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ALERT

IRS Issues Fact Sheet Providing Information on Federal Income Tax Return and Foreign Bank Filing Requirements

Potential Penalties Applicable to Dual U.S. Citizens and Residents

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The federal government has known for some time that taxpayers who are dual citizens or dual residents of the United States and another country may have knowingly or innocently failed to timely file U.S. federal income tax returns. This would occur, for example, where a U.S. citizen lived outside of the United States for an extended period of time without having formally expatriated both for U.S. immigration and tax law purposes. Such individuals may therefore have failed to file annual U.S. income tax returns, including quarterly estimated tax returns (and payments), and timely paid U.S. income taxes due, net after application of the foreign tax credit rules, other provisions in the Internal Revenue Code resulting in a reduction of U.S. income tax or by application of a pertinent income tax treaty or convention. The same problems could also arise with dual residents who, despite thinking they could be advantaged by a favorable tie-breaker provision in an applicable treaty, would still be accountable to file FBAR and other ownership disclosure forms despite holding a belief, in good faith, that they were “non-resident” for all purposes.

Therefore, dual citizens or residents may have failed to file timely Reports of Foreign Banks and Financial Accounts (FBARs) under the FINCEN regulations. The FBAR must be filed by any U.S. person by June 30 of the year following the calendar year in which the U.S. person has a financial interest in, or signature authority over, foreign financial accounts (FFAs) where the aggregate value of the FFAs exceeds $10,000 at any time during the calendar year. A "U.S. person" includes a U.S. citizen or U.S. resident, as well as a corporation, trust, partnership or limited liability company created, organized or formed under U.S. law. See 31 C.F.R.§1010.350(a); TD F 90-22.1 (Rev. 3-2011). "Signature authority" means the authority (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account by direct communication (in writing or otherwise) to the person with whom the financial account is maintained. "FFAs" include bank, securities and other types of accounts. 31 CFR §1010.350(c).

It is known that there are a large number of individuals who may have failed to meet their personal obligations under Title 26 (e.g., federal income tax) and Title 31 (FBAR reports) for a period of years. Now, in light of the increased scrutiny the IRS and Department of Justice is giving to those U.S. persons who are noncompliant in one or both of these areas, many of those individuals desire to come forward and disclose their unreported income as well as delinquent FBAR reports. In addition, Canadian government representatives have publicly noted their displeasure with the enhanced IRS scrutiny of tax and financial reporting failures of dual citizens since many dual Canadian-U.S. citizens have resided in Canada for most or a substantial portion of their lives. The problems associated with dual citizenship or residence are by no means, however, limited to those residing north of the border.

The fact sheet (FS-2011-13) released by the IRS on December 7, 2011, summarizes information about federal income tax return and FBAR filing requirements and how to file a federal income tax return or FBAR as well as potential penalties. Taxpayers who owe no U.S. income tax, perhaps as a result of available foreign tax credits or the availability of the foreign earned income exclusion under §911, may owe no U.S. income tax and therefore will not be subject to delinquency penalties for failure to file or pay. §§6651(a)(1), 6651(a)(2). For such individuals, no penalties will be imposed for delinquent returns and failure to timely pay. More importantly, the notice states that no FBAR penalty applies in the case of a violation that the IRS determines was due to reasonable cause.

The recent 2011 Offshore Voluntary Disclosure Initiative offered by the IRS allowed many taxpayers to disclose their previously undisclosed non-U.S. accounts (and assets) in exchange for some clarity as to the extent of penalties that may be imposed. However, the program ended on September 9, 2011, leaving those who did not participate, perhaps because they were unaware of the program, to face a difficult dilemma in light of the continuing and mounting efforts of the U.S. government to obtain U.S. account owner information from foreign banks and financial institutions.

