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This Outline is prepared to give readers a broad overview of the UBS scandal, which led the IRS to announce the IRS Offshore Income Reporting Initiative. It will summarize changes to the FBAR filing as a result of the proposed FBAR regulations issued earlier this year, and briefly discuss some of the most common informational returns applicable to United States taxpayers. It will review the ongoing voluntary disclosure program for taxpayers with noncompliance, as well as the consequences of the Foreign Account Tax Compliance Act. In the final Section of the Outline, readers are introduced to a number of tools available to IRS revenue agents.

I. UBS Situation

On August 13, 2009, the United States Department of Justice (the "DOJ") reached a settlement with Swiss bank UBS AG under which UBS will reveal the names of a number of United States taxpayers with undeclared foreign accounts.[1] Once Switzerland abides by the terms of the settlement, the IRS will withdrawal the "John Doe summons" it issued to UBS in 2008. On November 18, 2009, details of the settlement were revealed. [2] UBS will turn over identifying information on 4,450 United States taxpayers. The criteria set forth by the DOJ, on which these 4,450 taxpayers were singled out, includes those individuals with:

- Direct ownership of an undisclosed account with 1 million or more Swiss francs at any time from 2001 to 2008, even if the account is now closed;

- Direct or indirect ownership of an undisclosed account with 250,000 or more Swiss francs at any point during the same period, if there was a "scheme of lies" in connection with the account. This includes those holding accounts through entities such as trusts, corporations or foundations, especially if they had special cell phones or credit cards attached to the accounts that eased access and helped ensure secrecy. It might also include a direct account holder with more than 250,000 francs at any point during the period who, for example, did not disclose a United States citizenship when opening the account.

- Indirect ownership of an undisclosed account that generated an average of 100,000 Swiss francs per year in interest, dividends and capital gains for any three years from 1998 to 2008.[3]

Unfortunately, the settlement broke Swiss law and it was not until June 2010 that the Swiss parliament approved the necessary changes to its own law in order for Switzerland to comply with the terms of the settlement.[4] The Swiss government announced on August 26, 2010 that the

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[1] http://www.irs.gov/pub/irs-drop/bank_agreement.pdf

[2] http://online.wsj.com/article/SB10001424052748704431804574541461590575636.html?mod=WSJ_hpp_sections_news#articleTabs%3Darticle

[3] *Id.*

[4] http://www.vosizneias.com/58025/2010/06/17/zurich-switzerland-parliament-agrees-to-hand-over-names-of-u-s-tax-evaders-to-irs/

Swiss Federal Tax Administration ("SFTA") had completed the processing of all 4,450 accounts.[5] On the same date, the United States and Swiss governments indicated that only about 2,000 accounts had been turned over.[6] It is anticipated that information on the remaining accounts will be provided to the IRS by Fall.

The Swiss law firm of Bill*Isenegger*Ackwermann AG ("BIA AG") serves as registered agent for United States taxpayers who hold or held accounts with UBS in Switzerland. Unless the account holder signed a waiver permitting UBS to deliver information to the IRS, the account was processed by the SFTA to determine whether it should be included within the 4,450 turned over to the IRS. Once the SFTA made a determination, BIA AG sent correspondence to the account holder advising them that unless they appealed the verdict within the 30 day appeal period, the IRS would receive the information. The delay associated with Switzerland's providing the IRS with information on the additional 2,450 accounts is associated with the fact that the accounts are included within the appeal period.

The settlement follows UBS' deferred prosecution in February 2009, in which it admitted to helping United States taxpayers hide accounts from the United States government, paid $780 million in settlement and turned over the names of upwards of 250 United States account owners. From that initial list, a number of taxpayers were indicted and pled guilty to either filing a false income tax return, willfully failing to reveal the existence of a foreign account, or both.

II. IRS Offshore Income Reporting Initiative

Prior to the DOJ/UBS settlement and in an effort to encourage taxpayers to self report their unreported accounts, the IRS announced the creation of a new, six-month voluntary disclosure program on March 23, 2009. The IRS Offshore Income Reporting Initiative (the "Initiative") terminated on October 15, 2009. Under the settlement, UBS was required to advise its United States taxpayers who fell within the above referenced (and prior to November 18, 2009, unknown) criteria that the United States has requested their information. The notices were sent on a rolling basis over a number of months.

As originally described, the Initiative was to be available only for six months, until September 23, 2009, and provided that those taxpayers who qualified would not be subject to the civil fraud penalty; the possibility of a criminal prosecution also was reduced. Taxpayers were required, depending on their circumstances, to file six years of tax returns, either amended or delinquent, and to pay all taxes and interest due. Taxpayers also were subject to an accuracy-related penalty or a delinquency penalty, as well as a penalty of up to 20% on the highest aggregate balance held in the account during the six-year period. Certain taxpayers qualified for a reduced penalty of 5% on the highest aggregate balance in the foreign account.

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[5] *Swiss Complete Processing of UBS Accounts,* Tax Notes (August 30, 2010).

[6] *U.S., Switzerland Say Deadline for Processing UBS Accounts Met, Handover Not Yet Done,* 165 DTR GG-1 (August 27, 2010).

On September 21, 2009, in IR-2009-84, the IRS announced "a one-time extension of the deadline for special voluntary disclosures," giving taxpayers until October 15, 2009.[7] Similarly, the numerous exceptions to the Initiative, which were posted on the IRS website as a series of Questions and Answers,[8] also were extended through October 15, 2009.

The IRS publicized the first exception, Q&A 9, on May 6, 2009, and then supplemented it with the exceptions in Q&As 42 and 43, which were added on June 24, 2009. Through these exceptions the government agreed to forgo penalizing taxpayers who failed to file informational forms such as Forms 3520, 3520-A, 5471, and the FBAR (TD F 90-22.1), if taxpayers did not also have an omission of income associated with their income tax returns. When the Initiative was announced, Commissioner Shulman said that the Service would reevaluate its options after the six-month period, and warned taxpayers "who continue to hide their head in the sand, the situation will only
become more dire."

III. Voluntary Disclosure

Despite the expiration of the Initiative, voluntary disclosure would appear to remain an option.[9]

The Internal Revenue Manual ("IRM") defines a voluntary disclosure as having taken place when the taxpayer's communication is truthful, timely, and complete.[10] These terms require that the taxpayer show a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability, and the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.[11]

When successful, taxpayers can use the voluntary disclosure program to come into compliance and avoid criminal prosecution. Taxpayers need to be aware that not all voluntary disclosure submissions are accepted, and thus criminal prosecution is a potential outcome from a disclosure which is found not to qualify. [12] Cases involving illegal source income will not qualify. [13]

Disclosures are timely if they are received before:

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[7] http://www.irs.gov/newsroom/article/0,,id=213463,00.html

[8] http://www.irs.gov/newsroom/article/0,,id=210027,00.html

[9] See Dale, "No Amnesty, But Evaders Still Welcome," Wall St. J., 10/17/09 (reporting that an IRS spokeswoman, Michelle Eldridge, stated the "IRS remains willing to work with any taxpayer who wants to come forward and make a voluntary disclosure, even though the special program is over").

[10] IRM 9.5.11.9.3.

[11] IRM 9.5.11.9.3.A and B.

[12] IRM 9.5.11.9.2

[13] IRM 9.5.11.9.2

1) The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.

2) The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance.

3) The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.

4) The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).[14]

The Service decided to permit taxpayers with UBS accounts to qualify for voluntary disclosures under the Initiative even if such taxpayers had received notification from UBS or the SFTA that their information was destined to be turned over to the DOJ in accordance with the August 19, 2009 settlement.[15]

It is not clear if taxpayers who receive correspondence from BIA AG can qualify for a voluntary disclosure subsequent to the Initiative. Section 9.5.11.9.5 of the IRM was revised as of December 2, 2009, to inform special agents that if a taxpayer has any reason to believe that the IRS has obtained information concerning their tax liability, it could be a disqualifying fact. Whether the correspondence from BIA AG is a disqualifying fact is not known. In such circumstance, the special agent is to review the facts and circumstances to determine whether the taxpayer may still qualify for a voluntary disclosure.[16]

While taxpayers should understand that a voluntary disclosure subsequent to the Initiative remains a viable option for resolving noncompliance, it is likely that such a disclosure will include greater penalties. As noted above, taxpayers who qualified for the Initiative were able to avoid a series of penalties, including the civil fraud penalty, and perhaps avoid criminal penalties. Taxpayers were required to file six years of tax returns—depending on the circumstances, either amended or delinquent—and pay all taxes and interest due. Taxpayers would also incur an accuracy-related penalty or a delinquency penalty, as well as a penalty of up to 20% on the highest aggregate balance held in the account during the six-year period.

Under the Initiative, certain taxpayers were able to qualify for a reduced penalty of 5% on the highest aggregate balance in the foreign account. The 5% penalty would apply only if (1) the taxpayer did not open or create the foreign account, (2) the taxpayer had never withdrawn money from or added money to the foreign account, and (3) all United States taxes had been paid on the funds that were deposited into the account. Thus, the only noncompliance that would have

[14] IRM 9.5.11.9.4.

