# The IRS Is Looking For Non-Compliant Taxpayers With Foreign Interests: Is Your Taxpayer One Of Them?

Josh O. Ungerman and Anthony P. Daddino

**"Each year, in the United States alone, offshore tax evasion produces an estimated $100 billion in unpaid taxes that could help pay for health care, education, and more. It's time to put an end to offshore tax dodging that robs the U.S. Treasury of needed funds." —Statement of Senators Carl Levin (D-Mich.) Norm Coleman (R-Minn.), March 6, 2008.**

**When George Washington warned against "foreign entanglements," he probably didn't have taxes in mind. But today's taxpayers have to consider taxes as one of the risks of such "entanglements."**

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**THE PROBLEM WITH NON-COMPLIANT U.S. TAXPAYERS** is that, often times, their tax return and related forms fail to disclose both the existence of a foreign interest and the amount of realized income from interest. The IRS may view these actions as the omission of income and the concealment of its source. When the IRS takes this position, a criminal investigation/prosecution may be in a taxpayer's imminent future.

The solution for non-compliant U.S. Taxpayers may be a voluntary disclosure. Generally, if the IRS has not instituted an examination or investigation of a non-compliant U.S. taxpayer, the taxpayer may enter into a vol-

untary disclosure with the IRS. Many tax practitioners believe a voluntary disclosure is amnesty by the IRS. This is a common misconception. Instead, a voluntary disclosure is treated by the IRS as a "factor to be considered" in determining whether to pursue criminal prosecution of a non-compliant taxpayer. In practice, however, voluntary disclosures completed by experienced criminal tax practitioners have rarely been challenged criminally by the IRS.

**BACKGROUND** • Once reserved for wealthy and institutional investors, offshore investing has entered the mainstream. Proof of this trend is evident from the foreign taxes being reported by U.S. taxpayers. From 1987 to 2001, the amount of foreign taxes increased from $2.8 billion to $9.2 billion, and has undoubtedly reached new heights in 2008. *IRS Statistics of Income Studies of International Income and Taxes*. It is no wonder that the IRS is focusing heavily on international issues, which comprise nearly half of the IRS' Tier 1 compliance issues.

One of the most troublesome issues in this area is a genuine lack of familiarity on the part of the tax community with the reporting rules. The purpose of this article is to give the tax practitioner the lay-of-the-land for reporting requirements relating to investments abroad. (As with most tax legislation and regulations, highly technical conditions and exceptions apply, and a full discussion of every specific rule is outside the scope of this survey.)

**THRESHOLD QUESTION: IS THE TAXPAYER A "U.S. PERSON"?** • The threshold question is whether the taxpayer is a "U.S. Person." A "U.S. Person" is generally defined as a U.S. citizen or resident or domestic entity (corporation, partnership, estate, trust, etc.). Internal Revenue Code ("Code") §7701(a)(30). (All section references are to the Code unless otherwise indicated.)

There are two types of U.S. residents. The first type is the lawful permanent resident, which is a foreign person who has received a U.S. green card. The second type is the substantially present resident. This is a person who is present in the United States for 183 days either (i) during the current year, or (ii) over the past three years based on the following formula: (A) number of days present during the current year, plus (B) number of days present in prior year multiplied by 1/3, plus (C) number of days present two years ago multiplied by 1/6.

What about taxpayers who disclaimed their U.S. citizenship or terminated their residency status? Are these persons free and clear of the foreign-interest reporting rules? Not necessarily. Regardless of their status under immigration law, a taxpayer is still treated as a U.S. citizen or resident for tax purposes until proper notice is given to both the Department of State (or Homeland Security) *and* the IRS. Special tax rules under section 877 also apply.

**NAVIGATING THE MINEFIELD OF INTERNATIONAL TAX REPORTING** • There is a plethora of reporting rules applicable to the organization, ownership, maintenance, and/or transfer of various types of foreign interests.

### Is The Taxpayer *Aware* Of Any Account Outside The United States?

This question may be exaggerated, but only slightly. As discussed below, the reporting requirements applicable to foreign accounts are incredibly expansive, and carry severe penalties for taxpayers who fail to comply.

