An Overview of Select International Tax Compliance Issues & Solutions for US Taxpayers in Violation

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EXECUTIVE SUMMARY

United States persons are responsible for filing tax returns and reporting their worldwide income, including income associated with foreign accounts. In addition, there are numerous informational returns that United States persons may be required to file. The penalties associated with the failure to properly report income and/or the failure file these informational returns are significant. In March 2009, the Internal Revenue Service announced a six month settlement initiative through which taxpayers with offshore noncompliance could come forward to resolve their issues. The IRS settlement terminates on September 23, 2009. Thus for any taxpayer interested in benefiting from the settlement terms, it is imperative that the taxpayer initiate contact with their tax advisor immediately.

The national media has focused a great deal of time discussing the settlement, but it is generally brought up in the context of taxpayers who have unreported accounts with UBS. It is important to understand that the settlement is not limited to individuals with unreported accounts at UBS, or unreported accounts at any other financial institution. Thus, this article will briefly discuss some of the most commonly overlooked informational filings by United States taxpayers (Forms 3520, 3520-A, 5471, and TDF 90-22.1), and the penalties for doing so, before concluding with a description of the settlement initiative.

FACTS

FBAR. Do you have a foreign bank account you own either individually or jointly? Do you have a foreign investment account you own either individually or jointly? Do you have a debit or credit card that is tied to a foreign account even if not yours? Do you own a foreign mutual fund? Are you trustee of a trust with foreign investments? Do you hold a power of attorney for someone who owns foreign investments? If you can answer yes to any of these questions, you likely have an FBAR filing requirement.

All United States persons must file Treasury Department Form 90-22.1 ("the FBAR") to report the existence of a financial interest, signature authority or other authority over foreign financial accounts if in the aggregate at any time during the preceding calendar year the balance of all such accounts equals or exceeds $10,000. The FBAR is not a tax filing, but rather is an informational return that must be *received by* the IRS on June 30, simply mailing it on the 30th is insufficient.

The form is filed with the Detroit Service Center and is considered late if not filed at such time, since extensions are not granted. The duty to file the FBAR is independent of the obligation to file an income tax return even though the FBAR is cross referenced on Form 1040, Schedule B, Part III. A foreign account that meets the FBAR filing requirements must be reported even if the account does not generate taxable income. Thus, if a taxpayer fails to file an FBAR because the

account that meets the FBAR requirements generates no taxable income, the taxpayer will be subject to penalty. The penalties for failure to comply with the FBAR requirements are punitive, and because each of the respective terms is defined quite broadly and multiple persons can have a filing obligation to report the existence of the same accounts, it is easy for taxpayers to be noncompliant.

There are questions on multiple tax returns (such as Forms 1040, 1041, 1065 and 1120), which seek information related to the existence of foreign accounts. Even if the taxpayer has no interest or dividends, which would otherwise be reported in Question 7, Part III of Form 1040, Schedule B; Line 3, Schedule G of Form 1041; Line 9 of Schedule B of Form 1065, or Line 6a of Schedule N of Form 1120, the requisite Schedule must be completed to report the existence of the foreign account. If a taxpayer fails to report the account on the tax return, it may be considered by the IRS as an incomplete return on which the statute of limitations would remain open for the underlying income tax. Of much greater importance, however, Section 12.08(6)(g) of the US Dept of Justice Criminal Tax Manual provides that saying no on the Form 1040 can be the basis for a tax evasion prosecution. While it is doubtful a taxpayer would be criminally prosecuted for failing to properly answer the question on a tax return regarding the existence of a foreign account, especially if the taxpayer properly reported the income associated with the foreign account, all bets are off if the income was omitted from the US return.