[15] Q/A #52 posted online at http://www.irs.gov/newsroom/article/0,,id=210027,00.html

[16] Section 9.5.11.9.5

existed on the part of the taxpayer was not reporting the income earned on the foreign account.[17] The third requirement would have been the most difficult to satisfy for a person who either inherited a foreign account or received such an account as a gift. If the taxpayer inherited the account from a foreign relative, it is likely no United States taxes would have been paid, and the taxpayer may have failed to report the receipt of the foreign gift on Form 3520. If the taxpayer inherited the account from a United States relative, it may be unclear as to whether United States taxes were paid on the funds contributed to the account.

IV. Benefits of a Voluntary Disclosure

Practitioners should take note that filing *quiet* or stealth returns to correct noncompliance with the hope that taxpayers will achieve a better result, specifically no penalties, as a result of the returns sliding through, appears to no longer be an option. The IRS has identified, and will continue to identify, amended tax returns reporting increases in income. The IRS will be closely reviewing these returns to determine whether enforcement action is appropriate. Consistent therewith, the IRS has stated that taxpayers are strongly encouraged to make voluntary disclosures and that "[t]hose taxpayers making “quiet” disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years."[18]

Even though the penalties under the Initiative and a voluntary disclosure may cause some financial difficulties, taxpayers should not lose sight of what they avoid by submitting a disclosure. While not a complete summary of potential penalties, those that follow are some of the most common:

- Criminal prosecution.
- The civil fraud penalties under Sections 6651(f) and 6663, which can amount to 75% of the unpaid tax.
- Failure-to-pay penalties under Sections 6651(a)(2) and (a)(3).
- Failure-to-file penalties under Section 6651.
- Penalties for failure to file foreign corporation information returns (Form 5471 and/or Form 5472), which begin at $10,000 and can run as high as $50,000 per return.
- Penalties for failure to report transfers of property to a foreign corporation (Form 926), which begin at 10% of the value of the property transferred to the corporation and which can reach a maximum of $100,000 per return.

[17] Certain United States taxpayers who created a foreign account prior to becoming United States persons also may qualify for the 5% penalty, provided they did not contribute funds to or withdraw funds from the account once they became United States persons. See Q/A 46, posted online at http://www.irs.gov/newsroom/article/0,,id=210027,00.html.

[18] Q/A #10 posted online at http://www.irs.gov/newsroom/article/0,,id=210027,00.html

- Penalties for failure to file Form 3520, reporting the transfer of funds to or receipt of a distribution from a foreign trust, which begin at 35% of the amount transferred to or received from the foreign trust.

- Penalties for failure to file a Form 3520 to report the receipt of a gift or inheritance from a foreign person or estate, or a gift received from a foreign corporation or partnership, which begin at 5% of the value of the gift and can reach as high as 25% of the value.

- Penalties for failure to file Form 3520-A reflecting ownership of a foreign trust under the grantor trust rules, which amounts to 5% of trust assets.

- Penalties for failure to file foreign partnership information returns (Form 8865), which start at $10,000 and can reach a maximum of $50,000 per return, plus up to $100,000 of the value of property transferred to the foreign partnership.

- Penalties for failure to file FBARs, which can reach as high as 50% of the account balance, and in certain situations include jail time.

If avoiding the imposition of the above penalties is not a significant enough carrot for taxpayers, they should understand that the situation will not get any better. See Section VII of the outline in which numerous procedures available to the IRS to investigate taxpayers are discussed. Additionally, IRS agents have been instructed by Commissioner Shulman that if the taxpayer did not self report through a voluntary disclosure, they are "to fully develop these cases, pursuing both civil and criminal avenues, and consider all available penalties including the maximum penalty for the willful failure to file the FBAR report and the fraud penalty."[19]

V. TD F 90-22.1 – The FBAR[20]

On February 26, 2010, Treasury's Financial Crimes Enforcement Network ("FinCEN") issued proposals to amend the regulations under the Bank Secrecy Act [1] provisions that apply to the FBAR. The proposed regulations are intended to bring much needed clarity to the annual filing obligation.

A) Who is Required to File? Generally, a United States person with a financial interest in, or signature authority or other authority over, foreign financial accounts has to file an FBAR if at any point during the calendar year the aggregate value of all such foreign accounts equaled or exceeded $10,000, even if for one day. Prior to the introduction of the revised FBAR in the fall of 2008, a United States person was defined to include a United States citizen or resident, and a domestic corporation, partnership, estate, or trust.

[19] Statement dated March 26, 2009 from Commissioner Shulman on Offshore Income. http://www.irs.gov/newsroom/article/0,,id=206014,00.html

[20] See, Kevin E. Packman, "Reporting Foreign Accounts: Treasury Applies the Carrot and the Stick", *Journal of Taxation*, Jun 2010; Kevin E. Packman and Andrew H. Weinstein, "FBAR—Foreign Bank Account Reporting Obligations: A Primer for the Practitioner," *Journal of Taxation*, Jan 2007

The proposed regulations define "United States person" in much the same way; it includes citizens and residents of the United States as well as any domestic entity. "Resident" is defined by reference to Section 7701(b) and the Regulations thereunder. Consequently, if a nonresident alien can be classified as an income tax resident under the substantial presence test, that individual will have to file an FBAR to report his or her worldwide accounts.

In many jurisdictions, individuals go through significant expense to obtain privacy for purely personal safety reasons, and not for money laundering or any criminal financial enterprise. Resorting to the use of the income tax test for residency increases the number of persons affected. The proposed regulations indicate that the total number of estimated individuals and entities affected are 400,000; a great majority of those persons will likely come from this residency group.

LLCs are included within the definition of domestic entity. An entity will have to file regardless of whether it has made an election to be disregarded. The consequence is that a nonresident alien owner of a disregarded entity may have to file an FBAR regardless of whether such person qualifies as a United States income tax resident.

The definition of "United States" is expanded to include Indian lands and United States territories and possessions. FinCEN believes that it is necessary to expand the definition of United States because taxpayers hide their residency in an effort to "obscure the source of their income or location of their assets."[3]

B. What Accounts Are Reportable? FinCEN believes that only accounts at institutions where taxpayers have a formal relationship need to be reported. The length of the relationship is irrelevant; the fact that a relationship existed controls the filing obligation. "For this purpose, an account means a formal relationship with such person to provide regular services, dealings and other financial transactions."

An exception exists for taxpayers who do not have a relationship with the institution, but rather who use the institution for a transaction, such as wiring funds or purchasing money orders. These are the two examples provided in the proposed regulations, and it is not clear if a distinction exists between an individual who sends a wire as opposed to one who receives a wire. It would appear that someone who receives a wire from an institution, such as a Western Union, should not have to file an FBAR provided the individual does not otherwise have a relationship with the institution.

The FBAR instructions provide one definition for a "financial account." The proposed regulations, however, include individual definitions for bank account, securities account, and other financial accounts. The main focus in all three definitions is the kinds of financial services provided to the taxpayer by the institution.

1) Bank account. "Bank account" is defined to include a "savings deposit, demand deposit, checking or any other account maintained with a person engaged in the business of banking." Institutions where taxpayers can deposit funds and redeem the funds at a later date with interest are also included within the definition. While the definition includes a better description, there really is no expansion of the definition.

2) Securities account. Until the proposed regulations, there was not a definition for these "securities accounts." The term is defined to include "an account maintained with a person in the business of buying, selling, holding, or trading stock or other securities."

3) Other financial accounts. Even though "other financial accounts" previously appeared in the definition of "financial account," FinCEN believes that compliance will improve if it specifies the types of relationships that must be reported. The following relationships are included within the definition:

    a. An account with either a financial agency that is in the business of accepting deposits or with a person who accepts deposits as a financial agency.

    b. An insurance policy that has a cash value or an annuity policy.

    c. An account with a person that acts as a broker or dealer for futures or options transactions in any commodity on, or subject to the rules of, a commodity exchange or association.

    d. An account with a mutual fund or similar pooled fund which issues shares available to the public provided the investment's net asset value is regularly determined and the investment offers regular redemptions. FinCEN elected not to include hedge funds, private equity funds, and similar types of pooled investment companies in the definition of "other financial account," but reserved the right to do so at a later date. It agreed to wait until the legislative landscape has cleared to see if regulations affecting such investments will be enacted. Considering that the Foreign Account Tax Compliance Act ("FATCA") requires such investments to be disclosed, it would appear that FinCEN may forgo requiring the investments to be reported on an FBAR.

4) Exempt accounts. The proposed regulations continue to exempt certain types of accounts from the reporting regime, and add a few additional such accounts. These are generally accounts affiliated with the government, or those in which the owner's access to the funds is limited or tenuous.

    a. Correspondent or nostro accounts remain exempt, as these accounts are used by the institutions to make bank-to-bank transfers.

    b. An account in an institution known as a "United States military banking facility" (or "United States military finance facility"), operated by a United States financial institution designated by the United States government to serve United States government installations abroad, is not a reportable account even if the United States military banking facility is located in a foreign country.

    c. An account of an international financial institution of which the United States government is a member is an exempt account.

d. An account of a department or agency of the U.S., an Indian tribe, or any political subdivision of a state, or a wholly owned entity, agency, or instrumentality of the foregoing, is not reportable.

e. Participants and beneficiaries in a qualified retirement plan in accordance with Section 401(a), 403(a), or 403(b), as well as owners and beneficiaries of IRA and Roth IRA accounts created in accordance with Sections 408 and 408A, are exempt from filing an FBAR to report the existence of foreign investments held by the plan.

f. As stated above with regard to reportable accounts, if an individual does not have a relationship with an institution but receives funds in the course of a one-time transaction, such as a wire transfer, the account is not reportable. Nevertheless, a short-term account, such as an escrow account, *is* reportable.

g. As discussed below with regard to financial interests, certain trust beneficiaries are exempt from filing an FBAR provided an FBAR is filed by the trustee or an agent of the trustee.

