Expatriates and Retirees Coming to the Philippines: Giving Up U.S. Citizenship and the U.S. Exit Tax

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I. INTRODUCTION

Travelers move in more than one direction. While many people around the world are trying to get into the United States (U.S.), either legally or illegally, there are many others on their way out.[1] Individuals planning to

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leave the U.S. often include those who became U.S. citizens through naturalization or the U.S. permanent residents ("green card" holders) who have decided to return to their home countries,[2] i.e., to places such as the Philippines. Of course, there are also native-born U.S. citizens who, for a variety of reasons, simply decide to leave the U.S. and live elsewhere. Many of those leaving are retirees, and this group will be the focus of this Article.

There are many factors that can motivate individuals to leave the U.S. such as income and estate taxes, climate, health care, and family ties.

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1. *See* Vivek Wadhwa, *Why Skilled Immigrants Are Leaving the U.S.*, BLOOMBERG BUSINESSWEEK, Mar. 2, 2009, *available at* http://www.businessweek.com/technology/content/feb2009/tc20090228_990934.htm (last accessed May 23, 2011).

2. *Id.*

Whatever the reason, once a U.S. Person[3] becomes either a resident of the Philippines or a dual U.S.-Philippine citizen, they are subject to income taxes on their worldwide income earned from sources in both the U.S. and the Philippines.[4] In addition, property owned anywhere in the world may be subject to both U.S. and Philippine estate taxes. The U.S.-Philippine Income Tax Convention[5] helps to mitigate the impact of these income taxes. The Convention basically provides that income earned in the U.S. is subject to U.S. income taxes.[6] In contrast, income earned in the Philippines is subject to Philippine income taxes.[7] However, at this point in time there is no U.S.-Philippine estate tax treaty, or, at the very least, an intergovernmental regulatory measure which would spell out the details of such a regime.

Without an estate tax treaty or other U.S.-Philippine estate tax regime, a retiree with property in the U.S. and the Philippines faces the complex tax situation of their property being subject to both U.S. and Philippine estate taxes. In turn, and without even dwelling on constitutional issues prohibiting double or oppressive taxation, this can lead to legal and financial confusion. For example, assume a retiree owns real property, stocks, bonds, etc., worth $1,500,000.00 in the State of Florida and has additional assets worth $1,500,000.00 in the Philippines. The decedent's estate would not be subject to U.S. federal estate taxes because it does not exceed $5,000,000.00 in

3. United States Internal Revenue Service, Announcement 2010-16, *available at* http://www.irs.gov/pub/irs-drop/a-10-16.pdf (last accessed May 23, 2011) [hereinafter Announcement 2010-16]. The term *U.S. Person* includes: (i) a citizen or resident of the United States and (ii) a person residing in and doing business in the United States.

4. *See* An Act Amending the National Internal Revenue Code, as Amended, and for Other Purposes [Tax Reform Act of 1997], Republic Act No. 8424, § 23 (1997).

5. Income Tax Convention with the Republic of the Philippines, and an Exchange of Notes, U.S.-Ph., Oct. 1, 1976, 34 U.S.T. 1477 [hereinafter U.S.-Philippines Income Tax Convention]. Article 4 of the Convention signed in Manila between the government of the United States of America (U.S.) and the government of the Republic of the Philippines establishes sources of income; other sections of the convention set forth rules to determine which country income taxes will be paid to. *See generally* U.S.-Philippines Income Tax Convention, art. 4.

6. U.S.-Philippines Income Tax Convention, art. 4, ¶¶ 4 & 5.

7. *Id.*

value.[8] In this case, the decedent's entire estate property would be subject to Philippine estate taxes alone.[9]

Section 85 of the Philippine Tax Reform Act of 1997 provides that the value of the gross estate of the decedent citizen or resident shall be determined by including the value at the time of his or her death of all property, real or personal, tangible or intangible, wherever situated — i.e., anywhere in the world.[10]

For a net estate valued at $3,000,000.00 the following is the calculation of the estate tax liability under Section 84 of the Tax Reform Act of 1997:[11]

Over	But not over	The tax shall be	Plus	Of the excess over
	200,000.00	Exempt		
200,000.00	550,000.00	0.00	5%	200,000.00
500,000.00	2,000,000.00	15,000.00	8%	500,000.00
2,000,000.00	5,000,000.00	135,000.00	11%	2,000,000.00
5,000,000.00	10,000,000.00	465,000.00	15%	5,000,000.00
10,000,000.00	And over	1,215,000.00	20%	10,000,000.00

Using a ₱44.00 to $1 conversion rate, the net estate in Philippine Pesos is ($3,000,000.00 x ₱44.00) ₱132,000,000.00. The Philippine tax liability would be:

8. For 2010, the New York State Estate Tax exemption was $1,000,000.00. The U.S. Federal Estate Tax exemption will be $5,000,000.00 in 2011. Most likely, New York's estate tax exemption will remain at $1,000,000.00 for 2011. *See* New York State Department of Taxation and Finance, Estate Tax, *available at* http://www.tax.ny.gov/pit/estate/etidx.htm (last accessed May 23, 2011) & United States Internal Revenue Service, Estates Tax, *available at* http://www.irs.gov/businesses/small/article/0,,id=164871,00.html (last accessed May 23, 2011).

9. *See* Tax Reform Act of 1997, §§ 84 & 85. Under the Tax Reform Act of 1997, taxes are imposed on Philippine citizens and permanent residents' property wherever located in the world. The Philippines' taxable estate tax for amounts ₱10,000,000.00 and over is ₱1,215,000.00 plus 20% of the excess over ₱10,000,000.00.

10. Tax Reform Act of 1997, § 85.

11. *Id.* § 84.

₱10,000,000.00	₱ 1,215,000.00
₱122,000,000.00[12] x 20%	24,400,000.00
Total Tax	₱25,615,000.00
In U.S. tax dollars	
₱26,615,000.00 ÷ ₱ 44.00 =	$ 582,159.09

As noted above, the decedent would not owe U.S. estate taxes, but, in this case, he would owe Philippine estate taxes of $627,159.09. Prior to being subjected to the Philippine estate tax liability, the individual-retiree should do estate planning to reduce or eliminate his or her estate tax liability in the Philippines.

Beyond the estate tax consequences, there is also the issue concerning which country's laws will control the administration of the retiree's estate. Most states in the U.S. have common law jurisdictions, while the Philippines has a civil law jurisdiction.[13] A big difference between the two is that the Philippines has forced heirship rules,[14] whereas jurisdiction based on the English common law system, such as in the State of New York, does not. As a result, individuals who may inherit under New York law may not be

12. ₱132,000,000.00 - ₱10,000,000.00 = ₱122,000,000.00.

13. The U.S. common law system of laws originated in England and is based on court decisions, on the doctrines implicit in those decisions, and on customs and usages rather than on codified written laws. In the U.S., many of the common law rules have been codified in statutory law, such as in New York. *See* United States Department of State, Common Law v. Civil Law Systems, *available at* http://usinfo.org/enus/government/branches/messitte.html (last accessed May 23, 2011).

    Community property in the U.S. is a marital property regime that originated in civil law jurisdictions. The states in the U.S. that recognize community property are primarily located in the west of the country (except for Louisiana) and acquired this body of law from the law of Mexico, which was derived from Spanish law, which is from a Roman-derived civil law system. Louisiana traces its original system through French Civil Code and Roman Law. There are ten community property states in the U.S., namely: Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Puerto Rico also allows property to be owned as community property, as do several Indian jurisdictions. *See* I.R.S. Publ'n 555 (Rev. Dec. 2010), *available at* http://www.irs.gov/pub/irs-pdf/p555.pdf (last accessed May 23, 2011).

14. *See generally* An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386, bk. III, tit. IV (1950).

viewed as having the same right to the inheritance under Philippine law, and vice versa.

In most cases, the dual estate tax issues and common law or civil law issues can be dealt with through proper estate planning.[15] The more difficult issues which have to be dealt with are the assorted penalties imposed by the U.S. Internal Revenue Code (IRC).[16] The IRC has begun to bulge with various penalties directed at U.S. Persons holding trust assets, financial accounts, financial assets, and other financial interests located outside the U.S. Although at first glance many U.S. Persons assume that these penalties do not apply to them, for many, this assumption is incorrect.[17]

In the last two years, penalties have come to the forefront because they function as government revenue raisers. Backed by President Barack H. Obama and the U.S. Congress, the U.S. Internal Revenue Service (IRS) has become much more aggressive.[18] As a result, the IRS has been actively expanding and enforcing a wide variety of penalties. The IRS does this through bilateral and multilateral executive or administrative regulations that arise through agreement between and among partner states.[19]

Typically, when people move, they like to move their financial assets with them. This includes cash, financial accounts, etc. A retiree from the U.S. might like to open a bank account in the Philippines; maybe buy some stock on the Philippine Stock Exchange; or, create a trust for estate planning purposes in order to hold intact the real value of their U.S. and Philippine property.

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15. *See generally* DENIS CLIFFORD, ESTATE PLANNING BASICS 157-76 (5th ed. 2009).
16. The Internal Revenue Code, §§ 1-9834 (2010) (U.S.) [hereinafter I.R.C.].
17. Many comfortable, but not wealthy individuals residing outside the U.S., even if only for part of the year, may be subject to penalties of which they were not aware.
18. *See* Matthew Boyle, *Why does America need 4, 182 new IRS workers?*, THE DAILY CALLER, Feb. 18, 2011, *available at* http://dailycaller.com/2011/ 02/18/why-does-america-need-4182-new-irs-workers-obama-put-it-in-his-budget-butdidn t-say-what-the-goon-squad-would-do/ (last accessed May 23, 2011).
19. *See generally* Ernst & Young, The new joint audit landscape, *available at* http://www.ey.com/Publication/vwLUAssets/The_new_joint_audit_landscape /$File/Joint_audit_landscape_TPC6.pdf (last accessed May 23, 2011).

