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The Foreign Bank Account Bomb How to Defuse It*

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What's It All About?

For many unsuspecting taxpayers and their advisors (and this group may well include attorneys, accountants, financial planners, even bankers), a somewhat obscured and very often ignored simple question on everyone's U.S. income tax Form 1040 may be a bomb waiting to explode. The question is at the bottom of Schedule B, Part III on page 2 of the Internal Revenue Service (IRS) Form 1040 and asks, "At any time during (the previous year), did you have an interest in or a signatory or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?"

The question calls for nothing more than checking a "yes" or "no" box in response, but most taxpayers (and many tax preparers) just ignore it. The yes box or the no box, that's it. There are no boxes that say, "maybe" or "I don't understand the question," or "I decline to answer on the grounds that an answer may incriminate me." Maybe there should be such choices, since there are many who do not fully understand the serious implications of ignoring the question when such an account exists, or worse, of intentionally providing an incorrect answer, which, surprisingly, may include no answer at all. That is to say, intentionally leaving both boxes blank could be deemed a false answer by the IRS or a court.

Briefly, the civil penalties for failing to report the account on the prescribed form (explained below) can range from up to \$10,000 for a "non-willful" failure, and for a willful failure the greater of \$100,000 or half the balance in the foreign account. If criminal activities are involved, the monetary penalties are increased and may be accompanied by possible imprisonment for up to ten years.¹ Note that the foregoing penalties are independent of any other fines, interest, taxes, or penalties that may be associated with the taxpayer's return. And, failure to maintain adequate

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records of the foreign account may result in additional civil and criminal penalties. The IRS states that records should be kept for five years.

Although checking the “yes” box does call for another step (we’ll get to that later), it does not by itself result in an additional tax, nor (contrary to the average taxpayer’s knee-jerk reaction) has the authors’ research disclosed any evidence whatsoever that checking the box will, by itself, lead to an audit. So, if there’s no additional tax and no guaranteed audit, why do they even ask the question?

Foreign Banks Do Not Report to the IRS

In this country, our bank and other financial accounts are typically held in institutions that are required by federal law to report annually to the federal government (and to us) all income and capital transactions connected with our financial accounts. Such reports are tied to social security or federal tax ID numbers, so anything we forget or inadvertently fail to report is usually picked up by the cross-checking of our tax returns with the reports of the financial institutions.

Foreign financial institutions, on the other hand, generally do not deal with or care about social security or federal tax ID numbers, and so, generally (except in connection with certain criminal investigations or prosecutions and except in the case of certain dividends from US corporations), there is no reporting to the federal government. Thus, US taxpayers who had money in foreign bank accounts often got the mistaken impression that interest earned on those accounts was not taxable in the US, especially where they would just let the funds sit in the account and accumulate interest. And since there was no reporting by the foreign bank, the IRS would have no way of knowing of these accounts or of the interest earned. This arrangement allowed taxpayers to conveniently overlook the reporting of such accounts for many years, not knowing that (or not thinking about the fact that), in some cases, their failure to report could amount to tax fraud, as thousands of clients of UBS Bank in Switzerland are about to find out. Further, the privacy and non-disclosure that accompanied these foreign accounts encouraged their use by individuals engaged in illegal activities and money-laundering, all of which finally resulted in Congress’s enactment of the Bank Secrecy Act of 1970.²

The Foreign Bank Account Report – Under-used and Under the Gun – What’s Covered?

The Bank Secrecy Act included provisions requiring the Treasury department (not the IRS) to create forms and establish regulations requiring any US person who has a foreign financial account to report the existence of that account to the federal government. This mandate resulted in the creation of form TDF-90-22.1 which is a Treasury form, not an IRS form, (though as noted later, enforcement of filing and penalties is done through the IRS³) and is submitted separately from the taxpayer’s Form 1040 at a different time and to a different address. The form is actually titled “Report of Foreign Bank and Financial Accounts,” and is commonly known and referred to by practitioners as an FBAR (Foreign Bank Account Report - A new and revised FBAR form was introduced in late 2008 and we offer comments below on some of the important changes.)

