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FBAR Enforcement, What's Next

September 6, 2011

September 9, 2011 is the last date for taxpayers to submit requests to participate in the IRS Second Supplemental Offshore Voluntary Disclosure Initiative (OVDI). I have handled many OVDI filings and for some the program is a clear opportunity to avoid very severe outcomes if they do not enter the program. The lucky taxpayers who meet all the program requirements will avoid criminal and civil sanctions. But what about the taxpayers who really have no criminal liability, that is the risk of prosecution is minimal, and who chose not to enter the program? What should be done for those who chose to enter the program and ultimately "opt out" (OVDI Frequently Asked Questions "FAQ" 51.1?)

First, not all taxpayers should have entered the OVDI program. If a taxpayer has reported their foreign financial income on their income tax return, then the proper approach is to file previously unfiled Foreign Bank Account Reports (FBAR's) with a "reasonable cause" statement the makes clear all income from foreign financial sources has been reported. Reasonable cause in this case is limited to the act of failing to file the form, but the failure is excused because the income has been reported (FAQ 17). Reasonable cause may not necessarily include circumstances where the income was not reported. There still is the possibility that a non-willful penalty of $10,000 per unfiled year will be assessed for late filings after September 9, 2011 (OVDI FAQ 5).

Second, in the case of dual nationals or dual residents (taxpayers who have emigrated or are ex patriot workers) where foreign financial income was not reported, but even if reported after the application of all applicable foreign tax credits, there is no resulting U.S income tax liability. In these cases a reasonable cause argument may be supported by a written statement from the taxpayers U.S. tax preparer that the he/she failed to advise the taxpayer about the need report the foreign financial income for U.S. purposes. There is no certainty that a letter from the taxpayer's U.S. tax preparer will consitute "reasonable cause" for purposes of the non-willful penalty abatement but it may go a long way towards avoiding the "willfulness" penalty and criminal prosecution. I have seen

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numerous cases where the dual residents filed income tax returns in their country of origin and reported all their foreign financial income in that country. They also filed U.S. income tax returns but did not include their foreign income due to erroneous acts by their tax preparers. Some of these dual residents are Green Card holders (permanent residents).

Third, Green Card holders face special risks, not only of FBAR penalties, but they termination of their permanent resident status if their actions are found to be willful. If they are found to have willfully failed to file FBAR's they face prosecution for the FBAR crimes, and potentially for a False Statement crimes on their income tax returns. The FBAR crime and False Statement crimes are Crimes Involving Moral Turpitude ("CIMT") and may serve as ground for deportation under the Illegal Immigration Reform and Immigrant Responsibility Act of 1996). In the case of conditional Green Cards, such as in the case of an EB-5 Visa holder, (Immigrant Investor) the petition to remove the conditions may be denied. So what should Green Card holders do? They should file unfiled FBAR's and amend their U.S. income tax returns to include unreported foreign financial income. A reasonable cause letter from their immigration attorney may also be helpful, stating that the advisor did not specifically advise the taxpayer about the FBAR obligation. It should be noted, that the U.S. Citizenship and Immigration Services website makes no specific mention of FBAR filing requirements.

Fourth, all taxpayers who have unfiled FBAR's should also file unfiled or (late) income tax information returns including any unfiled Reports of Foreign Gifts (Form 3520) and unfiled Controlled Foreign Corporation returns (Form 5471). In these cases, a "reasonable cause" statement is very important to mitigate the intent element and limit penalty exposure. Each unfiled information returns has its own penalty scheme. The information return penalties were compromised in the OVDI program, but are now likely to be enforced, absent "reasonable cause.

Fifth , I am also seeing cases of U.S. citizens who live and work abroad who filed foreign income tax returns and have filed U.S. income tax returns. Many of these taxpayers have lived abroad for decades and were never told about their obligations to file FBAR's. For them the approach is to file unfiled FBAR's and amend income tax returns, if necessary. The goal is to limit FBAR penalty exposure to the "non-willful" penalties, which are $10,000 per year. Again, a statement from the tax preparer on the reason for the failure to file the FBAR and properly report foreign financial income may go a long way.

Sixth, what are the risks of taking no action after September 9, 2011? If taxpayers decide to take no action to cure unfiled FBAR's, report unreported foreign financial income, and file previously unfiled information returns like (Form 3520 and Form 5471) then the taxpayer may have crossed the line from into the category of "willful" penalty. The willful penalty is the greater of $100,000 or 50% of the foreign financial account balance per year for each year in which and FBAR is unfiled (OVDI FAQ18). In addition, criminal penalties may apply (OVDI FAQ 18).

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Seventh, the recalcitrant taxpayer will be faced with continuing compliance burdens and possible risks of prosecution and onerous civil penalties. FBAR's, and Form 3520 and Form 5471 are due annually, in addition the HIRE act, effective March 2010, added IRC sections 6048 and 6038D. These two sections combine to require reporting of foreign assets for income tax purposes on a new schedule. The FBAR reporting requirement will remain as it is required under the Bank Secrecy Act.

Finally, the Foreign Account Tax Compliance Act, (FATCA) was also added as part of the HIRE act. FATCA, now IRC sections 1471-1474, requires foreign financial institutions to report to the IRS all accounts with U.S. resident account holders, including individuals, partnerships, corporations, trusts, etc. The reports are required as of 2014 and will include names, i.d. numbers, account numbers, and addresses of records as well as account balances and will be filed quarterly.

For many taxpayers, there is still a chance, even without the OVDI to act before their conduct becomes willful and have limited penalty exposure that is nearly consistent with what a taxpayer who entered the OVDI program and "opts out" would obtain. For others who choose not to act now, they may just be playing the "audit lottery" in what may be an unfair game. Losers in this lottery may face incarceration, massive civil penalties and for some, even deportation.

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