All of these acts are innocent on the surface, but they can carry substantial penalties if they have not been properly disclosed to tax authorities.[20]

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20. The following are some of the penalties a retiree could incur:

    (1) Failure to file tax return — This penalty may be imposed in certain circumstances, amounting to five per cent of the net tax amount required to be shown on the tax return for each month or fraction thereof, to a cap of 25%, with an increase to 15% and a cap of 75% if fraud is established;

    (2) Failure to pay tax — A late payment penalty may be imposed equal to 0.5% of the late payment monthly with a cap of 25%;

    (3) Accuracy-related penalty — A penalty of 20% may be imposed on any underpayment attributable to negligence or substantial understatement; and

    (4) Fraud penalties — Under payments of tax due to fraud are subject to a penalty of 75% of the understatement or underpayment.

    I.R.C., §§ 6651, 6662, & 6663.

    The following are information returns that retirees living in the Philippines may be required to file under certain circumstances:

    (1) Form 5471 — to be filed by U.S. persons who are officers, directors or shareholders of certain foreign corporations. The penalty for failure to file Form 5471 is $10,000.00, with an additional $10,000.00 for each month that the failure continues following a period of 90 days after the taxpayer is notified of the failure by the IRS, to a cap of $50,000.00 per return;

    (2) Form 5472 — to be filed to report transactions between a 25% foreign-owned domestic corporation or a foreign corporation that is engaged in a trade or business in the United States and related parties. The penalty for failing to file Form 5472 is $10,000.00, with an additional $10,000.00 for each month that the failure continues following a period of 90 days after the taxpayer is notified of the failure by the IRS, to a cap of $50,000.00 per return;

    (3) Form 926 — required to be filed to report transfers of property to foreign corporations. The penalty for failing to file Form 926 is 10% of the value of the property, with a limit of $100,000.00, unless the failure to report was intentional; and

    (4) Form 8865 — required to be filed by U.S. persons with interests in certain foreign partnerships to report their interest in and transactions of foreign partnerships, transfers of property to foreign partnerships and the acquisition, disposition or change of interests in foreign partnerships. The penalty for non-filing is $10,000.00, with an additional $10,000.00

The top three penalties that retirees in the Philippines may encounter are: 1) failure to meet the filing requirements for the Report of Foreign Bank and Financial Account (FBAR) notices;[21] 2) failure to follow Foreign Financial Asset Reporting (FATCA) notices rules;[22] and, 3) failure to report

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> for each month that the failure continues, following a period of 90 days after the taxpayer is notified of the failure by the IRS, to a cap of $50,000.00 per return, and 10% of the value of any unreported transferred property, to a cap of $100,000.00.

See United States Internal Revenue Service, Forms and Publications, *available at* http://www.irs.gov/formspubs/index.html (last accessed May 23, 2011) for copies of the above forms and information on the penalties for non-filing.

21. 31 C.F.R. § 1010.350 (2011) (U.S.). This Section provides:

> *Reports of Foreign Financial Accounts* — Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relationship exists, and shall provide such information as shall be specified in a reporting form prescribed by the Secretary to be filed by such persons.

Id.

The form used to file the report required by Section 1010.350 is the Report of Foreign Bank and Financial Accounts — Form TD–F 90–22.1 (FBAR). The instructions to the FBAR specify which persons must file as well as the types of accounts that must be reported. *See* United States Internal Revenue Service, Report of Foreign Bank and Financial Accounts 1, *available at* http://www.irs.gov/pub/irs-pdf/f90221.pdf (last accessed May 23, 2011) [hereinafter FBAR Form and Instructions]. A person who is required to file an FBAR and fails to properly file one may be subject to a civil penalty not to exceed $10,000.00. If there is reasonable cause for the failure and the balance in the account is properly reported, no penalty will be imposed. A person who willfully fails to report an account or account identifying information may be subject to a civil monetary penalty equal to the greater of $100,000.00 or 50% of the balance in the account at the time of the violation. *See* 31 U.S.C. § 5321 (a) (5) (2010) (U.S.). Willful violations may also be subject to criminal penalties. *See* 31 U.S.C. § 5322 (a) (2010) (U.S.); 31 U.S.C. 5322 (b) (2010) (U.S.); & 18 U.S.C. § 1001 (2010) (U.S.).

22. Hiring Incentives to Restore Employment Act [HIRE Act of 2010], Pub. L. No. 111-147, 124 Stat. 73 (codified as amended in scattered sections of 26 U.S.C.), tit. V, subtit. A (2010) (U.S.).

transfers to a trust categorized as Foreign Trust with U.S. Beneficiaries (Form 3520).[23]

II. OVERVIEW OF THE FBAR RULES

The FBAR filing requirements apply to any person subject to the jurisdiction of the U.S. who has a financial interest in, signature, or other authority over a bank, securities, or other financial accounts in a foreign country which has an aggregate value exceeding $10,000.00 at any time during the calendar year.[24] The FBAR is not a U.S. income tax return; it is an informational return.[25] Its due date is 30 June, not 15 April, which is the annual due date for income tax Form 1040.[26] Unlike the income tax Form 1040, no extensions are available for the FBAR.[27] Also, unlike the income tax return, the FBAR is not considered filed until it has been received by the IRS.[28]

The FBAR reporting requirements evolved from the Bank Security Act (BSA)[29] passed by the U.S. Congress on 26 October 1970.[30] The BSA created a number of reporting requirements designed to produce a paper trail identifying currency transactions and foreign accounts.[31] As time passed, the IRS discovered that many U.S. Persons subject to the disclosure

23. United States Internal Revenue Service, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520), *available at* http://www.irs.gov/pub/irs-pdf/f3520.pdf (last accessed May 23, 2011).

24. FBAR Form and Instructions, *supra* note 21, at 6.

25. *Id.* at 7.

26. *Id.*

27. *Id.* at 6.

28. *Id.*

29. Bank Secrecy Act of 1970 [BANK SECRECY ACT], 31 U.S.C. §§ 5311-5314 (e), 5316-5330, 5331, & 5332 (e) (2010) (U.S.).

30. United States Internal Revenue Service, Internal Revenue Manual, § 4.26.5.2, *available at* http://www.irs.gov/irm/part4/irm_04-026-005.html#d0e23 (last accessed May 23, 2011) [hereinafter Internal Revenue Manual].

31. Bank Secrecy Act, § 5314. The Bank Security Act of 1970 (BSA) gave the U.S. Treasury the authority to require U.S. persons to record and report transactions with foreign financial agencies. As a result, U.S. residents or persons in and doing business in the United States must file a report with the Treasury if they have foreign financial accounts that exceed $10,000.00 at any time during the calendar year. FBAR Form and Instructions, *supra* note 21, at 6.

requirements of the BSA were failing to comply. As a result, the IRS stepped up its efforts to compel compliance.[32]

In January of 2003, the IRS and the Financial Crimes Enforcement Network (FinCEN) announced an initiative to encourage the voluntary disclosure of unreported income by people who had improperly used offshore payment cards or offshore financial arrangements to avoid paying taxes.[33] In April of 2003, the IRS and FinCEN announced that they had signed a memorandum of agreement to delegate the enforcement of the FBAR rules to the IRS.[34] To assist with enforcement, the American Jobs Creation Act of 2004[35] revised the penalties for failure to report the existence of an account and for failure to provide all required financial information.[36] In October 2008, the IRS expanded the scope of the foreign bank account reporting rules and the information required to be reported for 2008 and each year thereafter.[37]

Since their creation in 1970, the FBAR reporting requirements have grown in scope regarding who may be subject to the rules, and its ever increasing penalties have reached potentially draconian levels. In the Spring of 2010, to deal with the question which a U.S. Person in the Philippines may be confronted, "How will they find my account in the Philippines?" the IRS announced a worldwide joint audit program to share information with foreign governments,[38] including the Philippines.

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32. Internal Revenue Manual, *supra* note 30.

33. Bank Secrecy Act, §§ 5321 & 5322. Failure to file a FBAR report is punishable with both civil and criminal penalties. *Id.*

34. United States Internal Revenue Service, IRS and FinCEN Announce Latest Efforts to Crack Down on Tax Avoidance Through Offshore Accounts, *available at* http://www.irs.gov/newsroom/article/0,,id=108790,00.html (last accessed May 23, 2011).

35. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of 26 U.S.C.) (2004) (U.S.).

36. *Id.* § 811. The American Jobs Creation Act of 2004 revised the penalties for failure to file a FBAR form, for failure to report the existence of an account, and for failure to provide all required information.

37. FBAR Foreign Bank Account Reporting, *available at* http://www.mpbf.com/news/articles/20039129.pdf (last accessed May 23, 2011).

38. *See* Ryan J. Donmoyer, IRS Studying 'Protocols' for Joint Audits with Other Countries, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afm_d0Arl564 (last accessed May 23, 2011).

A. Persons Subject To FBAR

The term *U.S. Person* includes: (i) a citizen or resident of the United States[39] and (ii) a person residing in and doing business in the United States.[40] On 26 February 2010, the IRS announced it was suspending FBAR filing requirements for non-U.S. citizens, non-U.S. residents, and non-U.S. domestic entities (corporations, partnerships, trusts, estates, etc.) for 2009 and earlier years.[41] The IRS also suspended FBAR filing requirements for persons who have signature authority over — but no financial interest in — a foreign financial account, allowing time until 30 June 2011 to report those foreign financial accounts.[42]

It should be noted, however, that the above suspensions are only for the years covered by suspension. For the 2009 calendar year and prior years, the IRS excludes funds which are not mutual funds from *commingled funds.*[43] As a result, foreign mutual funds remain subject to FBAR notices, while excluding other types of commingled funds. For example, a financial interest in or signature authority over a foreign hedge fund or private equity fund is not subject to FBAR notices for 2009. Unless the IRS provides further clarification in this area, such accounts may not be excluded for 2010.[44]

B. The Financial Account Must Be in a Foreign Account

39. Announcement 2010-16, *supra* note 3. *Resident* is not defined in the FBAR instructions, statute, or regulations. Look at the Green Card test, substantial test, or determine whether the individual filed an election on their income tax return to be treated as a resident.