C. Foreign Country. In order for an account to be subject to the FBAR reporting requirement, it must be foreign (i.e., outside of the U.S.). There is no change in the proposed regulations to the definition; an account will be foreign if it is located outside the United States, Indian lands, United States territories, and United States possessions. Stated differently, if the account is located in a United States territory or possession, it does not have to be reported on an FBAR.

D. Which Financial Interests Are Reportable? The definition of "financial interest" is expanded to include the owner of a foreign trust under the grantor trust rules. There is also a catchall that states a financial interest will exist in any foreign account when a United States taxpayer holds ownership through an entity that is designed to evade the reporting requirement.

This simply appears to be another way of requiring individuals to report their indirect ownership of an account regardless of how such ownership is actually titled. FinCEN believes that this is an anti-avoidance rule, which will capture those individuals engaging in nefarious activities. Otherwise, the proposed regulations do not change the definition of "financial interest."

It would have been a nice surprise if the proposed regulations had clarified the reporting requirement for beneficiaries of a foreign discretionary trust. Such persons are classified as having a financial interest if the United States person has a beneficial interest in more than 50% of the assets or when the United States person receives more than 50% of the current income. Very often it will not be possible for the beneficiary to determine the percentage of income that he or she received. It is even more difficult to determine the percentage of ownership an individual has in a discretionary trust.

In an effort to avoid duplicative filings, trust beneficiaries are exempt from filing an FBAR if the trustee of a foreign trust or agent of the trust is a United States person that files an FBAR for the trust. Nevertheless, the trust beneficiary will have to file a Form 3520 for any year in which the trust makes a distribution, even if there is no FBAR filing obligation.

FinCEN provides the exemption for trust beneficiaries as an acknowledgment that in some instances the trust or its trustees are in a better position to be aware of the presence of foreign financial accounts, as well as whether the beneficiary has a greater-than-50% interest. FinCEN fails to acknowledge, however, that in several instances the beneficiary has no communication with the trustee. Thus, the universe of persons who may benefit from this exemption may be limited.

E. What Is Included in 'Signature or Other Authority'? Signature or other authority" includes the situation where an individual (alone or in conjunction with others) has control over the disposition of money, funds, or other assets held in a foreign financial account by delivering instructions (in writing or otherwise) to a person where the account is maintained. Previously, certain persons were exempt from filing an FBAR to report their signature or other authority if the accounts belonged to an employer, the employee did not have his or her own financial interest in a foreign account, and the employee was advised that the employer had filed its own FBAR.

The proposed regulations expand on the number of instances in which an individual with signature authority will be excused from filing an FBAR. They include the following:

1) Officers and employees of financial institutions that have a federal functional regulator, and certain entities that are publicly traded, are exempt from filing an FBAR so long as the individual does not have a financial interest of his or her own.

2) Officers and employees of a bank that is examined by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, the Office of Thrift Supervision, or the National Credit Union Administration are exempt from filing an FBAR so long as the individual does not have a financial interest of his or her own.

3) Officers and employees of a financial institution that is registered with and examined by the SEC or the Commodity Futures Trading Commission are exempt from filing an FBAR so long as the individual does not have a financial interest of his or her own. The individual does not need to determine whether the employer has filed itsown FBAR in order to qualify for the exemption.

4) Officers and employees of banks that are examined by a federal banking agency are exempt from filing an FBAR so long as the individual does not have a financial interest of his or her own. Similarly, the individual does not need to determine whether the employer has filed its own FBAR in order to qualify for the exemption.

5) Officers and employees of an authorized service provider that is registered with the SEC are exempt from filing an FBAR so long as the individual does not have a financial interest of his or her own. This exception is designed to cover persons affiliated with mutual funds and employed by fund service providers.

6) Officers and employees of an entity with a class of equities or securities that is listed on any United States national securities exchange are exempt from filing an FBAR so long as the individual does not have a financial interest of his or her own. Similarly, the

individual does not need to determine whether the employer has filed its own FBAR in order to qualify for the exemption. If, however, the employee or officer works for the United States subsidiary of such an entity, the exemption is not as broad. In that instance, the employee must make certain that the United States subsidiary is listed on a consolidated FBAR filed by its parent. If the parent does not file an FBAR, then the employee would have to file FBARs to report his or her signature authority over the parent's foreign accounts. FinCEN advises that these persons will have reduced filing obligations.

7) Officers and employees of domestic corporations are exempt from filing an FBAR so long as the individual does not have a financial interest of his or her own, and the corporation has more than $10 million in assets and more than 500 shareholders.

F. Special Rules. FinCEN will permit consolidated filings for individuals with a financial interest in 25 or more foreign financial accounts or those with signature or other authority over 25 or more foreign financial accounts. In addition, individuals who own more than 50% of an entity that is required to file an FBAR can file a consolidated FBAR to report the interest held by the entity as well as their individual interest.

The proposed regulations include a draft of new FBAR instructions, which provide an address for overnight delivery and procedures for seeking verification that FBARs were received by the Detroit Service Center. The overnight mailing address is: IRS Enterprise Computing Center, Attention CTR Operations Mailroom, 4th Floor, 985 Michigan Avenue, Detroit, Michigan 48226. Verification may be obtained, in accordance with the instructions, 90 days after the filing due date.

G. Civil Penalties. While there is a reasonable cause exception for persons who failed to file FBARs, there is also a nonwillful failure to file penalty of $10,000. If the amount of the transaction or the balance of the foreign account is reported on the taxpayer's Form 1040, the penalty may be eliminated as a result of the reasonable cause exception. It should be noted that Form 1040, Schedule B, Part III instructs a taxpayer who indicates that he has a financial account in a foreign country to review the FBAR filing requirements. To satisfy the reporting necessitated for the reasonable cause exception, the taxpayer must be certain to include on the Form 1040 any income generated by the foreign account and, to the extent possible, a detailed explanation of the transaction.

For a willful violation of the FBAR reporting requirement, the penalty is the greater of $100,000 or 50% of the amount of the transaction or of the balance of the account at the time of the offense. Violations that are deemed to be willful are of course not subject to the reasonable cause exception. [21]

H. Criminal penalties If the failure to file the FBAR is deemed to be a criminal violation, the penalty can include a fine of up to $250,000, imprisonment for up to five years, or both. [22] If the

[21] 31 U.S.C. section 5321(a)(5)(C).

[22] 31 U.S.C. section 5322(a).

failure to file is deemed to be part of a criminal activity, (i.e., it occurs during the violation of another law or is part of an illegal activity involving more than $100,000 in a 12-month period), the maximum fine increases to $500,000 and the possibility of imprisonment increases to up to ten years.[23] There is, of course, a possibility that both the $500,000 penalty and ten-year jail term will be subject to the applicable sentencing guidelines.

I. Reasonable Cause. The Initiative effectively eliminated the reasonable cause exception for failure to file the FBAR and assumed that all such failures were attributable to the taxpayer's willfulness. This was a complete reversal with how FBAR submissions were previously handled. This conclusion was also contrary to the Bank Secrecy Act, which permits a reasonable cause defense. [24] Reasonable cause will be assumed if the amount of the transaction or the balance of the foreign account was reported on the taxpayer's Form 1040.[25]

Similarly, the IRS website page dealing with frequently asked FBAR questions still provides that reasonable cause is a defense to the failure to file the FBAR. Question 16 asks: "What happens if an account holder is required to file an FBAR and fails to do so?" The answer provided is that "[f]ailure to file an FBAR when required to do so may potentially result in civil penalties, criminal penalties, or both. If you learn you were required to file FBARs for earlier years, you should file the delinquent FBAR reports and attach a statement explaining why the reports are filed late. No penalty will be asserted if the IRS determines that the late filings were due to reasonable cause. Keep copies, for your record, of what you send."[26]

Willfulness. What is even more troubling than the elimination of a reasonable cause defense is the Service's determination that all such failures to file the FBAR were deemed willful in nature. This conclusion ignores the statutory civil penalty of up to $10,000 for a nonwillful failure to file the FBAR that was enacted as part of the American Jobs Creation Act of 2004. [27] Will the facts and circumstances analysis that, prior to the Initiative, often dictated how FBAR penalties would be assessed apply now that the Initiative has terminated?

Willfulness generally requires a voluntary, intentional violation of a known legal duty. Another problem with ignoring the Regulations by automatically assessing the 20% penalty, as was done through the Initiative, is that the IRS also ignored precedent. The IRS Chief Counsel's Office previously stated in CCA 200603026 that "willful violation" should be interpreted in the same way for either a civil or criminal penalty: "[I]n order for there to be a voluntary and intentional violation of a known legal duty, the accountholder would just have to have knowledge that he had a duty to file an FBAR, since knowledge of the duty to file an FBAR would entail knowledge that it is illegal not to file the FBAR. A corollary of this principle is that there is no

[23] 31 U.S.C. section 5322(b).

