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Pressure Builds on US Taxpayers with Foreign Accounts

By Robert Barnett, CPA, JD, MS (taxation) and Renato Matos, JD, LLM (taxation)

The Foreign Account Tax Compliance Act of 2010 (FATCA) has manifested outside the United States in recent months, as a result of an agreement announced on Aug. 29, 2013, between the U.S. Department of Justice and the Swiss Federal Department of Finance. Recently, numerous Swiss banks have notified U.S. account holders to either provide evidence that their accounts have been properly disclosed to the IRS or to confirm participation in the Offshore Voluntary Disclosure Program (OVDP). Failure to comply will likely result in the bank releasing information about the account and account holder to the U.S. Department of Justice, which will then determine whether to pursue a criminal investigation and prosecution.

In addition to prompting international agreements, FATCA seeks to enforce U.S. tax and banking laws by requiring U.S. banks to withhold 30 percent of international fund transfers and by requesting foreign financial institutions to disclose account holders who might have failed to comply with U.S. tax obligations.

Under the Internal Revenue Code (IRC) and banking laws (i.e., the Bank Secrecy Act), U.S. residents and citizens—including those living outside the United States—have two primary reporting obligations to the Treasury Department. First, they must report all of their worldwide income (including income from wages and investments) and their interests in certain entities. Generally, such entities include corporations, partnerships, and trusts organized outside the United States and not publicly traded. Second, pursuant to the Bank Secrecy Act, all U.S. taxpayers must file Form 114, Report of Foreign Bank and Financial Account (FBAR), reporting their financial interest in financial accounts outside the United States when the aggregate value of such accounts exceeds $10,000.

Under U.S. law, noncompliant taxpayers face criminal prosecution and penalties that could exceed the undisclosed account's balance; however, taxpayers may become compliant and avoid criminal prosecution by entering agreements with the IRS through the OVDP or related procedures, such as opting out or theStreamlined Filing Compliance Program.

Offshore Voluntary Disclosure Program

Under the OVDP, a U.S. taxpayer discloses foreign bank accounts and amends returns for an eight-year voluntary disclosure period. Taxpayers must then pay taxes on all previously unreported income, along with a 20 percent accuracy-related penalty on such taxes. In addition, the taxpayer pays one of three nonnegotiable penalties based on the highest annual aggregate account balance that the taxpayer has previously failed to disclose. These OVDP penalties are applied in lieu of the FBAR penalty under the banking law, penalties under the tax code, and potential liabilities for years prior to the voluntary disclosure period:

27.5 percent OVDP penalty. The standard penalty equals 27.5 percent of the highest annual aggregate account balance during the voluntary disclosure period. This penalty applies in the majority of OVDP cases and, while substantial, it provides amnesty from criminal prosecution for noncompliance.

12.5 percent OVDP penalty. A taxpayer will qualify for a 12.5 percent penalty if the taxpayer's highest aggregate account balance, in each of the years within the voluntary disclosure period, is less than $75,000.

5 percent OVDP penalty. A taxpayer will qualify for a 5 percent penalty if the taxpayer falls within one of the following three categories, two of which apply to U.S. taxpayers living outside the United States (foreign resident):

- De minimis.To qualify, the taxpayer 1) must not have opened or caused the account to be opened; 2) exercised minimal, infrequent contact with the account; 3) must not have withdrawn more than $1,000 from the account in any year the taxpayer was noncompliant; and 4) must establish that all applicable U.S. taxes were paid on funds initially deposited to the account.
- Unaware foreign resident. The taxpayer must be a foreign resident who was unaware of being a U.S. citizen.
- Compliant foreign resident. The taxpayer must 1) reside in a foreign country, 2) have made a good faith showing that he timely complied with all tax reporting and payment requirements in the country of residence, and 3) have less than $10,000 of U.S. source income each year.

