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Avoiding Willful Noncompliance: When Does a Non-Willful Failure to Comply with U.S. Filing and Reporting Requirements Become Willful?

For more than seven years, the Internal Revenue Service ("**IRS**") has had formal programs in place that allow certain U.S. taxpayers to avoid significant penalties for prior failures to comply with certain filing and reporting obligations related to previously undisclosed foreign assets. However, earlier this year, Caroline Ciraolo, Acting Assistant Attorney General of the Department of Justice ("**DOJ**") Tax Division, said, "After three very well-publicized voluntary disclosure programs, nearly 200 criminal prosecutions, ongoing criminal investigations, and the increasing assessment and enforcement of substantial civil penalties for failure to report foreign financial accounts, a taxpayer's claims of ignorance or lack of willfulness in failing to comply with disclosure and reporting obligations are, quite simply, neither credible nor well-received." Ciraolo's statement was made at the annual meeting of the Federal Bar Association Section on Taxation in Washington. Her statement illustrates the U.S. government's skepticism that there could possibly still be any U.S. taxpayers in various parts of the world who are unaware of their U.S. filing and reporting obligations. While the level of media attention surrounding the U.S. government's pursuit of noncompliant taxpayers has kept the issue in the financial press, that does not mean that the current level of public awareness negates a taxpayer's previous lack of knowledge.

Background

The first Offshore Voluntary Disclosure Program ("**2009 OVDP**") was announced on March 23, 2009. The objective of the 2009 OVDP was to encourage taxpayers with unreported offshore assets and income to voluntarily disclose such assets and income in exchange for reduced penalties and protection from criminal prosecution. Over the following years, the IRS tweaked elements of the 2009 OVDP in an attempt to encourage more taxpayers to come forward, while expanding the number of years covered by the disclosure and increasing the miscellaneous Title 26 offshore penalty to more severely penalize those who waited on the sidelines.

However, neither the 2009 OVDP nor any of the later iterations were suitable for taxpayers whose failure was non-willful. It took the IRS nearly three and a half years to provide non-willful taxpayers with a formal means of regularizing their past non-compliance. On August 22, 2012, the IRS unveiled the streamlined filing and compliance procedures ("**Streamlined Program**"), which entered into effect on September 1, 2012. The Streamlined Program was designed for taxpayers who presented a low compliance risk. Low compliance risk was predicated on simple returns with little or no U.S. tax due. To be eligible for the Streamlined Program, a U.S. taxpayer must have: (i) been both a non-resident and non-filer of the required U.S. Federal Income Tax and Information Returns since January 1, 2009; and (ii) owed less than

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USD1,500 in U.S. federal income tax for each of the last three tax years (tax liabilities exceeding the USD1,500 threshold did not disqualify a taxpayer from the Streamlined Program; rather, the consequence was a determination of higher compliance risk and thus greater scrutiny by the IRS and possible exposure to penalties). Taxpayers who qualified for the Streamlined Program were required to file their delinquent U.S. federal tax and information returns for the past three years, and file delinquent FBARs for the past six years. In addition, taxpayers were required to complete and sign a questionnaire, and submit the questionnaire with their returns.

The Streamlined Program was extremely narrow, and a literal reading of the eligibility requirements meant many non-willful taxpayers still found themselves without a viable remedy. It would be another 22 months before the IRS expanded the Streamlined Program. This expansion was announced on June 18, 2014 and took effect July 1, 2014. The changes were intended to ease burdens and help more taxpayers come into compliance by extending the eligibility requirements for the Streamlined Program (now referred to as the "**Streamlined Filing Compliance Procedures**") to a wider population of U.S. taxpayers living outside of the United States, as well as to certain U.S. taxpayers residing in the United States.

The expanded Streamlined Filing Compliance Procedures eliminated the previously mandatory risk questionnaire, but required taxpayers to certify in writing that previous failures to comply were due to non-willful conduct.

What is Non-Willful Conduct?

Non-willful conduct is defined as conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.

The written certification requires taxpayers "to provide specific reasons for [their] failure to report all income, pay all tax, and submit all required information returns, including FBARs." Taxpayers who relied on professional advisors are required to provide the name, address, and telephone number of the advisor along with a summary of the advice.

