

# TAX ISSUES

## *Beware! The Big 4 Accounting Firms Can Produce Shoddy Work*

With tax season looming on the horizon, people are beginning to think about whether they should risk preparing their own tax returns or hire a professional. First, let me say it is always advisable to hire a professional, and the average taxpayer, with uncomplicated income and deductions, can generally find a reputable tax preparer to do the job for a reasonable price. However, when a taxpayer has a tax return with international components, it is a whole different story. There is a special expertise required for the preparation of tax returns with an international aspect, especially since the penalties for getting it wrong are significant.

We have always taken pride in our dedication to offering precise tax preparation services to taxpayers with international aspects to their tax returns. These particular taxpayers generally include: Americans living abroad; Americans with foreign income or assets; nonresident aliens with US source income; branches and subsidiaries of foreign companies; and US companies with foreign branches or subsidiaries. I usually caution these types of taxpayers that low-cost tax preparation services - even those who advertise that they are experts in international taxation - don't have the expertise to competently prepare these specialised tax returns.

Until recently, however, I thought it was a given that the "big" accounting firms - The Big Four as they are usually called (KPMG, PwC, Deloitte, and E&Y) - set the benchmark for preparing international tax returns. I assumed that if one of these firms prepared a tax return, it would be correct. However, two recent events have shown me that you don't always get what you pay for, even with the most prestigious firms.

The first incident came to my attention while we were preparing a long-time client's 2015 tax return. The client, let's call her Janet, is a US citizen who is married to a non-US citizen. The couple lived abroad for many years, and recently moved to a community property state in the US.

For those of you unfamiliar with community property states, they are states with laws that consider income community property; i.e. each spouse's income is viewed as belonging equally to both spouses.

### **Back to Janet**

Now settled in the US, Janet's husband has a US filing obligation. For personal reasons the couple decided to file using the filing status "married filing separately" rather than "married filing jointly." Janet hired Esquire Group to prepare her 2015 tax return. Her husband's tax return was to be prepared by one of the Big Four firms as part of his employment package.

When married couples living in a community

property state file separately, each of their income must be allocated 50/50 to one another; i.e. half of the husband's income needs to be reported on the wife's tax return and vice versa. This meant that we could not prepare Janet's tax return until we had her husband's draft tax return in order to do the income allocation. Likewise, the firm preparing Janet's husband's tax return would need her draft tax return so they could do the income allocation.

To our surprise, the Big Four firm never requested Janet's draft tax return from us and when we received the husband's tax return, it was not a draft, but the final version. The tax return reported 100% of his income and none of Janet's. We informed Janet of the mistake, and her husband contacted his preparer at the Big Four firm, who told him that the income allocation was not needed. We told Janet that this was absolutely not correct and asked that her husband go back to the Big Four firm and question them as to why they believed this was the case. This time the Big Four preparer admitted he had made a mistake and that he would have to amend the tax return to reflect the income allocation.

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### **Strike one for the Big Four!**

The second incidence of Big Four ineptitude came to my attention when I was reviewing a relatively complex tax return prepared by a CPA experienced as an international tax manager at a Big Four firm.

A tax manager is someone just below a partner and who generally reports directly to

a partner. The tax managers are also the ones responsible for managing a team of preparers and for reviewing their work.

When I began to review the tax return I was surprised to see that there was no currency gain or loss reported pursuant to Internal Revenue Code ("IRC") Section 988. This was especially surprising given the client had a relatively large investment account, which generally requires an IRC 988 calculation. I realise that unlike me, most of you aren't tax dorks and have never heard of IRC 988, so let me explain briefly.

Basically, IRC 988 requires you to track currency like stock. For example, let's assume you exchange USD 1,000 to EUR when the exchange rate is 1.25. You have to log that you now own EUR 800 (1,000/1.25) at an exchange rate of 1.25. If you later receive a dividend of EUR 100 when the exchange rate is 1.5, you have to log that you now own EUR 100 at an exchange rate of 1.5. Then, almost every time you conduct a payment transaction, whether a stock purchase, bond purchase, withdrawal, fee payment, etc., with few exceptions, you are treated as having sold that currency and an IRC 988 currency gain/loss must be recognised.

So, continuing with the example above, assume you buy a stock for EUR 850 when the exchange rate is 1.1. You will be considered to have sold all of the EUR acquired at 1.25 and 50 of the EUR acquired at 1.5.

### **Are you still with me?**

Based on this example, you would recognise a currency loss of USD 140; the loss is due to the decline in the exchange rate. Generally, the only exception to IRC 988 are personal transactions where the IRC 988 currency gain/loss is less than \$200. Having an investment account, however, like the client in this instance, does not have personal transactions because the account is held for investment purposes.

