Congress and the IRS Increase Enforcement Efforts Against Taxpayers with Offshore Financial Accounts and Assets

By

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Do you help your parents manage their bank accounts in their home country? Are you formally on the accounts as a joint owner? Do you own, co-own or help manage stock portfolios or other financial accounts located with financial institutions outside of the United States? Do you own an interest in a non-U.S. entity? If you answered yes to any of these questions, you likely will be affected by new legislation regarding offshore asset reporting that goes into effect for most taxpayers beginning January 1, 2011. Have you previously declared such foreign accounts on your U.S. tax returns? If not, you may be affected by increased IRS enforcement actions against U.S. taxpayers with undeclared offshore accounts and assets.

In March, Congress passed and President Obama signed The Hiring Incentives to Restore Employment Act of 2010 (the "Act") into law. The Act, primarily aimed at domestic job creation and other provisions designed to jump start the economy, also incorporated Senator Levin's bill, The Foreign Accounts Tax Compliance Act (the "FATCA"). The FATCA provisions incorporated in the Act are very numerous, far reaching, and too complex for a full explanation in the limited space provided by this column. Accordingly, I have only described, in the briefest of terms, three new provisions which, I believe will impact the readers of this publication the most. Readers are advised to consult their own tax professionals to determine how they will be affected by the Act and the IRS' increased enforcement of undeclared offshore assets and accounts.

As a result of the FATCA provisions contained in the Act, many U.S. persons with bank accounts, other financial accounts, or trusts located outside of the U.S., could be subject to new reporting obligations and penalties. Under current law, U.S. individuals who directly or indirectly own more than 50% of a non-U.S. financial account valued above $10,000, or who have signature authority over such account, are required to disclose this ownership on their annual Form 1040. Additionally, such individuals must report certain information with respect to such account(s) on Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, or "FBAR") generally due on June 30 and filed separately from the Form 1040.

The Act imposes new information reporting requirements on any U.S. individual who holds interests valued at more than $50,000 (in the aggregate) in: (i) depository or custodial accounts maintained by a non-U.S. financial institution; (ii) non-U.S. stock, interests in non-U.S. entities, and financial instruments or contracts with a non-U.S. counterparty not held within a custodial account of a financial institution. Failure to provide sufficient information to establish an account's value will result in the presumption that the value exceeds $50,000. Failure to report a reportable account will be subject to a penalty of $10,000, and additional penalties (up to $50,000) could apply.

In addition to the failure to file penalties noted above, the Act also: (i) imposes a 40% penalty with respect to any understatement of income attributable to any undisclosed foreign financial asset; and (ii) extends the current three year statute of limitations to six years in cases where an omission of more than $5,000 of income is attributable to one or more reportable foreign assets. More importantly, this six year period will not begin until a taxpayer files an information return disclosing these reportable assets.

The Act's new reporting requirements supplement and are in addition to the existing "FBAR" reporting requirements described above, and apply without regard to whether the individual owns more than a 50% interest in such accounts, as long as the $50,000 value threshold is met. Although information requested for this new filing is similar to the information requested on the FBAR, there are significant differences. Accordingly, going forward many individuals will need to track their foreign assets and accounts, if they're not already tracking, so that both reporting obligations can be satisfied. It should be noted that, initially, these new reporting requirements are applicable to individuals only; however, under the Act, the IRS has authority to apply the provisions to assets held by U.S. entities.

With respect to equity interests in non-U.S. companies held by U.S. taxpayers, currently, U.S. direct and indirect shareholders of certain non-U.S. funds and corporations categorized as "passive foreign investment companies" ("PFICs"), are only required to file information returns if they receive a distribution from the PFIC, recognize gain upon the disposition of their interest in a PFIC, or make certain U.S. tax elections regarding the PFIC. The Act now requires U.S. shareholders report their ownership interest in a PFIC annually, even if they don't receive a distribution or recognize gain from the PFIC. As with the new offshore financial account reporting, the new PFIC requirements supplement and are in addition to the currently existing information reporting requirements and have immediate effect.

The Act introduces a new provision under which the use of property owned by a non-U.S. trust, by the U.S. grantor or U.S. beneficiaries of such trust, is treated as a distribution in the amount of the fair market value of the use of the property, unless the grantor or such beneficiary, as the case may be, pays the trust for the use of the property within a "reasonable period of time." This provision could have a significant impact on trust structures that own assets such as real estate and art, if the trusts allow the beneficiaries or other U.S. persons to use this property without receiving adequate compensation. This provision will apply to any uncompensated use of trust property occurring after the date of enactment.

Lastly, many readers may be aware of the IRS' Offshore Voluntary Compliance Initiative ("OVCI") for taxpayers to come forward and report previously undeclared offshore assets and accounts which, expired in October 2009. Under this OVCI program, more than 15,000 taxpayers came forward and filed to report previously undeclared offshore assets and accounts under a partially amnesty that saw all criminal sanctions waived (for all but the most egregious of cases) in exchange for certainty that only limited civil penalties would apply. Based on the information discovered as a result of these 15,000 filings, the IRS is preparing itself for a new round of investigations targeting banks other than UBS and jurisdictions other than Switzerland. It is widely believed that such 15,000 taxpayers are only the tip of the iceberg when it comes to non-compliant taxpayers, and that banks in Asia and taxpayers using Asian offshore companies will be the next primary targets of IRS enforcement in this area. Further, practitioners currently assisting clients in the OVCI program are getting vibes from IRS auditors that the IRS is very upset most taxpayers did not take advantage of the OVCI program and, therefore, will enter the next round of enforcement with a harsher attitude and less amenable to leniency for such still non-compliant taxpayers.

As noted above, the summary above only describes a small portion of the new legislation and ongoing IRS enforcement actions with respect of offshore assets and accounts. The FATCA provisions are far reaching and complex, and likely will affect many readers of this publication, as could the next round of IRS enforcement actions in this area. Accordingly, you should consult your tax professional for a full explanation of how the Act and the IRS' enforcement actions will affect your financial and tax reporting matters.

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