International Tax Issues and Rising IRS Enforcement: Critical Matters in 2019 and Beyond

Chattanooga Tax Practitioners
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ABOUT THE SPEAKER – HALE E. SHEPPARD

Hale E. Sheppard is a shareholder in the Tax Controversy & Litigation Section of Chamberlain Hrdlicka and Chair of the International Tax Section. Hale represents individuals and businesses during tax audits, tax appeals, and tax litigation. He focuses on international tax disputes and compliance issues.

Recent Cases and Rulings. Hale has handled over 80 cases with the U.S. Tax Court. His recent reported cases and rulings include *Landow v. Commissioner*, T.C. Memo 2011-177 (Tax Court case regarding employee stock ownership plans and taxpayer rights in cases of involuntary conversations), *Virginia Historic Tax Credit Fund v. Commissioner*, T.C. Memo 2009-295, *rev'd* 639 F.3d 129 (4th Cir. 2011) (case of first impression regarding federal tax treatment of state tax-credit partnerships), *Heartland Automotive Enterprises, Inc. v. United States*, 10 AFTR 2d 2009-2406 (M.D. Ga 2009) (case concerning employment taxes and use of electronic federal tax payment system), *Topping v. Commissioner*, T.C. Memo 2007-92 (hobby loss case in which the Tax Court ruled in favor of the taxpayer on all issues), *Vines v. Commissioner*, 126 T.C. 279 (case of first impression involving use of mark-to-market accounting method by securities traders), and *IRS Private Letter Rulings 107887-17, 107272-17, 107273-17, 101616-17, 137767-16, 131079-14, 201408003, 201338014, 201309001, 201308003*, *201242004*, *201210009*, *201131017*, *201002030* and *200751012* (National Office rulings regarding various procedural, tax, and international issues).

Education and Awards. Hale holds five college degrees. At the University of Kansas, he earned a B.S., with distinction, M.A., with honors, and J.D. He later received an LL.M. degree in international law, with highest distinction, from the Universidad de Chile in South America. Finally, he obtained an LL.M. degree in tax from the University of Florida, where he was a graduate tax scholar. During his studies, Hale received several awards for academic excellence, including the prestigious Harry S. Truman Foundation Scholarship. Hale also served as a graduate editor of the Florida Tax Review and member of the Kansas Journal of Law & Public Policy. Recently, Hale has been selected by *Chambers* as a national leader in tax litigation every year since 2009, and was inducted into the American College of Tax Counsel.

Publications. Hale ranks among the most active tax writers in the country. He has published over 120 articles in some of the nation's top tax journals, including Journal of Taxation, International Tax Journal, The Tax Adviser, Journal of International Taxation, Journal of Tax Practice and Procedure, Taxes Magazine, Practical Tax Lawyer, Journal of Passthrough Entities, Tax Management International Journal, Journal of Multi-State Tax & Incentives, Tax Notes International, Practical Tax Strategies, Corporate Business Taxation, and Journal of Real Estate Taxation. He has also published major articles in more than 20 university law reviews, both in the United States and Latin America.

Activities and Affiliations. Hale has held leadership positions in many professional and civic organizations, including: (i) Journal of Taxation, former Editorial Board Member and tax columnist, (ii) IRS-Practitioner Liaison Committee, state bar representative, (iii) Journal of Tax Practice & Procedure, Editorial Board Member, (iv) Georgia Bar Tax Section, former President, (v) Georgia Bar Journal, former Editorial Board Member, (vi) GSU Low-Income Taxpayer Clinic, Advisory Committee Member, and (vii) Atlanta Bar Tax Section Board Member.

SOURCE OF MATERIALS FOR THIS OUTLINE

This outline derives from the following articles written by Hale. If you would like a copy of any of the articles, please send Hale an e-mail at *hale.sheppard@chamberlainlaw.com* or call him at 404-658-5441. He would be glad to send the articles to you.

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I. Form 8938 Duty Expands to Certain Domestic Entities

A. Introduction

1. Domestic entities are considered U.S. persons for federal tax purposes. As such, they have historically been obligated to complete various forms, disclosing details about foreign income, entities, activities, and accounts.

2. From 2011 to 2015, the duty to file Form 8938 (Statement of Specified Foreign Financial Assets) applied only to specified individuals ("SIs").

3. In 2016, the IRS expanded these reporting duties even more, forcing specified domestic entities ("SDEs") to file annual Forms 8938.

B. Breakdown of the Duty

1. The general rule in Section 6038D(a) is the following:

   a. any specified person ("SP"), which includes both SIs and SDEs

   b. who/that holds an interest

   c. in a specified foreign financial asset ("SFFA")

   d. during any portion of a taxable year

   e. must attach to his/her/its timely tax return

   f. a complete and accurate Form 8938

   g. if the aggregate value of all SFFAs

   h. exceeds the applicable filing threshold

C. Taxpayers with Form 8938 Filing Duty

1. The following categories of individuals ordinarily are considered SIs:

   a. U.S. citizens

   b. U.S. residents (by Green Card, substantial presence test, or election by spouse under Section 6013) for any portion of a year, and

   c. Nonresident aliens who are bona fide residents of Puerto Rico or American Samoa.[1]

2. The following entities ordinarily are considered SDEs:

   a. a domestic corporation, a domestic partnership, or a domestic trust

[1] Treas. Reg. § 1.6038D-1(a)(1) and (2).

b. that was "formed or availed of" for purposes of holding, either directly or indirectly

c. SFFAs.[2]

D. Assets Constituting SFFAs

1. The term SFFA includes two major categories

2. First Category - Foreign Financial Accounts

a. The concept of "financial account" for purposes of Form 8938 is complicated for several reasons, one of which is that the definition is not even found in the applicable statute, Section 6038D, or the corresponding regulations. Instead, it is located elsewhere in the Internal Revenue Code, in the international tax withholding provision, Section 1471, and its ultra-dense regulations.[3]

b. Items Considered "Financial Accounts"

i. Depository accounts. In this context, the term "depository accounts" generally encompasses (i) commercial accounts, (ii) savings accounts, (iii) time-deposit accounts, (iv) thrift accounts, (v) accounts evidenced by a certificate of deposit, thrift certificate, investment certificate, passbook, certificate of indebtedness, or any other instrument for placing money in the custody of an entity engaged in a banking or similar business for which the entity is obligated to give credit, regardless of whether such instrument is interest-bearing or non-interest-bearing, and (vi) any amount held by an insurance company under a guaranteed investment contract or similar agreement to pay interest.[4]

ii. Custodial accounts. Here, the term "custodial accounts" ordinarily means an arrangement for holding for the benefit of another person a financial instrument, contract, or investment, such as shares of corporate stock, promissory notes, bonds, debentures, other evidences of debt, currency or commodity transactions, credit default swaps, swaps based on a non-financial index, notional principal contracts, insurance policies, annuity contracts, and any options or other derivative instruments.[5]

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[2] Treas. Reg. §1.6038D-6(a).
[3] Treas. Reg. § 1.6038D-1(a)(7).
[4] Treas. Reg. § 1.1471-5(b)(1)(i); Treas. Reg. § 1.1471-5(b)(3)(i).
[5] Treas. Reg. § 1.1471-5(b)(1)(ii); Treas. Reg. § 1.1471-5(b)(3)(ii).

iii. Equity or debt interests in a foreign financial institution, other than interests regularly traded on established securities markets.[6]

iv. "Cash value insurance contracts" and certain types of annuity contracts issued or maintained by an insurance company, a holding company for an insurance company, or certain foreign financial institutions.[7]

v. Tax-favored foreign retirement accounts, foreign pension accounts, and foreign non-retirement savings accounts meeting certain criteria.[8] Moreover, even if these items have been excluded from the definition of "financial account" pursuant to an intergovernmental agreement ("IGA") between the United States and a foreign country to implement FATCA, they will still be considered "financial accounts" for purposes of Form 8938. In other words, while certain foreign governments and financial institutions are not required to provide data to the IRS pursuant to FATCA about certain retirement-type accounts, SPs holding an interest in such accounts will not benefit from such an accommodation.[9]

c. Items *Not* Considered "Financial Accounts"

i. Certain term life insurance contracts.[10]

ii. Accounts held by an estate of an individual will not be considered "financial accounts," if the documentation for such accounts includes a copy of the deceased's will or death certificate.[11]

iii. Certain escrow accounts.[12]

iv. A non-investment linked, non-transferable, immediate life annuity contract that monetizes certain types of retirement or pension accounts.[13]

v. An account or product that is excluded from the definition of "financial account" under an IGA (other than certain tax-

[6] Treas. Reg. § 1.1471-5(b)(1)(iii); Treas. Reg. § 1.1471-5(b)(3)(iii)(iv).
[7] Treas. Reg. § 1.1471-5(b)(1)(iv); Treas. Reg. § 1.1471-5(b)(3)(vii); Treas. Reg. § 1.1471-5(b)(2)(v).
[8] Treas. Reg. § 1.1471-5(b)(2)(i)(A), (B) and (D); *See also* Treas. Reg. § 1.6038D-3(a)(7).
[9] *See* Treas. Reg. § 1.1471-5(b)(2)(vi); Treas. Reg. § 1.6038D-1(a)(7); Preamble to 76 Fed. Reg. 73819-73820 (Dec. 12, 2014); Instructions to Form 8938 (October 2015), pg. 5.
[10] Treas. Reg. § 1.1471-5(b)(2)(ii).
[11] Treas. Reg. § 1.1471-5(b)(2)(iii).
[12] Treas. Reg. § 1.1471-5(b)(2)(iv).
[13] Treas. Reg. § 1.1471-5(b)(2)(v).

favored foreign retirement accounts, foreign pension accounts, and foreign non-retirement savings accounts).[14]

vi. Accounts held with "U.S. payors."[15] The regulations broadly define the term "U.S. payor" as a "U.S. person," which includes a foreign branch of the U.S. person, a foreign office of the U.S. person, and a U.S. branch of certain foreign banks and foreign insurance companies.[16] Examples of financial accounts that are exempt from reporting on Form 8938 because they are held with "U.S. payors" include U.S. mutual funds, U.S. individual retirement accounts, Section 401(k) retirement accounts, qualified U.S. retirement plans, and brokerage/investment accounts maintained by U.S. financial institutions.[17]

vii. Accounts whose holdings are subject to the mark-to-market rules under Section 475.[18]

3. Second Category - SFFAs Other Than Foreign Financial Accounts

a. Items That Are Considered Other SFFAs

i. stock issued by a foreign corporation,

ii. capital or profits interest in a foreign partnership,

iii. interest in a foreign trust,

iv. note, bond, or other form of debt issued by a foreign person, and

v. interest swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty.[19]

b. Items That Are <u>*Not*</u> Considered Other SFFAs

i. The IRS guidance *excludes* two types of foreign assets from classification as SFFAs.

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[14] Treas. Reg. § 1.1471-5(b)(2)(vi).
[15] Treas. Reg. § 1.6038D-3(a)(3)(i).
[16] Treas. Reg. § 1.6038D-3(a)(3)(i); Treas. Reg. § 1.6049-5(c)(5)(i); T.D. 9657, Preamble to 76 Fed. Reg. 78556 (Dec. 19, 2011); Instructions for Form 8938 (December 2014), pg. 6.
[17] Instructions for Form 8938 (Rev. December 2014), pg. 6.
[18] Treas. Reg. § 1.6038D-3(a)(3)(ii); Treas. Reg. § 1.6038D-3(b)(2).
[19] Section 6038D(b)(2); Treas. Reg. § 1.6038D-3(b)(1); Treas. Reg. § 1.6038D-3(d).

ii. First, an interest in a social security, social insurance, or other similar program of a foreign government is not an SFFA.[20]

iii. Second, an interest in a foreign trust or a foreign estate is not an SFFA, unless the SP either knows or has reason to know of the existence of the interest based on readily accessible information.[21]

E. Defining an SDE

1. What Is an SDE?

a. Definition. An SDE is (i) a domestic corporation, a domestic partnership, or a domestic trust (ii) that was "formed or availed of" for purposes of holding, either directly or indirectly, (iii) SFFAs.[22]

b. What Does "Formed or Availed of" Mean?

i. Rules for Domestic Corporations and Partnerships (But Not Domestic Trusts).

(a) The general rule is that a domestic corporation or a domestic partnership was "formed or availed of" for purposes of holding SFFAs if it meets both of the following two tests.[23]

(b) Test #1. The domestic corporation or domestic partnership is "closely held" by an SI.[24]

(1) Generally, a domestic corporation is "closely held" by an SI if at least 80% of the stock is owned (directly or indirectly or constructively) by an SI on the last day of the corporation's taxable year.[25]

[20] T.D. 9657, Preamble to 76 Fed. Reg. 78556 (Dec. 19, 2011); *See also* Instructions for Form 8938 (December 2014), pg.4. and Instructions for Form 8938 (October 2015), pg. 4.
[21] Treas. Reg. § 1.6038D-3(c).
[22] Treas. Reg. §1.6038D-6(a).
[23] Treas. Reg. §1.6038D-6(b)(1).
[24] Treas. Reg. §1.6038D-6(b)(1)(i).
[25] Treas. Reg. §1.6038D-6(b)(2)(i).