#### *FBAR Rules*

One would search endlessly through the Code to find the FBAR rules. That is because these rules are not found in the Code. Rather, they are set forth in the Bank Secrecy Act, first enacted by Congress in 1970. Since 2003, however, the IRS bears responsibility for enforcing these rules.

The FBAR rules require that every U.S. Person report (i) any financial interest or authority over a (ii) financial account in a foreign country with (iii) an aggregate value over $10,000 at any time during the taxable year. The report must be filed on a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (hence the acronym "FBAR"). U.S. Persons must also disclose the existence of the account on their Form 1040, Schedule B, Part III. This is commonly referred to as "checking the 'B' box."

**Trap For The Unwary**: *Taxpayers who fail to disclose the account on their Form 1040 could be subject to criminal sanctions for filing a false tax return.*

**Practice Tip:** *Contact an experienced criminal tax practitioner to determine if a non-compliant U.S. Person could qualify for an IRS voluntary disclosure.*

The FBAR report is due on one of the least intuitive dates in federal tax law: June 30th. This due date is *not* subject to extensions. To further complicate matters, the FBAR report must be filed separately from the U.S. Person's tax return.

### *Financial Interest Or Authority*

A U.S. Person has a financial interest in a foreign account if he or she is the legal or beneficial owner. Attribution rules apply in making this determination. Thus, a person serving as a shareholder, partner, and trustee may also be deemed to hold a financial interest if the owner of the account is (i) a person acting as an agent on behalf of the U.S. Person, (ii) a corporation where the U.S. Person owns, directly or indirectly, more than 50 percent of the outstanding stock, (iii) a partnership in which the U.S. Person owns more than 50 percent of the profits, or (iv) a trust in which a U.S. Person has either a present interest in more than 50 percent of the assets or from which the U.S. Person receives more than 50 percent of the income. If these thresholds are met, the U.S. Person has an FBAR reporting obligation, regardless of whether he or she has any *authority* over the account.

Non-owners with *authority* over a foreign account are also subject to the FBAR reporting rules. *Authority* means the U.S. Person has the ability to order a distribution or disbursement of funds or other property held in the account. This is not limited to signature authority, but includes the ability to order distributions by verbal commands or other communication. *Authority* does *not* include persons who have the right to invest, but not distribute, the foreign account funds.

There is no limitation for taxpayers who have *authority* over a foreign account, but only in an official capacity. For example, the president of a corporation, the general partner of a partnership, or the manager of an LLC could all fall subject to these rules. In these instances, both the entity, as beneficial owner, and the representative, who has control over the account, may be required to file an FBAR report. Similarly, when more than one U.S. Person has authority over an account, i.e., president and vice president, both persons may have an FBAR reporting obligation.

**Trap For The Unwary**: *Even when the account is subject to joint control, and the signature of someone other than the taxpayer is required to cause a distribution, the taxpayer is still considered to have authority over the account for FBAR reporting purposes.*

### *Financial Account In A Foreign Country*

The term *financial account* is broadly defined as any asset account and encompasses simple bank accounts (checking or savings), as well as securities or custodial accounts. It also includes a life insurance policy or other type of policy with an investment value (i.e., surrender value). *Foreign country* naturally refers to any country other than the United States. Puerto Rico, U.S. possessions and territories are included as part of the United States (as they should) for these purposes. Thus, accounts held by U.S. Persons in these areas are not foreign accounts subject to FBAR reporting.

**Practice Point**: *The IRS has indicated that a traditional credit card with a foreign bank is not a foreign account. However, use of a credit card as a debit or check card could trigger foreign account status and thus an FBAR reporting obligation.*

***$10,000 Threshold***

To be reportable, the account must have assets the value of which during the year, even if only for millisecond, exceeds $10,000.

