The IRS/Panama Papers: Money Laundering and Tax Evasion

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Published by **BG Digital Publishing**

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About the Author – Gary S. Wolfe

Chapter 1 – Introduction

The <u>International Consortium of Investigative Journalists</u> ("ICIJ"), recently began publishing a series of articles known as "The Panama Papers," which consists of millions of leaked financial documents, a trove of information much larger than anything obtained by either Wikileaks or Edward Snowden in their prior disclosures.

Hundreds of reporters and media organizations in over 70 countries spent over one year working secretly and collaborating with the ICIJ, a Project of the Center for Public Integrity, based in Washington D.C.

THE ICIJ report revealed that after a yearlong investigation the secretive, elite Panama Law Firm, Mossack Fonseca ("MF") established over 240,000 "shell companies" over the last 40 years for wealthy global clients to launder money, dodge sanctions and evade taxes.

MF clients include: politicians, celebrities, criminals, and heads of state. MF services appear to involve bribery, corruption, and rampant money laundering. In response MF was defiant, as their Managing Partner in a Financial Times interview stated: "I guarantee there is more money laundering in New York, London, and Miami than in Panama."

Allegations include the role played by major international banks that provided investment advisory services, and banking services to the MF clients including HSBC (who in 2012 paid the US a \$1.92B fine for laundering Mexican drug money) and Credit Suisse (who in 2014 paid a \$2.5B fine for helping rich Americans to evade taxes).

The ICIJ reviewed over 11m documents (leaked by an anonymous party from MF) which showed that MF established over 240,000 shell companies worldwide with the primary jurisdictions: BVI (113,648), Bahamas (15,915), and Panama (48,360). Anonymity was preserved by MF for their clients. For example, MF set up 14,086 companies in Seychelles (Tax haven in Indian archipelago) but only knew the identity of 204 companies' real owners.

Major political figures that have been implicated include:

- 1) Russian President Putin's cohorts;
- 2) Iceland Prime Minister Gunnlaugsson (See LA Times 4/5/16 article, <u>'Panama Papers'</u> revelations cost Iceland prime minister his job.)
- 3) Ukrainian President Poroshenko
- 4) Ian Cameron deceased father of UK Prime Minister David Cameron

- 5) FIFA ethics committee attorney (Uruguay) Pedro Damiani
- 6) Argentina President Macri.

Celebrities include: film star Jackie Chan, soccer star Lionel Messi and British golfer, Nick Falco.

So far, the names have revealed 12 current or former world leaders, 128 other politicians and public officials. More names will apparently be disclosed in May 2016 when the ICIJ releases them to the public.

MF apparently represented and set up shell companies for 33 individuals or companies who have been under sanctions by the US Treasury Dept. including companies based in: Iran, North Korea and Zimbabwe. MF registered these companies as offshore entities and kept the real owners out of the public documents making them hard to trace.

The World Bank/IMF and UN estimates that Tax Havens worldwide, of which Panama is a major player, holds between \$21-32 Trillion in assets whose value has grown substantially since the 2008 world wide financial crisis. MF, and others like them, set up companies in small tax haven countries (e.g. Caribbean, Cook Islands, et al) and facilitated the laundering of money and its "disappearance" for the super-wealthy into untraceable accounts hidden behind anonymous shell companies.

MF did not invent offshore tax evasion which has been going on in Switzerland for hundreds of years. Switzerland's oldest bank, Wegelin Bank, established in 1741, plead guilty in NY Federal Court to tax evasion and closed their doors after their Managing Director stated in open court that the Swiss banking system "profits from tax evasion." (See my ABA/Practical Tax Lawyer Article: Why Tax Evasion is a Bad Idea: UBS & Wegelin Bank).

Due to the 2008 worldwide financial crisis, world governments are hungry for tax revenue and are taking aim at their wealthy citizens who cheat on their taxes by hiding assets offshore. In response World Governments have implemented financial transparency programs like the US (FATCA) and the EU (Common Reporting Standards).

Separate investigations are now proceeding worldwide in response to the Panama Papers in the following countries: Australia (investigating 800 individuals named), Israel (600 Israeli company and 850 Israeli shareholders), France (close aide to Marine Le Pen used MF to transfer funds out of France to Hong Kong, Singapore, BVI and Panama to get money out of France thru shell companies/false invoices and evade French antimoney laundering laws).

