Cross-Border Information Reporting and Civil Penalties (in a Nutshell)

By Lucy S. Lee

Lucy S. Lee examines cross-border information reporting obligations.

I. In General

The Internal Revenue Code ("the Code")[1] generally imposes an income tax reporting requirement on all U.S. persons and certain foreign persons with sufficient nexus to the United States.[2] The rules that govern a taxpayer's obligation to file a tax return and pay taxes in the United States are exceedingly complex. For the individual income tax return, taxpayers annually spend enormous amounts of time collecting and compiling relevant financial information and determining how best to complete the return.[3] In addition, taxpayers must determine which of a multitude of supporting schedules and tax information returns should be filed along with, or in addition to, the tax return. It is no wonder even Einstein thought that "the hardest thing in the world to understand is the income tax."

II. Taxpayer Reporting Obligations

A. In General

For purposes of U.S. tax, the term "United States person" generally includes citizens and residents of the United States, domestic partnerships and corporations, and domestic trusts and estates.[4] Residents of the United States generally include lawfully admitted permanent residents (*i.e.*, green card holders) and individuals satisfying the substantial presence test.[5]

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A trust is "domestic" only if (i) a court within the United States is able to exercise "primary supervision" over the administration of the trust, and (ii) one or more U.S. persons has the authority to control *all* "substantial decisions" of the trust.[6] A trust which satisfies both requirements is generally treated as a U.S. person for U.S. federal tax purposes; a trust not meeting both tests is treated as a foreign person.[7] A corporation or partnership is generally treated as a U.S. person if it is created or organized in the United States or under the laws of the United States or any State thereof.[8]

Individuals who are citizens or residents of the United States are generally required to file annually a Form 1040 to report their worldwide income no matter where they reside.[9] Foreign persons, including foreign trusts, are generally required to file annually a Form 1040NR to report their fixed determinable and periodic (FDAP) income from sources within the United States (*e.g.*, dividends, interest, rents and royalties) and income that is effectively connected with the conduct of a trade or business within the United States for the year ("effectively connected income" or "ECI").[10] An income tax return is generally required to be filed annually following the close of a taxpayer's "tax year." The tax year of individuals and trusts generally is the calendar year.[11] Corporations and other business entities generally can use a "fiscal year" other than the calendar year.[12]

In addition to income tax filings, U.S. persons and certain foreign persons may be subject to certain information reporting requirements. For example, the Code requires a foreign grantor trust with a U.S. owner to furnish to the IRS certain information regard-

ing its identification, income and assets.[13] Reporting of such information is generally required on Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner.* As discussed below in Section III, the failure to file such information can result in significant civil penalties imposed on the U.S. owner of the foreign grantor trust.

Contrary to foreign grantor trusts, foreign non-grantor trusts generally do not have an information reporting requirement. However, U.S. persons who maintain or engage in certain transactions with foreign grantor or nongrantor trusts during the year are generally required to report such transactions to the IRS on a Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.* Such reportable transactions include (1) ownership of a foreign grantor trust; (2) transfer of property to a foreign trust (*i.e.*, the U.S. transferor must notify the IRS of the transfer and provide the IRS with the identity of the trustees and beneficiaries); and (3) receipt of property or distribution from a foreign trust.[14] Reporting is also required for any testamentary transfer of property, as well as the death of a U.S. citizen or resident who was considered to own any portion of a foreign trust or in whose estate are included a foreign trust's assets.[15] In the case of testamentary transfers and the death of a U.S. owner of a foreign trust, notice must be furnished by the decedent's executor.[16] As discussed below in Section III, the failure to timely file a Form 3520, or filing an incorrect or incomplete form, can result in significant civil penalties.

Information reporting on Form 3520 is also required where a U.S. person receives, in the aggregate, gifts or bequests in excess of $100,000 from a nonresident alien or a foreign estate during the year.[17] While a foreign person is not subject to the U.S. gift tax on gratuitous transfers of foreign property, as discussed below in Section III, the failure on the part of the U.S. recipient to disclose such gift to the IRS can result in significant monetary penalties.

