TAX TALK TODAY®

International Issues and U.S. Taxpayers

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Brought to you by the IRS and produced by L&M Production Design Group, based in Alexandria, VA, Tax Talk Today® is a free, live, monthly interactive Webcast aimed at educating tax professionals on the most contemporary and complex tax issues. The award-winning series, now in its fifth year, airs monthly at www.TaxTalkToday.tv and programs are archived on the site for one year after each episode. For additional information or to inquire about sponsorship opportunities, please contact Paul Lamonia at (703) 642-6505 or Lamonia@LMpdg.com or visit www.TaxTalkToday.tv.

BRUCE ELLIOTT: This is "Tax Talk Today," the tax show for the tax pro. Today's program, "International Issues and U.S. Taxpayers." Hello, and welcome to "Tax Talk Today." Today's program is part of a series that provides you, the tax professional, the opportunity to interact directly with representatives of the IRS and practicing professionals on current tax issues. The "Tax Talk Today" series is brought to you by the Internal Revenue Service. This is the only program that brings the IRS to your computer every month.

Viewing the "Tax Talk Today" series is an easy way to earn continuing education credits for tax practitioners, as well as continuing education credits for financial planners and payroll professionals. You can purchase CE credits through store at "Tax Talk Today" and earn one credit for today's program. You need the course number, which is given out at the end of the program, so don't forget to jot it down. Also, check out the "Tax Talk Today" website store for new educational tools and offerings.

We want your questions throughout today's program, so please email them to questions@taxtalktoday.tv. And if you've not already done so, visit the Resource section of the website. We have posted an outline for today's program, as well as many documents we'll be referring to throughout the show.

Let's move on today's discussion: "International Issues and U.S. Taxpayers." This program will center on international issues facing U.S. taxpayers. Our panel will discuss common sources and U.S. treatment of international income, common compliance issues, and the direction of the international program.

Let's go to our first panel. Today's moderator is Les Witmer. Les is a communications consultant in Atlanta, following a 23-year career with the IRS. Joining Les is Marty Sartipi, international policy program manager with the Small Business and Self-Employed Division of the IRS; and Richard Ward, planning and special programs territory manager, International Programs, also with the Small Business and Self-Employed Operating Division of the IRS. As always, the complete biographies for all of our guests are on the "Tax Talk Today" website.

Les?

LES WITMER: Thanks, Bruce. Welcome, Marty and Rick. You know, just watching the evening news on television we find just how much we do live in a global economy. Companies, through their mergers and growth and just plain operating this Internet-based 24/7 world that we live in, have really expanded their geographic boundaries, but so have individuals on their sources of income. And unique to the United States is the fact that we tax that income worldwide, not on where they reside or not where that income comes from. Regardless of that, it's still taxable income. So I guess a good place to start, Marty, is just how big is the international program? What's the scope of the international tax program with the IRS?

MARTY SARTIPI: Well, it's big, Les, and it's growing all the time. The ease of cross-border transactions with the Internet, with travel, it's not at all uncommon for people to do business outside the U.S. And so it's growing and it's a real challenge, actually, for IRS and for taxpayers to keep up with this area of tax administration. For the individuals, the challenge is the fact that international tax law is complex in and of itself, but when you interface that with foreign tax laws, it becomes even more complex. On the IRS side, it's difficult because, first of all, we don't have the same sources of information about income earned abroad. And then also, just because of the growth, it's expanding all the time; new issues are coming up. So it's difficult to keep up with it.

A couple of indicators, I think, of the growth in this area, or the extent of international tax issues – in 2003 we had over 4 million individuals claim a foreign tax credit. That means they had foreign-sourced income on which they paid foreign tax. In addition, we receive every year millions of documents from foreign treaty partners reporting billions of dollars of income earned in foreign countries, paid to U.S. residents. So it's a very large area.

MR. WITMER: Those are information documents?

MS. SARTIPI: That's right.

MR. WITMER: Okay. I guess it might be interesting to the viewer just how you're organized, how many people you have, how many employees work in the international area and how that's organized.

MS. SARTIPI: Well, probably not nearly enough, but we are growing. Right now we have just under 300 people working in the Small Business and Self-Employed area of International. That's in addition to people in the large- and mid-size business organization. And we're actually increasing – as we speak, we're in the process of hiring nearly 100 more people to work in the area of international compliance. And this is really needed because of the growth in this area. In fact, Rick is involved in some of the compliance issues dealing with international returns, and so maybe, Rick, you could talk a little bit about the type of income.

RICHARD A. WARD: Okay. The biggest problem that we have when people go overseas is they stop filing a U.S. tax return, and upwards of 50 percent of Americans who have gone overseas don't file the tax returns that they're supposed to. It continues year in and year out, and they need to file; they need to know that the tax return is due. They have to report worldwide income. Every dollar they make overseas has to be reported on a U.S. return, not just U.S.-sourced income.

The second thing you see is people that do file returns, they're entitled to claim the bona fide residence, fiscal presence thing under Section 911 of the code, but you have to make that election on a filed return in order to do it, and there are lots of returns filed that are incorrect and they claim the exclusion when they're not entitled to it.

And the third big thing is the foreign tax credit. It's very complicated. Individuals have a really hard time doing it, claiming credit for the foreign taxes that they've paid on their U.S. tax returns.

MR. WITMER: What are the – I guess, what are the penalties, what are the consequences of making mistakes or having it wrong?

MR. WARD: Well, if you don't file your return at all and the IRS catches up to you, you can not be entitled to the overseas income exclusion. So instead of getting an $80,000 exclusion from your wages, you can get zero, and it's a real risk. So you don't want to wait until the IRS knocks on your door and says, we've figured out you haven't filed your tax return. You want to come in and file every year.

There are other penalties for late filing, for failure to pay. There are estimated tax penalties, all sorts of things that you can – you could wind up being assessed if you're not careful.