As for the types of accounts that require reporting, the definition is extremely broad and includes not only bank accounts of all types, but also brokerage or other securities accounts involving virtually all types of financial instruments and goes on to include, “any other account maintained with a financial institution or other person engaged in the business of a financial institution.” Thus, foreign mutual funds and hedge funds must be reported, and the relevant instructions also include prepaid credit card and debit card accounts. Further, although at one time there was a question about the inclusion of foreign annuity and life insurance contracts as foreign accounts, that question seems to have been resolved as discussed below. Given the severe penalties for failure to report, the authors believe that the best rule to follow is, when in doubt, report the account. There is no harm in doing so.

Who Must File?

Any US taxpayer who has a financial interest in or signatory authority over any financial accounts in one or more foreign countries where the total combined value of all such accounts exceeds \$10,000 at any time during the calendar year must file the FBAR. Accounts in Puerto Rico, Guam, the Northern Mariana Islands, American Samoa, and the US Virgin Islands are exceptions to the rule.⁴ And note that the term, “US taxpayer,” would include resident aliens and other foreign individuals who are considered US persons because of the time spent here in a given year.⁵ Interestingly, the 2008 revised form also requires filing by a person “in and doing business in the United States.” Such persons who do not have a social security number are required to use their foreign ID number, which would typically be their passport number. In this regard, the instructions to the FBAR offer no guidance whatsoever on what it means to be “*in and doing business in*” the United States, nor has the IRS offered any further information, including whether the phrase would include individuals who do not fall under the definition of a US person.⁶ This could result in the needless filing of thousands of FBAR forms, since the form is only required of US persons with foreign accounts.

If the total value of all of a taxpayer’s foreign accounts does not exceed \$10,000 at any time during the calendar year, an FBAR need not be filed, but if the total exceeds that amount even for a day, an FBAR will be due, even though the account(s) may have been closed out long before the end of the year. But what if a spurt in value over the threshold was caused by a spike in the currency exchange rates? Or what if the securities held in the account rose for a short time then fell again? The difficulty in monitoring such random changes could make one inadvertently vulnerable to a failure to file charge. Fortunately, the rules for valuing the account offer relief from such risks. If the account is held in a foreign currency, then the taxpayer should use the rate of exchange in effect at the end of the year. With securities, the value will be based on the fair market value at the end of the year or the date of withdrawal or sale. Understand that this does not mean one should use the balance of the account at year end to determine the amount to report on the FBAR, it merely fixes a valuation rate to determine the highest value of the account throughout the year. With bank accounts, the amount is determined with each statement (typically monthly) received on the account.

You have the required “financial interest” in an account not only if you are the owner, but also if you have legal title to the account, even if held for someone else’s benefit, such as a custodial account for a minor or a person acting under a power of attorney. In this context, the financial

interest criteria often overlaps with the question of signatory authority, both generating the requirement to file the FBAR. For instance, when the account is in joint names, all joint owners must file their own FBAR (even though the funds may “belong” to only one of them), and each US trustee of a trust account must likewise file. This is the case even though the beneficiary of the trust is not a US person. An exception to the joint account double filing rule applies if the only joint owners are husband and wife, if they live together and file a joint return. Further, if the owner of an account gave someone a power of attorney over the account, both the owner and the attorney in fact must file an FBAR, assuming both are US persons.

Analogous to the power of attorney issue is the situation where a trust which holds a foreign financial account provides for a protector whose powers may extend, for example, to directing distributions or similar financial powers. In such cases, if the protector is a US person, he must file an FBAR. Where someone other than the “owner” of the account must file (as with a power of attorney, trustee, or other non-owner who has signature authority), the form requires the person to disclose the identity and ID number of the owner of the foreign account. This rule now also applies even if the owner is not a US person.

If several members of the same family have accounts, the rules apply to each account holder, individually. The IRC section 318 “attribution” rules do not apply to filing the FBAR.