Opting Out

Before or after entering the OVDP, a taxpayer may irrevocably elect to opt out of the OVDP's rigid penalty structure. In such case, the IRS will examine the taxpayer's former noncompliance under the IRC, the Bank Secrecy Act, and their accompanying regulations. Generally, a six-year statute of limitations applies, as opposed to the OVDP's eight-year disclosure period. Protection from criminal prosecution is generally provided to the taxpayer if the opt out occurs after entering the OVDP.

Generally, under the Bank Secrecy Act, there are three levels of penalties for the failure to file FBARs:

- *Willful penalty*. The penalty equals the greater of 50 percent of the highest account balance or $100,000 per account annually. The burden is on the IRS to prove that the taxpayer was willful (i.e., knew of or was willfully blind toward) the FBAR filing requirement. Evidence of willfulness includes letters from the IRS (or other entities) to the taxpayer informing of the FBAR filing responsibility or the taxpayer's previous FBAR filings.
- *Nonwillful penalty.* Where the IRS cannot prove that the taxpayer was willful in failing to file, the penalty is $10,000 per account annually.
- *Nonwillful penalty with reasonable cause.* Where the taxpayer had reasonable cause for failure to file, the IRS will not impose penalties. The taxpayer must show proof of reasonable cause, which includes reliance on a tax professional.

At all three penalty levels, taxpayers can negotiate based on facts and circumstances in their particular case. The willful and nonwillful penalties can be mitigated or lowered based upon certain criteria, including the size of the undisclosed account.

Streamlined Filing Compliance Procedure

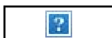
The Streamlined Filing Compliance Procedure is designed for U.S. citizens living abroad. It requires tax returns for a three-year period, as well as filing delinquent FBARs for a six-year period. Eligible taxpayers are only responsible for any U.S. back-taxes and do not pay any FBAR penalties.

To be eligible, a taxpayer must 1) have resided outside the United States since Jan. 1, 2009, 2) have not filed a U.S. tax return during the same period, and 3) present a low compliance risk. A variety of factors apply in determining the existence of low compliance risk, including whether the taxpayer owes less than $1,500 in taxes for each year being disclosed, has declared all income in the country of residence, and has a financial interest in an account located outside the resident country. Although seemingly "streamlined," this option is limited in scope. Minimal IRS guidance for its use exists.

Implications

As FATCA and the U.S. Department of Justice break down international legal barriers, it is important for noncompliant U.S. taxpayers living in the United States or abroad to consider the options discussed above.

There are many complexities associated in becoming compliant with U.S. tax laws and banking laws. Each taxpayer's situation is different and requires a thorough individual analysis. For this reason, noncompliant individuals are urged to seek legal advice from U.S. counsel knowledgeable regarding the relevant U.S. laws and IRS procedures.



***Robert Barnett, JD, MS (taxation),** and **Renato Matos, JD, LLM (taxation),** are partners at Capell Barnett Matalon & Schoenfeld LLP, where they focus primarily on taxation matters, both domestic and international. Mr. Barnett and Mr. Matos have extensive experience representing clients with unreported foreign assets, including failure to file FBAR forms, and have advised clients in all facets of the Offshore Voluntary Disclosure Program, including penalty minimization strategies and options. The authors would like to thank Mikhail Lezhnev, JD, an associate at their firm, for his assistance in preparing this article.*

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- Foreign National-Nonresident Aliens
- ITINs
- Journals, Publications & More Information
  - Adoption
  - Affordable Care Act (ACE)
  - Amended Filings
  - Bartering
  - Businesses
  - Capital Gains & Losses
  - Casualty Losses
  - Changing Your Name
  - Charitable Giving
  - Child and Dependent Care Credit
  - Dependent Children's Income
  - Divorce/Separation
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  - DOMA and Same-Sex Marriages
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  - Getting Married
  - Hobby Losses
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  - How to Pay Your Taxes
  - ID Theft
  - IRS Criminal Investigation
  - Itemized Tax Deductions
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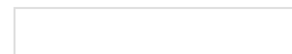

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