**Trap For The Unwary**: *The Instructions to the FBAR report state that if the aggregate value of all financial accounts exceeds $10,000 at any time during the year, the U.S. Person must file an FBAR report. Thus, a U.S. Person who possesses multiple foreign accounts, all of which have less than $10,000, but which collectively exceed $10,000, may have an FBAR reporting obligation.*

**Trap For The Unwary:** *Taxpayers will often transfer an appreciating asset to a foreign account, such as stock or securities. As these assets increase in value, they can quietly trigger an FBAR reporting requirement.*

**Practice Point:** *Whether the account generates any income is not relevant.*

***Penalties***

In an attempt to improve compliance, Congress enhanced the FBAR penalties in 2004. Under pre-2004 law, civil penalties applied only to willful violations. But today civil penalties up to $10,000 may be imposed on non-willful violations. This penalty may be avoided if there was reasonable cause and the U.S. Person reported the income earned on the account. 31 U.S. C. §5321(a)(5).

Although reasonable cause is not defined, the IRS will likely apply the reasonable-cause standard for late-payment/late-filing penalties. Questions remain, however, over the reporting requirement, and whether anything short of reporting the *full* amount of the income from the account will satisfy this requirement.

The penalty for willful violations is far more severe. It is equal to the greater of $100,000 or 50 percent of the balance of the account at the time of the FBAR violation. No reasonable cause exception exists for a willful violation. 31 U.S. C. §5321(a)(5)(c).

**Practice Point:** *The IRS has six years to assess a civil penalty against a taxpayer that violates the FBAR reporting rules.*

**Does The Taxpayer Have Any Relationship To A Trust Formed Outside The United States?**

The use of foreign trusts has exploded over the past two decades. The total property transferred to foreign trusts *annually* has risen from approximately $500 million in 1990 to $2.2 billion in 2002. *IRS Statistics of Income Studies of International Income and Taxes*. Over that same time period, the number of foreign trusts with at least one U.S. owner increased ten-fold, from 291 to 2,550. *Id.* In fact, in 2002, the IRS estimated that foreign trusts with at least one U.S. owner had nearly $15 billion in assets. *Id.* As the popularity of these investment vehicles continues to rise, it is imperative that tax professionals be familiar with the associated reporting rules.

Generally, there are three sets of reporting rules relative to foreign trusts. §6048. These are identified below as the "Trust Rules," "Responsible Party Rules," and the "Beneficiary Rules."

***Trust Rules***

These rules apply to grantors of a foreign trust. They provide that a foreign trust with a U.S. Person as an owner (as determined under the grantor trust rules of Subchapter J of the Internal Revenue Code) must file annually a Form 3520-A. The foreign trust must also provide certain financial information to all its U.S. owners and beneficiaries. Each U.S. owner has a duty to ensure that the foreign trust complies with these requirements.

The Form 3520-A must be filed by the 15th day of the third month after the trust's tax year. This return is filed separate from the U.S. Person's tax

return. Unlike the FBAR, this deadline *is* subject to extension.

**Traps For The Unwary** *The taxpayer must separately apply for an extension using a Form 7004. An extension filed for the U.S. Person's tax return does* not *extend the Form 3520-A deadline.*

### *Responsible Party Rules*

A second set of reporting rules applies to *reportable events*, and places the burden of reporting the event on the *responsible party*.

A *reportable event* is generally defined as the creation or funding (with money or property) of a foreign trust by a U.S. Person, including transfers by death. It also includes the death of a U.S Person if the person was an owner of the foreign trust or any portion of the trust is includible in his or her gross estate. Transfers for fair market value are excluded. A *responsible party* is generally the trust grantor, the transferor, or executor involved in the reportable event.

To satisfy the Responsible Party Rules, the U.S. Person must report the event on Form 3520. This return is due at the same time as the person's federal income tax return, including extensions, but is filed separately from that return.

**Practice Point**: *Unlike the Form 3520-A filed under the Trust Rules, discussed above, the U.S. Person is not required to file an extension separate from the extension for his or her tax return.*

### *Beneficiary Rules*

The third set of rules applies to U.S. Persons who receive a distribution from a foreign trust. They must report the distribution on Form 3520.

### *Penalties*

Non-compliance with the trust-reporting rules can create some of the heftiest penalties found in the Code. §6677.

The penalty for violation of the Trust Rules (i.e., failure to timely file a Form 3520-A) is equal to five percent of gross value of the trust's assets over which the U.S. Person is considered an owner. Each U.S. owner of the foreign trust may be subject to this penalty. The penalty for violation of the Responsible Party and Beneficiary Rules (i.e., failure to timely file a Form 3520) is even harsher. It is equal to 35 percent of the gross value of any property transferred to or distributed by the foreign trust (as applicable). Additional penalties up to the gross reportable amount may be imposed when the U.S. Person receives IRS notice of a violation and does not act to cure it.