Another often overlooked arrangement in this regard is any foreign trust (holding a foreign financial account) established by a US person for any US beneficiaries. Even though the US settlor of such a trust may not be a beneficiary and has no authority over the trust or over any trust accounts, he is nevertheless treated as the owner of the trust for US income tax purposes (i.e., because the trust is deemed a “grantor” trust⁷), and therefore the settlor is responsible for filing an FBAR showing the trust accounts.

A financial interest may be present even though there is no signatory authority. For instance, where a trust holds an account and a US taxpayer has a present beneficial interest in more than 50 percent of the trust assets, or receives more than 50 percent of the trust assets, or receives more than 50 percent of the current trust income, he must file an FBAR. Apparently, therefore, where a trust has three or more beneficiaries and none of the beneficiaries has more than a 50 percent interest in income or principal, then none of them needs to file an FBAR. (Although each trustee who is a US taxpayer must file one.) Presumably, the same would apply to a fully discretionary trust, although the instructions are unclear.

There are situations where the question of signatory “or other authority” may not appear to be technically present but the circumstances lend themselves to an element of control, even though indirect, and therefore, an FBAR must be filed. The FBAR instructions state,

“Other authority exists in a person who can exercise comparable power over an account by direct communication to the bank or other person with whom the account is maintained, either orally or by some other means.” (Emphasis added)

Thus, for example, where a US person is the owner of a foreign life insurance policy or annuity contract with a cash surrender value in excess of \$10,000, he must file an FBAR. This is so

because the owner of the contract, although having no direct authority over the accounts in which the premiums are deposited or invested, nevertheless has the authority to withdraw cash from the policy or contract simply by directing the insurance company to that effect. And if that's not enough, the owner clearly has a financial interest in the policy or contract itself, and therefore an indirect financial interest in the underlying accounts. Although this particular example is not in the FBAR instructions, it is confirmed in recent a Internal Revenue Manual Supplement.⁸

Similarly, where a foreign corporation holds the foreign account and a US person owns more than 50 percent of the corporation's shares, an FBAR must be filed by the shareholder. Note also that US persons who are officers or directors of a foreign corporation and have signatory authority over a foreign corporate account must also individually file an FBAR whether or not they own shares of the corporation. (Exceptions to this rule apply to certain publicly traded corporations and banks under US control.) A corresponding rule applies to partnerships holding foreign accounts where a US taxpayer holds more than a 50 percent interest in the partnership profits.⁹

Of course, all income (interest, dividends, capital gains, etc.) earned on the foreign account must be reported on the tax return of the beneficial owner(s), and as noted earlier, this is entirely separate from the FBAR. The FBAR is not a tax return; it is merely a report of the taxpayer's foreign financial accounts. Where applicable, it must be filed even if the reported accounts generate no interest or other taxable income.

What Information Must Be Disclosed?

Once again, the FBAR is not a tax return. It is a report designed only to disclose a US taxpayer's connection to a foreign financial account. And while prior to 2008 the disclosure was fairly general, beginning with any FBAR's filed after 12/31/08, the filer must report the "maximum value" of each foreign account reported. Of course the form asks for the name of the financial institution, the country, and the account number for each account, if more than one. If there are joint owners, their names and ID numbers are requested, and if the person who is reporting claims to have no financial interest in the account (such as a person holding a power of attorney or a corporate officer who has no shares of the corporation) then the name and ID number of each beneficial owner must be disclosed. There are no computations or complicated financial entries.

When and Where to File the FBAR

The FBAR (i.e., the TDF 90-22.1) is due by June 30th of the year following the year the account reaches the \$10,000 threshold, with no provisions for extension. And note that the "due date" means the date it must be received by the Treasury, so that mailing it on that date will result in a late filing. Although from a practical standpoint, nominal lateness, such a few days or so, seldom generates a problem (provided the IRS has not already made an inquiry and provided any interest from the account was reported on the responsible US person's income tax return), the longer the delay, the greater the vulnerability to a charge of willful failure to file, which can result in serious penalties. The FBAR form, which is to be filed separately from any income tax form, should be mailed to: US Department of the Treasury, P.O. Box 32621, Detroit, MI,

48232-0621, or by hand-delivering it to any local IRS office (a stamped, dated receipt notice on a copy of the filed form is recommended). As noted below, the IRS has been given the authority to enforce the filing rules and audit the reports as appropriate.