While returns submitted under the Streamlined Filing Compliance Procedures are processed like any other return (i.e., no acknowledgment of receipt or process by the IRS), and subject to the normal audit selection procedures, the IRS has stated that it reviews all certification statements. Because the certification statement will be reviewed, is important to include a comprehensive discussion of the taxpayer's background and history, as well as a thorough discussion of the facts surrounding the accounts including the source of funds. For taxpayers who have spent the better part of their lives living outside of the United States, explaining their financial situation in such detail can seem like an odd way to support their non-willful claim, but proving you were unaware of certain filing obligations requires more than simply saying, "I didn't know."

Cost of Becoming Compliant

One of the common frustrations we see with nonresident U.S. taxpayers looking to become compliant with U.S. filing and reporting requirements is the associated expense. Setting aside the fact that the United States is one of the few countries that taxes nonresident citizens on their worldwide income, taxpayers who engage qualified U.S. accountants and/or attorneys to shepherd them through the Streamlined Filing Compliance Procedures are looking at bills for professional fees that can dwarf the tax owed to the United

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States. Taxpayers must engage a tax return preparer to prepare three years of delinquent (or amended) U.S. income tax returns and six years of FBAR filings. More often than not, taxpayers require assistance in preparing their written certifications. Certification statements are more art than science, and the fees associated with their preparation can add up quickly.

For some, the costs to regularize noncompliance where the tax loss to the U.S. government is minimal or sometimes even nonexistent makes little sense. Their frustration, while understandable, can also cloud their vision. You would be hard pressed to find any attorney who advises clients in these matters who has not had at least one potential client choose to do absolutely nothing after the initial meeting. It is this decision that arguably turns historic non-willful behavior into an ongoing willful failure.

Streamlined Filings Are Still an Option

While Ciraolo's statement implies that taxpayers whose noncompliance stems from a failure to report foreign financial accounts can no longer claim their failure is the result of non-willful behavior, the situation is more nuanced than that. Contrary to statements like this, there will likely always be a group of taxpayers who will be eligible for the Streamlined Filing Compliance Procedures. This group shrinks every year, but it is naive to say that even with the U.S. government's focus on these matters over the years, and the surrounding publicity, that there will not continue to be taxpayers who are eligible for the Streamlined Filing Compliance Procedures. The determination of a taxpayer's level of culpability is driven by their individual facts and circumstances.

What the government overlooks or ignores is the fact that a taxpayer's prior noncompliance that was the result of non-willful behavior cannot be undone. Being put on notice of U.S. filing and reporting obligations does not mean that history is rewritten. Some taxpayers may be unwilling to pursue a regularization after being made aware of the filing and reporting obligations, and others may not be in a position financially to pursue a regularization. What becomes important is what the taxpayer does after he acquires the new knowledge. Sticking one's head in the sand and doing nothing is not the right answer because every *additional* year of noncompliance that follows may be considered willful by the IRS.

Do Not Let Prior Non-Willful Noncompliance Morph Into Willful Noncompliance

As we approach the June 15 filing deadline for income tax returns for U.S. citizens and resident aliens residing abroad as well as the June 30 FBAR deadline, it is important to realize that failing to file the necessary tax and information returns now may cause significant problems down the road. While the penalties for failure to file a tax return and failure to pay any tax due are based on the net tax liability shown on the return, which may be minimal or even zero for many nonresident taxpayers thanks to foreign tax credits, the civil penalty associated with a willful failure to file an FBAR is the greater of USD100,000 or 50% of the balance in the account(s) at the time of the violation.

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While it takes time to review the facts and circumstances surrounding one's noncompliance to determine whether it is appropriate to pursue a regularization via the Streamlined Filing Compliance Procedures or whether the more onerous OVDP may be necessary, what is clear is that the U.S. government's patience is wearing thin. Taking time to discuss one's situation in detail with a qualified U.S. attorney and tax return preparer is time well spent. At a minimum, such conversations can set a taxpayer on the proper path going forward.

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This alert was prepared by Jennifer O'Brien (Geneva)