FRAUD & NEGLIGENCE

FBAR—Foreign Bank Account Reporting Obligations: A Primer for the Practitioner

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Cross-border investing and multinational clients are both increasingly commonplace. A major concern may turn out to be the reporting requirements imposed on taxpayers with an interest in "a foreign financial account." And this concern will be substantially heightened if the Joint Committee's recommendations, which would essentially "delegate" the responsibility to a tax preparer, ever become law.

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While it is generally understood that U.S. persons are obligated to file income tax returns with the IRS on an annual basis, it is not as well understood that such persons may have additional reporting requirements if they have an interest in a foreign financial account. Form TD F 90-22.1, the "Report of Foreign Bank and Financial Accounts" and more commonly known as the FBAR, must be filed by U.S. persons on an annual basis if at any point during the calendar year they have an ownership interest in or signature authority over a financial account (or several such accounts) in a foreign country, with an aggregate value in excess of $10,000 (the "FBAR requirements"). Failure to file the report is punishable by both civil and criminal penalties.

Even though many professionals may be aware of the need to file the FBAR, there is much confusion surrounding the breadth of the reporting requirement. For example, multiple persons may be responsible for filing an FBAR to report the existence of the same financial account. Additionally, there are questions regarding who qualifies as a U.S. person, what constitutes signature authority over a financial account, and what is classified as a foreign account.

Notwithstanding any ambiguity regarding the FBAR requirements, the responsibility to file an FBAR currently falls on the taxpayer. If, however, Section E of the report by the Joint Committee on Taxation entitled "Additional Options to Improve Tax Compliance" (the "JCT Report") should be enacted, tax practitioners will be placed squarely on the front line. [1] The JCT Report proposals would put the responsibility for determining whether a taxpayer has an FBAR filing requirement on tax preparers, by extending to the FBAR the Section 6695(g) due diligence requirement, which currently imposes the responsibility on preparers to determine a taxpayer's eligibility for the earned income tax credit as well as the amount of the credit permitted. Consequently, preparers would have to become intimately familiar with the FBAR requirements. Practitioners would be liable for (1) discussing with taxpayers the FBAR filing requirement as well as the civil and criminal penalties for failure to file the FBAR, and (2) documenting taxpayers' responses to such discussion as well as retaining such documentation for the Service's possible use in an audit.

ORIGIN OF THE FBAR REQUIREMENTS

The FBAR is a by-product of the Bank Secrecy Act (BSA), which was first enacted in 1970. [2] Congress created the

BSA because of concern that financial institutions in tax haven jurisdictions were being used by U.S. persons to hide the proceeds of their illegal activities, evade tax, and for other criminal purposes. BSA section 5314 required Treasury to create forms that financial institutions and individuals would have to file that ultimately could be used by the government to track the movement in cash in the economy and crack down on nonfilers. The BSA specifically imposed responsibility on Treasury to promulgate

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regulations that would promote compliance and be useful in criminal, tax, regulatory, intelligence, and counter-terrorism matters, as well as to counter money laundering. 31 C.F.R. section 103.24 contains the requirement for an FBAR to be filed:

"(a) Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relationship exists, and shall provide such information as shall be specified in a reporting form...."

Originally, authority to investigate possible FBAR compliance issues was delegated to the Service, [3] and the authority for civil enforcement of FBAR violations was delegated to the Financial Crimes Enforcement Network ("FinCEN"). [4] FinCEN is an arm of the Treasury Department that has responsibility to oversee and implement policies to detect and prevent money laundering and terrorist financing. According to the "overview" on its website, "FinCEN is a network, a means of bringing people and information together to fight the complex problem of money laundering. Since its creation in 1990, FinCEN has worked to maximize information sharing among law enforcement agencies and its other partners in the regulatory and financial communities. Working together is critical in succeeding against today's criminals. No organization, no agency, no financial institution can do it alone. Through cooperation and partnerships, FinCEN's network approach encourages cost-effective and efficient measures to combat money laundering domestically and internationally." [5]

The FBAR is filed with the IRS Detroit Service Center, and the information on the return is entered into an FBAR database that is administered by both the Service and FinCEN. Once entered, the information can be accessed by multiple governmental authorities for purposes of tracking the flow of money.