40. *Id.* The term *person* includes individuals and all forms of business entities, trusts, and estates. A certificate of incorporation from a U.S. state establishes that the corporation is a U.S. person. However, a foreign subsidiary of a U.S. person is not subject to the FBAR filing requirements. The U.S. person will be considered to have a financial interest in any foreign financial account owned by its subsidiary. A corporation that owns directly or indirectly more than 50% interest in one or more other entities is permitted to file a consolidated FBAR. The consolidated report must include the list of entities. An authorized official of the parent corporation should sign the consolidated FBAR. *See* FBAR Form and Instructions, *supra* note 21, at 6.

41. Announcement 2010-16, *supra* note 3.

42. *Id.*

43. United States Internal Revenue Service, Notice 2010-23, *available at* http://www.irs.gov/pub/irs-drop/n-10-23.pdf (last accessed May 23, 2011). As a result, the FBAR rules as applied to foreign mutual funds were not suspended.

44. *Id.*

The financial account[45] must exist in a foreign country, which generally includes all geographical areas outside of the United States, with only a few exceptions. The United States includes: all the states; the District of Columbia; the Indian lands as defined in the Indian Gaming Regulatory Act; and the territories and insular possessions of the United States (i.e., the Commonwealth of Puerto Rico, American Samoa, Guam, the U.S. Virgin Islands, and the Commonwealth of Northern Marianna Islands).[46] A *financial account* refers to: bank accounts such as savings accounts, checking accounts, and time deposits; securities accounts such as mutual funds; brokerage accounts and securities derivatives accounts; accounts where the assets are held in a commingled fund and the account owner holds an equity interest in the fund; and, any other account maintained in a foreign financial institution or with a person doing business as a financial institution, or an insurance policy having a cash surrender value.[47]

It is the location of the account — not the nationality of the financial institution with which the account is held — that determines whether the account is in a foreign country, such as the Philippines.[48] For example, an account with a branch of a U.S. bank located in the Philippines would have

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45. I.R.C., § 1471 (d) (2). This Section provides:

> *Financial Account.* — Except as otherwise provided by the Secretary, the term 'financial account' means, with respect to any financial institution —
>
> (a) any depository account maintained by such financial institution,
>
> (b) any custodial account maintained by such financial institution, and
>
> (c) any equity or debt interest in such financial institution (other than interests which are regularly traded on an established securities market).
>
> Any equity or debt interest which constitutes a financial account under subparagraph (C) with respect to any financial institution shall be treated for purposes of this section as maintained by such financial institution.

Id.

46. FBAR Form and Instructions, *supra* note 21, at 6.

47. *Id.* Individual bonds, notes, or stock certificates held by the U.S. person are not accounts subject to the FBAR.

48. I.R.C., § 6018. Note: individual bonds, notes, or stock certificates held by the U.S. person are not accounts which are subject to the FBAR.

to be reported. Conversely, an account with a branch of a Philippines bank located within the U.S. is not required to be reported.

There are other exceptions to the FBAR filing requirements. These include accounts held in a military banking facility operated by a U.S. financial institution designated by the U.S. government to serve U.S. government installations located abroad.[49] An officer or employee of a bank that is currently examined by federal bank supervisory agencies for soundness and safety need not report that he or she has a signature or other authority over a foreign bank, securities, or other financial account maintained by the bank, as long as he or she has no personal financial interest in the account ('signature authority' is discussed further below).[50] An officer or employee of a domestic corporation, that has its equity securities listed in any U.S. national securities exchange or that has assets exceeding $10,000,000.00, and has 500 or more shareholders of record, also need not file a report concerning signature or other authority over a foreign financial account of the corporation, as long as they have no personal financial interest in the account and they have been advised in writing by the chief financial officer of the corporation that the corporation has met the filing requirements.[51]

C. The Financial Interest of a U.S. Person Needed for FBAR

The U.S. person must have a financial interest in, or signature authority, or other authority over the foreign account to come under the FBAR rules.[52] The financial interest rules are very broad. A financial interest would include legal title, irrespective of whether the account is maintained for the benefit of the title holder or the benefit of someone else.[53] If the account is maintained in the names of several persons jointly, each U.S. Person with a financial interest in the account must file the FBAR notice when the aggregate value of their foreign accounts exceeds $10,000.00.[54]

There is a minor exception for spouses.[55] The IRS will accept a single FBAR notice for an account jointly held by husband and wife. If the only

49. FBAR Form and Instructions, *supra* note 21, at 6-7.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. FBAR Form and Instructions, *supra* note 21, at 6. A spouse having a joint financial interest in an account with the filing spouse should be included as a

reportable accounts of the filer's spouse are those reported as joint owners, the filer's spouse need not file a separate report. However, where accounts are owned jointly by both spouses, the filer's spouse should also sign the FBAR notice.[56] Where the filer's spouse has a financial interest in other accounts that are not jointly owned with the filer, or has signature or other authority over other accounts, the filer's spouse should file a separate FBAR notice for all accounts, including those owned jointly with the other spouse.[57]

A person having signature or other authority over a foreign financial account must file a FBAR notice even if the person has no financial interest in the account.[58] A U.S. Person has 'signature authority' if that person can control the disposition of money or other property in the account by delivering a document containing his or her signature to the bank or another person with whom the account is maintained.[59] A person with 'other authority' over an account is one who can exercise power that is comparable to signature authority over the account by direct communication, either orally or by some other means, to the bank or other person with whom the account is maintained.[60]

Example 1: Sam, a U.S. citizen, gives Mary, a U.S. citizen, a power of attorney over his Philippine bank account, allowing her to make deposits and withdrawals. Both must file the FBAR notice. If Mary were a Philippine citizen, not a U.S. Person living in the Philippines, then only Sam would have to file the FBAR notice.

Example 2: Sam's mother, who is a Philippine citizen and not a U.S. Person living in the Philippines, gave Sam a power of attorney over her $20,000.00 bank account in the Philippines so that he can make deposits and withdrawals. Sam must file the FBAR notice.

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joint account owner in Part III of the FBAR. The filer should write 'spouse' on line 26 after the last name of the joint spousal owner. *Id.* at 8.

56. *Id.* at 6.

57. *Id.*

58. *Id.*

59. United States Internal Revenue Service, FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR) — Filing Requirements, *available at* http://www.irs.gov/businesses/small/article/0,,id=210244,00.html#FR1 (last accessed May 23, 2011).

60. *Id.*

There is also a 'financial interest' in an account in a foreign country for which the owner of record or holder of legal title is: (i) a person acting as an agent, nominee, attorney, or in some other capacity on behalf of a U.S. Person; (ii) a corporation in which the U.S. Person owns directly or indirectly more than 50% of the total value of the shares of stock or more than 50% of the total voting power for all shares of stock; (iii) a partnership in which the U.S. Person owns an interest in more than 50% of the profits, distributive share of income, or more than 50% of the capital of the partnership; or, (iv) a trust in which the U.S. Person has a present beneficial interest in more than 50% of the assets, or from which such person receives more than 50% of the income.[61]

An example of when an indirect ownership can qualify as a financial interest would be when a U.S. Person's indirect ownership is greater than 50% with respect to an entity owning the account in the Philippines. By way of illustration: Sam (a U.S. Person) owns more than 50% of a U.S. corporation and the U.S. corporation has a wholly owned foreign subsidiary with a bank account in excess of $10,000.00 in the Philippines. Here, both Sam and the U.S. corporation must file the FBAR notice.

D. Value of the Account

To be subject to the FBAR filing requirements, the aggregate amount of the accounts must have an excess value of $10,000.00 at any given time of the calendar year.[62] If the account value exceeds $10,000.00 on any account statement at any time during the calendar year, then a FBAR notice must be filed. The aggregate rule is a trap for the unwary who may think they can avoid the FBAR requirements by having multiple accounts under $10,000.00. Unfortunately, the IRS is already one jump ahead of them. If a U.S. Person has two accounts in the Philippines, one valued at $7,000.00 and

61. FBAR Form and Instructions, *supra* note 21, at 6. *See also* Internal Revenue Manual, § 4.26.16.3.4. The attribution rules in the Internal Revenue Code are not applicable to FBAR. The instructions for the FBAR provide guidance on whether an individual has a financial interest in a foreign account held by a partnership, corporation, estate, or trust.

62. FBAR Form and Instructions, *supra* note 21, at 6. *See also* Internal Revenue Manual, § 4.26.16.3.6. If a periodic account statement is not issued, the maximum account value is the largest amount of currency and/or monetary instruments in the account at any time during the year.

the other at $5,000.00, a FBAR notice would have to be filed for both accounts.[63]

E. Potential Penalties

Failure to file a FBAR notice can subject a U.S. Person to both civil and criminal penalties. The civil penalty associated with failure to file a required FBAR return is a maximum of $10,000.00 per negligent violation.[64] This can be increased to a maximum of $50,000.00 for a pattern of negligent activity.[65] For willful violations, the maximum penalty is the greater of $100,000.00 or 50% of the amount in the account at the time of the violation.[66] Generally, a willful violation requires the U.S. Person to have had knowledge that a FBAR notice was required to be filed.

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63. FBAR Form and Instructions, *supra* note 21, at 6.

