. for 330 out of each 365-day period. This may limit the perpetual traveler's ability to visit family or vacation in the States.

Simply gaining residency in a nation, such as Belize that only requires you to be in their country a few months each year, will not suffice for U.S. tax purposes. The residency test is based on a number of facts and circumstances, and having a residency permit is only one factor.

However, once you establish residency in one place, you will not lose that status in the U.S. tax system, until you give it up (also stated above). Therefore, if you move to a foreign country for a year or two, with the intent of making it your home, and then become a perpetual traveler, you should maintain your foreign residency status.

Travel Days

Since 2008, it has been the IRS's position that travel days, and time spent in international waters or airspace are not days outside of the U.S. for the purposes of the FEIE. This argument has been supported by a few U.S. tax court cases.

What does this mean to you? If you are using the 330-day test, you must count days traveling to and from the U.S., as days in the U.S., and not foreign days.

If you are using the FEIE physical presence test travel days to qualify for the exclusion, watch your calendar closely. As the IRS interprets the FEIE ever more harshly, one day here or there can cause you to lose the exclusion and cost you thousands.

As you know, the FEIE allows an American abroad to exclude up to $102,100 of wage or salary income for 2017 from your U.S. personal income tax return. You can qualify by becoming a resident of a foreign country or by being present in a foreign country or countries for 330 out of 365 days.

In recent years, a battle has raged on the definition of "present in a foreign country or countries" It is now interpreted very literally, and, of course, in favor of the IRS.

In prior years, we explained the FEIE physical presence test travel days like this: You must be out of the U.S. for 330 days out of 365. The 330 days do not need to be in a calendar year…any 12-month period is fine.

But this definition has been modified through a series of tax court cases. Now, we explain the FEIE physical presence test like this: You meet the FEIE physical presence test if you are **physically present in a foreign country or countries** 330 full days during a period of 12 consecutive months. The 330 days do not need to be in a calendar year…any 12-month period is fine.

This modification may seem minor, but has caused many to lose the benefits of the FEIE altogether, costing them thousands of dollars each year, and bringing millions in to the IRS.

The change in terminology means that, being "present in a foreign country" **does not include time in on or over foreign waters.** In other words, you are not present in a country while in or over international waters**.**

Also, a full day is now a period of 24 consecutive hours, beginning at midnight. It no longer includes partial days. Therefore, to meet the FEIE physical presence test travel days you must now spend each of the 330 full days in a foreign country or countries.

When you leave the United States, or return to the United States, the time you spend on or over international waters does not count toward the 330-day total. This means that most travel days to or from the U.S. does not count towards the FEIE physical presence test. Exceptions would include driving or flying to Mexico, or Canada. Travel to South and Central America depend on your flight path or course. However, because you must be present in the foreign country for a full day (24 hours), your path is only relevant if you are traveling at night and on the road at midnight.

Time over international water can be very important to those traveling to Europe or Asia.

- For example, if you leave the United States for Switzerland by air on March 28, and you arrive in Switzerland at 9:00 a.m. on June 29, your first full day in Switzerland is March 30.

You can take short trips from country to country (not including the United States) without affecting your FEIE physical presence test. However, if any part of your travel is over international waters, **and the trip takes 24 hours or more**, then you lose those day(s).

These new interpretations can hit perpetual travelers and cruise ship passengers hard.

- For example, you leave Panama by ship at 10:00 p.m. on February 6 and arrive in Brazil at 11:00 a.m. on February 8. Since your travel is not within a foreign country or countries and the trip takes more than 24 hours, you lose three FEIE physical presence days – February 6, 7, and 8. If you remain in Brazil, your next full day in a foreign country is February 9.

The IRS takes these calculations quite seriously and goes to extreme measures to deny the FEIE physical presence test travel days. For example, I was in the courtroom watching one of the first cases where the government attacked the captain of a small sailing ship. This guy and his wife were just getting by on $55,000 per year as the captain and crew of a millionaire's yacht, and the FEIE was everything to them.

The government spent a great deal of time going through the ship's course and even got the U.S. Navy involved to determine exactly when the yacht crossed in to international waters (over 50 times during the year). This endeavor took up hundreds of government man hours and resulted in the captain losing the FEIE physical presence test by three days.

I give you this example to stress the importance of watching your travel days. I guarantee the IRS will do anything to separate you from your money, so you must be even more diligent to protect your rights.

- A number of special rules apply to international airline pilots and are not considered here. For additional information, see the IRS website or the pilot's forum.

I will leave you with one last cautionary tale: A friend was traveling with his wife and three children, including their new baby, from Panama to the Cayman Islands. They decided to take the cheaper flight with a stop-over in Miami. Well, it was the most expensive vacation they ever had.

If you are in transit between two points outside the United States and are physically present in the United States for less than 24 hours, you are not treated as present in the United States during the transit. The U.S. airport is considered international space for this purpose. So, if the trip, including the stop-over in the U.S., takes less than 24 hours, you do not lose any FEIE physical presence test days.

Well, U.S. immigration took this opportunity to interview these Expat's on their time in Panama, their business interests and foreign assets, whether they had filed and paid their U.S. taxes each year, searched their luggage, and, the most damning, let them sit for two hours before beginning the grilling of all members, including the children.

As a result, they missed their flight from Miami to Cayman and had to spend the night in Florida. This meant the trip took more than 24 hours and that they were considered present in the U.S. during their stop-over. Thus, they lost two full FEIE physical presence test days.

Because this was at the end of their 330-day cycle, and they had previously spent some days in the U.S. during the year, they lost the FEIE in its entirety. That stop-over in Florida cost these fine people over $38,600.

I note that you can't pro-rate the FEIE physical presence test. You either qualify or you don't. For example, if you do not meet the physical presence test because of illness, family problems, a vacation, or your employer's orders cause you to be present for less than the required amount of time, the FEIE physical presence test is lost.

There is only one narrow exception to this rule. The minimum time requirement can be waived if you must leave a foreign country because of war, civil unrest, or similar adverse conditions in that country. You must be able to show that you reasonably could have expected to meet the minimum time requirements if not for the adverse conditions, and that you had a tax home in the foreign country and were a bona fide resident of, or physically present in, the foreign country on or before the beginning date of the waiver.

The moral of the story is that you must watch your travel days closely. If you are closing in on your 330-day limit, do not risk a trip through the United States. I guarantee that neither immigration officials nor the IRS will heed your cries for mercy. For additional information on the FEIE physical presence test, see: Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.

Forced Out

Relief from either the residency or the 330-day test is available if you are forced to flee a foreign country because of civil unrest, war, or other adverse conditions. To qualify, you must have been a bona fide resident of, or present in, the foreign country on or before the date the IRS determines that adverse conditions exist. In addition, you must establish that you could reasonably be expected to have satisfied the residency requirements had the adverse conditions not arisen. The IRS publishes the names of countries for which this waiver is available annually.

I note that the adverse conditions must arise after you moved to the country in question. Each year I have contractors working in war zones ask if they can use this clause to get out of their contracts and still use the FEIE. Of course, the answer is no. Anyone who travels to a country on the list is on notice and the exception is not available.

Use it or Lose It

In a perfect world, all U.S. citizens file their U.S. tax returns on April 15 and make use of all the proper exclusions and deductions. Of course, that is not the case. In fact, the majority of returns I prepare for those living abroad are delinquent.

This can be extremely costly for those using the foreign earned income exclusion. If you file late, and you are audited by the IRS, you might lose the foreign earned income exclusion, and pay tax on 100% of your foreign earned income!

Generally, a qualifying individual's initial choice of the foreign earned income exclusion must be made with one of the following income tax returns:

- A return filed by the due date (including any extensions),
- A return amending a timely-filed return. Amended returns generally must be filed by the later of 3 years after the filing date of the original return or 2 years after the tax is paid, or
- A return filed within 1 year from the original due date of the return (determined without regard to any extensions)

An exception to this rule will be made provided that:

- You owe no federal tax after accounting for the exclusion, or
- Prior to the IRS discovering you failed to elect/utilize the exclusion.

If you owe tax after taking the FEIE into account, and the IRS discovers your failure to use the FEIE, then you may request relief by requesting a private letter ruling under Income Tax Regulation 301.9100-3 and Revenue Procedure 2009-1.

Having handled several of these cases, I can tell you that negotiating a settlement, or securing a letter ruling, will be a very costly and time consuming battle. It is possible to have about $1 million in untaxed income at issue, where a husband and wife failed to file a return for 6 or 7 tax years and would have been eligible for the full FEIE.

What if I am not overseas for a full tax year?

If during a tax year, you are overseas for only part of one tax year, but not long enough to qualify for the exclusion based on either physical presence or bona fide residence, you have four options:

1. If you paid foreign income tax, claim the foreign tax credit if it means you can avoid paying any U.S. income tax. In general, this applies when the tax rate of your foreign country is higher than, or equal to the U.S. tax rate.

(Caution: This option should be made only with the advice of a tax professional. It is not entirely clear at this time whether claiming a foreign tax credit when you could have chosen the foreign

earned income exclusion will automatically revoke your election to take the exclusion for the following five years without the approval of the IRS.)

2. File your tax return for the year without claiming the exclusion. Then, once the physical presence or bona fide residence qualifying period is reached in the following year, you can file an amended return to claim a pro-rated exclusion for the part-year.

3. Those who were overseas for the last three months of the year (let's say in 2017 for this example) and expect to be overseas for the first nine months of the following year, can file an IRS Form 4868 and if necessary the applicable state return filing extension request for automatic extensions to October 15. This will allow time to meet the 12-month physical presence test before the extended due dates of the returns. Once the 12-month period is reached, the 2017 tax returns can be filed claiming the partial exclusion for the time spent overseas in 2017.

4. File a Form 2350—a further application for extension of time to file beyond October 15. This allows you sufficient time to qualify under either of the two time requirements, plus 30 days to file the return for the year in which you qualified for only the part-year exclusion. In choosing your strategy, you need to consider the consequences involved. If financial concerns are paramount, then you should seek advice from a tax professional. If you have a considerable amount to pay on the original return—most of which you will recover on an amended return—you may prefer to wait out the qualification period and file one return.

Housing exclusion or deduction

If your tax home is in a foreign country—and you meet either the bona fide residence test or the physical presence test—you may be able to claim an exclusion or deduction from gross income for housing provided by your employer. Employees claim an exclusion, whereas a deduction is claimed by those who are self-employed.

For the exclusion, foreign housing is provided by an employer if any amount is paid or incurred by the employer on your behalf and included in your foreign earned income (for example, housing allowance or reimbursement).

A housing amount is determined as the excess, if any, of your allowable housing expenses for the tax year over a base amount which increases each year. For 2017 the housing exclusion is generally calculated as 16% of the FEIE or $16,336. However, this varies by country. Allowable housing expenses are the "reasonable" expenses incurred by you and your family such as:

- Rent paid on your foreign property.
- Utility charges incurred (other than telephone charges).
- Real and personal property insurance for foreign housing.

Items that are not considered "allowable housing expenses" include:

- The cost of home purchase or other capital items.
- Wages of domestic servants. (Note: Under certain circumstances, such wages may qualify as "childcare expenses.")
- Deductible interest and taxes.

You can also include the allowable housing expenses of a second foreign household for your spouse and dependents if they did not live with you because of adverse living conditions at your tax home.

The base amount is figured on a daily basis. Your allowable housing amount is the IRS-determined base amount times the number of days during the year that you meet the bona fide residence or physical presence test. The base amount, which changes each year, is shown on each year's Form 2555. See line 32 of Form 2555.

For more information, see the IRS website.

Determining your housing amount

You can exclude or deduct (within the lower and upper limits) your entire housing amount from income if it is considered paid for with employer-provided amounts. Employer-provided amounts are any amounts paid to you—or on your behalf—by your employer, including salary, housing reimbursements, and the fair market value of pay given in the form of goods and services.

If you have no self-employment income, your entire housing amount is considered paid for with employer-provided amounts. If you claim the exclusion, you cannot claim any credits or deductions related to excluded income, including a credit or deduction for any foreign income tax paid on the excluded income.

If you are self-employed—and your housing amount is not provided by an employer—you can deduct the housing amount to arrive at your adjusted gross income.

However, the deduction cannot be more than your foreign earned income for the tax year, minus the total of your excluded foreign earned income and the foreign housing deduction amounts.

If you are an overseas employee who also carries on an overseas self-employment activity, the rules are more complicated. To determine the net self-employment income for both income and self-employment tax purposes, you should consult a tax professional.

Second foreign household

Ordinarily, if you maintain two foreign households, your reasonable foreign housing expenses include only costs for the household that bears the closer relationship (not necessarily geographic) to your tax home. However, if you maintain a second, separate household outside the United States for your spouse or dependents because living conditions near your tax home are dangerous, unhealthful, or otherwise adverse, include the expenses for the second household in your reasonable foreign housing expenses.

You cannot include expenses for more than one second foreign household at the same time. If you maintain two households and you exclude the value of one because it is provided by your employer, you can still include the expenses for the second household in figuring a foreign housing exclusion or deduction.

Adverse living conditions include:

- A state of warfare or civil insurrection in the general area of your tax home.
- Conditions under which it is not feasible to provide family housing—for example, if you must live on a construction site or drilling rig.

What exclusion will I take?

You make separate choices to exclude foreign earned income and/or to exclude or deduct your foreign housing amount. If you choose to take both the foreign housing exclusion and the foreign earned income exclusion, you must figure your foreign housing exclusion first.

Your foreign earned income exclusion is then limited to the smaller of (a) your annual exclusion limit, or (b) the excess of your foreign earned income over your foreign housing exclusion. This limitation is automatically computed on the Form 2555.

It is often difficult to follow the interplay of the lines on tax forms because forms are generally designed by mathematicians whereas the rules are most often written by lawyers. A simpler way of looking at it is that your combined earned income exclusion and housing exclusion cannot exceed your total overseas earnings.

Once you choose to exclude your foreign earned income and/or housing amount, that choice remains in effect for that year and all future years unless you revoke it. You can revoke your choice for any tax year. However, if you revoke your choice in one tax year, you cannot claim the exclusion again for your next five tax years without the approval of the IRS. For more information on revoking the exclusion, see (1) Effect of Choosing the Exclusion and (2) Revoking the Exclusion, both of which are found in Publication 54.

After reading these two sections, you may reach the conclusion that simply taking a foreign tax credit when you could have chosen the exclusion will automatically disqualify you from claiming the exclusion for the next five years without the approval of the IRS.

If, in your case, a foreign tax credit would be far more beneficial than claiming the exclusion, you should discuss your situation with a tax professional.

Form 2555 or Form 2555EZ?

The Form 2555EZ is a shorter, simpler version of the Form 2555 but may be used only if you meet all of the following requirements:

- Total foreign earned income is less than the exclusion amount ($102,100 for 2017).
- The return being filed is for a full calendar year.
- You have no self-employment income.
- You have no business or moving expenses.
- You are not claiming the foreign housing exclusion or deduction.

There is no need to memorize the above conditions. They are printed on the top of page one of the Form 2555EZ.

Married couples claiming exclusions

If both you and your spouse are eligible for either the foreign earned income or housing exclusion, you can file separate Form 2555s (or 2555EZs) and claim separate exclusion amounts. For further details on married couples filing separate 2555s, see Chapter Four of Publication 54.

If you are married and residing either in a foreign country with community property laws or a domiciliary of a U.S state with community property laws, you need to consult a tax expert.

Waiver of time requirements

Disruption of the qualifying time period because of war, civil unrest, or similar adverse conditions in the foreign country would not preclude you from claiming at least part of the exclusion. However, there are special rules to determining a reduced amount of the exclusion. Here again, you should refer to Publication 593 or Publication 54, or consult with a tax professional.

Exclusion of employer-provided meals and lodging

If your work requires you to live in a camp in a foreign country that is provided by or for your employer, you can exclude the value of any meals and lodging furnished to you, your spouse, and your dependents. For more details, see Publication 593 or Publication 54.

Withholding income tax and social security tax

If you are an employee of a U.S. company overseas, your employer may withhold income and social security taxes from your pay. In certain circumstances, it may be to your advantage to have your employer discontinue withholding income tax from all or part of your wages. You might do this if you expect to qualify for the income exclusions under either the bona fide residence test or the physical presence test. See Publication 54 for more information on withholding income tax.

See the U.S. security taxes section below for the requirements for employer withholding of social security taxes.

If a U.S. employer does not withhold income taxes from your foreign wages—or if not enough tax is withheld—you may have to pay estimated tax. Your estimated tax is the total of your estimated income tax and self-employment tax for the year, minus your expected withholding for the year.

When estimating gross income, do not include the income that you expect to exclude. In figuring your estimated tax liability, you can subtract from income your estimated housing exclusion or deduction. However, if the actual exclusion or deduction is less than you expected, you may be subject to a penalty for underpayment. You can use Form 1040-ES (Estimated Tax for Individuals) to estimate your tax due for the year. The requirements for filing and paying estimated tax are generally the same as those you would follow if you were in the U.S.

Withholding from pension payments

U.S. payers of benefits from employer deferred compensation plans (such as employer pensions, annuities, or profit-sharing plans), individual retirement plans, and commercial annuities are generally required to withhold income tax from these payments or distributions. This will apply unless you choose an exemption from withholding.

To qualify for this withholding exemption, you must provide the payer of the benefits with a residence address in the U.S. (or U.S. possession), or certify to the payer that you are not a U.S. citizen, resident alien, or someone who left the United States with the principal purpose of avoiding U.S tax.

For rules that apply to non-periodic distributions from qualified employer plans and tax-sheltered annuity plans, refer to Publication 575 (“Pension and Annuity Income”).

Although the U.S. Social Security Administration (SSA) is not required to withhold federal income tax on benefit payments to American recipients residing in the U.S. or overseas, benefit recipients may request voluntary income tax withholding. Based on rules too complicated to discuss here, some of the benefit payments may be subject to U.S. income tax and the recipients

may prefer to have the income tax withheld. You should check with a tax expert to determine if any of your benefit payments will be subject to U.S. income tax and whether or not it is advisable to have the tax withheld by the SSA.

Note: Some foreign countries may tax your benefit payments in spite of the fact the payments are also subject to U.S. tax. Although the many U.S. income tax treaties provide for taxation of certain income by the U.S. alone, you will need to be familiar with the laws of the foreign country in which you reside.

U.S. Social Security taxes

Under certain circumstances, you may be required to pay social security taxes to both the U.S. and a foreign country on the same income. For example, when Bob, an employee of a U.S. company, moves overseas on a foreign assignment, the employer is liable for the employer's share and Bob is liable for his share of U.S. social security taxes on his wages. At the same time, the foreign tax laws may require that Bob's employer pay the foreign social security taxes on the wages paid to Bob while he is living in that country.

Unless certain arrangements are made with the SSA, the same situation would occur if the U.S. company assigns Bob to work for a foreign subsidiary of which the American company is a principal owner.

The SSA is responsible for administering "totalization agreements," which are similar to the U.S. tax treaties.

At time of writing, the U.S. has totalization agreements with the following nations: Australia, Austria, Belgium, Canada, Chile, Finland, France, Germany, Greece, Ireland, Italy, Japan, Korea (South), Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

An agreement is under discussion with Poland. Agreements with the Czech Republic, Denmark, and Mexico have been signed but have not yet come into force. (See Appendix C for full details.)

On the other hand, if you have the option of working overseas for employers other than U.S. companies—or principally owned foreign subsidiaries of U.S. companies—you will avoid any double taxation on the social security side because you will no longer be liable for the U.S. social security taxes.

If you or your employer needs more information, contact the Social Security Administration online at www.ssa.gov. Its welcome page has a "Contact Us" link that provides a variety of means of getting in touch with a representative.

Credits and Deductions on Foreign Income Taxes

In filing your U.S. returns, you can take either a credit or a deduction for income taxes imposed on you by a foreign country. Taken as a deduction, foreign income taxes reduce your taxable income. Taken as a credit, foreign income taxes reduce your tax liability.

There is no rule to determine which approach is better. Generally, it is to your advantage to take the credit, which is subtracted directly from your U.S. tax liability. Your credit cannot be more than the part of your U.S. income tax liability allocable to taxable foreign income. In other words, if you have no U.S. income tax liability, or if all your foreign income is excludable, you will not be able to claim a foreign tax credit.

If foreign income taxes were imposed at a high rate, and the proportion of foreign income to U.S. income is small, a lower final tax may result from taking the foreign income tax deduction. You must treat all foreign income taxes in the same way—you generally cannot deduct some taxes and take a credit for others.

If you choose to credit foreign taxes against your tax liability, you will need to complete Form 1116 (unless you meet the requirements outlined below), and attach it to your U.S. income tax return.

Caution: Do not include the foreign taxes paid or accrued as withheld taxes on Form 1040.

If the foreign taxes you paid or incurred during the year exceed the limit on your credit for the current year, you can carry back the unused foreign taxes as credits to the two previous tax years, and then carry forward any remaining unused foreign taxes to the next five tax years.

You will not be subject to this limit, and may be able to claim the credit without using Form 1116, if the following requirements are met:

1. You are filing as an individual.
2. Your only foreign source income for the tax year is passive income coming from sources such as dividends, interest, and royalties, which are reported to you on a payee statement such as a Form 1099-DIV or 1099-INT.
3. Your qualified foreign taxes for the tax year are not more than $300 ($600 if filing a joint return) and are reported on a payee statement.
4. You elect this procedure for the tax year. (If you make this election, you cannot carry back or carry over any unused foreign tax to or from this tax year.)

If you choose to deduct all foreign income taxes on your U.S. income tax return, you need to itemize the deduction on Form 1040 Schedule A.

The foreign tax credit and deduction, their limits, and the carry back and carry over provisions are discussed in detail in IRS Publication 514.

Foreign Currency: The foreign income, expenses, and credits must be converted from foreign currency using an appropriate exchange rate and reported on the U.S. return in U.S. dollars.

Claiming a Deduction for Relocation Expenses

If you incur expenses when relocating overseas, you may qualify for a deduction of “reasonable” moving expenses. Keep in mind that moving expenses relate to the income earned after the move and you cannot claim expenses attributed to excluded income. For example, if you are an employee and move overseas, your unreimbursed moving expenses are generally deductible. However, if you are able to exclude all of your overseas earnings in the year of the move, the following year you cannot claim any of the unreimbursed moving expenses regardless of whether or not they are reasonable. See Publication 54 for more details.

Avoiding Double Taxation

If you have paid foreign taxes on the earnings that qualify for the earned income exclusion, you will have to make a choice of taking the exclusion, taking the tax credit/deduction, or taking a combination of the two.

A good tax software program should allow you to prepare a complete return claiming the income exclusion, housing exclusion/deduction, and the foreign tax credit. Once the return is prepared, the program should allow you to easily produce two duplicate computer copies. These can be produced individually using the other two options for comparison to figure out which option produces the best results. As mentioned earlier, you need to do the math.

If you claim the exclusion, you cannot claim any credits or deductions that are related to the excluded income—the concept being that you can’t get a double benefit. Nor can you claim the earned income credit, which is to benefit low income earners.

Also, for Individual Retirement Account (IRA) purposes, the excluded income is not considered compensation and, for figuring deductible contributions when you are covered by an employer retirement plan, the excluded income is included in your modified adjusted gross income.

Double Taxation Treaties

If a “double taxation” treaty exists between the United States and the country in which a U.S. citizen resides, then the tax treaty supersedes the Internal Revenue Code (IRC), and the language of the treaty governs. As a general rule, tax treaties allow you to offset foreign tax paid against what your federal tax liability would have been.

This means that if your foreign taxes are higher than your U.S. federal tax, no U.S. tax is due. If your foreign taxes are lower, then the difference would generally still be due to Uncle Sam, unless it was exempted under the rules for foreign earned income exclusion.

Treaties generally provide U.S. students, teachers, and trainees with special exemptions from the foreign treaty country's income tax.

Publication 901 contains detailed information on tax treaties and tells you where you can get copies of them. Click here for additional information from the IRS website on Pub 901.

Foreign Bank Accounts Must be Reported

If you had any financial interest in, or signature or other authority over a bank account, securities account, or other financial account in a foreign country at any time during the tax year, you may have to complete FinCEN Form 114 (previously called Form 90-22.1 and still referred to as the FBAR) and file it with the Department of the Treasury. You need not file this form if the combined assets in the account(s) are $10,000 or less during the entire year, or if the assets are with a U.S. military banking facility operated by a U.S. financial institution. The deadline for filing is June 30 of each calendar year.

There are no extensions and an extension to file the federal income tax return does not extend the deadline for filing the FinCEN Form 114. If you have a foreign account, you must also file a Form 1040 Schedule B and complete Part III regarding foreign bank accounts—regardless of whether you are required to file a FinCEN Form 114, or have any interest or dividend income to report on the Schedule B.

This requirement to report your foreign bank account is one of the most important obligations you have as a U.S. citizen living abroad. The law imposes a civil penalty for not disclosing an offshore bank account or offshore credit card up to $25,000 or the greatest of 50% of the balance in the account at the time of the violation or $100,000. Criminal penalties for willful failure to file an FBAR can also apply in certain situations. Note that these penalties can be imposed for each year.

In addition to the FBAR penalties above, intentionally failing to check the box on Schedule B to report a foreign account is a Felony. It is possible for a single violation to result in 6 to 12 months in prison!

I have personally handled many FBAR and Schedule B related cases and can tell you with certainly that the IRS is very aggressive in prosecuting these matters. For example, in one case in 2010 a client plead guilty to a single count of failing to check the box on Schedule B, and was given 6 months of confinement. In addition to the criminal case, the IRS initiated a civil audit

which, when taxes, fines, interest and penalties were calculated, the client was wiped out financially. Finally, to add insult to injury, the State of California came in with their taxes, interest, and penalties.

In another case in 2014, three defendants were charged in a tax case, the court found that there was no tax loss…that there was zero money lost by the IRS…but they still received 10 months in prison because forms were not filed on time.

The Schedule B rules and the FBAR are no joke, and they are not just used against money launders and drug dealers. Prosecutions and civil fines have become a major revenue sources for the IRS.

Changes to the FBAR from 2014

There were important *new FBAR filing requirements for 2014*. Some of these FBAR filing requirements are cosmetic and others could get the misinformed in hot water. If you've been living abroad for a few years, make sure you are up to date… yes, this is my 2016 edition, but I'm sure there are some of you out there who need to review these changes.

Note: If you have no idea what an FBAR is, you might check out my general article on filing requirements for those living, working, or investing abroad. If you want to learn how to legally avoid the FBAR, click here.

