

Internal Revenue Service Releases New Fact Sheet for Dual Citizens Residing Outside U.S., States that Penalty Relief May be Appropriate



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The **Internal Revenue Service's (IRS)** aggressive pursuit of U.S. taxpayers with foreign financial assets has been the topic of much discussion for the past three years. Key IRS executives have repeatedly stated that the IRS intends to pursue and "fully prosecute" those U.S. taxpayers hiding money in offshore accounts. However, many practitioners and U.S. citizens residing abroad have requested relief from the onerous penalties the IRS can assert against U.S. taxpayers who unknowingly fail to file U.S. tax returns reporting their income and disclosing their interests in foreign financial accounts because these taxpayers erroneously assumed that their tax compliance in their country of residence was sufficient for U.S. income tax reporting purposes.

After the IRS took a "one size fits all" approach to the implementation of negligence and offshore penalties in the **2009 Voluntary Disclosure Program ("2009 Program")** and the **2011 Offshore Voluntary Disclosure Program ("2011 Program")**, countries such as Canada were outraged at the IRS for punishing U.S. citizens living abroad who properly filed and paid income tax in their countries of residence. In September of 2011, Canadian Finance Minister Jim Flaherty spoke out

publicly against the IRS in an angry letter sent to the *Washington Post*, *New York Times* and *Wall Street Journal* telling the IRS to “back off” of Americans living in Canada. Flaherty blasted the IRS for creating unnecessary “stress and fear” on U.S. citizens living in Canada, noting that many were unaware that they had dual filing obligations in Canada and the U.S. Moreover, Flaherty noted that Canada is not a tax haven, stating that Canadian tax rates are higher than the U.S. rates.

Shortly after Canada’s public cross-border battle against the IRS, the IRS released a fact sheet in December of 2011 for U.S. or dual citizens living outside the U.S., not just in Canada. The fact sheet specifies instances where U.S. citizens who owe no U.S. tax and/or who have reasonable cause defenses to penalties, will not be subject to penalties for failing to file U.S. income tax returns or Foreign Bank Account Reports (FBARs). The fact sheet for U.S. and dual citizens living abroad is an important step for U.S. taxpayers who reside in foreign countries to come into compliance in the U.S. and, hopefully, be absolved of any penalties owed to the IRS.

The IRS states that the fact sheet is for informational purposes only and cannot be relied upon in any particular taxpayer’s situation. However, the fact sheet is instructive to U.S. citizens living abroad who may be considering whether to file past due U.S. income tax returns and FBARs and come into compliance. It can also be informative to those dual citizen taxpayers who have only recently learned about their obligation to file U.S. income tax returns or FBARs, as noted by the IRS in the fact sheet.

Generally, an 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 in the accounts exceeds \$10,000 at any time during the calendar year. Presumably, many U.S. citizens living abroad have interests in foreign financial accounts meeting this threshold. The normal annual filing date for FBAR is June 30 for the previous tax year. While the Association of Americans Resident Overseas estimates that some 6.32 million U.S. citizens live abroad, the Treasury Inspector General for Tax Administration reports that only a little more than 534,000 total FBARs were filed in 2009.

An FBAR is not a tax return, but an information return that discloses foreign account information to the Department of Treasury. The failure to file an FBAR can result in the assertion of onerous penalties. If the IRS determines the failure to file an FBAR was non-willful, it can assert a maximum penalty of \$10,000 per account, unless the failure was due to reasonable cause. The penalty increases to the greater of \$100,000 or 50% of the balance of the foreign account if the IRS determines that the taxpayer willfully failed to file the FBAR. In addition to civil penalties, a failure to file an FBAR can result in criminal penalties and potentially could lead to a criminal prosecution.

For the 2009 and 2011 Programs, the IRS imposed a 20% and 25% offshore penalty in each program, respectively, on the highest account balance (and highest asset balances) in addition to income tax penalties for the period covered in the programs. The 2009 and 2011 Programs reduced the offshore penalty to 5% where taxpayers were foreign residents who were unaware that they were a U.S. citizen or where the taxpayer was a foreign resident that was in tax compliance in their country and had less than \$10,000 of U.S. source income in a given year. Thus, U.S. taxpayers who

participated in the 2009 and the 2011 Programs paid significant offshore penalties, regardless of whether those taxpayers had reasonable cause defenses to the penalties they paid. In light of the newly released fact sheet, it is unclear whether the IRS will grant reasonable cause abatements for those U.S. citizens living abroad who participated in the 2009 or 2011 Programs and paid significant penalties.

The IRS fact sheet lists some factors that could warrant a reasonable cause defense for non-willful failure to file an FBAR, such as:

- Reliance upon the advice of a professional tax adviser who was informed of the existence of a foreign financial 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 the IRS identified as potentially weighing against a finding of reasonable cause for failure to file an FBAR, however, were:

- 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.

U.S. citizens living abroad that either failed to file income tax returns or failed to report the income from foreign accounts or assets can be subject to income tax penalties for the failure to timely file tax returns and the failure to timely pay the income tax due, as well as negligence penalties (if applicable). The fact sheet provides that the IRS will also consider reasonable cause defenses to the assertion of any income tax penalties. In addition to reasonable cause defenses, the fact sheet specifically states that the IRS will not assert income tax penalties if the tax return shows no income tax is due after the application of foreign tax credits and income exclusions.

Soon after the IRS fact sheet for U.S. citizens and dual citizens living abroad was released, the IRS released temporary and proposed regulations for reporting specified foreign financial assets, as well as the final Form 8938, Statement of Foreign Financial Assets. The Form 8938 will be required for all U.S. taxpayers who have specified foreign financial assets for tax years after March of 2010, which will mean that these forms will be required for 2011 tax returns filed in 2012. A *GT Alert* regarding the new IRS Form 8938, Statement of Specified Foreign Financial Assets, is forthcoming.

The IRS's fact sheet specifically recommends that U.S. taxpayers who live abroad file U.S. income tax returns and FBARs along with a statement attached to each return explaining why penalties should be abated in their case. The development of a reasonable cause statement for FBAR and income tax penalties is a technical

argument requiring skilled tax practitioners who are familiar with the legal authority regarding reasonable cause defenses to these penalties. For those U.S. taxpayers who are dual citizens and/or live abroad who are considering filing income tax returns and past due FBARs, the authors of this Alert recommend that you contact a tax practitioner familiar with the legal authority concerning these issues for assistance in filing the returns and the required statements with the IRS.

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