64. Bank Secrecy Act, § 5321 (a) (5) (B).

65. *Id.* This Section provides:

> (5) Foreign financial agency transaction violation. —
>
> …
>
> (B) Amount of penalty. —
>
> (i) In general. — Except as provided in subparagraph (C), the amount of any civil penalty imposed under subparagraph (A) shall not exceed $10,000.
>
> (ii) Reasonable cause exception. — No penalty shall be imposed under subparagraph (A) with respect to any violation if —
>
> (I) such violation was due to reasonable cause, and
>
> (II) the amount of the transaction or the balance in the account at the time of the transaction was properly reported.

Id.

66. *Id.* § 5321 (a) (5) (C). This Section provides:

> (C) Willful violations. — In the case of any person willfully violating, or willfully causing any violation of, any provision of section 5314 —
>
> (i) the maximum penalty under subparagraph (B)(i) shall be increased to the greater of —
>
> (I) $100,000, or
>
> (II) 50 % of the amount determined under subparagraph (D), and
>
> (ii) subparagraph (B)(ii) shall not apply.

The test for willfulness is determining whether there was a voluntary, intentional violation of a known legal duty to file the FBAR notice. The burden of establishing willfulness is on the IRS, but once established, the penalty is severe.[67]

Example: Paul, a U.S. citizen retiree, has a $1,000,000.00 bank account in a Philippine bank in Manila and is found to be in willful violation of the FBAR filing requirements. His penalty could be as much as $500,000.00 — a very costly penalty for simply failing to comply with the FBAR rules.

The possible criminal penalties include: (i) a maximum fine of $250,000.00; (ii) a maximum term of imprisonment of five (5) years; or, (iii) both.[68] These penalties can be increased in certain circumstances to: (i) a fine no greater than $500,000.00; (ii) imprisonment no longer than ten (10) years; or, (iii) both.[69]

The IRS has announced that no penalty will be asserted for late filing if the delinquency was due to reasonable cause. The *reasonable cause exception*[70] applies to numerous penalty provisions under the Internal Revenue Code, and there is a well-developed body of case law to consider in this context. Unfortunately, the reasonable cause exception tends to be difficult to establish in FBAR cases.[71]

F. Amnesty

On 8 February 2011, the IRS announced a new 2011 Voluntary Disclosure Initiative (OVDI) for U.S. Persons to disclose their unreported offshore accounts.[72] The initiative covers tax years 2003 through 2010.[73] The OVDI is open to U.S. Persons, including individuals, corporations, partnerships,

Id.

67. *Id.*

68. Bank Secrecy Act, § 5322 (a).

69. *Id.* § 5322 (b). *See also* FBAR Form and Instructions, *supra* note 21, at 6.

70. *See* Bank Secrecy Act, § 5321 (a) (5) (B).

71. The IRS may take the position that if Schedule B, Part III on Form 1040 is checked "no," and there is a foreign account, the act of checking "no" is willful.

72. United States Internal Revenue Service, 2011 Offshore Voluntary Disclosure Initiative (OVDI), *available at* http://www.irs.gov/newsroom/article/0,,id=234900,00.html (last accessed May 23, 2011).

73. *Id.*

and trusts. U.S. Persons under examination or under criminal investigation, however, are ineligible to participate in the program.[74]

This is the second amnesty offer from the IRS for U.S. Persons with unreported income from offshore accounts. The first amnesty period ended on 31 October 2009, and produced roughly 15,000 disclosures to the IRS. Participants were subject to a 20% penalty rate covering a six-year window.[75]

In exchange for participating in the OVDI, taxpayers with undisclosed offshore accounts can avoid criminal prosecution for their unpaid taxes and may be subject to significantly reduced penalties. To participate in the OVDI, U.S. Persons must file or amend their tax returns and the FBAR Notice, and pay all delinquent taxes, interest, and penalties by 31 August 2011.[76]

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74. United States Internal Revenue Service, 2011 OVDI Frequently Asked Questions and Answers, *available at* http://www.irs.gov/businesses/international /article/0,,id=235699,00.html (last accessed May 23, 2011) [hereinafter 2011 OVDI Details].

75. United States Internal Revenue Service, 2009 Offshore Voluntary Disclosure Program, *available at* http://www.irs.gov/newsroom/article/0,,id=206012,0 0.html (last accessed May 23, 2011).

76. 2011 OVDI Details, *supra* note 74. Taxpayers that fully comply with the offer will avoid criminal prosecution and will be able to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues. Taxpayers who do not submit a voluntary disclosure run at the risk of detection by IRS and the imposition of substantial penalties, including a fraud penalty and foreign information return penalties, and an increased risk of criminal prosecution. To take advantage of the 2011 OVDI, taxpayers must:

    (a) Provide copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure. Calendar year taxpayers must include tax years 2003 through 2010 in which they have undisclosed foreign accounts and/or undisclosed foreign entities. Fiscal year taxpayers must include fiscal years ending in calendar years 2003 through 2010.

    (b) Provide complete and accurate amended federal income tax returns (for individuals, Form 1040X, or original Form 1040, if delinquent) for all tax years covered by the voluntary disclosure, with applicable schedules detailing the amount and type of previously unreported income from the account or entity (e.g., Schedules B, D and E).

    (c) File complete and accurate original or amended offshore-related information returns and Form TDF90-22.1 (Report of Foreign Bank

Under the OVDI, U.S. Persons will be subject to a 25% penalty on the highest aggregate account balance on their undisclosed account(s) between the 2003 and 2010 tax years.[77] If the value of the undisclosed account(s) was less than $75,000.00 at all times during the tax years in question, the penalty is reduced to 12.50%.[78] Moreover, in limited situations, a penalty of 5% may be imposed.[79]

U.S. Persons who have made quiet disclosures by filing amended returns and paying related tax and interest for previously unreported offshore income without otherwise notifying the IRS are encouraged to participate in the OVDI. U.S. Persons who make quiet disclosures without seeking the

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and Financial Accounts, also known as an FBAR) for calendar years 2003 through 2010.

(d) Cooperate in the voluntary disclosure process, including providing information on offshore financial accounts, institutions and facilitators, and signing agreements to extend the period of time for assessing tax and penalties.

(e) Pay (i) 20% accuracy-related penalties under 26 U.S.C. § 6662(a) (2010)(U.S.) on the full amount of under payments of tax for all years; (ii) failure to file penalties under 26 U.S.C. § 6651(a)(1) (2010) (U.S.), if applicable and (iii) failure to pay penalties under 26 I.R.C. § 6651 (a)(2) (2010)(U.S.), if applicable.

(f) Pay instead of all other penalties that may apply, including FBAR and offshore-related information return penalties, a miscellaneous Title 26 offshore penalty, equal to 25% (or in limited cases 12.5% or 5%) of the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the period covered by the voluntary disclosure.

(g) Submit full payment of all tax, interest, accuracy-related penalty, and, if applicable, the failure to file and failure to pay penalties, or make good faith arrangements with IRS to pay in full, the tax, interest, and these penalties (the suspension of interest provisions of 26 I.R.C. § 6404 (g)(2010)(U.S.) do not apply to interest due in the new initiative).

(h) Execute a Closing Agreement on Final Determination Covering Specific Matters, Form 905.

Id.

77. *Id.*

78. *Id.*

79. *Id.*

protection of the OVDI run the risk of being examined, and potentially prosecuted, for all applicable years.[80]

III. THE HIRE ACT AND THE NEW FATCA RULES

The Hiring Incentives to Restore Employment Act of 2010 (HIRE Act)[81] was passed on 18 March 2010. In addition to encouraging U.S. employers to hire new employees, it made changes to the Foreign Account Tax Compliance Act of 2009 (FATCA).[82] These changes to FATCA includes a comprehensive set of measures to reduce offshore noncompliance by giving the IRS new administrative tools to detect, deter, and discourage offshore tax abuse.[83]

FATCA is generally effective for tax years beginning after 18 March 2010. The intent of FATCA's disclosure rules is to raise revenue. Thus, FATCA will make it more difficult for U.S. Persons to hide assets outside the U.S. in places such as the Philippines.[84]

The new FATCA rules mainly affect three areas: (i) increased reporting for U.S. Persons with foreign assets; (ii) changes made in the U.S. IRC; and, (iii) disclosure and compliance issues applicable to foreign financial institutions.[85] The term *U.S. Person* denotes a citizen or resident of the U.S., a domestic partnership or corporation, any estate (other than a foreign estate), and any trust if: (i) a court within the U.S. is able to exercise primary

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80. *Id.*

81. Hiring Incentives to Restore Employment Act [HIRE Act of 2010], Pub. L. No. 111-147, 124 Stat. 73 (codified as amended in scattered sections of the I.R.C.) (2010) (U.S.).

82. *Id.* tit. V, sub. A. Note that the Foreign Account Tax Compliance Act of 2009 was enacted as part of the HIRE Act of 2010, which is "an important development in U.S. efforts to combat tax evasion by U.S. persons holding investments in offshore accounts." United States Internal Revenue Service, Summary of Key FATCA Provisions, *available at* http://www.irs.gov /businesses/corporations/article/0,,id=236664,00.html (last accessed May 23, 2011).

83. *Id.*

84. *See generally* King & Spalding Client Alert, HIRE Act's Foreign Account Tax Compliance Provisions Will Change the Global Financial System, *available at* http://www.kslaw.com/Library/publication/ca032610b.pdf (last accessed May 23, 2011).