First, let me tell you how your accountant or CPA thinks. The foundation of tax preparation for professions is SALY…prepare the return the Same As Last Year to reduce the risk of an audit.

So, when your preparer pulls out your file, he or she will be thinking SALY and will reach for the same old forms to file. When new FBAR filing requirements for 2014 are announced, but don't get much press, tax preparers without many Expat clients can get caught unprepared.

It may be up to you to educate your preparer on the FBAR and these New FBAR filing requirements for 2014. Here they are:

Not one to bury the lead: IRA owners don't need to file an FBAR in 2014!

For those of you with Offshore IRA accounts, the IRS has finally come out and said that **IRA owners and beneficiaries do not need to file an FBAR**. Whether an offshore IRA needed to file an FBAR was never clear, so we all aired on the side of caution and filed it year after year. Well, that burden has been lifted (see below).

The cosmetic change is that the name of the form has changed. The official name of the FBAR changed from Treasury Form TD F 90-22.1 to FinCEN Form 114. I'll bet not many people even noticed, as we all refer to it as the FBAR.

The big change to the FBAR for 2014 is that it must now be filed online. No more paper allowed. So, when your preparer pulls out your file and grabs the same old forms, you may be in for penalties.

That's right, if you or your preparer are unaware of the change and mail in SALY, you could face significant penalties for filing late…or not filing at all. So, be sure to talk to your tax man or woman!

Note: the deadline for the electronic FBAR filing did not change and remains June 30. If you file your FBAR with your personal return on April 15, all is well. If you procrastinate and get an extension for your personal return until October 15, your FBAR is still due on June 30. That's right, the extension of time to file your personal return does not apply to the FBAR.

Do you prepare your own returns? Do you want to sound cool when you explain things to your preparer? Then here is how to file an electronic FBAR in excruciating detail.

To file an electronic FBAR:

1. Go to http://bsaefiling.fincen.treas.gov/main.html.
2. Click "File an Individual FBAR" on the left side of the page.
3. You will then be brought to the screen below, where you can download a PDF version the FBAR (FinCen Form 114). This PDF allows you to type information into the form and save the results (wow, a fillable PDF form – modern technology fresh from 2001!)
4. Fill in FinCen Form 114 PDF. You will need your information, including social security number and date of birth, as well as your bank name, address, account number, and highest balance for the year. Be sure to save the document when you are finished. If you are unsure what information you need to enter in a certain field, you can move the mouse cursor over that field, hold it for a moment, and a box of text will pop up explaining what you need to enter. See the picture below for an example.
1. Once everything is filled out correctly, go back to the first page digitally sign the document, save and validate it, and then finalize it for submission.
6. When you're ready to submit the form, go back to the page from Step 3 and click the link to "Submit FBAR." This will take you to the submission page, where you'll need to enter some contact information and then upload the finalized PDF. The process is not complete until you submit the form.

New FBAR Filing Requirements from 2014 – Who Must File?

Anyone who is a "U.S. person" must file an FBAR and enjoys the honor of paying U.S. tax on their worldwide income. Basically, this is anyone with a U.S. passport, green card, or someone who lives in America for 6+ months in the year.

If you are not sure you qualify as a U.S. person, please read: Who is a US Person?

The list of those exempt from filing an FBAR has also been updated and codified. For many of you, the most important statement is that IRA owners and beneficiaries are not required to file an FBAR.

Here is the complete list:

- Certain foreign financial accounts jointly owned by spouses;
- United States persons included in a consolidated FBAR;
- Correspondent/nostro accounts;
- Foreign financial accounts owned by a governmental entity;
- Foreign financial accounts owned by an international financial institution;
- **IRA owners and beneficiaries;**
- Participants in and beneficiaries of tax-qualified retirement plans;
- Certain individuals with signature authority over, but no financial interest in, a foreign financial account;
- Trust beneficiaries (but only if a U.S. person reports the account on an FBAR filed on behalf of the trust); and
- Foreign financial accounts maintained on a United States military banking facility.

To be clear, the above list is not necessarily new FBAR filing requirements from 2014. I am saying that the IRS finally listed the exceptions on their website and ended the debate, especially in regard to IRA owners and beneficiaries. For more information, see IRS.gov.

Filing Deadlines, Extensions, and Penalties

If your tax year is the calendar year, the due date for filing your income tax return is April 15 of the following year—unless that date falls on a weekend day or holiday, which would allow you an additional day or two.

Automatic two-month extension for Americans overseas

If you are living abroad, you have two extra months to file and pay without getting hit with any fees by the ever generous IRS. This means you have an extra two months to use that cash before it goes in to Uncle Sam's coffers.

If you use the automatic two-month extension for Expats, make sure the IRS knows that you qualify so you don't get stuck fighting over an erroneous bill. There is no form available to put them on notice, so you need to attach a letter to the front of the return with your name (or names if a joint return), foreign address, and social security number(s). Either tell the IRS that you are employed in Country X, or that you are a tax resident of Country Y and thus your return is due on June 15.

This extension is only for those who are resident or working in another country as of April 15th. If you were living abroad in 2016, and returned to the U.S. in January of 2017, you may not take the IRS Automatic Extension for Expats.

If you need more than two months, you can use IRS Form 4868 just like the rest of us gringos to get the standard 6-month extension. Of course, you will be expected to pay by June 15 and, if you pay after that date, interest and penalties will apply. For a rough estimate, paying after June 15 will cost about 4.5% per month in fines.

- For more information on Form 4868, see the IRS website.
- For information on late filing penalties, see this section of the IRS site.

You should also keep in mind that the two and six month extensions don't affect your FBAR filing deadline. You must report your foreign bank account by June 30th, no matter when you file your personal return. If you need to report a foreign bank account, checkout my article on New FBAR Filing Requirements for 2014.

If you are operating a business through an offshore corporation and filing Form 5471, this form is attached to your personal return. Thus, extending your personal return automatically extends the time permitted to file your corporate return. No additional extension is required.

However, the two month and six month extensions above do not apply to offshore trusts. If you file Form 3520-A or 3520, these are due on March 15 and can be extended until September 15 using IRS Form 7004 (see the IRS website for more information).

Finally, if you are an Expat who is going to qualify for the Foreign Earned Income Exclusion late in the year, you can get a special extension from the IRS to file after the October 15 deadline. To use this extension, you must file IRS Form 2350 by April 15, and pay any expected tax due by April 15 (that's right, not June 15 when using this extension). For more information, see Extension of Time to File in Order to Qualify for the Foreign Earned Income Exclusion.

When might someone need this FEIE extension? Let's say you left the U.S. on November 1, 2016 and want to use the 330-day test to qualify for the FEIE on income earned abroad from November 1, 2016 to December 31, 2016, as well as get credit for those days to qualify in 2017. In that case, you must file your 2016 return 30 days after you qualify for the FEIE, which would be December 2, 2017. You may not file your 2016 return until you actually qualify for the FEIE…you may not assume you will qualify.

For those of you who love trivia, here is the origin of the automatic extension for Expats to file their Federal tax returns. Under the mail box rule, your tax return is received by the IRS when you place it in the mail box. Lawyers also call this constructive receipt.

When you mail your tax return in the U.S. on April 15, it arrives at the IRS in just a few days. If you are out of the U.S., it might take a very long time in deed to go from China to a package to Uncle Sam using standard international post. The automatic extension for Expats came about as the longest time the IRS would allow a package to arrive from overseas. So, back in the day, the IRS was to receive your return by June 15, whereas you needed to post your return by April 15 from the U.S.

Today, those using the automatic extension for Expats can mail their return and payment on June 15… it need not be received on that date. If you will be sending in a paper return on this date, I strongly recommend you use FedEx or another courier service to avoid significant delays.

As electronic filing has become the norm, the justification for the automatic extension for Expats has changed. Today, it is explained as the extra time Expats might need to collect documents and file their local returns so that they know how to make use of the Foreign Tax Credit and related deductions.

What to do if you need more time

Better still is the Form 4868 ("Application for Automatic Extension of Time to File U.S. Individual Income Tax Return"). This form will get you a full six-month extension.

No signature and no reason will be required for the six-month extension to October 15 (or the alternate date under the weekend and holiday rule).

Time to pay tax due on a return

With the exception of the automatic two-month extension for overseas Americans, an extension of time to file does not mean an extension of time to pay the tax. Although you will be required to pay interest on any payment made after April 15, you will not be required to pay the late payment penalty (see below) for the period April 15 to June 15.

Where to file

If you claim the foreign earned income exclusion or the foreign housing exclusion or deduction on a paper tax return, you should file your return with the Internal Revenue Service, Austin, Texas 73301-0215.

Electronic filing has its own set of filing rules that are not treated here. A good software program with the electronic filing feature allows you to send the federal and, if applicable, the state income tax return to the relevant processing center.

Electronic filing is the way to go

If you have the option, paperless filing is the way to go. All you need is a computer, tax preparation software with the electronic filing feature, and Internet access. You complete your return (and with some software programs the Form 4868 as well), send it over the wires, and await confirmation from the IRS or a state tax department that your return was accepted. If rejected, you should receive an error message that either tells how to correct the error(s) for resubmission or a statement of why the return cannot be accepted for electronic filing. The deadline for electronic filing is April 15, or October 15 (or the alternate date under the weekend and holiday rule) if you file an extension. You may not file a late return electronically.

The rules that relate to formatting, what information must be included on the return, and what forms or schedules if included in the return forms will disqualify the return from electronic filing, are mind-boggling. However, as with any good software program, the computer does most of the analytical work. And, if you mess up, the programs are generally designed to alert you to your mistakes or provide other reminders to help you through the process.

Most software programs allow you to complete the state tax return along with the federal return, saving time spent on duplicating data entries. The state return in most cases is produced automatically as an offshoot of the 1040. Part-year return (or even a non-resident returns), if your situation warrants one, takes a little extra time because there are additional data entry steps. You will be required to allocate the annual income taxable on the federal return to the lesser amount taxable by a state for part-year residency or non-residency.

An additional benefit of tax preparation software is that, once you go through the process for the first year, most of the routine—and often tedious—data entries that apply year after year are carried forward to save you time in future years.

You'll find a variety of good tax preparation software programs on the market. Two of the most popular are TurboTax and TaxCut. Just be sure the version you select supports international forms.

I'd recommend that you do some research on the Internet to compare prices and availability. And make sure that whichever software program you purchase has the electronic filing capability. There are also some companies offering to prepare your taxes online, through their website, without your downloading and installing their programs. These include Intuit and H&R Block.

Foreign post marks and electronic filing

Generally, the IRS treats payments made—and tax returns filed—as received by the IRS on the date they are received by the U.S. Postal Service or a domestic courier service. Penalties could be applied by the IRS on late payments and, if applicable, late filed returns under certain circumstances including those received from overseas.

Consult a tax professional if sending tax documents from countries whose mail or courier systems are subject to lengthy delays. You should keep in mind that electronic filing is one means of avoiding mailing delays and possible penalties resulting from such delays. I generally recommend the electronic filing method to my clients overseas.

Interest and penalties

If you are late in filing your taxes, avoid filing altogether, or underpay taxes—whether intentionally or unintentionally—the IRS may impose a penalty. If the 1040 has no tax due, there are generally no penalties whether you filed or did not file.

Even if there are penalties, the IRS may waive them if the delay is due to "reasonable cause." The IRS doesn't like to pin itself down by trying to define the term reasonable cause—you have to write in with an explanation and hope for the best! The instructions for requesting elimination of a penalty for reasonable cause are found in Notice 433 on the IRS website.

The two more common penalties are the late filing and the late payment penalties. The penalty for late filing (or failing to file) a tax return is a percentage of the tax due but unpaid, unless the reason for the late filing or failure to file is due to reasonable cause. The penalty is 5% of the underpayment per month, or any part of the month, up to the maximum of 25%. If the return is not filed within 60 days of the due date (considering extensions), there is a minimum penalty which is the lesser of $100 or the tax due on the return. There is an interaction of the late filing penalty and the late payment penalty discussed below.

The late payment penalty is 0.5% for each month, or any part of a month, the tax due on a return remains unpaid. The maximum penalty is 25%.

The interaction between these two penalties in effect limits both penalties combined to the 25% maximum. For each month that both penalties apply, the late filing penalty is reduced to 4.5%.

Consequently, a return filed four months and one day late is subject to the late filing penalty of 4.5% times 5 (22.5%), and a late payment penalty of 0.5% times 5 (2.5%), for a total of 25% (the maximum).

However, if the return is filed on time but there is tax due, the late payment penalty is 0.5 per month of any fraction thereof until paid. These penalties are in addition to the interest charged for unpaid taxes. The IRS is required to determine the interest rate quarterly. For the latest information on interest rates, check with the IRS or a tax professional.

U.S. State Taxation of Foreign Income

If you have a choice of where to live and work overseas, it is important to understand how your last state of residency, the U.S., and your new home country will tax your income. High state or foreign tax rates, or lack of tax exemptions for income earned inside and outside of a new home country, can easily negate any tax advantages provided to overseas Americans under the U.S. federal tax laws.

Before we delve into state income taxes, it is important to understand the distinction between residency and domicile—although most states use these terms interchangeably. For tax purposes, your residence is generally where you currently live and work. Your domicile on the other hand may be the place you presently live, or previously lived and have a definite intention to return after living elsewhere.

Your domicile may also be a state in which you formerly lived, but failed to fulfill the conditions to abandon domicile when you moved elsewhere. For most of us, we are residents and domicile of the same state regardless of whether that state is a U.S. state or a foreign country.

Residence and domicile are important distinctions for those states that subject both their residents and their domiciliaries to state income tax. For example, you may have moved to another state and established residency in that new state, but still have to file tax returns in your former state (where you are officially domiciled).

Different states…different rules

Liability for state income taxes is a complicated matter. There are 51 jurisdictions including the 50 states and the District of Columbia and consequently 51 different sets of rules.

If you move from one of the more popular non-taxing states such as Florida and Texas, you needn't ordinarily worry about liability for state income taxes while living overseas.

Other states such as Oregon, New York, and Missouri to name a few will not tax an individual who is otherwise considered a domiciliary of the state, but maintains a permanent residence elsewhere (in the U.S. or overseas) and spends less than 30 days a year in the state. Also, New Hampshire and Tennessee only tax interest and dividend income.

Then there are those states desperate for money, like California. This state has no foreign earned income exclusion, is aggressive in determining "residency" for those abroad, and, when one spouse is abroad and one is in California, this state will tax the international spouse's income under a "community property" argument. If you live in an aggressive state, and you can first move to a non-taxing state, and then move abroad, I strongly recommend you do so.

Finding a complete listing of states who do not tax domiciliaries living outside the state is beyond the purpose of this guide. A good starting point is a very comprehensive website for finding all kinds of information on taxation. Try www.taxsites.com and click on "state links" in the tax column to check out your state of interest.

Don't be misled by the advice that you can make a quick trip to one of the non-taxing states, set up a local address, get a driver's license, and register to vote thereby establishing residency and domicile in that state. It doesn't work that way. The fact that many have done exactly that without being questioned is a matter of inadequate enforcement by state tax authorities, rather than a good faith compliance with the rules for establishing and abandoning state residency.

If you think you may be taxed by a former state as a domiciliary, you need to be aware of what elements that state will look at to determine your liability for its income taxes. Some of the most important are as follows:

- Where you live.
- Where and how you vote.
- What state driver's license you carry.
- Where your bank accounts are located.
- The location of any real property you own.
- Where your family is living if not with you.
- Whether or not you have a fixed intention of returning to a particular state if you are living elsewhere at the present time.

There is no magic formula for determining what combination of the above listed items will prompt your former state to subject your income to taxation. Some combinations are more important than others. Where you live; whether you vote in national but not state elections;

which driver's license you carry; and where your real property (if any) is located are often very critical elements. However, the most important and critical is the final point. A fixed intention to return to a particular state will always subject you to that state's income taxes, in those states that tax as residents not only those who physically reside within the state but also its domiciliaries.

What if I don't know which U.S. state I will return to?

Unlike in foreign countries, there is no such thing as a national U.S. residency or domicile. Residency and domicile apply to states only. So, if you don't have the fixed or definite intention to return to a particular state, but do have a fixed or definite intention to return to the U.S., you may still be able to abandon domicile in a particular state.

This is an important distinction when it comes to voting in U.S. elections. However, the Overseas Citizens Voting Rights Act allows U.S. citizens living outside the country who are presently not residents or domiciliaries of any U.S. state to vote in the federal elections (see U.S. Code 42, 1973ff).

To obtain the specific instructions and to download the form to request an absentee ballot, go to www.fvap.gov. On the opening web page, you will see a large white block with the heading The Basic Absentee Voting Process. Just follow the simple instructions.

Currency Issues with the FEIE

If you are using the Foreign Earned Income Exclusion and are paid in a foreign currency, **your U.S. taxes may have tripled in the last few years**! This is because the value of the FEIE is falling fast, along with the value of the US dollar. Let me explain.

- Note that this edition is updated for 2017. However, a strong dollar has reduced the impact of these currency issues in the FEIE. So, I have stuck with prior year numbers to make the point and explain what will happen again once the dollar begins it weaken.

The Foreign Earned Income Exclusion allows you to exclude $101,300 in 2016 from your Federal Income Taxes. This exclusion amount goes up most years and is indexed to inflation. For example, the Foreign Earned Income Exclusion was $91,400 for 2009, $91,500 for 2010, $92,900 for 2011, $95,100 for 2012, $97,600 for 2013, $99,200 for 2014 and $100,800 for 2015. For additional information on the FEIE, please see my article on taxation, or click here for About.com.

When you report your foreign salary, you must translate from your local currency into U.S. dollars. If your currency is strong compared to the dollar, as most are, your U.S. tax bill will increase as the dollar weakens.

Here is an example from a group of tax returns I prepared back in the day. It's an old example, but is useful to show what happens when the dollar is weak. In recent years, the dollar has been strong, so FEIE valuations have not been a problem.

This client is living and working in Japan and needed to catch up on his delinquent Federal 2009, 2010 and 2011 returns, and file his 2012 return. His salary has remained constant for these years at 12,000,000 Yen.

Using the yearly average charts on the IRS site for 2009, 2010 and 2011, and Oanda for 2012, here are the approximate conversion amounts:

- ¥12M is $123,250 in 2009, compared to a FEIE of $91,400.
- ¥12M is $131,370 in 2010, compared to a FEIE of $91,500.
- ¥12M is $144,400 in 2011, compared to a FEIE of $92,400.
- ¥12M is $150,500 in 2012, compared to a FEIE of $95,100.

If this client had earned the same salary of 12M Yen in 2006, the conversion to U.S. dollars would have been $97,938 against a Foreign Earned Income Exclusion rate of $82,400.

So, even as the buying power of this client's salary has done down over the years (no increase for inflation, etc.), his U.S. taxes have skyrocketed. In 2009, his net taxable income (salary in US$ minus FEIE) was $31,850. In 2012, his net taxable income is $55,400. Had this client earned ¥12M in 2006, his net taxable income would have been only $15,500. This means his taxable income has increased by a multiple of 3.5 since 2006!

There are a few planning tools you might use to mitigate these affects. For example, when reporting your salary, there is no exchange rate mandated by the IRS. The only requirement is that you be consistent year to year and use a published rate. If your salary is about the same each month, then a yearly average exchange rate is the most accurate. If you receive a large bonus at the end of the year, or other incentives, you may benefit from a more complex calculation. In that case, I generally recommend www.oanda.com,www.xe.com or www.x-rates.com.

The Foreign Earned Income Exclusion remains the most important tool in the Expat's tax toolbox, but its value is falling fast, just as your tax rates continue to climb. This means that other tools, such as foreign corporations for the self-employed and the ability to retain earnings offshore are becoming even more important.

Expatriation – The Final Solution

Each month I get one or two inquiries from U.S. citizens who have had enough and want to give up their U.S. citizenship. While it is rare for someone to take such drastic steps, especially after they learn how to manage their U.S. tax obligations while living abroad, it is an important subject. Here are the facts:

Individuals who give up their U.S. citizenship, or long-term residents who give up their residency status after June 16, 2008 are subject to a mark-to-market tax regime under which they are taxed on the unrealized gain in their property to the extent it exceeds $680,000. This value is expected to change in early 2017. Click here to review the IRS website.

To calculate gain, the IRS assumes the all of your assets were sold at fair market value on the day before you expatriated. If the net gain from these deemed sales exceed $680,000, you pay tax on that difference.

These rules apply to any U.S. citizen who relinquishes citizenship or any long-term resident who ceases to be a lawful permanent resident of the United States, and the individual who has:

- Your average annual net income tax for the 5 years ending before the date of expatriation or termination of residency is more than a specified amount that is adjusted for inflation ($147,000 for 2011, $151,000 for 2012, $155,000 for 2013, $157,000 for 2014, and $160,000 for 2015 – note that this is tax, not income!).
- Your net worth is $2 million or more on the date of your expatriation or termination of residency.
- You fail to certify on Form 8854 that you have complied with all U.S. federal tax obligations for the 5 years preceding the date of your expatriation or termination of residency.

Of course, paying tax on assets you do not sell can cause a problem, for which the IRS has graciously made allowances: You may elect to defer this tax so long as you provide adequate security, as required by the IRS, to ensure payment and you give up any treaty rights that would preclude assessment or collection of the tax in the future.

In addition to any other requirement, an expatriate must also file an information return on Form 8854 in each tax year they are subject to the rules above. This form can be found at http://www.irs.gov/pub/irs-pdf/f8854.pdf

Think dumping your U.S. passport is unthinkable? In fact, record numbers of Americans gave up US citizenship in 2015… and this number has doubled in the first quarter of 2016. As the IRS

mafia becomes ever more hostile to its citizenry, Americans give up US citizenship in record numbers. The number of citizens and long-term residents cutting their official ties to Uncle Sam jumped more than 20% last year to 4,279, according to an analysis of the latest government data.

It's a trend that's been increasing in recent years. Many of those severing links are Americans living overseas who are tired of dealing with complicated tax paperwork, a headache that has worsened since new regulations came into effect.

Eighteen times as many Americans renounced their citizenship or long-term residency in 2015 compared with 2008. Last year was the third record-breaking year in a row.

Why did so many Americans *give up US citizenship*? The three most common reasons given were 1) the IRS, 2) the IRS, and 3) the IRS.

Let's take a step back: America is about the only country in the world that taxes its citizens on their worldwide income, regardless of where they live. So long as you hold a U.S. passport, the IRS wants its cut. And the IRS has become very hostile in attacking American's abroad and those offshore accounts, putting a number of them in prison over the last few years. Of course, these attacks are limited to average people and not big corporations, who have record amounts of cash offshore.

This attitude has resulted in some very unreasonable tax assessments. For example, I have met many people who have never set foot in the U.S., but whose parents wanted them to have a U.S. passport at birth, who have been caught in the IRS mill. Once in the government's sites, they were forced to pay enormous fines and penalties, in addition to the tax due. Adding insult to injury, some of these people had their bank accounts seized and real estate sold at auction to pay in to the Obamanation.

Then there are the laws targeting offshore banks. If you are a U.S. citizen, you are not wanted at most financial intuitions. Of those banks that will do business with you, most will hit you with extra fees, such as $500 to open the account and a $300 per year special assessment to cover compliance costs.

Finally, there is the invasion of privacy. As an American, you have zero right to privacy in your financial dealings. In fact, nearly all offshore banks will report your transactions to the IRS.

- If an offshore bank fails to report your transactions, they are on the hook for major fines or being locked out of the banking system all together. Considering this risk, and the high cost of compliance, it's no wonder that Americans are persona non grata.

If you are thinking of giving up your US citizenship, as described above, there are several hoops you must jump through. First, you don't just show up at the embassy, burn your passport, give

the ambassador the finger, and go along your way. You must complete a complex process and receive a renunciation letter before you are free. This might include an audit of your last 3 to 5 years of tax returns and an in-depth review of your finances to ensure you are paid-up.

- Before you open a new account as a free man or woman, the bank will want proof that you have renounced your U.S. citizenship. Even if you have a second passport, you must prove that you gave up your US citizenship. Therefore, getting this renunciation letter from the consulate is of the utmost importance. It also ensures the IRS will not come after you years later looking for more cash.

Second, you might need to pay an exit tax. If your worldwide assets exceed $2 million, or your average tax bill over the past five years has been more than $151,000, a tax may be due on unrealized capital gains.

Basically, you will be required to file a final U.S. return as if you have sold all of your assets for fair market value and you will be taxed on that gain the year you give up US citizenship. Calculating this cost to escape is simple for those who hold major stocks. If your assets include private investments, real estate that has not easily appraised, or you have other issues in determining fair market value, you could be in for a battle with the IRS.

Third, you must have a second passport in hand before you give up your US citizenship. If you give up your US passport and don't have another ready and waiting, you will be a person without a country and it will become impossible to travel or immigrate.

If you don't already have a second passport, there are three ways to get one.

By nationality or family history: If your parents or grandparents were born outside of the U.S., you might be able to get naturalized in their home country.

Earn your second passport through residency: If you move to a country like Ireland, Panama, Chile, New Zealand, or Singapore, you should be able to gain citizenship within 3 to 9 years (assuming the rules don't change while you are waiting).

Of the residency programs that I have investigated, I believe the best is the favored nation's residency permit linked to a teak investment in Panama. This requires a minimal investment of $20,000 and allows you to gain residency immediately. Citizenship should be processed in 4 to 5 years. For more information on this program, please contact me at info@premieroffshore.com.

Pay for it: You can purchase citizenship and a second passport from St. Kitts and Nevis, Dominica, and a few other nations. Most of the available programs require you to have no criminal history and cost anywhere from $165,000 to $300,000, depending on family size and other factors.

For a detailed description of the available economic citizenship programs, please see Second Passports below. You will find the requirements and costs for Dominica and St. Kitts on this page. If you have issues in your past and need a more lenient jurisdiction, please contact me for a consultation. Click here for my Top 10 Second Passports.

Second Citizenships and Passports

Let's face it; American passports are not what they once were and Americans around the world are giving up their citizenship and seeking second passports in record numbers. While the number of Americans that turn in their passports is a small fraction of the estimated 3 million to 6 million U.S. citizens living in abroad, the rise in such renunciations is causing concern. "At the moment this phenomenon is bigger in Switzerland than anywhere else in the world," the U.S. ambassador told the Handelszeitung newspaper. "U.S. passports are becoming less attractive due to the implementation of stricter U.S. laws."