[24] 31 U.S.C. section 5321(a)(5)(B)(ii).

[25] *Id.*

[26] http://www.irs.gov/businesses/small/article/0,,id=210244,00.html

[27] 31 U.S.C. section 5321(a)(5)(B)(i).

willfulness if the accountholder has no knowledge of the duty to file the FBAR." The IRS indicated its belief in the CCA that the willfulness requirement must be proved by the same clear and convincing evidence required when imposing a civil fraud penalty under Section 6663.

On September 1, 2010, the United States District Court for the Eastern District of Virginia, held that a taxpayer who had pled guilty for tax evasion did not willfully fail to file an FBAR reporting the existence of his foreign accounts. [28] The result has dealt the Government a blow, and perhaps will impact the number of taxpayers who participated in the Initiative who elect to opt out, and try their luck at Appeals.[29] The IRS appears to have overlooked the CCA and perhaps felt emboldened to make use of the willful penalty since no court had yet to determine it was wrong to do so. The Tax Court previously found that it did not have jurisdiction to review FBAR penalties [30] and the Bankruptcy Court previously found that the FBAR penalty was not a *tax* or *tax penalty* that could be discharged in bankruptcy. [31] We shall see if the Government makes use of the non-willful failure to file penalty in the future since it is clear that it will not be afforded deference by the Federal Courts.

J. Tax Preparer Due Diligence. Because an FBAR is not a tax return, tax preparers are not obligated to prepare such returns. Nevertheless, due diligence requires practitioners to have the discussion with their clients.

On January 22, 2010, Karen Hawkins, director of the Service's Office of Professional Responsibility, told the Administrative Practice and Court Procedure and Practice Committees of the ABA Section of Taxation that preparers have a duty to ask about ownership, control, or interest in offshore accounts, and to advise about the obligation to file the FBAR. Preparers must do more than simply ask the question on their intake form; they must affirmatively discuss the topic. This standard has since been posted to the IRS website.[32]

Therefore, in order for preparers to meet their due diligence requirements, it is incumbent on them to become familiar with the continued expansion of the FBAR filing obligation. Preparers should also note that the disclosure mandated by FATCA is a Title 26 requirement, and thus, there is no ability to decline preparing such disclosures.

VI. Additional International Filing Requirements

The percentage of United States taxpayers living abroad that understand the extent of their filing obligations is unclear. Often such taxpayers believe that they no longer have a filing requirement

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[28] *United States v. J. Bryan Williams*, Civil Action No. 1:09-cv-437 available at http://www.leagle.com/unsecure/page.htm?shortname=infdco20100901b89

[29] Q/A # 34 at http://www.irs.gov/newsroom/article/0,,id=210027,00.html

[30] *J.B. Williams, III,* 131 TC No. 6 (Oct. 2.2008), 2008 WL 4443057.

[31] *Simonelli,* 102 AFTR 2d 2008-6577(D.Conn. Sept. 30, 2008).

[32] http://www.irs.gov/pub/irs-utl/fbar_document_on_irs_gov_ver_08-04-10.pdf

if they are residing in a country with which the United States has an income tax treaty. This is incorrect— United States taxpayers are obligated to file income tax returns and report their worldwide income regardless of where they reside.

What is often less understood than the income tax filing obligation is the numerous information returns that United States taxpayers may be required to file. While the penalties for failure to file these forms can be costly, each form does provide the taxpayer with an opportunity to demonstrate reasonable cause, and avoid a penalty. Reasonable cause can include the taxpayer's lack of knowledge/familiarity with the filing requirement as well as reliance on a professional advisor.

Even though it is likely that most preparers will not be able to recall with the same certainty they do their name, the multitude of filing requirements for taxpayers with foreign activities, such preparers should be certain to familiarize themselves with the following forms, which are among the most common.

A. Form 3520. A taxpayer who can answer "yes" to any of the following questions likely has a Form 3520 filing requirement:

- Have you ever set up a foreign trust?
- Have you ever contributed funds or property to a foreign trust set up by someone else?
- Have you ever received gifts from foreign persons?
- Have you ever received an inheritance from a foreign person?
- Have you ever received funds from a foreign corporation or partnership in which you do not have an ownership interest?
- Have you ever loaned funds to a foreign trust?
- Have you ever received a distribution from a foreign trust?
- Do you have a debit or credit card that is tied to a foreign trust?
- Do you own real estate in Mexico?

Sections 6039F and 6048 mandate the filing of a Form 3520. United States taxpayers must file this form to report their (1) creation of a foreign trust, (2) transfer of money or property to a foreign trust, including by reason of death, (3) receipt of distributions from a foreign trust, as well as (4) receipt of certain gifts from foreign persons.

For purposes of the filing, "distributions" include direct distributions (i.e., a distribution directly to the United States beneficiary) as well as indirect distributions (i.e., a United States person writes a check that will be satisfied from a foreign trust or uses a credit card that takes funds out of a foreign trust). If a United States person is subject to these reporting rules, the form is due on the date that such person's income tax return is due, including extensions. The form must be filed

in duplicate, one copy attached to the United States person's income tax return and the second sent separately to the IRS service center in Philadelphia.

The penalty for failure to file Form 3520 to report the transfer of funds to a foreign trust is currently "35% of the gross value of any property transferred to a foreign trust." Likewise, the penalty for the failure to report the receipt of a distribution from a foreign trust is "35% of the gross value of distributions received from a foreign trust." If the Form 3520 is incomplete, in addition to penalties, the entire trust distribution will be deemed an accumulation distribution and taxed as ordinary income. [33]

If Form 3520 is delinquent more than 90 days after the Service notifies the taxpayer of such delinquency, an additional penalty of $10,000 is permitted for every 30 days (or fraction thereof) the form remains delinquent.

Section 6039F(a) requires United States persons to disclose the receipt of large gifts or bequests from foreign persons. The disclosure requirement is tied to the identity of the donor, and there are different thresholds based on the donor. For example, there are higher thresholds for gifts received from nonresident alien individuals, and foreign estates, than there are for gifts from foreign partnerships, and foreign corporations. Consequently, a United States person is required to report the receipt of gifts from a nonresident alien or foreign estate only if the total amount of gifts from that nonresident alien or foreign estate is more than $100,000 during the tax year. Once the $100,000 threshold has been met, the United States person must separately identify each gift that is more than $5,000, but does not have to identify the donor.

The penalty for failure to file a Form 3520 reporting the receipt of a large foreign gift is less than that for failing to file the Form 3520 reporting the receipt of distributions from the foreign trust. The penalty for failing to timely report the receipt of a foreign gift is imposed by Section 6039F, rather than Section 6677, and is 5% per month. The penalty, which is due upon notice and demand, increases each month that the Form 3520 is delinquent and continues up to a total of 25%. [34]

B. Form 3520-A. A taxpayer who can answer "yes" to any of the following questions likely has a Form 3520-A filing requirement:

- Did you create a foreign trust at any time?
- If you have recently become a United States taxpayer, did you create a foreign trust within five years of becoming a United States taxpayer?

Under the Code and Regulations, a transaction can be recharacterized such that indirect transfers are included within the reach of Section 679. If a taxpayer transfers assets to parents who are not United States taxpayers, who then settle a foreign trust, the trust will likely be deemed created by the United States taxpayer. Reg. 1.679-3(c) provides that a "transfer to a foreign trust by any

[33] Section 6048(c)(2)(A).

[34] Section 6039F(c)(1)(B).

person ... to whom a United States person transfers property is treated as an indirect transfer by a United States person to the foreign trust if such transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of United States tax."

The principal purpose of a transfer will be deemed to be tax avoidance if (1) the United States person is related to a beneficiary of the foreign trust, and (2) the United States person cannot demonstrate to the satisfaction of the IRS that there was no other basis for creating the trust to benefit such person.

Additionally, even if a foreign trust appears to have no United States beneficiaries, under the Code the IRS can treat the trust as having a United States beneficiary regardless of what is provided in the trust document itself. For example, according to Section 679(c)(1) a trust will be deemed to have a United States beneficiary unless (1) under the terms of the trust no part of the income or corpus could be paid or accumulated for the benefit of a United States person and (2) if the trust terminated during the tax year, no part of the income or corpus could be paid to a United States person.

Furthermore, Reg. 1.679-2(a)(4)(ii)(A) provides that if the trust documents can be amended to benefit a United States person, the trust will be classified as if there were such a United States beneficiary. Similarly, Reg. 1.679-2(b)(1) provides that if a beneficiary of the trust is a controlled foreign corporation or a foreign partnership in which the taxpayer is a partner, the trust will similarly be classified as having a United States beneficiary.

The consequence of having settled a foreign trust, which is classified as having a United States beneficiary, is that the taxpayer will be deemed to own the trust under the grantor trust rules. Consequently, the taxpayer will be liable for paying the income tax on the trust's income. Additionally, the taxpayer will be required to file Form 3520-A. The form must be filed by March 15, but a six-month extension may be obtained by filing Form 7004. The penalty for failure to file Form 3520-A is 5% of the December 31 value of the portion of the trust's assets treated as owned by the taxpayer.