85. *See generally* HIRE Act of 2010.

supervision over the administration of the trust and (ii) one or more U.S. Persons have the authority to control all substantial decisions of the trust.[86]

A. Increased Disclosure Under FATCA

U.S. Persons with foreign accounts already have filing requirements under the FBAR notice requirements which are applicable to foreign accounts.[87] FATCA imposes another filing requirement that is broader than the FBAR notice rules.[88] Under the FATCA disclosure rules, U.S. Persons are required to report specified foreign financial assets when the aggregate value exceeds $50,000.00.[89] The statute defines a *specified foreign financial asset* to include ownership of (i) any financial account maintained by a foreign financial institution; (ii) any stock or security issued by a non-U.S. person; (iii) any financial interest or contract held for investment that has a non-U.S. issuer or counter party; and, (iv) any interest in a foreign entity.[90]

Because the FATCA reporting requirements are much broader than those of the FBAR, a U.S. Person who may not have an FBAR filing requirement may be subject to the FATCA reporting requirement. This situation is due to the fact that the FATCA notice is applicable to financial assets in addition to financial accounts. For example, under the FATCA, a U.S. Person who owns stock in a Philippine corporation that is held in the Philippines will have to report this investment, whereas the same person would not have to report the investment under the FBAR rules.[91]

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86. I.R.C., § 7701 (a) (30). The term *person* includes individuals and all forms of business entities, trusts, and estates. A certificate of incorporation from a U.S. State establishes that the corporation is a U.S. person. *See* I.R.C., § 7701 (a) (1).

87. *See* FBAR Form and Instructions, *supra* note 21.

88. HIRE Act of 2010, § 511. The said Section creates I.R.C., § 6038D.

89. I.R.C., § 6038D (b). It is not clear if the IRS will create a new form on which this disclosure will be made. If it is up to taxpayers to make the disclosure by a method they adopt, or whether a Form 8275 Disclosure Statement should be used. What is clear is that taxpayers are to attach the FATCA disclosure to their Form 1040.

90. *Id. Foreign Entity* is defined "by reference to Section 1473" as any entity that is not a U.S. person. *See* I.R.C. § 1473 (5). Consequently, taxpayers who purchase foreign real estate through an entity will have a filing obligation.

91. *See generally* Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations — Reports of Foreign Financial Accounts, 75 Fed. Reg. 8844 (proposed Feb. 26, 2010) (to be codified at 31 C.F.R. pt. 103), *available at* http://www.fincen.gov/statutes_regs/frn/pdf/2010-4042.pdf (last

The FATCA disclosure must include the maximum value of the asset during the tax year[92] and must include the name and address of the financial institution and account number of the taxpayer's account[93] or, in the case of a stock or security, the name and address of the issuer and the class or issue of the stock or security.[94] Similar identification must be disclosed for other types of assets.[95] In addition, the Secretary of the U.S. Treasury can require any domestic entity which is formed or availed for purposes of holding specified foreign financial assets, whether directly or indirectly, to file the FATCA disclosure as if it were an individual.[96]

There is also a presumption that a U.S. Person with foreign financial assets has a filing obligation for purposes of the penalty which will be imposed if the IRS believes the taxpayer has an interest in one or more of such assets and the taxpayer does not provide sufficient information to demonstrate the aggregate value is less than $50,000.00.[97] Therefore, having financial assets with values less than $50,000.00 in several foreign financial institution does not avoid the FATCA filing requirement.

B. Financial Institution Disclosure

Effective 12 December 2012, the FATCA has added a new withholding system[98] that requires foreign financial institutions with U.S. customers and foreign non-financial entities with substantial U.S. owners, to disclose information regarding the U.S. Persons. A foreign financial institution means any financial institution that is a foreign entity, but excludes any financial

accessed May 23, 2011). The FBAR regulations issued by FinCEN on Feb. 26, 2010 exempt these assets from FBAR reporting.

92. I.R.C., § 6038D (c) (4).

93. *Id.* § 6038D (c) (1).

94. *Id.* § 6038D (c) (2).

95. *Id.* § 6038D (c) (3).

96. *Id.* § 6038D (f). The Secretary is to issue regulations exempting nonresident aliens and bona fide residents of any U.S. possession from the disclosure. *Id.* § 6038D (h). The Secretary also has authority to exempt certain assets from being reported.

97. I.R.C., § 6038D (e).

98. HIRE Act of 2010, § 501. The said Section added a new chapter to the Internal Revenue Code and created Sections 1471 and 1472, where the new withholding system is laid out. *See* I.R.C., §§ 1471 & 1472. These provisions are generally applicable to payments made after Dec. 31, 2012.

institution organized under the laws of any U.S. possession.[99] Failure to comply will subject such institutions to penalties.

No withholding is required if an agreement exists between the foreign financial institution and the IRS and the institution agrees to: (1) obtain information regarding account holders that is necessary to determine which accounts are U.S. accounts; (2) comply with verification and due diligence procedures as the IRS requires with regard to identification of U.S. accounts; (3) report certain information annually on any U.S. account; (4) deduct and withhold a 30% tax with respect to certain recalcitrant account holders; (5) comply with any requests by the IRS for additional information regarding any U.S. account maintained at the institution; and, (6) attempt to obtain a waiver in any case where a foreign law would prevent the reporting of information required by this provision with respect to any U.S. account.[100]

A foreign financial institution that is a party to an agreement with the IRS must report the following information regarding each U.S. account maintained by the institution: (1) the name, address, and Taxpayer Identification Number (TIN) of each U.S. Person account holder; (2) the name, address, and TIN of each substantial U.S. owner (i.e., generally more than 10% ownership) of any account holder that is a U.S. owned foreign entity; (3) the account number; (4) the account balance as of the time prescribed by the IRS; and, (5) the gross receipts and gross withdrawals from the account in the manner prescribed by the IRS.[101]

In instances where the specific reporting requirements are not met, withholding agents are required to withhold 30% of the withholdable payments from sources within the U.S. made to a foreign financial institution or non-financial foreign entity.[102] Withholdable payments are any payments of interest, dividends, rents, salaries, wages, or other fixed or determinable annual periodic gains or income from sources within the U.S.[103] A withholding agent includes any person, in whatever capacity,

99. I.R.C., § 1471 (d) (4).

100. *Id.* § 1471 (b) (1).

101. *Id.* § 1471 (c) (1).

102. *Id.* §§ 1471 (a) & 1472 (a).

103. *Id.* § 1473 (1) (A).

having control, receipt, custody, disposal, or payment of any withholdable payment.[104]

The rules described above do not apply to any payment beneficially owned by: (i) any corporation that is a member of an expanded affiliated group that includes a publicly traded corporation; (ii) any foreign government (or political subdivision, wholly-owned agency, or instrumentality); (iii) any international organization (or wholly-owned agency or instrumentality); (iv) any foreign central bank of issue; or, (v) any other class of persons identified by the Treasury secretary.[105] Further, a foreign financial institution is not required to disclose account information if the account holder is an individual whose aggregate value of depository accounts held (in whole or in part) and maintained by the same financial institution which maintains such account does not exceed $50,000.00.[106]

C. Penalties

The minimum penalty for failing to submit the required disclosure is a fine of $10,000.00,[107] which increases by $10,000.00 for each 30-day period following notification from the Treasury Department, with a maximum penalty of $50,000.00.[108] There is, however, a 90-day grace period following notification from the Treasury before the additional $10,000.00 penalties accrue.[109] The penalty may be waived if the taxpayer is able to demonstrate that the failure to file was due to reasonable cause.[110] It is important to realize that taxpayers who have this disclosure requirement are also likely to have an FBAR filing requirement. While the penalty for failure to file the FBAR is harsher than the penalty under the FATCA, both of these penalties

104. *Id.* § 1473 (4). A withholding agent required to deduct and withhold any tax to enforce FATCA reporting on foreign accounts is liable for the tax. With regard to the tax withheld, the withholding agent will be indemnified against claims and demands from anyone for the amount of taxes withheld. *See* I.R.C., § 1474 (a).

105. I.R.C., § 1471 (d) (1) (B).

106. *Id.*

107. *Id.* § 6038D (d) (1). This is similar to the penalty for failure to file Form 5471 — *Information Return of U.S. persons With Respect To Certain Foreign Corporations,* and Form 3520 — *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*

108. *Id.* § 6038D (d) (2).

109. *Id.*

110. *Id.* § 6038D (g).

can be assessed with regard to assets covered by both the FBAR and FATCA rules.

Section 6662 (a) of the IRC permits the IRS to impose a 20% penalty on a substantial understatement of income tax or for negligence or disregard of rules or regulations that is not attributable to fraud (for which a 75% penalty applies).[111] Section 512 of the FATCA amended Section 6662 of the IRC and adds a penalty of 40% on any portion of an underpayment attributable to a transaction involving an undisclosed financial asset that should have been reported under Sections 6038, 6038B, 6046A, 6048 or new Section 6038D of the IRC.[112] The increased penalty structure is effective for tax years beginning after 18 March 2010.[113]

D. Expanded Statute of Limitations

Generally, the IRS has three years from the filing of a return in which to audit a taxpayer and assess additional taxes.[114] The period is increased to six years if a taxpayer omits 25% or more of their gross income.[115] The FATCA has extended the statute of limitations to six years where a taxpayer omits more than $5,000.00 of income attributable to one or more assets required to be reported under the FATCA notice rules. If the $5,000.00 test is met, the IRS will have six years in which to investigate and audit the taxpayer.[116] As a result, the extended stature of limitations is applicable to: (i) returns filed after the 18 March 2010 date of enactment and (ii) returns filed on or before such date if the limitation period has yet to expire.[117]

E. Foreign Targeted Obligations

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111. I.R.C., § 6662 (a).

112. HIRE Act of 2010, § 512 (a) (2).

113. *Id.* § 512 (b).

114. I.R.C., § 6501 (a).

115. *Id.* § 6501 (e).

116. HIRE Act of 2010, § 513 (a) (1) (A). However, the three-year and six-year statutes of limitations will be suspended until the information required to be reported under Sections 1295(b), 1298(f), 6038, 6038A, 6038B, 6046, 6046A, 6048, or new Section 6038D is provided to the IRS.

117. *Id.* § 513 (d).

