IRS Hot Topics

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FBAR and tax return non filers in the post IRS OVDI environment - What are the options now?

The IRS ended their 2011 Offshore Voluntary Disclosure Initiative (OVDI) for non filers of both U.S. tax returns and Foreign Bank Account Reports (FBARs) on December 9, 2011. After months of protests from U.S. individuals living abroad who either recently discovered they were dual citizens and/or thought they owed no U.S. tax because they had no U.S. filing obligations, the IRS issued an announcement on December 13, 2011 (Fact Sheet (FS) -2011-13) that summarizes the filing requirements and potential penalties for delinquent tax returns and FBARs. While this Fact Sheet was seen by many as a welcome return to "reasonableness," it left many procedural questions unanswered, particularly for those citizens who will owe U.S. taxes.

Even now with no formal program, the IRS international strategy is clearly reflected in other initiatives such as the new IRS Form 8938, the FATCA rules, the recent Tax Information Exchange Agreement with Liechtenstein, and the various Department of Justice indictments in the UBS-related cases. The pursuit of unreported foreign accounts of U.S. citizens, even if there is no U.S. income tax due, is not ending just because the OVDI period has ended. Offshore compliance is a top priority to all IRS divisions, including improving detection and data mining techniques. However, the IRS now seems to be separating those individuals who had no evasive intent in not filing returns and FBARs from those who set up foreign accounts to avoid offshore income reporting and detection.

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Although the OVDI program was well-publicized, we anticipate that there will still be a population of U.S. dual citizens, green card holders or long term expatriates who, for various and valid reasons, were unaware and uninformed of the OVDI. This article discusses the options in a still uncertain environment.

Who benefits from FS-2011-13?

FS-2011-13 returns to the practice that was more common for the IRS prior to the first 2009 Voluntary Compliance Initiative. Prior to 2009, if a non filer prepared returns, owed no tax due to the foreign earned income exclusion and/or the foreign tax credit, then no delinquency penalties applied. If FBAR filings were missed, there was no penalty assessed if there was reasonable cause and the filings were accompanied with a reasonable explanation of the delinquency.

While FS-2011-13 states that one needs only to file the last six years of unfiled returns to comply, there is still conflicting information on some government web sites. For example, the U.S. Embassy in Germany "Tax FAQs" web site still states:

> If you had a filing requirement, your earned income is foreign sourced, and you choose the exclusion, you should begin by filing the current year's tax return and the preceding two years...If a tax liability is incurred for one of those years, then you should generally file returns for an additional two prior years (for a total of 5 tax years). [1]

While the web site also discusses FBARs, this official government site demonstrates the confusion that may still linger within the expatriate or dual citizen community. FS-2011-13 restates and clarifies both the penalty provisions from the Internal Revenue Code, as well as the general delinquent filing requirement from the Internal Revenue Manual.[2]

Importantly, the Fact Sheet reminds potential filers that, "In addition, no FBAR penalty applies in the case of a violation that the IRS determines was due to reasonable cause." While the Fact Sheet explains some common reasonable cause factors, the obvious situation to most dual citizens living as long term residents in their other country of citizenship is that they had no idea they were dual citizens, and therefore were ignorant of their requirement to file U.S. returns or FBARs. Clearly the population of dual citizens or other long term expatriates who reside and work in high tax countries benefit from the IRS approach defined in FS-2011-13.

Options available if no tax is due

For those dual citizens or other long term expatriate non filers with no tax due, the Fact Sheet indicates that no penalties will be asserted on the prior (six) years of returns filed. The Fact Sheet also indicates that if a non filer

[1] http://germany.usembassy.gov/faqs/tax/
[2] IRM 9.5.11.9

has reasonable cause, then the prior six years of FBARs should also be filed with a reasonable cause statement attached explaining the late filings. The Fact Sheet also describes some reasonable cause factors.

PwC observation

While the Fact Sheet describes the law and policies in existence and practice prior to the 2009 and 2011 voluntary compliance initiatives, PwC notes that "reasonable cause" relief is always dependent on the facts and circumstances and that relief is subject to the judgment of the IRS. A well-constructed reasonable cause statement is therefore essential.

