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Out of Sight Isn't Out of (the IRS's) Mind: The Expanding Universe of Foreign Disclosure Requirements

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July 27, 2011

Taxpayers who fail to comply with U.S. income tax and foreign asset reporting requirements face draconian civil and criminal penalties, and enforcement of these requirements remains a priority for the IRS. For example, combating offshore tax evasion leads the list of operational priorities for the IRS Criminal Investigation division for the 2011 fiscal year. For tax years beginning on or after January 1, 2011, another disclosure requirement takes effect, for taxpayers with an interest in a foreign account.

Under U.S. income tax law, U.S. citizens and residents must report and pay U.S. income tax on their worldwide income, not just income originating in the U.S. Also, U.S. banking and income tax laws require filings of yearly informational returns disclosing ownership of certain foreign accounts and entities. Failure to report foreign income or file required information returns can result in severe civil and criminal penalties, even where no tax is due. Following is a brief discussion of various reporting requirements for foreign accounts, income and activities.

Report of Foreign Bank and Financial Accounts

The foreign financial account reporting requirements originated in the Bank Secrecy Act enacted by Congress in 1970 to address concerns that secret offshore financial accounts were being used in support of criminal activity, including tax evasion, illegal concealment of assets and securities law. U.S. citizens, residents and certain other persons must file Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts and commonly referred to as an FBAR) on an annual basis to report their direct or indirect financial interest in, or signature authority over, a financial account that is maintained with a financial institution located in a foreign country if the aggregate value of all foreign accounts exceeds $10,000 at any time during the year. Any person required to file the FBAR must also keep certain records of their foreign accounts for five years (and possibly longer for persons who have been formally charged with a criminal tax violation).

The FBAR is due by June 30 of the following year. It is not a tax return and no extension is available for its filing. Significant civil and criminal penalties can be imposed for violations of the FBAR requirements, including late or delinquent filings and failures to meet the recordkeeping requirement.

For violations occurring prior to October 22, 2004, there was no penalty for non-willful violations, while the penalty for willful violations was the greater of (a) $25,000 or (b) the balance of the account, up to a maximum of $100,000. In 2004, a new penalty structure was adopted for violations occurring after October 22, 2004 (i.e., FBARs due on or after June 30, 2005), which included for the first time a penalty for non-willful violations, and a dramatic increase in the penalties for willful violations.

The following chart shows the current penalties for FBAR violations:[1]

Violation	Civil Penalties	Criminal	Comments

		Penalties	
Negligent Violation	Up to $500	N/A	31 U.S.C. § 5321(a)(6)(A) 31 C.F.R. 103.57(h)
Non-Willful Violation	Up to $10,000 for each negligent violation	N/A	31 U.S.C. § 5321(a)(5)(B)
Pattern of Negligent Activity	In addition to penalty under § 5321(a)(6)(A) with respect to any such violation, not more than $50,000	N/A	31 U.S.C. 5321(a)(6)(B)
Willful - Failure to File FBAR or retain records of account	Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation	Up to $250,000 or 5 years or both	31 U.S.C. § 5321(a)(5)(C) 31 U.S.C. § 5322(a) and 31 C.F.R. § 103.59(b) for criminal. The penalty applies to all U.S. persons.
Willful - Failure to File FBAR or retain records of account while violating certain other laws	Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation.	Up to $500,000 or 10 years or both	31 U.S.C. § 5322(b) and 31 C.F.R. § 103.59(c) for criminal The penalty applies to all U.S. persons.
Knowingly and Willfully Filing False FBAR	Up to the greater of $100,000, or 50 percent of the amount in the account at the time of the violation.	$10,000 or 5 years or both	18 U.S.C. § 1001, 31 C.F.R. § 103.59(d) for criminal. The penalty applies to all U.S. persons.
Civil and Criminal Penalties may be imposed together. 31 U.S.C. § 5321(d).			

If a filing is delinquent, the violation occurs on the due date for filing the FBAR.[2] For example, the maximum penalty for failing to file a 2006 FBAR would be determined based on the amount in the accounts required to be disclosed in the FBAR on 6/30/2007, the date it was due.

In the case of a non-willful violation, no penalty will be imposed if the violation is due to reasonable cause and the account was properly reported. To be properly reported, the income from the account (if any) must be included on the taxpayer's U.S. income tax return and the taxpayer must correctly answer any questions on the return involving foreign accounts. For example, Form 1040, Schedule B, Part III, asks whether the taxpayer had an interest in or a signature, or other authority over a foreign financial account and whether the taxpayer received a distribution from or created or transferred property to a foreign trust. An incorrect answer to these types of questions may serve not only as a basis for asserting a willful violation of FBAR leading to increased penalties, but also as the basis for a criminal prosecution for tax evasion.[3]

Reporting Worldwide Income on U.S. Income Tax Returns

U.S. citizens must include in gross income all of their worldwide income, including income derived from any foreign account or entity. A failure to report foreign income on a U.S. tax return often results in an understatement and underpayment of U.S. income taxes, which can have serious consequences. Civil liabilities may include penalties in addition to payment of the underpaid tax plus interest.