Bearer bonds (i.e., bonds that do not have an official record of ownership) make it possible for individuals seeking to evade taxes to invest in secret.[118] Prior to the FATCA, a deduction was permitted for foreign targeted obligations that were issued in bearer format, provided certain exceptions were satisfied.[119] Section 502 of the FATCA repeals the foreign targeted obligation exception.[120] Consequently, for obligations issued in bearer format after 18 March 2012, an interest deduction will be prohibited under the FATCA unless the obligation: (i) is issued by an individual; (ii) matures in no more than one year; or, (iii) is not of a type offered to the public.[121] As a result, bearer debt obligations with a maturity greater than one year will not be permitted an interest deduction on the obligation unless the obligations qualify for the FATCA exception.[122] The FATCA also denies a tax exemption for interest on state and local bonds not issued in a registered form. For state and local bonds issued after 18 March 2012, the tax-exempt status will be denied unless the obligation matures in no more than one year or is not of a type offered to the public.[123]

F. Reporting Rule for PFICs

Effective 18 March 2010, activities with respect to passive foreign investment companies (PFICs) are subject to a new FATCA reporting rule.[124] Generally, a foreign corporation will qualify as a PFIC if: (i) 75% or more of its gross income in the tax year is passive income or (ii) on average during the tax year, at least 50% of the assets held by the corporation produce passive income or are held for the production of passive income.[125] Section

118. Ashley Quinn, Offshore Anti-abuse and Other Foreign Provisions in the HIRE Act, *available at* http://www.ashleyquinncpas.com/resources/view_res.php?resourceID=139 (last accessed May 23, 2011).

119. Kevin E. Packman & Mauricio D. Rivero, The Foreign Account Tax Compliance Act — Taxpayers face more disclosures and potential penalties, *available at* http://www.journalofaccountancy.com/Issues/2010/Aug/20102736.htm?action=print (last accessed May 23, 2011) [hereinafter FATCA Primer].

120. HIRE Act of 2010, § 502 (a).

121. FATCA Primer, *supra* note 119.

122. *Id.*

123. *Id.*

124. *See generally* Alston + Bird LLP, International Tax Advisory, *available at* http://ddcpatlaw.com/files/Publication/a9288f39-5ed3-415e-ad0b00ae05ae843a/Presentation/PublicationAttachment/24882616-2ffc-4bb094b801df0c8b276f/Int%20Tax% 20Adv%205-10.pdf (last accessed May 23, 2011).

125. FATCA Primer, *supra* note 119.

521 of FATCA amends Section 1298 of the IRC to require shareholders in a PFIC to file an annual information return disclosing their ownership in the PFIC.[126] Under the previous law, such disclosure was required only when taxpayers make a qualifying elective fund election, received certain distributions from the PFIC, or disposed of their interest in the PFIC.[127] A person who meets this new reporting requirement could, however, also have to meet the new reporting rule requiring disclosure of information with respect to foreign financial assets.[128] To avoid duplicative reporting, one could hope that the IRS will exercise its regulatory authority to require only one filing.

IV. FORM 3520 DISCLOSURE REQUIREMENTS

When a U.S. Person transfers assets to a foreign trust that has U.S. beneficiaries, the IRC deems the trust to be a grantor trust,[129] and the U.S. transferor is responsible for reporting the transaction on IRS Form 3520. To avoid the reporting requirement, the burden is on the U.S. Person funding a foreign trust to establish that it is not a grantor trust. To do so, where a U.S. Person directly or indirectly transfers property to a foreign trust (other than a trust established for deferred compensation or a charitable trust), they must demonstrate to the satisfaction of the IRS that under the terms of the trust: (i) no part of the trust may be paid or accumulated during the year for the benefit of a U.S. Person; (ii) that if the trust were terminated during the year, no part of the trust could be paid to a U.S. Person; and, (iii) that such person provides any additional information the IRS may require with respect to such a transfer.[130]

Where a taxpayer fails to file IRS Form 3520 the following penalties may apply:

> (1) 35% of the gross value of any property transferred to the foreign trust for failure of a U.S. transferor to report the transfer;
>
> (2) 35% of the gross value of the distributions received from a foreign trust for failure of a U.S. Person to report receipt of the distribution; or

126. *Id.*

127. *Id.*

128. *Id.*

129. I.R.C., § 679 (a) (1). *See also* FATCA Primer, *supra* note 119.

130. *Id.* § 679 (c) (1).

(3) 5% of the receipt of certain foreign gifts for each month for which failure to report continues (up to a maximum of 25%).[131]

Additional penalties may be imposed if noncompliance continues after the IRS notice of failure to comply with required reporting has been received.[132] This penalty may not exceed the gross reportable amount. Penalties will not apply if noncompliance is due to reasonable cause and not willful neglect.[133]

FATCA strengthens this penalty by imposing a minimum penalty of $10,000 on any failure to file.[134] This provision applies to notices and returns required to be filed after 31 December 2009.[135] Effective for transfers to a foreign trust after 18 March 2010, FATCA has added several new provisions to Section 679 of the IRC to enforce the obligation to file Form 3520, including three subparagraphs to Section 679(c), which are designed to find a U.S. beneficiary of the foreign trust.[136]

FATCA also provides that any use of trust property after 18 March 2010 by a U.S. grantor, U.S. beneficiary, or any U.S. Person related to a U.S. grantor or U.S. beneficiary is treated as a distribution.[137] The individual using the trust property will be subject to income equal to the fair market value on the use of the property or loan under Section 643(i)(1) of the IRC.[138] This rule does not apply to the extent that the foreign trust is paid fair market value for the use of the property within a reasonable period following the use.[139] FATCA does not define a *reasonable period*, but presumably, this will be defined in subsequent Treasury regulations.[140]

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131. *Id.* § 6677, ¶¶ (a)-(c). *See also* United States Internal Revenue Service, 2010 Instructions for Form 3520 2, *available at* http://www.irs.gov/pub/irs-pdf/i3520.pdf (last accessed May 23, 2011).

132. *Id.* § 6677 (a).

133. *Id.* § 6677 (d).

134. HIRE Act of 2010, § 535 (a).

135. *Id.* § 535 (b).

136. *Id.* § 531.

137. *Id.* § 533 (e).

138. *Id.* § 533 (a) (1).

139. *Id.* § 533 (b).

140. It is interesting to note that a subsequent return of the property to the foreign trust is disregarded for tax purposes under the IRC. *See* I.R.C., § 643 (i) (3).

This new rule can be a trap when a U.S. Person moves to the Philippines and buys a house to live in and then, for estate planning purposes, creates a trust to hold the house. Unless they pay fair market rent, income will be imputed to them, which will mostly likely come as an unpleasant surprise.

V. THINKING ABOUT GIVING UP U.S. CITIZENSHIP TO AVOID TAX ISSUES

When U.S. retirees in the Philippines are faced with or become aware of the top three penalties, plus the additional penalties that may apply to them, it comes as no surprise that many retirees who are in the Philippines and do not intend to return to live in the U.S. may ask themselves, "Should I give up my U.S. citizenship?" This is one of the means of avoiding penalties which could be triggered by a simple mistake. Perhaps they will start to think, "If I want to visit the U.S., I will get a visa." This could lead to an additional question, "What do I need to do to give up my citizenship?" To answer this question, the individual needs to review the tax issues associated with giving up citizenship, which are set forth in the IRC.[141]

A. Overview of a Covered Expatriate

Expatriation tax rules apply to U.S. citizens who relinquish their citizenship and also to long-term U.S. residents who cease to be lawful permanent residents.[142] A *long-term resident* is an individual who was a lawful permanent resident for at least eight of the past 15 tax years as a green card holder.[143] If the individual had a green card on any day in a certain year, he or she will be treated as a lawful permanent resident for that year.[144] A year in which the

141. Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, 122 Stat. 1624 (codified as amended in scattered sections of 26 U.S.C.) (2008) (U.S.). Section 301 of the Act dramatically alters the playing field for individuals who relinquish their U.S. citizenship or terminate their long-term U.S. residence (i.e., U.S. persons who 'expatriate'). It does this by adding new Sections 877A and 2801 to the IRC, which, respectively, impose "mark-to-market" and "succession tax" regimes on such individuals. *See also* I.R.C., §§ 877A & 2801.

142. I.R.C., § 877 (g) (2). The expatriation regime applies only to a covered expatriate. *Id.* § 877A.

143. *Id.* § 877, ¶¶ (e) (1) & (e) (2). The reference to *lawful permanent resident* in Section 877 (e) (1) means someone who has a "green card." *Id.* § 7701 (b) (6).

144. *Id.* § 7701 (b) (1) (a) (i).

individual had *substantial presence* in the U.S. but did not have a green card does not count towards the eight-out-of-15 year rule.

The *expatriation date* is defined to mean the date that a U.S. citizen relinquishes U.S. nationality or the date that a long-term resident alien ceases to be a lawful permanent resident.[145] A citizen is considered to have relinquished U.S. citizenship at the earliest of the dates: (i) he or she renounces his or her nationality before a U.S. diplomatic or consular officer; (ii) he or she provides a statement of voluntary relinquishment to the Department of State; (iii) the Department of State issues the individual a Certificate of Loss of Nationality (CLN); or, (iv) a U.S. court cancels a naturalized citizen's certificate of naturalization.[146] An individual ceases to be a lawful permanent resident if he or she: (i) commences to be treated as a resident of a foreign country under the provision of an applicable tax treaty with the U.S.; (ii) does not waive tax benefits available under the treaty; and, (iii) notifies the IRS of the commencement of such treatment.[147]

An expatriate is considered to be a *covered expatriate* if he or she: (i) has an average U.S. income tax liability for the five-year period prior to expatriation which is greater than $145,000.00 (adjusted annually for inflation); (ii) has a net worth of $2,000,000.00 or more; or, (iii) fails to certify under penalty of perjury that he or she has complied with U.S. tax requirements for the five preceding tax years.[148] Even if the U.S. citizen or long-term resident green card holder seeking to expatriate does not have significant wealth, which meets or exceeds the income tax test or the net worth test, the expatriation rules will still apply if the individual fails to certify under penalty of perjury that he or she has complied with U.S. tax obligations for the five preceding tax years, or if he or she fails to submit proper evidence of compliance to the IRS.[149]

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145. *Id.* § 7701 (b) (2) (a) (ii).