The Fact Sheet provides no guidance as to what procedures a taxpayer should follow if they entered the 2011 OVDI program, and signed the "Penalty Computation Worksheet" which computed a penalty of (probably) 5% on their highest bank account balance for the highest year's balance. Hopefully the IRS will provide guidance soon and these individuals will not have to go through the often burdensome "opt out" process to qualify for the reasonable cause provisions discussed in the Fact Sheet.

Green card holders

The same tax return and FBAR filing requirements apply to green card holders as U.S. citizens (with certain exceptions). Green card holders who have lived outside the U.S. for many years have been surprised to learn of their continuing tax return and FBAR filing requirements and many participated in prior disclosure programs. Green card holders represent another population, besides dual citizens and other long-term expatriates living overseas, where the option presented in FS-2011-13 may be beneficial.

PwC observation

Green card holders, including those whose green cards have "expired," but which have not been formally relinquished, are often surprised to learn that their U.S. tax return and FBAR filing obligations remain in place. Others who file Forms 1040NR on the basis of an income tax treaty do not realize that they continue to be U.S. residents for FBAR purposes. Some green card holders file the Homeland Security Form I-407, "Abandonment of Lawful Permanent Resident Status," in hopes of terminating continued U.S. tax and FBAR obligations, but are often faced with burdensome 'expatriation' consequences under IRC § 877A that outweigh the burdens of retaining the green card or that could have been mitigated with advance planning.

Other options available after OVDI if tax is due

The Fact Sheet addresses tax return and FBAR non filers who owe no tax. However, many expatriate citizens and green card holders, a significant number of whom are Canadians with Canadian retirement accounts called "RRSPs" or "RESPs," for example, may still owe some tax, unless the IRS considers other equitable solutions. There are of course many other

impacted taxpayers who, for some reason, missed the OVDI or chose not to enter it. Unless the IRS considers other equitable solutions for those with circumstances owing a small amount of tax, there are only four options. If tax is due, the four options available for becoming compliant for both delinquent tax returns and FBARs are discussed below. These were the same methods available to taxpayers before the 2009 and 2011 OVDIs.

Option 1: Enter the longstanding IRS voluntary disclosure process as detailed in the Internal Revenue Manual (IRM) 9.5.11.9. This formal process has applied to unfiled tax returns in the past. It includes completing an "optional format letter" for IRS Criminal Investigation (CI). CI then verifies (assuming appropriate) that there is no criminal information on file, accepts the VDA and sends the disclosure to Exam for consideration.

Option 2: File U.S. tax returns for past years with the ultimate exposure of being identified by the IRS for filing outside of a formal disclosure process. This is the long standing "soft or quiet disclosure." If the returns are examined by the IRS, there will likely be a higher penalty involved than entering the Voluntary Disclosure Program. This option does not relieve the taxpayer from criminal prosecution but assures that the taxpayer is now in 'the system.' A quiet disclosure is not considered by the Service to be a "voluntary disclosure" as described in Option 1.

Option 3: File U.S. tax returns prospectively. This option provides no relief from criminal prosecution for past years with the ultimate exposure of being identified by the IRS for filing under quiet disclosure. This option assures that the taxpayer is now in the system, but carries no guarantee that the IRS would not inquire and pursue prior year returns and FBARs and assert applicable penalties.

Option 4: Do nothing. This option has the ultimate exposure for past and prospective years to be subject to maximum criminal and civil penalties.

PwC observation

In the case of many impacted Canadians, two common forms of retirement accounts, RRSPs and RESPs, can result in other missed reporting obligations and a high maximum balance on the FBAR. Because so many Canadians are affected by the FBAR reporting requirement on these account balances, the Service hopefully will provide additional guidance in the near future.

Conclusion

FS-2011-13 provided welcome guidance for many dual citizens and green card holders living outside the U.S., who owed no tax but had FBARs due, had reasonable cause and who wished to come into tax return and FBAR compliance. Questions still remain for the same population who do owe tax. The risk in filing soft disclosures is that IRS has made public statements that they intend to filter quiet disclosures and choose certain ones to examine. T he likely question to be asked by IRS in any examination of a soft disclosure is "How could you

not know? It was well publicized in the media." The IRS faces the dilemma of balancing limited resources with their desire to be fair to those who did go through the 2009 and 2011 OVDI.

The options and risks discussed above are the current choices, and the best path to compliance for each taxpayer must be considered based on individual facts and circumstances.

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