The Perils Facing a U.S. Person Having an Undeclared Offshore Financial Account

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August 10, 2018

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Overview

There are legal and financial consequences to any U.S. person who underreports their income. Moreover, similar consequences may exist even in a situation in which all income is reported, yet certain information returns are not filed with the U.S. government. This article is specifically aimed at the potential offenders who have unreported foreign financial accounts with the aim of educating them of the legal perils they may face. The objective of this article is to inform the above set of individuals of the existing laws in order that they adhere to them and to the extent that they did not adhere to them in the past, to specify some of the possible alternatives they can use to remedy their situation and become fully compliant with the law, thereby avoiding more dire consequences. It is extremely important to note that this is a very technical and nuanced area of the law and this article will only present a very high level overview of the matter.

Foreign Financial Account Reporting Requirements

A Report of Foreign Bank and Financial Accounts also known as an FBAR (FinCEN Form 114, formerly Form TD F 90-22.1) has to be filed if a U.S. person (generally a U.S. citizen, Green Card holder, or resident) has a financial interest or signatory authority over foreign financial accounts with an aggregate value exceeding $10,000 at any time during the calendar year. Financial accounts subject to reporting include banks, securities, retirement plans, mutual funds, and certain life insurance policies. The report must be filed annually even if the accounts do not generate taxable income.

Foreign Financial Asset Reporting Requirements

In addition to the requirement to report the existence of foreign financial accounts, a U.S. person may also be required to report the existence of certain foreign financial assets on IRS Form 8938 – Statement of Specified Foreign Financial Assets. While there are some reporting similarities between this Form and the FBAR, which result in certain items being listed on both forms, there are numerous differences as well. The Form 8938 also has a higher reporting threshold requirement. Most importantly, while the FBAR report is filed electronically with FinCEN, the Form 8938 is included as part of the taxpayer's U.S. Income Tax return.

It is important to note that there are many other forms and filing requirements that may exist for U.S. persons with foreign financial accounts and assets, but they are outside the scope of this article. Anyone who has reason to believe that these rules may apply to them should make certain to discuss these matters with a competent tax attorney or accountant.

The Civil and Criminal Consequences of Not Reporting Offshore Accounts

Failure to comply with FBAR reporting can result in both civil and criminal sanctions. A non-willful failure to file an FBAR can result in a civil penalty assessment of $10,000. A willful violation constitutes tax fraud with a potential penalty being the greater of $100,000 (subject to inflation) or 50 percent of the highest balance during a calendar year. If that was not draconian enough, it could theoretically (and has been in a few cases in the past) be imposed on each year of the unreported account thereby totally wiping out the financial holdings of the individual. Generally, however, it is only imposed on the highest yearly balance in the unreported period.

On the criminal side, a willful failure to file an FBAR can be treated as a felony for tax evasion punishable by up to $250,000 and/or five years' imprisonment. A willful failure to file combined with certain other violations can be punishable by a penalty as high as $500,000 and/or ten years imprisonment. Historically prison terms, if applied, have been less than five years.

Moreover, filing the related Form 8938 may involve additional monetary penalties (potentially including a 40 percent penalty) for an understatement of tax attributable to the non-disclosed assets.

It is important to note that a civil monetary penalty may be imposed for an FBAR violation even if a criminal penalty is imposed for the same violation.

The End of Bank Secrecy

The U.S. has been increasingly active in finding ways to identify global income holdings of U.S. taxpayers. The Foreign Account Tax Compliance Act (FATCA) enacted in 2010 is a measure intended as a highly coercive penalty regime to have foreign financial institutions disclose private financial information, related to non-U.S. source income of a U.S. person to the IRS. The Act requires foreign financial institutions to identify to the United States their U.S. account holders. Failure to do so can result in the U.S. applying a gross withholding tax of 30 percent on all payments of gross income to these financial institutions. To date, the U.S. has not joined the OECD's Common Reporting Standard, but most low or no tax offshore financial centers have reached intergovernmental agreements with the U.S. in order to avoid FATCA withholding penalties. Those centers include most of the traditional tax havens. In addition, the U.S. has encouraged whistleblowing by individuals, including employees of the banks, to report on such U.S. related accounts and offers significant rewards for doing so.