MS. SARTIPI: And, Les, in addition, I think it's important for viewers to know that besides their income tax returns, there is a multitude of information returns requiring – related to international taxation. As I mentioned earlier, we don't have the same sources of information reported to us from foreign countries, and so we ask taxpayers, they are actually required to self-report on a lot of transactions. And just to give you an idea of some of these forms, for example, there's the Report of a Foreign Bank or Financial Account that's required to be filed. It's actually a Treasury form, and penalties for failure to file this form are quite steep.

Some other examples – there is a Form 5471 required if an individual owns a substantial interest in a foreign corporation, and then what we might call the sister form or inverse form, which is the Form 5472, a Foreign Corporation with a U.S. Owner. There are also forms required related to foreign trusts. If you transfer assets to a foreign trust, there's a return that's required, and a foreign trust with a U.S. owner must file a tax return. And then some maybe lesser known forms, like a Form 926, if an individual transfers assets to a foreign corporation. And while the IRS has probably not done a very good job in the past of monitoring compliance in the filing of these forms, we are getting better at it, and the penalties for failure to file are really quite steep.

MR. WITMER: Rick, earlier you mentioned the 911 exclusion, and that people miss this. What is the criteria for – when is it allowed, I guess?

MR. WARD: Well, there's a three-tiered test. First of all, you have to have a foreign tax home, and secondly, you have to have a foreign-sourced income, and third, you have to qualify as a bona fide resident of a foreign country or physically present in a foreign country. If you miss any of the tests, you don't get the exclusion.

MR. WITMER: Okay.

MR. WARD: Some people think because they're living overseas they get it, but, you know, they don't count their days right, they're not living overseas permanently, and there is no exclusion available.

MR. WITMER: Okay. What are some of the IRS initiatives that you all might be taking to deal with noncompliance? You mentioned people failing to file, and also just mistakes that are made. What are some of the compliance issues that you're doing?

MR. WARD: Well, one thing we're doing is we're looking at non-filers. We're using information that we have available to us, either from treaty partners or from our own withholding system, to identify people who haven't filed tax returns because they went overseas. And so we're sending them letters saying, we know you're there, we know you owe us a tax return; please file it now, and we're getting a good response from those people.

We're also looking at people claiming the income exclusion incorrectly. We're doing audits on groups of people that we've identified where they shouldn't be claiming a foreign income exclusion. We're also looking at non-resident aliens who live inside the United States who are claiming other issues, who claim employee business expenses that they're not entitled to, or benefits from tax treaties that they're not entitled to. There's a lot of people that are misunderstanding our laws.

MR. WITMER: Okay. Marty, we mentioned the Internet and the electronic way of doing business today. How has that impacted in the international area?

MS. SARTIPI: Well, I think the biggest impact has just been in the amount of investment overseas, the amount of business activity that we see by U.S. persons, but also, somewhat related to the use of the Internet along the lines of electronic administration or electronic commerce, it's very easy these days to have a foreign bank account and also to get a credit card issued by a foreign bank. And this has been used by some people as a means to avoid reporting income and paying tax in the U.S. They use the foreign credit card to repatriate money, to purchase assets or purchase items in the U.S. without ever reporting the income on their U.S. return. So it's had a huge impact on us.

MR. WITMER: Just the whole area here, we're seeing how big it really is and how complicated it might be. What are some of the things that you're doing to educate? Rather than the enforcement, the compliance side, what are some of the educational opportunities?

MS. SARTIPI: Well, hopefully this program today is a start. We're also, this year, in the nationwide tax forms, including an international session. We have enhanced substantially, I think, what we have on IRS.gov. Under the international section you will find a lot of information. And we have a lot of it on the resource page for the program today, but we are really working to get the word out because we do know that in some cases it's not a deliberate attempt not to report or pay U.S. tax; it's just a lack of awareness.

MR. WITMER: You mentioned the resource page, and that's a good reminder. I've looked at it and there's – we've just put a lot of things on there today that pertain to the program, and during the second part of our discussion we're certainly going to be referring to it, but there's a lot of good information and links there.

I guess a final question for this segment would be, what are – what lies ahead? What are some of the things that practitioners should be thinking about in the area of international taxes?

MR. WARD: Well, from the compliance point of view, I think they'll be hearing more from taxpayers who are being audited. We've got 11 revenue agent groups that will be on board in June. We're going to have about five TCO groups – those are tax compliance officers – and one tax examiner group, and they're all going to be sending out audit letters. And we expect to have upwards of 10,000 audits completed this year.

MR. WITMER: Okay, lots of good information. We certainly have set the background for a discussion. We've already received lots of questions, and during the second segment we're going to be joined by our practitioners to discuss some of these topics and answer some of those questions, but first let's hear from Bruce and the news.

MR. ELLIOTT: Here are the top stories from the IRS: Treasury and IRS propose to revise Circular 230. The Treasury Department recently issued a notice proposing amendments to Circular 230, which governs tax professionals who practice before the IRS, ensuring that tax professionals adhere to professional standards and follow the law. It is one of the top four enforcement goals for the IRS. The proposed revisions to Circular 230 would modify the definition of "practice," eligibility for enrollment, unenrolled practice, and other issues, including the rules for contingent fees and conflicts of interest. Visit the Office of Professional Responsibility on the IRS website for more information.

IRS and states join forces to combat money laundering. The Internal Revenue Service has announced agreements with 33 states and Puerto Rico to begin sharing Bank Secrecy Act information. This will ensure that money services businesses are complying with federal and state responsibilities to register with the government and report cash transactions and suspicious activities. Money services businesses are non-bank financial institutions that provide certain financial services to their customers. MSBs include currency exchangers, check cashers, issuers of traveler's checks or stored value cards, and money transmitters. The information the IRS and the states may share under these agreements is limited to Bank Secrecy Act examination information. The IRS has separate long-standing agreements with the states for the exchange of tax information.

E-News now comes to you each Monday. The IRS e-News for Tax Professionals electronic newsletter is now being sent to subscribers every Monday. Starting April 24th, this change was made to deliver the latest tax news from the IRS as it happens. IRS e-News will continue to bring a mix of national and local news from all IRS divisions. Local information such as IRS-sponsored seminars, practitioner institutes and events, are available in each edition through links to IRS.gov. To subscribe to IRS e-News for tax practitioners, visit the IRS website.