Additionally, if, during the year, a U.S. person, either directly or indirectly, (1) transfers property to a foreign corporation; (2) owns at least 10 percent of the vote of a foreign corporation, which is owned, in the aggregate, more than 50 percent (by vote or value) by U.S. persons; or (3) acquires or disposes of certain amounts of ownership interests in a foreign corporation, such U.S. person must generally file an information return on a Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations,* and, in the case of a transfer to a foreign corporation, also on Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation.*[18] For purposes of Form 5471, certain beneficiaries of foreign trusts can be treated as indirectly engaging in the transaction with the foreign corporation.

Information reporting is also generally required for each year a U.S. person, who is a direct or indirect shareholder of a "passive foreign investment company" (PFIC),[19] (1) recognizes gain on a direct or indirect disposition of PFIC stock; (2) receives certain direct or indirect distributions from a PFIC; (3) is making a reportable election as outlined in Part 1 of the form; or (4) is including income under an election to remove the PFIC taint by currently recognizing income (*i.e.*, the so-called mark-to-market or qualified electing fund elections).[20] Reporting is filed on Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.* Indirect shareholders can include certain beneficiaries of certain foreign trusts.

Finally, and importantly, each U.S. person having a financial interest in, or signature or other authority over, any foreign financial accounts with an aggregate value exceeding $10,000 at any time during the calendar year must report such relationship by filing Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR), in addition to noting that they have such foreign account filing requirement on Schedule B of Form 1040 and including the income from these accounts on the U.S. person's U.S. federal income tax return.[21]

The following are detailed discussions of the requirement to file a Form 3520-A, Form 3520, FBAR and Form 5471.

B. Form 3520-A Reporting

The trustee of a foreign grantor trust[22] with a U.S. owner must generally file an annual Form 3520-A.[23] Code Sec. 6048(b) provides that a U.S. grantor of a foreign grantor trust is "responsible for ensuring" that the trustee (i) files a return with the IRS for each tax year of the trust setting forth a full and complete accounting of all trust activities and operations,[24] and (ii) furnishes specified income (*i.e.,* Schedule K-1's) and other information to each U.S. grantor and trust beneficiary who directly or indirectly receives a trust distribution for that year.[25]

The Form 3520-A discloses the trust assets and the identity of the settlor and the name, social security number and contact details of the trust's agent in the

United States (if any). Form 3520-A is generally filed by the trustee or fiduciary of the foreign grantor trust.[26] To avoid penalties, a complete Form 3520-A must be filed by the 15th day of the third month after the end of the trust's tax year.[27]

In addition to reporting on Form 3520-A, a foreign grantor trust with a U.S. owner may be required to file a Form 1040NR.[28] It would indicate on Page 1 that (i) it is a grantor trust taxable under Code Secs. 671–679, and (ii) that a statement of income taxable to the grantor is attached. This is similar to the way that a Form 1041 is completed for domestic grantor trusts. The Form 1040NR is due on June 15 of the year following the calendar year when the nonresident alien individual, estate or trust received the taxable income.

C. Form 3520 Reporting

The Code generally imposes an information reporting requirement on U.S. persons that engage in certain transactions with foreign trusts. In addition, U.S. persons who receive certain foreign gifts or bequests must disclose such gifts or bequests.

Form 3520 is filed separately from the personal income tax return of the U.S. settlor, transferor or recipient and is due on the date of such personal income tax return, including extensions. Generally, Part I covers transfers to a foreign trust by a U.S. person; Part II provides information on the owner of a foreign trust settled by a U.S. person; Part III covers distributions received by a U.S. person from a foreign nongrantor trust; and, Part IV is used to report large foreign gifts. Note that a trust distribution will not constitute a foreign gift and should be reported on Part III rather than Part IV.

