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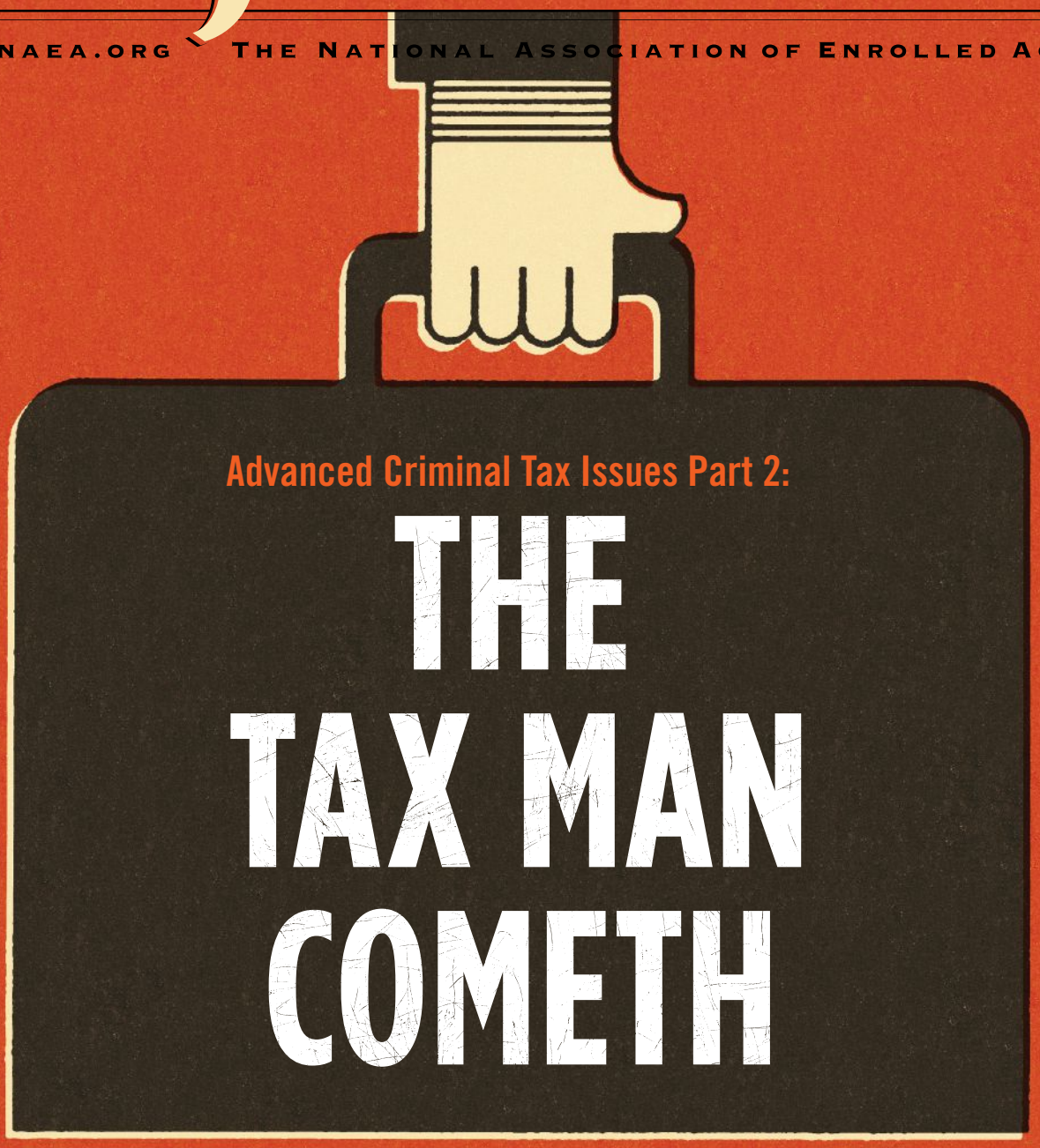

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By Gil Charney, CPA

Across the Border—International Tax Questions

Few tax practitioners can make it through a tax season without at least a few clients who have worked or lived abroad, or who have other types of non-wage foreign source income. In addition, some clients may have a foreign trust, rental income from property located abroad, gain or loss from the sale of foreign property, or income from a foreign pension. As a tax preparer, you may also have questions about your clients' residency, their visas, whether a foreign treaty with the United States offers favorable tax treatment, or whether your client is better off excluding foreign income or claiming a foreign tax credit. Below is a small sample of the questions you may have encountered, or may encounter, next tax season.