Despite the official closure of the 2011 Offshore Voluntary Disclosure Initiative, the IRS' standard voluntary disclosure practice remains a viable alternative for taxpayers who wish to correct prior non-reporting of foreign income, accounts and assets. Just this month, the IRS issued additional guidance for U.S. citizens and dual citizens residing outside the United States who may have not timely filed their U.S. federal income tax returns or reported their foreign accounts on an FBAR (Form TD F 90-22.1) despite having met the criteria for doing so. The guidance does not specifically describe a process by which to correct prior noncompliance. Methods of correction include consideration of making a "voluntary disclosure" as well as an alternative form of disclosure.

U.S. citizens, whether also citizens of a foreign country and irrespective of where they reside, are required to annually file U.S. federal income tax returns reporting their income from all sources (i.e., both U.S. and foreign income). Such persons may also be required to complete and file with the IRS specific forms reporting such items as foreign accounts (bank or investment accounts), the acquisition and disposition of interests in foreign entities, transfers of property to foreign entities or financial information of foreign entities controlled by the taxpayer. The guidance issued by the IRS in Fact Sheet 2011-13 does not present a new disclosure initiative but instead provides additional insight as to how the IRS may handle certain voluntary disclosures if specific criteria are met.

The Fact Sheet notes that where no U.S. tax is due with respect to unreported foreign income, those cases would not be subject to failure to file and failure to pay penalties under § 6651. For example, if a U.S. citizen derives income from a foreign source but does not report same on his or her U.S. return, no failure to file or failure to pay penalties would be imposed if as a result of the application of foreign tax credits, the taxpayer's U.S. tax liability is eliminated. For situations where there is an outstanding U.S. tax liability, taxpayers may assert a reasonable cause argument that would have to be supported by the facts existing at the time of the noncompliance. A successful reasonable cause defense would allow the taxpayer to avoid the failure to file and failure to pay penalties. The delinquent taxes and interest on the underpayments of tax would remain outstanding liabilities of the taxpayer, however.[1]

The question of unfiled FBARs is also addressed in the guidance and demonstrates the sharp contrast between participation in one of the previous tailor-made offshore disclosure programs (2009 Offshore Voluntary Disclosure Program and 2011 Offshore Voluntary Disclosure Initiative) and the standard voluntary disclosure practice.[2] Through the offshore disclosure programs, the IRS would impose a "miscellaneous Title 26 offshore penalty" of either 20 percent or 25 percent (for the 2009 and 2011 programs, respectively) with no consideration given to the extent of unpaid tax liability. In other words, even if the extent of unreported income from a foreign account was only one dollar and tax was due on that income, the flat-rate penalty would be imposed.

The guidance issued in the Fact Sheet describes a more reasonable approach based on the applicable statutes and explains that examiners have discretion in determining the extent of FBAR penalties, depending on the facts of the particular case. According to the guidance, penalties for failure to file FBARs can be avoided if, among other factors, there was "no tax deficiency (or there was a tax deficiency but the amount was de minimis)." Furthermore, a reasonable cause argument for failing to file FBARs may be asserted in seeking to eliminate potential FBAR penalties. While the guidance describes the potential for penalty relief under certain circumstances, each case should be carefully evaluated to determine the applicability of a reasonable cause defense for both income tax and FBAR penalty mitigation.

For questions involving consideration of international tax as well as compliance with civil and criminal tax provisions, please contact Co-chair Jerald David August (Taxation and Wealth Planning Department) at 215.299.2883, 561.804.4401 or jaugust@foxrothschild.com or Ricardo A. Antaramian at 561.804.4425 or rantaramian@foxrothschild.com or any member of Fox Rothschild's Business and International Taxation, Tax Controversy and Litigation or White Collar practices.

[1] Depending on the specific facts and the extent of the underpayment, additional penalties may be imposed.

[2] The guidance briefly mentions that other penalties for non-reporting may be imposed and presumably refers to failures to report ownership in or transactions with foreign entities. Starting in 2012, taxpayers will also be required to report under § 6038D certain financial assets if their aggregate value exceeds $50,000.