

# Tax Penalty Relief May Be Available For U.S. Citizens Residing Outside the United States for Late Filed U.S. Federal Income Tax Returns and FBAR Forms

Legal Alert  
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Garvey Schubert Barer Legal Update, December 2011.

## Introduction

In a Fact Sheet<sup>1</sup> released December 7, 2011, the Internal Revenue Service (IRS) addresses the rules applicable to U.S. citizens residing outside the United States and who have failed to file U.S. tax returns or Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR). The purpose of the Fact Sheet is to remind delinquent U.S. citizens living abroad that they can come into tax compliance and potentially avoid applicable penalties for failure to file U.S. tax returns or FBARs if they can establish noncompliance was due to reasonable cause.

## U.S. Income Tax Filing Requirements and Penalties

The Fact Sheet reaffirms the rule that while U.S. citizens and resident aliens (“U.S. Taxpayers”) are required to file federal income tax returns<sup>2</sup>, delinquent U.S. Taxpayers “who owe no U.S. tax will owe no failure to file or failure to pay penalties.” For U.S. Taxpayers residing abroad, the exclusion available for foreign earned income (e.g., salary) or credit for foreign taxes paid may eliminate any U.S. tax liability and as a result nullify income tax penalties.

Even if a delinquent U.S. Taxpayer residing abroad owes U.S. tax, the U.S. Taxpayer can avoid the failure to file or failure to pay penalties<sup>3</sup> if the noncompliance was due to reasonable cause. Reasonable cause relief is generally granted “when the taxpayer demonstrates the exercise of ordinary business care and prudence in meeting tax obligations but nevertheless failed to meet them.” In the Fact Sheet, the IRS provides insight into those facts that would support a reasonable cause argument. Specifically, the Fact Sheet provides that the IRS will consider the following to determine whether the taxpayer exercised ordinary business care and prudence:

The reasons given for not meeting the tax obligations;

The taxpayer’s compliance history;

The length of time between the taxpayer’s failure to meet one’s tax obligations and subsequent compliance; and

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Circumstances beyond the taxpayer's control.

Significantly, the Fact Sheet confirms that reasonable cause may be established if the U.S. Taxpayer can show that they "were not aware of specific obligations to file returns or pay taxes, depending on the facts and circumstances." Consequently, it appears that for delinquent U.S. Taxpayers residing abroad, ignorance of one's U.S. tax obligations may be a defense to income tax penalties. The IRS will consider the following facts and circumstances to determine if a taxpayer was not aware of their U.S. tax obligations:

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; and

The level of complexity of a tax or compliance issue.

The Fact Sheet does not provide a general amnesty to delinquent U.S. Taxpayers residing abroad. Whether a U.S. Taxpayer qualifies for the reasonable cause exception is based on each taxpayer's facts and circumstances and requires a careful review of their foreign tax returns, their U.S. tax obligations and the reason they were delinquent with the U.S. tax filing and tax payments. For delinquent U.S. Taxpayers residing abroad who owe U.S. income tax and are unable to establish reasonable cause, the Fact Sheet does not provide relief from U.S. federal income tax penalties

### **FBAR Filing Requirements and Penalties**

The Fact Sheet makes clear that if U.S. Taxpayer's failure to file an FBAR<sup>4</sup> was due to reasonable cause, a reprieve from FBAR penalties is available. The FBAR is an informational return disclosing an interest in a foreign account to the IRS and failure to file the FBAR can incur steep penalties. Non-willful failure to file may be penalized by up to \$10,000 per violation, unless the failure was due to reasonable cause. A willful failure to file can be subject to a higher civil penalty (up to \$100,000 or 50% of the balance of the foreign account, whichever is greater) and criminal penalties.

In the Fact Sheet, the IRS gives examples of factors that, considered along with all the facts and circumstances, could point to reasonable cause for non-willful failure to file an FBAR and therefore a lesser or no penalty:

Taxpayer's reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account;

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Legitimate purpose for establishing the unreported account;

A lack of any intentional effort to conceal income or assets related to an unreported foreign account that was established for a legitimate purpose; and

A lack of any material tax deficiency related to an unreported foreign account.

Factors identified as potentially weighing against a finding of reasonable cause, on the other hand, are:

Failure by the taxpayer to disclose a foreign financial account to his or her tax return preparer;

Background and education of the taxpayer indicating that he or she should have known of the FBAR reporting requirements; and

A tax deficiency related to the unreported foreign account.

For information about the reasonable cause exception to the FBAR penalty, the Fact Sheet references Internal Revenue Manual (“IRM”) 4.26.16, Report of Foreign Bank and Financial Accounts (FBAR). The IRM provides that although the reasonable cause factors described in relation to U.S. income tax filing requirements and penalties are not directly applicable to delinquent FBARs, the income tax factors may be relevant in determining whether the FBAR violation was due to reasonable cause. When pursuing the reasonable cause argument, it is critically important to analyze the facts applicable to the taxpayer, substantiate the facts with affidavits or other evidence, and ensure the reasonable cause argument is supported by existing law.

### **Conclusion**

The IRS has cautioned that it is still considering issues related to delinquent returns of U.S. Taxpayers residing abroad and will provide additional information. However, in the interim the Fact Sheet provides welcome guidance as to the criteria that a U.S. Taxpayer residing outside of the United States must establish to avoid penalties for noncompliance with U.S. income tax and FBAR filing obligations. The Fact Sheet does not provide a general amnesty, but does provide a basis on which to re-enter the U.S. tax system without draconian penalties. Persons who believe they qualify for the reasonable cause exception should carefully consider the benefits and implications of remedying delinquent U.S. tax filings.

For more information about filing U.S. federal income tax returns or making FBAR filings, please contact Gary P. Tober, Ada Ko, or any of the other members of the GSB Tax and Benefits Group.

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*Circular 230 Disclosure.* The income tax principles, rules, and outcomes discussed in this alert are intended to be used solely for general informational purposes. The information contained in this alert is not intended to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties. Further, this alert is not intended and cannot be relied upon by, or marketed to, others. Please contact us if a formal penalty-protection federal income tax opinion is desired with respect to the matters discussed herein.

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<sup>1</sup>FS-2011-13, December 2011. Note that the Fact Sheet is provided by the IRS for information purposes only, and it may or may not apply to a particular taxpayer's situation.

<sup>2</sup>U.S. citizens and residents are required to file a U.S. federal income tax return for any year in which gross income is equal to or greater than the applicable exemption amount and standard deduction. This amount varies by year, but in 2010 the amount was US\$9,350; in 2011 the amount is US\$9,500.

<sup>3</sup>The penalty for the failure to file a U.S. tax return or failure to pay the amount of tax shown on the U.S. tax return can each be up to twenty-five percent (25%) of the amount of tax shown on the tax return. IRC 6651.

<sup>4</sup>Generally, FBAR must be filed by U.S. persons having a financial interest in or signature authority or other authority over any financial account in a foreign country if the aggregate value of the foreign accounts exceeds \$10,000 at any time during the calendar year.