Early in 2003, FinCEN delegated its enforcement authority for FBARs to the Service. [6] The delegation was the culmination of a study imposed on Treasury by the usa patriot Act to find ways to improve compliance with reporting requirements. The IRS now has the ability to investigate noncompliance with the FBAR, assess and collect civil penalties associated with such noncompliance, and use the full investigative arsenal available to it.

WHO IS SUBJECT TO THE FBAR REQUIREMENTS?

The FBAR requirements apply to any "U.S. person," which includes all U.S. citizens and resident aliens. Nonresident aliens are not required to file an FBAR. Consequently, an individual who otherwise would qualify as a nonresident alien must be careful to avoid being classified as a resident alien under the substantial presence test of Section 7701(b)(3) and thus subjected to the FBAR requirements (and related penalties for failure to comply).

The substantial presence test provides that an individual becomes a resident if he or she is physically present in the U.S. for 183 or more days during the current tax year. [7] An individual not physically present in the U.S. for 183 days or more during the current tax year, still may satisfy the substantial presence test under a three-year look-back. [8] The rule requires the individual to be physically present in the U.S. during the current tax year for at least 31 days, and for a total of 183 days over a three-year period that includes the two preceding calendar years.

To determine if the 183-day count is satisfied, a separate multiplier is applied to each of the three years. For the current year, the multiplier is 1 and each day is counted as a full day. For the immediately preceding calendar year, the multiplier is 1/3 (e.g., 60 days in the U.S. × 1/3 = 20 days). For the next preceding calendar year, the multiplier is 1/6 (e.g., 60 days in the U.S. × 1/6 = 10 days). Thus, even if the individual was actually present in the U.S. for 183 days or more during the two preceding calendar years, the individual may not be deemed a U.S. resident alien for the current tax year.

In fact, if an individual is physically present in the U.S. for no more than 121 days every year, the individual will not meet the substantial presence test and will be classified as a nonresident alien. For example, in order to determine 2007 residency, if the individual was present in the U.S. for 121 days in each of 2005, 2006, and 2007, the formula would yield 121 days in 2007, 40.3 days in 2006 (121 days/3); and 20.16 days in 2005 (121 days/6) for a total of 181.46 days in 2007.

For purposes of the FBAR requirements, a U.S. person also includes all U.S. estates, trusts, partnerships, and corporations. Thus, if any of these domestic entities has an interest in or authority over a financial account worth more than $10,000, the entity must file an FBAR. Similarly, it is possible that the authorized representative of any of

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these domestic entities will have a personal filing requirement as a result of the affiliation with the entity (discussed in greater detail, below).

LLCs are not specifically classified as U.S. persons under the FBAR requirements. Nevertheless, since these entities are taxed as corporations, partnerships, or to the entity owner (i.e., a single-member LLC treated as a disregarded entity), it would appear as though the members of such entities would have a reporting requirement based on the entity's classification for income tax purposes. In the absence of specific IRS guidance, members of an LLC would be well advised to take the conservative approach and file an FBAR if the LLC otherwise meets the FBAR requirements.

U.S. jurisdictions. For purposes of proving residency in a U.S. possession, territory, or commonwealth ("U.S. jurisdictions"), Section 937 and the Regulations thereunder specify that time spent in a U.S. jurisdiction is deemed to be time spent outside of the U.S. [9] Additionally, time spent in a U.S. jurisdiction will not qualify as time spent in the U.S. for purposes of the substantial presence test. [10] By contrast, for FBAR purposes each U.S. jurisdiction is deemed to be part of the U.S. Consequently, contrary to what would be expected pursuant to Sections 937 and 7701, financial accounts in U.S. jurisdictions are not deemed to be foreign accounts and thus are not subject to FBAR reporting.