(2) Similarly, a domestic partnership is "closely held" by an SI if at least 80% of the capital or profits interest in the partnership is owned (directly or indirectly or constructively) by an SI on the last day of the partnership's taxable year.[26]

(c) Test #2. At least 50% of the gross income of the domestic corporation or the domestic partnership for the relevant year is "passive income," or at least 50% of the assets held by the domestic corporation or the domestic partnership for the relevant year are assets that actually produce or are held for the production of "passive income."[27]

ii. Rules for Domestic Trusts (But Not Domestic Corporations or Domestic Partnerships)

(a) Generally, a domestic trust is "formed or availed of" for purposes of holding SFFAs if one of more of the "current beneficiaries" is an SP.[28]

(b) The term "current beneficiary" means any person who, at any time during the relevant year, is entitled to, or at the discretion of any person may receive, a distribution from the principal or the income of the trust (determined without regard to any power of appointment to the extent that such power remains unexercised at the end of the taxable year).[29]

(c) The term "current beneficiary" also includes any holder of a general power of appointment, whether or not exercised, that was exercisable at any time during the year, but does not include any holder of a general power of appointment that is exercisable only upon death of the holder.[30]

F. "Holding an Interest" in an SFFA

1. Different meanings in different contexts – Form 8938 rules

a. Generally, an individual has an interest in an SFFA if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the SFFA are (or

[26] Treas. Reg. §1.6038D-6(b)(2)(ii).
[27] Treas. Reg. §1.6038D-6(b)(1)(ii).
[28] Treas. Reg. §1.6038D-6(c).
[29] Treas. Reg. §1.6038D-6(c).
[30] Treas. Reg. §1.6038D-6(c).

should be) reported, included, or otherwise reflected on the individual's annual tax return.[31]

b. The regulations clarify that an individual has an interest in the SFFA *even if* no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the holding or disposition of the SFFA for the year in question.[32]

G. Reporting Thresholds

1. Even if an SP holds an interest in certain SFFAs during a given year, the SP is only required to file a Form 8938 if the aggregate value of the SFFAs surpasses certain reporting thresholds.

2. This is easy to say but often hard to determine because the six thresholds vary depending on an SI's location, civil status, and return-filing status. The thresholds range from $50,000 to $600,000.

3. The filing threshold is more straightforward for SDEs: Reporting is required if the total value of the SFFAs is more than $50,000 on the last day of the year or more than $75,000 at any time during the year.

H. Reasons to Care about Form 8938

1. Civil penalties

a. If a taxpayer fails to file Form 8938, files a late Form 8938, or files an incomplete or inaccurate Form 8938, then the taxpayer "shall" pay a penalty of $10,000.[33]

b. If the taxpayer has not filed a Form 8938 within 90 days after the day on which the IRS sends a notice, then the taxpayer "shall" pay another penalty of $10,000 for each 30-day period during which he/it fails to file the Form 8938, with a cap of $50,000.[34]

2. Criminal penalties

a. The regulations explain that "[i]n addition to other penalties, failure to comply with the reporting requirements of Section 6038D and the regulations, or any underpayment related to such failure, may result in criminal penalties under Sections 7201, 7203, 7206, et seq., or other provisions of Federal law."[35]

3. Extended assessment periods in *two* different ways

[31] Treas. Reg. § 1.6038D-2T(b)(1).
[32] Treas. Reg. § 1.6038D-2T(b)(1).
[33] Section 6038D(d)(1); Treas. Reg. § 1.6038D-8T(a).
[34] Section 6038D(d)(2); Treas. Reg. § 1.6038D-8T(c).
[35] Treas. Reg. § 1.6038D-8T(f)(2).

a. Extended to six years under new Section 6501(e)(1)(A) in case of "substantial omissions" from income related to unreported SFFAs

b. Extended to three years after Form 8938 is filed under the expanded Section 6501(c)(8)

4. Taxpayers forced to fight the government on three fronts at once

a. First Front - Income tax deficiency and tax-related penalties

b. Second Front – Assessable information-return penalties

c. Third Front - Non-tax penalties (*i.e.*, FBAR penalties) asserted by IRS and subject to collection lawsuit by U.S. Department of Justice

II. Offshore Disclosure Programs – Still Going Strong

A. <u>Why Are Taxpayers Still Approaching the IRS?</u>

1. The U.S. government is gathering data through multiple mechanisms:

a. Analysis of FBAR data, which now must be e-filed

b. Cross-referencing of Form 8938 data and FBAR data

c. FATCA reporting obligations

d. Data from hundreds of thousands of disclosures made since 2009

e. Deferred prosecution agreements with foreign banks

f. Civil audits with international focus

g. Requests under bilateral tax treaties

h. Whistleblowers

i. Wikileaks, *e.g.*, Panama Papers

B. <u>A Long Series of Voluntary Disclosure Programs</u>

1. 2003 Offshore Voluntary Compliance Initiative ("OVCI")

a. Years at issue – 1999, 2000, 2001, 2002

b. Offshore penalties: (i) accuracy/delinquency only "in appropriate circumstances," and (ii) 0% of unreported accounts and assets

c. Life of program – January 2003 to April 2003

d. Number of participants – 1,321

2. Last Chance Compliance Initiative ("LCCI")

   a. The IRS will give you "one final opportunity" to comply

   b. Years at issue – rolling six years

   c. Offshore penalties: (i) accuracy/delinquency only "in appropriate circumstances," (ii) civil fraud penalty, for one year, only where "warranted," and (iii) FBAR penalty for only one year

   d. Life of program – 2003 to 2009

3. 2009 Offshore Voluntary Disclosure Program ("2009 OVDP")

   a. Years at issue – 2003 to 2008

   b. Offshore penalties: (i) Accuracy/delinquency penalties, and (ii) 20% of unreported accounts and assets

   c. Life of program – March 2009 to October 2009

4. 2011 Offshore Voluntary Disclosure Initiative ("2011 OVDI")

   a. Years at issue – 2003 to 2010

   b. Offshore penalty: (i) accuracy/delinquency penalties, and (ii) 25% of unreported accounts and assets

   c. Life of program – February 2011 to September 2011

5. 2012 Offshore Voluntary Disclosure Program ("2012 OVDP")

   a. Years at issue – rolling eight years

   b. Offshore penalty: (i) accuracy/delinquency penalties, and (ii) 27.5% of unreported accounts and assets

   c. Life of program – replaced by 2014 OVDP

6. 2012 Streamline Filing Compliance Procedure ("SFCP")

   a. The IRS's instructions to the SFCP explained that the following individuals were eligible: (i) U.S. citizens, (ii) who have resided outside the United States on a full-time basis since 2009, (iii) who have not filed Forms 1040 with the IRS from 2009 forward, and (iv) who present a "low level of compliance risk."

7. 2014 Offshore Voluntary Disclosure Program ("2014 OVDP")

   a. Overview of settlement terms and taxpayer obligations

i. File tax returns for eight years

ii. Pay taxes, accuracy-related penalties or delinquency penalties, and interest charges for eight years

iii. File FBARs for eight years

iv. File all other information returns for eight years

v. Pay "offshore" penalty equal to 27.5% of the highest total balance of non-compliant items at any point during eight-year period. Increase of "offshore" penalty from 27.5% to 50% in cases involving at least one "facilitator" bank.

8. 2014 Streamline Foreign Offshore Program ("SFOP")

a. Overview of settlement terms and taxpayer obligations

i. File tax returns for three years

ii. Pay taxes and interest charges for three years (no penalties)

iii. File FBARs for past six years

iv. File all other information returns for past three years

v. Pay "offshore" penalty of $0

9. 2014 Streamline Domestic Offshore Program ("SDOP")

a. Overview of settlement terms and taxpayer obligations

i. File tax returns for three years

ii. Pay taxes and interest charges for three years (no penalties)

iii. File FBARs for the past six years

iv. File all other information returns for three years

v. Pay "offshore" penalty equal to 5% of highest aggregate balance on non-compliant items.

10. Delinquent FBAR Submission Procedure ("DFSP")

a. Allows taxpayers who previously filed timely, accurate Forms 1040 reporting all worldwide income but who neglected to file annual FBARs to file late FBARs on a penalty-free basis.

11. Delinquent Int. Information Return Submission Procedure ("DIIRSP")

a. Allows taxpayers who had previously filed timely, accurate Forms 1040 reporting all worldwide income but who neglected to file international information returns other than FBARs (such as Forms 5471, Forms 8865, Forms 8938, Forms 3520, etc.) to file late information returns on a penalty-free basis.

C. <u>Current Options – What Do You Tell Clients</u>?

1. Participate in the SFOP

2. Participate in the SDOP

3. File information returns under DFSP and/or the DIIRSP

4. Participate in "Updated Voluntary Disclosure Practice," the terms of which are contained in IRS Memo LB&I-09-1118-014 (Nov. 20, 2018)

5. *Not* recommended

a. Start complying in the current year and maintain compliance in the future, but do nothing to rectify past non-compliance

b. Do a "quiet disclosure"

D. <u>Biggest Challenges of Participating in SFOP, SDOP, DFSP, and DIIRSP</u>

1. The taxpayer must convince the IRS that the non-compliance was "non-willful" in the case of SFOP and SDOP. The IRS and the courts have interpreted the concept of willful behavior broadly, and have identified the following items as potential evidence of willful violations by a taxpayer:

a. The taxpayer failed to inform his accountant about the existence of foreign accounts, assets, or companies, particularly when asked by accountant about such items during meeting.

b. The taxpayer failed to ask his accountant about potential U.S. tax and compliance issues with respect to foreign assets.

c. The taxpayer failed to complete the annual questionnaire/organizer distributed by his accountant or other return preparer.

d. The taxpayer incorrectly completed the annual questionnaire.

e. The taxpayer opened a foreign account in the name of a foreign company or trust.

f. The taxpayer opened a numbered account.

g. The taxpayer had a nominee (such as an attorney, accountant, investment advisor, friend, relative, etc.) hold the foreign account on his behalf.

h. The taxpayer instructed the foreign bank not to send periodic account statements.

i. The taxpayer used a foreign passport (*i.e.*, not a U.S. passport) to open the account.

j. The taxpayer worked with a foreign attorney, accountant, or adviser in opening the foreign account.

k. The taxpayer provided the bank an address outside the United States as his residence for purposes of the foreign account.

l. The taxpayer only accessed the unreported foreign account while outside the United States, using a credit card linked to the account or taking cash withdrawals.

m. The taxpayer filed an FBAR reporting some foreign accounts, but not others. This particularly applies if the undisclosed accounts were significantly larger than those reported on the FBAR.

n. The taxpayer not only violated U.S. tax laws, but also had tax non-compliance in one or more foreign countries.

o. The taxpayer held foreign accounts or other assets in foreign countries with which he had no logical connection, such as living there, working there, operating a business there, etc.

p. The taxpayer used a computer program to self-prepare his returns, such as TurboTax, which specifically ask about foreign accounts.

q. The taxpayer reviewed the annual Form 1040 (including the specific information in Schedule B about foreign accounts and the need to file FBARs), signed the Form 1040 under penalties of perjury as being accurate and complete, yet took no actions whatsoever to learn more about a possible duty to file FBARs.

r. The taxpayer checked the box "no" in response to questions on Schedule B to Form 1040 about the existence of foreign accounts.

s. After the IRS started publicly attacking foreign banks in 2008, and after the IRS announced its first OVDP in 2009, the taxpayer:

    i. transferred funds from one unreported account to another,

    ii. converted funds in an unreported account into an asset that might not be reportable to the IRS, such as foreign real estate, jewelry, artwork, etc.,

    iii. withdrew funds from an unreported foreign account and placed them in a vault or safe deposit box,

iv. withdrew funds and sent to foreign relative or friend, or

v. withdrew funds, had them sent to the United States, closed the foreign account, but took no steps to rectify past U.S. violations with the IRS.

III. IRS Attacking Children with Unreported Foreign Assets

A. <u>U.S. Income Tax Rules Concerning Passive Income of Minor Children</u>

1. Generally, tax dependents who have only investment/passive income, who are single, who are under 65 years old, who are not blind, and whose total income during the year is more than $1,050 must file a Form 1040.[36]

2. Main options for parents and child

a. A parent can elect to include the investment income of a child on his or her Form 1040 under certain circumstances. The parent makes the election by filing a Form 8814 (Parent's Election to Report Child's Interest and Dividends) with the Form 1040.[37]

b. If the parent is ineligible or unwilling to elect to report the child's income on the parent's Form 1040 through inclusion of Form 8814, then the child must file a separate Form 1040 and enclose a Form 8615 (Tax for Certain Children Who Have Unearned Income) under certain circumstances.[38]

B. <u>Special Information-Reporting Rules for Children</u>

1. Schedule B and Foreign Accounts of Children

a. The IRS has clarified that, if a parent is claiming the income of foreign accounts held by a child by filing a Form 8814, then such parent must be consistent when it comes to Schedule B on Form 1040. The IRS's instructions to Form 8814 include the following guidance on this point:

i. "Foreign accounts and trusts. You must complete Schedule B (Form 1040), Part III, and file it with your tax return if your child: (1) Had a foreign financial account, or (2)

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[36] Section 6011(a); Section 1(g); Treas. Reg. § 1.1(i)-1T; Treasury Decision 8158 (Sept. 4, 1987); IRS Publication 929 (Tax Rules for Children and Dependents) (2015).
[37] IRS Publication 929 (Tax Rules for Children and Dependents) (2015), pgs. 9-10; Instructions to Form 8814 (Parents' Election to Report Child's Interest and Dividends) (2015), pg. 3.
[38] IRS Publication 929 (Tax Rules for Children and Dependents) (2015), pgs. 12-13; Instructions to Form 8615 (Tax for Certain Children Who Have Unearned Income) (2015), pg. 1.