Certain interests, activities and transactions involving foreign income and property must be reported by filing information returns with the IRS. Failure to file a required information return subjects the taxpayer to penalties, which can be significant. Required income tax information returns include:

- Form 3520 - Receipt of foreign gifts and inheritances from nonresident individuals and from foreign estates, creation of a foreign trust by a U.S. person, transfers of property from a U.S. person to a foreign trust and receipt of distributions from foreign trusts;
- Form 3520-A - Ownership interests in foreign trusts by U.S. persons with various interests in and powers over those trusts;
- Form 5471 - U.S. persons who are officers, directors or shareholders in certain foreign corporations;
- Form 5472 - Transactions between a 25 percent foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the U.S. and a related party;
- Form 926 - Transfers of property to foreign corporations and related information; and
- Form 8865 - Interests of U.S. persons in and transactions of foreign partnerships, transfers of property to the foreign partnerships and acquisitions, dispositions and changes in foreign partnership interests.

Unreported foreign income and delinquent or inaccurate information returns can also lead to criminal prosecution for tax evasion and for filing a false tax return. It is not uncommon for income tax violations to occur in conjunction with FBAR violations (for example, a taxpayer who does not report foreign income often fails to file FBARs as well). In those cases, the possibility of both overwhelming financial penalties and years or even decades of incarceration if the taxpayer is convicted of the array of potential charges that could be brought gives the government enormous leverage.

2011 Offshore Voluntary Disclosure Initiative (OVDI)

On February 8, 2011, the Internal Revenue Service announced its 2011 Offshore Voluntary Disclosure Initiative (OVDI), a special voluntary compliance initiative to "bring offshore money back into the U.S. tax system and help people with undisclosed income from hidden offshore accounts get current with their taxes".[4] The new voluntary disclosure initiative is available through August 31, 2011 and addresses both income tax and FBAR deficiencies. Under the program, taxpayers who voluntarily disclose should be subject to significantly lesser penalties and generally eliminate the risk of criminal prosecution. However, the required payments under the 2011 OVDI can still be significant.

For more information on the 2011 OVDI, please click here to see our February 11, 2011 alert titled "Taxpayers Given Another Chance to Tell IRS About Unreported Foreign Accounts and Assets".

The Foreign Account Tax Compliance Act (FATCA)

The Foreign Account Tax Compliance Act (FATCA), was enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act. FATCA imposes additional foreign financial asset reporting requirements for individuals for assets held in taxable years beginning on or after January 1, 2011. Effective as of January 1, 2013, it also essentially forces both foreign financial institutions and foreign entities owned by U.S. persons to choose between agreeing to provide the IRS with information about their U.S. account holders, grantors and owners, or subjecting themselves to a 30 percent withholding tax on almost any payment they receive from a

U.S. payor. The discussion in this article is limited to the foreign financial asset reporting requirements for individuals.

The requirements for individuals are described in Section 6038D of the Internal Revenue Code and apply to assets held in taxable years beginning on or after January 1, 2011. Section 6038D requires that individual taxpayers who have an interest in a specified foreign financial asset attach a statement on a new form (Form 8938) to their income tax return if the aggregate value of all such assets during any year is greater than $50,000. Specified foreign financial assets include depository and custodial accounts at foreign financial institutions, stock or securities issued by foreign persons any other financial instrument or contract held for investment that is issued by or has a counterparty that is not a U.S. person, and any interest in a foreign entity. The FATCA disclosure requirements are in addition to, not in lieu of, the FBAR requirements.

Disclosures required under FATCA include:

- In the case of any account, the name and address of the financial institution in which such account is maintained and the number of such account;
- In the case of any stock or security, the name and address of the issuer and such information as is necessary to identify the class or issue of which such stock or security is a part;
- In the case of any other instrument, contract or interest, such information as is necessary to identify such instrument, contract, or interest, and the names and addresses of all issuers and counterparties with respect to such instrument, contract or interest; and
- The maximum value of the asset during the taxable year.

FATCA also imposes new income tax penalties for both the failure to disclose a foreign financial account and for understatements of tax attributable to undisclosed foreign financial assets. Failure to furnish the required information when due subjects the taxpayer to a $10,000 penalty. If the taxpayer fails to correct such failure for more than 90 days after receiving notice of the failure, an additional $10,000 penalty is imposed for each 30-day period (or fraction thereof) during which the failure continues after the expiration of the 90-day period following the notice, up to a maximum penalty of $50,000. The penalty on any portion of an underpayment of tax that is attributable to any undisclosed foreign financial asset understatement increases from 20 percent of the understatement to 40 percent of the understatement.

Finally, the statute of limitations for audits of certain unreported income from a foreign financial account is increased from three years to six years.

Conclusion

Taxpayers receiving non-U.S. income and holding foreign assets face increasingly strict and complicated reporting requirements, with potentially catastrophic penalties for failures to comply. Taxpayers who failed to comply with the income tax and reporting requirements in the past have a limited opportunity to mitigate the cost of non-compliance through the 2011 OVDI, but they must act now. Looking forward, prior planning with the assistance of an experienced tax professional will be essential to navigate the ever-changing offshore reporting requirements without falling victim to the expanding scope and intensity of the government's offshore compliance efforts.

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[1] From *Workbook on the Report of Foreign Bank and Financial Accounts (FBAR),* IRS.gov

[2] IRM 4.26.16.4.5(1) (7/01/08).

[3] For example, § 12.10[8][g] of the U.S. Department of Justice Criminal Tax Manual states that checking the box "No" can be the basis for a tax evasion prosecution.

[4] IR-2011-14, Feb. 8, 2011.