One of the major motivators pushing Expats and others to give up their U.S. passports is the Foreign Account Tax Compliance Act (FATCA) that requires banks worldwide to report the financial assets and transactions of their U.S. clients. The burdens this law places on international banks is enormous and most have decided compliance is impossible. The bottom line is that it's not financially feasible for an international bank to maintain a team of experts to ensure compliance with this convoluted law…which means those with U.S. passports will be unceremoniously dumped by their banks.

If you are considering taking the drastic step of renouncing your U.S. citizenship, keep in mind that you must first have a second passport in hand. When you give up citizenship in one country, you must already have citizenship in another…otherwise, you will be without a country and without travel documents.

NOTE: Residency is not the same as citizenship. Many clients contact us with the plan of obtaining residency in countries like Belize or Panama, then giving up their citizenship. This will leave you without a passport and may have other draconian consequences.

There are four methods for obtaining a second citizenship and a passport:

1. If you have distant relatives in countries like Ireland, Poland & Italy, you might qualify for citizenship by ancestry.
2. If you marry someone and become a resident of just about any country, even the U.S., you can obtain citizenship after a few years.

3. If you are a long term resident of a country like Belize, Paraguay, or Panama, you can qualify for citizenship. 3 to 10 years.
4. You can purchase economic citizenship and a second passport from St. Kitts, Dominica and Austria.

If you are looking to opt out of the U.S. system any time soon, the only option is to purchase economic citizenship. A second passport by ancestry is open to very few and has become much more difficult in recent years. Citizenship by marriage may upset your current spouse and citizenship by residency will take years to complete. For example, the constitution in Uruguay requires 3 years minimum, and Panama is about 10 years. Even if you qualify for citizenship through residency, a second passport is not guaranteed. Passports are granted by order of the President and often require a "contribution" to his election fund.

I recommend St. Kitts over Austria is because of the high cost of Austria, because Austria imposes a residency requirement and because St. Kitts is just so much more efficient to deal with compared to the bureaucrats in Austria. An Austrian passport can cost upwards of $1 million plus legal fees, while a St. Kitts passport will cost $250,000 plus legal fees.

St. Kitts and Nevis are two islands in the Eastern Caribbean that became independent from England in 1983 and have a history of providing privacy, asset protect, and the best second passport available. This country of 51,000 is a member of the United Nations, its primary language is English, and its currency, the Eastern Caribbean Dollar, is pegged to the United States dollar at 2.7 to 1. Click here for additional information on the Eastern Caribbean Community.

Your St. Kitts passport will provide you with visa free travel to over 100 countries, including Great Britain, Hong Kong, Liechtenstein, Ireland, Sweden, Switzerland and Schengen States of the European Union. Canada was removed from this list in 2015. For a list of these countries, click here.

Your St. Kitts passport will also provide an easier path to residency in a number of countries, such as Monaco, Switzerland, Andorra, United Kingdom, and Bermuda, Cayman Islands, Bahamas and other Caribbean countries.

Most importantly, there is no residency requirement to obtain a second passport from St. Kitts. You are not required to live in St. Kitts and there is no travel, regular meetings with immigration representatives, or other annoying requirements.

Processing Time: In most cases, you will receive your St. Kitts passport in 2 to 4 months after submitting your application.

There are two programs that will lead to a second passport in St. Kitts:

1. Citizenship through real estate investment in St. Kitts, and
2. Citizenship by making a donation to the St. Kitts Sugar Industry Diversification Fund.

St. Kitts Passport by Real Estate Investment

The minimum investment in St. Kitts real estate is $400,000 per applicant. If there are two related applicants, such as a husband and wife, you can invest $800,000 in a single property.

Government fees for the St. Kitts real estate investment program are as follows (updated for 2012):

1. US$7,500.00 for due diligence background checks and processing fees for the main applicant;
2. US$4,000.00 for due diligence background checks and processing fees for each dependent of main applicant who is over the age of sixteen years;
3. On approval in principle of an application through a real estate investment

i. US$50,000.00 for the main applicant

ii. US$25,000.00 for the spouse of main applicant;

iii. US$25,000.00 for each child of the main applicant under eighteen years of age;

iv. US$50,000.00 for each qualified dependent of the main applicant above the age of eighteen years, other than his or her spouse.

4. Application processing fee is $250 per applicant

Legal fees are in addition to the costs above and vary significantly by applicant. Typical real estate and related expenses are as follows:

- Purchase and Sale Agreement – 1% of the Purchase Price
- Memorandum of Transfer – Approximately 1% of Purchase Price
- Surveyor's Fees – Approximately US$327.00 per acre
- Government Fees – Registration fee of US$2.70
- Assurance Fund – Purchase price divided by 500

- Alien Landholding License Application – US$1,500.00 per applicant
- Stamp Duty (on select properties): 2.5% – 6% of purchase price

In addition to the high transaction costs, there are a number of issues with the St. Kitts passport by investment program. For example, you must purchase a "program approved" property, which means the cost will be higher than for a non-approved comparable property.

Second, if you give up your citizenship and sell the property, it will lose its approved status and your sale price will be lower. In other words, you can't sell the property to someone seeking economic citizenship, so the number of potential buyers and the sale price will be significantly reduced.

Third, real estate taxes and upkeep on a property you do not occupy may be prohibitive. The Comptroller of Inland Revenue assesses a property tax of 0.2% per year on market value.

Fourth, St. Kitts does not charge a capital gains tax when the property is sold. Instead, they have a 12% transfer tax due on the full sales price. So, even if you are selling the property at a loss, a 12% tax is charged on the transfer.

Fifth, I said that $400,000 is the minimum investment per application. However, this assumes you can find an approved property you wish to purchase in this price range. Many single family homes are significantly more expensive than this minimum investment and large homes can be in the millions on St. Kitts or Nevis.

In my experience, clients who will spend significant time in St. Kitts opt for the investment option and purchase a single family home. Those who will visit the island from time to time opt for the condos provided by Marriott (for additional information, click here) and the rest will prefer to acquire a passport by donation.

St. Kitts Passport by Donation

If the preceding page on the St. Kitts passport by investment option left you dazed and confused, as it does many clients, there is an easy solution. You can purchase your St. Kitts passport by making a "donation" to the Sugar Industry Diversification Fund (SIDF).

Under the SIDF Citizenship-by-donation option there are four cost structures based on family size:

1. $250,000 for a Single applicant,
2. $300,000 for an applicant with no more than 3 dependents (two children under 18 and a spouse),

3. $350,000 for an applicant with no more than 5 dependents (four children under 18 and a spouse), or

4. $450, 000 for an applicant with no more than 6 dependents (five children under 18 and a spouse).

In this program you simply pay the fees, gain economic citizenship and are handed second passport…with no strings attached. This is the recommended program for clients who do not plan to spend significant time in St. Kitts or Nevis.

The costs above do not include legal, due diligence, application, agent, and other professional fees. A single applicant should expect to pay out around $350,000 to complete the process.

Dominica is another Caribbean island that has been making a name for itself in the offshore world for the last several years. Its passport is not as travel friendly as St. Kitts, but the costs are much lower.

Officially the Commonwealth of Dominica, this island is in the Lesser Antilles region of the Caribbean Sea, south-southeast of Guadeloupe and northwest of Martinique. Its 290 square miles has a population of about 71,000. Dominica has been nicknamed the “Nature Isle of the Caribbean” and is generally considered one of the most eco-friendly and beautiful islands in the regions.

A second passport from Dominica will cost a family of four (applicant, spouse and two children under 18-years-old) of $200,000, plus $25,000 for each additional child under age 25. With filing, registration and professional fees, applicants can anticipate a total cost of $300,000. In other words, a family of four can obtain economic citizenship and second passports from Dominica for less than the cost of a single passport from St. Kitts.

Dominica offers three options to obtain a second passport:

Package A: Single Applicant	A non-refundable investment of US$100,000.00
Package B: Family Application One (Applicant and spouse)	A non-refundable investment of US$175,000.00
Package C: Family Application Two (Applicant plus spouse and two children below the age of 18)	A non-refundable investment of US$200,000.00

Package D: Family Application Three (Applicant plus spouse and more than two children below the age of 18)	A non-refundable investment of US$200,000.00 and US$50,000.00 for every additional person below the age of 18

Dominica's application and other fees are also significantly lower than St. Kitts.

- Application fee – US$1,000 per investor (Non-refundable)
- Processing Fee – US$200 per applicant (Non-refundable)
- Naturalization Fee – US$550 per applicant
- Stamp Fee – US$15 per applicant

Considering legal and other costs, an individual applying for economic citizenship and a second passport from Dominica should expect to part with about $165,000, including the donation of $100,000. This is about half the fee charged by St. Kitts.

The Dominica passport allows visa-free travel to more than 60 countries, including the United Kingdom and CARICOM nations. Click here for list of visa free countries. Dominica imposes no residency requirements to obtain, nor maintain, citizenship and there are no taxes imposed on citizens who do not reside in Dominica; however, those who do reside in Dominica are subject to substantial taxes on worldwide income.

The only countries that offer official citizenship and second passports without residency requirements are St. Kitts and Nevis and Dominica. There are a number of websites offering "grey market" passports, but, buyers beware! The vast majority of these are scams.

For example, I am often asked about offers of passports from Paraguay and Dominican Republic costing $25,000 to $50,000. The constitution of Paraguay requires 3 years of residency before citizenship can be granted and the average timeline is about 4 years (3 years of residency and 1 year processing). The Dominican Republic does not offer a passport for purchase or investment program. Anyone promising immediate passports for purchase is either selling forgeries or skirting the system and running a risk of discovery and cancellation. If you give up your U.S. passport and your second passport is invalidated, you are truly up the river without a paddle.

Feel free to contact us with questions regarding second passports and economic citizenship in St. Kitts and Dominica. We will be happy to answer your questions and streamline the process.

Phone us at (619) 550-2743 or email info@premieroffshore.com for a free and private consultation. Also, please see my Top 10 Second Passports article.

Taxation of Foreign Real Estate Investments

When it comes to investing in property overseas, there is often little difference than if you were investing in U.S. property. Three situations bear investigation:

1. The first is the **purchase of raw land or a building for speculation**. In this scenario, the investor buys a property overseas and plans on holding it for a period of time to later sell for a profit. The result is a capital gain taxed by both the U.S. government and, in some cases, the state of domicile of the taxpayer. The U.S. has favorable tax rates (currently 15%) if the holding period is over one year. There may also be a capital gains tax in the country that the property is located in. If this is the case, a credit can be used to offset U.S. taxes.

In this situation, there is no difference in how the U.S. taxes the sale of an investment property in the U.S. and one outside of the U.S.

2. Let's look at the same scenario, except this time, instead of selling the property outright you want to **exchange it into another property**. This can be accomplished by using the provisions of section 1031 of the IRS code. Under this section, you can defer some or all of the gain from the sale of one property by simultaneously purchasing another property of "like kind." Here again, there is no difference in the taxation of property inside the U.S. and outside the U.S.

What we must look at in this situation is the exact definition of "like kind." When dealing with real property, the government gives quite a bit of latitude in what is considered "like kind." Examples are raw land, a single family house, a condo, an apartment building, a restraint, etc. As long as you're selling real estate to buy real estate, you will generally be allowed to perform a 1031 exchange.

The main thing to be aware of is that foreign real property and U.S. real property is not considered to be like kind. For instance, you cannot exchange a rental property in California into a rental property in France or to raw land in Costa Rica (or vice versa). You could however exchange the rental property in France into raw land in Costa Rica. What this boils down to for you, the investor, is that, if you want to move an investment back into the U.S. you will have to pay taxes on any gains you made.

If a property qualifies as "like kind" then you must also qualify the exchange. There are complexities involved with this type of transaction, and you should hire a tax consultant to facilitate the transaction and make sure that you don't do anything to disqualify the non-recognition of gain. Another critical point is that your new property needs to be more expensive and have a larger note on it. Otherwise a portion of the gain will be recognized and taxable. For more information, see the "Nontaxable Exchanges" section of IRS Publication 544 Sale or Other Dispositions of Assets available at *www.irs.gov/pub/irs-pdf/p544.pdf*.

3. The third consideration is when you have a rental property overseas. In this case, it is much the same as a rental situation within the U.S. The main consideration is that rental activities are considered passive. This means that losses from your passive rental activities can only offset income from other passive sources. If you do not have any other passive income, the losses are suspended until such time that you have passive income or you sell the property—at which time the losses are released and can offset other types of income.

An exception to this rule applies to active participants in the management of real property. As an "active participant," you must share in the management decisions for the property, arranging for others to provide services like repairs, etc. Owning property in a foreign country makes it more difficult, but not impossible, to qualify as an active participant. If you meet this requirement, you can deduct the losses from your rental property against your other income (like wages, self-employment, interest, and dividends).

Besides the need to qualify as an active participant you must also meet these additional requirements:

- You must own more than 10% of the property.
- You cannot be a limited partner.
- You must be an active participant in the year of the loss and the year that the loss is deducted. The benefit phases out at an adjusted gross income of between $100,000 and $150,000.

Finally, you will only be allowed straight line depreciation on property outside of the U.S. You are not eligible for the various accelerated depreciation methods.

Implications of your "Tax Home"

If you only have one tax home regardless of whether you reside in the U.S. or overseas, there are few, if any, complications.

For people with multiple homes or multiple business ventures at which they spend varying amounts of time, it gets trickier. These situations are decided on a case-by-case basis, according to individual circumstances. Some of the facts that will be looked at are:

- Total business time spent at the different locations.
- The amount of business activity that is carried on at each location.
- The significance of the business activity to the taxpayer's return (where is more money made and what percentage of the total income does it represent?)

Let's look at some examples of how the tax home concept can affect the taxes of the international real estate investor.

Example 1—Bob and Jane live in the United States and work close to their home. They own some real estate outside the U.S.

In this case, their tax home is their residence and all expenses they incur when visiting their real estate (whether rental property or investment property) are deductible against the income from that property.

Example 2—Bob and Jane live in the United States and work close to their home. They spend part of the year at their foreign property—a small house in France with a vineyard.

In this case, whether they can deduct all their living expenses (travel, meals, utilities, incidentals) as "away-from-home" expenses in pursuit of a business is dependent on the facts. Which home do they spend more time at? Where do they make more of their money? How much of their time at the foreign home is devoted to the vineyard business?

If it is determined that more time is spent at the foreign location, the deductions will not be allowed. This is exactly what happened in the case of Bowles v. United States. The taxpayers claimed away-from-home expenses for their grape-growing business, but the IRS and then the courts ruled that, since more of the couple's time was spent at the vineyard, the vineyard was their tax home and the deductions weren't allowed.

Example 3—Bob and Jane live in the United States and work close to their home. They own a seasonal B&B in Europe, which they spend the summer operating.

In this case, if Bob and Jane can prove that their tax home is in the United States, all of their living expenses can be deducted as away-from-home expenses (in any case the direct expenses of operating the business are allowed).

What is important to note is that you need to plan your actions beforehand. If you are going to operate a business, or own real estate overseas, and you want to deduct your overseas living expenses as away-from-home expenses, you need to make sure that you create a fact pattern consistent with a tax home in the U.S. Direct expenses of the business or investment are always deductible and are not dependent on where your tax home is.

Note: There is an important distinction in the concept of "tax home" for purposes of deducting away-from-home expenses and qualifying for the foreign earned income exclusion. Multiple homes may cause the loss of the away-from-home expenses but, as long as they are all overseas, you may still qualify for the earned income exclusion and the housing exclusion.

U.S. Tax Breaks for Offshore Real Estate

Do you own property outside of the United States? Are you thinking about investing in offshore real estate? Are you an offshore real estate mogul looking to reduce or eliminate your US taxes? This article will cover all areas of US taxation of offshore real estate and provide insider tips and techniques to get your US tax bill under control.

So long as you carry a US passport, the IRS wants you pay tax when you sell offshore real estate. US citizens are taxed on their worldwide income and there are very few offshore tax breaks for capital gains and the passive income. Thus, it doesn't matter whether you are living in the good 'ole U S of A or abroad, passive income and capital gains are taxable as earned.

- Active investors, real estate professionals, and those who buy in a retirement account are exceptions to the rule.

This means that offshore real estate is taxed the same as domestic real estate (with the exception of depreciation). The same tax rates apply, the same deductions for expenses are allowed, and the same credits are available. I will describe the best of these below.

In most cases, if buy a property in Panama and sell it after 3 years, you have a long term capital gain in the US, and owe tax at 20% to 23.8%. For the rest of this article, I will assume a long term US rate of 20%.

This doesn't mean you must pay double tax, first in the country where the property is located and then again in the United States. The IRS allows you to deduct or take a dollar for dollar credit for any taxes paid to a foreign country…for every dollar paid to Panama your US bill *should* go down by one dollar. In practice, this never works out perfectly, but it does eliminate most double tax.

For example, let's say you bought a property in Medellin, Colombia in 2005 for $100,000. In 2013, you received an offer you couldn't refuse for $150,000, giving you a capital gain of $50,000. The capital gains tax rate in Colombia is 33%, so you pay $16,500 to Colombia.

The capital gains rate of Colombia is significantly higher than the United States at 20%, so you should not expect to pay any tax to the US. You will report the sale on Schedule D of your US personal return and deduct or take a credit for the $16,500 paid on Form 1116, leaving nothing for the IRS to leach on to.

Now let's say you sell a property in Panama, where capital gains are taxed at 10%. In this case, you will pay 10% to Panama ($5,000) and 10% to the United States ($5,000), to get to the US 20% rate for long term capital gains.

If you had this same transaction in Argentina, Ecuador or Costa Rica, where real estate sales are not taxed, you will pay all of the "available" 20% to the United States.

Important Note: When deciding in which country to buy real estate, *that country's capital gains rate only comes in to play if it exceeds the US rate*. If a country's capital gains rate is 0% to 20%, you will pay 20% in total. If a country's rate is more than 20%, then only the excess should be considered in your decision. For example, you are paying a 13% tax premium to buy property in Colombia because Colombia's rate is 13% higher than the US's capital gains rate.

Many clients look at a country like Costa Rica and think they are getting a deal or saving money by paying no capital gains tax when they sell their property. Well, these countries have other taxes and duties to make up for their zero capital gains rate, *which might not deductible on your US return*. In most cases, you are better off buying property in a country whose system mirrors that of the United States.

The exception to the rule above is offshore real estate held in an IRA LLC. By purchasing offshore real estate in your retirement account, you can defer or eliminate US tax on both rental profits and capital gains. If the country where your property is located doesn't tax the sale, then you just might avoid the tax man all together. If the country taxes you at a relatively low rate, such as Panama at 10%, this might be the only tax you pay (ie. the IRA cut your total tax bill by half).

Let me explain: If you move your IRA or other type of retirement account away from your current custodian and in to an Offshore LLC, you can invest that account in foreign real estate. The LLC is owned by your retirement account and holds investments on behalf of that account. You buy the rental property in the name of the LLC, pay operating expenses from the LLC, and profits flow back in to the LLC and in to your retirement account.

I note that this structure is for investment or rental real estate and not property you want to occupy. If you later decide to live in the property, it must first be distributed out of the retirement account to you and taxes paid if applicable.

If you wish to purchase offshore real estate with funds from your IRA and a non-recourse loan, or you are in the active business of real estate, you can add a specially structured offshore corporation to eliminate US tax.

If you buy real estate with an IRA in the United States, you get the joy of paying tax on the gain attributed to the money you borrow (the mortgage). If 50% of the purchase price comes from your 401-K and 50% from a loan, half of the rental profits and half of the gain is taxable, with the other half flowing in to your retirement account.

Take this same transaction offshore and no US tax is due. *Tax free leverage in a retirement account is one of the great offshore loopholes.* Please check out this article for more information.

Owners of rental real estate in the United States get to utilize accelerated depreciation and deduct the value of the property over 27.5 years. If the property is offshore, you must use straight-line depreciation over 40 years and you get less bang for your depreciation buck.

On a $100,000 rental property, your annual depreciation deduction would be about $3,636 for US situated property vs. $2,500 if located outside the country. This means you would be paying a premium of $1,136 offshore real estate.

Don't get too excited and cancel your offshore real estate deals just yet! The benefit of depreciation can be fool's gold. The accelerated depreciation is great if you plan to hold the property for 20 years. However, if you plan on buying, improving and selling over a short period (a few years), then accelerated depreciation will cost you money, not save you money.

This is because depreciation is "recaptured" when you sell the property. Every dollar you were allowed to deduct over the years prior must be paid back, is added to your basis, and taxed at 25% rather than 20%. So, as a rough example, if you have a gain of $50,000, and took depreciation of $20,000, you owe tax at 20% of $50,000 for $10,000 plus 25% of $20,000 for $5,000. Therefore, your total tax due is $15,000.

The more depreciation you take, the more you must repay. If you hold a property for many years, taking a deduction today, and paying it back in the distant future, is a benefit. If you will sell the property in 3 or 5 years, taking the deduction now, and paying an additional 5% in tax later, is of little to no benefit.

I have had several clients over the years shocked at the size of their tax bills from the sale of a rental property. They had planned for a 15% rate (the previous long term rate), and ended up at 20% + recapture. In States like California, where values property values have gone down, it is possible to sell a rental at a loss and still have a big time tax bill from recapture.

This might lead some to think a good strategy is to not take depreciation, especially on property you plan to flip ASAP. Well, the IRS has a surprise for you: The tax law requires depreciation recapture to be calculated on depreciation that was "allowed or allowable" (Internal Revenue Code section 1250(b)(3)). This means you will pay tax on depreciation whether you take it or not.

All of this is to say that not being allowed accelerated depreciation on offshore real estate might be a good thing.

As I said to begin this article, all of the same US tax rules apply to offshore real estate that apply to onshore properties. This holds true for the primary residence exclusion: If you qualify, you can exclude up to $250,000 single or $500,000 married filing joint, from the sale of your primary residence.

To qualify, you must own and occupy the home as your principal residence for at least two years before you sell it. Your "home" can be a house, apartment, condominium, stock-cooperative, or mobile home fixed to land anywhere in the world.

Tax Tip: You can take the $250,000/$500,000 exclusion any number of times. But you may not use it more than once every two years.

Have you owned and been renting out a property in Panama for a few years? You might consider kicking out those renters, moving to Panama, and occupying the property for two years before you sell.

Did you convert a home from your primary residence to a rental property? The rule is that you must have lived in the property for 2 of the last 5 years to qualify for the exclusion. Therefore, you can live in it for two years, rent it out for up to 3 years, and then sell and get the full exclusion.

To get the $500,000 exclusion, both a husband and wife must live in the home as their primary residence. It is possible for one spouse to qualify while the other does not. For example, husband is living in the United States and visiting his wife and family in Panama. On a joint return, only the wife may take the exclusion for $250,000 when they sell the home in Panama.

You don't need to spend every minute in your home for it to be your principal residence. Short absences are permitted—for example, you can take a two-month vacation and count that time as use. However, long absences are not permitted. For example, a professor who is away from home for a whole year while on sabbatical cannot count that year as use for purposes of the exclusion.

You can only have one principal residence at a time. If you have a home in California and a condo in Panama, the property you use the majority of the time during the year will be your principal residence for that year. So, it would be possible for Panama to be your primary resident for one year and California to be your primary residence the next. Before you sell, make sure you have spent at least 2 of the last 5 years in the property.

Because you get the "benefit" of all US tax rules when it comes to offshore real estate, you can use like-kind exchanges (also called a Section 1031 exchange) to defer US tax. The only caveat is that you can't exchange US property for foreign property – it must be a foreign property for foreign property transfer.

In a like-kind exchange, you defer paying taxes by swapping your property for a similar property owned by someone else. The property you receive is treated as if it were a continuation of the property you gave up. The benefit is that you defer paying taxes on any profit you would have received.

You may only exchange property for other similar property, called like-kind property by the IRS. Like-kind properties must have the same nature or character, even if they differ in grade or quality. All real estate owned for investment or business use in the United States is considered to be like kind with all other such real estate in the United States, no matter the type or location. For example, an apartment building in New York is like kind to an office building in California.

All real estate owned for investment or business use outside of the United States is considered to be like kind with all other such real estate outside of the United States. Therefore, you can exchange an office building in Panama City, Panama for an apartment building in Medellin, Colombia. You may not exchange a property in Panama with a property in New York.

In practice, it's rare for two people to want to swap their properties with each other…especially offshore, where only US persons benefit from this loophole. Instead, one of the owners usually wants cash and the other (the gringo) wants to avoid tax on his gain. In this case, you can still qualify for a like-kind exchange by adding a licensed third party specialist to the deal, called a qualified intermediary or QI.

Let's say your property in Panama is worth $300,000, and you have a capital gain of $100,000. You can defer paying tax on this sale if you can find someone in Colombia who wants to swap. Of course, no Colombian wants any part of a US 1031 exchange because they get no benefit…only an American living in Medellin would find the tax deal interesting. So, after you identify the property you want in Colombia, you need to hire a QI.

Essentially, the QI buys the property in Colombia and then enters in to a like-kind exchange with you. So long as you can identify the replacement property within 45 days after you sell the Panama property, and your replacement property purchase is completed within 180 days, you have a qualified 1031 exchange. Because of these time limits, it's a good idea to have a replacement property lined up before you sell your property.

You should also note that this tax strategy is only advantageous in countries with low capital gains rates. If the country has a tax rate equal to or higher than the US, there is no reason to enter in to an exchange. It will not reduce your tax in the country where the property is located, only in the United States. If the Foreign Tax Credit will eliminate your US tax obligation, then an exchange is pointless.

By swapping a property in Panama with a property in Colombia, you are deferring US tax on 10% of the gain. This is because you pay 10% to Panama and nothing at this time to the United States. When you sell the property in Colombia, there is no reason to enter in to a like-kind exchange – unless you want to defer the gain from Panama a second time. The tax rate in Colombia is higher than in the United States, so no tax will be due to Uncle Sam on the gain from that property.

- Let's say you had a gain of $100,000 on the property you sold in Panama in 2011 and you will have another gain of $50,000 when you sell the property in Colombia in 2016 (very good for you by the way).
- When you sold the property in Panama, you paid 10% to Panama and transferred the gain to the property in Colombia for US tax purposes.
- When you sell the property in Colombia in 2016, you will pay 33% on the $50,000 to Colombia, leaving nothing for the US on this portion of the transaction.
- You will also recognize the deferred capital gain on $100,000 from the Panama property. You already paid 10% to Panama, so you will pay 10% ($10,000) to the US in 2016 from the sale of the Panama property in 2011.

All of this planning and structuring allowed you to defer a 10% US capital gain for 5 years.

Combo Deal: Yes, you can combine a 1031 exchange with the $250,000 primary residence exclusion. To qualify for both, you must hold the property for more than five years and live in it for at least two of those five years. Then, you can use the exclusion to reduce or eliminate the capital gains, including tax carry-over from a like-kind exchange.