Received a distribution from, or was the grantor of, or transferor to, a foreign trust."[39]

ii. "Enter 'Form 8814' on the dotted line next to line 7a [At any time during 2015, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country?] or line 8 [During 2015, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust?], whichever applies. Complete line 7b [If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located], if applicable."[40]

2. Form 8938 and Foreign Accounts of Children

a. The IRS follows the same rationale with respect to Form 8938. The regulations and the Instructions to Form 8814 and Form 8938 explain the following in this regard:

i. "If you file Form 8814 with your income tax return to report your child's foreign financial account, you have an interest in the assets from that account and may be required to file Form 8938."[41]

ii. "Interests in assets generating certain unearned income of children. If you file Form 8814, Parents' Election To Report Child's Interest and Dividends, with your income tax return to elect to include in your gross income certain unearned income of your child (the "kiddie tax" election), you have an interest in any specified foreign financial asset held by the child."[42]

iii. "For purposes of Section 6038D and the regulations, a parent that makes an election under Section 1(g)(7) to include certain unearned income of a child in the parent's gross income required to be reported for the taxable year has an interest in any specified foreign financial asset held by the child."[43]

iv. "Special rule for parent making election under Section 1(g)(7). A parent who makes an election under Section 1(g)(7) to include certain unearned income of a child in the

[39] Instructions to Form 8814 (Parents' Election to Report Child's Interest and Dividends) (2015), pg. 3.
[40] Instructions to Form 8814 (Parents' Election to Report Child's Interest and Dividends) (2015), pg. 3.
[41] Instructions to Form 8814 (Parents' Election to Report Child's Interest and Dividends) (2015), pg. 3.
[42] Instructions to Form 8938 (Statement of Specified Foreign Financial Assets) (2015), pg. 5.
[43] Treasury Decision 9567 (Dec. 19, 2011); *See also* Treasury Decision 9706 (Dec. 12, 2014).

parent's gross income has an interest in any specified foreign financial asset held by the child for the purposes of section 6038D and the regulations."[44]

3. FBAR and Foreign Accounts of Children

a. The FBAR instructions broadly state that a U.S. child is not excused from his FBAR filing duty, regardless of age or capacity. The instructions to the FBAR state the following in this regard:

i. For purposes of the FBAR, the term "person" means "an individual (including a minor child) and legal entities . . . "[45]

ii. The term "U.S. person" means "United States citizens (including minor children); United States residents; entities, including, but not limited to, corporations, partnerships, or limited liability companies created or organized in the United States or under the laws of the United States; and trusts or estates formed under the laws of the United States."[46]

iii. "Responsibility for Child's FBAR: Generally, a child is responsible for his or her own FBAR report. If a child cannot file his or her own FBAR for any reason, such as age, the child's parent, guardian, or other legally responsible person must file it for the child."[47]

iv. "Responsibility for Child's FBAR. Signing the child's FBAR: If the child cannot sign his or her FBAR, a parent or guardian must electronically sign the child's FBAR. In Item 45 Filer Title, enter 'Parent/Guardian filing for child."[48]

IV. New Duties for Foreign-Owned Disregarded Entities

A. Background

1. The U.S. government, fed up with international tax evasion, has taken significant steps to curb the problem. Among the most notorious of these steps was the enactment of FATCA, which effectively forces foreign financial institutions to provide the IRS with data about U.S. clients.

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[44] Treas. Reg. § 1.6038D-2(b)(3).
[45] BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (FinCEN Form 114) (June 2014) (v1.3), pg. 5.
[46] BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (FinCEN Form 114) (June 2014) (v1.3), pgs. 5-6.
[47] BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (FinCEN Form 114) (June 2014) (v1.3), pg. 6. This language was added by the government in June 2014.
[48] BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (FinCEN Form 114) (June 2014) (v1.3), pg. 6. This language was added by the government in June 2014.

2. International organizations have pointed out a flaw with these efforts: While occupied pressuring others to surrender client data, the U.S. government has failed to keep its own house in order. The criticism is that foreigners can easily hide money in the United States by utilizing a domestic, single-member limited liability company, treated as a disregarded entity ("DRE") for federal tax purposes.

3. In an effort to halt this practice, the IRS issued proposed regulations in May 2016 and then final regulations in December 2016 that obligate foreign-owned, single-member, domestic DREs to file annual Forms 5472.

B. Filing Requirements

1. Domestic corporations that are foreign-owned are governed by Section 6038A, while foreign corporations with U.S. operations are controlled by Section 6038C.[49]

2. Form 5472 generally must be filed by a "reporting corporation" in order to disclose to the IRS certain "reportable transactions" between it and "related parties." Thus, taxpayers must analyze each of these three concepts to determine if they must file Forms 5472. These concepts are terribly complicated and technical, even for tax professionals, and a detailed discussion is beyond the scope of this outline.

C. Penalties for Violations

1. A reporting corporation that fails to file timely, accurate, and substantially complete Forms 5472 is subject to civil penalties.[50]

2. The IRS generally may impose a penalty of $10,000 for each violation for each year, which can add-up quickly if a reporting corporation fails to file multiple Forms 5472 for multiple years.[51]

D. What Is/Was the Problem?

1. The entity-classification regulations, also known as the check-the-box regulations, located in Treas. Reg. § 301.7701-1 through Treas. Reg. § 301.7701-3, contain default rules that function to treat entities with just one owner as DREs, unless they file a Form 8832 with the IRS electing to be treated as an association/corporation for U.S. tax purposes;

2. Many of these DREs consist of domestic limited liability companies owned by one foreign person;

3. Persons forming DREs in certain states are required to provide little, if any, information about the ultimate owner;

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[49] Omnibus Budget Reconciliation Act of 1990 (Public Law 101-508), Section 11315.
[50] Section 6038A(d)(1); Treas. Reg. § 1.6038A-4(a)(1).
[51] Section 6038A(d)(1); Treas. Reg. § 1.6038A-4.

4. The current rules do not require the filing by a DRE of a Form 8832 (because it is accepting the default classification as a DRE) or a Form SS-4 (because it does not need to obtain an EIN);

5. In situations where neither the DRE nor its owner received any US-source income during a taxable year and was not engaged in a U.S. trade or business, no U.S income tax returns are required to be filed;

6. If a DRE receives only certain types of US-source income, such as portfolio/investment interest or US-source income that is subject to automatic tax withholding, the owner of the DRE might not be obligated to file a U.S. tax return;

7. The current lack of U.S. filing and record-keeping requirements for certain foreign-owned, single-member, domestic DREs makes it difficult for the IRS to ascertain whether a DRE or its owner is liable for any U.S. taxes and hinders the ability of the U.S. government to comply with international standards concerning financial transparency and tax enforcement; and

8. The current weaknesses triggered by the U.S. tax rules have been highlighted by various organizations, including the Financial Action Task Force and the Global Forum on Transparency and Exchange of Information for Tax Purposes.[52]

E. <u>Main Effects of New Regulations</u>

1. Foreign-owned, single-member, domestic DREs would be treated as "domestic corporations" (and thus "reporting corporations") *solely* for purposes of Section 6038A;

2. As reporting corporations, these entities would be required to file annual Forms 5472 and comply with the rigid record-keeping requirements;

3. Because the entities will now have a filing requirement with the IRS (*i.e.*, Form 5472), they must also file a Form SS-4 (giving the IRS information about the "responsible person") in order to obtain an EIN;

4. The types of "reportable transactions" that must be disclosed on Form 5472 would be expanded; and

5. Certain exceptions to the strict record-keeping requirements (normally shielding corporations with small gross incomes and/or small reportable transactions) would not be available to help foreign-owned, single-member, domestic DREs.

[52] REG-127199-15 (May 6, 2016), Preamble.

V. Revoking or Denying U.S. Passports for Tax Debtors

A. Background

1. Fixing America's Surface Transportation ("FAST") Act was enacted in December 2015. It contained new Section 7345, called "Revocation or Denial of Passport in Case of Certain Tax Delinquencies."

B. Key Aspects of New Section 7345

1. General Rule - If the IRS determines that an individual taxpayer has a seriously delinquent tax debt ("SDTD"), then it will send a "certification" to the Secretary of the Treasury, who, in turn, will send the "certification" to the Secretary of State, who then will deny, revoke, or limit the U.S. passport of the individual, as appropriate.

2. General Definition - An SDTD generally means an unpaid, legally enforceable federal tax liability, of an individual, which has been assessed, which is greater than $50,000, and with respect to which (i) the IRS has filed a Notice of Federal Tax Lien ("NFTL") and the taxpayer's right to request a Collection Due Process hearing has been exhausted or has lapsed, or (ii) the IRS has levied already.

C. Taxpayer's Ability to Seek Redress

1. The IRS website explains to taxpayers that their ability to seek judicial review is immediate: "You are *not* required to file an administrative claim or otherwise contact the IRS to resolve the erroneous certification issue before filing suit in the U.S. Tax Court or a U.S. District Court." [53]

2. In terms of remedies, if the relevant court rules that the certification was erroneous, then it can order the IRS to inform the State Department of this reality.[54] The legislative history makes it clear that this is the sole power of the court, and "[n]o other relief is authorized."[55] The IRS website indicates the same, stating that Section 7345 "does *not* provide the court authority to release a lien or levy or award money damages in a suit to determine whether a certification is erroneous."[56]

D. Initial Issues and Questions

1. Does the $50,000 Threshold Include Penalties and Interest?

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[53] *www.irs.gov/businesses/small-businesses-self-employed/revocation-or-denial-of-passport-in-case-of-certain-unpaid-taxes*, as of February 19, 2017.
[54] Section 7345(e)(2).
[55] U.S. Joint Committee on Taxation. General Explanation of Tax Legislation Enacted in 2015. JCS-1-16 (March 2016), pg. 93.
[56] *www.irs.gov/businesses/small-businesses-self-employed/revocation-or-denial-of-passport-in-case-of-certain-unpaid-taxes*, as of February 19, 2107.

a. Section 7345(b)(1) indicates that an SDTD is a federal tax liability that exceeds $50,000, but it does not clarify the components of the calculation. To find this answer, one must look to the legislative history. The congressional conference report states that an SDTD generally includes any "outstanding debt for federal taxes in excess of $50,000, *including interest and any penalties*," for which a post-lien notice or a pre-levy notice has been filed.[57] Likewise, the so-called Bluebook issued by the U.S. Joint Committee on Taxation states that an SDTD entails taxes and "interest and any penalties."[58]

2. Are "Assessable Penalties" Part of an SDTD?

a. Section 7345(b)(1) explains that an SDTD is a "federal tax liability" greater than $50,000, and the legislative history indicates that this term covers not only the federal income taxes related to Forms 1040 of individual taxpayer, but also corresponding penalties and interest. What remains murky is whether "assessable penalties" will be considered part of an SDTD. The term "assessable penalties" refers to those items found in Section 6671 through Section 6725. For its part, Section 6671(a) expressly states that "assessable penalties" shall be paid by the taxpayer upon notice and demand by the IRS, and "shall be assessed and collected in the same manner as taxes." It goes on to clarify that any reference in the Internal Revenue Code to the term "tax" shall include "assessable penalties."[59]

3. Can Partial Payment Avoid SDTD Status?

a. Section 7345(c)(1) explains that the IRS Commissioner must notify the Secretary of the Treasury, who will then notify the Secretary of State, if any certification is later found to be erroneous, if the individual taxpayer "fully satisfies" the debt that triggered the certification, or the debt is no longer an SDTD as a result of one of the exceptions found in Section 7345(b)(2). Despite this language, uncertainty remained, and practitioners requested that the IRS issue regulations clarifying whether a taxpayer can avoid denial or revocation of a passport "by making a payment that reduces the underpayment to less than $50,000."[60]

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[57] U.S. House of Representatives, 114th Cong., 1st Sess., Conference Report 114-357, Dec. 1, 2015, p.531.

[58] U.S. Joint Committee on Taxation. General Explanation of Tax Legislation Enacted in 2015. JCS-1-16 (March 2016), pg. 92.

[59] Section 6671(a); Treas. Reg. § 301.6671-1(a).

