



The joys of spring

Kent Lawson looks at cross-border tax reporting

Spring abounds with blossoms, new leaves and, in the US, tax forms. The importance of tax reporting cannot be over emphasized. It is the window through which the Internal Revenue Service (IRS) views a client's cross-border activity. In the US, preparing the forms relating to cross-border activity is a specialized practice area. The filing requirements are often elaborate. The civil and criminal penalties for the failure to file are severe.

The main tax filing deadlines of the year are 15 March and 15 April. Every year, the IRS publishes several hundred different forms. About 50 or so come up regularly in a cross-border tax practice. This article discusses generally when the forms relating to cross-border activity might be required. It is intend to give the reader a general sense of when to do further reading or to seek specialized expertise. A good place for further reading is the IRS website. The forms and instructions can be downloaded at www.irs.gov. Although this article focuses on federal tax forms, state and local governments often have their own requirements.

Caught unaware

We frequently see clients who have failed to file the proper forms relating to cross-border activity. Often they have been working with accountants who do not specialize in international taxation. US tax reporting often catches clients coming from other countries unaware. Unlike most other countries, the US taxes citizens and Green Card holders as residents regardless of where in the world they are living. Others who spend sufficient time in the US are also taxed as residents.

The US taxes residents on worldwide income. The fact that taxes have been paid

in a foreign jurisdiction does not justify the failure to file in the US. US residents must file a return to claim the foreign tax credit. If no return is filed, the credit can be lost. In some cases, income earned by residents working abroad can be excluded from taxation if a form is filed to claim the foreign earned income exclusion.

The US also requires residents to report their interests in foreign entities. The US rules classify foreign entities as trusts, partnerships, corporations, or disregarded entities. Separate forms exist for each type of entity. Some foreign entities do not fit neatly into this classification scheme, particularly those from civil law jurisdictions that have characteristics of both trusts and corporations.

Filing requirements

These can depend on how the US tax rules apply to an entity after it is classified as a trust, partnership, corporation, or disregarded entity. For example, reporting can be different for grantor and non-grantor trusts. Determining whether a trust is classified as a grantor trust can require much analysis.

Similarly, foreign corporations and partnerships can fall into several different reporting categories. The concentrations of US ownership in a foreign corporation can determine whether it is a controlled foreign corporation or a passive foreign investment company. Different tax consequences and filing obligations can result.

Attribution and constructive ownership rules can treat a person as having an interest in a foreign entity even in cases where a person has no direct interest. These rules are particularly unclear in cases where a US beneficiary of a trust may be required to report an ownership interest in underlying entities.



The US tax rules often prevent income from being deferred in foreign trusts and corporations by treating them as transparent for tax purposes or by imposing back taxes and an interest charge when distributions are made. Taxpayers receiving distributions from foreign entities often have filing requirements. The forms are complex and can require financial statements going back to the inception of the entity.

Consequences

Often the classification of a foreign entity can be determined by filing an election. If the election is missed, unintended consequences can result. A frequent mistake is assuming that a foreign Limited Liability Company (LLC) is classified automatically as a partnership or disregarded entity, as is the case for a domestic LLC. If no election is filed for a foreign LLC, the LLC is classified as a foreign corporation.

US residents who have a beneficial interest in or signatory authority over foreign bank and securities accounts also have



filing obligations. Individuals are sometimes treated as the beneficial owner of accounts owned by foreign entities.

Non-resident individuals and foreign entities doing business or investing in the US may also have filing requirements. Reporting is sometimes required even if they are doing business in the US through a domestic corporation. Even when no tax is owed because of an income tax treaty with the US, a return is often still necessary simply to claim the benefit of the treaty.

Residents paying income to non-residents may also have reporting and withholding obligations. Payments of interest, dividends, rents, and royalties are often subject to withholding tax at a 30 per cent rate or at lower treaty rates. A non-resident must provide the payer with a form establishing residence in a treaty country to be entitled to withholding at lower treaty rates.

