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The Foreign Bank Account Bomb How to Defuse It

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For many unsuspecting taxpayers (and this group may well include attorneys, accountants, and financial advisors), 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 people 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.

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 are independent of any other fines, interest, taxes, or penalties that may be associated with the taxpayer’s return. And, failure to maintain adequate records of the foreign account for the years may result in additional civil and criminal penalties.

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?

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, 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, in some cases, their failure to report

could amount to tax fraud. 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 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 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).

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."

Who Must File?

Any US person who has a financial interest in or signatory authority over any financial accounts in a foreign country if the total value of 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

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. In this regard, 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. An exception to the joint account rule applies if the only joint owners are husband and wife, if they live together. This is the case even though the beneficiary of the trust is not a US person. 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 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.

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” trust⁶), 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, 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.

Similarly, where a foreign corporation holds the foreign account and a US person owns more than 50 percent of the shares, an FBAR must be filed. 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.⁷

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 the disclosure is fairly general. After requesting the basics of name, address, and ID number, the balance held in the foreign account is disclosed by simply checking one of four boxes, e.g., \$10,000 to \$99,000; \$100,000 to \$1,000,000; etc. Of course it 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 the beneficial owner must be disclosed. And that's about it. 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 of the report, 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 several 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, to be filed separately from any income tax form, must be mailed to: US Department of the Treasury, P.O. Box 32621, Detroit, MI, 48232-0621. Nevertheless, the IRS has been given the authority to enforce the filing rules and audit the reports as appropriate. In an “emergency,” the form can be hand delivered to a local IRS office for forwarding to the Treasury Department in Detroit.

An amended FBAR may be filed by completing a revised FBAR with the correct information, writing the words “Amended” at the top of the revised FBAR, and stapling it to a copy of the original FBAR. If you are amending a late-filed FBAR you should include a statement explaining the reason for the late filing.

Penalties For Failure to File

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).⁸ The IRS, then enforces all penalties associated with the FBAR with the same powers it enforces tax reporting and payment compliance.

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* failure to file. Although a request for waiver of this penalty (discussed

below) will be considered by the IRS, it is totally at their discretion. In the case of a willful failure to file, 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 IRS⁹ (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.

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.¹⁰ 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.”¹¹ 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.¹²

As suggested above, the civil penalty for non-willful failure to file may be waived by 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 US 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;
- 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, 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.¹³

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.

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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 §679.

⁷ TDF 99-22.1 Instructions.

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

⁹ *Supra*, note 1.

¹⁰ 31 USC 5321(b)(1).

¹¹ *Cheek v. U.S.*, 498 U.S. 192 (1991).

¹² *Id.*

¹³ See V. Jacobs, CPA, *2006 Guide to Reporting Offshore Financial Accounts*, p. 19 (Offshore Press, Inc., Kansas).