[60] Kenneth M. Horwitz. TSCPA Seeks Proposed Regs on Denial of Passports for Unpaid Taxes. 2016 Tax Notes Today 134-17.

b. The IRS has since made its point of view on this topic utterly clear, explaining on its website that "the IRS will ***not*** reverse the certification because the taxpayer pays the debt below $50,000."[61]

4. Does Currently-Not-Collectible ("CNC") Status Affect the Analysis?

a. Another open issue was, if an individual's federal tax liability exceeds $50,000 and thus is considered an SDTD, can this taint be purged if the IRS places the individual in CNC status.[62] Certain tax professionals have argued that, if the IRS has determined that an individual is in such an economic bind that he should be deemed CNC, then, for purposes of Section 7345, the liability should no longer be considered a "D," much less an SDTD.[63]

5. Does Filing a Penalty-Abatement Request Affect Matters?

a. Practitioners urged the IRS not to utilize its power to deny or revoke a passport where a component of the relevant SDTD is a penalty, the taxpayer has filed a proper penalty-abatement request, and the IRS has not yet responded to such request.[64]

E. Trickling Guidance from the IRS

1. The FAST Act was passed in December 2015. The IRS has still not issued any type of regulations regarding Section 7345 (*i.e.,* proposed, temporary, or final), but it has released guidance in various forms as of May 2018. These are examined below.

2. New Language in IRS Collection Notices

a. The FAST Act added new language to Section 6320 and Section 6331, mandating that the IRS include information for taxpayers, in "simple and non-technical terms," about the existence and effects of new Section 7345. The IRS started issuing post-lien notices and pre-levy notices in late 2016 containing the following warning:

i. "On December 4, 2015, as part of the Fixing America's Surface Transportation (FAST) Act, Congress enacted Section 7345 of the Internal Revenue Code, which requires the Internal Revenue Service to notify the State Department of taxpayers certified as owing a seriously delinquent tax

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[61] *www.irs.gov/businesses/small-businesses-self-employed/revocation-or-denial-of-passport-in-case-of-certain-unpaid-taxes*, as of February 19, 2017.

[62] For general information about CNC status and related IRS procedures, *see* I.R.M. § 5.16.1 - Currently Not Collectible (12-17-2015) and I.R.M. § 5.19.17 – Campus Procedures for Currently Not Collectible and Offers in Compromise (12-7-2015).

[63] See Kenneth M. Horwitz. TSCPA Seeks Proposed Regs on Denial of Passports for Unpaid Taxes. 2016 Tax Notes Today 134-17; John M. Colvin and Claire H. Taylor. "Owe the IRS? Passports at Risk Under New Code Sec. 7345," Journal of Tax Practice & Procedure, February-March 2016.

[64] Kenneth M. Horwitz. TSCPA Seeks Proposed Regs on Denial of Passports for Unpaid Taxes. 2016 Tax Notes Today 134-17.

debt. The FAST Act generally prohibits the State Department from issuing or renewing a passport to a taxpayer with a seriously delinquent tax debt. Seriously delinquent tax debt means an unpaid, legally enforceable federal tax debt of an individual totaling more than $50,000 for which a Notice of Federal Tax Lien has been filed and all administrative remedies under IRC Section 6320 have lapsed or been exhausted, or a levy has been issued. If you are individually liable for a tax debt (including penalties and interest) totaling more than $50,000 and you do not pay the amount you owe or make alternate arrangements to pay, or request a Collection Due Process hearing by [insert date which is 30 days after issuance of relevant post-lien or pre-levy notice], we may notify the State Department that your tax debt is seriously delinquent. The State Department generally will not issue or renew a passport to you after we make this notification. If you currently have a valid passport, the State Department may revoke your passport or limit your ability to travel outside the United States. Additional information on passport certification is available at www.irs.gov/passports."[65]

3. News Release IR-2018-7

   a. This news release put taxpayers on notice about imminent passport problems, but it did not clarify any major substantive issues.

4. Notice 2018-1

   a. Notice 2018-1 is comprised of two segments, the first of which simply provides a basic summary of Section 7345. The other segment, labeled "Discussion," provides a few relevant bits.

   b. First, in what comes as no surprise, the IRS tells delinquent taxpayers that they "should consider" resolving their issues by paying in full, entering into an Installment Agreement, or applying for an Offer-in-Compromise.

   c. Second, the IRS confirms that the State Department generally will grant taxpayers a 90-day grace period to handle payment matters, but the window may be shorter if there is an urgent need to travel internationally.

   d. Finally, the IRS addresses taxpayer rights if there is a dispute about the filing of an SDTD certification. Notice 2018-1 first confirms that taxpayers are out of luck in terms of quick, inexpensive, administrative procedures: "The taxpayer may not go to IRS Appeals to challenge the certification or the decision by the [IRS]

[65] Letter 3172 (DO) Rev. 9-20-16; Notice CP 504.

Commissioner or specified delegate not to reverse a certification." Notice 2018-1 then describes the limited courses of available action, including calling the number on the SDTD certification notice or filing a lawsuit with the Tax Court or U.S. district court.

5. Internal Revenue Manual

a. The IRS, in preparation to start the SDTD certification process, updated and expanded the Internal Revenue Manual ("IRM") in December 2017. Below is a discussion of new and/or important material from the IRM.

b. Guidance Added to the IRM about Components of an SDTD

i. The SDTD threshold of $50,000 is the aggregate unpaid balance of assessment. It includes assessed taxes, penalties, and interest, but it does *not* include accrued-but-unassessed penalties and interest.[66]

ii. Importantly, unless it falls into one of the statutory exclusions (*i.e.*, those identified by Congress) or one of the discretionary exclusions (*i.e.*, those identified by the IRS), the IRM states that an SDTD includes *all* tax assessments made under an individual's SSN, including individual income taxes, trust fund recovery penalties, business taxes for which the individual is liable, and other penalties.[67]

iii. Equally noteworthy for taxpayers in the international arena, the IRM now indicates that the term SDTD does *not* include certain "non-tax liabilities," such as FBAR penalties because "FBAR penalties are asserted under Title 31 as a non-tax debt . . . ."[68]

c. Guidance Added to the IRM about Full Payment

i. Once the SDTD has been certified, paying the account below the threshold of $50,000 (or the appropriate threshold at the time of certification) will *not* result in a decertification.[69]

d. Guidance Added to the IRM about "Statutory Exclusions"

i. If a taxpayer misses the deadline for filing a CDP hearing request to challenge a post-lien notice or pre-levy notice, or if the taxpayer is ineligible to demand a CDP hearing for

[66] IRM § 5.1.12.27.2 (12-20-2017).
[67] IRM § 5.1.12.27.2 (12-20-2017).
[68] IRM § 5.1.12.27.2 (12-20-2017).
[69] IRM § 5.1.12.27.2 (12-20-2017).

some other reason, the taxpayer generally has the right to seek a so-called "Equivalent Hearing."[70] The updated IRM states that a pending request for an "Equivalent Hearing" (as opposed to a CDP hearing) in connection with the filing of an NFTL or a proposed levy will *not* prevent a liability from being considered an SDTD.[71]

e. Guidance Added to the IRM about "Discretionary Exclusions"

i. The IRM announces the IRS's decision to exclude the following categories of debts from the definition of SDTD: (i) debt that is CNC status due to financial hardship, (ii) debt that resulted from identity theft, (iii) debt of a taxpayer in bankruptcy, (iv) debt of a deceased taxpayer, (v) debt that is included in a "pending" Offer-in-Compromise, (vi) debt that is included in a "pending" Installment Agreement, (vii) debt with a pending adjustment with the IRS that will fully pay the tax liability, and (viii) debt of a taxpayer located in a federal disaster area.[72]

ii. The IRM warns that Offers-in-Compromise or Installment Agreements that a taxpayer makes solely for purposes of delaying IRS collection actions will not fall within the "discretionary exclusions."[73]

iii. The IRS expressly reserves the right to alter course later, stating that "[t]hese discretionary exclusion categories are subject to change in the future."[74]

f. Guidance Added to the IRM about Notifying Taxpayers

i. The IRM confirms that, while it does not delay issuing a SDTD certification, the State Department will afford taxpayers a little wiggle room. If an individual who has been certified by the IRS as having an SDTD applies for a new or renewal passport, the State Department will hold the application for 90 days in order to allow the taxpayer a chance to resolve any certification errors, make full payment, or enter into an acceptable payment alternative with the IRS.[75] In other words, the IRM indicates that the State Department intends to give taxpayers a 90-day grace period to straighten out tax payment matters with the IRS.

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[70] Treas. Reg. § 301.6320-1(i).
[71] IRM § 5.1.12.27.2 (12-20-2017); IRM § 5.1.12.27.3 (12-20-2017).
[72] IRM § 5.1.12.27.4 (12-20-2017).
[73] IRM § 5.1.12.27.4 (12-20-2017).
[74] IRM § 5.1.12.27.4 (12-20-2017).
[75] IRM § 5.1.12.27.7 (12-20-2017).

g. Guidance Added about "Adjustments" – Penalty Abatements

i. The IRM states that the IRS has discretion to request decertification (*i.e.*, removal of SDTD status) for various reasons. Among them is when there is an "adjustment," not a payment, to the taxpayer's account that reduces the debt below the $50,000 threshold.[76]

ii. The IRM provides an example of an adjustment warranting decertification: "IRS assesses taxpayer's liability of $54,000, of which $9,000 is attributable to a penalty. The taxpayer's [SDTD] is certified. The taxpayer requests penalty abatement on the basis of reasonable cause. IRS finds the taxpayer had reasonable cause and abates the penalty, lowering the taxpayer's total liability to $45,000. Since the liability is reduced below the threshold for certification . . . the taxpayer is eligible for decertification."[77]

iii. The IRM warns that not all adjustments, particularly penalty abatements, will lead to SDTD decertification: "For example, a penalty abatement of a certified module due to an administrative waiver under the First Time Abate criteria . . . will not result in decertification, even if the adjusted total liability is less than the threshold amount indexed for inflation."[78]

h. Guidance Added to the IRM about "Adjustments" – Non-Filers

i. The IRM provides another illustration of an acceptable adjustment: "The taxpayer has a liability of $66,000 for [2015] due to [a substitute-for-return] assessment. The taxpayer is certified as a [SDTD] . . . . The taxpayer is in the process of renewing their U.S. Passport with the Department of State. The taxpayer files a return for [2015] which reduces the tax debt to $30,000. Once the taxpayer's return for [2015] is processed and posted on IDRS, the taxpayer will be eligible for decertification."[79]

i. Guidance Added to the IRM about Decertification

i. The IRM admonishes that a taxpayer's account will remain as SDTD in many instances, including where the taxpayer requests a CDP hearing for tax periods that are not the basis

[76] IRM § 5.1.12.27.8 (12-20-2017).
[77] IRM § 5.1.12.27.8 (12-20-2017).
[78] IRM § 5.1.12.27.8 (12-20-2017).
[79] IRM § 5.1.12.27.8 (12-20-2017).

for the SDTD certification. For instance, a taxpayer is already certified by the IRS as SDTD, a Revenue Officer later issues a pre-levy notice to the taxpayer concerning an additional/later tax period, and the taxpayer files a timely CDP hearing request. The existing SDTD certification is not reversed, despite the pending CDP hearing, because such hearing relates to tax periods beyond/after those on which the certification is based.[80]

j. Guidance Added to the IRM about Dispute Resolution

i. The IRM confirms that taxpayers have no right to seek administrative review by the Appeals Office of an SDTD certification and that their main remedy is going straight to litigation. The updated IRM, like the IRS's website, states the following: "The taxpayer is not required to file an administrative claim or otherwise contact the IRS to resolve the erroneous certification issue before filing suit in the Tax Court or a District Court of the United States."[81]

ii. Nevertheless, the IRM explains that, before starting litigation, taxpayers can attempt to resolve disputed SDTD certification issues by (i) personally visiting a taxpayer assistance center, (ii) calling the number on SDTD certification notice, which will get routed to a centralized office in Philadelphia, or (iii) sending a written reply to the SDTD certification notice, which will also get forwarded to Philadelphia.[82]

6. Chief Counsel Notice 2018-005

a. Chief Counsel Notice ("CC-2018-005) begins with a couple of obvious observations: This is a "new area of litigation" and "there are still many unanswered questions."[83]

b. No Access to the Appeals Office, Ever

i. CC-2018-055 clarifies that taxpayers challenging Section 7345 issues will never have a right to seek review by the Appeals Office. The IRS authorities indicate that taxpayers have no ability to access the Appeals Office *before* filing starting litigation. CC-2018-055 builds on this notion, expressly stating that taxpayers will not get to present their

[80] IRM § 5.1.12.27.8 (12-20-2017).
[81] IRM § 5.1.12.27.9 (12-20-2017).
[82] IRM § 5.1.12.27.8 (12-20-2017); IRM § 5.19.1.5.19.10 (12-26-2017).
[83] Chief Counsel Notice 2018-055 (April 5, 2018).

side to the Appeals Office, even *after* getting started with the Tax Court or appropriate U.S. district court.[84]

c. IRS Perspective on Three Novel Issues

i. CC-2018-055 identifies three issues the IRS anticipates that taxpayers will raise, which are not explicitly addressed by Section 7345.

ii. First, the IRS concludes that taxpayers *cannot* challenge the amount of the liability during litigation because it is contrary to the relevant law and because it would restrain the collection of an assessed tax liability as "a liability determination in a Section 7345 proceeding would bind the [IRS] in other litigation."[85] CC-2018-005 instructs IRS attorneys to swiftly dispense with Section 7345 cases where taxpayers question the underlying tax liability, by filing Motions to Dismiss for Failure to State a Claim or Motions for Summary Judgment on the Pleadings.[86]

iii. Second, in terms of timing, CC-2018-055 indicates that taxpayers have six years from the date on which the IRS issues a notice of SDTD certification, or six years from the date on which grounds for decertification exist, to bring an action in Tax Court or the appropriate U.S. district court.[87]

iv. Third, the IRS addresses scope and standard of judicial review, stating the following: "Judicial review is thus *logically limited to the computerized records of those modules*. When review is confined to the administrative record, the standard of review is whether agency action was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." . . . *Accordingly, review should be limited to the [IRS's] records and whether the certification or failure to reverse the certification was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law*."[88]

[84] Chief Counsel Notice 2018-055 (April 5, 2018).
[85] Chief Counsel Notice 2018-055 (April 5, 2018).
[86] Chief Counsel Notice 2018-055 (April 5, 2018).
[87] Chief Counsel Notice 2018-055 (April 5, 2018).
[88] Chief Counsel Notice 2018-055 (April 5, 2018).