1. Transfers to a Foreign Trust

Any U.S. person who gratuitously transfers property to a foreign trust must notify the IRS of the transfer and provide the IRS with the identity of the trustees and beneficiaries.[29] Reporting a transfer to a foreign trust is done on Form 3520 (Part I).[30]

For this purpose, a "gratuitous transfer" is any transfer other than a transfer for fair market value (to an unrelated foreign trust) or corporate or partnership distributions.[31] The determination of whether a transfer is gratuitous is made without regard to whether the transfer is a gift for U.S. federal gift tax purposes.[32] Transfers to foreign trusts for fair market value include only transfers that are consideration for the fair market value of the property transferred to the foreign trust.[33] Thus, a sale of property by a U.S. person to a foreign trust must be reported as a transfer to a foreign trust unless the trust pays fair market value for the property.[34] A credit sale to a trust will not be treated as a fair market value sale unless the obligation issued by the trust is a "qualified obligation."[35]

2. U.S. Beneficiary Receives a Distribution

Whenever a U.S. beneficiary receives a distribution, either directly or indirectly, from a foreign trust, the Code requires such U.S. beneficiary to file a Form 3520.[36] For this purpose, a distribution from a foreign trust includes (i) any gratuitous transfer of money or property from a foreign trust, whether or not the trust is deemed to be owned by another U.S. person; (ii) the receipt of trust corpus and the receipt of a gift or bequest that is not otherwise subject to income tax; and (iii) a direct or indirect loan of cash or marketable securities to a U.S. grantor or U.S. beneficiary by a foreign trust. Note that a distribution is reportable whether is it actually or constructively received.

3. U.S. Donee Receives a Certain Foreign Gift or Bequest

If the aggregate value of foreign gifts or bequests received by a U.S. person from a nonresident alien or foreign trust exceeds $100,000 ("large foreign gift"), or more than $12,760 from a foreign corporation or foreign partnership, such U.S. person must report the receipt of the gift or bequest to the IRS on Part IV of Form 3520.[37] Reporting of a large foreign gift is required unless (1) the U.S. donee is a tax-exempt entity, (2) the gifts are "qualified tuition or medical payments," or (3) the gifts are distributions to a U.S. beneficiary of a foreign trust which are otherwise properly disclosed.[38]

4. Exceptions

There are several exceptions to the general requirement of reporting certain transactions with foreign trusts, including the following: (i) transfers to certain employee benefit plans; (ii) transfers to foreign trusts having a current determination letter from the IRS recognizing their status as tax exempt under Code Sec. 501(c)(3); (iii) transfers to, ownership of or distributions from a Canadian registered retirement savings plan or a Canadian registered retirement income fund, where the U.S. citizen or resident alien is eligible to file Form 8891; and (v) distributions taxable as compensation and which have been reported as compensation on the applicable tax return.[39]

D. Report of Foreign Financial Accounts

Each U.S. person having a financial interest in, or signature or other authority over, any foreign financial accounts with an aggregate value exceeding $10,000 at any time during the calendar year must report such relationship by filing Form TD F 90-22.1, FBAR, in addition to noting that they have such foreign account filing requirement on Schedule B of Form 1040 and including the income from these accounts on the U.S. person's U.S. federal income tax return.[40]

Reporting on Form TD F 90-22.1 is required for each calendar year that a U.S. person maintains such interest or authority over foreign financial accounts.[41] The Form TD F 90-22.1 must be filed on or before June 30 each calendar year. An extension for filing one's U.S. income tax return does not extend the deadline for making a TD F 90-22.1. That is, there is no extension of time available for the late filing.[42]

The Form TD F 90-22.1 was revised in October 2008. The revised form must be used for FBAR filings after December 31, 2008. The revised form provides additional definitions and clarifications. It also generally expands the class of individuals and companies required to make annual reports, including certain foreign persons in and doing business in the United States (including a branch of a foreign entity) and certain trusts with U.S. settlors. There are also more detailed rules regarding consolidated reports for corporate parents and subsidiary corporations. The revised form confirms that there is no extension of time for filing the form.

1. Definitions

For purposes of FBAR, the term "United States person" means a citizen or a resident of the United States, or a person in and doing business in the United States.[43] A foreign subsidiary of a U.S. person is not required to file this report, although its U.S. parent corporation may be required to do so.[44] A branch of a foreign entity that is doing business in the United States is required to file this report even if not separately incorporated under U.S. law.[45]

The term "financial account" generally includes any bank, securities, securities derivatives or other financial instrument accounts, including any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund.[46] The term also means any savings, demand, checking, deposit, time deposit or any other account (including debit card and prepaid credit card accounts) maintained with a financial institution or other person engaged in the business of a financial institution.[47] Individual bonds, notes or stock certificates held by the filer are a financial account, nor is an unsecured loan to a foreign trade or business that is not a financial institution.[48]