Penalties may not be imposed, however, when the violation is due to reasonable cause and not willful neglect. For these purposes, the IRS applies the reasonable cause standard applicable to late-filing/late-payment penalties. Two carve-outs apply. First, the mere fact that a foreign jurisdiction would impose a penalty for disclosing the information is not considered reasonable cause. Second, the refusal on the part of a foreign trustee to provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of required information, is also not a basis for reasonable cause.

**Practice Point**: *These penalties are payable on notice and demand. The IRS is not required to issue a notice of deficiency. Accordingly, a pre-payment appeal of the penalty is not automatically available.*

## Does The Taxpayer Control, Or Have Any Dealings Involving, A Foreign Corporation Or Partnership?

U.S. Persons must also report to the IRS certain types of involvement with foreign business entities. These requirements are three-fold: U.S. Persons must report (1) control of, (2) transfers of property to, and (3) transfers of ownership interests in foreign corporations and foreign partnerships.

***Control Rules***

Any U.S. Person who *controls* a foreign corporation or foreign partnership during the tax year must file a Form 5471 (for a corporation) or Form 8865 (for a partnership). §6038. These forms must be filed with the U.S. Person's timely filed federal tax return (including extensions).

For foreign corporations, *control* means ownership (direct or indirect) of more than 50 percent of the outstanding stock or voting power for at least 30 consecutive days during the year. Treas. Reg. §1.6038-2. For foreign partnerships, *control* means direct or indirect ownership of a more than 50 percent interest in partnership profits, capital, or deductions or losses. It also includes certain groups of U.S. Persons, who collectively own more than a 50 percent and individually own more than a 10 percent interest in the foreign partnership.

**Practice Point**: *The IRS takes an expansive view of the level of involvement needed to constitute control over a foreign corporation or partnership.*

**Traps For The Unwary** *Attribution and constructive ownership rules apply. Thus, a taxpayer with no direct ownership in the foreign corporation or partnership could potentially have a reporting obligation.*

**Traps For The Unwary** *The check-the-box regulations provide default corporate status for certain foreign limited liability entities. Thus, a U.S. Person's involvement with a foreign entity that does not resemble a corporation under local law may nonetheless trigger a foreign corporation reporting obligation.*

***Penalties***

A violation of the Control Rules (i.e., failure to timely file a Form 5471 or Form 8865) has a double-penalty impact. First, the U.S. Person's foreign tax amount used to compute the foreign tax credit is reduced by 10 percent. Second, the U.S. Person is subject to a flat $10,000 penalty. Additional penalties apply if the violation continues for 90 days after IRS notice: (i) the foreign tax reduction increases by five percent for each three-month period, and (ii) there are additional $10,000 penalties for each 30-day period, up to $60,000 ($10,000 initial penalty and $50,000 maximum additional penalties). When both penalties apply, however, the foreign-tax penalty is reduced by the amount of the fixed-dollar penalty imposed.

**Practice Point**: *Unlike most of the penalties discussed in this article, the IRS* must *follow deficiency procedures and issue a notice of deficiency to the taxpayer with respect to the foreign tax credit reduction. The IRS may summarily assess the other penalties and collect them upon notice and demand.*

These penalties may be avoided when the taxpayer proves that the failure was due to reasonable cause and not willful neglect. Although historically there was some debate regarding the meaning of reasonable cause here, the IRS has recently clarified that the standard under section 6651 applies.

**Practice Point**: *It is noteworthy that a reasonable-cause exception exists for all reporting penalties discussed in this article.*

***Special Rules For Officers And Directors***

Special rules apply for directors and officers of foreign corporations. A U.S. Person who becomes an officer or director of a foreign corporation, and owns at least 10 percent of the corporation's stock (by value or vote), must also file a Form 5471. §6046. Constructive stock ownership rules apply, although this rule generally requires that the U.S. Person directly own some amount of stock. The Form 5471 must be filed with the U.S. Person's timely filed federal tax return, including extensions. In the absence of reasonable cause, the penalty for failure to timely file is $10,000, with additional penalties up to $50,000 for failure to cure the violation after IRS notice.