Notwithstanding the fact that U.S. jurisdictions are deemed to be part of the U.S. for purposes of the FBAR requirements, there is some confusion between the FBAR instructions and the IRS website. The instructions define "foreign country" as one outside the U.S., Guam, Puerto Rico, and the Virgin Islands. "Frequently Asked Questions Regarding FBARs" on the IRS website, however, also include the Northern Mariana Islands and American Samoa. [11] An additional difference between the instructions and the IRS website is that the FBAR directions do not limit the "Virgin Islands" to the U.S. Virgin Islands, whereas the IRS website does.

In spite of the conflict between the directions and IRS website, it would appear as though the intent is to exempt accounts in any U.S. jurisdiction from FBAR reporting. This would be consistent with Sections 937 and 7701 and the associated Regulations.

WHAT TYPES OF ACCOUNTS HAVE TO BE REPORTED?

Generally, any type of account that holds liquid assets or marketable securities will be a "financial account" for purposes of the FBAR requirements. Thus, everything from a cash account to a foreign mutual fund, such as an exchange traded fund, is classified as a financial account.

The breadth of this statement is perhaps best illustrated by a posting on the Asset Protection Blog. [12] The posting contained an e-mail from Treasury which stated its position on FBAR financial accounts as follows: "[T]he premium payments for insurance policies with cash surrender value or other investment features constitute deposits within the meaning of Form TD 90-22.1. Therefore, if a life insurance policy is a whole life or other policy with investment value, then it is an 'other financial account' subject to reporting." When Treasury takes the position that the payment of life insurance premiums can be classified as a deposit, and thus as a financial account for purposes of the FBAR, it should be evident to taxpayers that *any* financial activity in the foreign arena should be reviewed carefully for compliance with the FBAR filing requirement.

Only financial accounts actually located in a foreign jurisdiction are subject to FBAR reporting. [13] For example, an investment account with Credit Suisse's New York office would not require an FBAR but an account with one of Credit Suisse's European offices would. Similarly, a whole life insurance policy with ING would not automatically generate a reporting requirement since such a policy could be obtained from its U.S. subsidiary ReliaStar. If, however, the underlying investment account associated with the insurance is held in Europe, there would be such a filing requirement.

Taxpayers should be aware that the Regulations state that all records that are required to be reported on an FBAR must be kept for five years. [14] Failure to keep the records for the stated period may result in civil penalties, criminal penalties, or both.

Signature or Other Authority

If an individual can order the distribution or disbursement of funds or other property from the institution where the

funds or property are maintained, by signing a document providing such direction (or in conjunction with one other person signing the document), that individual has signature authority over the financial account. Similarly, if an individual can exercise the same control verbally or via other means of communication, the individual has other authority over a financial account.

These powers should not be

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confused with the power of investment. Individuals who can make investment decisions but who do not have the ability or discretion to make disbursements do not have an FBAR reporting requirement. Notwithstanding the foregoing, the JCT Report would treat a U.S. person as having signature or other authority over a foreign account if the U.S. person creates a trust with a foreign protector. Specifically, the JCT Report will attribute any duties and powers held by the foreign protector to the U.S. person.

In summary, an individual who holds a power of attorney or who is a custodian of an account for a minor would appear to have the ability to exercise sufficient powers that would cause the attorney-in-fact or custodian to have an FBAR reporting duty. Similarly, a trustee, personal representative, president of a corporation, president of a general partner or managing member of an LLC, to name but a few individuals by title, could be deemed to have signature authority or other authority over a financial account held by the entity and thus a reporting obligation.

Financial Interest

The definition of what constitutes a financial interest for purposes of the FBAR is based on who owns the interest. For example, a foreign pension account satisfying the FBAR requirements and which is owned by an employer or a foreign government would not have to be reported by a U.S. person, since the U.S. person does not have any ownership over the pension account. If, however, the employer maintains individual accounts for each employee, similar to a Section 401(k) account, the employee would have a filing requirement.