Despite the late introduction (October 2008) of the revised FBAR form, the IRS has indicated that the revised form *should* be used for years prior to 2009.

An amended FBAR may be filed by completing a revised FBAR with the correct information, checking the “Amended” box at the top of the revised FBAR, and stapling it to a copy of the original FBAR. If you are amending or filing a late FBAR, it is very important to include a statement explaining the reason for the amendment or late filing.

Penalties For Failure to File and Keep Adequate Records

In April of 2003, the Financial Crimes Enforcement Network (FinCen) delegated enforcement authority on the TDF 90-22.1 (FBAR) to the Internal Revenue Service (IRS).¹⁰ The IRS then enforces all penalties associated with the FBAR with the same powers it enforces tax reporting and payment compliance.

Recent reports of the huge bank scandal at UBS Switzerland, among other related reports, have resulted in criticism of the IRS for not being more aggressive in catching taxpayers who fail to report their foreign accounts and pay their taxes on the earnings from these accounts. Consequently, practitioners have been warned to expect the IRS to increase the imposing of penalties against taxpayers who fail to report the accounts and pay the related tax. Of course, the FBAR form may be due even if there are no earnings on the account and therefore no tax (as with a foreign life insurance policy or annuity, for instance, where income tax on the earnings is deferred until withdrawn). Whether or not a tax is due will have no bearing on the exposure to penalties for failure to file the FBAR. However, if a tax is due and has not been paid, the likelihood of the imposition of penalties for a concomitant failure to file the FBAR is far greater.

Failure to file the FBAR form can leave the taxpayer in an extremely vulnerable position and can have serious consequences. A 2004 change to the penalty rules provides a penalty of up to \$10,000 for *non-willful* (negligent) failure to file. Although a request for waiver of this penalty (discussed below) will be considered by the IRS, it is totally at its discretion. In the case of a willful failure to file, or a willful failure to maintain adequate records, the penalty limit jumps to the greater of \$100,000 or half the balance in the foreign accounts for the year in question. If the failure is found to be willful, there is no opportunity to request a waiver. Willfulness, of course, must be proven by the IRS¹¹ (under the standard of “clear and convincing evidence”), but if the taxpayer could be shown to have known about the requirement to file he may not have much of a defense, and if he also failed to report the foreign account interest or other income on his income tax return, he may have virtually no defense. As for knowing about the requirement to file the FBAR, remember that “simple” yes or no question on Form 1040, Schedule B, noted at the very outset of this discussion. When you sign your Form 1040, you are deemed to have read and approved everything on it.

The foregoing are civil penalties for failure to file the FBAR, and note that these would be in addition to any income tax penalties if the interest or other income is not reported. The IRS must assess civil penalties within six years of the violation.¹² If the failure to file is deemed to be part of a criminal activity involving more than \$100,000 in a 12 month period, the penalty limit increases to \$500,000 and up to ten in years in prison, this being obviously aimed at drug dealers and money laundering.

Whether a failure to file is willful or non-willful is a subjective evaluation based on the facts of each case. Willfulness has been defined as the “voluntary, intentional violation of a known legal duty.”¹³ Therefore, a taxpayer’s good faith belief that he did not have to file or even his negligent failure to file can be a good defense to the charge of willful failure to file.¹⁴

As suggested above, the civil penalty for non-willful failure to file may be waived at the discretion of the IRS if the taxpayer can show reasonable cause. Facts that may assist in requesting a reasonable cause waiver may include, among other relevant factors,

- All of the income from the foreign account was included on the taxpayer’s return;
- The taxpayer was truly unaware of the requirement to file (e.g., a lack of understanding of what constitutes a “financial interest”) or was advised by his advisor that no report was required (after full disclosure of all relevant information to the advisor);
- The taxpayer was not under audit or under IRS inquiry;
- Once the taxpayer became cognizant of the requirement, he filed all delinquent reports (up to six years).

