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Fear Factors: Dual Nationals and the IRS

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What do the recent G20 discussions and the IRS' enforcement of foreign asset reporting have in common and why should "dual nationals" be concerned? First, a brief definition for purposes of this article. A "dual national" is an individual who has income tax reporting requirements in two or more countries. Such a person includes individuals in the U.S. on work Visas, Green Card holders and individuals who are citizens of the U.S. and another country (by birth, as an example). I am not, in this discussion, including corporate or other business interests in this definition.

According to published reports from the G20 meeting, a total of $14bn in unpaid tax has recently been collected by seven of the G20 members from about 100,000 individuals worldwide from hidden assets (bank accounts) estimated to be worth in excess of $120bn. There remain, according to some estimates, in excess of $1tn in hidden untaxed assets globally. Since 2009 the IRS has offered two voluntary disclosure programs to get U.S. taxpayers to report foreign held financial accounts, the most recent program was the 2011 Offshore Voluntary Disclosure Initiative (OVDI). Many of the participants in the two IRS programs were "dual nationals", but many more did not enter either program. However, some "dual nationals" are now being forced to come forward because of actions being taken by offshore financial institutions.

Foreign financial institutions, including banks, trust companies, and investment companies are preparing for the implementation of the Foreign Account Tax Compliance Act (FATCA) which mandates these institutions report U.S account holder information to the IRS no less often than quarterly beginning in 2014. Some institutions are sending letters to account holders with a U.S. address or other nexus, which demand they account holder do severl things, among which are: (1) consent to release of account information to the IRS, (2) sign IRS Form W-9. (3) provide a certification, and in some cases proof, that the account holder has filed a Report of Foreign Bank Account (FBAR) and reported income earned on the foreign account on U.S. income tax returns and paid the tax. The failure to provide such information, in many cases, will result in the account being

Law Offices of Sanford I. Millar

Office: 310-556-3007
Fax: 310-556-3094
Address: 1801 Avenue of the Stars, Suite 600
Los Angeles, CA. 90067
Email: smillar@millarlaw.net

www.millarlawoffices.com

closed and a potential disclosure to the IRS of the account information. These letters are now being issued with regulalry and may have serious consequences to the account holders. The consequences include penalties for failure to file FBAR's; failure to file and failure to pay income tax penalties and penalties associated with failing to file information returns, like Form 5471, Controlled Foreign Corporation Return, or Form 3520, Report of Foreign Gift or Bequest. Dual Nationals are particularly vulnerable to these penalty risks if they have financial interests in their country of origin or elsewhere outside the U.S.

The IRS issued a press release on December 13, 2011 which was addressed to "dual nationals" and attempts to clarify their reporting obligations and potential penalty relief mechanisms. What is very clear from the press release is that the IRS is putting the "dual national" community on notice that it will enforce the filing requirements and impose penalties if this class of taxpayer does not come forward. The IRS is also alerting the "dual national" community that it will look at not imposing penalties based upon "reasonable cause". Reasonable cause definitions vary a bit based upon the particular form of non-compliance. A reasonable cause effort should be put foth for a failure to file an FBAR may possibly result in no penalty, or a warning letter, but can escalate to a "non-willful" penalty of $10,000 per violation per year or in the case of a "willful violation" a penalty of the greater of $100,000 or 50% of the account balance per year per violation. Failure to file information returns like Form 3520 Report of Foreign Gift or Bequest carry penalties of up to 35% of the value of the gift or bequest. Of course there are failure to file and failure to pay income tax penalties as well.

Many "dual nationals" have inherited or been gifted business interests or real property interests which have not been reported to the IRS. Under the two voluntary disclosure programs these taxpayers could have come forth and filed FBAR's and any other unfilled information returns and be eligible for a single unified penalty structure, in the form of a "miscellaneous civil penalty" or elect to "opt out" of the program and make reasonable cause arguments. In the absence of a third formal program an option for a "dual national" who is subject to any of these potential penalties is to file the missing returns, and make reasonable cause arguments for penalty mitigation. A reasonable cause argument may include reliance on the advice of a professional who was fully informed of all facts, or specific facts showing lack of awareness of U.S.filing obligations. The alternative of continuing non-compliance (the Ostrich factor) is offset by the fact that beginning with income tax returns due for 2011, a new schedule, Form 8938 will require disclosure of specified foreign financial assets in excess of $50,000 in value and statements that information returns, like Form 5471 and 3520 have been filed. This new Form 8938 is much more detailed in scope and required information and is in addition to the FBAR reporting obligation; it is a Super FBAR. The income tax return is filed under penalty of perjury, so a taxpayer runs the risk of committing a false statement crime if assets are intentionally left off Form 8938. Further, in light of preparer penalties, return preparers may have a greater duty of inquiry about foreign held assets as part of return preparation where dual nationals are the clients.

When the global scale of enforcement as reflected in the OECD statements is put into context with the affect that FATCA is having already and the warning issued in the form of the IRS news release,

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“dual nationals” with assets offshore have complex analysis ahead. They must consider the income tax consequences of filing returns including income tax treaty benefits where applicable, information return penalties, including FBAR penalties, and reasonable cause defenses. While these non-filer deficiencies apply equally to all taxpayers, including those with unreported offshore asset protection plans, the fact that the IRS has singled out the “dual national” community for a special news release, would to the conclusion that they know where to look to find more of what the OECD says in $1tn in hidden offshore assets. The new release may raise as many fears as it seeks to dispel.

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