Essentially, an individual has a financial interest in every account for which the individual is the owner of record or has legal title, whether the account is for the owner's benefit or for the benefit of another. There can be many situations in which several persons have an obligation to file a report with respect to the same account. For example, if the account is owned by more than one person, such as a joint account or an account held by tenants in common, each person has a financial interest for purposes of the FBAR. Similarly, if a U.S. person who owns a foreign bank account gave a power of attorney to another U.S. person to sign over the account, both the owner of the account and the individual exercising the power of attorney would have a reporting requirement. Multiple filings also would be required from the trustees of a trust with several trustees if the trust has an interest in a foreign financial account.

Individuals serving as shareholders, partners, and trustees also may be deemed to hold a financial interest in an account if the account is owned by or the individual with legal title is any of the following:

(1) A person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person.
(2) A corporation in which the U.S. person owns more than 50% of the total stock either directly or indirectly.
(3) A partnership in which the U.S. person owns an interest in more than 50% of the profits.
(4) A trust in which a U.S. person has either a present interest in more than 50% of the assets or from which the U.S. person receives more than 50% of the income.

Thus, while the domestic entity that has a financial interest that otherwise meets the FBAR requirements will have to file an FBAR, it also is possible that the shareholders, officers, or directors of foreign corporations, partners in foreign partnerships, grantors of foreign trusts, or beneficiaries of a foreign trust or estate also will have to file the FBAR.

The JCT Report would extend the definition of "financial interest" to include (1) an account held by a corporation in which a U.S. person owns,

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directly or indirectly, more than 50% percent of the value or voting power of the corporation, (2) a partnership in which a U.S. person owns an interest either directly or indirectly in more than 50% of the profits or capital of the partnership, and (3) an account held by a trustee for a U.S. person who had a beneficial interest either directly or indirectly in more than 50% of the trust's assets.

An officer or employee of a U.S. corporation that is listed on a trading exchange, which has in excess of 500

shareholders and $10 million in assets, does not have to file an FBAR to reflect that the individual has signature authority or other authority over the financial investments if the individual has no personal financial interest in the account and has been advised in writing by the corporation's CFO that the corporation has filed an FBAR to report the investments.

Similarly, an officer or employee of a U.S. subsidiary of a U.S. corporation that is listed on a trading exchange, which has in excess of 500 shareholders and $10 million in assets, does not have to file an FBAR to reflect that the individual has signature authority or other authority over the financial investments of the subsidiary if the individual has no personal financial interest in the account and has been advised in writing by the corporation's CFO that the subsidiary corporation has filed an FBAR to report the investments. This exemption for officers and employees of a U.S. subsidiary is not in the FBAR instructions. Rather, the IRS answered the question as to whether the exemption for such individuals existed on its website. The Service stated that "the question was resolved in an interpretive ruling published prior to a 1988 revision of Appendix A in 31 Code of Federal Regulations (CFR) Part 103. In October 1988, the interpretive ruling was removed from Appendix A but was not revoked." [15]

An officer or employee of a bank that is subject to the supervision of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, or the Federal Deposit Insurance Corporation, does not need to file an FBAR if he or she has signature authority or other authority over the accounts so long as the individual does not have a personal financial interest in the account.

DUE DATES FOR FILING AN FBAR

If a U.S. person has a foreign account that satisfies the FBAR requirements, the FBAR is due on June 30 of the following year (with no extensions). The form is filed with the Detroit Service Center. The duty to file the FBAR is independent of the obligation to file an income tax return even though the FBAR is cross referenced on Form 1040, Schedule B, Part III.

A foreign account that satisfies the FBAR requirements must be reported even if the account does not generate taxable income. Thus, a taxpayer who fails to file an FBAR because the account generates no taxable income will be subject to penalty.