More information on these stories can be found on the website. And now let's rejoin our panel discussion.

MR. WITMER: Joining the panel is Geoffrey DeHaven, CFP, and an enrolled agent and a cross-border tax advisor with a Brussels-based firm, USTaxAbroad; and Robert Panoff, an attorney from Miami and a member of IRSAC. Again, the complete biographies for all of our guests can be found on the "Tax Talk Today" site.

Les?

MR. WITMER: Thanks. Welcome to those of you – and Geoff, I think you set the record for a panel member traveling the greatest distance to be on this show, but welcome to both of you.

During the first segment, we kind of hit some background on the international tax area, and we have some topics that we would really like to cover. And as I mentioned before, we've already gotten a good many questions in and we're going to – I'll try to work those in from our viewers. But I guess a good place to start is on this whole area of worldwide income. How does this impact your particular practice? Bob, we'll start with you.

ROBERT E. PANOFF: Well, Les, what I see is that – and it's partly, as Marty mentioned, income is defined in different ways in different jurisdictions. So are deductions. The tax systems tend to overlay the cultural aspects of the particular nation involved. There is an attempt internationally to mesh those through various treaties. It's not perfect; it's extremely complicated, as Marty said, and recordkeeping is vastly different also.

So whether it's the U.S. person going overseas or the U.S. person who wishes to expatriate, or the non-resident who is coming in to invest, or the non-resident who is coming in perhaps to reside here for enough time to be a tax resident or obtain a green card, there are various things they need to know about and get used to before they do it. So one of the things I'd say is before the U.S. person goes overseas, make sure they get competent tax help from their accountant or their other professional to think about it before they leave. And with respect to the non-resident, make sure they get competent help before there are immigration consequences to what they do.

MR. WITMER: Geoff?

GEOFFREY DEHAVEN: What we find a lot in our practice is – like Bob said, is a lot of people taking a green card and not knowing the tax consequences until after they have the green card, and by then it's too late to do any tax planning. So they effectively are volunteering to pay more taxes than they should have had they had some planning done.

MR. WITMER: Okay. I guess some of the basics would be a good place to look at, like who has to file and where do these returns go?

MR. PANOFF: Well, I think that everyone who triggers the particular filing requirements involved has to file. The question is whether they're aware of them. U.S. persons certainly have far less of an excuse not to be aware of them, particularly if they've filed before they have left the country. Someone who has filed here and goes abroad and doesn't file has a little bit of explaining to do, as opposed to someone who has never been here, who doesn't have a good understanding of our system, not filing. I think that the IRS perhaps has a more kind view toward that person in general.

MR. WARD: If you're a U.S. citizen living outside the U.S., you have to file with Austin Service Center right now. It's been changing. In the past it was Philadelphia and the service center there is getting ready to close down, so the proper place to file this year is Austin. If you're a business taxpayer outside the U.S. it's going to be Ogden, in Utah.

MR. WITMER: What happens if the return goes to the wrong place?

MR. WARD: They'll transship the return back to the right service center. There won't be any additional penalties.

MS. SARTIPI: Regarding where you file, I think the best advice is really to look at the instructions because there are a lot of different scenarios that would require you file in a different location, depending on whether a practitioner prepared the return and whether there's a payment, whether – this year it's the year of transition, as Rick mentioned, from Philadelphia to Austin, so non-resident returns go one place whereas addresses of residents or citizens with a foreign address go another place.

One other thing I think it's very important to remember for people living outside the U.S. is that they are taxed on their worldwide income, and that means all sources of income. And sometimes – Bob mentioned this – there are differences in what is reportable in a foreign country versus in the U.S. A person may get an information document from their employer in another country that only reflects their net income, that of Social Security taxes or other taxes. But in the U.S. you have to file – report your gross amount. So there are some differences there that it's important to be aware of.

MR. WITMER: Okay, what about the tax treaties? How does this impact on filing?

MR. PANOFF: Well, tax treaties are an attempt to level the playing field, to avoid double-tax situation. Once again, there are differences among the tax treaties. There are different types of provisions within tax treaties. For instance, a bit esoteric is there is a tiebreaker provision that is in some tax treaties when the facts and circumstances make it unclear as to whether you're a resident for U.S. tax purposes or you're a resident with a foreign tax purposes and which ones do you pick? Certain treaties have tiebreakers to solve that problem.

But the treaty regime in one way or another in certain jurisdictions is almost constantly under negotiation, and we are in an evolving global society, so changes are periodically necessary. And I think Marty will comment on the importance of the competent authority in that process.

MS. SARTIPI: Yes, well the tax treaties, as Bob mentioned, are really intended to prevent double taxation, and in most cases they do, although not entirely, not always in a dollar-for-dollar manner. But there are some things to be aware of in looking at a tax treaty. One important aspect that is not always clear when you first look at a treaty is that while the treaty may say a certain type of income is only taxed by one of the treaty partners, all of the U.S. treaties contain what we call a savings clause that says the U.S. reserves the right to tax its citizens and residents as if the treaty doesn't exist.

So that could put you in a situation where on the surface it would seem you were paying double tax. But we have what is called a competent authority process where you can apply and have the two treaty partners work out the details and determine where the tax is appropriately paid, which will in most cases avoid double taxation.

MR. WITMER: We have gotten some questions in, and let me take some of these that probably deal in the area of worldwide income.

"The U.S. taxpayer lives abroad, is paid in a foreign currency, and does not get the equivalent of a foreign W-2. How do we calculate income and what is attached to the return?"

MR. DEHAVEN: Well, normally there is no requirement to attach a copy of the non-U.S. or foreign W-2 equivalent. You just use an average exchange rate for the year and obtain the dollar equivalent and report that on your return unless you have a substantial or material amount that is paid at one lump sum. In that case you'd use the particular exchange rate for the day.