C. Form 5471. A taxpayer who can answer "yes" to any of the following questions likely has a Form 5471 filing requirement:

- Do you own a foreign corporation?
- Are you a director or officer of a foreign corporation?

Certain United States citizens and residents who are officers, directors, or shareholders of foreign corporations must file Form 5471. While there are several categories of persons who must file the form, if a United States officer or director acquires stock to meet the 10% ownership requirement, or if a United States person had "control" of a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation, such person also would have a filing obligation. A person is in control of a foreign corporation if (1) the person owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or (2) the person owns more than 50% of the total value of shares of all classes of stock of a corporation.

The form is due at the same time as the United States person's income tax return. There is a $10,000 penalty for each annual accounting period for which the failure to file a Form 5471 exists.

D. Form 926. A taxpayer that owns a foreign corporation likely also has an obligation to file Form 926 in addition to Form 5471, if the taxpayer transferred property to the foreign corporation.

VI. FOREIGN ACCOUNT TAX COMPLIANCE ACT[35]

The Foreign Account Tax Compliance Act ("FATCA") became effective on March 18, 2010. The intent of the legislation is to deter the use of tax havens for tax evasion. To accomplish this goal, among other provisions, FATCA: (i) enhanced the mandatory disclosure; (ii) expanded the statutes of limitation; (iii) increased penalties; and (iv) imposed rebuttable presumptions to ease the burden on the government in prosecuting tax cases involving offshore noncompliance.

FATCA is used as a revenue offset for the Hiring Incentives to Restore Employment Act (HIRE), which President Obama signed on March 18, 2010. HIRE is designed to incentivize the creation of up to 300,000 new jobs this year. Employers who hire previously unemployed workers are entitled to a Social Security and Medicare Tax holiday as well as credits if the employees are retained for at least one year. A more detailed discussion of HIRE is beyond the scope of this Outline.

A. Increased Disclosure.

1) Foreign accounts and assets. Section 511 of FATCA creates new Section 6038D, which requires United States taxpayers holding specified foreign financial assets with an aggregate value exceeding $50,000 to report them on an informational return. It is unclear whether the $50,000 threshold applies if the balance of foreign accounts and assets exceeds $50,000 at the end of the tax year or at any time during the tax year, as in the case of the FBAR $10,000 requirement. FATCA's provisions of Section 6038D apply to assets held during tax years beginning after March 18, 2010. The new reporting requirement is much broader than the FBAR, so individuals who do not have an FBAR filing obligation may be subject to the new reporting requirement. For example, FATCA requires taxpayers with investments in foreign entities, such as foreign hedge funds and private equity funds, to report these investments. The FBAR regulations issued by FinCEN on Feb. 26, 2010, exempt these assets from FBAR reporting.

   Section 6038D(b) defines a "specified foreign financial asset" to include ownership of (1) any financial account maintained by a foreign financial institution, (2) any stock or security issued by a non-U.S. person, (3) any financial interest or contract held for investment that has a non-U.S. issuer or counterparty, and (4) any interest in a foreign

[35] See, Kevin E. Packman and Mauricio D. Rivero, "The Foreign Account Tax Compliance Act," *The Journal of Accountancy, August 2010;* Kevin E. Packman and Mauricio D. Rivero, "Increased Disclosure, Penalties, and Audit Periods Courtesy of the Foreign Account Tax Compliance Act," *The Journal of Taxation,* May 2010.

entity. Section 6038D(b) defines a foreign entity by reference to section 1473(5): any entity that is not a United States person. Consequently, taxpayers who purchase foreign real estate through an entity will have a filing obligation.

The Secretary of the Treasury can require "any domestic entity which is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets" to file the disclosure as if it were an individual (section 6038D(f)). Similarly, the Secretary is to issue regulations exempting nonresident aliens and bona fide residents of any United States possession from the disclosure. The secretary also has authority to exempt certain assets from being reported (section 6038D(h)).

There is a presumption that a taxpayer with "specified foreign financial assets" has a filing obligation for purposes of the penalty if the IRS believes the taxpayer has an interest in one or more such assets and the taxpayer does not provide sufficient information to demonstrate the aggregate value is less than $50,000 (section 6038D(e)).

2) Foreign companies. Generally, a foreign corporation will qualify as a passive foreign investment company (PFIC) if (1) 75% or more of its gross income in the tax year is passive income, or (2) on average during the tax year, at least 50% of the assets held by the corporation produce passive income or are held for the production of passive income (section 1297). Section 521 of FATCA amends section 1298 of the Code to require shareholders in a PFIC to file an annual information return disclosing their ownership of the PFIC (section 1298(f)). Under previous law, such disclosure was required only when taxpayers made a qualifying elective fund election, received certain distributions from the PFIC, or disposed of their interest in the PFIC. The PFIC disclosure was effective March 18, 2010.

3) Financial institution disclosure. Section 501 of FATCA added a new withholding system described in a new chapter 4 to the Code and created new sections 1471 and 1472. These provisions are generally applicable to payments made after December 31, 2012. Taken together, these sections require foreign financial institutions with United States customers and foreign nonfinancial entities with substantial United States owners to disclose information regarding the United States taxpayers.

Failure to disclose the information will result in the United States payor being required to withhold a 30% tax on U.S.-source income. The withholding will occur on income normally subject to United States taxation when received by nonresident aliens, such as dividends, as well as to certain types of income that are traditionally excluded from taxation for nonresident aliens under section 871, such as certain bank interest and capital gains not effectively connected to a United States trade or business. Failure to comply will subject the United States withholding agents to financial penalties. Foreign financial institutions include trust companies, banks, brokerages and investment funds. Furthermore, non-publicly traded equity and debt interests in foreign financial institutions are deemed to be accounts for purposes of this section. Failure to comply will subject such institutions to financial penalties.

The rules described above do not apply to any payment beneficially owned by (1) any corporation that is a member of an expanded affiliated group that includes a publicly traded corporation; (2) any foreign government (or political subdivision, wholly owned agency or instrumentality); (3) any international organization (or wholly owned agency or instrumentality); (4) any foreign central bank of issue; or (5) any other class of persons identified by the Treasury secretary. Further, under new section 1471(d)(1)(b), a foreign financial institution is not required to disclose account information if the account holder is an individual whose aggregate value of depository accounts held (in whole or in part) and maintained by the same financial institution which maintains such account does not exceed $50,000.

On August 26, 2010, the IRS issued Notice 2010-60, which provides initial guidance applicable to the disclosure and withholding required pursuant to the new Chapter 4.[36] The Notice exempts additional entities from the reporting regime. Those entities include: (i) certain holding companies for non-financial enterprises, but not if the entity serves as an investment organization, (ii) start up companies, other then financial institutions, during the first 24 months of the entities existence, (iii) non-financial entities liquidating or emerging from bankruptcy or reorganization, and (iv) hedging/financing centers of non financial groups. [37] At present, insurance companies that issue term life insurance products will not be considered to be financial institutions.

The Notice provides detail guidance on the due diligence that foreign financial institutions must undergo in order to determine if they have any United States taxpayers as account holders. The due diligence varies between whether it is an existing individual account, existing entity account, new individual account or new entity account. If however the existing individual account has an average balance less than $50,000, the account will be viewed as de minimis, and the institution does not have to determine whether there is a United States person as owner. The Notice seeks comments by November 1, 2010 on a number of additional issues, and possibly exemptions applicable to individual family trusts, foreign trusts, and charitable organizations.

4) Statutes of Limitation. Generally, the IRS has three years from the filing of a return in which to audit a taxpayer and assess additional tax (section 6501(a)). This statute of limitations also applies to information required to be reported on certain foreign transfers, now including those under FATCA. The period is increased to six years if a taxpayer omits 25% or more of gross income (section 6501(e)). Section 513 of FATCA amended section 6501(e) to also extend the statute of limitations to six years where a taxpayer omits more than $5,000 of income attributable to one or more assets required to be reported under section 6038D. Thus, even if the taxpayer does not have a substantial understatement, the IRS will have six years in which to investigate and audit the taxpayer. Additionally, however, the three-year and six-year statutes of limitations will be

[36] http://www.irs.gov/pub/irs-drop/n-10-60.pdf

[37] *Id.*

suspended until the information required to be reported under sections 1295(b), 1298(f), 6038, 6038A, 6038B, 6046, 6046A, 6048 or new section 6038D is provided to the IRS.

The extended statute of limitations is applicable to (1) returns filed after the March 18, 2010, date of enactment and (2) returns filed on or before such date if the limitation period under section 6501 has yet to expire. Thus, the extended six-year statute and suspended three-year statute could theoretically apply to tax returns that were filed as early as 2004 if a six-year statute applies, or 2007 if the normal three-year statute applies.

5) Penalties for failure to disclose. Section 6662 permits the IRS to impose a 20% penalty on a substantial understatement of income tax or for negligence or disregard of rules or regulations that is not attributable to fraud (for which a 75% penalty applies). Section 512 of FATCA amended section 6662 to add a penalty of 40% on any portion of an underpayment attributable to a transaction involving an undisclosed financial asset that should have been reported under sections 6038, 6038B, 6046A, 6048 or new section 6038D. The increased penalty structure is effective for tax years beginning after March 18, 2010.