VI. Automatic International Penalties – Forms 5471 and 5472

A. Overview of Form 5471

1. Filing Duty. Four "categories" of U.S. persons (*i.e.*, U.S. citizens, U.S. residents, or U.S. domestic entities) must file a Form 5471 with the IRS to report their relationships with a foreign corporation. [89]

2. Penalties. If the U.S. person fails to file the Form 5471 in a timely manner, the IRS generally may assert a penalty of $10,000 per year.[90]

B. Overview of Form 5472

1. Filing Duty. Form 5472 generally must be filed by a "reporting corporation" in order to disclose to the IRS certain "reportable transactions" between it and "related parties."

2. Penalties. The IRS may impose a penalty of $10,000 for each violation for each year, which can add-up quickly if a reporting corporation fails to file multiple Forms 5472 for an extended period.[91]

C. Automatic/Computer-Generated Penalties

1. The "robo" penalties for Form 5471 started in 2009, while such penalties for Form 5472 began in 2013.

2. This was the result of two reports by the U.S. Treasury Inspector General for Tax Administration ("TIGTA"), which advocated the assess-penalties-now-consider-excuses-later situation. The initial TIGTA report was released in 2006.[92] The follow-up report was released in 2013.[93]

D. Obscure "Decision Tree"

1. Most Form 5471 and Form 5472 penalties must be resolved by IRS personnel <u>*not*</u> by applying the standards contained in other tax provisions (such as accuracy-related penalties under Section 6662) and <u>*not*</u> by applying the general standards contained in the IRS's Penalty Handbook and regulations, but rather by applying the special "Decision Tree." This

[89] Instructions to Form 5471.
[90] Section 6038(b)(1); Treas. Reg. § 1.6038-2(k)(1)(i).
[91] Section 6038A(d)(1); Treas. Reg. § 1.6038A-4.
[92] U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006).
[93] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (September 25, 2013).

"Decision Tree," found in the Internal Revenue Manual, features standards that are much more stringent than those located elsewhere.[94]

2. The following examples from the "Decision Tree" demonstrate that attaining abatement can be extremely challenging.

   a. If the taxpayer claims that it was unaware of the Form 5471 or Form 5472 filing requirement, the "Decision Tree" instructs the IRS to deny abatement because "ordinary business care and prudence requires taxpayers to determine their tax obligations when establishing a business in a foreign country."

   b. The "Decision Tree" mandates that penalty abatement be denied where the taxpayer seeks clemency because of financial problems.

   c. The "Decision Tree" further indicates that the IRS will show no mercy in situations where a taxpayer states that Form 5471 or Form 5472 was late because the transactions, tax laws, or business structure was complicated.

   d. If the taxpayer claims that multiple layers of ownership prevent the taxpayer from obtaining all the data necessary to file a timely Form 5471 or Form 5472, the "Decision Tree" instructs the IRS not to abate penalties.

   e. Rejection of the penalty abatement request will also occur, according to the "Decision Tree," when the taxpayer relies on challenges in obtaining the necessary foreign data as the excuse for late Forms 5471 or Forms 5472.

   f. The "Decision Tree" demands imposition of penalties if the reason for the delinquent filings is that the person with sole authority to file Form 5471 or Form 5472 was absent for a reason other than death or serious illness. Moreover, even if death or serious illness of the sole responsible person is claimed, the IRS will only accept this justification if (i) the corporation can provide tangible proof, such as insurance claim, police report, letters or bills from hospitals, or newspaper clippings describing event, (ii) the absence was not foreseeable, (iii) the absence occurred before and in close proximity to the filing deadline, and (iv) the taxpayer filed within two weeks of when the absence ended.

   g. The IRS will not waive Form 5472 penalties under the "Decision Tree" if the taxpayer neglected to file a Form 7004 (Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns) to secure an automatic six-month extension to file a Form 1120 or Form 1120-F.

[94] I.R.M. Exhibit 21.8.2-2 - Failure to File or Late-Filed Form 5472 - Decision Tree.

h. The "Decision Tree" also denies abatement where the taxpayer hired a third-party (such as an accounting firm) to prepare returns and erroneously believed that such third-party has filed a Form 7004 on behalf of the taxpayer.

i. Abatement requests will also be rejected under the "Decision Tree" if the taxpayer relies on the ignorance-of-the-law defense and the taxpayer was a U.S. resident, resided outside the United States but failed to even retain U.S. tax representation, or claims that it was unaware of the obligation to file U.S. tax returns.

j. For purposes of seeking penalty abatement, the "Decision Tree" clarifies that reliance on an accountant or attorney might be appropriate in certain situations, but reliance by a taxpayer on the following types of people is not reasonable: Bookkeeper, financial advisor, business associate, information in a tax plan or promotion, and person assisting in establishing the corporation.

k. Finally, the "Decision Tree" indicates that it might abate penalties based on the reasonable-reliance-on-a-qualified-tax-professional defense if, and only if, the taxpayer relied on an accountant or attorney, the taxpayer provided such tax professional all relevant information, the taxpayer supplied the information before the deadline for filing Form 5471 or Form 5472, the tax professional advised the taxpayer that it was not required to file, the taxpayer has tangible evidence to prove the preceding facts, and, in the opinion of the IRS, the taxpayer's reliance was reasonable.

VII. Is the Substantial Compliance Defense Dead?

A. <u>Overview</u>

1. As taxpayers become increasingly international, they face a number of complexities, one of which is the need to file convoluted international information returns with the IRS. Errors and oversights frequently occur. These trigger penalties, expansion of assessment-periods, and more.

2. Taxpayers attempt to avoid these negative consequences by taking the position with the IRS that, while not perfect, the international information returns that they filed were at least "substantially compliant" or "substantially complete."

3. The Large Business and International division of the IRS trains its personnel in various ways, including the issuance of so-called International Practice Units ("IPUs"). They do not constitute legal

precedent, but many Revenue Agents give IPUs considerable weight in conducting audits, determining whether penalties apply, etc.[95]

4. The IRS issued a new IPU in May 2017 directed solely to the applicability of the substantially compliant/complete defense to a long list of international information returns.

B. Interpretation of the Guidance in the New IPU

1. Below is an interpretation of the guidance from the new IPU to the front-line IRS personnel tasked with deciding whether taxpayers should be subjected to international information return penalties:

   a. The existing IRS rulings regarding the concepts of substantial compliance and substantial completeness *only* apply to situations involving Forms 5471 and Forms 5472, because *only* the regulations for these two returns specifically mention such concepts. In all events, with one exception, all the IRS rulings in this area have concluded that the taxpayer filed a Form 5471 or Form 5472 that was *not* substantially compliant/complete.

   b. The judicial substantial compliance doctrine, which was created by judges through court decisions, and which usually involves tax returns, tax-related elections, and deductions, might apply to other international information returns.

   c. There is no guidance yet on whether this is true; therefore, if a Revenue Agent believes that a taxpayer has judicial substantial compliance, he cannot rely on his own discretion, experience, and profound factual knowledge of the situation. Instead, the Revenue Agent must consult the IRS "field" attorneys, who, in turn, will consult the relevant attorneys in the IRS National Office.

   d. In deciding whether to elevate a potential substantial compliance matter to the IRS attorneys, Revenue Agents will understand that, according to the IPU, *Prussner v. United States*, 896 F. 2d 218 (7th Cir. 1990) demonstrates that federal district courts and federal courts of appeal generally have applied the judicial substantial compliance doctrine much more narrowly than the Tax Court.

   e. In deciding whether to elevate a potential substantial compliance matter to the IRS attorneys, Revenue Agents will also understand that, according to the IPU, General Counsel Memo 36372 shows that the judicial substantial compliance doctrine might only apply to tax returns, not information returns.

[95] Jasper L. Cummings, Jr. "LB&I International Practice Units," *Tax Notes*, Nov. 23, 2015, p. 1077; Kristen A. Parillo and Jaime Arora, "IRS Plans to Release International Training Materials," *Tax Notes*, March 24, 2014, p. 1317.

f. If the judicial substantial compliance doctrine were to expand beyond Forms 5471 and Forms 5472, it is unclear to which international information returns, exactly, it would apply. The new IPU lists some international returns, but it omits other common ones, including Form 8938 and the FBAR.

VIII. IRS Starts to Use FATCA Weapons

A. Doubling the Accuracy Penalty

1. Section 6662(a) generally provides that, if there is a tax underpayment on any return, then the IRS may assert a penalty equal to 20% of the amount of such underpayment.

2. FATCA expanded this penalty regime by adding new Section 6662(b)(7), which says that any "undisclosed foreign financial asset understatement" can be grounds for an accuracy-related penalty.

3. To appreciate this new brand of penalty, one must turn to the related provision introduced by FATCA, Section 6662(j). It does the following:

    a. It defines an "undisclosed foreign financial asset understatement" as the portion of any understatement that is attributable to any transaction involving an "undisclosed foreign financial asset."

    b. It also describes the term "undisclosed foreign financial asset" as any asset with respect to which information was required to be reported to the IRS under various international tax provisions, but was not reported. The relevant provisions include: (i) Section 6048 (foreign corporations and partnerships); (ii) Section 6038B (transfers to foreign persons); (iii) Section 6038D (foreign assets); (iv) Section 6046A (foreign partnerships); and (v) Section 6048 (foreign trusts).

    c. It doubles the size of the penalty, providing that, in the case of any underpayment due to an "undisclosed foreign financial asset" the penalty jumps from 20% to 40% of the underpayment.

    d. The Instructions to Form 8938 contain the following examples:

        i. "You do not report ownership of shares in a foreign company on Form 8938 and you sold the shares in the company for a gain and did not report the gain on your income tax return."

        ii. "You do not report a foreign pension on Form 8938 and you received a taxable distribution form the pension plan that you did not report on your income tax return."

B. Extending Assessment Period in Cases of "Substantial Omissions"

1. FATCA added new Section 6501(c)(1)(A), which states that:

a. if a taxpayer omits from gross income an amount that should have been included, *and*

b. such amount exceeds 25% of the amount of gross income actually reported on the return, *or*

c. such amount is attributable to one or more SFFAs that should have been reported under Section 6038D, and exceeds $5,000,

d. then the tax may be assessed within six years of the time the relevant tax return was filed.

C. Extending Assessment Period for Three Years After Return Is Filed

1. Generally, under Section 6501(a), the IRS has three years from the time a taxpayer files his tax return to audit him and propose adjustments. There are various exceptions to the normal three-year rule.

2. One exception applies where a taxpayer fails to file an information return with the IRS regarding foreign assets, entities, or transfers. Section 6501(c)(8) *before* the enactment of FATCA stated the following:

a. "In the case of any information which is required to be reported to the Secretary *under Section 6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048*, the time for assessment of any tax imposed by [the Internal Revenue Code] with respect to any event or period or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported."

b. FATCA changed the preceding rule in two major ways:

i. First, Congress specifically (i) added Section 6038D (related to Form 8938) and (ii) added Sections 1295(b) and 1298(f) (related to the new Form 8621 for PFICs) as relevant international provisions.

ii. Second, Congress added the phrase "tax return," such that under Section 6501(c)(8) the IRS now has additional time to assess taxes and penalties with respect to any "tax return, event, or period" to which the omitted information relates. Thus, if an individual neglects to file the relevant international information return, then the assessment period essentially stays open indefinitely with respect to the *entire tax return*.

c. Notably, Section 6501(c)(8)(B), which was added in 2010 by separate legislation, clarifies that the extended assessment period applies, even if the taxpayer's failure to file the information return was unintentional. However, in such instances, the only open issues are those related to the information return itself, not the entire tax return to which the international information return should have been attached.