Any of the financial accounts described above is considered to be a foreign financial account for purposes of FBAR, if it is located outside the United States, Guam, Puerto Rico and the Virgin Islands.[49] However, an account maintained with a military banking facility[50] is not considered to be a foreign financial account for purposes of FBAR, even if the military banking facility is located in a foreign country.[51] The geographical location of the account, not the nationality of the financial entity institution in which the account is founds determines whether it is in an account in a foreign country.[52] That is, the situs of a financial account is determined by the location where the branch is, not the location of the institution's home office. Thus, for example, an account maintained at a German branch of a U.S. bank is a foreign financial account, but an account maintained at a U.S. branch of a German bank is not a foreign financial account.

2. Ownership of Accounts

The instructions to Form TD F 90-22.1 explain that a U.S. person has a financial interest in a bank, securities or other financial account in a foreign country under either of the following circumstances:

1. A U.S. person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non-U.S. persons. If an account is maintained in the name of two persons jointly, or if several persons own a partial interest in an account, each of those U.S. persons has a financial interest in that account.[53]
2. A U.S. person has a financial interest in each bank, securities or other financial account in a foreign country for which the owner of record or holder of legal title is:
   a. a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person;
   b. a corporation in which the U.S. person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power of all shares of stock;

c. a partnership in which the U.S. person owns an interest in more than 50 percent of the profits (distributive share of income) or more than 50 percent of the capital of the partnership; or
d. a trust in which the U.S. person either has a direct or indirect present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.[54]

3. A U.S. person has a financial interest in each bank, securities or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such U.S. person and for which a trust protector has been appointed.[55]

3. Signature Authority

For purposes of Form TD F 90.22-1, a U.S. person is considered to have signature authority over a foreign financial account if such person can control the disposition of money or other property in the account by delivering his or her signature (or his or her signature and that of one or more other persons) to the bank or other person maintaining the account. In addition, a U.S. person has "other authority" subject to FBAR reporting if such person can exercise comparable power over an account by direct communication to the bank or other person maintaining the account, either orally or by some other means.

4. Exceptions

Notwithstanding the general rules, Form TD F 90.22-1 is not required to be filed under the following circumstances:

1. An officer or employee of a bank that is currently examined by Federal bank supervisory agencies for soundness and safety need not report that he or she has signature or other authority over a foreign bank, securities or other financial account maintained by the bank, if the officer or employee has NO personal financial interest in the account.[56]
2. An officer or employee of a domestic corporation whose equity securities are listed upon U.S. national securities exchanges or which has assets exceeding $10 million and 500 or more shareholders of record need not file such a report concerning the other signature authority over a foreign financial account of the corporation, if he has NO personal financial interest in the account and he has been advised in writing by the chief financial officer of the corporation that the corporation has filed a current report, which includes that account.[57] There are additional exceptions for domestic and foreign subsidiaries.
3. As noted above, a U.S. person is not required to report any account maintained with a branch, agency, of other office of a foreign bank or other institution that is located in the United States, Guam, Puerto Rico and the Virgin Islands.[58]

E. Form 5471

Form 5471 is generally used by certain U.S. citizens and residents who are officers, directors or shareholders in certain foreign corporations to satisfy the reporting requirements of Code Secs. 6038 (reporting with respect to certain foreign corporations) and 6046 (returns relating to organizations and reorganizations of foreign corporations). A separate Form 5471 and applicable schedules for each foreign corporation must be attached to the U.S. federal income tax return of the U.S. person obligated make the information return.