B. Foreign Trusts.

1) Grantor trust status. When a United States person transfers assets to a foreign trust that has United States beneficiaries, section 679 deems the trust to be a grantor trust, and the United States transferor is responsible for reporting the trust's income. As stated above in the section discussing Form 3520-A, the regulations under section 679 make the presumption that the trust will have United States beneficiaries; thus, it is rare that a person will fund a foreign trust and it will not be qualified as a grantor trust. Whether taxpayers simply failed to look at the regulations or intended to avoid paying United States income tax on the trust's income, the IRS felt that it needed to codify the regulations into the statute. Sections 531 and 532 of FATCA add several new provisions to section 679, including three subparagraphs to section 679(c), which are designed to find a United States beneficiary of foreign trust. The FATCA additions are effective for transfers to a foreign trust after March 18, 2010.

2) Taxable distributions. Section 533 of FATCA provides that any use of trust property after March 18, 2010, by a United States grantor, United States beneficiary or any United States person related to a United States grantor or United States beneficiary is treated as a distribution. The individual using the trust property will be subject to income equal to the fair market value on the use of the property or loan under section 643(i)(1). This rule does not apply to the extent that the foreign trust is paid fair market value for the use of the property within a reasonable period following the use. FATCA does not define "a reasonable period," but presumably, this will be defined in subsequent Treasury regulations.

3) Trust Penalties. The penalty under section 6677 for failure to file a Form 3520 is 35% of the gross reportable amount (generally the amount transferred to or received from the trust). Section 535 of FATCA amended section 6677 so that a failure to file Form 3520 would have a minimum penalty of $10,000. Thus, the penalty is now the greater of

$10,000 or 35% of the gross reportable amount. The penalty increases by $10,000 for each 30-day period following notification from the Treasury that the filing is delinquent. There is, however, a 90- day grace period following notification from the Treasury before the additional $10,000 penalties accrue. The penalty is effective for Forms 3520 filed after December 31, 2009.

C. Income Attribution.

1) Foreign targeted obligations. Prior to FATCA, a deduction was permitted for foreign targeted obligations that were issued in bearer format (that is, not registered), provided certain exceptions were satisfied (that is, they could not be sold to United States persons). Section 502 of FATCA repeals the foreign targeted obligation exception. Consequently, for obligations issued in bearer format after March 18, 2012, an interest deduction will be prohibited unless the obligation: (1) is issued by an individual, (2) matures in no more than one year, or (3) is not of a type offered to the public. Therefore, bearer debt obligations with a maturity greater than one year will not be permitted a deduction for interest on the obligation unless the obligations qualify for the FATCA exception.

   Similarly, FATCA denies a tax exemption for interest on state and local bonds not issued in a registered form. Thus, for state and local bonds issued after March 18, 2012, the tax-exempt status will be denied unless the obligation matures in no more than one year or is not of a type offered to the public.

2) Dividend equivalent payments. The term "dividend equivalent" is defined as any payment made pursuant to a notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. It also includes any other payment determined by the Treasury secretary to be substantially similar to those described above.

   Section 541 of FATCA amended section 871(l)(1) to eliminate the disparate tax treatment between dividends on stock of United States corporations and dividend equivalent payments by treating dividend equivalent payments as U.S.-source dividend payments. Consequently, any such payments made to a nonresident alien will be subject to a withholding tax applicable to the payment. The effective date of this provision is 180 days after FATCA's date of enactment (that is, on or after September 14, 2010).

VII. IRS Investigation and Examination Tools

A. LMSB/International Realignment. On August 4, 2010, the IRS issued a news release indicating that effective October 1, 2010, its Large and Mid-Size Business division ("LMSB") will be renamed the Large Business and International division ("LB&I").[38] The purpose behind the reorganization is to improve its global tax administration efforts and create a more centralized organization dedicated to improving international tax compliance.

[38] IR 2010-88, August 4, 2010. http://www.irs.gov/newsroom/article/0,,id=226284,00.html

While its name may be changing, LB&I will continue to serve the same taxpayers that were served by LMSB. Specifically, LB&I will focus on taxpayers, whether individuals or entities, that have more than $10 million in assets.

The release also indicated that the realignment would strengthen international tax compliance for individuals and entities in several ways, including:

- "Identifying emerging international compliance issues more quickly.
- Removing geographic barriers, allowing for the dedication of IRS experts to the most pressing international issues.
- Increasing international specialization among IRS staff by creating economies of scale and improving IRS international coordination.
- Ensuring the right compliance resources are allocated to the right cases.
- Consolidating oversight of international information reporting and implementing new programs, such as FATCA.
- Coordinating the Competent Authority more closely with field staff that originate cases, especially those dealing with transfer pricing.
- Otherwise centralizing and enhancing the IRS's focus on transfer pricing."[39]

B. Technology. The IRS is utilizing technology in ever increasing ways to help close the tax gap, and reduce the extent of noncompliance. IRS Commissioner Shulman has publicly stated the importance of investing in technology for this very purpose.

- In a May 27, 2010 speech to the American Payroll Association and the American Accounts Payable Association, he stated "[t]he better use of technology translates into better use of data – extracting knowledge and intelligence. So, we must invest in technology to keep up with new legislation, regulations and strategies in a more complex and interrelated global tax system."[40]
- In an April 2010 interview with Paul Bonner, Editor of the *Journal of Accountancy*, he stated: "I've been very public that the future of tax administration is all about more and better third-party information and continuing to develop our programs to analyze that data and act on it. The way we're going to get better at handling the volume and complexity of

[39] *Id.*

[40] WebCPA, "IRS Sees Need for More Tax Information Reporting." http://www.webcpa.com/news/IRS-Sees-Need-for-More-Tax-Information-Reporting-54401-1.html

> both the Tax Code and the business world and individual finances isn't by throwing more auditors at the problem; it's by doing better data management and analysis."[41]

It would appear that the Senate Appropriations Committee was listening to Commissioner Shulman as it approved the IRS' request for $387 million to modernize its business systems on July 29, 2010.[42] Senator Richard Durbin (D-Ill) indicated that this would allow the IRS to migrate from its obsolete Legacy system to state-of-the-art data systems in the 2012 filing season.[43]

Even after the IRS updates its computer systems, it will continue to rely on YK1, which is just one of the software programs examiners are using to assist them in their investigations. The software was initially created to assist the IRS in identifying tax shelters. Today, it is used to help an examiner identify all parties connected to an entity, as well as any other entities to which the parties may have a connection. The IRM advises examiners on the use of YK1, and provides as follows: "[f]or cases in which entities related through a flow-through relationship are suspected, but cannot be otherwise identified, examiners should request research using the yK1 Link Analysis Tool. This Tool provides a graphic representation of flow-through relationships created by partnerships, trusts, and S corporations. The Tool uses Schedule K-1 data to depict ownership relationships and income/loss flows between payers and payees. More information is available at http://sbse.web.irs.gov/Exam/Apps/yK1/yK1.htm."[44]

On December 15, 2009, the United States Government Accountability office released a report to the United States Senate Finance Committee titled "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules." The report detailed the use of YK1 for audits involving S corporations. Specifically, it stated:

> One way that examiners detect S corporation noncompliance is IRS's yK1 software program, which uses Schedule K-1 information to graphically depict relationships among taxpaying entities. It displays the shareholders of S corporations as well as any other businesses that are linked to the S corporation, including parent companies and subsidiaries that have common shareholders with the S corporation. Starting with a business entity or individual shareholder, yK1 can show its connections in sending or receiving Schedule K-1s. It shows common use of paid preparers, some family relationships (e.g., husband/wife), and common addresses, among other linkages. For example, if IRS discovers noncompliance that is related to a scheme marketed by a preparer, IRS can use yK1 to identify other entities that used the same preparer. In addition to K-1 data, IRS pulls data from various IRS databases, such as those showing data from filed returns or from information returns filed by third parties. Although there

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[41] http://www.journalofaccountancy.com/Issues/2010/Apr/20102509.htm

[42] *Senate Appropriations OK $12.5 Billion in Funding for IRS Enforcement, Services*, 145 DTR G-8 (August 2, 2010).

[43] *Id.*

[44] http://www.irs.gov/irm/part4/irm_04-010-004.html

have been no formal analyses of yK1's effectiveness, IRS officials say that its examiners report that using yK1 has helped to identify millions of dollars in unpaid taxes from entities, including S corporations. For S corporations, yK1 data can help examiners determine if the shareholder has stock or debt basis, as well as establish trends in officer's compensation.[45]

The IRM provides even greater detail into the use of YK1 when the taxpayer is a Federal contractor or vendor. Interestingly, information obtained through the software cannot be revealed to the taxpayer or the taxpayer's examiner. It appears, however that this prohibition may be limited to information obtained on behalf of a Federal contractor or vendor. The IRM advises examiners in such investigations, that YK1:

- Is a collection of analytic tools specifically designed to help explore relationships between taxpayers. Currently, it focuses on flow-through relationships (K-1 data) created by partnerships, trusts, S corporations, and corporations.

