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THE TIME IS NOW: TAX AMNESTY OPTIONS, GILTI AND THE TRANSITION TAX

SUMMARY: Even after the closing of the Offshore Voluntary Disclosure Program (OVDP) there are very attractive options for taxpayers to become compliant with their taxes and international reporting. In some cases, without even having a penalty. Additionally, there are two new laws for foreign corporations that need to be addressed.

Global Transparency

In recent years, the IRS has made it known that international enforcement is a top priority. Additionally, through FATCA, CRS, and other anti-money laundering laws, the financial world is becoming much more transparent. All of this assists the IRS in obtaining information needed to discover non-compliance from U.S. taxpayers. On top of everything, the rules over the past few years have become much more complicated and require even more reporting.

The good news is that for taxpayers that are not in compliance there are still options to get caught up, sometimes even without any penalties. However, with the IRS having internal discussions about the closing date of these options, and continued information sharing between countries, the time is now to address the situation.

U.S. Amnesty Programs

Although the Offshore Voluntary Disclosure Program (OVDP) closed in 2018, another sign the IRS is gathering useful information through FATCA, there are still amnesty programs available. The main goal of the U.S. amnesty programs was to gain compliance from taxpayers; however, even with this wealth of information from FATCA there are still undiscovered taxpayers and insufficient resources to locate everyone, especially the lesser offenses. Although these programs are not codified laws, the U.S. has stated that it will not try to excessively punish taxpayers who are making an honest effort to properly report. Basically, the IRS wants taxpayers to come forward and is not going to go after taxpayers that properly use these programs. However, it is clear that the U.S. will make an example out of anyone who blatantly evades and/or ignores their obligations, or who uses the programs in an improper manner.

Streamlined Filing Compliance Procedures

Until 2014, taxpayers had limited options. They could do nothing, participate in the OVDP or take their chances with unsanctioned methods such as quiet disclosure. This outraged many taxpayers who felt it was unfair for those who made innocent mistakes or were unaware of their reporting obligations to have to pay the same penalty as potential criminals and tax evaders. In response to this, the streamlined filing compliance procedures were implemented. Taxpayers who can certify that their noncompliance was not willful and meet certain other requirements may take advantage of this program. Even if a taxpayer has never filed returns, only three years of tax returns and informational reports along with six years of FBARs are required. Also, for taxpayers who have spent less than 35 days in the U.S. during any of the past 3 years there is NO PENALTY. For taxpayers who have spent more than

35 days in the U.S. there is a 5% penalty on the value of the assets and tax returns must have been previously filed.

This program may seem too good to be true for some people. However, the "non-willful" standard is not as simple as the taxpayer claiming they had no knowledge of their tax obligations or FBAR reporting. Taxpayers need to be aware that through a series of court cases, the U.S. has created a term “willful blindness.” The importance of this development is that it may not matter whether the taxpayer actually knew about the requirements, but whether if they should have known. This makes the decision of whether to enter the streamlined filing compliance procedures a significant one requiring detailed analysis and should not be taken lightly.

Delinquent FBAR Reporting Procedures

Taxpayers who do not have to use the streamlined program, report income, and are not currently under audit can take advantage of this programs. For accounts that did not generate income, such as non-interest-bearing accounts or signature authority only accounts, or when income was reported but the FBAR was unknown, this can be a great option. If qualifying, this allows taxpayers to become compliant and avoid severe FBAR penalties by simply filing the FBARs under this program.

Delinquent International Information Return Submission Procedures

Taxpayers who have in good faith and with reasonable cause committed non-filing violations that have not resulted in unreported income can take advantage of this program. However, the requirement of “reasonable cause” for the international information returns can make this option difficult, as “reasonable cause” is a stricter standard than the "non-willful" standard in the streamlined procedures. For this reason, especially for taxpayers that pay no penalty under streamlined, the preferred option is always streamlined. Additionally, generally best practices are to file 3 years of returns, but there is no bright line and an argument could be made, including by the IRS, that all years need to be filed.

GILTI and The Transition Tax

Complicating things further, in both 2017 and 2018, a new reporting law for foreign corporations began and created additional work, stress, confusion, and in some cases taxes. Although some taxpayers may want to ignore these changes, the problem with not addressing these two laws is that on a properly filed tax return the IRS has all the information it needs to not only determine the reporting should have been done but also to make an assessment. Furthermore, there have been discussions that the IRS is beginning to target these exact situations. For example, the IRS is now sending letters to taxpayers that did not report the transition tax in 2017. Therefore, it is imperative to know if these laws apply to you so they can be addressed, and the effects mitigated as much as possible.

The two laws are known as “GILTI” and the “Transition Tax.” GILTI (Global Intangible Low Taxed Income) is a tax on income earned by a foreign subsidiary which is considered intangible income in a low tax

jurisdiction. The Transition Tax was a one-time tax on all of the past, undistributed earnings of a foreign subsidiary. On their face, these both appear straightforward but they both have issues in their application that cause problems.

The policy goals behind the laws make sense in theory, but the application was flawed. This was possibly the consequences of rushing through the Tax Cuts and Jobs Act. Regardless of the cause, these problems in application create effects that are not intuitive, therefore, taxpayers cannot assume the laws do not apply to their situation.

