

IRS GUIDANCE FOR U.S. CITIZENS LIVING ABROAD

Federal/International Tax Alert
December 13, 2011

A recently released Internal Revenue Service (IRS) Fact Sheet (FS-2011-13, December 2011) provides guidance to U.S. citizens residing outside the U.S. who have failed to file U.S. tax returns and information reports, including the Report of Foreign Bank and Financial Accounts (FBARs). The Fact Sheet is particularly welcome guidance because the 2009 and 2011 Offshore Voluntary Disclosure Programs (VDPs) frequently resulted in harsh penalties for U.S. citizens resident abroad who had been unaware of the need to file U.S. income tax returns and FBARs, and the parameters of those programs did not give IRS examiners discretion to consider reasonable cause or a particular individual's facts and circumstances.

Tax Return Penalty Relief

The Fact Sheet confirms that U.S. citizens resident abroad who owe no U.S. tax for the prior six tax years (currently, 2005-2010) may file U.S. tax returns for such years without the imposition of penalties for failure to file income tax returns or to pay tax. For many U.S. citizens resident in Canada, this will be the case due to the availability of foreign tax credits for taxes paid in Canada.

For U.S. citizens who owe U.S. tax, the Fact Sheet indicates that the IRS will consider whether the failure to file or pay tax was due to reasonable cause based on consideration of the facts and circumstances. The IRS will look at whether the taxpayer exercised ordinary business care and prudence in meeting his or her tax obligations. Other factors that will be considered include:

- Reasons given for not meeting the tax obligations
- The taxpayer's compliance history
- Length of time between the taxpayer's failure to meet his or her tax obligations and his or her subsequent compliance
- Circumstances beyond the taxpayer's control

Reasonable cause may be established if a taxpayer shows that he or she was not aware of specific obligations to file returns or pay taxes, depending on the facts and circumstances. The IRS will consider the following factors:

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- The taxpayer's education
- Whether the taxpayer has previously been subject to the tax
- Whether the taxpayer has been penalized before
- Whether there were recent changes in the tax forms or law that the taxpayer could not reasonably be expected to know
- The level of complexity of a tax or compliance issue.

In addition, reasonable cause for noncompliance may be established due to ignorance of the law if a reasonable and good faith effort was made to comply with the law or the taxpayer was unaware of the requirement and could not reasonably be expected to know of the requirement.

FBAR Penalty Relief

If a U.S. citizen abroad failed to file U.S. tax returns for 2005 through 2010, it is likely that he or she failed to file FBARs reporting his or her financial interest in or signature authority over certain types of non-U.S. financial accounts, including bank accounts, securities accounts, mutual funds, and Registered Retirement Savings Plans (RRSPs). FBAR penalties can be imposed for willful and nonwillful violations. The imposition of this penalty can produce harsh results, because the penalty is imposed per violation, which means per account per year. The maximum penalty imposed per nonwillful violation is \$10,000; the penalty for willful violations is even higher.

The Fact Sheet provides very welcome guidance in this respect, indicating that no penalty will be imposed if the IRS determines that the late filings were due to reasonable cause. To establish reasonable cause, U.S. citizens resident outside the U.S. should file delinquent FBARs for each of the prior six years (i.e., 2005-2010) and attach a statement indicating the reasons they are late.

The IRS notes certain factors it will consider to determine if reasonable cause exists, with no single factor being determinative. Factors that may weigh in favor of finding reasonable cause include 1) a U.S. citizen's reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account, 2) if the unreported account was established for a legitimate purpose and no efforts were made to intentionally conceal the reporting of income or assets, and 3) if there is no tax deficiency related to the unreported foreign account, or if there is a tax deficiency of a de minimis amount.

The IRS will also consider factors that weigh against a finding of reasonable cause, including 1) whether the taxpayer's background and education indicate that he or she should have known of the FBAR reporting requirements, 2) whether there was a tax deficiency related to the unreported foreign account, and 3) whether the taxpayer failed to disclose the existence of the account to the person preparing the tax return.

While the Fact Sheet does not provide for automatic penalty relief for U.S. citizens resident abroad who failed to file U.S. tax returns and FBARs, it does provide helpful guidance for taxpayers that can affirmatively show that their failure is due to reasonable cause. The IRS is continuing to review these issues and may provide additional guidance.

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The Facts Sheet also reminds U.S. taxpayers that, starting in 2012, interests in certain foreign financial assets with an aggregate value of at least \$50,000 must be reported to the IRS with the taxpayer's U.S. tax return on Form 8938. This is in addition to a taxpayer's FBAR reporting obligations.