The Voluntary Disclosure Programs

In parallel to the FATCA effort directed at financial institutions and foreign governments, the Offshore Voluntary Disclosure Programs (OVDP) was rolled out by the IRS in 2009 in order to encourage individuals with unreported offshore accounts to come into compliance with U.S. tax laws. The IRS was very pleased with the results of its 2009 program and made another program in 2011 and one in 2012. Individuals can enter the program assuming certain parameters are met, including the fact that their case involves only legal source income. Those entering the program must pay back taxes, interest and penalties, as well as a significant FBAR penalty. Under the current program, the offshore penalty can be as high as 50 percent of the highest aggregate value of the OVDP assets during the period covered by the voluntary disclosure. However, at the same time, the program also minimizes the chance of criminal prosecution. The IRS provides that when a taxpayer truthfully, timely, and completely complies with all provisions of the voluntary disclosure practice, the IRS will not recommend criminal prosecution to the Department of Justice for any issue relating to tax noncompliance or failure to file the FBAR.

Since the OVDP's initial launch in 2009, more than 56,000 taxpayers have used one of the programs to comply voluntarily and as a result of the programs those taxpayers paid a total of $11.1 billion in back taxes, interest and penalties. The number of taxpayer disclosures under the OVDP peaked in 2011, when about 18,000 people came forward. The number steadily declined through the years, falling to only 600 disclosures in 2017.

The IRS has recently announced that it is closing the current program effective September 28, 2018. It is unclear as of now if a new program will be started when the current one ends. The planned end of the current OVDP reflects advances in third-party reporting and increased awareness of U.S. taxpayers of their offshore tax and reporting obligations.

For certain individuals, including some of the population to whom this article is addressed, there is a 'cheaper' option. The Streamlined Filing Compliance Procedures (SFCP) program was initiated in 2012 and the prerequisites for entry have been liberalized since that time. Since that time, approximately 65,000 additional taxpayers have used this program to come into compliance. The IRS has stated that the Streamlined Filing Compliance Procedures will remain in place even after the OVDP program ends and will continue to be available to eligible taxpayers. As with OVDP, the IRS has said it may end the Streamlined Filing Compliance Procedures at some point.

Under the Streamlined program, among other requirements, taxpayers must certify under penalties of perjury that their failure to report all income, pay all tax and submit all required information returns, including FBARs, was due to non-willful conduct. The IRS states that "non-willful conduct is 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." Over time, it seems that the IRS has raised the bar for acceptance into the SFCP. Most importantly, the SFCP does not provide any assurances that the individual will not be subject to criminal liability and/or substantial monetary penalties.

Finally, at the State level, several states including New York, Connecticut, Pennsylvania, Virginia, New Jersey, Ohio and California have their own voluntary disclosure programs. Generally, in these programs the individual is required to pay back taxes with interest, but no other financial penalties or criminal consequences are imposed.

Continued IRS Focus

In January of 2017, the IRS Large Business and International division announced 13 campaigns that they were going to focus on. LB&I has been moving toward issue-based examinations and a compliance campaign process in which it decides which issues present greater compliance risks. The goal of these campaigns is to improve return selection, identify issues representing a risk of noncompliance, and make the greatest use of limited resources. Most recently, in May of 2018, the IRS announced another six campaigns, five of which target foreign tax matters. This clearly illustrates that these matters are still highly relevant and ripe for IRS audits and enforcement action. In fact, the IRS notes that it will continue to use tools besides voluntary disclosure to combat offshore tax avoidance, including leads from whistleblowers, civil examinations and criminal prosecution. Since 2009, the IRS Criminal Investigation unit has indicted 1,545 taxpayers on criminal violations related to international activities, of which 671 taxpayers were indicted on international criminal tax violations.

Summary

In recent years, the U.S. has been gradually able to cause both overseas financial institutions and governments to provide the identities of U.S. persons' offshore financial holdings. The likelihood of a U.S. person holding such accounts not being detected is becoming more remote. It is therefore highly advisable, if not imperative, that any U.S. person holding such an account and not reporting it should take immediate action to rectify this situation.

*Co-author Dan Horsky experienced first-hand the serious consequences of noncompliance discussed in this article. He failed to report an offshore account, was prosecuted for this offense, pled guilty and was sentenced to seven months of incarceration. In addition, he paid an FBAR penalty of $100 million. Seth Kossman is a shareholder in Baker Donelson's Tax Group and heads the Firm's Tax Controversy Subgroup, leading a team of more than 20 attorneys who spend a significant part of their practice in this area.