IX. IRS Sets Sights on Nonresident Aliens with U.S. Property

A. Overview of General Rules

1. Passive income (including rental income), generated by U.S. sources, not connected with a U.S. trade or business, and received by an NRA generally is subject to 30-percent income tax on the *gross* amount.[96]

2. This means that the so-called U.S. withholding agent (normally the renter, lessee, or property manager) must reserve a significant portion of the total income and send it to the IRS, as opposed to the NRA.

3. By comparison, an NRA who is engaged in a U.S. trade or business during a year is taxed at the normal graduated/progressive rates on *net* income; that is, after taking into account the deductions that are effectively connected with the business.[97]

B. Special Rules Exist for Certain Rental Real Estate

1. Section 871(d) provides that an NRA who obtains income from U.S. real property held for the production of income or from any interest in such property, which is not otherwise treated as income effectively connected with a U.S. trade or business, has the option of electing to treat all such income (including rental income) as effectively connected income.[98]

2. The main benefits of the Section 871(d) election for an NRA are that he can (i) essentially convert the passive renting of U.S. real property into an active trade or business for U.S. tax purposes, (ii) avoid a flat tax rate of 30 percent on gross income, effectuated by tax withholding at source, and (iii) claim a multitude of tax deductions related to the property.

3. Once an NRA makes a Section 871(d) election for one year, it remains in effect for all later years, unless the IRS gives permission to revoke it.[99]

4. An NRA who makes the Section 871(d) election reports income and deductions related to the U.S. real property on Schedule E (Supplemental Income and Loss from Rental Real Estate, Royalties, Partnerships, S Corporations, Estates, Trusts, REMICs, etc.) to Form 1040NR.

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[96] Section 871(a).
[97] Section 871(b); Section 873.
[98] Section 871(d); Treas. Reg. § 1.871-10.
[99] Section 871(d)(1); Section 871(d)(3); Treas. Reg. § 1.871-10(a).

C. How to Make the Section 871(d) Election

1. Section 871 is vague about how to make the relevant election, limiting itself to stating that it "may be made only in such manner and at such time as the [IRS] may by regulations prescribe."[100]

2. The regulations explain the election procedure in the following manner:

a. "An election made under this section without the consent of the [IRS] shall be made for a taxable year by *filing with the income tax return* required under Section 6012 and the regulations thereunder for such taxable year a *statement* to the effect that the election is being made. This statement shall include (a) a complete schedule of all real property, or any interest in real property, of which the taxpayer is titular or beneficial owner, which is located in the United States, (b) an indication of the extent to which the taxpayer has direct or beneficial ownership in each such item of real property, or interest in real property, (c) the location of the real property or interest therein, (d) a description of any substantial improvements on any such property, and (e) an identification of any taxable year or years in respect of which a revocation or new election under this section has previously occurred."[101]

D. Need for a Timely Tax Return

1. Section 874(a) generally provides that an NRA is not permitted to claim deductions, unless the NRA files a true, accurate, and timely Form 1040NR.[102] This includes deductions related to rental real estate that become available to NRAs after making a Section 871(d) election.

E. Recent TIGTA Report

1. NRAs are Buying Significant Amounts of U.S. Property

a. The TIGTA Report paints a fairly bleak picture about U.S. tax compliance. It begins by putting things into perspective, explaining that NRAs have purchased a significant amount of U.S. real property in recent years, a large portion of which is used to generate rental income. The TIGTA Report indicated that NRAs purchased $34.8 billion in 2013, $45.5 billion in 2014, $54.4 billion in 2015, and $43.5 billion in 2016.[103]

2. Four Main Categories of Non-Compliance

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[100] Section 871(d)(3).
[101] Treas. Reg. § 1.871-10(d)(1)(ii).
[102] Section 874(a); Treas. Reg. § 1.874-1(a); Treas. Reg. § 1.874-1(b).
[103] Treasury Inspector General for Tax Administration. Additional Controls Are Needed to Help Ensure that Nonresident Alien Individual Property Owners Comply with Tax Laws. Report No. 2017-30-048 (Aug. 23, 2017), pgs. 2-3. [TIGTA Report].

a. *First*, TIGTA discovered that lots of NRAs were claiming net income treatment on the annual Forms 1040NR, despite the fact that they never made a proper Section 871(d) election. TIGTA estimates that approximately 12,000 NRAs failed to comply with the Section 871(d) regulations in just one year.[104]

b. *Second*, TIGTA learned that some NRAs are double dipping, taking inconsistent tax positions in order to acquire two improper benefits. This is made possible, according to the TIGTA Report, because the IRS's systems do not adequately input or track the data about U.S. rental property that is supplied to the IRS in the first-year Section 871(d) election statement attached to Form 1040NR.

   i. The initial benefit is that certain NRAs deduct rental expenses annually and subject the remaining net income to the graduated tax rates, which are often less than the standard 30-percent withholding rates on gross income.

   ii. The additional benefit comes when the property is later sold. Some unscrupulous NRAs conveniently forget to reduce their basis in the property by the amount of the depreciation expenses that they took over the years, thereby diminishing the total gain when they sell the property.[105]

c. *Third*, some NRAs never file Forms 1040NR, never notify withholding agents that they should be subject to a 30 percent tax rate on gross income, and thus never pay any amount of U.S. income taxes on rental income from U.S. real property.[106]

d. *Fourth*, many withholding agents (*i.e.*, renters, lessees, and property managers) are doing a deplorable job of collecting taxes on behalf of the IRS and of meeting their information-reporting duties. Withholding agents must file Forms 1042-S (Foreign Person's U.S. Source Income Subject to Withholding) for each tax year in which rent is paid to NRAs, even when the NRA is exempt from withholding. They must also file Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons) if taxes were actually withheld from the rental payments and remitted to the IRS.

   i. The TIGTA Report indicates that non-compliance in this area is rampant. Indeed, only 3.6 percent of the NRAs owning U.S. real property who reported rental income and expenses on Schedule E of their Forms 1040NR were

[104] TIGTA Report at pgs. 7-8.
[105] TIGTA Report at pgs. 11-12.
[106] TIGTA Report at pgs. 18-19.

supported by a corresponding Form 1042-S filed by the withholding agent.[107]

3. Suggestions by TIGTA

a. The most important recommendation, made by TIGTA and embraced by the IRS, is to develop and implement a "***compliance initiative***" to address the problems caused by NRAs who do not properly report U.S. rental income.[108]

F. Solutions - Rectifying Matters with the IRS Before Enforcement Hits

1. Solutions for NRAs Who Filed Form 1040NR But Did Not Make Election

a. Making a Late Election Pursuant to Section 871 Regulations

i. NRAs can file an amended Form 1040NR within the designated period to retroactively make the Section 871(d) election, without seeking advanced permission from IRS.[109]

b. Making a Late Election Thanks to Section 9100 Relief

i. If an NRA is unable to file a retroactive election to cover all affected years because the first Form 1040NR was filed beyond the general refund-period contemplated by Section 6511(a), or if the NRA wants the explicit, advanced blessing of the IRS, another option remains: Seeking a PLR from the IRS pursuant to Treas. Reg. § 301.9100-3. This is commonly known as getting "Section 9100 relief."

ii. The IRS has discretion to grant reasonable extensions for filing certain elections.[110] The regulations provide that extension requests "will be granted" by the IRS when the taxpayer provides sufficient evidence to establish that (i) the taxpayer acted reasonably and in good faith, and (ii) granting the extension will not prejudice the interests of the U.S. government.[111]

2. Solutions for NRAs Who Never Even Filed Forms 1040NR

a. As indicated earlier, Section 874(a) generally deprives an NRA of the deductions related to U.S. rental property, unless he files a timely Form 1040NR.[112] The IRS can waive the timely-filing

[107] TIGTA Report at pgs. 15-16.
[108] TIGTA Report at pg. 20.
[109] Treas. Reg. § 1.871-10(d)(1)(i).
[110] Treas. Reg. § 301.9100-1(c).
[111] Treas. Reg. § 301.9100-1(c).
[112] Section 874(a); Treas. Reg. § 1.874-1(a); Treas. Reg. § 1.874-1(b).

duty, though, if the NRA demonstrates to the satisfaction of the IRS that, based on all the facts and circumstances, he acted reasonably and in good faith in failing to file a Form 1040NR.[113]

b. The IRS must consider the following factors in making a decision:

i. Whether the NRA voluntarily approaches the IRS before the IRS discovers the failure to file Form 1040NR;

ii. Whether the NRA was aware of his ability to file a "protective" Form 1040NR;

iii. Whether the NRA filed a Form 1040NR for earlier years;

iv. Whether, after exercising reasonable diligence (taking into account the experience and sophistication level of the NRA), he was understandably unaware of the duty to file Form 1040NR;

v. Whether the failure to file Form 1040NR was due to intervening events beyond the control of the NRA; and

vi. Whether other mitigating or exacerbating factors exist.[114]

X. New Procedures for Filing Late Forms 1120-F

A. Overview

1. Foreign corporations with limited activities in the United States, especially those with minimal international business experience, sometimes are unaware of their duty to file annual Forms 1120-F (U.S. Income Tax Return of a Foreign Corporation).

2. In addition to normal penalties for late filing, late payment, and failure to enclose required information returns, foreign corporations running afoul of their Form 1120-F duties face a formidable stick: The IRS disallows business-related deductions and credits to which the foreign corporations normally would have been entitled, such that they are essentially taxed on gross income, instead of net income.

3. Cognizant of the harshness of the deduction-and-credit disallowance rule, the IRS created an exception. The IRS will ignore tardiness in situations where a foreign corporation can demonstrate that it acted reasonably and in good faith ("Late-Filing Waiver").[115]

4. Inconsistencies have arisen over the years concerning where foreign corporations should submit requests for Late-Filing Waivers, the degree of scrutiny to be applied by the IRS, the number of years that must be

[113] Treas. Reg. § 1.874-1(b)(2).
[114] Treas. Reg. § 1.874-1(b)(2)(i) through (vi).
[115] Treas. Reg. § 1.882-4(a)(3)(ii).

addressed, etc. The IRS, in an effort to centralize and standardize the process, issued in February 2018 instructions for handling late Forms 1120-F and requests for Late-Filing Waivers ("Guidelines").[116]

B. Description of Applicable Law – Section 882

1. Broad General Filing Duty

a. A foreign corporation generally must file a Form 1120-F if it (i) was engaged in a U.S. trade or business, regardless of whether it derived any income that was effectively connected with such trade or business ("ECI"), (ii) has income, gains, or losses that are treated as if they were ECI, (iii) was not engaged in a U.S. trade or business, but had other US-source income that was not fully paid through tax withholding, (iv) is making a claim for refund, (v) is claiming the benefit of any deductions or credits, or (vi) needs to file a Form 8833 (Treaty-Based Return Position) to disclose to the IRS that it is taking the position that a tax treaty overrules or modifies the normal rules found in the Internal Revenue Code.[117]

2. Disallowance of Deductions and Credits

a. Section 882 generally allows foreign corporations that derive ECI to be taxed at the rates applicable to domestic corporations on "taxable income."[118] In determining "taxable income," foreign corporations (i) include only the amount of gross income that is ECI, and (ii) then reduce such amount by claiming all allowable deductions and credits.[119]

b. Section 882(c) and the corresponding regulations allow foreign corporations to claim such tax benefits *only if* they file proper, timely Forms 1120-F with the IRS.[120]

C. IRS Waiver of "Timely" Filing Requirement

1. The IRS can grant a Late-Filing Waiver, thereby allowing a foreign corporation to claim deductions and credits, under certain circumstances.

2. Current Rules and Standards

a. The regulations begin by explaining that the IRS will not grant a Late-Filing Waiver if the foreign corporation "knew" it had a duty to file Form 1120-F but "chose not to do so."[121] Moreover, the regulations clarify that a condition to getting a Late-Filing Waiver

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[116] Internal Revenue Service. "LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. § 1.882-4(a)(3)(ii)." February 1, 2018.
[117] 2016 Instructions for Form 1120-F (U.S. Income Tax Return of a Foreign Corporation), pg. 2.
[118] Section 882(a).
[119] Section 882(b); Section 882(c)(1)(A); Treas. Reg. § 1.882-4(a)(2).
[120] Section 882(c)(2); Treas. Reg. § 1.882-4(a)(2).
[121] Treas. Reg. § 1.882-4(a)(3)(ii).

is cooperation by the foreign corporation in the process of determining its income tax liability for the relevant years.[122] Finally, a foreign corporation is ineligible for a Late-Filing Waiver if it has a "permanent establishment" in the United States, as this term is used in treaties.[123]

b. With those preliminaries out of the way, the current regulations provide that the IRS will permit a Late-Filing Waiver if the foreign corporation can demonstrate that, in light of the relevant facts and circumstances, it acted "reasonably and in good faith" in failing to file a timely Form 1120-F or "protective" Form 1120-F.[124]

c. The IRS must consider the following list of factors in deciding whether a foreign corporation meets the current standard for relief:

i. Whether the foreign corporation voluntarily identifies itself to the IRS as having failed to file a Form 1120-F before the IRS discovers the issue;

ii. Whether the foreign corporation did not become aware of its ability to file a "protective" Form 1120-F by the normal deadline;

iii. Whether the foreign corporation has previously filed a Form 1120-F;

iv. Whether the foreign corporation failed to file a Form 1120-F because, after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the foreign corporation was unaware of the necessity;

v. Whether the foreign corporation failed to file a Form 1120-F because of intervening events beyond its control; and

vi. Whether other mitigating or exacerbating factors exist.[125]

D. <u>New IRS Guidelines about Late-Filing Waiver</u>

1. Centralized Filing

a. Perhaps the most significant revelations by the Guidelines are that (i) Revenue Agents and others working on the compliance side of the IRS generally will not entertain late Forms 1120-F filed directly with them, and (ii) late Forms 1120-F will effectively be subjected to some form of an audit.