As best expressed by Jeremy Corbyn, Head of UK Labor Party: "David Cameron, UK Prime Minister, must "stop pussyfooting around" and take action on "tax dodgers"... more and more people feel that there is one rule for the rich and another for everyone else...It is time to get tough on tax havens, Britain has a huge responsibility since many of these tax havens are British overseas territories or crown dependencies... tax havens have become honey pots of international corruption, tax avoidance and evasion... fueling inequality... shortchanging public services for our people."

Shell companies have legitimate uses if properly disclosed and taxes are paid including: protecting trade secrets, avoid kidnapping, resist price gouging. However, they also are used illegally to hide assets from a future ex-spouse, to go bankrupt and stay rich, to evade taxes, to bribe officials, to manipulate markets, to cover fraud, to deal drugs or arms, to finance terrorism.

US taxpayers appear not to yet be identified in the Panama Papers but it is too early to tell. US taxpayers who set up offshore accounts and do not disclose the accounts annually (on their tax filings) or pay taxes on the income earned from the accounts face multiple felonies for their tax crimes: willful evasion of tax (IRC 7201; 5-year felony); obstruct/impede tax collection (IRC 7212; 3-year felony); conspiracy to commit tax evasion (18 USC 371; 3-year felony); failure to disclose foreign bank account by filing Fincen Form 114 (FBAR); 10-year felony for each year not filed. In addition separate 20-year felonies for related sister crimes: wire fraud, mail fraud, and money laundering.

Many US taxpayers do not understand that FATCA passed as legislation in March 2010, implemented in 2015, and now has over 100,000 foreign financial institutions in over 80 countries passing their tax information to the IRS. To these taxpayers I say, "Time to wake up, you are facing a grave danger."

Chapter 2 – U.S. Launches Crackdown on International Tax Evasion

In an explosive new development, the <u>White House announced</u> on May 5, 2016 that President Obama has signed executive orders to attack tax evasion, money laundering and corruption. The executive orders focus is on increasing transparency regulations as a tool to flush offshore tax abuses into the public view and subject them to both criminal investigation and prosecution. The key executive orders:

- 1) Immediate Executive Action to combat tax evasion/money laundering & terrorist financing by imposing tighter transparency rules on ownership of assets/transfer of funds;
- 2) New Treasury rules close a loophole allowing foreigners to hide financial activity behind anonymous US entities;
- 3) Stricter "customer due diligence" rules for banks handling money on behalf of clients.

President Obama's Executive Orders are in response to the Panama Papers disclosure (i.e. millions of documents revealing the use of anonymous shell companies for tax evasion, bribery, corruption, terrorist financing and money laundering). As stated by President Obama: "There is no doubt that the problem of global tax avoidance generally is a huge problem. We need to make global tax avoidance illegal."

As stated by US Treasury Secretary Jack Lew: "The US has long focused on countering money laundering and corruption, cracking down on tax evasion and hindering those looking to circumvent our sanctions...actions today increase transparency and prevent abusive conduct."

See UK Guardian 5/5/16 article "Panama Papers: US Launches Crackdown on International Tax Evasion"

Chapter 3 – Panama Papers & The U.S. Government

The Obama Administration, the US Treasury Department and the IRS are waging an all-out war on offshore tax evasion and money laundering. Their actions have been stimulated by the shocking disclosures in the Panama Papers of world-wide tax cheating and corruption by celebrities, politicians and the wealthiest Americans who hide their criminal activities thru anonymous shell companies. The attack is against the "shell companies" that facilitate tax evasion and money laundering by hiding behind nominee owners, officers, directors, trustees, powers of attorney and a cottage industry of lawyers, CPAs and financial advisors who make billions of dollars by facilitating tax evasion and money laundering.

In the words of John Doe, the anonymous source behind the Panama Papers: "Banks, financial regulators and taxing authorities have failed... decisions have been made that spared the wealthy while focusing instead on reigning in middle and low-income citizens... the law firm at the heart of the Panama Papers (Mossack Fonseca) "did not work in a vacuum... despite repeated fines and documented regulatory violations it found allies and clients at major law firms in virtually every nation."

John Doe calls for an end to the "abuse of corporate registrations ... putting an end to the financial secrecy that enables tax evasion and money laundering and the hiding of other ill-gotten sources of wealth... the collective impact of these failures has been a complete erosion of ethical standards, ultimately leading to a dual system we still call capitalism but which is tantamount to ECONOMIC SLAVERY".

On 5/9/16 the International Consortium of Investigative Journalists published a searchable database detailing over 368,000 of the world's richest people and their over 300,000 offshore entities created by Mossack Fonseca, which was the result of the media leak of 11.5m e-mails and client records covering nearly 40 years from Mossack Fonseca. The database involved more than 350 journalists in 77 countries.