Rental income and expense from offshore real estate is reported on your personal return, Schedule E, just as a US rental property would be. You must keep US quality books and records, including all expenses from management, improvements, repairs, and taxes paid. You must follow all US tax rules for these deductions and expenses, such as depreciating improvements and deducting repairs.

The IRS has a right to audit you offshore real estate, so be ready. It may be common to pay your bills in cash in Colombia, but you will have a tough time deducting any expenses without a receipt and proof of payment (such as a cancelled check).

An area of emphasis in an audit of offshore real estate is travel and other expenses associated with visiting the property. If you are flying to Panama five times a year, hanging out for a week, and then expensing these trips against your one rental unit on Schedule E, the deduction will not survive an audit. In fact, it is likely to be the cause of an IRS investigation.

I generally advise clients that they may visit their rental properties once a year for a couple of days. If they have no other business abroad, and are not using the getaway as a vacation, the entire trip may be deductible. If you have a large portfolio abroad, then you might get away with spending more time traveling, but one trip per year is a safe deduction.

When reporting your rental property, remember to take depreciation. As stated above, the only difference in offshore real estate is the allowed depreciation method. You must utilize straight-line depreciation over 40 years.

Your offshore real estate comes with a number of new and exciting US tax forms to file. It is important you master these forms or hire someone experienced in their preparation. Failure to file, or filing late, can result in outrageously high penalties.

- These draconian penalties are aimed at Americans hiding money offshore. Unfortunately, regular folks, with simple offshore investments, often get caught in the crossfire.

The most critical offshore tax form is the Report of Foreign Bank and Financial Accounts, referred to as the FBAR. Anyone who is a signor or beneficial owner of a foreign bank or brokerage account with a value of more than $10,000 must disclose their account(s) to the U.S. Treasury.

For example, if you opened an offshore bank account to receive rent payments, and that account has more than $10,000 in it on any given day, then you must file an FBAR. If you send the funds to buy the property in to your offshore account, and then on to escrow, you must file this form. If you wired money from your US bank account directly in to escrow (which is a bank account you do not control), then the FBAR is not required.

The law imposes a civil penalty for failing to disclosing an offshore bank account of up to $25,000 or the greatest of 50% of the balance in the account at the time of the violation or $100,000. Criminal penalties for willful failure to file an FBAR can also apply in certain situations. Note that these penalties can be imposed for each year.

In addition to filing the FBAR, the offshore account must be disclosed on your personal income tax return, Form 1040, Schedule B.

Other international tax filing obligations for offshore real estate include:

- If your property is held in a foreign corporation, you must file Form 5471 – Information Return of U.S. Persons with Respect to Certain Foreign Corporations.

- If you hold your offshore real estate in a foreign LLC, you may need to file Form 8858– Information Return of U.S. Persons with Respect to Foreign Disregarded Entities.

- If your property is held in an international trust, a Panamanian foundation, or a Mexican Fideicomiso, you may need to file Form 3520-A – Annual Information Return of Foreign Trust and possibly Form 3520 – Annual Return to Report Transactions With Foreign Trusts.
- If your foreign assets are significant, you must file Form 8938 – Statement of Foreign Financial Assets was new for tax year 2011. The filing requirements (who must file) for this form are too complex to list here, so please see the instructions before filing.

The Offshore Real Estate Professional

If you are living and working abroad and in the business of real estate, you can realize some great tax benefits. The following section is for those who spend a significant amount of time and effort working their offshore properties, and not those with only one or two apartment units.

The typical investor in offshore real estate may only deduct his losses against other passive income. If you do not have any other passive income, losses are carried forward until you can use them.

An exception to this rule applies to a) active participants and b) material participants in the management of offshore real estate.

As an **active participant in offshore real estate**, you can deduct up to $25,000 of passive losses against other income (like wages, self-employment, interest, and dividends) on your US tax return. This allowance is phased out on a 50% ratio if your adjusted gross income is $100,000 or more.

As an active participant, you must share in the management, financial and operational decisions of the property and be knowledgeable in the day to day issues (usually by reviewing financial statements and other documents produced by the manager). This means you should be responsible for arranging for others to provide services like repairs, collect rents, etc. You may have a paid manager for the property and still be considered an active participant, so long as you manage that manager.

Besides the need to qualify as an active participant you must also meet these additional requirements:

- You must own more than 10% of the property.
- You cannot be a limited partner…you must be a general partner.
- You must be an active participant in the year of the loss and the year that the loss is deducted. For example, if you are a passive investor in 2015, and active in 2016, you

can't deduct a loss from 2015 on your 2015 or 2016 return (because the 2015 loss was carried forward).

If you are a **material participant in offshore real estate**, you are much more involved and in control than an active participant. As a material participant (sometimes referred to as a real estate professional), you are in the active business of real estate and may deduct your expenses against any and all of your other income, without limitation or AGI phase-out.

It is relatively easy to qualify as an active participant. It is far more challenging to be classified as a material participant in offshore real estate. If you can meet the criterion, you will find that there are major international tax breaks and loopholes available to the real estate professional.

NOTE: The major benefit of being offshore and material participant / real estate professional is that you may draw a salary from an offshore corporation and qualify for the Foreign Earned Income Exclusion. This tax break is only available to offshore professionals and not those living or working in the United States.

To be classified as a material participant or real estate professional you must be active year-round in the operation of your offshore real estate business. You must work on a regular, continuous, and substantial basis, and offshore real estate should be your primary occupation. If you work a full time job and do real estate on the side, you are probably not a real estate professional.

According to the IRS, you materially participate in offshore real estate:

- If (based on all of the facts and circumstances) you participate in the activity on a regular, continuous, and substantial basis during the year; or
- If you participate in the activity for more than 500 hours during the year.

To meet the facts and circumstances test, offshore real estate should be your principal trade or business and you must have significant knowledge and expertise in that industry.

You can prove your level of involvement to meet the 500-hour test by any reasonable means. This includes calendars, appointment books, or narrative summaries identifying work performed and hours spent. Contemporaneous daily time reports or logs aren't required but it is your responsibility to prove you meet the test, so any evidence you can muster will be a benefit. This is to say that the *burden of proof is on you to demonstrate you qualify as a real estate professional*.

In order to materially participate in offshore real estate, you should be living and working abroad. It would be near impossible to qualify as materially involved in properties in Colombia

while living Texas. Therefore, you should also plan to qualify for the Foreign Earned Income Exclusion (FEIE). When the FEIE is combined with an eligible offshore real estate business, you can take out up to $102,100 in salary from that enterprise free of Federal income tax and make use of a number of other tax mitigation strategies.

In other words, a qualified offshore real estate professional can deduct his or her expenses against all other income, regardless of source and without limitation based on his or her AGI, and draw out up to $102,100 in profits free of Federal income tax. If a husband and wife both qualify as material participants and for the FEIE, they can each take out a salary of $102,100, for a more than $200,000+ in tax free salary from your active business.

To qualify for the FEIE, you must be out of the US for 330 out of 365 days or a resident of another country. If you are a resident of another country, preferably where your properties are located, then you can spend up to 4 months in the US each year.

The 330-day test is quite simple: you are either out of the US or you are not. The 365 days need not be in a calendar year (for example, May 2016 to May 2017 is fine) and there is no requirement to file for residency or spend a certain amount of time in particular country.

The residency test is more challenging. You must be a resident for a calendar year and move to a particular country with the intention of making that your home for the foreseeable future. You must submit a residency application to that country, file taxes, and generally become a member of the community.

The 330-day test is based on travel days and the residency test involves your intentions to move to a particular country and make that your home. It is always easier to prove how many days you are in the US. To put it another way, it can be a challenge to prove your “intent,” especially if your needs or intent changes after only a year or two.

For this reason, I suggest you qualify under the 330-day test in your first year abroad and then move to the residency test. This is the safest way to deal with the possibility of changes in circumstances.

If your offshore real estate business is focused in one country, you can obtain residency in that nation after a year and utilize the residency test to qualify for the FEIE. Utilizing the residency test in the long run is the best way to ensure you receive the benefits of the FEIE while being classified as a real estate professional.

If your offshore real estate business spans many countries, and you are on the road several months of the year, then you may need to utilize the 330-day test in year two and beyond. You may not be able to put down roots in one country, or you might not want to become a tax resident of any nation. In this case, you will need to watch your travel days to and from the US

closely. If you miss the 330 days, even by one day, you lose the FEIE in its entirety and pay US tax on 100% of your salary.

If you qualify for the FEIE, you must operate your offshore real estate business through a foreign corporation. In order to minimize worldwide tax, you might consider a holding company in a jurisdiction that will not tax your income and subsidiaries in each country you do business to transact on behalf of your properties.

Whatever your structure, and wherever you decide to setup shop, you must incorporate outside of the United States. If you decide to skip this step, you will pay US self-employment tax on the salary. Even though you might pay nothing in Federal income tax, you will pay around $15,000 per person in SE tax. US SE tax is eliminated completely by the use of a properly structured foreign corporation.

The FEIE allows you to take out up to $204,200 (joint) free of Federal income tax, and a foreign corporation eradicates US SE tax. What if your profits are significantly more than $200,000? You can retain earnings in to your foreign corporation to be taken out as salary subject to the FEIE in future years or as dividends whenever you choose. Withdraws that qualify as salary under the FEIE, are taken out tax free. If they come out as dividends, they are tax deferred for as long as you see fit to maintain the corporation…which can be decades, even if the business has long since been shuttered.

If you are able to combine material participation / active business status with the Foreign Earned Income Exclusion, and do so through a foreign corporation, you might just operate your offshore real estate business free of any and all US tax and keep Uncle Sam out of your pocket entirely. But, this is a major endeavor and one you should not take lightly.

You must be ready to defend your position in an audit and keep US quality books and records to support both positions. To succeed in an audit of your active business status, keep extensive files, to-do lists, home and mobile phone records, business plans, project descriptions and instructions to employees documenting your active involvement in day-to-day activities of the business.

In order to prove your FEIE, keep track of travel to and from the United States and have your credit card and other records available to support you claims of days out of the country. If you will use the residency test, file for residency and, if possible, a work permit. Also, file a tax return in your country of residence and put down as many roots in to that community as possible. You may be able to structure your affairs in such a way as you pay very little in tax to this country, but you should file a return.

Tax Deals Only Available in Puerto Rico

Are you tired of paying in to U.S. social programs? Is most of your income from capital gains taxed at 24% plus whatever your State grabs? *You can eliminate tax on interest, dividends and capital gains by moving to Puerto Rico…immediately and legally.*

Most of this book is focused on showing business owners how they can move their operations offshore to eliminate or defer US tax using the Foreign Earned Income Exclusion. While this model works great for the entrepreneur or small business owner, it provides little benefit for retirees or those who make a living trading stocks and investing.

While the US is taxing and redistributing wealth as quick as it can, Puerto Rico has seized upon this opportunity to entice high net worth individuals to move to their happy islands. Puerto Rico has completely eliminated tax on capital gains, interest and dividends. Yes, that's right, once you become a resident of PR, you can legally pay zero capital gains tax. No more Federal tax, no complex planning, and no fear of the US government finding your offshore account.

I am not talking about only cutting out your State tax…I am saying you can jettison ALL United States tax on interest, dividends, and capital gains. This is possible because Puerto Rico, while a commonwealth of the United States, is treated as separate for tax purposes. By moving to PR, you can opt out of the Federal tax system and in to the PR tax program. This is because, under the Internal Revenue Code (IRC), capital gains are sourced to your place of residence and the IRC has one section detailing Federal law and another specifying laws of the territories.

Retired? Puerto Rico does not tax social security or unemployment income.

I would like to note here that moving to a foreign country with a low capital gains tax rate does not reduce your effective tax rate on passive investments. This can only be accomplished by relocating to a tax friendly US territory. As a US citizen, you are taxed by the US IRC on your worldwide income no matter where you live. When you move abroad, you remain under the jurisdiction of the Federal Government. So, if your country of residence taxes your gains at 5%, and the US at 20%, then you pay 5% to your country and 15% to Uncle Sam for the right to carry his passport. But, when you move to Puerto Rico, you fall under a unique section of the US tax code for the Commonwealth which trumps Federal law. You are opting out of the IRC Federal system and opting in to the IRC commonwealth system.

In other words, once a U.S. citizen becomes a resident of Puerto Rico, any income derived by that person from sources within Puerto Rico is excluded from U.S. Federal income tax, and taxed under the Puerto Rican income tax code. However, any income derived from outside of PR remains taxed under the Federal law.

So, capital assets (such as land, stocks, bonds, etc.) acquired after moving to PR are tax free. As for property acquired prior to becoming a resident, special provisions can result in a 10% long term rate from the day you qualify and a 5% tax rate applies to property acquired prior to becoming a resident and held for at least 10 years thereafter. See details below.

Why is Puerto Rico Doing This?

While I could pontificate on how PR sees the error of our ways and is a bastion of freedom and capitalism, the truth is probably less grandiose. Puerto Rico's per-capita income is around $15,200, half that of Mississippi, the poorest state in the nation. Puerto Rico has been battered by several years of recession and its unemployment rate is over 13 percent, well above the national rate, and its economy remains in a funk. Moody's Investors Services rates the island's debt one notch above junk status; and in a recent research note, Breckenridge Capital Advisors said the island was "flirting with insolvency." The island has the weakest pension fund in America and ran out of money January of this year (2016).

I also note that these tax breaks apply only to new residents and not those currently living in Puerto Rico. More specifically, they are available to individuals who have not been residents of Puerto Rico within in the last 15 years and who become residents of Puerto Rico on or before December 31, 2035. As such, PR is obviously attempting to bring in new money to revitalize their fledgling economy.

Qualifications

To qualify, you must become a tax resident of Puerto Rico, reside in PR for at least 183 days a year, buy a home on the island (new as of December 2015) and file an application for the exemption with the local tax authority. Once approved, the decree establishes the terms of the exemption and has the effect and force of a contract during the entire benefit period. Considering the weakness of the PR economy, and how frequently tax laws change, this contract status is a major benefit.

Incentives

The tax incentives available to individuals are as follows:

- 100% tax exemption on interest and dividend income earned after the nonresident individual becomes a resident of Puerto Rico; also applies with respect to alternative minimum tax (AMT) up to tax year 2036
- 100% tax exemption on interest, financial charges, dividends or distributive share on partnership income from international banking entities in Puerto Rico including AMT

- 100% tax exemption on long-term capital gains realized and recognized after becoming a resident of Puerto Rico but before January 1, 2036
- If not realized and recognized within the incentive timeframe, regular individual long-term capital gain applies (currently at 10%)
- Applies to appreciation of property after becoming a resident of Puerto Rico
- 5% tax on long-term capital gains realized before becoming a resident of Puerto Rico, but recognized after 10 years of becoming a resident of Puerto Rico, as long as recognized before January 1, 2036
- This 5% long-term capital gain tax only applies to the portion of gain that relates to the appreciation of the property while the individual lived outside Puerto Rico
- If the long-term capital gain is not recognized within these time periods, applicable individual long-term capital gain rate would apply on any Puerto Rico-source long-term capital gain

Puerto Rico Tax Deal for Corporations

Thinking about moving your business offshore? You might get a better tax deal in Puerto Rico…maybe much better!

As I reported last month, a US citizen can move to Puerto Rico and pay zero capital gains tax on his or her passive income and investments. That's right, no US Federal or State tax on capital gains tax from real estate, stocks, and/or other investments acquired after you move to and become a resident of Puerto Rico.

This time around, I am here to tell you that Puerto Rico has a deal for business owners and entrepreneurs…a deal you can't find anywhere else in the world unless you turn in your US passport.

Puerto Rico is offering business owners a tax contract similar to the one Switzerland and Russia negotiates with high net worth Europeans. Yes, Snowden's Russia is a tax haven. For example, the actor Gérard Depardieu, angry over a plan by the French government to raise taxes to 75 percent for the wealthy, accepted a Russian passport from President Vladimir V. Putin. Russia has a flat tax rate of 13 percent.

A tax contract with Puerto Rico will allow you to cut your total (worldwide) tax rate down to 10% or lower without the need for any complex planning or structuring. Once you enter in to a contract, it can't be modified or revoked by the government until 2036. Of course, you can leave

Puerto Rico, thereby opting out of the tax deal, at any time. You can also spend a few months a year in the United States.

To receive these benefits, you are required to move yourself and your business to Puerto Rico, spend at least 183 days a year on the island, become a legal resident of this territory, hire a minimum of 5 employees in Puerto Rico, and enter in to a tax contract with the government. Once you have relocated, you have opted out of the US Federal and State tax systems and in to the Puerto Rico tax code…which trumps the Federal code.

- As a US territory, Puerto Rico's tax code takes precedent over the US Federal tax code. While US Expats are bound by Federal tax law, American's in Puerto Rico need only follow local tax rules.
- The minimum number of employees for Act 20 increased from 3 to 5 in December 2015.

Such a contract is the inverse of the Foreign Earned Income Exclusion (FEIE) and allows you to pay all of your taxes now at a reduced rate without the need to lock earnings in to an offshore corporation, captive insurance company, or some other complex tax deferral mechanism.

Let me explain: If you qualify for the FEIE you can earn up to $102,100 in salary free of Federal income tax in 2017. If a husband and wife are both working in the business, they might take out $200,000+ combined. That is a major tax break which allows a properly structured offshore business earning $200,000 to be completely free of US tax.

Well, what if your business earns significantly more than the FEIE amount? You can usually retain excess profits in to your corporation and thereby defer US tax until you distribute these profits as a dividend. Capital gains, interest income and other returns derived from these retained earnings are taxable (may not be deferred) and dividends are taxed as ordinary income.

While the FEIE works great for those with business profits near the exclusion amount, it is not so wonderful for those earning significantly more. If you net $1 million a year and want to take that money as income now, then you are stuck paying US tax on the amount over the FEIE at 39.6% in 2017. This comes to about $316,800 in Federal income tax assuming a husband and wife both qualified for the FEIE and no State tax is due (($1m – $200,000) x .396) = $316,800. If only one person qualifies for the FEIE, your tax bill will be about $355,687 (($1m – $101,300) x .396) = $355,867.

In Puerto Rico, you pay income tax on the first $250,000 (using a graduated rate of up to 33%) and 4% on income over $250,000. There is no need to retain earnings in an offshore corporation and no issues related to tax deferral. You are paying tax each year as the money is earned…at a lower rate compared to those of us in the States, but no deferral or retainer earnings to worry about.

For example, on $1 million of business profits, your tax bill in Puerto Rico will be about $105,000, significantly less than the same US owned business operating offshore using the FEIE. This equates to an effective tax rate of about 10% ((.30 x 250,000) + (.04 x 750,000)) = $105,000 or 10%.

As your net profits increase, the benefit of Puerto Rico's tax system increase and your effective tax rate drops. For example, on net profits of $3 million, your tax is approximately $185,000, for an effective tax rate of 6.2% ((.30 x 250,000) + (.04 x 2,750,000)) = $185,000 or 6.2%.

As stated above, if your net profit is anywhere near the FEIE amount, then living and working abroad and operating through a foreign corporation will give you the best tax deal. If your profits are between $100,000 and $500,000, then you might need to run the numbers to determine whether Puerto Rico or the FEIE provides the better option. Such an analysis would take in to account how much you are willing to retain in to an offshore corporation, how long you can lock those profits away, and the deductions you have available on your US personal income tax return (itemized deductions such as mortgage interest, property tax, charitable contributions, etc.). I have not considered these issues in the examples provided.

What about those of us earning less than $1 million from our business? In Puerto Rico, you will be required to take salary of 1/3 of your net profits, up to a maximum salary of $250,000, and pay 4% on the remaining 2/3. So, if you earn $300,000 in total profits, your tax would be about $38,000 or 12.6% ((.3 x $100,000) + (.04 x $200,000)) = $38,000 or 12.6%.

If that same $300,000 was earned as salary by a US citizen using the FEIE and an offshore corporation, the first $102,100 would be tax free and the remaining $197,900 would be taxed at around 31% in 2017. This means your US Federal income tax will be about $61,597 (($300,000 – $102,100) x .31) = $61,349 for an effective rate of about 20%.

If a husband and wife are both working in that business with a net of $300,000, the FEIE amount becomes $204,200, and the balance is taxed at approximately 29%, for a total tax of $27,782. Therefore, at this income level it will be more efficient for a single person to operate in Puerto Rico and a married couple to be based offshore (($300,000 – $204,200) x .29) = $27,782 or about 10%.

When you combine these business tax incentives with the personal tax benefits of zero capital gains, you have a very strong contender in Puerto Rico. It is a deal that no country in the world can offer a US citizen.

So, why is Puerto Rico doing this? This island territory is in its 8th year of recession and is desperate to attract some wealth and prosperity. 4% tax on business profits is better than no business and no tax revenues.

How bad is the economy? Puerto Rican bonds are sold in the US with yield above 10%, which is extremely high. So high that Puerto Rico was forced to cut its offering this week the island's Government Development Bank announced it would cut bond sales to between $500 million and $1.2 billion for the rest of the year. This yield compares to California municipal bonds at a current high of 3.13%,

As the territory struggles with $70 billion in public debt and a 13.9% unemployment rate, higher than any U.S. state, it is searching for new ways to bring in capital, employment and investment. The government hopes to cut its $820 million budget deficit in half by 2015. As of the date of this publishing, Puerto Rico is working with Congress to restructure its debt.

But, there is hope for Puerto Rico. While the US is completely out of control, Puerto Rico's deficit has been reduced from $2.4 billion over the last couple of years. The island's five-year economic plan calls for creating more than 90,000 jobs that would add as much as $7 billion to the economy by 2016, and another 130,000 jobs and as much as $12 billion of growth by 2018.

While these tough economic times might prevent a firm from building a large factory, or committing millions to the Island, they should not deter a high net-worth investor and business owner from picking up and moving. These tax incentives are guaranteed by the government until 2036 and can't be withdrawn or amended. Even a law change would have no affect because your earnings are not locked in to the corporation, as they are with retained earnings in excess of the FEIE.

For more information, here are some links to other sites.

Links to Outside Resources

- Detailed Report on Puerto Rico
- Bloomberg on Puerto Rico's Incentives
- NPR Audio on Puerto Rico's Incentives
- Is Puerto Rico the Next Liechtenstein?
- NY Times on Puerto Rico's Incentives
- Fox Business Interview on Moving to Puerto Rico

If you are considering moving your business to Puerto Rico or abroad, please contact me for a free and confidential consultation. You can reach me directly at info@premieroffshore.com or 619-550-2743.

U.S. Tax for Business Owners & Self Employed

This section is an introduction to the benefits of an offshore corporation for U.S. citizens living and working abroad. It is not meant for those living abroad on their pension (retirees) or those with passive investment income.

Most Expats know that the U.S. taxes its citizens on their worldwide income and that all U.S. citizens must file a U.S. tax return every year. What most do not know is that a foreign corporation, in a zero tax jurisdiction, can legally and legitimately be used to reduce, defer or eliminate U.S. tax on their business income.

As discussed in Section one, your first line of defense is the Foreign Earned Income Exclusion (FEIE or exclusion). This exclusion was covered in detail in Section One, and can be summarized for our purpose here as follows: The FEIE excludes from your U.S. income tax the first $102,100 for 2017 of wage or self-employment income earned by a U.S. citizen who is a "resident" of another country or who was outside of the U.S. for at least 330 of any 365-day period.

The FEIE can be used to reduce or eliminate U.S. Federal income tax on wages paid to you by a U.S. corporation or a foreign corporation. It does not matter if you are the owner of the corporation…the FEIE still applies as long as you are an employee of that company drawing a salary.

The exclusion can also be used to reduce federal income tax on self-employment income paid to you while you are living and working abroad. "Self-employed" generally refers to someone operating a small business without the protection of a corporation.

Now, that you have become an expert on the FEIE by reading this book, let's look at the practical applications to the employee and the self-employed person.

Employees

Let's say you are the employee of a U.S. corporation and live outside of the U.S. You receive a Form W-2, and may have had reduced withholding of your federal income tax, or will file a claim for a refund with the IRS because of the exclusion. However, the exclusion only applies to income tax, thus you still get to pay Medicare, Social Security, and FICA tax…which, for our purposes, I will estimate at about 7.5%, or $7,500 on a salary of $100,000. In addition, your employer is required to match your Medicare, Social Security and FICA contributions, which is a cost to him of about 7.5%. Therefore, the total cost is about 15%. Again, these numbers are rounded off for this example.

Now, let's say you are an employee of foreign corporation, rather than a U.S. corporation. This foreign corporation can be owned by you, or be a subsidiary of your U.S. employer. In that case, you would not have a Form W-2 sent to the IRS, might not have any U.S. withholding, and may not be required to contribute to the U.S. Medicare, Social Security, or FICA programs (unless the foreign corporation opted in to the U.S. system).

In addition to the benefits to the employee, the employer incorporated offshore is not required to pay in to these U.S. programs, thereby resulting in a total savings of about 15%.

Please note that I have assumed that the foreign entity is incorporated in an offshore jurisdiction that will not tax its income or levy a Social Security tax. Also note that I assume it is a corporation, and not a partnership or Limited Liability Company.

Self-Employed

Now for the self-employed person operating without a corporation: The IRS and the entrepreneur will (or should) receive a Form 1099 from each payment over $500 done for a U.S. company or person. Presumably, there will be no report for work done for non-US businesses, though this does not impact your tax obligations. You then report your business income and expenses on Schedule C and use the foreign earned income exclusion to reduce your federal income tax…and that is where things go horribly wrong.

First, the FEIE does not reduce self-employment tax, which is about 15%, similar to the tax charged to the employee and employer above. Unfortunately for the self-employed person, he must pay the entire tax, rather than only half, as he would as an employee.

Second, the exclusion is reduced in proportion to your Schedule C business expenses. This roughly means that, if your gross income is $200,000, and your business expenses are $100,000, your exclusion is reduced by about 50% to $50,000. Thus you are paying federal income tax on $50,000, or about 50% of your net business income, in addition to paying 15% self-employment tax on $95,100. **Note that I am rounding down the FEIE to $100,000 in this section.**

Ok, so that is rough, but the IRS is not done with you yet! Since January 1, 2006, when the Tax Increase Prevention and Reconciliation Act of 2005 came into effect, taxpayers claiming the foreign earned income exclusion have been paying tax at the tax rates that would apply had they not claimed the exclusion. That means, instead of having your income taxed starting at the 10% rate, most expatriates are taxed starting at the 25% tax bracket.