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[122] Treas. Reg. § 1.882-4(a)(3)(ii).
[123] Treas. Reg. § 1.882-4(a)(3)(v).
[124] Treas. Reg. § 1.882-4(a)(3)(ii).
[125] Treas. Reg. § 1.882-4(a)(3)(ii)(A) through (F).

b. The Guidelines divide situations into two main categories.

i. Scenario 1 contemplates a foreign corporation that is not currently under audit, which voluntarily approaches LB&I about its unfiled Forms 1120-F for prior years. Here, the Guidelines tell LB&I personnel to instruct the foreign corporation to file late Forms 1120-F in the regular manner, pursuant to the Instructions to Form 1120-F.

ii. Scenario 2 arises when LB&I gets assigned to audit a foreign corporation with respect to a late Form 1120-F. The actions of LB&I depend on whether the foreign corporation has already filed a request for a Late-Filing Waiver. If this has occurred, then the Exam should develop the facts relevant to the request for a Late-Filing Waiver, reach a recommendation to grant or deny such request, and then follow the recommendation-processing rules described below.[126] Conversely, if the foreign corporation has not previously filed a request for a Late-Filing Waiver, then the Exam Team is supposed to notify the foreign corporation in writing of its ability to do so. If the foreign corporation decides to submit a request for a Late-Filing Waiver, then the Exam Team should develop the facts, decide whether to grant or deny such request, and then follow the recommendation-processing rules.

2. Interesting Issues

a. Did Somebody Say Amnesty?

i. It seems that most everybody has forgotten that this is not a new issue. The IRS stated approximately two decades ago in PMTA 2007-00131 that it was inappropriate to offer any type of amnesty to foreign corporations with unfiled Forms 1120-F and NRAs with unfiled Forms 1040-NR. The IRS had a change of heart in 2003, though, when it announced a "compliance initiative" in Notice 2003-38.

ii. The Guidelines, issued in February 2018, are <u>*not*</u> a rehash of the "compliance initiative" from 2003. Indeed, they do not offer any guarantee that a foreign corporation will be granted a Late-Filing Waiver, latitude on the applicable standard, limitation on the number of past years for which Forms 1120-F must be filed, etc. The Guidelines solely

[126] Internal Revenue Service. "LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. § 1.882-4(a)(3)(ii)." February 1, 2018. Section IV – Processing the Exam Team's Recommendation on a Request for Waiver.

provide a set of rules for foreign corporations and IRS personnel to follow in the case of Form 1120-F violations.

b. Penalties Anyone?

i. The Late-Filing Waiver allows a foreign corporation to escape the harsh treatment contemplated by Section 882(c)(2); that is, paying U.S. taxes on gross income effectively connected with a U.S. trade or business, without the benefit of many deductions and credits. This is beneficial to a foreign corporation, no doubt, but it is far from *carte blanche*. Foreign corporations that file late Forms 1120-F often are subject to other penalties, some of which are described below.

(a) Delinquency Penalties

(1) Under Section 6651(a), the IRS generally may assert delinquency penalties if a taxpayer fails to file returns and/or fails to pay taxes by the deadline (including extensions). The IRS may not assert penalties, however, if the taxpayer shows that the violation was due to "reasonable cause" and not due to "willful neglect."[127]

(b) Failure to Disclose Treaty Position

(1) Certain U.S. persons generally are required to file a Form 8833 to notify the IRS that they are taking a position that a provision in a treaty to which the United States is a party overrules or modifies a provision of the Internal Revenue Code during the relevant year.[128] The IRS generally may assert a penalty of $1,000 for each violation. This sanction increases to $10,000 in the case of a C corporation.[129] This penalty will not be asserted, however, where there is "reasonable cause" for the violation and the taxpayer acted in good faith.[130]

(c) Failure to File Forms 5472

[127] Section 6651(a); Treas. Reg. § 301.6651-1(a)(1).
[128] Section 6114; Treas. Reg. § 301.6601-1(a).
[129] Section 6712(a); Treas. Reg. § 301.6712-1(a).
[130] Section 6712(b); Treas. Reg. § 301.6712-1(b).

(1) Form 5472 generally must be filed to disclose "reportable transactions" between a "reporting corporation" and "related parties," as these terms are specifically defined for purposes of Section 6038A.[131] The general penalty is $10,000 per violation.[132] However, if the reporting corporation acted in "good faith" and there is "reasonable cause" for not filing a Form 5472, then the IRS will waive the $10,000 penalty.[133]

c. Silence Is Ominous

i. The standard for achieving a Late-Filing Waiver is “reasonable cause” and “good faith.” This is identical or very similar to the thresholds for obtaining abatement of delinquency penalties, Form 8833 penalties, and Form 5472 penalties. Therefore, logic dictates that, if the IRS were to grant a Late-Filing Waiver after reviewing the six criteria set forth in the regulations (*i.e.*, Treas. Reg. § 1.882-4(a)(3)(ii)), then the IRS should also eliminate the potential penalties on the following grounds:

(a) First, thanks to the Late-Filing Waiver, the Form 1120-F is not considered delinquent, such that any tax payments triggered by the Form 1120-F and any international information returns enclosed with Form 1120-F should not be deemed late either.

(b) Second, if the IRS has concluded that a foreign corporation has acted reasonably and in good faith with respect to Form 1120-F, then it should reach the same conclusion with respect to all related payment and filing issues.

ii. The Guidelines do not mention or cross-reference penalties; there is silence on this critical issue.

XI. Latest and Greatest in “Willful” FBAR Penalty Cases

A. <u>Victories for U.S. Government</u>

1. *United States v. Williams* (2012)

2. *United States v. McBride* (2012)

[131] Section 6038C(a); Treas. Reg. § 1.6038A-1(c)(1).
[132] Section 6038A(d)(1); Treas. Reg. § 1.6038A-4.
[133] Section 6038A(d)(3); Treas. Reg. § 1.6038A-4(b)(1).

3. *United States v. Bussell* (2015)

4. *United States v. Bohanec* (2016)

5. *United States v. Kelley-Hunter* (2017)

6. *United States v. Markus* (2018)

7. *Norman v. United States* (2018)

8. *United States v. Toth* (2018)

9. *United States v. Marsteller* (2018)

10. *United States v. Garrity* (2018)

11. *Kimble v. United States* (2018)

12. *United States v. Horowitz* (2019)

B. Lessons Learned So Far from Willful FBAR Cases

1. The cases cited above stand for the following general propositions:

a. The Tax Court lacks jurisdiction over FBAR penalty matters, in both pre-assessment and post-assessment (*i.e.*, collection) cases. Therefore, FBAR litigation will take place in the appropriate District Court or the Court of Federal Claims.

b. The standard for maximum FBAR penalties is "willfulness."

c. The government must only prove willfulness by a preponderance of the evidence, not by clear and convincing evidence.

d. The government can establish willfulness by showing that a taxpayer either knowingly or recklessly violated the FBAR duty.

e. Recklessness might exist where a taxpayer fails to inform his accountant about foreign accounts.

f. Recklessness might also exist where a taxpayer is "willfully blind" of his FBAR duties, which can occur when the taxpayer executes but does not read and understand every aspect of a Form 1040, including all Schedules attached to the Form 1040 (like Schedule B containing the foreign-account question) and any separate forms referenced in the Schedules (like the FBAR).

g. If the taxpayer makes a damaging admission during a criminal trial, the government will use such statement against him in a later civil FBAR penalty action.

h. The taxpayer's motives for not filing an FBAR are irrelevant, because nefarious, specific intent is not necessary to trigger the highest FBAR civil penalty.

i. The government can prove willfulness through circumstantial evidence and inference, including actions by the taxpayer to conceal sources of income or other financial data.

j. In determining whether an FBAR violation was willful, courts might consider after-the-fact unprivileged communications between taxpayers and their tax advisors.

k. The IRS might adhere to its Interim Guidance, thereby limiting the total willful FBAR penalty to 50 percent of the highest balance of the unreported accounts, spread over all open years.

l. The courts review the question of willfulness on a *de novo* basis, which means that taxpayers generally cannot offer evidence at trial related to the IRS's administrative process in conducting the audit, determining whether willfulness existed, etc.

m. Courts might reject as irrelevant, in an evidentiary sense, reports and testimony from tax practitioners that attempt to make a link between general public unawareness of FBAR duties and particular ignorance of the taxpayer under attack.

n. Depending on the circumstances, the U.S. government might be able to ensnare a taxpayer in four different, stressful, costly, and time-consuming cases at one time, including those for (i) income taxes, accuracy-related or civil fraud penalties, (ii) assessable international information return penalties, (iii) FBAR penalties, and (iv) estate taxes.

o. Courts might give credence to the argument that age-related mental conditions preclude a finding of willfulness.

p. While the IRS undeniably has authority to impose FBAR penalties, it is unclear whether it is empowered to extend the relevant assessment periods.

q. Rooted in *Colliot* and other District Court cases in which taxpayers are raising similar arguments, courts might cap willful FBAR penalties at $100,000 per violation, unless and until the regulations are changed to match current law.

C. <u>Recent Taxpayer Victories</u>

1. *Bedrosian v. United States* (2017)

a. Court determined that taxpayer was "negligent" but not "willful" despite the following facts:

i. He is a lifelong U.S. citizen

ii. He earned undergraduate and law degree

iii. He was CEO of a pharmaceutical company

iv. He held accounts at a tainted/facilitator bank, UBS

v. He met with UBS bankers periodically

vi. He did not file FBARs until UBS notified about disclosure

vii. He filed FBAR for first time in 2007, and it was inaccurate

viii. He reported small account on FBAR, while omitting large

ix. He failed to report account income for about four decades

x. He did not inform CPA about accounts for over 20 years

xi. He supposedly relied on bad advice of CPA, who was conveniently dead and thus unable to testify

xii. He moved funds from UBS to another foreign bank

b. Remanded by Third Circuit Court of Appeals to District Court in 2018. *Bedrosian v. United States*, 122 AFTR 2d 2018-7052 (3rd Cir. 2018)

2. *United States v. Colliot* (W.D. Tex. May 16, 2018).

a. This case essentially held that the IRS could not assert an FBAR penalty exceeding $100,000 per violation, even if such violation were willful, because the relevant regulations (which indicate the size of the penalty) were not properly updated to correspond to the changes made by Congress in 2004 to 31 U.S.C. § 5321(a)(5).

3. *United States v. Flume* (S.D. Tex. Aug. 22, 2018)

a. The IRS assessed against Mr. Flume penalties for "willfully" failing to file an FBAR to report the UBS account held by the foreign corporation. Mr. Flume refused to pay the penalties, and the DOJ started a collection lawsuit against him in District Court.

b. The DOJ filed a Motion for Summary Judgment, asking the District Court to rule, without even conducting a trial, that Mr. Flume "willfully" violated his FBAR duties.

c. The District Court refused to grant the Motion for Summary Judgment filed by the DOJ, so the case will proceed to trial. Mr. Flume might still lose at trial, but the published decision by the District Court regarding the Motion for Summary Judgment might help all taxpayers. Specifically, it held that the DOJ cannot win an FBAR case based solely on "constructive knowledge;" the DOJ will need to prove that the taxpayer either (i) had actual knowledge, or (ii) acted with reckless disregard. Below are some reasons why the District Court rejected the "constructive knowledge" position:

i. First, the constructive-knowledge theory ignores the distinction that Congress drew between willful and non-willful FBAR violations: "If every taxpayer, merely by signing a tax return, is presumed to know the need to file an FBAR, it is difficult to conceive of how a violation could be non-willful."

ii. Second, the constructive-knowledge theory is "rooted in faulty policy arguments."

(a) "[T]here is no policy need to treat constructive knowledge as a substitute for actual knowledge . . . Accordingly, the Court will not hold that [Mr. Flume] had constructive knowledge ---and that he owes the Government more than half a million dollars--- merely because he signed his tax returns under penalties of perjury. The Government has thus failed to conclusively establish that [Mr. Flume] was willful on the ground that he knowingly disregarded his FBAR obligations."

XII. Alarming Rules for Foreign Retirement Plans

A. Introduction

1. More Americans than ever before will work abroad at some point in their careers. The responsible ones will gain valuable professional experience, learn the local language, and save for the future, likely by participating in a foreign workplace retirement plan, which they believe to be similar to a Section 401(k) plan in the United States.

2. Most U.S. taxpayers, and way too many U.S. tax advisors, make the crucial mistake of thinking that the IRS treats foreign retirement plans just like domestic ones. It does not.