The IRS has six years within which to assess a civil penalty related to an FBAR violation. It is unclear, however, whether the statute will toll if the FBAR is not filed. [16]

PENALTIES FOR FAILURE TO FILE

A taxpayer who fails to file an FBAR may be subject to both civil and criminal penalties under Title 31 of the United States Code. The same violation may be punishable by both a civil and criminal penalty. [17]

Civil Penalties

Prior to the Americans Jobs Creation Act of 2004 (AJCA), civil penalties were imposed on willful violations of the reporting requirement. The minimum penalty was $25,000 and the maximum penalty was $100,000. After the AJCA, there is now a penalty of up to $10,000 for a non-willful failure to file the FBAR. [18] If, however, the amount of the transaction or the balance of the foreign account is reported on the taxpayer's Form 1040, the penalty may be eliminated as a result of the reasonable cause exception. [19] Nevertheless, Form 1040, Schedule B, Part III instructs a taxpayer who indicates that he or she has a financial account in a foreign country to review the FBAR. To satisfy the reporting necessitated for the reasonable cause exception, the taxpayer must be certain to include on the Form 1040 any income generated by the foreign account and to the extent possible a detailed explanation of the transaction.

For a willful violation of the FBAR reporting requirement, the penalty is now a fine equal to the greater of $100,000 or 50% of the amount of the transaction or of the balance of the account at the time of the offense. [20] Violations that are deemed to be willful are not subject to the reasonable cause exception. [21] In the event the suggestions in the JCT Report are enacted in their present form, it would appear that the availability of the reasonable cause exception would be severely curtailed absent documentation of extenuating circumstances (such as the taxpayer's tax preparer advising the taxpayer that the FBAR was not required).

The Service has created internal "Guidelines for Calculation of FBAR Civil Penalty for Willful Violations." According to commentators, [22] IRS personnel are to apply the Guidelines and, if certain prerequisites are satisfied, the IRS agent is to use discretion to impose a less severe penalty under

the statute. The prerequisites require that:

(1) The taxpayer has no prior FBAR reporting violations.
(2) None of the money passing through the foreign account was used for a criminal purpose or came from such activity.
(3) The taxpayer cooperated during the examination.
(4) The IRS did not impose a civil fraud penalty against the taxpayer for the year in question as a result of the taxpayer's failing to report income related to the account.

While the commentators go into significant detail to explain the manner in which the penalty is to be calculated under the Guidelines, it should be understood that these Guidelines were issued prior to the AJCA and there is no official pronouncement from the Service discussing the existence of such Guidelines, their application, or whether they remain valid under current law. We understand that, as a matter of practice, these Guidelines are being applied with respect to certain voluntary disclosures.

Criminal Penalties

While the AJCA did not change any aspect of the criminal penalties, such penalties are premised on the violation's being willful. Thus, if the failure to file the FBAR is deemed to be a criminal violation, the penalty can include a fine of up to $250,000, imprisonment for up to five years, or both. [23] If the failure to file is deemed to be part of a criminal activity (i.e., it occurs during the violation of another law or is part of an illegal activity involving more than $100,000 in a 12-month period), the maximum fine increases to $500,000 and the possibility of imprisonment increases to up to ten years. [24] There is, of course, a possibility that both the $500,000 penalty and ten-year jail term will be applicable. [25]

To establish willfulness, the government must prove that the taxpayer had knowledge of the reporting requirement and in spite of such knowledge chose to ignore the requirement. [26] Some courts, however, have held that the government may prove willfulness by demonstrating that the taxpayer consciously or recklessly disregarded the law. [27]

In recent guidance, the IRS Chief Counsel's Office stated that "willful violation" should be interpreted in the same way for either a civil or criminal penalty. CCA 200603026 goes on to state that "in order for there to be a voluntary intentional violation of a known legal duty, the accountholder would have to have knowledge that he had a duty to file an FBAR, since knowledge of the duty to file an FBAR would entail knowledge that it is illegal not to file the FBAR. A corollary of this principle is that there is no willfulness if the accountholder has no knowledge of the duty to file the FBAR."

Thus, the IRS appears to interpret the willfulness requirement differently from some courts. The CCA also observes that the Service must prove willfulness by the same clear and convincing evidence required when imposing a civil fraud penalty under Section 6663.