U.S. RETURN REQUIRED FOR THESE CANADIAN CLIENTS?

Q: I have two Canadian clients and would like to know if either of them is required to file a U.S. tax return. The first client is a Canadian citizen living in Canada. She receives pension income from her deceased husband's U.S. pension plan (not Social Security). No taxes are withheld by the payer. The second client is a Canadian citizen living and working in Canada under a contract with a U.S. employer. He is self-employed, working out of his home in Canada, and does not travel to the United States. He has no green card or work visa.

A: Depending on the type and amount of pension the first client is receiving, there is likely a U.S. tax liability and filing requirement. Article XVIII of the U.S.-Canada treaty allows the U.S. to tax U.S.-source private pension distributions made to Canadian residents. The tax rate is limited to 15 percent for periodic distributions. Your client may receive Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding) and may want to provide the withholding agent with a completed Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding).

Your second client, a Canadian citizen living and working in Canada for a U.S. employer, would not have a U.S.-filing requirement under these circumstances. Income from personal services is sourced to the location where the services are performed (Canada), and the residence of the payer of the compensation (the U.S. employer) has no bearing on the taxability of the income. If your client was a U.S. citizen or resident and earned the income while living in Canada, the income would be taxable on a U.S. tax return because U.S. citizens (and resident aliens) are taxed on worldwide income. Provided this client had no other U.S.-source income, he has no U.S. filing requirement.

A PARTIAL FOREIGN INCOME EXCLUSION?

Q: My client made a traditional IRA contribution but will need to withdraw contributions and earnings because all earned income would be excluded under his foreign earned income exclusion. To avoid having to withdraw the IRA contribution, could he exclude most of his income but not exclude the $5,000 he needs to contribute to his IRA? There would be no change in tax liability as the $5,000 in income would be offset by the $5,000 IRA contribution adjustment. Is a taxpayer required to include all foreign income if eligible, up to the allowable maximum, or since this is an election, can the taxpayer elect to exclude only part of the foreign income?

A: If the foreign earned income exclusion is claimed, it must be claimed to the full extent of the taxpayer's earnings. That is, the taxpayer cannot claim a lesser amount in order to qualify for other benefits based on AGI or MAGI. Thus, he would not be able to contribute to his IRA unless he had income in excess of the exclusion threshold for the year or revoked the exclusion election. For 2012, the exclusion limit is $95,100.

Excluding less in earnings than the available amount could be deemed a revocation of the election to exclude foreign earned income. Once a taxpayer chooses to exclude foreign earned income, that choice remains in effect for that year and all later years unless he or she revokes it.

A taxpayer who does not claim the foreign earned income exclusion may be able to claim a foreign tax credit or deduction for foreign income taxes.

INTEREST AND RENTAL INCOME FROM A FOREIGN TRUST

Q: My client, a U.K. citizen living in the United States, received interest and rental income from a U.K. trust. The interest income was less than $1,200. In addition to the interest, she received about $5,000 in rental income. Capital from the trust also was distributed to her. She did not report any of this on her tax return, although she did claim EIC. Would she be subject to any penalties under failure to file FBAR or FATCA reports?

A: The terms of the trust should be reviewed to determine if the beneficiary (your client) has an immediate and absolute right to both the capital and the income held in the trust. If so, the trust would be classified as a foreign grantor trust for U.S. purposes, and the taxpayer is treated as the owner or grantor of a foreign trust if he or she has the power to liquidate the trust's assets.