The Service has six years within which to assess a civil penalty related to an FBAR violation. However, it is unclear whether the statute will toll if the FBAR is not filed. 31 U.S.C. § 5321(b)(1). A taxpayer who fails to file an FBAR may be subject to both civil and criminal penalties. The same violation may be punishable by both a civil and criminal penalty. 31 U.S.C. § 5321(d)

Civil Penalties. The penalty for a non-willful failure to file the FBAR can be up to $10,000. 31 U.S.C. § 5321(a)(5)(B)(i). However, 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. 31 U.S.C. § 5321(a)(5)(B)(ii). Note, however, 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.

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. 31 U.S.C. § 5321(a)(5)(C). Violations that are deemed to be willful are not subject to the reasonable cause exception. 31 U.S.C. § 5321(a)(5)(C)(ii).

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. 31 U.S.C. § 5322(a). If the 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 twelve month period) the maximum fine increases to $500,000 and the possibility of imprisonment increases to up to 10 years. 31 U.S.C. § 5322(b). There is, of course, a

possibility that both the $500,000 penalty and 10-year jail term will subject to the applicable sentencing guidelines be applicable. Id.

Taxpayers should also be aware that the IRS has increased enforcement of the FBAR, and the filing requirements are expanding. For example, on September 30, 2008, and with no pronouncement, the IRS posted a revised FBAR form on its website, which is to be used for all filings subsequent to December 31, 2008. The revised FBAR also included a significant definitional change to the definition of US person, which has since been tolled by the IRS. The persons required to file an FBAR previously included United States citizens, residents, domestic partnerships, domestic corporations, domestic trusts and domestic estates. The revised FBAR expanded the definition to include "a citizen or resident of the United States, or a person in and doing business in the United States." The IRS introduced insufficient guidance as to who would classify as being "in and doing business in the United States." Consequently, on June 5, 2009, the IRS issued Announcement 2009-51, which suspends the requirement for persons who are not citizens, residents or domestic entities to file an FBAR for the 2008 tax year. However, nonresident aliens should pay close to attention to future guidance as it is likely they will be required to file FBARs in 2010 if they were "in and doing business in the United States."

The definition for a *financial account* in the prior instructions included "any bank, securities, securities derivatives or other financial instruments accounts. Such accounts generally also encompass any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund. The term also means any savings, demand, checking, deposit, time deposit, or any other account maintained with a financial institution or other person engaged in the business of a financial institution." The revised FBAR expanded the definition to make clear that it also encompasses the use of a debit card or credit card.

Notwithstanding, on June 12, 2009, an IRS representative stated on a telephone conference call sponsored by the American Institute of Certified Public Accountants and the ABA Sections of International Law Committee on International Taxation and Section of Real Property Trust & Estate Law that an FBAR was required to be filed for US persons with an investment in a foreign hedge fund, foreign private equity fund, foreign partnership if those investments were operated similar to a mutual fund, whereby funds were commingled, regardless of the ownership percentage the US person held in the investment ("foreign commingled funds"). This marked the first time the IRS had publicly stated that the definition for a foreign account reached such investments.

On August 7, 2009, the IRS in Notice 2009-62 suspended the need for taxpayers to report their investment in a foreign commingled fund until June 30, 2010. The IRS intends to introduce further guidance explaining the types of foreign commingled funds that must be reported on an FBAR. This ten month extension follows the relief provided on June 24, 2009, where the IRS stated that taxpayers who had recently learned of their need to file an FBAR with regard to their investment in a foreign commingled fund could file the form by September 23, 2009.

Forms 3520. 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? If you answer yes to any of these questions you may have a Form 3520 filing requirement.

Sections 6039F and 6048 mandate the filing of a Form 3520. U.S. persons must file Form 3520 to report their (i) creation of a foreign trust; (ii) transfer of money or property to a foreign trust including by reason of death; (iii) receipt of distributions from a foreign trust as well as (iv) receipt of certain gifts from foreign persons. For purposes of the filing, "distributions" include direct distributions (i.e., a distribution directly to the US beneficiary") as well as indirect distributions (i.e., a US 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 US 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 US 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" and "35% of the gross value of distributions received from a foreign trust" for the failure to report the receipt of a distribution 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. Section 6048(c)(2)(A).