Generally, there are five categories of U.S. taxpayers that are required to complete a Form 5471 for each tax year regarding certain foreign corporations:

- **Category 1 Filer.** This filing requirement was repealed by the American Jobs Creation Act of 2004.[59] Prior to this repeal, U.S. citizens or residents who were officers, directors or 10-percent shareholders of a foreign personal holding company were required to file a Form 5471 as Category 1 Filers.
- **Category 2 Filer.** U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired (i) 10 percent of stock of the total value of the corporation's stock or of the total combined voting power of all classes of stock with voting rights ("10-percent requirement"); or (ii) an additional 10 percent or more (in value or vote) of the outstanding stock of the foreign corporation.[60]
- **Category 3 Filer.** (i) U.S. person who acquires stock in a foreign corporation that, when added to any stock owned on the acquisition date, meets the 10-percent requirement; (ii) U.S. person who acquires stock which, without regard to stock already owned on the date of acquisition, meets the 10-percent requirement; (iii) a person treated as a U.S. shareholder in a captive insurance com-

pany situation (as defined in Code Sec. 953(c)(1)); (iv) a person who becomes a U.S. person while meeting the 10-percent requirement; or (v) U.S. person who disposes of sufficient stock in the foreign corporation to reduce interest to less than the ownership requirement (*i.e.*, less than 10 percent).[61]

- **Category 4 Filer.** U.S. person who had "control" (more than 50 percent of vote or value) of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation (exception for consolidated returns) ending with or within the tax year of the U.S. person.[62]
- **Category 5 Filer.** U.S. shareholder who owns, directly or indirectly, at least 10 percent of the vote of a controlled foreign corporation (CFC) and who owns stock in the CFC for an uninterrupted period of 30 days or more during any tax year of the foreign corporation, and who owned the stock on the last day of that year.[63]

> The rules that govern a taxpayer's obligation to file a tax return and pay taxes in the United States are exceedingly complex.

A CFC is a foreign corporation that has U.S. shareholders that own (either directly, indirectly or constructively within the meaning of Code Sec. 958(a) and (b)) on any day of the tax year of the foreign corporation, more than 50 percent of (i) the total combined voting power of all classes of its voting stock; or (ii) the total value of the stock of the corporation.[64] In this 50-percent test, only the U.S. shareholders who own 10 percent or more of the vote of the foreign corporation are counted.

For purposes of Form 5471 reporting, a U.S. taxpayer can own shares of a CFC directly or indirectly. Stock owned (directly or indirectly) by or for a portion of a trust of which a person is considered the owner under the grantor trust rules is considered to be owned by such person.[65] Under the indirect ownership rules, if an individual has an interest in a foreign corporation, foreign partnership, foreign estate or foreign trust that own shares in a foreign corporation, the individual will be deemed to "indirectly" own a proportionate share of the foreign entity's shares in the foreign corporation.[66] Accordingly, if a U.S. taxpayer has a beneficial interest in a foreign nongrantor trust that owns shares in a foreign corporation, the taxpayer will be deemed to "indirectly" own a proportionate share of the foreign trust's shares in the foreign corporation.[67]

III. Potential IRS Penalties

The failure to file the required tax returns and information returns may result in civil and criminal penalties, as discussed below.

A. Income Tax Returns

In addition to the tax due, if a taxpayer fails to file a return, there may be imposed a penalty of five percent per month of the amount of tax required to be shown on a tax return.[68] The amount of the penalty is not to exceed 25 percent of the amount of tax in the aggregate. There is an exception if the failure was due to reasonable cause, not willful neglect.

In certain circumstances, a taxpayer can be subject to an additional penalty of 20 percent of the amount of the underpayment.[69] This penalty can be imposed on both (i) negligence or disregard of rules or regulations, and (ii) any substantial underpayment of tax (understatement of greater than 10 percent or $5,000). There is a reasonable cause exception whereby the substantial underpayment of tax penalty may be alleviated if there was a reasonable cause for the underpayment (*i.e.*, there is "substantial authority" for or adequate disclosure of the position and the position is not a tax shelter) and the taxpayer acted in good faith with respect to the underpayment. In addition, if the taxpayer is subject to the (worse) fraud penalty under Code Sec. 6663, the substantial underpayment penalty does not apply.

B. Certain Information Returns (Forms 3520, 3520-A and 5471)

1. Forms 3520 and 3520-A

If a U.S. transferor fails timely file a Form 3520 to report the transfer of property to a foreign trust, or files the form incorrectly or incompletely, the IRS may impose a penalty equal to 35 percent of the gross value of the property transferred to the foreign trust.[70] Similarly, if a U.S. beneficiary fails to timely file a Form 3520 to report the receipt of a distribution from a foreign trust, or files the form incorrectly or in-

completely, there may imposed a penalty equal to 35 percent of the gross value of the distribution received from the foreign trust.[71] Finally, if a U.S. donee fails to timely file a Form 3520 to report the receipt of a large foreign gifts, or files the form incorrectly or incompletely, such donee may be subject to a penalty equal to five percent, not to exceed 25 percent, of the value of the gift or bequest received in the relevant year.