Non-resident partners in partnerships doing business in the US are also subject to withholding on their allocations of partnership income. Non-residents selling US real estate are also subject to withholding from the sales proceeds. Both situations require reporting.

In some foreign countries, the recipient of a gift or a bequest must report income. In the US, however, gift and estate tax is imposed on the donor or the estate rather than on the recipient. Nevertheless, the doctrine of transferee liability allows the IRS to collect from the recipient if the donor or the estate fails to pay. US residents must report gifts and inheritances from non-residents even if there are no US tax consequences.

US resident donors and their estates are subject to gift and estate tax regardless of where in the world assets are located. Non-residents and their estates are only subject to gift and estate tax on US assets.

Spouses are generally able to make gifts and bequests to each other free of gift and estate tax. However, reporting can still be required. Transfers to non-citizen spouses often require the use of a special trust and related reporting to avoid tax.

In the US, Spring is a time for tax forms. Those with cross-border activity should spring into action as early as possible. In most cases, they should seek expert advice regarding their tax filing obligations.

APPENDIX

- Form TD F 90.22-1 Report of Foreign Bank and Financial Accounts
- Form SS-4 Application for Employer Identification Number
- Form SS-5 Application for a Social Security Number Card
- Form W-7 Application for IRS Individual Taxpayer Identification Number
- Form W-8BEN Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding
- Form W-8ECI Certificate of Foreign Person's Claim for Exemption from Withholding on Effectively Connected Income
- Form W-8IMY Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain US Branches for United States Withholding Tax
- Form 706 United States Estate and Generation-Skipping Tax Return
- Form 706-NA United States Estate and Generation-Skipping Tax Return of a Nonresident Alien
- Form 706-QDT United States Estate Tax Return for Qualified Domestic Trusts
- Form 709 United States Gift and Generation-Skipping Transfer Tax Return
- Form 926 Return by a US Transferor of Property to a Foreign Corporation
- Form 1040 US Individual Income Tax Return
- Form 1040-NR US Nonresident Alien Income Tax Return
- Form 1041 (Schedule J) Accumulation Distribution for a Complex Trust
- Form 1042 Annual Withholding Tax Return for US Source Income of Foreign Persons
- Form 1042-S Foreign Person's US Source Income Subject to Withholding
- Form 1040-C US Departing Alien Income Tax Return
- Form 1065 US Return of Partnership Income
- Form 1116 Foreign Tax Credit – Individuals, Estates, or Trusts
- Form 1118 Foreign Tax Credit - Corporations
- Form 1120 US Corporation Income Tax Return
- Form 1120-S US Income Tax Return of an S Corporation
- Form 1120-F US Income Tax Return of a Foreign Corporation
- Form 2555 Foreign Earned Income
- Form 2063 US Departing Alien Income Tax Statement
- Form 3520 Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
- Form 3520-A Annual Information Return of Foreign Trust with a US Owner
- Form 4970 Tax on Accumulation Distribution of Trusts
- Form 5471 Information Return of US Persons With Respect to Certain Foreign Corporations
- Form 5472 Information Return of a 25 per cent Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US trade or Business
- Form 5713 International Boycott Report
- Form 8621 Return by a Shareholder of a Passive Foreign Investment Company
- Form 8288 US Withholding Tax Return for Dispositions by Foreign Persons of US Real Property Interests
- Form 8288-A US Withholding Tax Return for Dispositions by Foreign Persons of US Real Property Interests
- Form 8804 Annual Return of Partnership Withholding Tax (Section 1446)
- Form 8804-W Installment Payments of Section 1446 Withholding Tax for Partnerships
- Form 8805 Foreign Partner's Information Statement of Section 1446 Withholding Tax
- Form 8822 Change of Address
- Form 8832 Entity Classification Election
- Form 8833 Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)
- Form 8840 Closer Connection Exception Statement for Aliens
- Form 8854 Initial and Annual Expatriation Statement
- Form 8858 Information Return of US Persons With Respect to Foreign Disregarded Entities
- Form 8865 Information Return of US Persons With Respect to Certain Foreign Partnerships