MR. WARD: It's important to recognize that people should use the average exchange rate and not go through the rates and pick the best one for the year. A lot of them will go through and say, well, I was in Australia for a whole year; I'm going to pick the one on June 30th because that was a really good rate. That doesn't work; you have to take the average for the year if you are getting the income rate if you owe within an entire year.

MR. WITMER: And if you would be audited, that is what you would look for.

MR. WARD: And that is what we look for when we do audits.

MR. WITMER: Here is another question: "A U.S. taxpayer lives abroad and is married to a non-resident alien who has never worked in the U.S. and does not want to get any U.S. identification. The U.S. taxpayer files "married filing separately," and in the box where the spouse's Social Security number would go we write non-resident alien. Is this correct way to do it?"

MR. DEHAVEN: Normally you would write NRA and that would take care of the issue. However, doing so would preclude you from e-filing. So you will not be able to e-file to the extent that you take that approach.

MR. WITMER: I had a couple more of these. "Must a sole proprietor who is a U.S. resident doing periodic consulting work overseas pay self-employment tax on his foreign-earned income received from these foreign companies?"

MR. WARD: The answer is yes. He has got to report worldwide income; it doesn't matter if he goes outside the U.S. to earn it. The concept is U.S. citizens pay tax on worldwide income.

MR. WITMER: Okay.

MR. DEHAVEN: However, to the extent that they are living, a resident in a foreign-treaty country, there may be a treaty, a totalization agreement, which would require, allow that the Social Security tax be paid in the country of residence versus to the U.S. And that, again, is something that will vary depending on where you are living at and the treaty – particular treaty involved.

MR. WARD: We have 21 totalization agreements between the U.S. and other foreign countries. Most of them are in Europe. There are some in Asia. There is Japan and Korea and Australia and the rest are in Europe except for – Chile I think is one in South America.

MR. WITMER: Let's talk a little bit about the area of compliance then. We have set the stage for this in talking about the fact that some of the compliance initiatives are aimed at high-income non-filers. I guess maybe a question for our practitioners would be what happens, what do you do when somebody comes in who has not filed in the past? What do you look for here and how does this fall into the IRS international tax program?

MR. PANOFF: Well, the first thing you would want to do is debrief them in a privileged environment. And I can't emphasize that enough, is debriefing them in a privileged environment because you never know what they are going to say and they might be saying things that disclose criminal acts and that needs to be protected by privilege.

And after that debriefing – which needs to be very thorough – is done, assuming that there aren't any non-tax criminal issues – non-tax criminal issues – then you would look at that within the context of the IRS's voluntary disclosure policy under IR 2002-135, which is part of our materials, and determine whether or not you are in compliance with the rest of the requirements for that.

And all of this assumes that the IRS hasn't contacted that person first or a flow-through entity directly related to that person or that the person is under grand jury investigation, whether they know it or they don't know it, et cetera, et cetera. These events are listed in IR 2002-135.

Then you also have to make a decision what type of voluntary disclosure is going to be done. Is it going to be done through the service center -- and you must disclose that it is a voluntary disclosure. It is one of the requirements of IR 2002-135, that it be disclosed that it's a voluntary disclosure or else it isn't.

Or there is a process that is less used because it's a specialized process and it should only be used for certain situations. It's an anonymously initiated voluntary disclosure that is – describing it as a bit beyond the scope of this program. But it results eventually in a closing agreement at the end of the process and gives considerably more certainty. Which method they use depends on the facts and circumstances and also to some extent on the taxpayer's budget.

MS. SARTIPI: One other thing I think people need to be aware of – and I think Jeff probably sees this some in his practice overseas – there are a lot of people living abroad that truly don't know they are supposed to be filing U.S. returns. They are in full compliance with the tax laws of the country where they reside. And in those cases often they won't owe any money when they file their tax returns because of foreign tax credits and the foreign-earned income exclusion.

In those cases, the taxpayer really can just prepare and file the tax returns. We go back generally a maximum of six years. And this is a situation where there has been no intent to evade tax. The income is from legal sources and the person just truly did not know they had this filing requirement. In those cases we would recommend they just file their tax returns and send them into the service center.

MR. PANOFF: And following up on Marty, in terms of the six years, it's important for people practicing in the international area, sort of the in-between area, to realize that there are different statutes of limitation. The FBAR filing, which is under Title 31, not Title 26 – it is not a code-powered form – is a six-year statute of limitations. And then with respect to the 5471, the 5472, the 3520, and the 3520A, there's a specialized statute of limitation under subsection 6501(c)(8) of the Internal Revenue Code that says that the statute of limitations with respect to adjustments attributable to the data that should have been in those forms doesn't start to run until three years after those forms are filed.

So it isn't just the normal three-year, six-year fraud; there are some specialized statutes which everyone has to be aware of.

And while we are on this compliance subject – it's a little bit broad of what we are talking about – but one of the traps for the unwary is that FBAR is due in June; it's not due with the return. It is a Title 31 form; not a Title 26 form. And some of the other forms aren't due with the returns. So there's a trap for the unwary that each practitioner should make a tickling system for.

MR. DEHAVEN: And you can't extend those forms. The FBAR must be filed by June 30th.

MR. WITMER: Looking at the compliance initiatives that we talked about before and Rick mentioned some of the problems in the area, in the 911 exclusion. What are some of the things that you see there?

MR. DEHAVEN: For 911, we find a lot of people claiming IRA deductions or making IRA contributions when they are excluding all of their income. To the extent that they exclude their income, there is no basis on which to make IRA contributions. So these IRA contributions in turn will be considered excess IRA contributions, and then you have a 6-percent penalty for a year apply to the balance of these accounts for each year they remain in there. So it's really important that they be aware that they normally should not be making contributions to IRAs while overseas.

MR. PANOFF: And I see record-keeping issues when I have defended 911 cases proving the continuous-presence element in particular. People don't realize that, you know, you need to be able to prove this. The burden of proof is on you, not the IRS, with respect to proving each of these elements to get the exclusion.