I questioned the CPA as to why there was no IRC 988 currency gain/loss reported on the tax return. Her reply - are you ready for this? - was that they generally don't do those calculations for individuals because it is too much work! I could not believe my ears. Failing to report IRC 988 gains/losses could result in having unreported foreign income, which may cause a taxpayer to be noncompliant. Noncompliance may require the taxpayer to take part in one of the IRS' amnesty programmes, which is a long and costly process.

### **Strike two for the Big Four!**

My point in sharing these two stories, is that pricey tax preparation services do not always translate to quality work. While our own Firm is not a low-cost tax preparation service, our

*International tax is complex and the penalties for noncompliance are high. Your international tax preparer needs to be an expert in international taxation.*

fees are nowhere near those of the Big Four. The Big Four are by far the most expensive tax preparation services available and they consider themselves the best in the business. For the fees they charge, a client's tax return should not just be accurate, but delivered in a golden envelope with platinum staples. Whether their mistakes were due to complacency (we don't make mistakes) or ignorance of the tax code is irrelevant, their mistakes can cost their clients dearly.

International tax is complex and the penalties for noncompliance are high. Your international tax preparer needs to be an expert in international taxation. That is why you must seek tax preparers who specialise in international taxation.

**Jimmy Sexton, LL.M. is the President and CEO of Esquire Group, a company he co-founded in 2005.**

Mr. Sexton focuses primarily on advanced tax planning strategies and corporate structuring aimed at reducing clients' global effective tax rate. His areas of special competence include corporate structure design and implementation, tax treaties, expatriation, and tax compliance.

Esquire Group is a boutique international tax advisory firm with a global presence. We specialise in tax planning and compliance for both corporate and individual clients.

We are a team of dynamic professionals that have dedicated our careers to international taxation. Our organisation includes LL.M.s in international tax, accountants, CPAs, enrolled agents, and consulting attorneys who are experts in both domestic and international taxation. Our core client bases can be broken up as follows:

- US Businesses with Foreign Assets or Operations

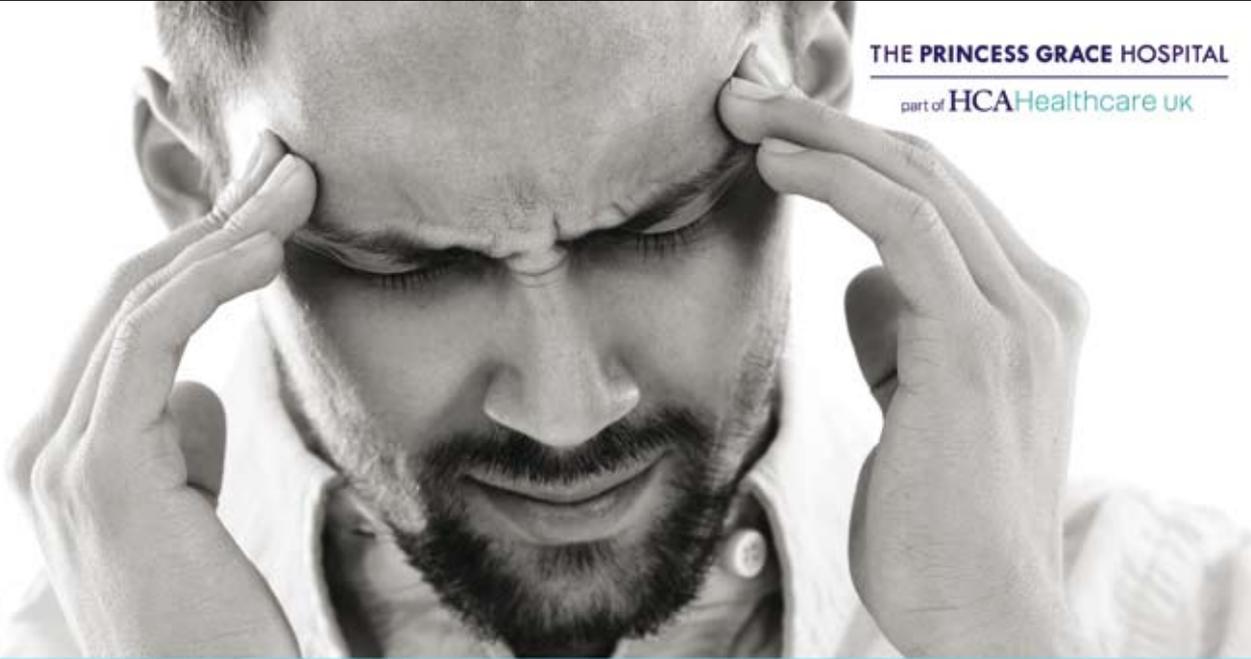
- Foreign Businesses Owned by US Persons
- Foreign Businesses Investing or Doing Business in the US
- US Individuals with Foreign Assets or Income
- US Individuals Residing Abroad
- Foreign Individuals with US Assets or Income

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