3. Based on a recent study by the U.S. Government Accountability Office ("GAO Report") criticizing the IRS and Congress for allowing the perpetuation of a complex, obscure, and inconsistent system, this outline

explains the surprising rules for U.S. individuals with interests in foreign workplace retirement plans and proposes solutions for solving unintentional violations.[134]

B. Main Points from GAO Report

1. Different U.S. Tax Treatment of Domestic and Foreign Plans

a. The GAO Report starts by underscoring the size of the problem; there are nearly nine million U.S. citizens living abroad, many of whom have interests in local retirement instruments.[135]

b. It then describes the distinct manner in which the U.S. tax system treats domestic versus foreign retirement plans. The GAO Report explains that, in the United States, contributions by employees, contributions by employers, and passive earnings (such as interest, dividends, and capital gains) within a "qualified" retirement plan generally are *not* taxed until the employee receives actual distributions from the plan.[136]

c. By contrast, the GAO Report explains that foreign workplace retirement plans ordinarily are not considered "qualified" plans under the Internal Revenue Code, so American expatriates working as employees do not enjoy the same benefits as their counterparts with "qualified" domestic plans. Depending on several factors, including the characteristics of the plan, the local law, and the provisions in the applicable bilateral treaty, U.S. individuals who participate in foreign retirement plans might be currently taxed on (i) contributions made to the plans, by themselves or their employers, (ii) the accrued-but-undistributed earnings in the plans, and (iii) distributions from the plans that they have not actually received, such as transfers between various foreign plans.[137]

2. IRS Guidance Is Insufficient and Unclear

a. The GAO Report acknowledges that the IRS has provided some limited guidance about foreign workplace retirement plans, such as the International Tax Gap Series and Publication 54, titled "Tax Guide for U.S. Citizens and Resident Aliens Abroad."

b. However, the GAO Report explains that neither item "describes in detail how taxpayers are to determine if their foreign workplace retirement plan is eligible for tax-deferred status, or how to

[134] U.S. Government Accountability Office. Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings. GAO-18-19 (Jan. 2018).
[135] GAO Report, at pg. 3.
[136] GAO Report, at pgs. 11-12.
[137] GAO Report, at pgs. 12-14.

account for contributions, earnings, or distributions on their annual U.S. tax return, particularly whether and when contributions and earnings should be taxed as income."[138]

c. The GAO Report also indicates that, while the IRS directs taxpayers to review the relevant bilateral tax treaties for any provisions related to foreign pensions, even IRS officials admit that "these treaties can vary from country to country and . . . can be difficult for nonexperts to understand."[139]

d. The GAO Report confirms the IRS's positions that foreign workplace retirement plans generally are *not* considered "qualified" plans for U.S. tax purposes and thus are *not* entitled to the corresponding tax benefits.[140]

e. The lack of clarity from the IRS has created disagreement among U.S. tax practitioners about how to treat foreign plans. According to the GAO Report, some practitioners advise clients to report them as passive foreign investment companies ("PFICs") on Forms 8621, others recommend disclosing them as foreign financial accounts on FBARs and Forms 8938, while still others treat them as foreign trusts reported on Forms 3520 and Forms 3520-A.[141]

f. To exacerbate matters, the GAO Report explains that "receiving incorrect tax advice from a *foreign* tax preparer may not be a sufficient mitigating circumstance to avoid penalties for reporting a foreign retirement account incorrectly on a tax return [because] tax preparers in other countries are usually not considered qualified preparers by IRS."[142]

3. <u>Transfers Generally Trigger Immediate Taxation</u>

a. A major issue addressed by the GAO Report, but unknown to many U.S. individuals and tax practitioners, is that changing jobs and transferring (*i.e.*, "rolling over") savings from one foreign workplace retirement plan to another likely triggers immediate U.S. taxation.[143] The IRS acknowledges that such movements of money generally do not undermine tax-deferred status in the foreign country where the plan is located, but this does not alter the fact that the U.S. tax system views it differently:

[138] GAO Report, at pg. 37.
[139] GAO Report, at pg. 37.
[140] GAO Report, at pgs. 38-39.
[141] GAO Report, at pgs. 38-39.
[142] GAO Report, at pg. 39.
[143] GAO Report, at pg. 46.

i. "IRS generally considers routine administrative transfers of retirement assets that occur between or within foreign retirement plans to be distributions to the participant and therefore taxable income . . . [T]he transfers would generally constitute a "constructive receipt of funds" by the participant and would be reportable and taxable. As a result, a U.S. individual who participates in a foreign retirement plan could owe U.S. tax on the entire amount of their retirement savings when they separate from their employer and their account is transferred to another account within the plan or to a different workplace retirement plan."[144]

C. <u>Examples of IRS Treatment of Foreign Retirement Plans</u>

1. <u>Swiss Retirement Plans</u>

a. The IRS released in November 2017 a legal memo dealing with retirement instruments in Switzerland.[145] The taxpayer in the memo worked in the United States, had an employer-established U.S. pension, was terminated from her job, accepted a new position and moved to Switzerland, transferred the funds from the U.S. pension to a Swiss "libre passage" account (which the taxpayer argued was analogous to a tax-deferred Individual Retirement Account), did not report on Forms 1040 any accumulated-but-undistributed gain within the Swiss retirement account or any distributions from such account, and, presumably, did not report the account on all necessary U.S. international information returns, such as Form 8938, FBAR, and more.

b. The IRS concluded the following in the memo:

i. The transfer from the U.S. pension to the Swiss account was not a tax-free, qualified rollover, such that the taxpayer should have been taxed on the total amount relocated;

ii. The taxpayer should have reported on her annual Forms 1040 all accumulated-but-undistributed gains within the account and all distributions from the account;

iii. The tax treaty in effect between the United States and Switzerland "provides no exceptions or relief;" and

iv. Because the Swiss account was not compliant with U.S. law, the taxpayer must include the value of such account in the "offshore" penalty calculation.

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[144] GAO Report, at pgs. 47-48.
[145] 2017-97023, Tax Notes (November 21, 2017)

v. In what tax practitioners might label as one the biggest understatements in recent memory, the legal memo concludes that "[t]he facts of this case are sympathetic in that the rules relating to foreign pension accounts are not intuitive, *and we anticipate that the taxpayer's representatives will not be pleased with the conclusion in this memorandum*."

2. Australian Retirement Plans

a. Taxpayers and practitioners have sought guidance and a remedy from the IRS for many years with respect to a common retirement vehicle, the Australian Superannuation Fund ("ASF"), by sending letters underscoring the inconsistent tax treatment provided by the U.S. and Australian tax authorities, and the lack of specific language in the US-Australian treaty to correct the issue.[146]

b. Neither Congress nor the IRS is heeding the call for change. In 2017, the IRS released a portion of the written guidance that it provides to personnel answering calls from taxpayers on the so-called "voluntary disclosure hotline."[147] The IRS guidance instructs personnel to say the following with respect to ASFs:

i. Unlike certain retirement plans in Canada, ASFs are not covered by a favorable treaty provision;

ii. The voluntary disclosure programs offered by the IRS do not have special provisions for ASFs;

iii. The highest value of ASFs that are not compliant with U.S. tax and/or information-reporting obligations will be subject to the "offshore" penalty; and

iv. ASFs must be reported on various international information returns, including, but not limited to, Forms 3520 and Forms 3520-A related to foreign trusts.

D. Violations Keep Assessment Periods Open

1. A relatively obscure procedural provision, Section 6501(c)(8)(A), contains a powerful tool for the IRS.

2. It generally states that where a taxpayer fails to file in a timely manner a long list of international information returns (*e.g.*, Forms 926, 3520, 3520-A, 5471, 5472, 8621, 8858, 8865, and 8938) the assessment period

[146] "Remedy Sought for Taxation of Retirement Funds in Australia," 2016 Tax Notes Today 178-29; Document 2016-18374 (Aug. 26, 2016).
[147] "IRS Releases OVDP, Streamlined Program Hotline Guide," 2017 Worldwide Tax Daily 160-16; Document 2017-66433.

remains open "with respect to any tax return, event, or period" to which the information return relates, until three years after the taxpayer ultimately files the information return.

3. Thus, if a taxpayer never files information returns that might be applicable to foreign workplace retirement plans, such as Forms 8938, Forms 3520, Forms 8621, etc., the general three-year assessment period never starts.

XIII. Government Pursuing Executors, Representatives, Fiduciaries, Beneficiaries, Distributees, and Others for FBAR Penalties Assessed against Deceased Taxpayers

A. Initial Observations

1. Death generally does not relieve a taxpayer of the obligation to pay FBAR penalties, and the burden often falls on family. This is because the IRS and DOJ are now raising, and the District Courts are largely accepting, creative theories for pursuing payment from a long list of parties.

2. These include, but are not limited to, executors, court-appointed and *de facto* representatives, beneficiaries, surviving spouses, distributees, fiduciaries, trustees, and recipients of fraudulent transfers.

3. Attention in recent years has focused on an arguably sexier issue, which is what, exactly, constitutes a "willful" violation in the FBAR context. However, an equally important issue, is who will be legally responsible for paying the tab if a taxpayer against whom the willful FBAR penalties were assessed dies.

B. Five Important, Recent Cases about Expansive Liability

1. *United States v. Estate of Steven Schoenfeld and Robert Schoenfeld, a distributee of the Estate of Steven Schoenfeld*, M.D. D.C. Fla. Case No. 3:16-cv-1248-J-34PDB (2018).

a. The Original Complaint named only Steven as a defendant, and it was filed with the District Court in a timely manner, within two years of the assessment of the FBAR penalty. By contrast, the Amended Complaint named the Estate and Son (as a distributee of the Estate) as defendants, and it was filed late, after the expiration of the applicable two-year period.

b. Issues Addressed by the District Court

i. The first issue was whether a deceased individual, like Steven, can be a defendant in an FBAR penalty collection lawsuit. The District Court swiftly dispensed with this matter, stating that "[u]nder Florida law, a decedent lacks the capacity to be sued . . . Thus, there is no dispute that this action could not proceed against [Steven]."

ii. The second issue was whether the Original Complaint is a legal nullity or an amendable document, and if it is the latter, does the Amended Complaint "relate back" to the date on which the Original Complaint was filed?

iii. The third issue is the validity of the new legal theories raised by the DOJ for liability of Steven's estate or son. The Amended Complaint explains the following grounds for pursuing these two new defendants: (i) The claim against Steven is enforceable against his Estate pursuant to 28 U.S.C. § 2404, which says that certain civil actions survive the death of a taxpayer and can be enforced against his or her estate; and (ii) The claim against Steven is also enforceable against Son because he is the closest living relative, and, upon Steven's death, he inherited all Steven's assets. The DOJ added yet another theory; that is, even if the first two grounds described in the Amended Complaint fail, the DOJ may nevertheless proceed against the Estate and Son on equitable principles.

iv. The final issue is whether the cause of action against Steven for collection of FBAR penalties assessed against him during his lifetime disappears, or "abates," upon his death. This would occur if the FBAR penalty were considered to be penal/criminal in nature, instead of remedial/civil.

c. Summary of Holdings by the District Court

i. "In sum, the Court finds that the Original Complaint was not a legal nullity which rendered this action void *ab initio*, and therefore, could be cured by amendment."

ii. "The Amended Complaint, filed by the [DOJ] as a matter of right, relates back to the date of the filing of the Original Complaint and as such is not barred by the statute of limitations."

iii. "Additionally, although the [DOJ] cannot state a claim against the Estate under [28 U.S.C. § 2404], it has stated a claim against [Son] as a distributee of the Estate."

iv. "Finally, the Court finds that the [DOJ's] claim did not abate upon [Steven's] death."

2. *United States v. David Moser and John Moser, Co-Executors of the Estate of Walter Moser*, D.C. N.J. Civil Action No. 2:17-cv-02891 (2017).

a. DOJ is seeking FBAR penalties from co-executors of the estate.

3. *United States v. Diana M. Garrity, Paul G. Garrity, Jr., and Paul M. Sterczala, as fiduciaries of the estate of Paul G. Garrity, Sr., deceased*, D.C. Conn. Case No. 3:15-cv-243 (2018)

   a. DOJ is seeking FBAR penalties from co-fiduciaries of the estate.

4. *United States v. Nancy E. Kelley, individually and as representative of the Estate of Burt Hunter*, 120 AFTR 2d 2017-5566 (D.C. Dist. Col. 2017).

   a. DOJ is seeking FBAR penalties from representative of the estate and surviving spouse.

5. *United States v. Jung Joo Park, individually and as trustee of the Que Te Park Declaration of Trust and as the De Facto representative of the estate of Que Te Park; John Doe, as personal representative of the Estate of Que Te Park; Charles Park, individually, and as successor co-trustee of the Que Te Park Declaration of Trust; James Park, individually and as successor co-trustee of the Que Te Park Declaration of Trust; and Nina Park, individually, and as successor co-trustee of the Que Te Park Declaration of Trust*, N.D. Ill. Civil Case No. 16 C 10787 (2017).

   a. DOJ is seeking FBAR penalties from trustees, de facto representatives, personal representatives, and successor co-trustees of the estate.

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