MR. WARD: Just counting the days to qualify for the physical presence – that's the partial day is a U.S. day. So the day you leave the U.S. is a U.S. day. The day you leave the foreign country is a U.S. day. And people don't realize that. They say, well, it's a half a day here and half a day here; I've got a foreign day in there. And if you're right on the edge, you're going to not be qualified.

MS. SARTIPI: I think one final pitfall – I'm not sure if it's the final one, but another pitfall is the tax home test. A lot of people get so intent on looking at their days of presence or looking at the year – full calendar year of bona fide residence, they forget that they have to also show that that is in fact their tax home.

MR. PANOFF: And then another little area of tension with 911 is not all countries have the same rules with respect to residency and what they allow and what they don't allow. And our system looks at it from our point of view. So there are some inequities in 911 that have been and remain there.

MR. WITMER: You mentioned voluntary disclosures a minute ago. And I guess a question for the IRS side would be what is a voluntary disclosure and what isn't a voluntary disclosure?

MR. WARD: Well, a voluntary disclosure is not when you come in after you have gotten a letter from the IRS, and the IRS says we know about you and you have got to file your return. Anything you do after that point is no longer a voluntary disclosure. Voluntary disclosure is when you come in on your own and say, I made a mistake, I would like to file. That is voluntary; otherwise it's not.

MR. PANOFF: I would just like to amend that slightly. An IR 2002-135 – if you get a letter from the collection division, not the examination division, asking for your return it is not too late; if it is from the examination division it is definitely too late. And it has to be timely, it has to be truthful, and it has to be complete, which means that you'd better do your homework. You don't go in and try to do it before you have done your own – the equivalent of your own full examination. That is the wrong way to do it. You get your own forensics and you do a full-blown situation.

Now, in the international context, you still have the last-chance compliance initiative, which is in existence and the materials – it's an information – form 1341 from May 2005 that describes the LCCI. And the LCCI was the child of OVCI, which ended in April 15th, 2003.

MR. WITMER: What was it? OV –

MR. PANOFF: OVCI, office of voluntary compliance initiative. That had a better deal but the LCCI still has a very good deal. It's by invitation only. Some people might not consider it an invitation. Some people might consider it sort of a life-changing event type of situation. And even if you don't get that letter, you can still do a voluntary disclosure. The LCCI is a subset of voluntary disclosure. LCCI basically, without getting into the details: If there is an FBAR required for each year and if there is fraud present, what they will do is they will offer civil fraud for the greatest year, one year of FBAR penalty and essentially a pass on most of the other.

And when you're looking at the penalty regime, the penalty is just the mention on the 30 – if you file 3520 and 3520A, the 3520, it can be 35 percent of the amount of the distribution not reported. The 3520A could be 5 percent of the gross amount held in the trust that's deemed owned by the taxpayer under the grant jury trust rule. So assume there is a trust with $20 million in it and the form isn't filed, the penalty is $1 million unless there is reasonable cause. So these are very, very severe, and professionals really need to be diligent here because there is obvious malpractice exposure.

MR. WITMER: Okay, we have come to a couple more questions and I am going to try to work these in to try to get as many as we can. As always, if we don't get all of the questions answered during the program, we will post them on our resource page.

"If you're an overseas employee of a foreign entity, is there any way of paying voluntarily into the Social Security system?"

We have talked about Social Security before. Is there any way of paying voluntarily into it?

MR. DEHAVEN: No, there is not. The U.S. Social Security system is not a voluntary system, so –

MR. WITMER: What if you're self-employed? You would be paying the FICA and the –

MR. DEHAVEN: Normally if you're self-employed and under the treaty, which you would have to look at individually, you either pay to the U.S. – in some treaties it's possible to pay to the U.S., but in most you pay where you are living, where you're a resident of.

MR. PANOFF: Well, you could pay as an employee of a foreign corporation; you just won't get any Social Security benefits, but we would be very grateful for the contribution.

MR. WITMER: It would help the deficit.

MR. PANOFF: Yes.

MR. WITMER: "Why can't you contribute to a traditional or Roth IRA even if you include all of your – even if your income is all excluded?"

MR. WARD: Because you have to have taxable income in order to do it. So if you make $70,000 and you exclude $70,000 under the 911 exclusion, the taxable income is zero. For the traditional Roth, why would you want to, though, because what you are doing is turning non-taxable income into taxable income at the end when you take it out. So that is a non-starter from the very beginning. And some people like to do it because they have always done it but it's the wrong thing to do. The Roth one, you're putting money in and tying it up when you don't need to, and it won't be taxable at the end but why do you have to tie your money up when you have already got it non-taxed?

MR. WITMER: You don't have to.

MR. WARD: There is no advantage.

MR. WITMER: Do you see that very much?

MR.DEHAVEN: Yes, we do. And unfortunately overseas too what we see happening is that the foreign countries do not recognize any tax deferral within these vehicles. So you end up paying foreign taxes on these IRAs when for U.S. purposes they are taxed deferred or not taxed at all.

MR. PANOFF: Well, that would be in those jurisdictions where there is a tax to begin with since in some jurisdictions there wouldn't be. I can't see why anybody would want to do that because generally any asset protection value that might be available under local law to protect the assets could probably be done in a different fashion under more tax-favorable circumstances.

MR. WITMER: Okay, here is a question on something we haven't talked about, maybe we could spend a little bit of time on. "When a foreign trust makes a distribution to a U.S. beneficiary having held passive foreign investment company investments, is it true that both interest charges apply, i.e., on the accumulated income and on the PFIC income?"

I guess before we maybe answer that question, we need to spend a little time on what is a passive foreign investment company.

MR. PANOFF: It is a type of – it's a foreign mutual fund basically that is – has a tax regime that, once again, is very complicated. It is a trap for the unwary. It is very harsh for a U.S. person who goes overseas who might be there for a while. They see a foreign mutual fund with tremendous returns. They go to a preparer that may not be aware, particularly an overseas preparer – not like Geoff, who does know – but someone who doesn't know and doesn't tell them about the PFIC and they get into this thing and find out their tax is absolutely terrible.