Therefore, if you have a Schedule C business operating at a 50% net profit margin with sales of $200,000 in 2015 your tax bill might be $27,500 ($100,000 x 15% + (100,000 - ($100,000 FEIE/2) = 50,000) x 25%). This is a very, back of the envelope, example, but you get the idea.

If a husband and wife both operate the same business, and sales are doubled, with the same 50% margin, the cost of reporting the business on Schedule C, rather than through a properly structured offshore corporation, could be around $55,000. Using an offshore corporation eliminates this tax completely.

Tax Benefits of Incorporating

If you are self-employed and living and working abroad you do have options.

For example, had the same self-employed person above operated through a properly domiciled and structured offshore corporation, he or she may have eliminated just about all of the tax on net active business profits of $100,000… to say nothing of the benefits of limited liability. This is accomplished as follows:

First, form an offshore corporation in a zero tax jurisdiction, open a foreign bank account, and resister that company with the IRS.

Second, draw a salary of up to $102,100 for 2017 from that foreign corporation. As long as you qualify for the FEIE and the company's income is derived from active, not passive business, there will be no federal income tax on this income.

Third, the properly registered and domiciled foreign corporation is not responsible for Medicare, Social Security, or FICA taxes.

Fourth, you are not considered self-employed; you are an employee of your offshore corporation, and not subject to self-employment tax.

Fifth, the expenses of the offshore corporation do not reduce your foreign earned income exclusion.

Sixth, you might be able to retain some or all of the offshore corporation's earnings in excess of the exclusion. Careful planning in this area might allow the deferral of U.S. income tax on active business income inside the corporation.

Therefore, the use of an offshore corporation by an international business with net profits of $100,000 and sales of $200,000 (example above) and one employee saves about $27,500 in U.S. taxes. If the corporation's net profits are doubled, and there are two employees, such as a husband and wife, the total savings might be as high as $55,000.

When planning an international business, be it large or small, you should consult with a qualified U.S. licensed tax attorney experienced in forming and advising international businesses.

OVERSEAS TAX FAQ #1: How can an offshore corporation be used to reduce U.S. taxation?

If you live in the United States while you do your work, you will pay U.S. tax on the income you earn. Using a foreign corporation while you are physically present in the U.S. does not affect your U.S. tax situation.

If you retire to a foreign country and your only income is from a pension, investments, Social Security, etc., you will continue to pay tax in the States. There is no tax benefit to retiring abroad.

If you live abroad, work for either a U.S. company or a foreign employer, and meet the foreign earned income exclusion requirements, up to $102,100 in wage income (for 2017; the amount is adjusted upward each year) will be free of U.S. federal income tax.

If you run a business or are self-employed, live and work abroad, meet the foreign earned income exclusion requirements, and operate through an offshore corporation, you could be able to reduce or even eliminate all U.S. tax on your ordinary income.

If you operate a business from and reside in a country that does not tax foreign-source income, and your clients are outside that country, you could be able to operate free of tax in that country as well, meaning it could be possible for you to live completely income tax free.

OVERSEAS TAX FAQ #2: What if I set up an offshore corporation but continue living in the United States? Could I have foreign clients wire money to my offshore corporation, then pay U.S. tax on that income only when it is brought into the States?

No. This is one of the most common types of tax fraud…a strategy for going to prison.

If you are present in the United States while you work, all income you earn is taxable in the United States when received. When money is sent to an offshore corporation that you own or control, it is deemed received. It does not matter if you use nominee directors or add some other layer of complexity.

Of course, there are legitimate benefits to incorporating offshore. For example, you could have access too better or more diverse investment options, you could enjoy better asset protection than available in a domestic vehicle, and your customers could prefer to do business with a non-U.S. entity.

I am asked this question all the time by people seeking tax advice. Typically, they are looking for honest counsel and have no intention of breaking the law. However, you must understand that, when you call an offshore attorney or an online incorporator, you often receive no guidance and often can be given misleading information.

OVERSEAS TAX FAQ #3: If I retire overseas, will I owe income on my retirement or pension income?

U.S. retirement and pension income was earned while you were working in the United States. In many cases, you were allowed to defer income on the pension component of your wages.

Now that you are ready to take that income, it is taxable in the country where it was earned. The foreign earned income excision and other international tax tools do not apply.

The same is true of most types of investment income. Income from stocks sold, dividends received, rental income, and bank interest does not qualify for the foreign earned income exclusion and is taxed as if you were living in the United States.

OVERSEAS TAX FAQ #4: Living overseas, must I still pay Social Security, Medicare, and FICA?

If you live abroad but work for a U.S. corporation, you qualify for the foreign earned income exclusion and can exclude up to US$102,100 in wage income (for 2017) from federal income tax.

However, you still must pay Social Security, Medicare, and FICA. This usually amounts to 7.5% paid by you and 7.5% paid by your employer. For the purposes of this conversation, I'm ignoring Social Security treaties, which are country-specific.

Also, you could still be required to pay state tax if your spouse is living in the United States while you are working abroad. For example, if your spouse lives in California, which does not have the foreign earned income exclusion, the state would tax 50% of your income under a community property tax rule.

If you are employed by a non-U.S. corporation, the foreign earned income exclusion rules are as I've described, but you do not pay U.S. Social Security, Medicare, or FICA taxes. This is the case even if the foreign corporation is a subsidiary of a U.S. company (unless that subsidiary elects into the U.S. social tax system, which is extremely rare).

OVERSEAS TAX FAQ #5: What is my U.S. tax obligation operating a business or being self-employed outside the States?

If you are self-employed or operate a business outside the United States and qualify for the foreign earned income exclusion, you can use that exclusion to reduce the amount of federal income tax you owe. If you operate your business without a corporation or through a single-member LLC that does not file an election with the IRS, you must pay U.S. self-employment tax on your income. This amounts to about 15% tax of your income.

Making things worse, your business is reported to the IRS on the "Schedule C" form, and your business expenses proportionately reduce your foreign earned income exclusion. Adding insult to injury, you must pay U.S. income tax on the amount over the allowed foreign earned income exclusion.

All three of these problems can be managed by operating your business through a foreign corporation.

First, operating this way, you are a non-U.S. corporation and not required to pay Social Security, Medicare, or FICA taxes.

Second, you can draw a salary from your corporation of US$99,200, avoiding the issue of a reduced exclusion because of business expenses.

Third, you may be able to retain net profits in excess of the foreign earned income exclusion and pay U.S. income tax on that money only when you take it out of the corporation.

OVERSEAS TAX FAQ #6: If I operate a business in a foreign jurisdiction (such as Panama), what is my local tax obligation?

Several countries, including Panama, do not tax foreign source income. These jurisdictions tax only domestic income (profits you make by selling to people in that country).

Therefore, you can mitigate income tax in your country of residence if you sell to people or businesses outside that nation. For example, from a base in Panama, you could offer products or services over the Internet to clients in the United States. If you don't take orders from people in Panama, this is foreign-source income in Panama and not taxable by that country.

Note: Selling to customers in the United States does not affect your foreign earned income exclusion or your ability to retain earnings in your corporation. These tax rules require only that you live outside the United States and otherwise qualify for the foreign earned income exclusion.

As discussed above, you must take a salary from your foreign corporation to maximize the benefits of living and operating a business abroad. If you draw a salary from your Panama corporation while you are living in Panama, you could be subject to Panama's various income, payroll, and social taxes.

You can comply with your U.S. obligations by selling through a second foreign corporation, such as one incorporated in Cayman or Nevis, drawing a salary from that entity, and then passing funds sufficient to pay business expenses in Panama up to your Panama company.

In this way, you mitigate tax in Panama on your salary, and your domestic (Panamanian) entity breaks even for domestic tax purposes.

As long as you report both entities and all non-U.S. bank accounts to the U.S. government, you remain in compliance with your U.S. tax obligations. If you take a salary less than or equal to the foreign earned income exclusion, and retain the balance in your offshore structure, you could eliminate or defer U.S. tax on up to 100% of your revenues.

Where to Incorporate

Before forming an offshore company, give some thought to where you will incorporate that entity and where you will operate the business. Of course, these don't need to be the same country…you may do better to incorporate in one jurisdiction and operate from another. The following article will help you select the best jurisdiction for your *offshore company*.

Offshore Company Tax Tip: If you are an American living and working abroad, the country where you form your company does not make difference. It should be somewhere that will not tax your business and will not require you to file any tax forms. To put it another way: your only reporting requirements should be to your home country of the United States and not to the country where you form your offshore company.

I have developed the following offshore company formation checklist based on my own experiences through the years of operating a number of businesses in five countries, as well as in structuring the affairs of a wide variety of clients around the world.

The first list are business reasons to select your country of operation:

Offshore Company Tax Issues – Start your business in a country that will not tax your income. Of course, if you open a bar selling beer to the locals in Belize, they will tax you. I am referring to a business that sells a product or service to people outside of your country of operation…usually an internet based business. There are a number of countries that will not tax offshore company foreign sourced income in that case.

Time Zone – One of the most overlooked issues is the time zone. You should operate your business from the same time zone as your clients. If you are selling to the US, then you should be in South or Central America. I can't tell you how many clients started up an internet business from Asia, only to give up the night shift and move to Panama after a few months.

Banking – Your offshore company can open an account at any number of international banks around the world. The account need not be in your country of incorporation. Of course, you will need a business account in your country of operation. To open that account, you may be able to use your offshore corporation from another jurisdiction, or you may be required to form a local corporation. <u>Never put business income in a personal account…you must use an offshore company!</u>

Tax Tip: I suggest that your offshore company bill your clients and receive payment outside of your country of operation. Then, you should only bring in funds necessary to operate your business, leaving the balance as retained earnings in the offshore structure.

For example, if you operate your business in Panama, bill your customers from a Belize corporation and send only the minimum necessary from Belize to Panama to avoid tax in Panama.

World Image – The way your country of incorporation is perceived by perspective clients might be relevant to some entrepreneurs. This is the country listed in contracts and other documents, so customers will see it. Your country of operation can be kept private, but your country of incorporation will be public knowledge.

Cost of Labor and Office Space – Of course, you will expect labor to be significantly cheaper offshore, but you might be surprised that office space is quite costly. Quality office space in Panama City costs about the same as in my home city of San Diego, California.

Availability of Labor – While cost of labor is low, the demand for English speakers is high. You may find it challenging to hire good people in certain countries. I also note that labor is rather transient in many countries. English speakers are in demand and often move from job to job in search of a dollar more an hour.

Availability of Professionals (CPAs & Lawyers) – One of the most overlooked aspects of starting a business offshore is the need for quality LOCAL counsel. You must have someone nearby who can advise you on leases, employment law, local taxation, and any number of issues. Going in blind, or expecting things to work as they do in the US, is a very common gringo mistake. Don't be that guy or gal…find a few local experts on which you can rely. We at PremierOffshore.com can get you started, but there is no substitute for local knowledge.

Quality of Telecom and internet – Be sure your office has excellent internet and telecom facilities. You never want to sound like you are in a banana republic!

Availability of Computer Equipment – You might be surprised how expensive it is to import quality computer equipment in to some counties. I have had desktop systems, including monitors, stashed in my large checked cases on many occasions.

In addition to the business checklist above, careful consideration should be given to the quality of life offered in your country of operation. The following are the personal considerations of forming an offshore company and operating a business outside of the United States.

Things to consider:

- Can you learn the language?
- Is there a community you will fit in to?
- Can you adapt to the culture / speed of life?
- Can you adapt to the weather?
- Is the country accessible by air in 1 day?
- Can you live with the security concerns?

Now, let's apply these offshore company criteria to doing business in Panama City, Panama.

For myself and PremierOffshore.com, we decided to form an offshore company in Panama, operate from Panama, and form our offshore corporate billing entity in Belize. While the heat and humidity in Panama City is challenging for a San Diegan, the quality internet and low cost of labor won out. Also, escaping the heat to Medellin, Colombia is only a 30-minute flight!

Shelf Companies

I am frequently asked about the use of offshore "shelf" corporations in international business. Some claim they are useless, while others market them as the greatest invention since the numbered bank account. I would like to take this opportunity to put my two cents worth in to the debate.

Bottom Line: I believe offshore shelf corporations can be helpful if you are marketing a business because they improve your image. Since this can be accomplished without backdating any documents, or doing anything improper, I support shelf companies.

First, what is a shelf company? It is a corporation formed months or years ago that has been sitting on the incorporator's shelf, unused. Because it has no history of operation, no bank account, and no creditors, there should be no risk in purchasing a shelf company.

The legitimate benefits of an offshore shelf corporation are:

1. The company is ready to use off the shelf. You do not need to wait for the company to be formed, the name to be approved, or for the directors to be assigned.
2. You can market the name and age of the shelf company. For example, your letterhead and marketing materials can refer to "International Marketing Services (Panama), S.A., Established 2006," if you bought a corporation by that name formed in Panama in October of 2006.

Of course, the abuses of shelf companies are well documented. Many purchase these entities and then ask the director to sign back dated documents. While you can find some less scrupulous directors who are willing to provide this service, such a practice is obviously improper.

Because of the nature of the industry, it is difficult to find a shelf company older than about 14 months. This is because these companies are usually formed by the incorporator on behalf of a particular client. The client does not pay the incorporation fee, so the entity sits on the shelf to be sold to someone else. After 12 months, the annual dues must be paid, which the incorporator is not willing to do. Around the 14th to 16th month, the company is closed by the government registrar.

The only significant exception that I have found is in Switzerland. There, it is possible to purchase a company formed many years ago, revive that company in the government registry, let it sit on the shelf for about 2 years to eliminate any potential creditors and then file for a tax clearance. The result is a clean shell with the original incorporation date attached.

So, while a shelf company may help in marketing your business, it has no tax benefit.

International Foundations

Many offshore promoters are pushing Liechtenstein Foundations on the very wealthy and Panamanian Foundations on the rest of us.

Note: Foundations are more commonly used in asset protection, but some operate offshore businesses under them, thus their inclusion in this book.

Many are taken in by the term “foundation,” hoping or believing that it makes the structure a charitable foundation which is tax exempt. This is simply not true. For an entity to be tax exempt, it must be registered with the IRS as such, under IRC §501(c)(3)., and this applies to both foreign and domestic entities.

Tax tip: Only donations to charities licensed by the U.S. are deductible on your personal tax return. You can donate money to any charity or group around the world, but, if they do not have the IRS’s blessing, you are not entitled to a deduction.

Adding to the confusion, Foundations typically have multiple levels of nominee directors and boards which allegedly control the Foundation’s assets. Some promoters’ claim that, because you gave up control of your assets, you are not taxed on the interest, dividends, and earnings of the foundation. Again, this is not true. You remain the beneficial owner and have indirect control, which equals ownership in the U.S. tax code.

Most accept that a simple foreign corporation with a nominee director, or an offshore trust with a foreign trustee, does not reduce U.S. tax on earnings. But, change the ending from Inc. to foundation; add a few layers of directors, and many are willing to believe the impossible.

Taking it one step further, some foreign attorneys will issue an option stating that the Foundation is not a grantor trust under the U.S. rules. I do not see anything inherently incorrect in this statement. It seems possible that the Foundation can be classified as something other than a grantor trust. However, these statements are often used to confuse and mislead the U.S. client in to believing that there is some tax benefit to such a classification.

All of the opinions I have read say something like this: "The design and structure of the Foundation is to achieve an entity classification as other than a trust such as a partnership, corporation or disregarded entity for U.S. tax purposes."

Keeping in mind that the U.S. citizen is taxed on his or her worldwide income, and if we agree that the foundation is not some magical tax exempt structure, the classification does not make a tax difference. Under all options, income to the foundation will be taxed in the U.S. as earned, transfers to the entity will be reportable events, and (most) transfers of appreciated property will be deemed sales.

Some opinions also have the following clause: "Furthermore, there is the option of seeking a private letter ruling from the Internal Revenue Service confirming the proper entity classification of the Foundation." Such a statement should cause alarm...it means that the IRS has not classified the Panamanian or Lichtenstein Foundation and that U.S. citizens have no certainty regarding when, what, and how to file returns for a foundation.

What would happen if you assumed the foundation was a corporation, filed foreign corporate returns, and then it was classified as a trust? I have no idea, but I would not want to find out! In my opinion, Panamanian and Lichtenstein Foundations are potential options and competitors of the offshore Asset Protection Trust. However, I will not recommend them until the IRS provides some clarity on their status and filing requirements.

I am a big fan of Panama as a country in which to operate an international business and I hope these issues are resolved, and that promoters take a more realistic view of U.S. taxation, so that Panamanian Foundations can become legitimate Asset Protection tools.

Offshore Corporation or LLC?

Which is better, an offshore corporation or offshore LLC? Does an offshore corporation provide more protection than an offshore LLC? What are the benefits of an offshore LLC compared to the benefits of an offshore corporation?

These are the questions I get every day, and the answer is not as simple as you might think. There are a number of important differences between an offshore corporation and an offshore LLC that you should take in to consideration when setting up your offshore structure.

First, there is no difference in the level of protection offered by an offshore corporation or an offshore LLC. They are equal in the eyes of the law. Offshore jurisdictions have always afforded them the same high levels of deference, and U.S. courts have generally maintained that a corporation is equivalent to an LLC for asset protection purposes.

When thinking about how to best use an offshore corporation or offshore LLC, your first instinct should be to put an active business in a corporation and passive investments in an LLC. Here is why:

Benefits of an Offshore Corporation

When you operate an active business in an offshore corporation, you maximize the value of the Foreign Earned Income Exclusion and can retain earnings in excess of the FEIE. This allows you to eliminate or defer U.S. tax on your offshore earnings. You accomplish this by:

1. Drawing a salary from the offshore corporation of up to the FEIE, about $102,100 for 2017, and reporting that salary on your personal return, Form 1040 and Form 2555. If a husband and wife operate the business, they can each draw out the FEIE amount in salary, and thus earn over $200,000 free of Federal income tax.

2. If your corporate profits exceed the FEIE amount, then you leave (retain) those funds in the corporation. If you take them out in salary, they will be taxable in the U.S. By leaving them in the corporation, you defer U.S. tax until they are distributed as dividends…or possibly as salary in future years.

3. Using an offshore corporation allows you to eliminate Self Employment or social taxes (FICA, Medicare, etc.), which are about 15% on your net profits and not covered by the FEIE.

These tax breaks come at a compliance cost: you must file a detailed offshore corporation return on IRS Form 5471 each year. Because this form includes a profit and loss statement, balance sheet, and many sub forms, the cost to pay someone to prepare it for you should be at least $1,250 per year.

Benefits of an Offshore LLC

The primary benefit of an offshore LLC over an offshore corporation is the lower cost of compliance. An offshore LLC owned by one person, or a husband and wife, will usually files IRS Form 8858, which is much easier to prepare and Form 5471.

Because of this lower (and simpler) filing obligation, offshore LLCs are the best option for passive investments. Whether you are living in the U.S. or abroad, there is no tax break for passive investments in a corporation (these breaks apply only to active businesses income). Passive income is taxed as earned, reduced only by the Foreign Tax Credit, so you might as well make it as easy as possible to report.

- The Foreign Tax Credit allows you to deduct any money paid in taxes to other countries on your foreign investments. It generally means you will not be double taxed on offshore transactions.
- The tax rules around foreign real estate and other passive investments can be complex. For a detailed article, please see my U.S. Tax Breaks for Offshore Real Estate.

An offshore LLC can't retain earnings, so it is usually not the best entity for an offshore business. However, if the business will never earn more than the FEIE, then an offshore LLC might do just as well as an offshore corporation.

If you were to operate a business through an offshore LLC, you would report your total net profits on Form 2555, and if those profits exceeded the FEIE amount the excess would be taxable.

To put it another way, if your net profits are $200,000 and you are operating through an offshore LLC while qualifying for the FEIE, then you would get $100,000 in salary tax free and pay U.S. tax on the remaining $100,000. If those same profits were earned in an offshore corporation, you would draw out a salary of $100,000 and leave the balance in the corporation, deferring U.S. tax indefinitely. **Note that I am rounding down the FEIE in this section to $100,000.**

If your business earns $50,000, then the full amount would be covered by the FEIE and no tax would be due. Likewise, if a husband and wife both operated the business which earned $200,000, each could draw out $100,000 tax free, leaving nada for the IRS. So, if your business will always earn less than $100,000 or $200,000, you might as well use an offshore LLC.

I estimate that the cost to have a professional prepare Form 8858 to be $790.00, and that, if you usually prepare your own personal return, then you can prepare 8858 yourself. In other words, if you are experienced in advanced personal return forms like Schedules C, D, or E, or you are used to dealing with complex K-1s, then you will have no problem with Form 8858.

So, when deciding between *an offshore corporation or an offshore LLC*, if the structure will hold passive investments or a small business, then you might save a few dollars and simplify your life with an offshore LLC. If you will operate an active business that might someday earn more than $98,000 in profits, you should form an offshore corporation.

Risks of Offshore Corporations

An Offshore Corporation can provide extraordinary tax planning opportunities to those living and working offshore. For the misinformed, this same structure is fraught with risk and may blow up in your face if planned or reported incorrectly.

I take calls every day from those who want me and my team of U.S. licensed tax experts to form an offshore corporation and to discuss their tax filing obligations. Most of you have done your research and are well versed on the topic. You have searched the web, called around, got a few quotes, and talked to a variety of sources.

I take great pride in the fact that my readers are well informed and I'm glad you, like me, are significantly invested in being offshore. Unfortunately, so much of the information on the internet, or provided by unscrupulous unlicensed promoters, is incorrect and intended to deceive.

For example, I was speaking with a potential client…we will call her Ms. Q…yesterday. By way of background, she is living and working in California, is self-employed, and most of her clients (and revenue) are from Asia. She had been talking with a promoter in Nevis and was convinced she could operate her business through a Nevis corporation and not pay any tax.

Here is the gist of her conversation with the promoter:

Q: If my Nevis offshore company earns money from Asia, will I pay any taxes on that money if I don't bring it in to the U.S.?

A: No, you will not pay any taxes in Nevis. Your offshore company is not required to file a tax return or pay any taxes of any kind.

Q: Do I need to follow certain accounting standards, file accounting reports, or keep records?

A: No, Nevis does not require you to keep business records, provide audited statements, or file any documents. Basically, all you need to do is pay your monthly fee to keep the company in good standing.

Q: Can my offshore corporation retain earnings?

A: Sure, you can retain as much capital in your Nevis Corporation as you like. Nevis imposes no requirements on dividends or corporate capital.

Q: When will I need to pay taxes on the money earned by my offshore corporation?

A: In most cases, clients must pay tax on the money they pay themselves in salary. So, you may need to pay taxes on your earnings when you take them out of the company.

Q: Is my offshore bank account private?

A: Absolutely. We value your privacy in Nevis and have very strict laws preventing disclosure of your offshore corporation or bank account to anyone.

The client came away from this conversation with the belief that her bank account would be secret and that no taxes would be due unless and until she repatriated money from Nevis to the U.S. The promoter stuck to the facts, misdirects but did not lie, and gave only one side of the story…that of Nevis…ignoring the client's obligations in her home country.

In fact, the tax rules for offshore corporations are rather simple:

1. **If you are living and/or working in the United States, an offshore corporation or LLC provides no tax benefit.** Where your clients are located is irrelevant. Your domicile while performing the work controls.

a. The offshore corporation will provide unparalleled asset protection, access to international markets, the ability to diversify out of the United States and its currency, and other benefits, but it is tax neutral for the U.S. resident.

2. If you are **living and operating a business outside of the United Sates**, and qualify for the Foreign Earned Income Exclusion, then doing business through an offshore corporation may reduce or eliminate all U.S. taxes.

(Note: An IRA or other retirement account may achieve significant tax savings by going offshore but this is outside the scope of this article. For more information on this topic, click here.)

In other words, if you are living in the U.S., an offshore corporation should not increase or decrease your U.S. tax bill. It may require you to file a number of forms with the IRS, but it should be tax neutral. If you are living outside of the States, then an offshore corporation may be a great tax tool and you should consult with a U.S. licensed expert.

Ms. Q was asking all the right questions, but to the wrong person. If you ask a Nevis attorney a tax or legal question, you will get an answer according to the law of Nevis. As a U.S. citizen, it is important that you operate from a tax free jurisdiction like Nevis, Belize or Panama, but the majority of your tax planning and structuring concerns involve the U.S. tax code. So, your offshore corporation must be created and maintained by a U.S. licensed tax expert.

Here is another example: I recently received a call from an investment advisor who had read my article on International Taxation. He came away from that page thinking that an offshore corporation can be used to eliminate self-employment taxes for those living in the U.S.

To eliminate self-employment and/or Social Security, Medicare, and FICA taxes through an offshore corporation, you must 1) live and work outside of the United States, 2) operate your business through a non-US corporation, and 3) qualify for the Foreign Earned Income Exclusion.

A U.S. resident may operate his business through an offshore corporation for asset protection or other reasons, but your salary will be fully taxed. Your corporation should issue a W-2 and have proper withholding. If a W-2 is not filed, or a payroll system is not in place, you should report all income from the offshore corporation on your personal return as being subject to self-employment tax.

The moral of the story: If you carry a U.S. passport, your offshore corporation or international asset protection structure must be created and maintained by a U.S. licensed tax expert. Failure to comply with the various tax laws can result in extremely draconian penalties. For example, click here for FBAR rules or click here for the IRS Disclosure Initiative.

If you are considering incorporating offshore, please contact Premier Offshore for a free and confidential consultation. We can be reached at (619) 550-2743 or info@premieroffshore.com. For more information on offshore corporations, please click here.

Offshore Merchant Accounts

You read a lot of stories about how difficult it is for Americans to get an offshore bank account. Well, opening a low cost, efficient, offshore merchant account 10 times more difficult. Many of us are used to the extraordinarily low rates of the U.S., and have no idea what to expect when we venture offshore. I have more than a decade of experience in this arena, and can tell you an offshore merchant account is a whole different animal that you have experienced in the good ole U. S. of A.

If you are setting up an internet business offshore, you will need a corporation, a bank account, and a way to process credit card transactions in to that bank account…this is the offshore merchant account. Before I talk about rates and what to expect, I want to take some time to explain how the industry is different from the U.S., and how credit card processors view you, the potential client.

- Definitions: This article will use quite a few industry terms, such as reserve, discount rate, high risk, etc. If you are new to the game, one of the better glossaries on the web can be found here.

When a credit card processor opens a new account, they view it as extending some level of credit to their new customer. This is because the processor is liable for any refunds demanded by your customers, called chargebacks, if you, the merchant, is unable or unwilling to pay.