If a late filing of the FBAR is anticipated, we repeat that it is a good idea to add a statement with the report explaining why the report is late, itemizing as many of the above factors that are present, stating that the taxpayer believes the delay was due to reasonable cause, and expressly requesting a waiver of any penalties.¹⁵

What the Future May Hold

Again due to the international scandals and tax evasion we have seen, together with Congress’s strong reaction to the situation, a number of bills have been proposed and are being seriously considered by Congress as of this writing. A sampling of some of the proposed changes relevant to foreign accounts includes the proposal that: transfers of more than \$10,000 from a US financial institution to the non-US account of a US person would have to be reported to the IRS; and the FBAR would be filed along with the reporting person’s federal income tax return.

With the increasing international mobility of US persons, often including international property ownership, more and more individuals find it necessary or at least convenient to maintain some sort of foreign financial account. And the trend is further amplified by those who implement an international investment strategy or who utilize offshore asset protection strategies, including trusts, and life insurance and annuity contracts. Quietly lurking in the shadows of all this activity is the requirement for US persons to report their interest in all foreign financial accounts to the federal government, with the risk of serious penalties for failure to do so. For anyone with offshore financial interests, it is a foolish risk to take.

Late News on “Defusing the Bomb”

On March 23, the Internal Revenue Service announced the start of a Voluntary Disclosure Program permitting US persons who have not filed all required FBAR forms and paid applicable tax to voluntarily come forth, file any overdue forms, and pay appropriate tax going back six years. If the person qualifies for Voluntary Disclosure, the IRS will assess interest and certain penalties (late filing and accuracy – related penalties) together with a one-time payment of 20% of the highest balance in the foreign account, but will forego criminal prosecution and possible additional penalties, such as the civil fraud penalty. In certain cases, the 20% penalty may be reduced to 5%. The program will expire on September 23, 2009 and will not be extended. Persons who are already being audited or are under investigation or whose names have already been disclosed to the IRS will not qualify for the Program. In our opinion, it will not be a good idea for a person to try to “get lost in the crowd” by simply filing amended returns and filing their FBAR forms late, because the IRS has stated it intends to review all amended returns for offshore activities and single them out. In the words of IRS Commissioner Shulman, agents are being instructed “to fully develop these cases, pursuing both civil and criminal avenues, and consider all available penalties, including the maximum penalty for willful failure to file the FBAR report [the greater of \$100,000 or half the balance in the foreign account] and the fraud penalty.” Our best advice for those with offshore accounts? See an expert and get the matter properly resolved.

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¹ 31 USC §5321(a)(5)(B); CCA 200603026; see also, *US v. Eisenstein*, 731 F. 2d 1540 (CA-11, 1984).

² Pub. L. 91-508, 84 Stat. 1114, 12 USC §§1730d, 1829b, 1951-1959, and 31 USC §1051-1062,1081-1083.

³ *Infra* Note 8.

⁴ See IRS Manual (Workbook) on Foreign Bank and Financial Accounts (FBAR), November 16, 2006, although it is interesting to note that these jurisdictions are not included in the instructions to the form.

⁵ Internal Revenue Code (IRC) §7701(b)(1)(A)(ii) and (b)(3), as well as a domestic trust, estate, partnership, or corporation.

⁶ IRC §7701 (a)(30)

⁷ IRC §679.

⁸ IRM §4.26.16.3.2(1)(a).

⁹ TDF 99-22.1 Instructions.

¹⁰ IR 2003-48, April 10, 2003; 31 C.F.R. 103.56(b)(8).

¹¹ *Supra*, note 1.

¹² 31 USC 5321(b)(1).

¹³ *Cheek v. United States*, 498 U.S. 192 (1991).

¹⁴ *Id.*

¹⁵ See V. Jacobs, CPA, *2006 Guide to Reporting Offshore Financial Accounts*, p. 19 (Offshore Press, Inc., Kansas).