And Geoff, I think has a few comments on that.

MR. DEHAVEN: Yes, the tax for these PFICs normally is the highest marginal rate you happen to be at in that year. So if you sell a PFIC in one year, and you have zero taxes due because your income is low enough, nevertheless for PFIC purposes, you are going to pay tax at the 35 percent rate, plus an interest surcharge for each year that you have held the fund. So it can be really devastating. After 20 years, it's possible that you end up with nothing after the tax and the interest surcharge, so –

MR. PANOFF: And it's not unusual to see a U.S. person who has a foreign corporation that has something within it that they may not have been watching that closely or that may be managed by a – in a situation where the corporation is the beneficiary of a trust and there's a foreign trustee, and they have PFIC there and don't even know it.

One of the things that needs to be evaluated is, is it a PFIC or can it be CFC situation – controlled foreign corporation situation – and the CFC provisions generally will allow a better treatment if it's possible to get it into that and, of course, in a lawful and ethical way – if you happen to get stuck with it.

MR. DEHAVEN: The best advice you could give a client is not to invest in a foreign fund like that. The same funds are available in the U.S. that meet all the U.S. requirements. You don't need to expose yourself to that.

MR. WITMER: Okay. I would imagine this would be a red flag for the auditor –

MR. DEHAVEN: If they see it, yes, absolutely.

MR. WITMER: Yes, okay.

Marty, earlier, I think we were talking about offshore – what about offshore credit cards, offshore banks? Is this an area that you have problems with?

MS. SARTIPI: Ah, yes. Definitely so, and probably many people are aware that we've been looking at that area very closely. The Offshore Voluntary Compliance Initiative was an opportunity for people to come in and disclose to us their use of these offshore credit cards, but we continue to look at that area, to scrutinize it. Although the opportunity to come in – other than through the Last Chance Compliance Initiative – has passed, we're not through looking at that area. So it's definitely an area of concern to us.

That's not to say, though, that there aren't legitimate situations where a person would have a credit issued by an offshore financial institution. We're not assuming that every offshore credit card is a vehicle to evade tax, but we do look at it very closely.

MR. PANOFF: The Internal Revenue Service gleaned a lot of information through – with the assistance of the Justice Department issuing the John Doe summonses on the credit cards through Visa, American Express, MasterCard. And to say the least, there are still a lot of Johns out there with a lot of dough, and they know it, and they're pursuing it. LCCI is there; it isn't exclusive. You can still go – if you don't get the letter, you can still go in. And I think that that model has worked well, and in the future – at some future date, I think that you are likely to see other initiatives in that sector. It has been a rewarding compliance initiative, both with respect to the OVCI and the LCCI, and the LCCI is ongoing.

MR. WITMER: Marty, here's one that kind of relates to that, and it's something that I think Bob talked about before. "If a person has an offshore account that is a standard bank or investment account, do these types of accounts need to be reported on the Report of Foreign Bank Accounts?" I believe you call it the FBAR.

MS. SARTIPI: Yes, they do generally if they meet the threshold amounts. In all cases they would need – the person would need to check the box on the 1040 form indicating they have a foreign bank account. You only have to file the report of a foreign bank account if the amount in the account at any point during the year exceeds $10,000 dollars, or if you have several accounts, that the aggregate amount exceeds $10,000.

But it's extremely important that they file the form if they meet those thresholds because, as I mentioned earlier, the penalty is quite stiff. In fact, the maximum amount of penalty for non-willful failure to file is $10,000 and for willful failure to file is $100,000 for each report that's not filed.

MR. WITMER: These FBARs – are they used a lot like the cash transaction reports here in the United States are used once they're filed as far as who has access to them and –

MS. SARTIPI: Well, in some respects, but one finer point with those forms – and Bob mentioned this earlier – is that these forms are actually required under Title 31, and the income tax provisions come under Title 26. So there are some limitations in terms of how we can use that information to address income tax issues.

MR. PANOFF: But if a FBAR has not been filed and the IRS becomes aware of it, and they know that there is an offshore account and they cross-check the 1040 or 1120 – whatever – and they see that the income and the – or dividend – the income, whether it be interest, dividends, et cetera, is not reported, then the non-filing of the FBAR could be looked at as an overt act, a willful act to conceal. So it could be – the act itself can cross-fertilize what's going on either in the examination or a possible referral to CI.

MR. WARD: Now most people living overseas – you'd think they would be filing these forms because they're living in England or someplace. They've got a bank account, they're paid there, the money goes into the account. Chances are sometime during the year there's going to be more than $10,000 in their account. So you would expect most people living and working overseas to be filing these forms.

MR. PANOFF: And that goes to the importance of having competent preparation mentally before you go overseas because many overseas preparers just are not aware of the form, and as Marty said in the opening, they're also – they're not aware that the U.S. is a income-from-whatever-source-derived, citizenship-based jurisdiction.

MR. WITMER: Okay. Here's a question that's very timely with the situation in Iraq and a lot of our contractors.

"I have a question regarding civilian contractors working in a combat zone. They are required to live and eat on their employer's premises. Which of the following can I deduct from income and where would the deduction be reported, on the forms 2555 or 1040? First is the food and housing allowance – money added to wages to compensate for substantial food and lodging; travel back to the U.S. for school; travel back to the U.S. for beginning and end of tour."

Let's stop there. There's more to this question, but are those things that are reported on these forms?

MR. WARD: I think the first one, the food and housing – that's probably not in his W-2 in the first place. The employer provides it. He has to live on the employer's site; the employer provides the lodging and the meals. It's probably not in the W-2, so it's nothing to be backed out because it shouldn't be there in the first place.

The next one was to travel back to the U.S.

MR. WITMER: For school.

MR. WARD: That's not deductible at all.

And the next one is –

MR. WITMER: Travel back and forth to begin with and end it.

MR. WARD: That's just personal expense.

MR. WITMER: Is any portion of their pay not taxable?