***Rules For Property Transfers***

Subject to certain exceptions, transfers of property by U.S. Persons to foreign corporations must be reported to the IRS. §6038B. The U.S. Person must file a Form 926 with its timely filed income tax

return for the year in which the transfer occurred. Transfers of cash to a foreign corporation are also reportable, provided that (i) immediately after the transfer the U.S. Person owns 10 percent (by vote or value) of the corporation, or (ii) the amount of cash transferred by the U.S. Person during the preceding 12 months collectively exceeds $100,000.

**Practice Point**: *A reportable transfer by a partnership to a foreign corporation must be reported by each individual partner. The partnership cannot file a single Form 926 and satisfy this obligation on all the partners' behalf.*

Transfers by U.S. Persons to foreign partnerships are likewise subject to reporting. A reportable transfer occurs when (i) immediately after the transfer, the person holds, directly or constructively, a 10 percent or greater interest in the partnership, or (ii) the value of the property transferred, when added to the value of the property previously transferred by the person (or related person) to the foreign partnership over the last 12 months, exceeds $100,000. §6038B. The U.S. Person must report the transfer on a Form 8865, which is filed with the person's timely filed federal tax return (including extensions).

**Traps For The Unwary** *If a domestic partnership contributes property to a foreign partnership, the partners of the domestic partnership are each treated as transferring their proportionate share of the contributed property. Thus, each has an obligation to file a Form 8865. Unlike the Form 926 discussed above, however, the domestic partnership itself may file the Form 8865 and satisfy the reporting requirements of its partners.*

The penalty for failure to file a Form 5471 or Form 8865 is equal to 10 percent of the fair market value of the property at the time of the exchange/transfer. The penalty will not apply if the failure to comply is due to reasonable cause and not willful neglect. The penalty is also limited to $100,000 unless the failure to comply was due to intentional disregard.

***Rules For Ownership Transfers***

Yet another set of reporting rules applies to the transfer of *ownership* in a foreign corporation or foreign partnership.

With respect to a foreign corporation, a U.S. Person must file a Form 5471 if any of the following occurred during the tax year: (1) the person acquired stock and thereafter possessed a 10 percent ownership interest (by vote or value) in the foreign corporation, (2) the person acquired a 10 percent or more stock ownership interest, or (3) the person disposes of sufficient stock to reduce the person's interest below 10 percent ownership. §6046.

**Practice Point**: *These rules do not require that the transfer occur in a single transaction. Rather, a reporting obligation arises if this threshold is met as a result of one or more transactions during the tax year.*

Substantially similar rules apply to foreign partnerships. A U.S. Person must file a Form 8865 if during the tax year (1) the person acquires or disposes of an interest in the foreign partnership, and before or after the transfer the person holds (directly or indirectly) a 10 percent interest in the partnership, or (2) the person's proportional interest in the partnership changes by 10 percent or more. §6046A. To illustrate, a reporting obligation is triggered if a U.S. Person (1) holds a five percent interest and acquires an additional five percent interest in the foreign partnership, (2) holds a 10 percent interest in the partnership and disposes of a five percent interest, and (3) owns a 10 percent interest and acquires an additional 10 percent interest in the foreign partnership.

Both Form 5471 and Form 8865 must be filed with the U.S. Person's timely filed tax return (including extensions).

**Traps For The Unwary** *A change in proportional partnership interest can occur without any involvement by the taxpayer. For example, the taxpayer might have a reporting event as the result of another partner withdrawing from the foreign partnership.*

A fixed $10,000 penalty is imposed on any failure to disclose a reportable transfer. If the failure continues for more than 90 days after IRS notice, an additional penalty of $10,000 will apply for each 30-day period (or fraction thereof) during which the failure continues, up to $50,000. §6679.

### Does The Taxpayer Own An Interest In A Foreign Disregarded Entity?

Special reporting rules also apply to U.S. Persons who are owners of a foreign disregarded entity. Interestingly, these rules are not expressly set forth in the Code; rather, the IRS promulgated these rules under the "general" authority of sections 6011, 6012, 6031 and 6038 and the related regulations.