GILTI

GILTI attempts to tax intangible income in a low tax jurisdiction. The thinking behind taxing this income is because the IRS feels the only reason to hold an intangible asset generating income in a low tax jurisdiction is for tax purposes. Since it is an intangible asset, there is no reason it could not be held within the U.S. While this may be true, it ignores possible legitimate reason to have IP outside of the U.S., but that is not the major issue. The problem is that GILTI does not actually tax intangible income. Instead, the calculation allows for a 10% return on a fixed asset base, anything above this return is deemed "intangible" income. The flaws with this are obvious. First, a 10% return is relatively low for some assets, and this would seem to penalize anyone making productive use of their fixed assets. Next, not all businesses use fixed assets, such as a sales entity or consulting company. Also, the fixed asset base is calculated after depreciation and many assets could have a useful life well after their depreciable life. These are only some of the most obvious issues. Overall, a tax on intangible income that does not have intangible income anywhere in the calculation is bound to have its problems in application.

Transition Tax

To fully understand the policy behind the Transition Tax it is necessary to consider the Participation Exemption. The Participation Exemption was a new law that allows U.S. corporations to repatriate earnings from certain foreign-owned subsidiaries tax free. The idea is that this will encourage the money to come back to the U.S. to create jobs and help the economy. However, the government did not want to reward the corporations that had been keeping earnings offshore for years. The answer was the Transition Tax, a one-time tax on the accumulated earnings at the end of 2017. This interaction between the Transition Tax and Participation Exemption would make it clear going forward that dividends paid back from these foreign subsidiaries would all be tax free – previous earnings were already taxed and new earnings were tax exempt. The problem is that the Participation Exemption only applies to corporate shareholders, but the Transition Tax applies to both corporate and individual shareholders. This means that individual shareholders had to pay the Transition Tax but do not have consistency in distributions going forward. Previous earnings have been taxed and can be distributed tax free, but new earnings are taxable since they are not eligible for the Participation Exemption. The tracking of this inconsistency also changed a simple one page form to a complicated two page form. This inconsistency and problem are well known, but in the end, Treasury and the IRS chose not to address the problem.

Application

First, it must be determined if the law applies to you. For both laws, the key terms are "U.S. shareholders" and "controlled foreign corporations (CFC)." A "U.S. shareholder" is a U.S. person for tax purposes who owns at least 10% of the stock for a foreign corporation. A business is a U.S. person for tax purposes by being incorporated in the U.S., while an individual is a U.S. person for tax purposes by either citizenship, permanent resident status (green card), or substantial presence. A "CFC" is a foreign corporation that is controlled (greater than 50%) by "U.S. shareholders."

Both GILTI and the Transition Tax apply to U.S. shareholders of CFCs, and the Transition Tax also applies to corporate U.S. shareholders of a foreign corporation even if it is not a CFC. This means, both laws apply to foreign corporations which have U.S. taxpayers who own at least 10% of the stock (vote or value) owning collectively more than 50%. Also, the Transition Tax applies to foreign corporations that have at least one U.S. corporate shareholder owning 10% of the corporation. However, even this analysis is not quite that simple. When considering ownership there are rules that can apply constructive and indirect ownership through other investments or attribution from family members. These rules themselves have been recently changed and are too complex to summarize here. In general, if you file a Form 5471 as a category 5, these apply to you.

What's Next?

When deciding how to address this issue, taxpayers fall into two categories, those that have filed a Form 5471 and those that haven't. A Form 5471 is required for several situations regarding foreign corporations, but always required for a CFC. If a Form 5471 has not been filed, the compliance options need to be analyzed for penalty exposure. Failure to file a Form 5471 carries a $10,000/year penalty, and depending on foreign account and asset values a Form 8938 could be required which also has a $10,000/year penalty. Additionally, if the taxpayer has signature authority on the business bank accounts or is deemed to have a direct financial interest because they own greater than 50%, an FBAR (foreign bank account report) might be needed. Generally, the minimum penalty for not filing an FBAR is $10,000/year but could be as high as $10,000/account/year for a non-willful violation, and up to 100% of the account balance if the non-filing is deemed willful. Assuming there is not any criminal exposure, which requires analysis with a qualified tax attorney, taxpayers would most likely use either the streamlined program or file under reasonable cause to get into compliance. Both of these methods have pros and cons which require examination to pick the best option. While these are the main choices, there may be other unique paths to compliance that could be taken making it very important that each case has a detailed analysis of the risks, exposure, and options. If there is criminal exposure, the Voluntary Disclose Program should be considered. This program is less defined than the former Offshore Voluntary Disclosure Program, and will very likely come with the highest penalties, but it will give criminal protection.

If the Form 5471 has been filed, this is a good news – bad news situation. The good news is that you may not have to be concerned about the non-filing penalty. "May" not need to be concerned because the IRS can still give this penalty if a Form 5471 is "substantially incomplete." What it takes for a form to

be substantially incomplete is not well defined but missing the GILTI or Transition Tax forms might get you there. However, the problem is that an accurate Form 5471 gives the IRS information needed to make an assessment of the potential GILTI or Transition Tax – an assessment that is likely to be unfavorable. Also, it would not allow for any mitigation planning such as a possible Section 962 election allowing for foreign taxes paid to be used as a credit.

Overall, if GILTI or the Transition Tax have not been addressed, it is very clear it needs to be done as soon as possible, the only decision is what path to choose to get there.

The Time is Now

Between FATCA, IRS international enforcement increasing, and new, complex laws such as GILTI and the Transition Tax, it has become a difficult time for international taxpayers and the professionals who prepare their returns. Additionally, the non-filing penalties are severe and the IRS is pushing the envelope on maximizing those penalties. The only thing that is clear is that ignoring the problem is not an option as it will only make things worse. Taxpayers need to take advantage of these programs while there is still time.

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