MR. WARD: If they qualify for the Foreign Earned Income Exclusion, yes, but they need to go through the steps – the three steps you have to go through to make sure you qualify.

MR. WITMER: And I would imagine this is an area – we have a lot of contractors now and who are in this situation. Is there – where can they get information besides maybe a practitioner? Again, is there stuff on your –

MR. WARD: Well, they can go to the IRS website.

MR. WITMER: – website to get this type of information.

MR. WARD: Right.

MR. PANOFF: And there are those people who are going to take a liberal position, albeit not lawfully, with deductions. And there are those people who are offshore who have the same mindset.

MR. DEHAVEN: And to the extent that they are receiving per diems, they should not be taking the 911 exclusion if they're receiving per diems for that period of short-term assignment –

(Cross talk.)

MR. WARD: Because they're only going in and out, like a lot of people shuffle in and out. That's not going to be their tax home. They're going in and they're going out.

MR. PANOFF: What they really need to do is negotiate ahead of time to consider the fact that they can't deduct a lot of these things, and perhaps try to negotiate a higher growth salary so after tax they come out about the same place they'd come out if it was deductible.

MR. WITMER: Okay. Here is one that hits a little bit more on the compliance areas. "I am a resident of the United States and I enjoy dual U.S. and French citizenship. I received both U.S. Social Security benefits as well as French Social Security benefits. I understand that generally all income worldwide is taxable in the U.S. However, the International Tax Convention between the U.S. and France states 'Payments made under the Social Security legislation of a contracting state to a resident of another contracting state shall be taxable only in the first-mentioned state.' Based on that, are my French Social Security benefits taxable only in France?"

MS. SARTIPI: Well, that's an interesting question because that points to the savings clause that I mentioned earlier in a tax treaty. While the tax treaty may say that the French Social Security benefits may only be taxed by the French, in fact, because of that savings clause, the U.S. can also tax those benefits. In that case, then they would use a foreign tax credit to offset the double taxation of the income. They would have to establish in this case France would be the primary party to tax the income, so the U.S. would have to give a foreign tax credit.

But it points to the complexity of the treaties and how easy it is to misunderstand and misapply a treaty because it says clearly in the section under "Social Security or Pension Income" only France may tax it, but in another part of the treaty it says, oh, but the U.S. can also tax it, too.

MR. DEHAVEN: The Belgian treaty is a little more interesting in that it also has a savings clause, but there is an article that specifically says that the Belgian Social Security will not be taxed by the U.S. even though the savings clause does exist in there.

MS. SARTIPI: And that's a situation where there is the exceptions even to the savings clause.

MR. DEHAVEN: Exception to the exception.

MR. PANOFF: And then there are situations where the taxing authorities do bump up against each other, and there is a mechanism, as we've mentioned before, called the competent authority in the IRS, and that authority actually is quite competent within the IRS where you can go and there's a rev proc on point and try to get it straightened out, where the competent authority approaches the other competent authority and they discuss the matter.

MR. WITMER: Okay. Here's another question. "A non-resident alien owns rental property in the United States. Thirty percent withholding is taken from the gross income. Must this person still file a tax return in the United States or is the withholding considered sufficient?"

MR. WARD: Well, there's two answers to that question. The first answer is he doesn't have to file a U.S. return because his income is not effectively connected with the trade of business and the tax rate is 30 percent. So he can just let it go and drop the 30 percent and walk away and never file that return. The right answer is that he can make a real property tax selection and agree to have his rental income taxed at a net basis, and he gets to claim rental expenses and depreciation, which probably wipes out his income and he gets a refund. And then the tax-planning guys here can probably talk about what he should do otherwise, because there are other things you can do as well.

MR. PANOFF: Right. If he's holding it individually, there is a potential estate tax issue because he was holding it in his own name. If he happens to die with that, there is possibly an estate tax consequence here. Most of the people that have real estate here have it in some structure that at the top at least there is a foreign entity of some type that is not subject to our estate tax. And then the 30 percent, you know, it's rental real estate depreciation might normally offset a considerable amount of the income, so the 30 percent while at first glance it's less than 35 percent, the maximum current rate, it's not that good a deal. So that person needs some planning.

MR. WITMER: Okay.

MR. DEHAVEN: And for state purposes too – not estate but state – like California, for example, you would still be required to file a state tax return, even though the federal return would say, well, you don't have to file because they withheld the 30 percent.

MR. WARD: The 30 percent is the federal tax only, not the state –

MR. WITMER: That's the tax only, not the state.

MR. WARD: – and they have their own rules.

MR. WITMER: Which there is another whole area of confusion or complexity into this. And I guess that begs the question – we talked with – in the opening segment with Rick and Marty about the things the IRS is going to educate folks about this, the website and things that we've put on our resource page. How do practitioners stay up with all of this? I mean, it sounds pretty confusing, and I guess – what happens? Do you end up specializing in some areas, or what happens?

MR. PAHOFF: Well, in Florida we have – each January the Tax Section of the Florida Bar and the FICPA put on a joint program in Miami. It's limited to international. It's been put on for approximately 26 years, and it's very, very thorough. It's attended by over 250 people each year who tend to specialize in the area or at least have enough to justify going and taking the time out of the office and paying the fee to go. And since

Florida, particularly South Florida, has so much foreign investment and so much foreign activity, it's pretty crucial for any preparer that wishes to be competent to have some exposure in this area. The website has a lot of very good information. For instance, on FBAR there's an FAQ section which is pretty good considering that there are statutory issues because it's under Title 31 instead of Title 26 that needs some fixing. There's some glitches. The IRS is aware of it, but the IRS is not Congress, and I think practitioners have to be a bit patient. Eventually some of these things will get fixed.

The international area has quite a few issues. Just one final comment about that. When people talk about tax simplification or flat tax, I think they're ignoring globalization and I think that they're ignoring how complicated the world is, and that if we want to have a system that reflects freedom of behavior, it's impossible for it to be simple because the behavior is constantly changing. If you want to tax fairly and appropriately, complexity is just going to be there; there's no way to get rid of it.

