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What does it mean to be a US person?

US persons are subject to tax in the US on their worldwide income, even if they do not live in the US or have any income from a source within the US. This is often referred to as citizen based taxation (CBT). Only the US and Eritrea, which imposes an annual tax on its citizens who live outside the country, use a CBT system. The rest of the world taxes based on physical residence. This is generally called 'territorial or residence based taxation'. Under this system, individuals are only subject to tax in the country in which they physically reside or if they earn income from sources within that country.

A US person includes:

- A US passport holder
- A Green Card holder
- Born of US parents
- Born inside the US
- Someone who meets the substantial presence test (i.e. they spend a sufficient amount of time in the US to become US tax resident).

The IRS has spent the last few years actively hunting down US persons overseas who have not been paying their US tax liabilities. Many of these people are unaware of their potential status or the associated obligations.

The US has established tax treaties with many countries to reduce the burden of double taxation. Contrary to popular belief, however, these treaties do not change the US taxation of US persons. All US tax treaties contain a savings clause that, with limited exceptions, states that no provision of the treaty shall be construed to prevent the US from taxing US persons as if the treaty did not exist. In effect, citizen based taxation requires that tax treaties take this approach.

All income received by US persons derived from any source is subject to US federal income taxation unless specifically exempted or excluded. 'Subject to tax' is not the same as 'being taxed'. Thus, US persons, who are also subject to US federal income tax on income from sources outside the US, are able to claim a tax credit in the US for any foreign tax paid on their income and use that 'foreign tax credit' to offset US federal tax on that same income.

Despite the existence of CBT, section 911 of the IRC allows US persons who meet certain requirements to exclude from US federal taxation some amount of foreign earned income plus a housing cost amount. The foreign earned income exclusion (FEIE) provided for in section 911 allows US persons to exclude the equivalent of approximately $100,000 from their taxable income. US persons cannot claim foreign tax credits for any foreign income tax paid on the amount of foreign earned income excluded from US taxation by the FEIE.

Generally speaking outside of the FEIE US persons can claim a foreign tax credit for income taxes paid to foreign countries. The purpose of the foreign tax credit is to eliminate double taxation on the same income. The foreign tax credit allows a taxpayer to subtract income taxes paid to other countries from the tentative tax owed to the US Government. Foreign taxes other than income taxes (such as property taxes, excise taxes, payroll taxes, or value-added taxes) cannot be credited against US tax. All foreign income taxes can be credited against US tax, including taxes levied by governments below the national level.

Another non-tax filing requirement that is often overlooked is the foreign bank account report (FBAR), the non-filing of which can carry substantial penalties. US persons are required to file a FBAR if they have financial accounts located outside the US and the total on deposit in all such financial accounts at any time during a calendar year exceeds the equivalent of $10,000.

The FBAR is really nothing more than a report of financial accounts located outside the US detailing the name of the financial institution, the address, account number, and the maximum balance of each foreign financial account for each year. The FBAR is an informational filing, not an income tax filing. For the mobile US executive or investor, the FBAR filing is important because failure to comply with the filing requirement carries large penalties.

The individual compliance filing requirement under the Foreign Account Tax Compliance Act (FATCA) is similar to, but slightly different from, the FBAR filing requirement. There is a corresponding obligation for foreign financial institutions under FATCA which requires foreign financial institutions to report in one way or another to the IRS the account information of US persons held at the foreign financial institution. The foreign financial institution reporting requirements make US persons' compliance with both the FBAR and FATCA filing requirements more significant, as now the IRS will be supplied with the information about the accounts to impose penalties for non-compliance.

There are also special tax reporting rules for certain types of foreign corporations. For example, if US persons own more than 50% of the equity in a foreign company, it will be considered a controlled foreign corporation (CFC) for purposes of US taxation. CFCs are subject to special tax rules that must be taken into account when US persons file their tax returns.

Also, under certain circumstances, a corporation classified for US tax purposes as a passive foreign investment corporation (PFIC) which has adverse tax consequences for US persons. For example, foreign mutual funds are taxed as PFICs in the US. The adverse tax consequences including the cost of tax compliance associated with a PFIC often makes investing in foreign mutual funds prohibitive for US persons.

Unfortunately, since foreign mutual funds are routine investments in other countries as they are in the US, US persons are often surprised to learn of the adverse consequences of their foreign mutual fund investments. Foreign trusts also cause US tax complications.

The enactment of the Tax Cuts & Jobs Act 2017 has several consequences for US citizens living outside of the US. Significant changes include the expansion of the scope of CFC profits subject to US tax. This effectively has retrospective effect through the imposition of a transition tax on previously non-US taxed profits of the CFC.

Since foreign companies are generally not required to file US tax returns, where a US person's interest exceeds certain levels or other tests are met, that person is required to file special information returns to essentially provide the information that would be contained in a US corporate or partnership tax return. The burden of providing the information is shifted to the US person under these circumstances.

Another important tax issue for US persons, particularly executives working overseas, is the status of foreign deferred compensation or retirement (pension) plans. The IRC does not include special rules for taxation of foreign retirement or deferred compensation plans. It has provisions covering qualifying US retirement plans (e.g., 401ks, IRAs, etc.). Equivalent retirement accounts in other countries are not tax deferred in the US because they do not qualify under the IRC rules. Very few US tax treaties cover retirement plans. Canada and the UK are two that do. A tax deferred retirement plan in most foreign countries is not likely to be tax deferred in the US. Thus, it is not uncommon for US persons employed abroad to be currently taxable in the US on their and their employers' contributions to their foreign retirement plans even though they are tax deferred where they live.

An associated issue is that a foreign retirement plan may be classified under IRC rules as a foreign trust. If it is, in addition to the unfavorable tax treatment in the US, there is a trust reporting obligation.

The IRC makes the lives of US persons living abroad, particularly executives, entrepreneurs and investors, much more challenging than their compatriots living in the States and their tax compliance challenges significantly more complex. The position has been further complicated by the US tax reform in 2017. It is therefore important that if you are a US person, or are at risk of being considered to be so, you take professional advice as soon as possible. PKF Francis Clark can introduce you to the appropriate advisers here in the UK.

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