In certain situations, a taxpayer may be able to avoid a penalty. For example, if the taxpayer can show that the violation was not willful, it may be possible to avoid a penalty if the account was properly reported on the Form 1040 and the taxpayer can show reasonable cause. [28] Further, the Service occasionally creates a short-term amnesty program permitting delinquent taxpayers or those in noncompliance to avoid certain penalties.

The first such program was the Offshore Voluntary Compliance Initiative (OVCI), which expired on 4/15/03 but under which FinCEN granted a complete waiver of civil penalties for those taxpayers who complied with the program's terms and conditions. [29] Concurrent with OVCI and continuing beyond the program was the Last Chance Compliance Initiative (LCCI) within which the Service offered certain identified taxpayers an opportunity to minimize their exposure to penalties. The LCCI, however, did not offer complete amnesty from civil penalties as did the OVCI.

CONCLUSION

While the FBAR requirements include some ambiguities and could be clearer, the major issue for taxpayers and their advisors is the general level of ignorance with respect to both the filing requirement itself and the substantial and ongoing penalties that may follow noncompliance. It is not advisable to continue violating the statute in hopes that the IRS will provide an additional amnesty program in the future.

Practice Notes

- U.S. financial institutions with international branches could provide a great service to their U.S. clientele by advising them of the need to file an FBAR any time foreign assets are purchased. The taxpayer's financial advisor, as well as the institution, will be aware of when the taxpayer's account holds foreign investments.
- Practitioners should immediately begin preparation of an FBAR checklist in the event the JCT Report proposals are implemented.
- The FBAR was last revised in July 2000. Treasury and the IRS intend to release a revised form in the near future.

[1]

The purpose of the JCT Report, which was prepared on 8/3/06 but not released for distribution by the Senate Committee on Finance until 10/19/06, was to discuss options that may help bring about a reduction in the tax gap. Section E of the Report pertains to offshore bank accounts and trusts.

[2]

12 U.S.C. sections 1951-1959 and 31 U.S.C. sections 5311-5330.

[3]

Treasury Directive 15-41, 12/1/92.

[4]

31 C.F.R. section 103.56(b).

[5]

www.fincen.gov.

[6]

IR-2003-48, 4/10/03.

[7]

Section 7701(b)(3)(A).

[8]

Reg. 301.7701(b)-1(c).

[9]

Reg. 1.937-1(c)(3)(iii)(A).

[10]

Section 7701(a)(9); Reg. 301.7701(b)-1(c)(2)(ii).

[11]

www.irs.gov/businesses/small/article/0,,id=148845,00.html.

[12]

www.apbook.com, 11/12/05.

[13]

A financial account located in a U.S. military banking facility in a foreign country and operated to serve the U.S. military is *not* required to be reported on an FBAR.

[14]

31 C.F.R. section 103.32.

[15]

www.irs.gov/businesses/small/article/0,,id=139727,00.html.

[16]

31 U.S.C. section 5321(b)(1).

[17]

31 U.S.C. section 5321(d).

[18]

31 U.S.C. section 5321(a)(5)(B)(i), as amended by AJCA section 821.

[19]

31 U.S.C. section 5321(a)(5)(B)(ii), as amended by AJCA section 821.

[20]

31 U.S.C. section 5321(a)(5)(C).

[21]

31 U.S.C. section 5321(a)(5)(C)(ii).

[22]

Toscher and Stein, "FBAR Enforcement is Coming!," www.taxlitigator.com/articles/FBar.htm.

[23]

31 U.S.C. section 5322(a).

[24]

31 U.S.C. section 5322(b).

[25]

Id.

[26]

See, e.g., U.S. v. Eisenstein, 731 F2d 1540 (CA-11, 1984).

[27]

See, e.g., U.S. v. London, 66 F3d 1227 (CA-1, 1995).

[28]

31 U.S.C. section 5321(a)(5)(B)(ii), as amended by AJCA section 821.

[29]

Rev. Proc. 2003-11, 2003-1 CB 311. See generally Ostrander, "The Offshore Credit Card and Financial Arrangement Probe: Fraught With Danger for Taxpayers," 99 JTAX 113 (August 2003).