It should be noted that if the Form 3520 is delinquent more than 90 days after receiving notification from the IRS of such delinquency, an additional penalty of $10,000 is permitted for every 30 days (or fraction thereof).

Section 6039F(a) requires US 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 upon 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 US 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 US person must separately identify each gift which is more than $5,000, but doesn't 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 filing the Form 3520 reporting the receipt distributions from the foreign trust. The penalty for failing to timely report the receipt of a foreign gift is imposed by section 6039F, as opposed to section 6677, and is 5% per month. The penalty increases each month that the Form 3520 is delinquent and continues up to a total of 25%. The penalty is due upon notice and demand. Section 6039F(c)(1)(B)

<u>Form 3520-A.</u> Did you create a foreign trust at any time? If you have recently become a US taxpayer, did you create a foreign trust within five years of becoming a US taxpayer? Be sure not to answer too quickly.

The Internal Revenue Code and Treasury regulations can recharacterize a transaction such that indirect transfers are included within the reach of Section 679. If a taxpayer transfers assets to his or her parents who are not US taxpayers, who then settle a foreign trust, the trust will likely be deemed created by the US taxpayer. Treas. Reg. Section 1.679-3(c) provides that "a transfer to a foreign trust by a person to whom a US person transfers property is treated as an indirect transfer by a US 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: (i) the US person is related to a beneficiary of the foreign trust, and (ii) the US 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 US beneficiaries, the Internal Revenue Code can override the determination and treat the trust as having a US 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 US beneficiary unless (i) under the terms of the trust no part of the income or corpus could be paid or accumulated for the benefit of a US person and (ii) if the trust terminated during the tax year, no part of the income or corpus could be paid to a US person. Furthermore, Treas. Reg. Section 1.679-2(a)(4)(ii)(A) provides that if the trust documentation can be amended to benefit a US person, then it will be classified as if there were such a US beneficiary. Similarly, Treas. Reg. Section 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 US beneficiary.

The consequence of having settled a foreign trust, which is classified as having a US 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 received 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.

Form 5471. Do you own a foreign corporation? Are you a director or officer of a foreign corporation? If the answer to either of these questions is yes, you may have an obligation to file Form 5471.

Certain US 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 US officer or director acquires stock to meet the 10% ownership requirement, or if a US 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 would also have a filing obligation. A person is in *control* of a foreign corporation if (i) the person owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, *or* (ii) 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 US 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.

Settlement Initiative. On March 23, 2009, the IRS announced the creation of new voluntary disclosure program for undeclared foreign accounts. The IRS Offshore Income Reporting Initiative (the "Initiative") is only available for six months, or until September 23, 2009, and provides that those taxpayers who qualify will not be subject to criminal penalties or the civil fraud penalty. Taxpayers will have to file six years of tax returns, depending upon the circumstances, either amended or delinquent, and pay all taxes and interest due. Taxpayers will 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. Certain taxpayers may qualify for a reduced penalty of 5% on the highest aggregate balance in the foreign account.

The 5% penalty will only apply if the taxpayer: (i) did not open or create the foreign account, (ii) has never withdrawn money from the foreign account or added money to the foreign account, and (iii) all US taxes have been paid on the funds which were deposited into the account. Thus, the only noncompliance that may exist on the part of the taxpayer is not reporting the income earned on the foreign account. Of course, the third requirement may be the most difficult to satisfy as it only applies to persons who either inherited a foreign account or received a foreign account as a gift. If a taxpayer inherited the account from a foreign relative, it is likely no US taxes would have been paid, and possible that the taxpayer failed to report the receipt of the foreign gift on a Form 3520. If a taxpayer inherited the account from a US relative, it may be unclear as to whether taxes were paid on the funds contributed to the account.

