

THE IRS' VIEW OF FOREIGN NONFILERS

The world is getting smaller and smaller and that applies as well to the long arm of the United States Internal Revenue Service. U.S. citizens and green card holders are required to file annual tax returns with the IRS, even if these persons live abroad or are dual citizens. Moreover, U.S. citizens are required to report the existence of foreign bank accounts that they own with the Department of Treasury (Foreign Bank Account Reporting Form, or FBAR). This reporting requirement almost certainly applies in the case of a U.S. citizen living abroad.

In a series of recently highlighted initiatives, the IRS has offered quasi-amnesty programs (the Offshore Voluntary Disclosure Initiatives) the last of which expired in September 2011. These initiatives primarily focused on U.S. taxpayers who had deliberately hidden assets offshore and allowed U.S. taxpayers to come forward to report income on these hidden assets without risk of criminal prosecution. The price, however, was high and included significant civil penalties and interest. By reducing (but not eliminating) civil penalties for certain U.S. citizens living abroad, the most recent initiative tried to distinguish between U.S. taxpayers who had deliberately underreported income from those U.S. citizen residing abroad, who often did not realize that they had U.S. tax filing obligations.

The amnesty programs are finished and there does not seem to be any appetite to repeat them in the near future. For U.S. citizens living abroad who now realize that they are out of compliance with their U.S. tax affairs, the situation is somewhat unclear. In a press release issued on December 8, 2011, the IRS clarified the government's position and restated the IRS's historic stance that a taxpayer who is out of compliance should file returns and, assuming the failure to comply with the U.S. tax rules was due to "reasonable cause", no penalties would be imposed for past failures.

In essence, the IRS is asking delinquent taxpayers to file returns to get back into the system – the door is open and the IRS may not go after U.S. citizens and green card holders who in the IRS's views "were not aware of specific obligations to file returns or pay taxes, depending on the facts and circumstances." The IRS is leaving itself some element of discretion and is not giving a blanket exemption from penalties for nonfilers. However, the IRS is asking for a letter to be submitted with delinquent prior returns to explain why the reasonable cause exception to penalties should apply.

For U.S. citizens and green card holders living abroad, this is good news indeed. The IRS had in the past adopted a very lenient position to U.S. taxpayers, whether living in the U.S. or abroad, who had failed to file tax returns for reasons other than fraud (*e.g.* hard financial times, recent family changes, illness and the like) provided the taxpayer contacted the IRS first to seek to get back into the system. However, practitioners were concerned that after the expiration of the Offshore Voluntary Disclosure Initiatives, the world may have changed and the IRS may not have been willing to allow nonfilers back into the system without draconian penalties. It is comforting to see that, although the IRS is retaining discretion in this circumstance, the prevailing attitude is one of treating innocent nonfilers in a reasonable way.

Of course, the other lesson from the press release is equally clear. The IRS is welcoming back nonfilers who voluntarily come forward with the intent on cleaning up past failings; however, if the IRS discovers taxpayers resident abroad who have not complied with the various rules, no mercy can be expected. Indeed, the IRS has stepped up enforcement action against nonresident U.S. taxpayers and this scrutiny is here to stay. Additional reporting rules are also coming into effect, the so-called FATCA rules, designed at making foreign banks report U.S. accountholders to the IRS.

In conclusion, the press release issued a few days ago warns as much as it reassures. For taxpayers who are not in compliance, the message is clear – come clean before we find out about you and you can expect the IRS to be more lenient. The opposite will also be true – if the IRS finds you before you find them, do not expect such a pleasant welcoming.