> While making a full faith voluntary disclosure may alleviate the risk for criminal prosecution, taxpayers can still face substantial civil penalties.

If a foreign grantor trust that fails to timely file a Form 3520-A, or fails to furnish all of the required information, the U.S. owner may be subject to a penalty equal to five percent of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of the tax year.[72]

The failure to timely file a complete and correct Form 3520 or Form 3520-A may result in an additional penalty of $10,000 per 30-day period for failing to comply within 90 days of notification by the IRS that the information return has not been filed.[73] The total penalty for failure to report a trust transfer, however, cannot exceed the amount of the property transferred.[74] The monetary penalty is in addition to any applicable criminal penalty.[75] If the person responsible for reporting can demonstrate that the failure to timely file was due to reasonable cause, and not willful neglect, the IRS can abate the penalty under Code Sec. 6677(a) or 6677(b).[76]

2. Form 5471

For Category 2 and 3 Filers, the IRS may impose a penalty of $10,000 for each failure to timely file a Form 5471, or filing a Form 5471 that does not show the information required under Code Sec. 6038.[77] If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign corporation) can be imposed for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to $50,000. There is no reasonable cause exception for either the initial or additional penalty.

For Category 4 and Category 5 Filers, the IRS may impose a penalty of $10,000 for each failure to timely file a Form 5471, or filing a Form 5471 which does not show the information required under Code Sec. 6046.[78] If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign corporation) can be imposed for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to $50,000. There is a reasonable cause exception for the initial $10,000 penalty; however, there is no such exception for the additional penalty.

3. Form 926

If a U.S. person fails to timely provide information regarding certain transfers to foreign corporations as required under Code Sec. 6038B, the IRS may impose a penalty equal to 10 percent of the fair market value of the property transferred at the time of the exchange.[79] There is a reasonable cause exception. Additionally, the amount of the penalty imposed under this section is limited to $100,000, unless the failure was due to intentional disregard.

4. Information Returns Generally

An additional penalty of $50 may be imposed for *each* return (not to exceed $250,000 per year) that fails to include all of the correct information.[80] There is an exception if the failure is corrected within 30 days after the required filing date. However, no exception (including the $250,000 cap) applies if the failure is based on intentional disregard and the amount of the penalty is the greater of $100 or 10 percent of the aggregate amount of the items required to be reported. There is no reasonable cause exception. Finally, there may be imposed an additional penalty of $50 for each failure to comply with a required information reporting (not to exceed $100,000 per year).[81] There is no exception, including a reasonable cause exception.

C. Form TD F 90.22-1

The willful failure to file the FBAR is a felony[82] and can result in the imposition of substantial civil and/or criminal penalties. For FBARs due before June 30, 2004, there was no civil penalty for the nonwillful failure to file an FBAR. However, in 2004, Congress significantly altered the potential civil penalties applicable to FBAR violations. The revised penalties are

applicable to violations occurring after October 22, 2004, *i.e.*, FBARs due on or after June 30, 2005.

As revised, a nonwillful violation of the FBAR reporting requirement can result in a civil penalty not exceeding $10,000.[83] The penalty may be waived if (i) the violation was due to reasonable cause, *and* (ii) the amount of the transaction or the balance in the account at the time of the transaction was property reported.[84] A willful failure to file the FBAR can result in a civil penalty of the greater of $100,000 or 50 percent of the value of the foreign account at the time of the violation.[85] The reasonable cause exception does not apply to willful violations.

D. Criminal Penalties

In addition to the civil penalties discussed above, criminal penalties under Code Secs. 7203 (monetary and penal penalties for willful failure to file supply information), 7206 (monetary and penal penalties for fraud and false statements) and 7207 (monetary and penal penalties for fraudulent statements) may apply.