The IRS has released a series of Questions and Answers on its website related to the Initiative, the most important of which provide a procedure for taxpayers to file delinquent informational returns without penalty provided there was no omission of income on the taxpayer's US tax return.

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

- criminal prosecution;
- The civil fraud penalties under IRC 6651(f) and 6663, which can amount to penalties of 75% of the unpaid tax;
- Failure to pay penalties under IRC 6651 (a)(2) and (a)(3);
- Failure to file penalties under IRC 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;

- Penalties for failure to file a Form 3520 reporting the transfer of funds to a foreign trust or receipt of a distribution from a foreign trust, which begins 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 begins 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 consists of a penalty of 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; and

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

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. IRS agents have been instructed by IRS 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."[1]

COMMENT. Whether taxpayers have an undeclared UBS account, other international noncompliance, or have already been contacted by the IRS, a qualified tax advisor can offer assistance. This is crunch time. The Initiative terminates on September 23, and a taxpayer wishing to take advantage of its terms should immediately contact their tax advisor to discuss how to proceed. Taxpayers only have one opportunity to make a submission, and failure to qualify for the Initiative, depending upon the facts, may lead to criminal prosecution. Additionally, if the taxpayer has an undeclared account with UBS, there is a great sense of urgency to come forward immediately.

On Wednesday, August 12, 2009, the United States Department of Justice reached a settlement with UBS through which UBS will reveal the names of a number of US taxpayers with undeclared foreign accounts. The details of the settlement have yet to be revealed publicly, such that we do not know how many taxpayers will be revealed or the criteria set forth by the DOJ for the names to be revealed. Notwithstanding, what is perfectly clear is that the time is quickly ending through which any US taxpayers with undeclared UBS accounts may avoid severe penalties and criminal prosecution. The IRS settlement initiative announced on March 23, and which continues through September 23, is only available for these taxpayers provided they come into the system before the IRS receives their names.

[1] Statement dated March 26, 2009 from Commissioner Shulman on Offshore Income.

We do not yet know if this will officially close the chapter in the ongoing battle between UBS and the DOJ. However, it follows UBS' deferred prosecution in February 2009 in which it admitted to helping US taxpayers hide accounts from the US, paid $780 million in settlement, and turned over the names of upwards of 250 US account owners. From this initial list, there have been four guilty pleas entered by US taxpayers. On 4/14/09, Robert Moran pled guilty to filing a false 2007 income tax return, on 6/25/09 – Steven Michael Rubinstein pled guilty to filing a false 2004 income tax return, and on 7/28/09 – Jeffrey Chernick pled guilty to filing a false 2007 income tax return. All three taxpayers in addition to having to resolve their income tax obligations for the open years under the statute of limitations (this includes payment of the omitted income tax, interest on the tax, and penalties) a maximum fine of $250,000 and up to three years in jail. However, the Rubinstein plea makes it clear that he is also subject to an FBAR penalty, which is 50% of the highest balance in his foreign accounts over a 6 year period.

On Friday, August 14, 2009, John McCarthy, a Los Angeles taxpayer, pled guilty to the willful failure to file an FBAR for the years 2003-2008. Even though this is the first plea following the DOJ/UBS settlement, it is unlikely that the DOJ has already received any names from UBS following the settlement. It does appear, however, to mark a significant change in what the government will accept in the way of a guilty plea. McCarthy's plea includes a civil fraud penalty (75% on the omitted tax) for the six year period, a 50% FBAR penalty on the highest balance in the foreign accounts for each of the six years, and incarceration for up to five years.

In the press release announcing McCarthy's plea, Eileen C. Mayer, Chief of IRS Criminal Investigation stated "The prosecution of John McCarthy is the tip of the iceberg." This is consistent with a New York Times article on August 14, 2009 which states that the US is building criminal cases against 150 US taxpayers. These prosecutions stem from the initial list of names UBS provided in February.

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