To date, those outed have included: 12 current and former heads of state and government, 61 relatives and associates of leaders and 128 other public officials. John Doe further alleged, "in the United States, tax evasion could not be fixed while politicians relied on the super-rich for campaign funding."

The ICIJ database release in tandem with efforts by the White House, US Treasury Dept. and the IRS seeks to combat tax evasion by eliminating the illicit use of secret offshore bank accounts and shell companies to hide the real owners. The ICIJ database confirmed companies, trusts, foundations, and funds in 21 tax havens from Hong Kong to Nevada with links to people in more than 200 countries and territories. The new rules announced by the White House include:

- 1) Increased transparency and disclosure requirements that will enhance law enforcement's ability to attack tax evasion, money laundering and terrorist financing;
- 2) Customer due diligence for banks & financial institutions on who owns the companies that use their services as well as for prepaid credit cards and debit cards;
- 3) Close existing loophole that allows foreigners to hide assets or financial activity behind anonymous entities established in the US;
- 4) Request Congress to pass legislation to increase transparency and set up a national registry of the real owners of companies;
- 5) Request Congress to ratify 8 tax treaties pending for years to crack down on offshore tax evasion.

The White House efforts are in tandem with the Foreign Account Tax Compliance Act (passed into law March 2010), under which over 150,000 foreign financial institutions in over 80 countries have agreed to report customer information to the US in an effort to ensure that wealthy US "tax cheats" can no longer hide assets offshore, commit tax evasion and then use the tax evasion proceeds (i.e. unpaid tax) to launder money and buy investment assets (e.g. stock, bonds, real estate, cars, boats, planes, jewelry and art).

The key new rule to disclose the real owners of shell companies (i.e. the beneficial owners) requires financial institutions (banks, brokers, mutual funds) to obtain the identities of "beneficial owners of companies verified by documentation (e.g. passports), and at least one senior manager who are clients of the firm. The US Treasury Dept. has a two-year transition for the implementation of the new rule which will be effective in 2018.

The US response has been a 3 pronged attack against money laundering and tax evasion:

- 1) Released a Customer Due Diligence Rule for Banks/Mutual Funds/Securities Brokers/Financial Institutions to disclose 25% owners of companies;
- 2) Issued Proposed IRS regulations relating to foreign-owned LLCs requiring them to obtain an IRS Employer ID # and authorizing the IRS to calculate their taxes due;
- 3) Send to Congress legislation to create a federal registry of beneficial owners of US companies (these appear unlikely for passage as law due to pending November 2016 elections and the currently dysfunctional Congress).

The US Treasury Dept. has announced that the Panama Papers exposed that politicians, criminals, and celebrities are avoiding paying taxes by hiding their wealth in offshore shell companies so their efforts will be to "target key points of access to the international financial system, when companies open accounts at financial institutions, when companies are formed, or when company ownership is transferred and when foreign-owned US companies seek to evade taxes". The goal is to prevent wealthy individuals from using offshore shell companies to hide assets, receive bribes, embezzle funds, avoid taxes and launder money.

The center point to their attack is the new Customer Due Diligence Rule for financial institutions which includes banks, stock brokers, mutual funds, securities dealers, commodities brokers who must collect and verify the personal information of real people (i.e. the beneficial owners who own, control and profit from companies when those companies open accounts. According to the Treasury Dept. the rule contains 3 core requirements: identifying and verifying the identity of the beneficial owners of companies opening accounts, understanding the nature and purpose of customer relationships to develop customer risk profiles, conduct ongoing monitoring to identify and report suspicious transactions and to maintain and update customer information.

The Treasury Dept. has requested that Congress pass legislation that would require companies formed in the US to file beneficial ownership information with Treasury and face penalties for failure to file. The proposed Congressional legislation would amend the current GTO (geographic targeting order), which would clarify Fincen's ability to collect information under GTOs such as bank wire transfer information.

Proposed IRS regulations would require foreign-owned "disregarded entities" (including foreign owned single member LLCs) to:

- 1) Obtain an Employer ID # from the IRS to prevent foreign owners from shielding disclosure of non-US assets or non-US bank accounts:
- 2) File IRS Form 5472 to disclose 25% or greater ownership in a US company;
- 3) Subject these tax returns to IRS tax audit and tax due.

As stated by Wally Adeyemu, National Security Advisor for International Economics:

"Our financial system should not provide the rich, the powerful and the corrupt with the opportunity to shield their assets and avoid paying their fair share of taxes or with the opportunity to hide any illicit activity... nobody should be able to play by a different set of rules".