- Is most beneficial when it is known the taxpayer has flow through income, e.g., parent/subsidiary relationships, abusive transaction, other related entity relationships.

- Provides a graphic representation of the taxpayer and their investment relationship to other entities. It is not limited to direct investment and displays multiple levels of investment tiering, i.e., one entity is invested into another that is invested into a third.

- Uses information from filed Forms 1120, 1120S 1041, and 1065, and the K-1 associated with those returns

- Uses individual tax return information of high income individuals.

- Can be searched using an SSN or EIN."[46]

C. Criminal Enforcement. The days of the kinder, gentler IRS have long passed. Taxpayers should be aware that the Service intends to continue its focus on enforcement, a direction reinforced by both the President and Congress. On October 14, 2009, Commissioner Shulman announced that the IRS would be opening three new international criminal investigation offices, which will be located in Beijing, Panama City, and Sydney. The Service also will be expanding the staff at eight current international criminal investigation offices.

Reinforcing the Commissioner's statements of increased enforcement, Victor Song, Chief of IRS Criminal Investigation Division ("CID"), told the American Bar Association Section of Taxation Civil and Criminal Tax Penalties Committee at its January 23, 2010 meeting that the IRS' most significant criminal focus would be on the international arena. He stated "our big focus is

[45] http://www.gao.gov/new.items/d10195.pdf

[46] http://www.irs.gov/irm/part5/irm_05-007-009.html

international. We are not going to go away." [47] Song also indicated that CID's hiring was "unprecedented." [48] Song was back speaking to the ABA Section of Taxation Civil & Criminal Tax Penalties Committee at its spring meeting on May 8, 2010, where he indicated that CID now had a presence in 11 countries.[49] Additionally, he indicated CID employs 4,200 employees worldwide, of whom 2,700 are special agents. [50]

Treasury Secretary Geithner has expressed the view that increasing funding for IRS enforcement is a necessary part of closing the tax gap.[51] Perhaps consistent with Geithner's view, the Senate Appropriations Committee on July 29, 2010 allocated $5.68 billion for fiscal year 2011 towards IRS enforcement efforts on July 29, 2010.[52]

D. Global High Wealth Industry Group. On October 26, 2009, Commissioner Shulman spoke at the American Institute of Certified Public Accountants (AICPA) National Conference on Federal Taxation in Washington DC. While he touched on a number of topics during his presentation, the Commissioner announced for the first time that the IRS had recently created the Global High Wealth Industry group ("Global Wealth").[53] At the time of his announcement, the group was housed within LMSB. However, in accordance with the August 4, 2010 reorganization announcement, effective October 1, 2010, Global Wealth will be housed within LB&I.[54]

Global Wealth will be focused on unraveling the business structures created by wealthy taxpayers to avoid their tax obligations. While it was not stated, this program may use the economic substance doctrine as its main weapon.

Shulman did not provide the minimum dollar threshold for a taxpayer to be included within the Global Wealth group, but he did state that initially "we will be looking at individuals with tens of millions of dollars of assets or income." [55] He went on to explain that "high wealth individuals

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[47] *Biggest Focus of CI Unit to Be International As Global Footprint Increases, Song Says,* 15 DTR G-6 (January 26, 2010).

[48] *Id.*

[49] *Tax Crime Enforcement Expanding to More Locations, New Financial Crimes, Song Says,* 90 DTR G-5 (May 12, 2010).

[50] *Id.*.

[51] Statement at House Budget Committee hearing on President Obama's proposed 2010 budget. http://www.ustreas.gov/press/releases/tg51.htm

[52] *Senate Appropriations OK $12.5 Billion in Funding for IRS Enforcement, Services,* 145 DTR G-8 (August 2, 2010).

[53] http://www.irs.gov/irs/article/0,,id=215606,00.html

[54] IR 2010-88, August 4, 2010. http://www.irs.gov/newsroom/article/0,,id=226284,00.html

[55] http://www.irs.gov/irs/article/0,,id=215606,00.html

are not your typical Form 1040 filers with a W-2, some 1099 income, and maybe a Schedule C enclosed with their return. And you cannot assess compliance among the nation's wealthiest individuals by looking only at their 1040s. Their tax picture is much more complicated than this. … They may include trusts, real estate investments, royalty and licensing agreements, revenue-based or equity-sharing arrangements, private foundations, privately-held companies, and partnerships and other flow-through entities that require looking at the entire, and often huge, spectrum of transactions and entities. A single high wealth individual may have actual or beneficial ownership of numerous related entities, sometimes alone and sometimes along with other family members or business associates." [56]

IRS believed that it was unable to adequately examine taxpayers who would be included within Global Wealth, as a result of their sophisticated business and investment structures, which led to the group's creation. Shulman indicated that the IRS was hiring agents and specialists, such as flow-through specialists and international examiners, to begin the examinations of taxpayers included within Global Wealth. [57] It would appear that agents within Global Wealth will rely substantially on the YKI software to assist them with their investigations.

Shortly before announcing the creation of the group, Shulman indicated that it was part of "the globalization of tax administration," which he called a "game changing trend." [58]

E. Ongoing Investigations. John McDougal, an attorney in the IRS Office of Associate Chief Counsel (SB/SE), while speaking at an American Law Institute International Trust & Estate Planning Conference in Chicago, Illinois on August 20, 2010, indicated that the IRS has three current initiatives underway designed to help detect undisclosed offshore accounts.

The offshore credit card initiative is designed to uncover United States taxpayers who use debit and credit cards linked to offshore bank accounts. Of course, the accounts are unreported, and the funds are untaxed. The IRS obtains the information by issuing John Doe summonses to credit card companies. Between 2000 -2002 the Department of Justice issued such summonses to American Express, MasterCard and Visa International.[59]

The IRM defines a John Doe Summons as "any summons where the name of the taxpayer under investigation is unknown and therefore not specifically identified."[60] According to Section 7609(f), the IRS must establish that (i) the summons relates to an identifiable group or class of persons, (ii) there is a reasonable basis for believing that such group or class of persons have failed to comply with the tax law, and (iii) the information sought is not readily available through other sources.

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[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] http://www.irs.gov/newsroom/article/0,,id=105698,00.html

[60] IRM 25.5.7.2

Offshore merchant accounts are especially prevalent among e-commerce businesses and members of high-risk industries, such as pornography and gambling, that domestic banks refuse to take as customers. Domestic businesses that already need to seek offshore banking arrangements often avail themselves of the potential for tax evasion, McDougal said.[61] The offshore merchant account initiative uses the data stored by electronic payment processors, which are "usually totally innocent intermediaries who happen to have the information" that is subject to summonses if in the United States, McDougal said. [62]

On April 15, 2009, the DOJ asked a federal court in Denver to approve service of a John Doe summons on First Data Corporation. The information expected in response to the summons will help the IRS identify merchants who use offshore accounts to evade their United States tax liabilities. The petition alleges that the merchants have opened bank accounts in offshore jurisdictions and directed their payment card processor, in this instance First Data, to deposit the proceeds from their debit or credit card transactions directly into the offshore accounts.[63]

The electronic payments systems initiative is designed to identify United States taxpayers who use offshore debit cards, credit cards and bank accounts to fund their United States based electronic payment accounts with untaxed income. Similar to the merchant initiative where John Doe summonses were issued to the intermediaries, a John Doe summons was issued to PayPal, which is "just a lead to the foreign account," McDougal said from which a user transfers funds to make Internet purchases. [64] In the PayPal summons the IRS sought information on United States taxpayers who have signature authority over bank and credit card accounts issued by, or through, financial institutions in more than 30 countries.[65]

F. Whistleblowers/Informants. In 2006 Congress introduced legislation creating a whistleblower office within the IRS.[66] The legislation, codified at 26 U.S.C. § 7623, became effective on December 20, 2006 and provides incentives for ordinary citizens to share information with the IRS about tax cheats.[67] The program is designed to prevent annoyance claims from being filed by disgruntled neighbors, jilted spouses, and angry employees because the claim must meet minimum standards.

To be eligible for an award, the tax, penalties, interest, additions to tax, and additional amounts in dispute must exceed $2 million for any taxable year and, if the taxpayer is an individual, the

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[61] *IRS Opens Initiatives to Detect Undisclosed Offshore Accounts,* Tax Notes (August 30, 2010).

[62] *IRS Opens Initiatives to Detect Undisclosed Offshore Accounts,* Tax Notes (August 30, 2010).

[63] http://www.justice.gov/tax/txdv09349.htm

[64] *IRS Opens Initiatives to Detect Undisclosed Offshore Accounts,* Tax Notes (August 30, 2010).