IV. Conclusion

There are numerous complex U.S. tax provisions potentially relevant to cross-border fact patterns that can give rise to challenging tax issues and "unforeseen circumstances." It is important to recognize that taking remedial actions to bring a taxpayer back into compliance with U.S. tax rules inevitably involves more than just the substantive tax rules. Close attention must also be paid to the equally numerous and complex procedural rules contained in the Code, including the potential civil penalties. While making a full faith voluntary disclosure may alleviate the risk for criminal prosecution, taxpayers can still face substantial civil penalties. The good news may be that, while "ignorance (or confusion) of the law" is no excuse for noncompliance, in the civil context, there may be reasonable causes to alleviate the burden of culpability.

Endnotes

1 Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

2 Code Sec. 6012.

3 The instructions to the 2008 Form 1040, the return filed by most (the instructions say 71 percent) U.S. citizens and residents, estimate that an average of 32.7 hours is normally required to collect, compile and analyze the information necessary to complete and file the form. The instructions to the 2008 Form 1040NR, the basic income tax return filed by nonresident alien individuals and foreign trusts, estimate an average time of 29.7 hours.

4 Code Sec. 7701(a)(30).

5 The "substantial presence test" measures the weighted average of days an alien is physically present in the United States over a three–calendar year period. Specifically, if an individual is present in the U.S. for at least 31 days in the current year and the weighted average for the three year period totals 183 days or more, he generally will be treated as a resident alien of the United States as of the first day in the current year he is physically present in the United States. Code Sec. 7701(b)(2)(A)(iii); Reg. §301.7701(b)-4(a). The formula counts days present in the current year at full value, days present in the immediately preceding year at one-third value, and days present in the second preceding year at one-sixth value.

6 Code Sec. 7701(a)(30)(E).

7 Code Sec. 7701(a)(31).

8 Code Sec. 7701(a)(4).

9 Code Sec. 6012(a); Reg. §1.6012-1(a)(1); *see also* Instructions to Form 1040. Code Sec. 6012 contains the exceptions for when an individual is not required to file a Form 1040.

10 Code Sec. 6012(a); Reg. §1.6012-1(b)(1); *see also* Instructions to Form 1040NR.

11 Code Secs. 441(b) and 644(a).

12 Code Sec. 641(b) and (e).

13 Code Sec. 6048(b).

14 Code Sec. 6048(a). In Notice 97-34, IRB 1997-25, 22, the IRS clarified Code Sec. 6048(a)'s notice requirements. The Form 3520, used to report transfers to foreign trusts, is filed with a U.S. transferor's annual income tax return.

15 Code Sec. 6048(a)(3).

16 Code Sec. 6048(a)(4).

17 Code Sec. 6039F(a).

18 Code Secs. 6038, 6038B; 6046.

19 A foreign corporation is treated as a PFIC for a tax year if it satisfies one of two tests: (1) at least 75 percent of the corporation's gross income for the year is passive or investment-type income; or (2) at least 50 percent of the average fair market value of its assets during the year are assets that produce or are held for the production of passive income. Code Sec. 1297(a). If a foreign corporation satisfies either test, the corporation is a PFIC and any U.S. person owning an interest (directly or indirectly) in the corporation generally is subject to the PFIC rules, regardless of how large an ownership interest the person has in the foreign company. Unless the shareholder makes a special election to be taxed on a current basis, a distribution or sale of the shares may result in additional tax and interest charges. That is, the portion of a distribution from a PFIC that exceeds 125 percent of the average distributions made to the shareholder within the three preceding years included in the shareholder's holding period, or if the holding period is less than three years, the actual holding period itself. Code Sec. 1291(b)(2).

20 Proposed Reg. §1.1291-1(i).

21 *See* Instructions for Form TD F 90-22.1 (revised October 2008).

22 In addition to other applicable rules, where a U.S. person transfers property to a foreign trust, such U.S. transferor may be treated as the owner of the trust's assets for U.S. federal tax purposes if the foreign trust that has or could have one or more U.S. beneficiaries. Code Sec. 679.

23 Code Sec. 6048(b).

24 Code Sec. 6048(b)(1)(A).

25 Code Sec. 6048(b)(1)(B).

26 *See* Instructions for Form 3520-A; *see also* Rev. Proc. 2002-23, IRB 2002-15, 744, §3, for other eligible Canadian plans.

