

Individual Nonfilers and The International Tax Gap

By Paula N. Singer

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On April 15 the IRS announced its new approach to international tax law with the goal of improving voluntary compliance with international tax provisions, thereby reducing the international tax gap. A historic problem the IRS has faced is how to identify international nonfilers and bring them into compliance. Those international nonfilers include inbound foreign national employees transferred to work in the United States who continue to be paid on their home-country payrolls and U.S. citizens and immigrants (popularly called green card holders) who live and work outside the United States.

Announced strategies such as “leverag[ing] partnerships with other government organizations to gather and share information” will go a long way toward solving the problem of foreign national nonfilers. For example, U.S. Citizenship and Immigration Services has records of all sponsored foreign workers as well as who sponsored them. That information would allow the IRS to establish compliance initiatives for payroll withholding and reporting by business sponsors, resulting in increased payroll tax revenue. Form W-2 reporting will identify individuals obligated to file U.S. tax returns. Compliance with U.S. worldwide taxation provisions by foreign national filers (and U.S. citizen filers) could be enhanced by adding a certification to Form 1040 that their taxable worldwide income has been included in the return.

Payroll education and audit initiatives that include information about benefits in kind, including items provided overseas, that must be included in wages will increase revenue. However, those initiatives must include educating business personnel who have the information, personnel who initiate the immigration

process, and those who cross-charge salaries from abroad without regard to the payroll and individual tax return implications of those transactions. Payroll practitioners can comply only with withholding and reporting obligations on employment income that they know about.

Payroll education and audit initiatives will also improve compliance by U.S. citizens and green card holders sent abroad (U.S. expatriates) by U.S. employers to work temporarily — particularly employers such as small and medium-size firms involved in the international economy that lack tax advisers who have experience with the special payroll and tax return rules that apply to U.S. expatriates. Those education and audit initiatives would result in increased tax compliance by the U.S. expatriates because of more accurate Form W-2 income reporting.

The historically intractable problem of nonfiling U.S. citizens who live and work or retire abroad might not be resolved soon, if at all, by the new IRS strategies. The total number of overseas Americans is estimated to be between 4 million and 7 million. That now includes a huge number of “accidental citizens” — the sons and daughters of foreign workers, students, and scholars who were born in the United States and moved home with their parents when they were still children. It also includes the U.S.-born children of illegal aliens who left the country with their parents when they returned home voluntarily or through deportation. According to a survey of expatriate voters conducted after the 2008 election, 72 percent of overseas Americans have lived abroad for a long-term or indefinite period.

While efforts with other U.S. agencies such as the State Department could help identify many nonfilers (a 1984 law mandates that U.S. citizens provide their foreign address to the IRS when renewing a U.S. passport), convincing them to come into compliance voluntarily will be difficult because of the associated administrative and tax costs. Most overseas Americans are subject to worldwide taxation by their country of residence as well as by the United States. The two tax regimes designed to help avoid worldwide double taxation — section 911 foreign earned income exclusions and foreign tax credits — are complicated. Congress made section 911 more complex with the 2005 revisions designed to generate revenue. The foreign tax

credit regime, simplified somewhat in recent years, mitigates, but does not necessarily allow for avoiding completely, worldwide double taxation.

Voluntary compliance by overseas Americans can be accomplished more readily in the short term by recognizing the administrative and cost burdens imposed on those Americans compared with resident Americans and by simplifying U.S. tax rules and administrative procedures accordingly. Eliminating the cap on section 911 exclusions for income from labor (including deferred retirement income) is one obvious solution. Considering the administrative impact on individuals (and the IRS) when tightening the foreign tax credit regime is another. While those changes would be helpful for the future, overseas Americans coming into voluntary compliance would still have to deal with the more complicated and costly rules in effect for prior calendar years.

The long-term solution is for Congress to recognize that the United States is part of a global economy and to adopt residence-based U.S. taxation for individuals, the norm in the industrialized world. That can be accomplished by adopting the U.S. residence-based tax regime, which now applies only to foreign nationals, for nonresident U.S. citizens and green card holders as well. U.S. tax residency status for all individuals could be based on substantial presence enforced through an entry and exit system. The tax rules and procedures that now apply to nonresident alien taxpayers could apply to all nonresidents. The new exit tax could apply to taxpayers who leave the United States and become U.S. tax nonresidents. The uncapped section 911 exclusions could be maintained for a temporary period for U.S. citizens and green card holders moving abroad (for example, for three calendar years following relocating abroad). U.S. citizens and green card holders with a substantial nexus to the United States (for example, employees with a U.S. employer and retirees with U.S. family members) could be allowed to elect to stay in the U.S. tax system. In lieu of requiring years of tax returns to come into voluntary compliance, Congress could provide an amnesty with a one-time payment for overseas Americans who have lived abroad for six or more years (with an exemption for accidental citizens) who become nonresidents under this new tax regime. ■