[65] http://news.cnet.com/IRS-to-search-PayPal-records-for-tax-evaders/2100-1030_3-6060920.html#ixzz0yhcDD2UV

[66] IR-2007-201, Dec. 19, 2007. http://www.irs.gov/newsroom/article/0,,id=176632,00.html

[67] Notice 2008-4. http://www.irs.gov/pub/irs-drop/n-08-04.pdf

individual's gross income must exceed $200,000 for any taxable year in question.[68] The amount of award will be at least 15%, but no more than 30%, of the *collected proceeds* in cases in which the IRS determines that the information submitted by the informant substantially contributed to the collection of tax.[69] The amount of the award can be reduced if the whistleblower was involved in the noncompliance.[70] If the whistleblower is convicted of criminal conduct arising from his or her role in planning and initiating the action, the Whistleblower Office will deny the award.[71]

On June 18, 2010, the IRS added new provisions to the IRM applicable for the whistleblower program.[72] Senator Charles Grassley (R-Iowa) wrote a letter to Treasury Secretary Geithner asking that he delay the implementation of the new IRM update, as he was troubled by the fact that the provision was posted without public comment. He was also disturbed by the fact that the definition of "collected proceeds" appears to limit the payment of a 7623(b) award to only those cases where the IRS receives cash from a taxpayer.[73]

There is also a program for whistleblowers who are unable to satisfy the income threshold. Section 7623(a) provides authority for the informant to receive a discretionary award with the maximum award being 15% up to $10 million. Since the award is discretionary, the informant cannot dispute the determination of the award in Tax Court. [74]

To file a claim with the Whistleblower Office, the informant must complete Form 211, and sign it under penalties of perjury. When the Whistleblower Office has made a final determination regarding a claim, it will send notification to the informant indicating the amount of the reward it intends to pay. If the informant is not satisfied with the reward, he/she has 30 days in which to file an appeal to the Tax Court.[75]

Whistleblowing is becoming a cottage industry for private bankers. On May 3, 2010, Rudolf Elmer spoke at the 8th Annual OffshoreAlert Financial Due Diligence Conference on Miami Beach. [76] Elmer worked for Bank Julius Baer in Switzerland, where he was a Senior Auditor

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[68] Section 7623(b)(5).

[69] Section 7623(b).

[70] Section 7623(b)(3).

[71] Section 7623(b)(3).

[72] http://www.irs.gov/irm/part25/irm_25-002-002.html

[73] *Updated Whistleblower Procedures Could Deter Claims, Grassley Says, Seeks Delay*, 126 DTR G-4 (July 2, 2010).

[74] Section 7623(a)

[75] Section 7623(b)(4).

[76] http://www.offshorealertconference.com/2010/articles/juliusbaer-release.asp

from 1987 to 1994, and then in the Cayman Islands, where he was the group's local Chief Operating Officer from 1994 to 2003. He indicated that he gave internal company documents to officials in several countries, including the United States and Germany.[77] He also indicated that the bank helped clients evade tax.

Elmer was not the first such banker, nor will he be the last. On August 4, 2010, Bloomberg.com reported that Herve Falciani, a former HSBC Holdings Plc software technician now in police protection in France took computer files containing data on at least 24,000 current and former account holders from several countries.[78] Falciani was preceded by Heinrich Kieber, a former employee of the LGT Bank of Liechtenstein, who in 2008 took more than 12,000 pages of bank documents detailing secret, multi-million-dollar accounts held by taxpayers around the world.[79] Kieber is living in an undisclosed location, reportedly as part of a witness protection program, after providing information to government officials in England, Germany, the United States and other countries on their citizens who hid billions in wealth through the bank.[80]

Joseph Insinga, a finance specialist with the Dutch Bank, Rabobank, is another banker turned whistleblower. He told the IRS that the bank was financing tax shelters on behalf of United States companies. He provided information that led to investigations against Cardinal Health[81] and Newell Rubbermaid Inc.[82] Of course, Insinga was preceded by the revelations former Swiss UBS private banker, Bradley Birkenfeld, provided the IRS and Department of Justice, which ultimately led to the February 2009 UBS deferred prosecution.

G. Tax Treaties & Tax Information Exchange Agreements. The United States currently has 68 income tax treaties and 22 tax information exchange agreements ("TIEA") in effect. The key provision within an income tax treaty is the exchange of information clause. Generally, this gives the IRS broad powers to obtain information from another country. A number of treaties are based on the OECD Model Treaty, which contains a broad exchange of information provision in Article 26. Essentially, Article 26 provides for the exchange of information "without regard to whether the conduct being investigated would constitute a crime under the laws of the requested Party if such conduct occurred in the requested Party." The Model Treaty also permits the tax examiners from the requesting country to travel to the requested party to conduct a tax examination, interview witnesses and review documents.

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[77] http://www.reuters.com/article/idUSN0322700320100503

[78] http://www.bloomberg.com/news/2010-08-04/whistleblower-helps-berlusconi-prosecute-tax-fraud-while-he-stands-accused.html

[79] http://abcnews.go.com/Blotter/story?id=5396300

[80] *Id.*

[81] http://www.federalcriminaldefenseblog.com/2009/06/articles/tax-crimes/179-million-tax-whistleblower-case/

[82] http://www.batemangibson.com/docs/05_30_2008.pdf

Article 26 of the OECD Model Treaty states that the information must be "foreseeable relevant" to the administration or enforcement of the domestic tax law of the country concerned. The commentary indicates that "the standard for foreseeable relevance is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in fishing expeditions or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer."[83]

Some of the treaties the United States previously entered into did not have such a broad exchange of information provision. For example, in September 2009, Switzerland signed a new treaty with the United States incorporating Article 26 from the Model Treaty. The new treaty expanded the circumstances in which the Swiss would disclose information to the United States. Previously, disclosure required that the conduct classify as tax fraud under Swiss law. Now disclosure is permitted for conduct that involves the failure to report income (i.e., tax evasion).

TIEAs are executive agreements under United States law based upon either the United States Treasury Discussion Draft TIEA created in 1984 or the OECD Model TIEA created in 2002. TIEAs are designed to provide assistance in civil and criminal tax matters. Information must be provided even if the information relates to a person who is not a resident or national of the United States or the TIEA partner. Finally, the TIEA must provide for the disclosure of information regardless of local "confidentiality" laws that may prohibit such disclosure, including laws relating to bank secrecy or bearer shares.[84]

The exchange of information provisions are quite similar to those within treaties. For example, on December 8, 2008, the United States signed a new TIEA with Liechtenstein, which will permit the United States to obtain information from Liechtenstein on all types of federal taxes, and in both civil and criminal matters.[85] Under the TIEA, the requested information must be obtained and exchanged without regard to whether the country receiving the request needs the information for its own tax purposes or whether the conduct being investigated would constitute a crime under its law. [86] If the country receiving the request for information does not have the requested information in its possession, it must take relevant information gathering measures to provide the requested information. [87] Moreover, requests from one country to the other must be honored, even if the information relates to, or is held by, nonresidents. [88]

The United States can and does access information received pursuant to a TIEA to prosecute United States taxpayers. On April 23, 2010, Bill Melot, a New Mexico businessman was

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[83] http://browse.oecdbookshop.org/oecd/pdfs/browseit/2310081E.PDF

[84] http://www.ustreas.gov/press/releases/hp385.htm

[85] HP-1320 (December 8, 2008). http://www.treas.gov/press/releases/hp1320.htm

[86] *Id.*

[87] *Id.*

[88] *Id.*

convicted with the assistance of information provided by a Bahamian bank in accordance with the TIEA, which should indicate the effectiveness of TIEAs.[89]

Under a treaty or TIEA, information can be exchanged automatically or following a specific request or simultaneous examination. "Exchange of information on request occurs when the competent authority of one country asks for particular information regarding specific taxpayers from the competent authority of another country. …Information that is exchanged automatically is typically information comprised of many individual cases of the same type. Usually, this type of information exchange consists of details of income arising in the source country (e.g., interest, dividends, royalties, or pensions). This information is obtained on a routine basis (generally through reporting of the payments by the payer) by the sending country and is thus available for transmission to its treaty partners. … Information is exchanged spontaneously when a country, having obtained information in the course of administering its own tax laws, which it believes will be of interest to one of its treaty partners for tax purposes, passes on the information without the latter having asked for it."[90]

There are additional formal means the United States has for acquiring information from other jurisdictions. These include the Convention on Mutual Administrative Assistance in Tax Matters[91] and exchanges made pursuant to the Joint International Tax Shelter Information Centre.[92]

On May 27, 2010 the Treasury Department announced that the United States and 16 other countries in the OECD signed a protocol to the Convention on Mutual Administrative Assistance on Tax Matters, in order to bring the existing Convention into conformity with current international standards for the exchange of information for tax purposes between national revenue authorities.[93] The protocol provides for the full exchange of information on request in tax matters without regard to a domestic tax interest requirement or bank secrecy laws, such as those that have delayed the sharing of information on UBS's bank customers with United States authorities. [94] The proposed protocol also provides updated rules regarding the confidentiality and permitted uses of exchanged information as well as the level of detail that countries must provide when making a request for information. [95] In addition, the Protocol permits countries that

[89] http://www.justice.gov/opa/pr/2009/August/09-tax-813.html

[90] http://www.ustreas.gov/press/releases/hp385.htm

[91] http://www.oecd.org/document/14/0,3343,en_2649_33767_2489998_1_1_1_1,00.html

[92] http://www.irs.gov/pub/irs-utl/jitsic-finalmou.pdf

[93] TG-726 (May 27, 2010). www.ustreas.gov/press/releases/tg726.htm

[94] *Id.*

[95] *Id.*

are not members of the OECD or of the Council of Europe to become parties to the Convention, subject to unanimous consent by the existing parties. [96]

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[96] *Id.*