Any U.S. Person that is treated as the owner of the assets or liabilities of a foreign disregarded entity is required to file a Form 8858 with its timely filed income tax return, including extensions. A foreign disregarded entity is simply an entity organized outside the United States that, under the check-the-box regulations, is treated as a disregarded entity. The penalties for failing to file a Form 8858 are the same as the penalties under the Control Rules for foreign corporations and partnerships, which include (1) a fixed $10,000 penalty, (2) 10 percent foreign tax reduction, and (3) additional penalties for failure to respond to an IRS notice of violation.

**Practice Point**: *The disregarded status of the foreign entity is determined under U.S. law—not the law under which the entity was organized.*

**Traps For The Unwary** *A U.S. Person that controls a foreign corporation or a foreign partnership, which corporation or partnership owns a foreign disregarded entity, may also have a reporting obligation. Thus, a U.S. Person may be required to file a Form 8858, even when (i) the person has no direct ownership in the foreign disregarded entity, and (ii) the constructive or indirect ownership is less than 100 percent.*

### Did The Taxpayer Receive Any Gifts From A Foreign Person?

U.S. Persons that receive gifts from foreign individuals or entities must also report such transfers.

Generally, a U.S. Person must report on a Form 3520 (1) any gifts from a non-resident individual or foreign estate that collectively exceed $100,000, (2) any gifts from foreign corporations and foreign partnerships that collectively exceed $10,000 (adjusted for inflation). §6039F.

**Practice Point**: *In calculating the $100,000 threshold, the U.S. Person must aggregate gifts from different foreign nonresident aliens and foreign estates if he or she knows (or has reason to know) that one of those persons is acting as the nominee for the other person.*

**Practice Point**: *For tax years beginning in 2008, the reporting threshold amount for gifts from foreign corporations or partnerships is $13,561.*

**Traps For The Unwary** *The Form 3520 is due at the same time as the U.S. Person's federal tax return, including extensions. But the Form is filed separately from that tax return.*

If the U.S. Person, without reasonable cause, fails to disclose a foreign gift, the IRS has the right to determine the "proper" tax treatment of the gift, and the IRS's determination (although reviewable) is subject to an arbitrary and capricious standard. For each month that the failure continues, the U.S. Person is subject to a penalty of five percent of the gift for each month, up to a 25 percent maximum.

**Practice Point**: *The IRS must issue a notice of deficiency and follow deficiency procedures in making any determination regarding the proper tax treatment of the gift, but it may summarily assess the five percent additional penalty.*

## PRACTICE CHECKLIST FOR

### The IRS Is Looking For Non-Compliant Taxpayers With Foreign Interests: Is Your Taxpayer One of Them?

- Is the taxpayer a U.S. Person?
  __ Citizen, resident or domestic entity?
- Is the taxpayer aware of any foreign accounts?
  __ Own an account?
  __ Signature authority over, or cause a distribution from, the account?
  __ $10,000 threshold met?
- Does the taxpayer have any relationship to a foreign trust?
  __ Create or form a trust?
  __ Fund a trust?
  __ Receive a trust distribution?
- Does the taxpayer control, or have any dealings involving, a foreign corporation or foreign partnership?
  __ Own or control a foreign corporation or partnership?
  __ Officer or director of any foreign corporation?
  __ Transfer any property to a foreign corporation or partnership?
  __ Acquire or transfer any ownership in a foreign corporation or partnership?
- Does the taxpayer own an interest in a foreign disregarded entity?
  __ Treated as owner of assets/liabilities under U.S. law?
  __ Ownership through tiered structure involving foreign entities?
- Did the taxpayer receive any gifts from a foreign person?
  __ Collectively more than $100,000 from a foreign individual?
  __ Collectively more than $13,561 from all foreign corporations and partnerships?
- Could the taxpayer qualify for an IRS voluntary disclosure?
  __ Has the IRS already initiated an examination or investigation?
  __ Are the funds offshore the result of legal or illegal activity?
  __ Has an experienced criminal tax practitioner been contacted for the potential voluntary disclosure?

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