146. I.R.C., § 877A (g) (3).

147. *Id.* § 7701 (b) (6). Having a green card lapse for immigration purposes does not, by itself, render an individual an expatriate. Notification to the IRS by a lawful permanent resident is done by claiming treaty benefits on a Form 8833 filed with his or her U.S. income tax return. Article 3 of the U.S.-Philippine Income Tax Convention sets forth the rules to determine when a person is a resident of the Philippines under the treaty. *See* U.S.-Philippine Income Tax Convention, art. 3.

148. I.R.C., § 877 (a) (2).

149. *Id.* § 877 (a) (2) (C).

The bottom line is that any individual planning to give up their U.S. citizenship or lawful permanent resident status needs to understand the U.S. expatriation exit tax rules. Failure to do so could result in substantial income taxes under the *mark-to-market* rules.

B. The Mark-to-Market Exit Tax and the Inheritance Tax

The so-called mark-to-market acceleration rules create the so-called exit tax which applies to the net unrealized gain on the expatriate's worldwide assets as if such property were sold for its fair market value on the day before the expatriation date.[150] The assets subject to this tax are those that would have been included in the expatriate's gross estate for U.S. estate tax purposes if the individual had died while domiciled in the U.S. the day before the expatriation date.[151] The exit tax is calculated by computing the expatriate's income tax liability, assuming the worldwide property of the covered expatriate is deemed to have been sold at fair market value on the date before the expatriation date.[152]

Under these mark-to-market rules, any gain on the deemed sale is recognized, notwithstanding any other non-recognition rules. Any loss is taken into account for the tax year of the sale to the extent otherwise provided in the tax law, except that the wash sale rules do not apply.[153] The covered expatriate is then liable for U.S. income tax on the net gain of the deemed sale to the extent that it exceeds $627,000.00 (in 2010 and adjusted for inflation).[154]

In calculating the gain and resulting exit tax due for a long-term resident, property is treated as having a basis equal to the fair market value of the property on the date that the individual first became a resident of the

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150. *Id.* § 877A (a) (1).

151. I.R.S. Bull No. 2009-45, 2009-45 I.R.B. 598 (Nov. 9, 2009), *available at* http://www.irs.gov/pub/irs-irbs/irb09-45.pdf (last accessed May 23, 2011). Fair Market Value will generally be determined in accordance with estate tax valuation principles. *Id.*

152. *Id.* § 877A (a) (2).

153. *Id.* § 1091. *See also* I.R.S. Bull No. 2008-45 (Nov. 10, 2008), *available at* http://www.irs.gov/pub/irs-irbs/irb08-45.pdf (last accessed May 23, 2011) & I.R.S. Rev. Proc. 2008-66, 2008-45 I.R.B. 1107 (Nov. 10, 2008) (U.S.).

154. Richard Cassell et al., Details of the exit tax for US expatriates, *available at* http://www.international-adviser.com/article/number-of-expat-americans-renouncing-their-citizenship-rises¤t_page=2 (last accessed May 23, 2011).

U.S., unless the individual elects otherwise.[155] For property acquired after the individual became a resident, the standard basis rules apply.[156]

The calculation of the exit tax includes the worldwide property of the covered expatriate (with some exceptions), including: (i) property held in a trust in which any portion is treated as owned by the expatriate under the grantor trust rules; (ii) the present value of the covered expatriate's accrued benefit with respect to deferred compensation; and, (iii) the fair market value of unvested property and property rights received in connection with the performance of service not previously included as income pursuant to IRC 83.[157] As discussed below, the acceleration rules do not apply to certain types of deferred compensation.

Under the acceleration rules, the expatriate is treated as having received the entire interest in the following accounts the day before the effective date of expatriation:[158]

(a) an Individual Retirement Account (IRA), other than a simplified employee pension as defined in IRC 408(k) or a simplified retirement account as defined in IRC 408(p);

(b) a qualified tuition account as defined in IRC 529;

(c) a Coverdell education savings account as defined in IRC 530;

(d) an Archer medical savings account as defined IRC 220; and

(e) a health savings account as defined in IRC 233.[159]

Subject to certain requirements, a covered expatriate may elect to defer payment of the exit tax on some or all of the property deemed to be sold until the due date of the return for the taxable year in which the property is actually disposed (or transferred by gift or death). To take advantage of the deferral, the individual must provide adequate security; waive any right under any treaty which would preclude assessment of the tax; and, pay

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155. Deloitte, Frequently Asked Questions About the Changing Expatriate Environment 2, *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_tax_ExpatHEARTAct_080808.pdf (last accessed May 23, 2011).

156. *Id.*

157. *See* I.R.C., § 877A (c) for the exceptions.

158. I.R.C., § 877A (e).

159. *Id.* Although expatriation causes the deemed receipt of these amounts, no early distribution penalty that would result from an actual distribution applies.

interest at the underpayment rate. Furthermore, the election to defer is irrevocable.[160]

The *deemed sale rule* in determining the exit tax does not apply to certain types of deferred compensation. Instead, eligible deferred compensation is subject to a flat 30% withholding tax on any taxable payment at the time of distribution (which is lower than the U.S. income tax top marginal rate for 2010).[161] A taxable payment for a covered expatriate is any payment that would be included in the gross income of the covered expatriate if the expatriate continued to be subject to tax as a U.S. citizen or resident.[162]

Deferred compensation includes qualified pension, profit sharing, and stock bonus plans (including 401(k) plans). Such deferred compensation qualifies as eligible deferred compensation if: (i) the payor is a U.S. Person or a non-U.S. Person who elects to be treated as a U.S. Person for this purpose; (ii) the covered expatriate notifies the payor of his or her status as a covered expatriate; and, (iii) the covered expatriate irrevocably waives any treaty right that would otherwise reduce the 30% withholding tax applicable to the eligible deferred compensation.[163]

Where a trust is treated as owned by a covered expatriate under the grantor trust rules, whether directly or indirectly, the assets held by the trust are subject to the exit tax net worth calculation.[164] If the trust is not treated as a grantor trust, then the exit tax does not apply.

Where the trust is a non-grantor trust, a withholding tax in lieu of the up-front exit tax applies to distributions from the trust to the covered expatriate.[165] For the withholding tax to apply, the covered expatriate must be a beneficiary of the trust on the day before the expatriation date.[166] Therefore, if the covered expatriate ceases to be a beneficiary prior to the expatriation date, then there is no withholding tax.

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160. *Id.* §§ 877A (b) & 6601.

161. *Id.* § 877A (d) (1) (A).

162. *Id.* § 877A (d) (3) (A).

163. *Id.* § 877A (d) (3) (B).

164. STAFF OF JOINT COMM. ON TAXN., 110TH CONG., TECHNICAL EXPLANATION OF H.R. 6081, "THE HEROES EARNINGS ASSISTANCE AND RELIEF TAX ACT OF 2008," AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON MAY 20, 2008 (JCX-44-08) 43 (2008) (U.S.).

165. *Id.* at 44.

166. *Id.*

Where the withholding tax applies, the trustee of the trust must deduct and withhold an amount equal to 30% of the taxable portion of the distribution to the covered expatriate.[167] For this purpose, the taxable portion of the distribution is the portion of the distribution that would be includible in the gross income of the covered expatriate if the expatriate continued to be subject to tax as a U.S. citizen or resident.[168] If the fair market value of the property exceeds its adjusted basis in the hands of the trust, gain is recognized by the trust as if such property were sold to the expatriate at its fair market value.[169]

In addition to the mark-to-market tax on the covered expatriate's worldwide assets, there is also an inheritance tax imposed on certain gifts and bequests made by the covered expatriate to any U.S. Person.[170] The inheritance tax differs substantially from ordinary U.S. gift and estate tax principles in that it is a tax upon the act of receiving, whereas the transfer tax has historically been imposed only upon the act of giving.

The inheritance tax applies to the extent that the gift or bequest to any individual exceeds $10,000.00[171] during the calendar year, and is assessed at the highest marginal estate or gift tax rate in effect on the date of transfer.[172] The inheritance tax is imposed on a covered gift or bequest in which any property is acquired: (a) by gift, directly or indirectly, from an individual who was a covered expatriate at the time of such acquisition or (b) directly or indirectly, by reason of the death of an individual who was a covered expatriate.[173] A covered gift or bequest does not include: (i) any property shown as a taxable gift on a timely filed gift tax return by the covered expatriate; (ii) any property included in the gross estate of the covered expatriate for estate tax purposes and shown on a timely filed estate tax return of the estate of the covered expatriate; or, (iii) any property for which a gift or estate tax charitable or marital deduction would be allowed.[174]

C. The Reed Amendment

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167. *Id.*

168. I.R.C., § 877A (f) (2).

169. *See generally* I.R.C., § 877.

170. I.R.C., § 2801 (a).

171. *Id.* § 2801 (c).

172. *Id.* § 2801 (a) (1).

173. *Id.* § 2801 (e) (1).

174. *Id.* §§ 2801 (e) (2) & 2801 (e) (3).

For those individuals that may want to visit the U.S. after they expatriate, there is the so-called *Reed Amendment* provision of immigration reform enacted in 1996.[175] That provision bars former citizens from re-entry into the U.S. if, in the opinion of the Attorney General, they expatriated for a principal tax avoidance purpose.[176] Due to certain statutory defects, it has never been implemented or enforced.[177] Nonetheless, the Reed Amendment continues to be an issue when considering expatriation, even if it is not likely to be enforceable.