27 *See* Instructions for Form 3520-A.

28 A foreign nongrantor trust is treated as its own taxpayer, separate from the grantor or settlor. Code Sec. 641(b). It is taxed as a foreign individual and therefore must file a Form 1040NR to report certain types of income from U.S.-source FDAP income, if not fully withheld at source, and effectively connected income. Reg. §1.6012-1. The Form 1040NR is generally due on June 15 of the year following the calendar year when the foreign nongrantor trust received the taxable income. The form should be signed by the trustee.

29 Code Sec. 6048(a); Notice 97-34, IRB 1997-25, 1.

Endnotes

[30] Form 3520 is filed separately from Form 1040, but the Form is due on the date the individual's U.S. income tax return (Form 1040) is due (including extensions). Form 3520 must be filed timely to avoid penalties for failing to timely report. *See* Instructions for Form 3520.
[31] Reg. §1.671-2(e)(2)(ii).
[32] Reg. §1.671-2(e)(2)(i).
[33] Reg. §1.684-3(d).
[34] Code Sec. 679 provides for exceptions to the exception for transfers at fair market value to a foreign trust that is a related party (for transfers occurring after February 5, 1995).
[35] Notice 97-34. To be treated as a "qualified obligation," an obligation must (i) be reduced to writing by an express written agreement; (ii) have a term not exceeding five years including options to renew and rollovers; (iii) be denominated in U.S. dollars; (iv) have a yield to maturity of between 100 percent and 130 percent of the applicable AFR on the date the obligation was issued; (v) have a U.S. person willing to extend the statute of limitations for assessment of any income or transfer tax changes attributable to the transfer to three years beyond the maturity date of the obligation; and (vi) have a U.S. person report on the status of the obligation and the interest and principal payments on Form 3520.
[36] Code Sec. 6048(c).
[37] Code Sec. 6039F(a); *see also* Instructions for Form 3520.
[38] Notice 97-34; Instructions for Form 3520.
[39] Code Sec. 6048(a)(3)(B)(ii); Notice 97-34.
[40] *See* Instructions for Form TD F 90-22.1 (revised October 2008).
[41] 31 CFR §103.24. Such persons will be required to provide detailed information concerning each account when so requested by the Secretary or his delegate. *Id.*
[42] *See* Instructions for Form TD F 90-22.1.
[43] *See id.*
[44] *See id.*
[45] *See id.*
[46] *See id.*
[47] *See id.*
[48] *See id.*
[49] *See id.*
[50] Such facilities are generally known as a "United States military banking facility" or a "United States military finance facility" that are operated by a U.S. financial institution designated by the U.S. government to serve U.S. government installations abroad.
[51] *See id.*
[52] *See id.*
[53] *See id.*
[54] *See id.*
[55] *See id.*
[56] *See id.*
[57] *See id.*
[58] *See id.*
[59] American Jobs Creation Act of 2004 (P.L. 108-357).
[60] Code Sec. 6046(a)(1)(A).
[61] Code Sec. 6046(a)(1)(B).
[62] Code Sec. 6038(a)(1).
[63] Code Sec. 6038(a)(4).
[64] Code Sec. 957(c).
[65] Code Sec. 318(a)(2)(B)(ii).
[66] Code Sec. 958(a)(2).
[67] Code Secs. 958(a)(1) and 318(a)(2)(B)(i); Reg. §1.958-2(c)(ii)(a).
[68] Code Sec. 6651.
[69] Code Sec. 6662.
[70] Code Sec. 6677; s*ee also* Instructions for Form 3520.
[71] *See id.*
[72] *See id.*
[73] Code Sec. 6677(a).
[74] *Id.*
[75] Code Sec. 7203.
[76] Code Sec. 6677(d).
[77] Code Sec. 6038(b).
[78] Code Sec. 6679.
[79] Code Sec. 6038B(c).
[80] Code Sec. 6721.
[81] Code Sec. 6723.
[82] 31 USC §5322(a).
[83] 31 USC §5321(a)(5), as amended by P.L. 108-357.
[84] *Id.*
[85] *Id.*