Let me explain: If the bank processes $10,000 a month for a merchant, and 5 months in finds out that their customer (you) has been selling a fraudulent product; the processor is on the hook for $50,000. The same is true if a new merchant account is opened and a batch of stolen credit cards is run through…the processor is responsible for 100% of the loss if the merchant has disappeared with the cash.

In the United States, the processor has a relatively easy time assessing risk and protecting against fraud. They can check the credit score of the applicant (again, you) and review your banking history. If both of these indicators are clean, it is unlikely that any illegal activity will go through your account. And, if the processor is duped, American police departments are more than willing to step in and hall you off to jail.

But, what happens when you have a processor in Belize, the merchant's corporation and bank account is in Panama, and the owner of the Panama entity is a citizen and/or resident of Costa Rica? There may be no easy way to validate the creditworthiness of the owner or perform proper due diligence on the account. Also, once the processor sends money to Panama, there is no effective way to get it back and it is unlikely that legal action will be successful…except in the gravest of cases. Basically, the international processor has no recourse in the case of fraud.

Of course, scammers get all the headlines, but fraud and theft are rare. More common is the case where a few customers have a problem with a merchant and chargeback their purchase(s). In the U.S. and Europe, the processor can debit the merchant's account, withhold future processing to cover these expenses, ruin the owner's credit, and sue for damages in extreme cases.

Offshore, the processor is limited to withholding future transactions and closing the account. If the merchant is a high volume low dollar account, they will obviously pay the chargeback. If they are a low volume high dollar account, they may be unwilling to pay…and simply open a new account elsewhere. Most sophisticated merchants will run two or more merchant accounts for this reason.

To protect against this risk, offshore account processors typically require a "rolling reserve" of 10% to 20% from new accounts. A rolling reserve is when the processor holds a percentage of each and every transaction, usually for 60 to 120 days, until the risk of chargebacks has past.

If you are considering moving offshore, you must be prepared for the rolling reserve. If your profit margin is such that the reserve is an issue, you will need sufficient operating capital, credit, or payment terms with your vendors, to support this cash flow "cost" of doing business abroad.

I note that strict rolling reserve rules will apply to new accounts. Once you have processed 6 to 12 months, and your chargeback rate is less than 1%, most processors will reduce or eliminate the reserve.

Certain industries and business models have high chargeback rates and are thus termed "high risk" by credit card processors. Anyone in these trades is certain to pay a higher rate to process credit cards and to have a significant rolling reserve. The following are typically considered high risk:

Adult: Pornographic websites have high chargeback rates, especially on their recurring billing practices. Add to this the fact that most large processors don't want to be associated with porn, and it is easy to see why adult sites get the shaft when it comes to fees.

Gambling: Because deposits in to gambling accounts are typically higher dollar and lower volume than adult, and because of the number of legal issues this industry has faced, internet gambling accounts are considered the highest of risk.

MOTO (Mail Order & Telephone Order) and Telemarketing: If your business accepts phone orders, or you market through outbound phone calls, you must code your transactions as MOTO and will be classified as a high risk account. You will also need a virtual terminal rather than an e-commerce shopping cart.

Pharmacy: If you are an internet pharmacy selling outside of your country of origin, you are considered high risk by the offshore merchant account providers. In most cases, an offshore merchant account will be your only option

Replicas and knock-offs: Most merchant account providers will not process transactions for sellers of replicas. Such products usually violate trademark and other laws.

Travel: A travel agent selling airline tickets or vacation packages over the internet is one of the highest risk accounts out there. The reason is simple: these transactions are for large dollar amounts, often sold months in advance, allegations of fraud are common (we all define a 5-star hotel differently), rights to refund are rare, and buyers love to chargeback…even after the trip has been completed.

Tobacco: If your business is related to cigars, cigarettes, or any type of tobacco, you are a high risk e-commerce client. If you are shipping worldwide, you will need an offshore merchant account.

<u>Your Business Must Be Legal</u>

We at Premier, and all reputable credit card processors, accept only clients operating legal businesses. It is the merchant's responsibility to research, understand, and comply with all applicable laws and regulations related to the sale and use of their products and services.

If you are concerned that your product or services may be prohibited, here are some basic rules that apply:

- Products or Services that violate any law, statue, ordinance or regulation
- Donations or any configuration in which the value of the transaction is greater than the value of the product or service.
- Products or services that are illegal, infringe upon the intellectual property rights of others, or can be used illegally.
- Any product or service enabling consumers to circumvent locks, programming codes or to gain access to any service for which they have not expressly paid.

Higher Number of Rejections

When you process through a non-U.S. merchant account, you need to be prepared for a higher number of failed transactions. This is when the card / sale is declined by the customer's bank (the issuer), for one reason or another.

When you are using a U.S. processor, just about the only time the issuing bank declines a transaction is when the customer has maxed out his credit. When you are using an international processor, a number of your transactions will be declined simply because you are offshore.

Basically, the bank who issued your customer's card is concerned that a large transaction originating from, for example, Belize, is fraudulent, and has stopped it before any money has changed hands. When this happens, you can ask the customer to provide a different card, or ask him to phone his issuer and authorize the transaction. The bank will approve the transaction at the customer's request and you can run the transaction a second time.

When building a website, you should have a system to easily communicate these issues to your customers…typically through a live chat pop-up, or a full service call center. Remember, being offshore means that you must take a proactive approach to each transaction.

A typical offshore merchant will pay 4% to 6% to process transactions and will have a rolling reserve of 20% for 60 days. High risk merchant accounts should expect to pay 5% to 10% and may be subject to a higher reserve.

If you are a brand new offshore merchant account, there will be little room to negotiate these fees and reserves. However, if you can bring in significant transactional volume, and have been operating a clean account for 6 to 12 months, providers will often cut deals to get you to move. If you are low risk and paying more than 5.25%, it is probably time to negotiate.

When selecting an offshore merchant account, there are a number of fees to keep in mind. In addition to the discount rate above, you have a per transaction fee (often $0.50 for offshore), a

fee on each chargeback of $30 to $100, a dispute fee each time a buyer lodges a complaint, and a gateway fee, just to name a few. For high volume low dollar merchants, the offshore transaction fees can be a killer.

Why a U.S. Social Security Number Helps

A U.S. Social Security Number is now a requirement for all merchant accounts in the U.S. The Patriot Act and similar laws of the land have scared processors in to demanding SSNs for all applicants (not ITINs).

While the Patriot Act does not specifically mandate that financial institutions must ask for a customer's SSN in order to set up a merchant account, the regulations, which took effect in 2003 and were implemented in accordance with Section 326 of the Act, require that all financial institutions establish a Customer Identification Program (CIP), to verify the identity of any individual who wishes to conduct financial transactions through their businesses.

These regulations govern banks and trust companies, credit unions, mutual funds, savings associations, futures brokers, and other similar financial institutions, including institutions that offer merchant accounts to companies for the purpose of accepting credit cards. An institution's CIP requires that it gather identifying information about any individual seeking to open an account in order to engage in financial transactions, and that it further (1) verify the identity of the individual creating the account such that the institution has reasonable certainty that it knows who the account holder is, (2) establish and keep records of the information used to verify the identity of the account holder, and (3) compare the identity of the account holder to lists provided by the government of known or suspected terrorists.

The "purpose" of these regulations is to allow the US government to work with financial institutions to prevent identity theft, money laundering, the financing of terrorist organizations and activities, and other types of fraud. A financial institution's CIP is incorporated into its Bank Secrecy Act compliance program, which every US financial institution must have as a means of cooperating with the government to combat money laundering. Financial institutions are required to have procedures in place to ensure that they can verify a customer's identity and establish that the customer does not appear on any government list of terrorists within a "reasonable time," and to dictate under what circumstances the institution should refuse to open an account, close an account previously opened, or file a Suspicious Activity Report, based on its ability to successfully establish the identity of the customer.

Each financial institution develops its own CIP, which is then approved by its board of directors. As such, while the Patriot Act does not specifically require that a customer's SSN must be provided in order to obtain a merchant account, most financial institutions consider a SSN to be a simple and reliable means of verifying identity, and may choose to deny service to a customer

who does not wish to provide it. Using a SSN as a requirement for creating a merchant account has been demonstrated to be an effective means of discouraging criminal use of these accounts, and remains one of the easiest ways for financial institutions to comply with U.S. government regulations regarding the verification of customer identity and fraud prevention.

Onshore / Offshore Merchant Account Solutions

If you are a U.S. citizen living and operating a business abroad, or just looking to move some profits offshore for asset protection purposes, you may benefit from an onshore / offshore business structure. This solution may cut your processing costs in half and eliminate or reduce the rolling reserve.

We can setup a U.S. Limited Liability Company in Delaware, owned by an offshore corporation (typically Belize), and open a U.S. merchant account under the Delaware entity. In order to utilize this structure, you must be a U.S. citizen or resident with a valid Social Security Number, have good credit and provide the following:

1. A U.S. mailing address,
2. A U.S. utility bill reflecting that address and your name, and
3. Be willing to travel to the U.S. to open a bank account (if necessary).

In order for this structure to have any tax benefit, you must be living and working outside of the United States, you may not have an office or employees in the US, you must qualify to retain earnings in your offshore corporation (click here for a detailed article), and the owners of the offshore company must qualify for the Foreign Earned Income Exclusion (click here for a detailed article on international taxation).

For additional information on offshore merchant accounts or to form an offshore corporation, please contact me directly at info@premieroffshore.com or call (619) 550-2743 for a free and confidential consultation.

Offshore Filing Requirements

One of the most misunderstood areas of living, investing or operating a business abroad are the U.S. tax filing and reporting requirements. The purpose of this summary is to review the basic requirements and I recommend that you consult an international tax expert as to how they fit your particular situation.

One of the foundations of the United States tax system is that U.S. citizens and residents are taxed on their worldwide income. When handled properly, an active business, conducted outside of the United States, may have significant tax deferral and savings opportunities.

International Bank and Brokerage Accounts

One of the most critical filing requirements is the Report of Foreign Bank and Financial Accounts (FinCEN Form 114). Anyone who is a signor or beneficial owner of a foreign bank or brokerage account(s) with more than $10,000 must disclose these accounts to the U.S. Treasury.

The law imposes a civil penalty for not disclosing an offshore bank account or offshore credit card up to $25,000 or the greatest of 50% of the balance in the account at the time of the violation or $100,000. Criminal penalties for willful failure to file an FBAR can also apply in certain situations. Note that these penalties can be imposed for each year.

In addition to filing the Foreign Bank Account form, the offshore account must be disclosed on your personal income tax return, Form 1040, Schedule B.

Corporate and Trust Filing Requirements

There are a number of filing requirements for IBCs and International Trusts. Failure to file the required returns may result in civil and criminal penalties and may extend the statute of limitations for assessment and collection of the related taxes.

- ✓ Form 5471 - Information Return of U.S. Persons with Respect to Certain Foreign Corporations must be filed by U.S. persons (which includes individuals, partnerships, corporations, estates and trusts) who owns a certain proportion of the stock of a foreign corporation or are officers, directors or shareholders in Controlled Foreign Corporation (CFC). If you prefer not to be treated as a foreign corporation for U.S. tax reporting, you may be eligible to use Forms 8832 and 8858 below. http://www.irs.gov/pub/irs-pdf/f5471.pdf

- ✓ A foreign corporation or limited liability company should review the default classifications in Form 8832, Entity Classification Election and decide whether or not to make an election to be treated as a corporation, partnership, or disregarded entity. Making an election is optional and must be done on or before March 15 (i.e. 75 days after the end of the first taxable year). http://www.irs.gov/pub/irs-pdf/f8832.pdf

- ✓ Form 8858 – Information Return of U.S. Persons with Respect to Foreign Disregarded Entities was introduced in 2004 and is to be filed with your personal income tax return if making the election on Form 8832. A $10,000 penalty is imposed for each year this form is not filed. http://www.irs.gov/pub/irs-pdf/f8858.pdf

- ✓ Form 3520 - Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts is required when a U.S. person:

  1. Creates or transfers money or property to a foreign trust,
  2. Receives (directly or indirectly) any distributions from a foreign trust, or
  3. Receives certain gifts or bequests from foreign entities. http://www.irs.gov/pub/irs-pdf/f3520.pdf

- ✓ Form 3520-A – Annual Information Return of Foreign Trust is required of any foreign trust with a U.S. Owner (Grantor). Failure to file this form can result in a penalty of 5% of the gross value of the U.S. person's portion of the trust. http://www.irs.gov/pub/irs-pdf/f3520a.pdf

- ✓ Form 5472 - Information Return of a 25% Foreign-Owned U.S. Corporation is required to be filed by a "reporting corporation" that has "reportable transactions" with foreign or domestic related parties. A reporting corporation is either a U.S. corporation that is a 25% foreign-owned or a foreign corporation engaged in a trade or business within the United States. A corporation is 25% foreign-owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year. http://www.irs.gov/pub/irs-pdf/f5472.pdf

- ✓ Form 926 - Return by a U.S. Transferor of Property to a Foreign Corporation is required to be filed by each U.S. person who transfers property to a foreign corporation if, immediately after the transfer, the U.S. person holds directly or indirectly 10% of the voting power or value of the foreign corporation. Generally, this form is required for transfers of property in exchange for stock in the foreign corporation, but there is an assortment of tax code sections that may require the filing of this form. The penalty for failing to file is 10% of the fair market value of the property at the time to transfer. http://www.irs.gov/pub/irs-pdf/f926.pdf

- ✓ Form 8938 – Statement of Foreign Financial Assets was created for tax year 2011 and must be filed by anyone with significant assets outside of the United States. Who must file is complex, but, if you live in the U.S. and have an interest in assets worth more than $50,000, or you live abroad and have assets in excess of $400,000, you probably need to file. If you are a U.S. citizen or resident with assets abroad, you must consult the instructions to Form 8938 for more information. Determining who must file is a complex matter. See http://www.irs.gov/uac/Form-8938,-Statement-of-Foreign-Financial-Assets for additional information.

How Careful Structuring of Your Affairs Can Help Minimize Taxes

Before you move overseas, there are certain steps you can take to protect your assets and—in some cases—minimize your worldwide tax obligations. Best first step is to consult a tax accountant or attorney—one who specializes in helping Americans organize their affairs before moving overseas.

He or she will likely have some smart advice about the best way to structure your financial affairs so that you don't end up paying unnecessary taxes.

Multiple Bank Accounts

When relocating overseas, it is usually a good idea to maintain a checking account in the U.S. if for no other reason than convenience. Unless you are severing all ties with the U.S. you will have some need to write U.S. dollar checks or make online electronic bank transfers while overseas. The funds would also be available to you either through wire transfers to a foreign bank account or an ATM card.

In limited circumstances, foreign countries do not tax certain kinds of income unless the funds are actually transferred to that country. Maintaining one or more accounts elsewhere would in this case be a tax savings device as well as being a convenience. Here again, the need for information on local tax rules is very important.

Transfer Title of Accounts to One Spouse

There may be situations in which spouses should transfer title to certain assets before relocating overseas. This can be easily accomplished with financial assets such as savings accounts and investment accounts. Such transfers would be beneficial where one spouse will have a special exemption from foreign taxes on the earnings of the accounts.

Transferring title to jointly owned U.S. real estate, rented while you are overseas, may also provide a tax savings. Keep in mind that the transfers are reversible once you move back to the U.S.

However, such transfers may have a downside, particularly if the marital status is less than solid. The spouse with full title may not be willing to transfer half interest back to the other spouse. Don't take the decision to transfer assets lightly.

Form a Discretionary Trust

Although principally considered an estate-planning device, a trust can also serve as a tax savings device. One such trust is a discretionary trust that requires payments to beneficiaries under stated

conditions in the trust instrument, such as financial need or education. The important thing to keep in mind, to avoid payment of foreign taxes on payouts, is that the conditions should prevent payments to beneficiaries while they are overseas. Under the right circumstances, trusts can save on foreign taxes.

However, you should only set one up with the help of a tax professional.

Estate Planning

If you decide to abandon your U.S. residency and domicile, there is an important catch. While you may avoid any liability for the income taxes of a U.S. state, abandoning your domicile in a U.S. state may cause some real estate and probate issues.

In other words, if you or a family member passes away while living overseas, real or personal property that you would have expected to be either distributed under a previous will (or in the absence of a will, be distributed under a U.S. state's intestacy laws) may be subject to distribution under the laws of the foreign country in which you are currently living. And these foreign rules may cause property to be distributed in a completely unintended way in a costly probate process. France, for example, has a complex set of inheritance laws that date back to Napoleonic times and guarantee children (and sometimes parents) a share of the estate. In such a situation, a spouse has no automatic right of inheritance.

While we won't explore estate-planning strategies in this guide, you should be aware that estate succession is an important consideration in your planning process.

There are many simple and convenient tools to assure the orderly and least costly succession of your property while living overseas such as use of a trust, naming a beneficiary on a financial account where permitted, or a transfer of assets. You should consult a competent tax expert who can guide you through all aspects of avoiding state, federal, and possibly even foreign income taxes and assist you with some effective estate-planning strategies. You owe it to yourself and your loved ones.

2014 IRS Offshore Voluntary Disclosure Program

Great News for Some ExPats and Dual-Nationals

First, I would like to note that the 2014 IRS Offshore Voluntary Disclosure Program (OVDP) is the current offer as October, 2016. The program went through major changes on June 18, 2014 and has updated a few times since. We still refer to the current iteration as the 2014 OVDP.

As an Expat American, you know that you are required to file a U.S. tax return each year and report your foreign bank accounts if you have more than $10,000 offshore. Unless you have been living under a rock in Bangladesh, you also know that the IRS has been pushing hard to force disclosure, compliance and payment.

The drive for increased revenues started in 2003 when the IRS began investigating offshore credit cards. At that time, it was about compliance. The government had not yet figured out that putting people in jail for tax crimes would generate a lot of news, and thus cause many more thousands to come forward.

In 2008 the U.S. government began its attack on UBS in Switzerland, eventually forcing the Swiss to disclose 4,450 names of U.S. citizens with unreported accounts. The U.S. followed this up by prosecuting a few people in each State or region of the country to ensure maximum news coverage and created the voluntary disclosure program to maximize the return on their campaign.

So far, there have been three programs allowing people to come forward and voluntarily report their offshore bank accounts. As of 2014, the IRS had brought in over $7 billion in new taxes, interest and penalties.

On June 18, 2014, the Internal Revenue Service (IRS) announced major changes in its offshore voluntary compliance programs. The changes include an expansion of the streamlined filing compliance procedures and key modifications to the 2012 Offshore Voluntary Disclosure Program (OVDP). The expanded streamlined procedures are available to a wider population of U.S. taxpayers living outside the country and, for the first time, to certain U.S. taxpayers residing in the United States. The modifications to the existing OVDP program in part provide for increasing the offshore penalty percentage from 27.5 percent to 50 percent in certain circumstances.

The following pages is a very detailed analysis of the various options available. For a more general discussion, see my post: The IRS Offshore Settlement Program in 2016 specifically written for US citizens living abroad who file and pay taxes in their country of residence rather than US residents with offshore assets. Then review the streamlined version below… which is also for US expats and not residents.

OPTIONS AVAILABLE FOR U.S. TAXPAYERS WITH UNDISCLOSED FOREIGN FINANCIAL ASSETS

The IRS now offers taxpayers with undisclosed foreign financial assets the following options:

1. Offshore Voluntary Disclosure Program,
2. Streamlined Filing Compliance Procedures,
3. Delinquent FBAR submission procedures and
4. Delinquent international information return submission procedures.

Each of these options and the transitional rules applicable to taxpayers already in the OVDP are discussed below.

OFFSHORE VOLUNTARY DISCLOSURE PROGRAM (OVDP)

The OVDP is specifically designed for taxpayers with *exposure to potential criminal liability and/or substantial civil penalties due to a willful failure to report foreign financial assets and pay all tax due in respect of those assets*. The OVDP provides protection from criminal liability and fixed terms for resolving their civil tax and penalty obligations.

The terms of the OVDP may change at any time. For example, the IRS may increase penalties or limit eligibility for all or some taxpayers or defined classes of taxpayers – or decide to end the program entirely at any point. The terms of the program will also be offered to taxpayers who made offshore voluntary disclosures after the deadline for the 2011 Offshore Voluntary Disclosure Initiative (OVDI). The OVDP is effective for all applications made on or after July 1, 2014. A taxpayer who made an OVDP submission prior to July 1, 2014, may elect to have his case considered under the OVDP.

OVDP Requirements

Participating taxpayers are to:

- Provide the following:
    - Payment in the total amount of tax, interest, offshore penalty, accuracy-related penalty and, if applicable, the failure-to-file and failure-to-pay penalties. If the taxpayer cannot pay the total amount due, a proposed payment arrangement and certain financial information must be provided.
    - Copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure ("the Disclosure Period");

  - Amended federal income tax returns or original Form 1040 (if delinquent) for the Disclosure Period.
  - Offshore Voluntary Disclosure Letter.
  - Foreign Account or Asset Statement.
  - Taxpayer Account Summary with Penalty Calculation.
  - Agreements to extend the period of time to assess tax and to assess Report of Foreign Bank and Financial Accounts (FBAR) penalties.
  - Copies of filed FBARs reported on FinCEN Form 114.
  - Copies of statements for all financial accounts reflecting all account activity for each of the tax years included in the Disclosure Period. For OVDP assets other than foreign financial accounts, provide all relevant documents pertaining to the asset. For example, if a taxpayer has foreign-issued life insurance with cash value, provide all documents governing the policy and, if any, all legal and tax opinions issued to the taxpayer relating to the policy.
  - If foreign entities (trusts, corporations, partnerships, etc.) are involved: A statement identifying all foreign entities and a statement concerning ownership or control of such entities. If the foreign entities held OVDP assets, provide complete and accurate information returns. If the taxpayer requests that the IRS waive information reporting requirements, the taxpayer must submit a "Statement on Abandoned Entities" form.
  - If the taxpayer is a decedent's estate, provide complete and accurate amended estate or gift tax returns.
  - If passive foreign investment companies (PFICs) are involved, provide a statement whether the amended or delinquent returns involve PFIC issues, and if so, whether the taxpayer chooses to elect the alternative to the statutory PFIC computation that resolves PFIC issues on a basis that is consistent with the mark to market (MTM) methodology authorized in Internal Revenue Code (IRC) § 1296 but does not require complete reconstruction of historical data.
- Cooperate in the voluntary disclosure process, including providing information on foreign accounts and assets, institutions and facilitators.
- Pay the 20-percent accuracy-related penalties on the full amount of the tax on unreported offshore-income for all years.
- Pay failure-to-file and failure-to-pay penalties, if applicable.
- Pay a miscellaneous offshore penalty equal to 27.5 percent (or 50 percent in certain circumstances) of the highest aggregate value of OVDP assets.

- Execute a Closing Agreement on Final Determination Covering Specific Matters, Form 906.
- Agree to cooperate with IRS and Department of Justice offshore enforcement efforts, if requested, by providing information about financial institutions and other facilitators who helped the taxpayer establish or maintain an offshore arrangement.

Foreign and Domestic Disclosure. In addition to disclosing all items relating to foreign financial accounts, OVDP submissions must correct any previously unreported income from domestic sources; inappropriate deductions or credits claimed; or other incomplete, inaccurate or untruthful items on the originally filed returns. The OVDP resolves only liabilities and penalties related to offshore noncompliance. Domestic portions of a voluntary disclosure are subject to examination.

Comment: *This is a key point since many taxpayers taking advantage of the OVDP focus solely on the foreign assets and not on "domestic" issues, resulting in the filing of an erroneous amended tax return that could potentially complicate the matter further.*

The 50-Percent Penalty. *Beginning on August 4, 2014*, any taxpayer who has an undisclosed foreign financial account will be subject to a 50-percent miscellaneous offshore penalty if, at the time of submitting the preclearance letter to IRS Criminal Investigation, an event has already occurred that constitutes a public disclosure that either:

(a) the foreign financial institution where the account is held, or another facilitator involved in the taxpayer's offshore arrangement, is or has been under investigation by the IRS or the Department of Justice (DOJ) in connection with accounts that are beneficially owned by a U.S. person;

(b) the foreign financial institution or other facilitator is cooperating with the IRS or the Department of Justice in connection with accounts that are beneficially owned by a U.S. person; or

(c) the foreign financial institution or other facilitator has been identified in a court-approved issuance of a summons seeking information about U.S. taxpayers who may hold financial accounts (a "John Doe summons") at the foreign financial institution or have accounts established or maintained by the facilitator.

Examples of a public disclosure include: a public filing in a judicial proceeding by any party or judicial officer, or public disclosure by the DOJ regarding a Deferred Prosecution Agreement or Non-Prosecution Agreement with a financial institution or other facilitator.

The foreign banks and facilitators meeting this criteria as of June 18, 2014, are as follows:

Bank and Promoter List

1. UBS AG
2. Credit Suisse AG, Credit Suisse Fides and Clariden Leu Ltd.
3. Wegelin & Co.
4. Liechtensteinische Landesbank AG
5. Zurcher Kantonalbank
6. swisspartners Investment Network AG, swisspartners Wealth Management AG, swisspartners Insurance Company SPC Ltd. and swisspartners Versicherung AG
7. CIBC FirstCaribbean International Bank Limited, its predecessors, subsidiaries, and affiliates
8. Stanford International Bank, Ltd., Stanford Group Company and Stanford Trust Company, Ltd.
9. The Hong Kong and Shanghai Banking Corporation Limited in India (HSBC India)
10. The Bank of N.T. Butterfield & Son Limited (also known as Butterfield Bank and Bank of Butterfield), its predecessors, subsidiaries and affiliates

Comment: *The IRS has not identified the persons who are cooperating with the government or who are the subject of court-approved summons. It is highly unlikely that the government will announce the names of cooperating persons, and unless the taxpayer carefully watches the press, a taxpayer will be unaware if the bank or advisor involved is the target of a summons. Consequently, it may be very challenging for taxpayers to know in advance whether their foreign assets will be subject to the 50-percent penalty.*

Once the 50-percent miscellaneous offshore penalty applies to *any* of the taxpayer's accounts or assets, the 50-percent miscellaneous offshore penalty will apply to *all* of the taxpayer's assets subject to the penalty, including accounts held at another institution or established through another facilitator for which there have been no events constituting public disclosures of (a) or (b) above.

Time Frame. The Disclosure Period is the most recent eight tax years for which the due date has already passed. For taxpayers who submit a voluntary disclosure *before* the due date (or properly extended due date) for the 2013 tax year, the disclosure must include each of the tax years 2005 through 2012. For taxpayers who submit a voluntary disclosure *after* the due date (or properly extended due date) for 2013, the disclosure must include each of the tax years 2006 through 2013 in which they have undisclosed OVDP assets.