VI. PLANNING CONSIDERATIONS

The first step for an individual considering expatriation is to analyze their financial situation. To be considered as a covered expatriate subject to the exit tax, an expatriate needs to have an average U.S. income tax liability for the five-year period prior to expatriation which is greater than $145,000.00 (adjusted annually for inflation) or a net worth of $2,000,000.00 or more (not adjusted for inflation).[178] The potential expatriate may be able to fail these tests by recognizing tax losses, making charitable gifts, shifting income, gifting to family members, or creating Roth IRAs,[179] etc. For those that are

175. 8 U.S.C. § 1182 (a) (10) (2010) (U.S.). *See also* Illegal Immigration Reform and Immigrant Responsibility Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009–68 (1996) (U.S.).

176. Responsibility for administering and enforcing the provisions of the Reed Amendment was formerly within the province of INS, an agency within the Department of Justice (DOJ). Because the role of the INS has now been transferred to USCIS, an agency of the Department of Homeland Security (DHS), overall responsibility presumably has shifted from the Attorney General to the Director of DHS.

177. There are several apparent statutory defects with the Reed Amendment. First, it is unclear from the language of the statute whether it encompasses all acts of expatriation or only those expatriations accomplished by formal oath of renunciation. Second, it is unclear what the applicable tax avoidance standard is or should be; this is especially troublesome since tax avoidance has ceased to be relevant to enforcement of the expatriation tax provisions.

178. I.R.C., § 877A. *See also* United States Internal Revenue Service, Expatriation Tax, *available at* http://www.irs.gov/businesses/small/international/article/0,,id =97245,00.html (last accessed May 23, 2011).

179. RothIRA.com, Frequently Asked Questions, *available at* http://www.rothir a.com (last accessed May 23, 2011) [hereinafter Roth IRA FAQ]. "A Roth Individual Retirement Account is an after-tax investment vehicle for retirement focused investing. Withdrawals from Roth IRAs are not taxed. Funds held in a

already close to not being treated as covered expatriate, advance planning to reduce income and assets can help to avoid being treated as a covered expatriate subject to the exit tax.

There is no expatriation exit tax on cash and other assets which have no imbedded appreciation. A person who has just liquidated their assets and holds only cash can avoid the exit tax on the cash.[180] For example, expatriates can not claim the $250,000.00 ($500,000.00 for a couple) capital gain exclusion on the sale of their principal residence. Consideration should be given to selling the residence before expatriating. This avoids capital gains taxes for gains made on the sale of the principal residence up to $250,000.00 ($500,000.00 for a couple)[181] and the mark-to-market exit tax on the cash.

For those long-term U.S. residents approaching their eighth year of being a U.S. resident, they should immediately review their plans. If they do not intend to stay in the U.S. much longer, they should consider leaving before their eighth year anniversary. If they plan to stay in the U.S., but not retire in the U.S., they should review their income and assets and develop an exit tax strategy.

When assets exceed $2,000,000.00, the potential covered expatriates should consider making gifts that exhaust their $5,000,000.00 U.S. gift tax exemption.[182] Once they expatriate and lose their U.S. domicile, they will lose this exemption as well. Thereafter, they should take advantage of the IRC rule, which excludes U.S. property that is subject to tax under the U.S. gift or estate tax rules.[183]

The $5,000,000.00 U.S. gift tax exemption can be a useful tool to reduce the value of a potential covered expatriate's estate to avoid the exit tax. For a couple, they can gift $10,000,000.00 worth of gifts free. However,

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Roth IRA can be invested in numerous different types of securities, funds, and more through various account providers." *Id.*

180. *See* McDermott Will & Emery, New Guidance on Expatriation Exit Tax, *available at* http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/3892307d-1b8e-4636-ba2b-f58609256689.cfm (last accessed May 23, 2011).

181. I.R.C., § 121.

182. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provides a $5 million-per-person exemption for gift and estate taxes. Depending on the state that the person died in, there may or may not be gift and estates.

183. I.R.C., § 2801 (e) (2).

notwithstanding that there may be no U.S. gift taxes for individual gifts under $5,000,000.00, there may be significant Philippine gift taxes due if the individual is a resident or dual citizen of the U.S. and the Philippines at the time of the gift.[184] Therefore, if an individual is thinking about leaving the

184. Tax Reform Act of 1997, § 98. This Section provides —

> There shall be levied, assessed, collected and paid upon the transfer by any person, resident or nonresident, of the property by gift, a tax, computed as provided in Section 99. The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible. For Philippine residents or citizens, property located anywhere in the world is subject to the gift tax.

Id.

> Meanwhile, Section 99 provides:
>
> The tax for each calendar year shall be computed on the basis of the total net gifts made during the calendar year in accordance with the following schedule:

Over	But Not Over	The Tax Shall Be	Plus	Of the Excess Over
	100,000.00	Exempt		
100,000.00	200,000.00	0.00	2%	100,000.00
200,000.00	500,000.00	2,000.00	4%	200,000.00
500,000.00	1,000,000.00	14,000.00	6%	500,000.00
1,000,000.00	3,000,000.00	44,000.00	8%	1,000,000.00
3,000,000.00	5,000,000.00	204,000.00	10%	3,000,000.00
5,000,000.00	10,000,000.00	404,000	12%	5,000,000.00
10,000,000.00		1,004,000.00	15%	10,000,000.00

> When the donee or beneficiary is a stranger, the tax payable by the donor shall be thirty per cent (30%) of the net gifts. For the purpose of this tax, a 'stranger,' is a person who is not a:
>
> (1) Brother, sister (whether by whole or half-blood), spouse, ancestor and lineal descendant; or
>
> (2) Relative by consanguinity in the collateral line within the fourth degree of relationship.
>
> For a qualified family member, the tax is 15 % for gifts over 10,000,000.00 Pesos.

Id. § 99.

U.S., they would want to execute their gifting program before they become subject to the Philippine gift tax rules.

When a covered expatriate has an IRA 401(k), or other type of retirement plan in the U.S., they should consider the long term tax consequences on their plans caused by their expatriation. Under the exit tax, their retirement plan, such as an IRA, is either going to be fully taxable the day before they expatriate, or the distributions from assets such as 401(k)s are going to be subject to a 30% withholding tax.[185] Either way, the plan is subject to income taxes up front or as distributed.

A long-term planning option is to convert the retirement plan, such as an IRA, into a Roth IRA.[186] When the IRA is converted to a Roth IRA, the IRA account balance will become subject to income taxation. Thereafter, however, the account balance will grow tax free and all qualified distributions will be tax free. Plus, the Roth IRA is not subject to required minimum distribution.[187]

Therefore, the Roth IRA owner never has to take a distribution, letting the account balance grow until they die. Upon the death of the Roth IRA owner, the account balance can be distributed over the life expectancy of the beneficiary of the inherited Roth IRA.

Under the exit tax, a regular IRA account balance would be subject to income taxation but any gain in the account thereafter is tax deferred, but not tax free when distributed.[188] When a distribution is made, part of it will be taxable and the IRA will be subject to the required minimum distribution

185. Roth IRA FAQ, *supra* note 179.

186. *Id.*

> A Roth IRA conversion is a rollover from another account type (typically a 401k or Traditional IRA) into a Roth IRA account. In the past, many investors that earned above the annual income limits for Roth IRAs were restricted to other retirement products. Recently, Roth IRA restrictions were loosened, opening up the Roth IRA to higher income investors that previously exceeded income limitations.

Id.

187. *See* United States Internal Revenue Service, Roth IRAs, *available at* http://www.irs.gov/publications/p590/ch02.html#en_US_2010_publink1000231081 (last accessed May 23, 2011).

188. *See* United States Internal Revenue Service, Traditional IRAs, *available at* http://www.irs.gov/publications/p590/ch01.html (last accessed May 23, 2011).

rules. With the Roth IRA, both gains and qualified distribution are tax free, and no required minimum distributions.

In the typical estate plan where the retirement account owner wants to leave the account to a grandchild or great grandchild, often an IRA account, if the IRA is going to be subject to the exit tax, the biggest bang for the tax dollar is with the Roth IRA. The objective should be to keep the money in the Roth IRA for as long as possible, thereby creating an account where it can grow tax deferred, and where it can be distributed income tax free over the life of the designated beneficiary. The younger the beneficiary, the longer the period of tax free growth.[189]

The Roth IRA can be stretched out over the life of the Roth IRA owner and the beneficiary. Since the tax deferred growth continues for many years inside the Roth IRA over the owner's life, and, subsequently, the beneficiary's life, it can be expected that the Roth IRA will grow to become a very substantial asset.

For example, if a $100,000.00 IRA was left to an 18-year old grandchild, and the IRA earned an income at a rate of 8%, and only minimum distributions were made to the grandchild over the projected life of the grandchild, then the grandchild would receive approximately $3,000,000.00 in distributions from the Roth IRA; and these distributions would be tax free.

VII. CONCLUSION

Retirees moving from the U.S. to the Philippines will face many tax issues that were not applicable to them while living in the U.S. Taking the time to become informed about the U.S. and Philippine rules they may be subject to can help avoid unpleasant surprises. For those who plan to give up their status as a U.S. Person and expatriate, the U.S. expatriation exit tax can be harsh; it could be considered a trap for the uninformed. Understanding the exit tax rules can often create an opportunity to develop a plan to mitigate or eliminate the potential of being subject to the U.S. expatriation exit tax. As with most tax situations, a little planning can often result in substantial tax savings.

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189. Neal Frankle, How to Select The Right Roth IRA Beneficiary, *available at* http://wealthpilgrim.com/roth-ira-beneficiary/ (last accessed May 23, 2011).