MR. WITMER: And I would imagine for people like you, Geoff, you've really become an expert on the treaty for the country you're working in and the information that pertains to that country.

MR. DEHAVEN: Yes, there's not very much training that's available out there, so when you do find it, even though it's expensive at times, you have to make an effort to attend these to get your CPEs that are required as an enrolled agent, or as required by Circular 230.

MR. WITMER: And a good way to do that is watch "Tax Talk Today."

Here's another question. "If you have more than one foreign employer during the year, is it important which one you list on the Form 2555?"

MR. WARD: Not really. You could – I would put the one that you earned the most income with, but you may be able to put both names and put a slash between them –

MR. DEHAVEN: Or just put a statement on the back of your return.

MR. WARD: But it's not really – you've just got to get the income right is what's important.

MR. PANOFF: And make sure you disclose all the income, right?

MR. WARD: Right.

MR. DEHAVEN: And talking about that, it's important to know that for U.S. purposes, the income – the gross income from wages can be different from that on the foreign return because some countries, in Europe especially, tend to deduct Social Security from the taxable wages. So you'd have to add back that Social Security to get the gross taxable wages for U.S. purposes.

MR. WITMER: Okay, in the remaining minutes here I'm going to try to get as many of the questions in as we can. "If a U.S. citizen lives abroad for five years and becomes a citizen of another country, does that exempt the citizen from filing? Is there a length of time where a U.S. citizen can cease filing tax returns when they have no U.S. income ever?

MR. DEHAVEN: No.

MR. PANOFF: Oh, no U.S. income? But it's taxable income in the other country?

MR. WITMER: Yes.

MR. PANOFF: No.

MS. SARTIPI: I think the important thing to remember is if their worldwide income is above the threshold amounts to file a return, they have to file a return, and it makes no difference where they live.

MR. PANOFF: I think there might be, sub silencio, a question there about immigration, meaning to what extent would their actions affect their U.S. citizenship if that's their – the problem is, is there's a little rule called Section 877 on expatriation and you just can't willy-nilly expatriate. The IRS doesn't say, okay, you chose to do it and you automatically get a pass. There are procedures that have to be followed to expatriate.

MR. WITMER: "I'm a U.S. person doing business in a foreign country as a sole proprietor. Do I use Form Schedule C to report foreign income and expenses, as I would do for domestic Schedule C businessES?

MR. WARD: Yes.

MS. SARTIPI: Yes.

MR. DEHAVEN: Correct. (Inaudible.) But as soon as he starts a corporation overseas, actually, he needs to file the Form 5471 or make an election to check the box.

MR. WITMER: Okay, here's –

MR. WARD: The concept underlying all of this is we tax worldwide income, so the Schedule C works anywhere. It's not a U.S. Schedule C; it's a worldwide Schedule C.

MR. WITMER: I think that's an important point that – again, that we've kind of emphasized is the worldwide income.

MR. DEHAVEN: And on top of that, the amount that's excludable for earned income purposes is the gross amount of income, not the net amount after deduction of expenses.

MR. PANOFF: And I'm sure that a number in our audience will be raising the question now, well, you know, that's all fine and well in terms of reporting from a country where the tax system is truthful and honest and respected, but what about all the countries in the world where the data received is not complete, not accurate, corrupted; what do we do? And I think all you can do is, to the extent it's possible, restate the data to the extent you can accurately, and use a disclaimer where appropriate, I don't think the IRS can reasonably expect any more than that.

MR. WITMER: Okay. "If a U.S. taxpayer owns property outside of the U.S. as a second home, can they deduct the mortgage interest using Schedule A of Form 1040?"

MR. DEHAVEN: Yes, but that deduction, like if it's a vacation home, the deductions are sourced per where the income is coming from, so at the end of the day, how much benefit that will give them is probably limited because they probably already have more than enough foreign tax credits to take care of the liability.

MR. WITMER: All right. "Facts: A U.S. corporation is hired by a foreign government to install cable wiring in their country. The employees are stationed abroad for an entire year. Corporation pays wages to its shareholder employees and all living expenses abroad. The question: Can the shareholder employees elect the foreign-earned income exclusion under Code Section 911? If so, is the corporation required to withhold federal income tax on the payments for services outside the U.S.?"

MS. SARTIPI: I think one of the keys to the first part of that question – again, from the way it's worded, there seems to be this assumption that one year is the magic date – that if you're there for one year or more you qualify. And so the first step would be to establish whether or not they really have moved their tax home to the foreign country.

MR. WITMER: Okay.

MR. PANOFF: Were they U.S. citizens in that question?

MR. WITMER: Yes – a U.S. corporation.

MR. WARD: And the company is a U.S. company.

MR. WITMER: Yes, and the company is U.S.

MR. PANOFF: And the employees are U.S. people?

MR. WITMER: Yes.

"A taxpayer came to the U.S. on a work visa and then married a U.S. citizen. They received retirement from a foreign employer who withholds taxes in that foreign currency. How should this transaction be treated on the taxpayer's joint 1040?"

MR. DEHAVEN: Normally they would report the income and they would claim a foreign tax credit for that foreign tax paid to the foreign country.

MR. WITMER: Okay. All right, I think we might have set a record on the number of questions that we've answered on this program, but the questions were all really pertinent to the subject. We've covered a lot of information -- a lot of good information was covered on the program. And just a reminder that the questions we didn't get to will be on the resource page, and also there's a lot of information on the resource.

I'd like to thank you all for quite an interesting discussion this afternoon. And now before we close out, let's hear from Bruce.

MR. ELLIOTT: That brings us to the end of today's program. Remember that you will be able to view reruns of today's and any "Tax Talk Today" program 24 hours a day, seven days a week for a full year on our site.

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And mark your calendars for Tuesday, June 13th, 2006, for a discussion on Why Fix Mistakes in Retirement Plans Now Rather than Later.

I'm Bruce Elliott. See you in June on Tax Talk Today.

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