Eligibility. Taxpayers who have legal source funds invested in undisclosed OVDP assets and meet the requirements of Internal Revenue Manual (IRM) 9.5.11.9 are eligible to apply for IRS Criminal Investigation's Voluntary Disclosure Practice and the OVDP penalty regime. The OVDP is available only to address the taxpayer's own liability. Individuals who facilitated the tax noncompliance of others are not eligible to participate in OVDP. The aforementioned IRM provides in part that:

1. It is currently the practice of the IRS that a voluntary disclosure will be considered, along with all other factors in the investigation, in determining whether criminal prosecution will be recommended. …
2. A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. *This practice does not apply to taxpayers with illegal source income.*
3. A voluntary disclosure occurs when the communication is truthful, timely and complete, and when:
   A. A taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability.

   B. The taxpayer makes good faith arrangements with the IRS to pay, in full, the tax, interest and any penalties determined by the IRS to be applicable.
4. A disclosure is timely if it is received before:
   A. The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.

   B. The IRS has received information from a third party (*e.g.*, informant, other governmental agency or the media) alerting the IRS to the specific taxpayer's noncompliance.

   C. The IRS has initiated a civil examination or criminal investigation that is directly related to the specific liability of the taxpayer.

   D. The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (*e.g.*, search warrant, grand jury subpoena).

Comment: *The IRM and the OVDP are slightly inconsistent in the sense that the IRM states that a voluntary disclosure will be taken into account in determining whether criminal prosecution will be recommended, while the OVDP provides that if the voluntary disclosure is truthful, timely and complete, there will be no recommendation for criminal prosecution to the DOJ.*

If the IRS has initiated a civil examination for any year, regardless of whether it relates to undisclosed OVDP assets, the taxpayer will not be eligible to participate in the OVDP. A

taxpayer under criminal investigation by IRS-CI is also ineligible. In these circumstances, the IRS recommends that the taxpayer or the taxpayer's representative should discuss undisclosed financial accounts and assets with the agent.

Comment: *Notwithstanding the IRS recommendation to discuss the undisclosed account with the agent in the course of a civil examination, that decision should be made only after consultation with an attorney experienced in criminal tax matters.*

"Quiet Disclosures." Some taxpayers have made "quiet disclosures" by simply filing amended returns, by filing delinquent FBARs and by paying the tax liability in hopes that these filings will end the taxpayer's compliance issues. The IRS encourages such taxpayers to participate in the OVDP and to avail themselves of the protection from criminal prosecution and the favorable penalty structure.

Timely Disclosure in the Face of Summonses and Treaty Requests. The mere fact that the IRS served a John Doe summons, made a treaty request or has taken similar action does not make every member of the John Doe class or group so identified ineligible to participate in the voluntary disclosure. But such activity may subject a taxpayer to a higher offshore penalty at the rate of 50 percent.

However, once the IRS or DOJ obtains information that provides evidence of a specific taxpayer's noncompliance, that particular taxpayer will become ineligible for OVDP. Taxpayers concerned that a party subject to a John Doe summons, treaty request or similar action will provide information about him to the IRS may want to apply to make a voluntary disclosure as soon as possible.

In addition to the above, there are two other ways in which an otherwise eligible taxpayer will become ineligible. First, if a taxpayer appeals a foreign tax administrator's decision authorizing the providing of account information to the IRS and fails to serve the required notice on the Attorney General of the United States, the taxpayer will be ineligible to participate in OVDP. Second, the IRS may determine that certain taxpayer groups that have or had accounts held at a specific financial institution will be ineligible due to U.S. government actions in connection with the specific financial institution.

Applying for Pre-Clearance. Taxpayers must send a fax to the IRS – Criminal Investigation Lead Development Center (LDC) in Philadelphia, Pennsylvania, with:

(a) Applicant-identifying information, including complete names, dates of birth, tax identification numbers, addresses and telephone numbers, as well as if the application is by a representative, a power of attorney.

Comment: *In the prior OVDPs, the foregoing was all the information that was required to request pre-clearance. The OVDP now requires the up-front submission of the following additional information.*

(b) Identifying information of all financial institutions at which undisclosed OVDP assets were held. Identifying information for financial institutions includes complete names, addresses and telephone numbers.

(c) Identifying information of all foreign and domestic entities through which the undisclosed OVDP assets were held by the taxpayer; this does not include any entities traded on a public stock exchange. Information must be provided for both current and dissolved entities. Identifying information for entities includes complete names, employer identification numbers, addresses and the jurisdiction in which the entities were organized.

Comment: *The information provided to IRS Criminal Investigation is a road map for the IRS to the taxpayer's noncompliance. All this information is required before the taxpayer receives any assurance from the IRS that his disclosure is timely. In instances where the taxpayer is notified that his application to the OVDP is "untimely," there is nothing to stop the IRS from using the provided information in a civil examination or a criminal investigation. Accordingly, the decision to apply for pre-clearance must be made with the assistance of experienced criminal tax counsel.*

After receipt of the request for pre-clearance and within 30 days, IRS Criminal Investigation will notify taxpayers whether or not they are eligible to make an offshore voluntary disclosure. (Experience shows that the time frame to process the pre-clearance application is between four and six weeks, not 30 days.)

Post Pre-Clearance Requirements. Pre-clearance does not guarantee a taxpayer acceptance into the OVDP. Taxpayers pre-cleared for OVDP must provide an Offshore Voluntary Disclosure Letter and attachment to the IRS within 45 days from receipt of pre-clearance notification.

The Disclosure Letter requires the taxpayer to provide considerable information regarding the taxpayer and the foreign financial account. The "attachment" is filed for each account and asks questions in great detail regarding the account, persons associated with the account and the taxpayer's advisers.

Comment: *All of this detail is provided before the taxpayer has any assurance that he or she will be accepted into the OVDP. Criminal prosecution is still a risk, although realistically a slight one for taxpayers who are truthful and complete in their disclosure.*

Criminal Investigation reviews the Offshore Voluntary Disclosure Letter and notifies the taxpayers within 45 days whether their offshore voluntary disclosures have been *preliminarily accepted* as timely or declined. (Again, experience shows that the time frame for preliminary acceptance is closer to five to seven weeks.)

Post Preliminary Acceptance Procedure. Once a taxpayer's disclosure has been preliminarily accepted by CI as timely, the taxpayer must complete the submission and cooperate with the civil examiner in the resolution of the civil liability before the disclosure is considered complete.

The preliminary acceptance letter from CI will instruct the taxpayer to submit the full voluntary disclosure submission to the IRS within 90 days of the date of the timeliness determination.

Comment: *Extensions of this time line are routinely granted.*

The voluntary disclosure submission is sent in two separate parts.

Part 1. Payment to the Department of Treasury in the total amount of tax, interest, offshore penalty, accuracy-related penalty and, if applicable, the failure-to-file and failure-to-pay penalties. If the taxpayer cannot pay the total amount due, a proposed payment arrangement and financial information must be submitted.

Part 2. Provide all the information (tax returns, FBARs, account records, etc.) set forth in **OVDP Requirements** above.

The taxpayer may be contacted by an examiner for specific additional information. The examiner will certify that the voluntary disclosure is correct, accurate and complete. The examiner will also verify the tax, interest and civil penalties owed.

A taxpayer who holds OVDP assets through a foreign entity is required to file information returns for that entity regardless of whether the taxpayer honored the form of the entity in his dealings with the OVDP assets. However, in cases where the taxpayer certifies that the entity had no purpose other than to conceal the taxpayer's ownership of assets and the taxpayer liquidates and abandons the entity, the IRS may agree to waive the requirement that delinquent information returns be filed. Taxpayers requesting this relief must file a Statement on Abandoned Entities.

Calculating the Penalty. Convert foreign currency by using the foreign currency exchange rate *at the end of the year* regardless of when during the year the highest value was reached. Each OVDP asset is to be valued separately.

No amount of unreported gross income is considered de minimis for purposes of determining whether there has been tax noncompliance with respect to an OVDP asset. Even one dollar of unreported gross income from an OVDP asset will bring it into the offshore penalty base.

Gain realized on a foreign transaction occurring before the voluntary disclosure period (generally 2005 or 2006) does not need to be included as part of the voluntary disclosure. If the proceeds of the transaction were repatriated and were not offshore during the voluntary disclosure period, they will not be included in the base for the offshore penalty. However, if the proceeds remained offshore during any part of the voluntary disclosure period, they will be included in the base for the offshore penalty.

OVDP Assets. The offshore penalty applies to all offshore holdings that are related in any way to tax noncompliance, regardless of the form of the taxpayer's ownership or the character of the asset ("OVDP Assets"). OVDP Assets include all assets directly or indirectly owned by the taxpayer, including financial accounts holding cash, securities or other custodial assets; tangible assets, such as real estate or art; and intangible assets, such as patents or stock or other interests in a U.S. or foreign business.

"Tax noncompliance" *includes failure to report gross income from the assets (e.g., "even one dollar" of unreported rental income pulls the rental property into the penalty calculation), as well as failure to pay U.S. tax that was due with respect to the funds used to acquire the asset (e.g., art work acquired with untaxed U.S. income).*

Unlike the published materials in the prior OVDPs, the OVDP clarifies that if a taxpayer holds OVDP assets through an entity or a series of entities, the taxpayer may not apply valuation discounts, such as a discount reflecting lack of marketability; a discount for holding a minority interest; or a discount for holding a tenants in common interest.

Mere Signature Authority and Family Financial Accounts. Where a disclosing taxpayer has mere signature authority over an undisclosed account, that failure to disclose the account will be treated as *unrelated* to the tax noncompliance the taxpayer is voluntarily disclosing. The taxpayer may cure the FBAR delinquency for this account at any time prior to being contacted by the IRS regarding an income tax examination or delinquent returns by filing the FBAR with an explanatory statement. *See* **Delinquent FBAR Submission Procedures**, below.

The treatment might be different if: (1) the account over which the taxpayer has signature authority is held in the name of a related person, such as a family member or an entity controlled by the taxpayer; (2) the account is held in the name of a foreign entity for which the taxpayer had a reporting obligation; or (3) the account was related in some other way to the taxpayer's tax noncompliance (*e.g.*, was used by the taxpayer as a conduit). In these cases, the taxpayer may have an OVDP asset to which the offshore penalty applies.

Signatories with no ownership interest in the account, such as the children with signature authority on parents' accounts, should file delinquent FBARs with explanatory statements. *See* **Delinquent FBAR Submission Procedures**, below.

As for the parents in this scenario, only one offshore penalty will be applied with respect to voluntary disclosures relating to the same foreign financial account.

In the case of co-owners, each taxpayer who makes a voluntary disclosure will be liable for the penalty on his percentage ownership of the highest value of the OVDP asset. The IRS may examine any co-owner who does not make a voluntary disclosure. Co-owners examined by the IRS will be subject to all applicable penalties.

Statute of Limitations. As a condition to participate in the OVDP, the taxpayer must agree to the assessment of tax and penalties for all voluntary disclosure years. If the taxpayer does not agree, the case will be referred for a complete examination of all issues. In that examination, normal statute of limitations rules will apply. If no exception to the normal three-year statute of limitations applies, the IRS will be able to assess only additional liabilities for three years. The IRS may assess additional liabilities for six years if the taxpayer failed to report more than 25 percent of gross incomes. Similarly, if there was a failure to file certain information returns, the statute of limitations will not have begun to run. If the IRS can prove fraud, there is no statute of limitations for assessing tax. In addition, the statute of limitations for assessing FBAR penalties is six years from the date of the violation, which would be the date that an unfiled FBAR was due to have been filed.

Case Resolution, No Discretion and Opting Out. The penalty framework for offshore voluntary disclosure and the agreement to limit tax exposure to an eight-year period are *nonnegotiable* terms. If any part of the closing agreement is unacceptable to the taxpayer, the taxpayer may *opt out* and the case will be examined and all applicable penalties will be imposed.

Offshore voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. Under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes for the years included in the Disclosure Period.

Examiners will compare the amount due under the OVDP to the tax, interest and applicable penalties (*at their maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors or other circumstances that may reduce liability*) that a taxpayer would owe outside of the OVDP. The taxpayer will pay the lesser amount. If the taxpayer disagrees with the result, the taxpayer may opt out of the OVDP.

An "opt out" is an irrevocable election made by a taxpayer to have his case handled under the standard audit process. Some taxpayers may prefer this approach; in some cases, the results under the OVDP may appear too severe given the facts of the case.

STREAMLINED FILING COMPLIANCE PROCEDURES

Purpose: The Streamlined Filing Compliance Procedures are available to taxpayers certifying that their failure to report foreign financial assets did not result from willful conduct.

General Eligibility: The modified Streamlined Filing Compliance Procedures are designed for only individual taxpayers, including estates of individual taxpayers. The streamlined procedures are available to both U.S. individual taxpayers residing outside of the United States and U.S. individual taxpayers residing in the United States.

Taxpayers using either the Streamlined *Foreign* Offshore Procedures or the Streamlined *Domestic* Offshore Procedures will be required to certify that the failure to report all income, pay all tax and submit all required information returns, including FBARs, was due to non-willful conduct.

If the IRS has initiated a criminal investigation or a civil examination of a taxpayer's returns, the taxpayer will not be eligible to use these procedures.

Taxpayers who have made "quiet disclosures" may still use the Streamlined Filing Compliance Procedures. However, any penalty assessments previously made with respect to those filings will not be abated.

General Procedure: Tax returns submitted under either streamlined program will be processed like any other return. Receipt of the returns will not be acknowledged. The streamlined filing process does not include a closing agreement.

Returns submitted will not be subject to IRS audit automatically, but may be subject to IRS examination and *even criminal investigation*, if appropriate. Taxpayers who are concerned that their failure to report income, pay tax and submit required information returns was due to willful conduct and who therefore seek assurances that they will not be subject to criminal liability and/or substantial monetary penalties should consider participating in the OVDP.

Comment: *Whether a taxpayer's conduct was or was not "willful" and the existence of "reasonable" cause for the taxpayer's noncompliance are questions of law which should be analyzed by an experienced criminal defense tax attorney.*

Coordination with OVDP: Once a taxpayer makes a submission under the streamlined programs, the taxpayer may not participate in the OVDP. Similarly, a taxpayer who submits an OVDP voluntary disclosure letter on or *after July 1, 2014*, is not eligible to participate in the streamlined procedures.

A taxpayer eligible for treatment under the streamlined procedures who submits, or has submitted, a voluntary disclosure letter under the OVDP (or any predecessor offshore voluntary disclosure program) prior to July 1, 2014, *but who does not yet have a fully executed OVDP closing agreement*, may request treatment under the applicable penalty terms available under the streamlined procedures. A taxpayer seeking such treatment does not need to opt out of OVDP, but will be required to certify that the failure to report all income, pay all tax and submit all required information returns, including FBARs, was due to non-willful conduct. As part of the OVDP process, the IRS will consider this request in light of all the facts and circumstances of the taxpayer's case and will determine whether or not to incorporate the streamlined penalty terms in the OVDP closing agreement.

Streamlined Procedures for U.S. Taxpayers *Residing Outside* the United States

Eligibility. In addition to having to meet the general eligibility criteria described above, individual U.S. taxpayers, or estates of individual U.S. taxpayers, seeking to use the Streamlined Foreign Offshore Procedures must: (1) meet the applicable non-residency requirement described below (for joint return filers, both spouses must meet the applicable non-residency requirement described below); and (2) have failed to report the income from a foreign financial asset and pay tax as required by U.S. law, and may have failed to file an FBAR with respect to a foreign financial account, and such failures resulted from non-willful conduct.

Non-Residency Requirement - Citizen or Green Card Holder. Individual U.S. citizens or lawful permanent residents, or estates of U.S. citizens or lawful permanent residents, meet the applicable non-residency requirement if in any one or more of the most recent three years for which the U.S. tax return due date (or properly applied for extended due date) has passed, the individual did not have a U.S. abode and the individual was physically outside the United States for at least 330 full days. "Abode" has been variously defined as one's home, habitation, residence, domicile or place of dwelling. It does not mean a person's principal place of business. "Abode" has a domestic rather than a vocational meaning and does not mean the same as "tax home." The location of a person's abode often will depend on where the person maintains his economic, family and personal ties.

Non-Residency Requirement - Other Persons. Individuals who are not U.S. citizens or lawful permanent residents, or estates of individuals who were not U.S. citizens or lawful permanent residents, meet the applicable non-residency requirement if in any one or more of the last three years for which the U.S. tax return due date (or properly applied for extended due date) has passed, the individual did not meet the "substantial presence test." To meet this test, the person must be physically present in the United States on at least:

1. 31 days during 2013 and
2. 183 days during the three-year period that includes 2013, 2012 and 2011, counting:
3. all the days the person was present in 2013 and
4. ½ of the days the person was present in 2012 and
5. ⅓ of the days the person was present in 2011.

Scope and Effect of Foreign Streamlined Procedures

U.S. taxpayers (U.S. citizens, lawful permanent residents and those meeting the substantial presence test) who are eligible to use the Streamlined Foreign Offshore Procedures must:

— for each of the most recent three years for which the U.S. tax return due date (or properly applied for extended due date) has passed, *file delinquent or amended tax returns*, together with all required information returns;

— for each of the most recent six years for which the FBAR due date has passed, file any delinquent FBARs;

— pay the full amount of the tax and interest due at the time the returns are filed; and

— Complete and sign a *Certification by U.S. Person Residing Outside of the U.S.* certifying: (1) that the taxpayer is eligible for the Streamlined Foreign Offshore Procedures; (2) that all required FBARs have now been filed; and (3) that the failure to file tax returns, report all income, pay all tax and submit all required information returns, including FBARs, resulted from non-willful conduct.

An eligible taxpayer who complies with all of the applicable procedures *will not be subject to failure-to-file and failure-to-pay penalties, accuracy-related penalties, information return penalties or FBAR penalties*. Even if returns properly filed under these procedures are subsequently selected for audit under existing audit selection processes, the taxpayer will not be subject to the foregoing penalties, unless the examination results in a determination that the original tax noncompliance was fraudulent and/or that the FBAR violation was willful. Any previously assessed penalties with respect to those years, however, will not be abated.

Comment: *There is no miscellaneous offshore (FBAR) penalty in the Nonresident Streamlined Program.*

For returns filed under these procedures, retroactive relief will be provided for failure to timely elect income deferral on certain retirement and savings plans where deferral is permitted by the applicable treaty.

Transition Rules. The risk assessment process associated with the 2012 Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer U.S. Taxpayers has been eliminated for all streamlined filers. A taxpayer who has initiated participation in the 2012 Streamlined Filing Compliance Procedures prior to July 1, 2014, and who has not already been notified of a high- or low-risk determination, will not receive correspondence related to their risk determination. The returns will be processed without regard to that risk assessment.

Streamlined Procedures for U.S. Taxpayers *Residing In* the United States
Eligibility.

In addition to having to meet the general eligibility criteria described above, individual U.S. taxpayers, or estates of individual U.S. taxpayers, seeking to use the Streamlined *Domestic* Offshore Procedures must:

— fail to meet the applicable non-residency requirement described above (for joint return filers, one or both of the spouses must fail to meet the applicable non-residency requirement);

— *have previously filed a U.S. tax return* (if required) for each of the most recent three years for which the U.S. tax return due date (or properly applied for extended due date) has passed;

— have failed to report gross income from a foreign financial asset and pay tax as required by U.S. law, and may have failed to file an FBAR and/or one or more international information returns with respect to the foreign financial asset; and

— such failures resulted from non-willful conduct.

Comment: *It appears that the Domestic Streamlined Program is not available to non-filers.*

Scope and Effect of Domestic Streamlined Procedures.

U.S. taxpayers (U.S. citizens, lawful permanent residents and those meeting the "substantial presence" test) eligible to use the Streamlined Domestic Offshore Procedures must:

— for each of the most recent three years for which the U.S. tax return due date (or properly applied for extended due date) has passed (the "covered tax return period"), *file amended tax returns*, together with all required information returns;

— for each of the most recent six years for which the FBAR due date has passed (the "covered FBAR period"), file any delinquent FBARs;

— pay a miscellaneous offshore penalty;

— pay the full amount of the tax, interest and miscellaneous offshore penalty due in connection with these filings at the time the foregoing returns and FBAR are filed; and

— complete and sign a statement on the *Certification by U.S. Person Residing in the U.S.*, certifying:

(a) that the taxpayer is eligible for the Streamlined Domestic Offshore Procedures;

(b) that all required FBARs have now been filed;

(c) that the failure to report all income, pay all tax and submit all required information returns, including FBARs, resulted from non-willful conduct; and

(d) that the miscellaneous offshore penalty amount is accurate.

It is important to note that a taxpayer may not file delinquent income tax returns (including Form 1040, U.S. Individual Income Tax Return) using these procedures.

The Miscellaneous Offshore Penalty is equal to 5 percent of the highest aggregate balance/value of the taxpayer's foreign financial assets that are subject to the miscellaneous offshore penalty during the years in the covered tax return period and the covered FBAR period.

A foreign financial asset is subject to the 5-percent miscellaneous offshore penalty if:

— the asset should have been, but was not, reported on an FBAR for that year;

— the asset should have been, but was not, reported on a Form 8938 for that year; and

— the asset was properly reported for that year, but gross income in respect of the asset was not reported in that year.

A participating taxpayer will be *subject only to the 5-percent miscellaneous offshore penalty and will not be subject to accuracy-related penalties, information return penalties or FBAR penalties*. Even if returns properly filed under these procedures are subsequently selected for audit, no such penalties will be imposed unless the examination results in a determination that the original return was fraudulent and/or that the FBAR violation was willful. Any previously assessed penalties with respect to those years, however, will not be abated.

For returns filed under these procedures, retroactive relief will be provided for failure to timely elect income deferral on certain retirement and savings plans where deferral is permitted by the applicable treaty.

DELINQUENT FBAR SUBMISSION PROCEDURES

Taxpayers who do not need to use either the OVDP or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who:

— have not filed a required FBAR,

— are not under a civil examination or a criminal investigation by the IRS and

— have not already been contacted by the IRS about the delinquent FBARs,

should file the delinquent FBARs and include a statement explaining why the FBARs are filed late.

The IRS will not impose a penalty for the failure to file the delinquent FBARs if the taxpayer properly reported on his U.S. tax returns and paid all tax on the income from the foreign financial accounts reported on the delinquent FBARs, and the taxpayer has not previously been contacted regarding an income tax examination or a request for delinquent returns for the years for which the delinquent FBARs are submitted.

DELINQUENT INTERNATIONAL INFORMATION RETURN SUBMISSION PROCEDURES

Taxpayers who do not need to use the OVDP or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who:

1. have not filed one or more required international information returns,
2. have reasonable cause for not timely filing the information returns,

   Comment: This requirement is not present in the case of the Delinquent FBAR Submission Procedures.
3. are not under a civil examination or a criminal investigation by the IRS and
4. have not already been contacted by the IRS about the delinquent information returns,

should file the delinquent information returns with a statement of all facts establishing reasonable cause for the failure to file. As part of the reasonable cause statement, taxpayers must also certify that any entity for which the information returns are being filed was not engaged in tax evasion. If a reasonable cause statement is not attached to each delinquent information return filed, penalties may be assessed in accordance with existing procedures.

All delinquent international information returns other than Forms 3520 and 3520-A should be attached to an amended return. All delinquent Forms 3520 and 3520-A should be filed according to the applicable instructions for those forms. A reasonable cause statement must be attached to each delinquent information return filed for which reasonable cause is being requested.

TRANSITIONAL RULES

Transitional treatment under OVDP will allow taxpayers *currently participating in OVDP* who meet the eligibility requirements for the expanded Streamlined Filing Compliance Procedures an opportunity to remain in the OVDP while taking advantage of the favorable penalty structure of the expanded streamlined procedures.

A taxpayer will be considered to be *currently participating in an OVDP* for purposes of receiving transitional treatment if:

— Before July 1, 2014, he has mailed to IRS Criminal Investigation his OVDP voluntary disclosure letter and attachments, and

— As of July 1, 2014, he has either:
a. remained in OVDP but not yet completed the OVDP certification process where a Form 906 Closing Agreement has been fully executed by the IRS or

b. opted out of OVDP, but not yet received a letter initiating an examination and enclosing a Notice 609.

A taxpayer who, as of July 1, 2014, has completed the OVDP certification process where a Form 906 Closing Agreement has been fully executed by the IRS will not be considered currently participating in an OVDP and thus will not be eligible for transitional treatment.

A taxpayer who makes an offshore voluntary disclosure on or after July 1, 2014, will not be eligible for transitional treatment under OVDP, even though he may have made a request for OVDP pre-clearance before July 1, 2014.

Upon IRS approval, taxpayers currently participating in OVDP who meet the eligibility requirements of the:

- Streamlined *Foreign* Offshore Procedures will not be required to pay the miscellaneous offshore penalty; and
- Streamlined *Domestic* Offshore Procedures will not be required to pay the miscellaneous offshore penalty at the OVDP rate, but will instead be subject the miscellaneous offshore penalty terms of the Streamlined Domestic Offshore Procedures.

Taxpayers are not required to opt out of the OVDP to receive transitional treatment, but in order to qualify, a taxpayer must provide to the IRS:

a. all submission documents required under the voluntary disclosure program in which the taxpayer is currently participating;

b. a written statement in the appropriate certification form that would be required under the Streamlined Filing Compliance Procedures signed under penalty of perjury certifying their non-willfulness with respect to all foreign activities/assets, specifically describing the reasons for the failure to report all income, pay all tax and submit all required information returns, including FBARs, and if the taxpayer relied on a professional advisor, including the name, address and telephone number of the advisor and a summary of the advice; and

c. full payment of tax, interest and any accuracy-related, failure-to-file and/or failure-to-pay penalties that would be due under OVDP, if not already made.

Requests for transitional treatment will be reviewed to determine whether the taxpayer is eligible, the taxpayer's certification of non-willfulness is complete and the available information is consistent with the certification. The examiner assigned to the case will make the initial determination and the examiner's manager must concur. A central review committee may also review the determination. For those cases designated for central committee review, the examiner will document the facts and rationale for the determination, document the taxpayer statement of facts and prepare a summary of the case to be forwarded to the committee for review.

The central review committee will review the facts of the case and the examiners' determination to determine if it is consistent with other determinations made across the IRS. The central review committee will advise the examiner of concurrence, non-concurrence or additional actions required to process the request. The decision of the central review committee is final and may not be appealed.

