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Navigating the New Reporting Requirements and Penalties for Holders of Offshore Bank Accounts

Holders of offshore bank accounts will soon be required to disclose additional information with their tax returns. The Hiring Incentives to Restore Employment ("HIRE") Act of 2010 subjects them to increased penalties for failing to report foreign assets and investment information.

Press coverage on the issue of unreported foreign financial accounts over the past year has led 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 and President Obama's 2011 Budget. The HIRE Act, signed by President Obama on March 18, 2010, continues this trend of focusing on foreign financial accounts.

Historically, a U.S. person who has signatory authority or a financial interest in a foreign financial account has been required to report the existence of the account on a Form 90-22.1 ("FBAR") which is filed with the U.S. Treasury Department by June 30 of the following year. Under the new law, individuals will have to comply with the new disclosure requirements, in addition to filing FBARs, beginning with their 2011 tax returns.

Individuals who are subject to the FBAR requirements need to become familiar with the new reporting requirements, because they are significantly different from the FBAR requirements.

Reporting Requirements

Under Section 6038D as added by the HIRE Act, a new income tax reporting form must be filed by individuals with their income tax returns if the aggregate value of specified foreign financial assets exceeds $50,000 during any taxable year. This reporting threshold differs from the FBAR threshold, which is only $10,000. However, assets that are not currently considered for purposes of FBAR filing are included in the assets subject to the new filing requirement. The new form is in addition to, and not in lieu of, the FBAR filing requirement.

The new requirement also creates different due dates for filing information about an individual's foreign holdings. The new form would be filed with an individual's income tax return, presumably by the due date, including extensions, while the FBAR is filed with the U.S. Treasury Department by June 30. Also, domestic entities that hold foreign financial assets may be required to file the new form as well.

It remains to be seen whether pension plans, tax-exempt entities and the like will need to file the new form, or whether those entities will only be subject to FBAR reporting. Any filing requirements would be contained in regulations issued by the IRS.

Specified Foreign Financial Assets

An individual must first identify all reportable assets in order to determine whether, and what, information needs to be disclosed. The term "specified foreign financial asset" includes (i) any financial account maintained by a foreign financial institution, (ii) any stock or security issued by a non-U.S. person, (iii) any financial instrument or contract held for investment that has an issuer or counterparty who is a non-U.S. person, and (iv) any interest in a foreign entity.

It is important to note the following points when identifying assets subject to disclosure:

- Unless regulations provide otherwise, it appears that a U.S. bank account maintained with a U.S. branch of a foreign financial institution would have to be reported on the new form. This differs from the FBAR which reports only foreign accounts, regardless of whether the financial institution which maintains the account is domestic or foreign.
- The new form requires the reporting of all investments in foreign stock, securities, bonds, partnership interests, and disregarded entities as well as bank accounts, mutual funds and the like. This would be in addition to disclosure already required for ownership of stock of a foreign corporation (Form 5471), a foreign partnership (Form 8865) or a foreign disregarded entity (Form 8858).
- The reference to financial instruments or contracts would presumably include interest rate and

other swap agreements, futures and forward contracts, and other derivatives to which a foreign entity is a party.
- The term "financial institution" includes any entity that is engaged (or holds itself out to be engaged) primarily in the business of investing, reinvesting or trading securities, partnership interests, commodities or any interest (including futures or forward contracts) in the preceding items.
    - A private equity fund or a hedge fund appears to qualify as a financial institution, and any investment in a foreign private equity fund or hedge fund may have to be reported on the new form.
    - It should be noted that, based upon recently released proposed changes to the FBAR, investments in foreign private equity funds or hedge funds would not need to be reported on that form. It remains to be seen whether the FBAR regulations will be revised in light of the treatment of private equity and hedge funds under the HIRE Act.
- Unlike the FBAR, the new form does not have a "look-through" rule under which the individual is considered to have a financial interest in financial accounts held by controlled foreign corporations, partnerships or trusts that would require those indirect financial interests to be disclosed.
- The new form is a tax form, unlike the FBAR, and is subject to the non-disclosure rules applicable to tax returns and tax forms. In comparison, the FBAR may be shared by the Treasury Department with other governmental departments.

Information Required to Be Disclosed

The new form would require disclosure of (i) the name and address for each foreign financial institution, as well as the account number for each account, (ii) the name and address of each issuer of each foreign stock or security, as well as information about the class or issue of which the stock or security is a part, (iii) the name and address of each issuer or counterparty and the information required to identify the instrument, contract or interest, and (iv) the maximum value of each asset during the taxable year.

Penalties

Significant penalties are imposed for failures to file FBARs - $10,000 for failures which are not willful, and fines of up to the greater of $100,000 or 50% of the value of the account for failures which are willful. In addition, there are potential criminal penalties including imprisonment of up to 5 years.

Because the filing requirements and enforcement procedures are different than for the FBAR, the HIRE Act adds an additional penalty regime for failures to file the new form. Penalties under the HIRE Act could be imposed in addition to any applicable FBAR penalties. There is no coordination among the penalty provisions.

Under the HIRE Act, a $10,000 penalty is imposed on any failure to timely file the required information, which could go up to $50,000 if the failure is not cured within a certain period of time. A penalty may be waived if the failure was due to reasonable cause. The determination of what constitutes reasonable cause will presumably be governed by existing tax return related reasonable cause law and regulations. This could result in a different determination than may be made under the reasonable cause exception for FBAR failures.

In addition, a 40% accuracy-related penalty would apply to understatements attributable to undisclosed foreign financial assets. Undisclosed foreign financial 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 assets that are required to be disclosed under sections other than Section 6038D and on different information returns are subject to the new penalties. There are already significant penalties for failing to file those other information returns.

Statute of Limitations

The HIRE Act amends Section 6501(e) to extend the statute of limitations from 3 years to 6 years in cases where income omitted from the taxpayer's U.S. tax return exceeds $5,000 and the omission is attributable to one or more assets required to be reported under the new reporting rules. This differs from the typical 6-year statute extension which applies where there has been a 25% or greater understatement of gross income.

Under Section 6501(c)(8), as amended by the HIRE Act, the statute of limitations would be tolled for the period for which the new tax reporting forms are not filed, and would not expire until 3 years after the date on which the Secretary is furnished the required information. Accordingly, a failure to file the new form would result in the IRS having until 3 years after the form is filed to assess any additional taxes, penalties, etc.

Effective Date

The new form and related penalty provisions will apply to taxable years beginning after the date of enactment of the HIRE Act (for individuals, the 2011 tax year).

However, it is important to note that 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, without further clarification from the IRS or Congress, income tax returns for calendar year tax payers filed for the 2006, 2007 2008, 2009 and 2010 tax years are potentially subject to the new 6-year statute rather than the traditional 3-year statute. Presumably the tolling rules would not apply to those tax years since the new reporting forms would not have been in existence.

Conclusion

The HIRE Act provides another tool for the IRS in their effort to identify unreported foreign financial assets. However, it requires disclosure of assets and information that individuals who are familiar with FBAR requirements will not be expecting. Further, because of the expanded asset types included, the reporting requirements will come as a surprise to individuals who have not been subject to FBAR reporting. Finally, failures could result in significant penalties to individuals, especially if they are combined with FBAR filing penalties. Therefore, individuals with offshore accounts and those who have engaged in financial transactions with non-U.S. persons should consult carefully with their tax accountants when preparing their tax returns to ensure that they comply with the new requirements.

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