Thus, as a U.S. resident, your client is liable for tax on the income and will need to file Forms 3520 (Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts) and 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner). These forms are filed separately from the taxpayer's income tax return. The Form 3520-A is due on March 15 and contains a foreign grantor trust owner's statement that will report the current trust-level earnings. The income on this statement will be reported directly on your client's income tax return. The income passes through the trust currently, and your client would not have the ability to defer income at the trust level. If U.K. tax was paid on the income, your client may be able to claim a foreign tax credit.

If the trust was a nongrantor trust for U.S. purposes, the beneficiary would be taxed when the funds are distributed, but accumulation distribution interest charges apply if funds are not regularly distributed.

Finally, even with the filing of these forms, your client may still be subject to FBAR- and FATCA-reporting requirements. Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts) would be required if foreign financial accounts held by the taxpayer, including those held in the trust's name, are valued in excess of $10,000 in the aggregate. Additionally, the ownership of the trust itself may trigger additional reporting requirements on Form 8938 (Statement of Foreign Financial Assets) if the value of her foreign assets is in excess of the appropriate reporting threshold listed in the form instructions. If the value of her foreign assets exceeds the appropriate reporting threshold, the foreign trust can be reported by simply checking the box in Part IV of Form 8938, stating that Forms 3520 and 3520-A have been filed.

FORM TD F 90-22.1 FOR PREVIOUS YEARS

Q: I am filing tax returns for the last five years for my new clients who are U.S. citizens living abroad. They did not file tax returns in 2006 and 2007, and I am filing amended returns for all open years. Do I need to file the FBAR form for every year, only the year of the amended returns, or only for the current year? Must Form 8938 be filed as well?

A: A taxpayer is required to file Form TD F 90-22.1 if he or she has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account.

Your clients are required to file Form TD F 90-22.1 for each year they met the filing-requirement threshhold, which generally is met when the aggregate value of foreign financial accounts exceeds $10,000 at any time during the calendar year. The statute of limitations for civil penalties on unfiled FBARs is six years from the date of violation, which covers all the years for which you are filing returns for your client. The FBAR statute of limitations is a "hard" six-year limit, unlike an income tax return whose statute of limitations begins the due date of the return or the date the return was actually filed, whichever is later. Thus, the IRS may assess penalties for failure to file an FBAR for any year after 2005.

In January 2012, the IRS re-opened its Offshore Voluntary Disclosure Initiative, but participating in this program may not be desirable for your client if the failure to file the forms was due to reasonable cause. If there is reasonable cause, the penalties may be waived entirely. Whether a reasonable cause prevented the filing of the form is a matter for the IRS to decide, and no definitive outcome can be assured. However, in a recently issued fact sheet, the IRS has laid out the factors that will be considered in applying the reasonable cause exception.

Factors that might weigh in *favor* of finding reasonable cause include:
1. Reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account.
2. The unreported account was established for a legitimate purpose, and there were no indications of efforts taken to intentionally conceal the reporting of income or assets.
3. There was no tax deficiency (or there was a tax deficiency but the amount was de minimis) related to the unreported foreign account.

Factors that might weigh *against* a finding of reasonable cause include whether:
1. The taxpayer's background and education indicate that he should have known of the FBAR reporting requirements.
2. There was a tax deficiency related to the unreported foreign account.
3. The taxpayer failed to disclose the existence of the account to the person preparing his tax return.

There may be factors in addition to those listed that weigh in favor of or against a finding of reasonable cause. No single factor is determinative.

Form 8938 is a new form, effective for tax years beginning after March 18, 2010. Thus, for most taxpayers, the filing requirement started with the 2011 tax year. EA

About the Author:

Gil Charney, CPA, CFP®, MBA, is a principal tax analyst at The Tax Institute at H&R Block where he conducts research into complex tax problems and analyzes tax legislation. He also leads a team of EAs, CPAs, and tax attorneys in maintaining The Tax Institute's Tax Research Center. He has extensive experience in consulting, research, and corporate financial management. He also has taught graduate-level courses in accounting and finance and directed H&R Block's tax-training department.

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