If the IRS does not agree that the taxpayer is entitled to transitional treatment, the case remains governed by the terms of the OVDP in which the taxpayer is participating. In these circumstances, if the OVDP miscellaneous offshore penalty is unacceptable to the taxpayer, the taxpayer may opt out of the OVDP and choose to have the case resolved in an examination.

If you have unreported accounts or questions about your U.S. taxes please contact a U.S. licensed tax attorney or Enrolled Agent at Premier Offshore, Inc. We offer a free and 100% confidential consultation and have decades of experience in international taxation of U.S. citizens abroad. We can be by email info@premieroffshore.com.

Note: Premier is not a law firm and we do not practice law. If you’re being targeted by the IRS Criminal Investigation Division, or have been charged with a crime, you need a lawyer. Send a brief email to info@premieroffshore.com and I’ll put you in touch with a tax attorney who specializes in IRS criminal matters.

Dealing with the IRS

Let's say you have filed all of your delinquent returns, maximized the foreign-earned income exclusion, and taken all of the other suggestions in this book, but you still owe the IRS. For example, maybe you took a salary of $300,000 from your offshore corporation and only the first $100,000 was covered by the FEIE. Now the IRS is at your door…what should you do?

Step One: Know your risks

First, you must understand that the IRS can levy your U.S. bank account, and possibly your foreign bank accounts, put a lien on any real estate in the United States, and possibly take your real estate outside of the U.S.

Levy: A Tax levy, under United States Federal law, is an administrative action by the IRS under statutory authority, without going to court, to seize property to satisfy a tax liability. A levy is generally used to take money out of your bank account.

Lien: A tax lien is a lien imposed by the IRS upon real estate or other property to secure the payment of taxes. It may allow the IRS to seize your property. If you sell the property, the proceeds from the sale go first to the IRS to settle your debt, and then the remainder comes to you. An IRS lien comes after any preexisting liens, such as a first or second mortgage.

Here are several questions to consider if owe money to the IRS. Did you know:

- that the IRS can levy your foreign bank account if your bank has a branch in the U.S.?
- that the IRS may be able to levy your paycheck if your parent company is a U.S. entity?
- that the IRS can seize real estate in certain countries, such as France?
- that moving money out of the U.S. to avoid an IRS levy, even if you live abroad, can be a crime?
- that failure (refusal) to pay taxes can be a crime, in very specific circumstances?

Once your debt to the IRS becomes final and payable, the Service will attempt to mail four collection letters demanding payment. After sending those letters, whether or not you received them, the IRS can levy any U.S. bank account. This means they can take up to the amount of the debt out of your account(s). For example, if you owe $30,000, and you have $20,000 on the bank, they get $20,000. If you owe $30,000, and have $35,000, they get $30,000.

In addition, the IRS can levy any foreign account, so long as your bank has a branch in the U.S. For example, if you are living in Mexico, and banking with HSBC, the IRS can issue a levy to a U.S. branch of HSBC, and it must be honored by the branch in Mexico…and your money is gone. <u>This can be avoided by banking with institutions that do not have branch offices in the United States</u>.

Second, the IRS can take real estate in the U.S. and real estate in certain foreign countries. The IRS can seize property in any country where such a taking is provided for in the treaty, known as a Mutual Collection Assistance Requests (MCARs) clause. There are currently five treaty countries with which the IRS has ongoing programs for MCARs that may involve seizure and sale.

Third, the IRS can levy a bank account, or garnish your wages (take money out of your paycheck) in most countries with which it has a MCARs.

This means that anyone living in a MCARs country is at risk of having their assets seized, just as if they were living in the United States. The treaty partners and types of taxes covered for collection are as follows:

- Canada — All taxes
- France — Income, Estate and Gift, Wealth and other specified taxes
- Denmark — Income and other specified taxes
- Sweden — Income and other specified taxes
- Netherlands — Income and other specified taxes

Note: It is very rare for the IRS to seize real estate, especially one's primary residence. This only happens after the IRS exhausts every other collection alternative, and the taxpayer refuses to cooperate. If you owe money, and can't afford to pay, a tax attorney can negotiate a settlement that both you and the IRS can live with. As long as clients are honest and cooperate, the process is surprisingly painless. It is those who are unwilling to cooperate, or are too scared to do so, that get hit the hardest by the IRS.

Step Two: Negotiate

There are two basic options for those who owe the IRS, and are unable to pay:

1) An installment agreement; or

2) Offer in Compromise.

In an **installment agreement**, you agree to pay what you can afford each month, and the IRS agrees to stop collection actions while you make these payments. The IRS has 10 years to collect from you, thus your installment agreement can go on for several years.

In an **Offer in Compromise**, or OIC, you and the IRS agree to settle your debt for one lump sum, or payments over a few months. Let's look at the OIC process in detail.

Offer in Compromise

Everyone is well aware of the U.S. credit crunch, plummeting home values, and the generally tough economic situation. At the same time, the U.S. government is running at a staggering

deficit and looking to the Internal Revenue Service (IRS) to bring in more cash by stepping up audits and collections.

Put simply, an OIC is an offer to settle your IRS tax debt for less than the total obligation because you cannot pay the debt in full over the "collection period." Before you can request an OIC, all of your tax returns must be filed and you must pay a deposit of 20% of your offer amount.

Collection Period: In most cases, the IRS has 10 years to collect on a tax debt after it has been assessed. A debt is assessed when you file your returns, the IRS files returns for you, or an audit is finalized.

A settlement can be made in one lump sum, or over a number of months. However, it is more difficult and costly to get OICs approved that will pay over time, so a lump sum payment is the most practical option for most taxpayers.

During the OIC process, your objective is to convince the Service that you are paying them something that they would not otherwise get. To prove this claim, you are required to complete a detailed financial statement, listing all of your income, bank accounts, and assets. If your assets exceed your debt, your offer will not be accepted.

If you do not have sufficient assets to satisfy the debt, your income is compared to your allowed expenses to calculate your offer amount. For example, in 2014, a family of four living in San Diego, California is allowed to spend $3,159 per month for housing and utilities. The same family of four, living in Armstrong County, Texas, would be allowed only $1,427 per month, and $5,625 in New York County, New York.

If your income exceeds your allowed expenses, the difference, times 48 months, is added to your assets to determine your total offer amount.

For example, if you owe $100,000 to the IRS, the equity in your home, your only asset, is $20,000, and your net income after allowed expenses is $1,000 per month, your total offer amount is $68,000 ($1,000 x 48 = $48,000 + $20,000), or 68% of the debt.

Expats & Allowed Expenses: When negotiating with the IRS, you are allowed to spend fixed amounts on housing, utilities, automobile, health care expenses, food, clothing, and other living expenses. Collection Financial Standards are published for U.S. residents, but none have been created for those living abroad. Therefore, every aspect of an expats financial statement must be negotiated. For more information on the Collection Financial Standards, visit *www.irs.gov/individuals/article/0,,id=96543,00.html*

Installment Agreement

Let's say you owe $10,000, $30,000, $100,000 or more to the IRS and your assets exceed your debt. You are working full time abroad, but you have no savings to pay off the IRS. Can you pay off your debt over time?

Yes. In fact, almost every client onshore or offshore client I have worked with in the last 10 years, who has requested an installment, has been approved…eventually. The trick is always the same: getting to a number that both you and the IRS can live with.

If you owe taxes to the IRS, but can't afford to pay it off all at once, and you don't qualify for (or can't afford) an Offer in Compromise, then you can usually set up a payment plan, called an "Installment Agreement" in IRS lingo. The amount you will need to pay each month is based on a number of factors, including:

- Your income;
- Your assets;
- The amount you owe;
- Your actual expenses;
- Your allowed expenses;
- The remaining collection statute of limitations; and
- Whether or not you can afford to pay off the debt in full over the collection statute.

The key to setting up an Installment Agreement is the analysis of these and other factors, and thereby proving to the IRS how much you can afford to pay each month.

Here are the basics of an IRS Installment Agreement.

The IRS will enter a written agreement with you which requires installment payments based on the amount you owe and your ability to pay it within the period of time the Service has to collect from you (the "statute of limitations," as it is called). The IRS has 10 years to collect from you once you filed a return. When the 10 years are up, the debt is canceled and you get a fresh start.

Depending on the amount of tax due, there are different options within the program (see below). To apply for an Installment Agreement, you usually need to file Form 9465 and Form 433-A or Form 433-F (versions of the IRS Financial Statement, the key form when dealing with IRS collections at any level). If you are self-employed, or own a business, you may also need to file Form 433-B. A few people also need Form 433-D. If your Agreement is accepted, you will be charged a fee of $105 for a new agreement, or $45 for a reinstated agreement.

"What is a 'reinstated agreement,'" you'd ask.

An Installment Agreement is binding. You must pay the amount agreed-upon on time, every month of the year. If you skip a payment, you usually have 30 days to catch up. If you are not able to get current with your payments, the Agreement is canceled. You may apply for a new

Agreement, but your new proposal may be met with skepticism and can even be rejected. Worse, you must provide updated financial information, which may have very dire consequences if your income has increased or the person reviewing your data is less accommodating than the prior agent. If you're lucky and it's accepted again, then you'll have a "reinstated agreement."

There are two types of Installment Agreements, *mandatory* and *discretionary*. A "mandatory" agreement means that the IRS is required to accept the Agreement you propose if:

- You owe less than $10,000 (exclusive of interest and penalties);
- You've filed your tax returns and paid your due taxes on time during the past five years;
- You haven't entered another Installment Agreement during those past five years;
- You demonstrate that you can't pay the tax in full;
- You agree to pay the full amount you owe within a period of three years;
- You guarantee that you'll comply with the tax laws during the term of the Installment Agreement.

If you meet all these criteria, the IRS doesn't have the right to reject your Installment Agreement. An additional advantage of this type of agreement is that it doesn't require the same in-depth financial verification that a normal application does.

If you owe more than $10,000, you need a "discretionary" Installment Agreement, which means that the IRS can deny you a payment plan if it deems it unsatisfactory. The IRS has to consider your Installment Agreement and will request you to prepare a Financial Statement (Form 433-A or Form 433-F). If the IRS concludes that more information is needed to evaluate the proposal, then it can request you to provide supporting documents or other proof of income and expense. If not supplied, the IRS can reject your application.

During the processing of your Installment Agreement (until you receive the notice about the result of your application) your stress level will lower considerably as the IRS is not allowed to collect from you. If your IRS installment agreement request is rejected, your case will be on hold for 30 days, giving you time to appeal. If you file a timely appeal, then the IRS can't touch your property or money during the pendency of the appeal.

How much of my debt will I pay through an Installment Agreement?

The answer is that it depends on your ability to pay, the assets you have available, and the collection statute of limitations. If you have sufficient means, then the IRS will require a Full-pay Agreement. This is when you pay your tax debt in full, including interest and penalties, over a period of time.

A Full-pay Installment Agreement may be for a fixed monthly amount, or it may increase at predetermined intervals. In each case, it will pay off the debt during the collection statute of limitations.

An IRS Installment Agreement where you pay a fixed amount each month until the debt is paid in full is easy to understand. An Installment Agreement where your monthly payments increase over time takes a bit of explaining.

As you know, your ability to pay the IRS is based in part on your income vs. your allowed expenses. When your actual expenses exceed your *allowed* expenses, you are generally given time to modify your lifestyle.

For example, you may be given six months to find a lower-cost apartment. If your current apartment exceeds your allowed rental expense by $400, the IRS may set up an Installment Agreement that will increase by $400 in six months' time.

Another example is where your allowed expenses go down. The most common situation is where your automobile will be paid off, thereby reducing your allowed expenses. If your auto payment is $550 and your car will be paid off in eight months, you might set up an Installment Agreement that will increase by $550 in eight months' time.

Warning: What if you have unexpected repair bills, or need to purchase another car when this one is paid? You might be forced to default on the IRS Installment Agreement and need to start the process over…something everyone dreads.

Careful analysis of your current and future finances, along with a solid understanding of IRS practice and procedure, prior to applying for an Installment Agreement can prevent these and other problems.

For example, as a result of planning ahead, you might decide to purchase a new car, with a longer payoff period, before submitting your request.

What if I can't afford to pay off the IRS in full?

In the case you (1) do not have sufficient income to support a Full-pay Agreement, and (2) have no significant equity in assets or cannot sell or borrow against assets due to the fact that selling them will cause an undue hardship, then the IRS will grant a Partial-pay Agreement and you'll pay off only a portion of your debt within the statute of limitations, with the remaining debt being canceled.

However, if you are granted a Partial-pay Agreement, you must provide updated financial information every two years to prove your continuing financial hardship. If your income has increased, or your allowed expenses have decreased, you will be required to increase your monthly payment.

Still, there's a third situation. You pay zero dollars. Is that possible? Sure. Basically, when you cannot afford an Offer in Compromise, you have no assets to use to pay the IRS, and your income equals your allowed expenses, you can't afford to pay IRS anything.

A taxpayer in an Installment Agreement at zero dollars is referred to as being "temporarily uncollectable," with temporarily being the operative word here. As with a Partial-pay Installment Agreement, the IRS will review your financial situation periodically to see if it can start collecting from you. If your financial situation doesn't improve and the statute of limitations runs out, then your debt is eliminated. In other words, if you prove to the IRS that you are uncollectable over the entirety of the collection statute of limitations, you have paid nothing and your debt expires.

IMPORTANT NOTE: While you are making installment payments to the IRS, penalties and interest accrue on the unpaid balance. Essentially, you are locked into a late-payment penalty of one quarter of a percent a month plus interest on the unpaid amount. Taken together, the cost comes at around 10% a year. It's still less than the interest you pay on your credit card, but you need to think before you commit.

What if my Installment Agreement is rejected?

This may happen in one of the following cases:

(1) The information included in Forms 433-A or 433-B is incomplete or untruthful. If the IRS discovers that you have property or income not recorded on the forms then it will reject your application. Be careful here…your financial statement is signed under penalty of perjury, so it is very important to be truthful and very detailed in the information you provide to the government.

(2) The IRS deems some of your living expenses unnecessary. If you owe money to the government but nevertheless send your kids to private schools or drive expensive cars, then be prepared to get no deal at all. The IRS expects you to have quite a frugal life while paying off your debt.

(3) You defaulted on a prior Installment Agreement. It's a matter of trust…if you've once defaulted on your payments then the IRS will think twice whether to grant you a second chance. If your Installment Agreement is rejected, then you can appeal the decision. If the IRS sees your efforts to pay off your debt, then your application may be reconsidered.

What if I need professional help with filing an Installment Agreement?

So, why do you see so many claims on the Internet and television promising to settle your tax debt for pennies on the dollar? Because there are settlements like that, which are then used by a few unscrupulous promoters to mislead people into spending thousands of dollars to only have their OICs rejected.

Take the example above, but assume the tax debt is $1 million. It will still settle for $68,000, or about 15%.

If that same family owes $1 million, has lost their home, and their income does not exceed their allowed expenses, or the breadwinner is permanently disabled and unable to work, then total offer amount might be $1,000. This is a dream scenario for any national OIC marketing firm…the perfect client who can be used in their multi-million-dollar advertising campaign!

I have had a few such clients over the years. For example, a 72-year-old retired person, who was living with family and on Social Security only, settled his debt of $150,000 for about $2,000.

NOTE: Government figures show that 75% of Offers in Compromise are returned due to forms being filled out incorrectly; and of the 25% that are processed, approximately 50% of them are rejected. Add to this the complexities of expat negotiations, and it is clear quality representation is required…just be careful!

How to Avoid an Audit, Expat Edition

If you are living and working abroad, you still need to worry about the IRS. In this article, I will talk about how to avoid an IRS audit with a focus on Expats.

Are you worried that the IRS will come knocking on your door? Want to know how to avoid an IRS audit? I battled the IRS for a decade and here are a few of the tips and tricks learned, often the hard way, in those skirmishes.

So, what are the major audit flags? What will bring the IRS to your door? Some are selected at random, a kind of control group, but there are a number of items that can increase your chances of being selected by the computer for an audit.

The key factors are the amount you earn, the type and quantity of deductions you take, the volume of capital gains transaction on Schedule D, your line of work, and whether you own your own business.

Of these, income level is far and away the most important factor. As I said above, less than 1% of the taxpaying population is audited each year. If your income is $200,000 or more (defined as rich in today's America), your chance of an audit jumps to 3.26%. If you have a great year, and make $1 million, your chance of a visit skyrockets to just over 11% (about 1 in 9). So, you want to know how to avoid an IRS audit…just stop working!

I assume you won't decide to work less, or earn less, to keep the IRS from your door, so let's talk about what you can control. By far, the most egregious error is failing to report all of your income…and this is exactly what the IRS is targeting with FACTA and its offshore banking initiatives.

You see, FACTA forces all banks around the world to report the income and transactions of their American clients to the IRS, just as American banks do today. It essentially turns your foreign banker in to an unpaid agent of the U.S. government.

Next, IRS computers compare these reports to the return you file and audit those whose report doesn't match the computer file. The larger the discrepancy, the higher your chance of an audit.

The purpose of FACTA is to ensure all Americans are reporting each and every transaction and to provide a tool to the IRS to easily track down and persecute those who failed to toe the line.

Therefore, the best way for the U.S. person living, working or investing abroad to avoid an IRS audit is to file all necessary forms.

Another red flag is your charitable donations. The IRS keeps statistical data by income bracket on this category. The further you get from the standard deviation, the higher your chance of an audit. If you give 5% of your income to charity, with no non-cash donations, your audit meter will hardly register a beep. Give 50% of your adjusted gross income in donations of clothing and personal affects, and I guarantee you will be audited…possibly before you have time to cash the refund check.

Next on the list of red flags are rental real estate losses. If you have a loss from one foreign or domestic property of less than $25,000, your risks are minimal. If you claim to be a real estate professional so you can take larger losses, or because your income from other sources exceeds $150,000, then your risk of an audit is very high.

The last major caution is to day traders and those claiming to be professional traders of their own accounts. I understand that the desire to be considered a professional trader can be strong, and I field a number of calls from those wishing to do this "business" offshore.

Those who trade in stocks and securities as professionals have big time advantages over the rest of us. Their expenses are fully deductible and their profits are exempt from self-employment tax. Losses of traders who make a special section 475(f) election are fully deductible and aren't subject to the $3,000 cap on capital losses.

But, to be a professional trader, and not just a simple investor, you must regularly and continuously trade stocks. It must be your primary business and you should be spending about 30+ hours a week trading, researching, and working on your craft. If you aren't that involved, you are not a trader.

And the IRS realizes that it can be quite difficult for a person trading his own portfolio to prove he is a professional, so they are easy targets…often fish in a barrel.

If you are reporting your business on Schedule C, rather than an onshore or offshore corporation, you have a significantly higher risk of audit compared to someone who is properly structured. The favorite categories on this form are home office deduction, automobile expenses, notoriously hard to prove and often estimated by clients, and meals and entertainment. Did you actually bother to keep all of your receipts and write down who you met with and why? Keep it "simple" and get a corporation.

Why will a corporation reduce your chances of an audit? Let's say you reported $200,000 on Form 1120. You will be grouped together will all of the other corporate entities. At $200,000, you are probably a small fish in a big pond. But, report that same profit on Schedule C, you are probably a medium to large fish to the self-employed audit group in the IRS. In other words, not

many are making $200,000+ on Schedule C, but the number of corporate entities earning more than that is significant.

As someone who has handled hundreds of IRS exams over the years, I believe that these categories cover 90% of the non-random audits. If you want to know how to avoid an IRS audit, focus on compliance and your corporate structure. I will give you a few more examples below, but as we move on, the effect on your chances of an audit get less.

Hobby losses are major red flags, but one most people manage to avoid. You must report income from a hobby (such as horse racing) and you can deduct expenses up to the amount of that income. You are prohibited from deducting expenses in excess of that income. So, if you are considering racing ponies in Panama, don't deduct them on your U.S. return.

The same is true of gambling. U.S. casinos will report your wins, and you are allowed to deduct your losses to the extent of those wins. You should never take a loss from gambling, though some try on Schedule C by calling it a business. Keeping in mind that you must be able to prove your losses, usually with a gambling log, you can deduct foreign losses against U.S. wins. If you took $100,000 from a lucky streak in Las Vegas, and gave it all back to the Trump Casino in Panama City in the same year, you can net losses against wins to break-even.

Just about any small business has a high risk of audit. This is especially true of bars and restaurants with cash transactions. In fact, these establishments often get hit by the IRS, State tax board, and employment tax board in the same year.

If you are in a business offshore, and pay your employees or consultant's in cash, you will have a tough time if the tax man comes calling. You must prove all expenses to the U.S. IRS, so you should try to pay by check or wire whenever possible and have an invoice or receipt in the file. If not possible, then a signed receipt may get you by.

I will conclude with this: if you are living, working, or investing offshore, and have been filing all of the proper forms, you have nothing to fear from the IRS. If you have been lax in your reporting, then you might just find yourself at the top of the IRS hit list. Did you miss an FBAR or two? Do you have foreign real estate in a corporation that you did not report? You should get these issued resolved before FACTA arrives in full for on January 1, 2015.

If you are considering filing your delinquent forms, please take a look at my article on the voluntary disclosure program. If you qualify as an expat, and you owe no tax to the IRS, you might get away with zero penalties.

When do I need help?

Many clients ask, "Do I need an attorney to help me deal with the IRS?" That's a hard question and depends on your ability to negotiate, organize, and handle IRS paperwork. Some people are much more capable than others when it comes to handling their tax matters.

My standard answer is this:

1. If you owe the IRS $24,000 or less, and can afford to pay $500 per month, just call them up and make that offer. If it is accepted, as it usually is, you do not need professional help.

2. If you owe $24,000 to $99,000, you have an average sized case that will usually be handled by a centralized collection unit. While this size accounts for about half of my collection cases, they are easier to handle than larger cases…thus, we charge a lower fee.

3. If you owe $100,000 or more, you have a large case and can expect the IRS to be very aggressive in collecting from you. I suggest that anyone with a debt in excess of $100,000 seek legal counsel immediately.

4. Finally, you should decide if you need representation before contacting the IRS. It is very difficult to overcome mistakes and I generally do not take on cases after the documents have been filed. It's like coming in to the game down by 21 points and being asked to bring the team back with five minutes to go.

Taxpayer's Bill of Rights

In tough economic times, many business owners and self-employed people find it difficult or impossible to pay their federal taxes. When the debt is too large to pay, you then get the joy of negotiating with the Internal Revenue service.

Note: Of course, everyone has a hard time paying their taxes. Business owners and the self-employed are more likely to have large debts because many do not have taxes withheld from their paychecks, do not make quarterly estimates, and hope that there is enough cash in the business at the end of the year to keep the IRS at bay.

The following is a list of protections that taxpayers have when facing the IRS, known in the industry as the "Taxpayer's Bill of Rights." The first step in dealing with the IRS is to know these basic rights.

1. Innocent Spouse Relief (Publication 971):

    a. Is available for all understatements of tax (previously, only substantial understatements) attributable to erroneous items (previously, only grossly erroneous items) of the other spouse.

    b. You must file this claim within two years of the IRS beginning collection action.

    c. You must show that the innocent spouse did not know and had no reason to know about the underpayment of taxes.

    d. Innocent Spouse can be claimed for any tax liability arising after July 22, 1998 and any tax liability unpaid as of that date.

e. If Innocent Spouse is claimed and rejected, you can file a petition and go to tax court.

f. The IRS can grant equitable relief to taxpayers who do not satisfy the above tests.

g. If you filed a joint return, you can use innocent spouse as long as: 1) you are divorced or legally separated, or b) have been living apart for more than one year.

2. The IRS must abide by the Fair Debt and Collections Practices Act, which includes not communicating with you at an inconvenient time or place. This right basically protects against harassment.

3. The 10-year statute of limitations period on collection may generally not be extended if there has been no lien on any of the taxpayer's property.

4. The IRS must give you an installment agreement if:

    a. You owe less than $10,000,

    b. In the previous five tax years you have **not** 1) failed to file a tax return, 2) failed to pay any tax required to be shown on a return, and/or 3) entered into an installment agreement, and you

    c. Agree to full payment within three years.

5. A supervisor must approve the issuance of a Notice of Lien or Levy or seizing of property.

6. The IRS must notify you within five business days after the filing of a Notice of Lien and must include certain information in the notice, such as the amount of the tax and your appeal rights.

7. Anyone who will be affected by the filing of a lien is entitled to a fair hearing with an Appeals officer who had no prior involvement with the unpaid tax that gave rise to the filing of the lien.

8. You can get a certificate of discharge of a lien by depositing the amount in question with the IRS or you furnish a bond. You then have the right to sue to dispute the tax due.

9. The IRS must release a wage levy once it is determined that your outstanding tax liability is uncollectible. This basically means that the IRS determines that you do not have the financial resources (cash flow after allowed business and personal expenses and assets) to pay the debt.

10. You and third parties can sue for money damages for reckless or intentional disregard of the statutory collection provisions. This has been made easier because it includes negligence on the part of an IRS employee. You must first follow administrative

remedies and you are limited to $100,000 for negligence and $1 million for intentional or reckless disregard.

11. The IRS must notify you, 30 days before filing a levy, that you have a right to a hearing.
    a. You can then request an Appeals officer hear the case before the levy.
    b. You cannot challenge the underlying tax unless you had no previous opportunity to do so.
    c. If not resolved, you have 30 days to appeal to the U.S. Tax Court or Federal Court.
12. Standards are provided exempting some personal property and tools of the trade from levy.
13. Property can't be sold below the property's minimum bid price.
    a. Where no one is willing to pay the minimum bid price, the IRS can return the property or it is deemed to have paid that price.
    b. Generally, this is 80% or more of the forced sale value.
14. If the amount of the debt is less than $5,000, the IRS cannot take your primary residence.
15. The IRS cannot seize your principle residence without prior court approval.
16. The IRS cannot reject an Offer in Compromise from a low income taxpayer solely on the basis of the amount of the offer.
    a. This does not apply to the self-employed.
17. While you have an Offer in Compromise pending, and 30 days thereafter, the IRS cannot take your property or levy your bank account.

For additional information, please refer to these IRS publications:

- Form 565 http://www.irs.gov/pub/irs-pdf/f656.pdf
- Form 433-A http://www.irs.gov/pub/irs-pdf/f433a.pdf
- Form 433-B http://www.irs.gov/pub/irs-pdf/f433b.pdf

For more of my musings on dealing with the IRS, please see the tax debt relief portal on EscapeArtist.com

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Please note that our open office hours are Monday through Friday, from 8:30 a.m. to 5:30 p.m. PST.