VENABLE LLP

tax bulletin

www.Venable.com

FEBRUARY 2010

Authors

Charles Kolstad
ckolstad@Venable.com
310.229.9954

Jessica Lubar
jrlubar@Venable.com
410.244.7736

Bradford Cohen
bcohen@Venable.com
310.229.9942

If you have any questions regarding this bulletin, please contact any member of our Tax and Wealth Planning practice group.

2011 Budget Greatly Expands Reporting Requirements and Penalties for Holders of Offshore Bank Accounts

Holders of offshore bank accounts, along with their accountants and tax advisors, should be aware of recent proposals which could significantly change their reporting obligations, increasing both the disclosed information and the penalties for non-compliance.

The President and Congress, along with the US Treasury and the Internal Revenue Service, have recently focused extensively on the issue of unreported foreign financial accounts. Currently, a US person who has signatory authority or a financial interest in a foreign financial account must report the existence of the account on their income tax returns, and file Form 90-22.1 ("FBAR") by June 30 of the following year.

There has been significant press coverage on the issue of unreported foreign financial accounts over the past year, leading to the introduction of the Foreign Account Tax Compliance Act of 2009 in both the House and the Senate, as well as the inclusion of similar provisions in the Tax Extenders Act of 2009. The 2011 Budget recently introduced by President Obama continues this trend of focusing on foreign financial accounts, but includes provisions that expand upon or differ from previous draft legislation.

Foreign Financial Accounts

Under the Budget Proposals, a new reporting form must be filed if the aggregate value of assets held in foreign financial accounts, including investments in a foreign entity and financial instruments or contracts held for investment by a foreign person, exceeds $50,000. Note that this reporting threshold differs from the FBAR threshold, which is only $10,000. This form is to be filed in addition to the FBAR, not in lieu of the FBAR as many commentators have suggested. In addition, this reporting form would be filed with the IRS along with a holder's income tax return, while the FBAR is filed separately with the US Treasury. Lastly, this reporting requirement would apply not just to investment in foreign entities but also, to the extent provided for in regulations, investments in domestic entities formed or availed of to hold foreign financial assets.

Transfers between Accounts

The Budget Proposals go beyond the prior legislative proposals, and would require US individuals to report on their income tax return any transfers of money or property to, or receipt of money from, a foreign bank, foreign brokerage or other financial account ("Covered Transfers"). This reporting requirement would also apply to Covered Transfers by any entity, domestic or foreign, in which the US individual owns a greater than 25% interest. The Budget Proposals further require that any such entity, including foreign entities, apparently would have to report the name, address and TIN of any US individual who owns more than a 25% interest in the entity. The Treasury would be granted significant regulatory authority to require such additional information and reporting as the Treasury Secretary may prescribe.

Penalties

There are significant penalties for failure to file FBARs - $10,000 per failure which are not willful, and fines of up to $500,000 for failures which are willful. In addition, there are potential criminal penalties including imprisonment of up to 5 years.

Despite these existing, severe and potentially draconian penalties, the Budget Proposals add an additional penalty regime. There would be a $10,000 per form penalty, with a reasonable cause exception. Note that while there is a reasonable cause exception for the current FBAR penalties, that exception works very differently than the reasonable cause exception which tax practitioners know and work with on a regular basis.

In addition, a 20% accuracy-related penalty would apply to understatements attributable to undisclosed foreign financial assets, increased to 40% in certain cases. Undisclosed foreign assets for these purposes would include assets required to be disclosed under sections 6038, 6038B, 6046A and 6048, as well as the new regulations. It is not clear why the penalty for the new disclosure requirements links the assets required to be disclosed under the listed sections, since there are already existing information returns prescribed for reporting assets under the listed sections, and significant penalties for failing to file such information returns.

Lastly, an additional penalty could apply that would be equal to the lesser of $10,000 per reportable transaction or 10% of the cumulative amount of the unreported Covered Transfer.

Statute of Limitations

The Budget Proposals would extend the statute of limitations from 3 years to 6 years in cases where the income omitted from the taxpayer's U.S. tax return exceeds $5,000. This differs from the typical situation which requires an understatement of gross income to extend the statute of limitations to 6 years. The statute would be tolled for the period for which the new tax reporting forms are not filed.

Unlike other portions of the Budget Proposals, the amendments to the statute of limitations would be effective for income tax returns due after the date of enactment OR for tax returns filed on or before that date if the statute of limitations has not yet expired. This means that income tax returns for calendar year taxpayers filed for the 2006, 2007 and 2008 tax years are potentially subject to the new 6-year statute of limitations rather than the traditional 3-year statute of limitations. Presumably the tolling rules would not apply to those tax years since the new reporting forms would not have been in existence.

Things to Consider As the Legislation Progresses

The Budget Proposals raise a number of issues that should be considered before they are adopted in final form. Firstly, it is not clear that there is a need for a new, additional reporting form. Much of the information appears duplicative of what has to be filed on the FBAR forms. There has been significant commentary on the scope of the existing FBAR program, with many suggestions on how to make that program more effective. The Budget Proposals do not appear to reflect any of that positive commentary.

Secondly, the fact that some reported 14,000 taxpayers availed themselves of the amnesty program in 2009 suggested that many taxpayers were unaware of their reporting responsibilities. It is unclear that adding a second reporting form which will require the reporting of substantially the same information will increase compliance by taxpayers. In addition, unless great care is taken by the Treasury in drafting the regulations to implement the new reporting requirements, the rules and definitions for the FBAR form may differ from the rules and definitions for the new tax form, further leading to uncertainty and increasing the likelihood of errors by taxpayers with resulting penalties and fines.

Thirdly, the penalties for failure to file the new report are, in essence, duplicative of the existing FBAR penalties. Taxpayers should not be penalized for failing to report the same information to multiple authorities.

Fourthly, the requirement that foreign entities with US individuals owning greater than 25% interests in that entity file a report with the IRS could result in many entities having to file US tax returns even though they do not conduct any business in the U.S. There are significant enforcements issues with this requirement that require further thought.

Lastly, the change in the statute of limitations from 3 years to 6 years on a retroactive basis may or may not be constitutional. The constitutionality of such a retroactive expansion of the statute of limitations may be challenged if significant penalties are applied in situations where the 3-year statute would have otherwise applied.

If you have any questions regarding this bulletin, please contact any member of our Tax and Wealth Planning practice group.

CALIFORNIA MARYLAND NEW YORK VIRGINIA WASHINGTON, DC

1.888.VENABLE | www.Venable.com