The Customer Due Diligence Rules will be phased in over 2 years. The rule requires that banks and other financial institutions in the US must collect and keep accurate records

on these same beneficial owners after they open a new bank account. The rule mandates that banks know the identities of anyone who owns at least 25% of an entity, or who controls it which information could be provided to law enforcement or tax authorities.

The Treasury Dept. called on Congress to pass 8 separate tax treaties stalled in the Senate including Switzerland and Luxembourg, two know tax havens (Switzerland has \$2.7 Trillion; Luxembourg \$600 billion in tax haven assets). The tax treaties would allow for a greater exchange of tax information so that cross border tax cheating may be stopped. The Treasury Dept. wants to allow the federal government to determine whether companies owed any taxes in the US or whether they were set up to illegally shield owners from having to pay taxes overseas. The goal is to end anonymous shell companies for politicians, criminals, and corrupt financiers and go after "tax cheats, kleptocrats, and other criminals who abuse the financial system thru shell companies."

To date, 36 Americans accused of financial fraud and other financial crimes are on the Panama Papers list. Many athletes are also listed: Golfers: Padraig Harrington, Retief Goosen, Ian Woosnan, Tennis Player: Thomas Enqvist, whose accounts were apparently set up offshore (tough to trace at the direction of their agency IMG, International Management Group).

In the end, the Panama Papers have shown how the rich and powerful exploit offshore tax havens, working with major banks and law firms to create hard to trace companies, and a "long history of corruption" in which the Political Leaders around the world have been found to have "taken and made bribes, dodged taxes and amassed fortunes of unimaginable scale".

Chapter 4 - U.S. Taxpayers (General & Criminal Issues)

The Panama Papers highlight important IRS issues for US Taxpayers with international (i.e. offshore holdings). Tax issues include:

- 1) US taxpayers must annually report all of their income both in the US and worldwide.
- 2) In a divorce action, both spouses must disclose under penalty of perjury, all of their worldwide assets which are owned by them or in which they have a beneficial ownership interest. Assets must be disclosed whether held in their individual names, through trusts, foundations, corporations or through a "straw person" (i.e. a 3rd party nominee who is the "title holder" but not the actual owner in interest).
- 3) In a divorce, disclosing US financial accounts in a public forum (i.e. divorce court) may reveal transactions with offshore entities which assets may be subject to equitable distribution. In California, community property assets that are not distributed in a divorce remain community property and subject to division as community property under a "Henn action" (case Henn v. Henn);
- 4) In California, community property is subject to each spouse's separate property creditors, which include taxing authorities. An unintended consequence of a divorce is that transactions with offshore entities may become public record (in the divorce proceeding) and are subject to investigation, audit and criminal tax prosecution by the taxing authorities.

In the case of the Panama Papers, US taxpayers who are listed (over 2000) now face IRS audits, and US Attorney criminal prosecution for multiple felonies: Tax Crimes (tax evasion, obstruction of tax collection, filing false tax returns, conspiracy with others to commit tax evasion).

In addition they face a trio of "sister felonies" each with a 20 year jail sentence: money laundering (investing the tax evasion proceeds into new assets which they own e.g. house, car, boat, plane, art, jewelry, stocks, bonds), wire fraud (using inter-state wires as part of a "scheme to defraud" which includes wire transfers, and phone calls/fax messages) and mail fraud (using the US mails as part of a scheme to defraud).

5) If a US taxpayer is in bankruptcy, federal US bankruptcy courts have jurisdiction over their worldwide assets. The US bankruptcy court may issue a turnover order relating to off-shore assets and has the authority to hold a debtor in contempt, subject to jail if the debtor does not comply with the order.

The Bankruptcy Court order in the US is only effective to compel the debtor to individually respond. US Courts (whether federal bankruptcy court or state divorce courts) issue orders that are effective in the US but since these courts do not have

jurisdiction outside of the US their orders have no effect on offshore assets and must either be enforced by a foreign government or under a new action filed in the non-US country.

Since wire transfers of assets (\$) are instantaneous and legal proceedings may take years, the prospects of a successful offshore enforcement action is remote.

The more compelling resolution is if a US court jails the debtor (spouse with offshore assets) for contempt of court until they repatriate the offshore assets to the US.

Criminal Issues

The IRS may scrutinize the over 2000 US taxpayers named to date in the Panama Papers for numerous complex civil and criminal tax issues. They may open a civil tax audit, a criminal tax investigation (IRS/CID), or refer the matter to the US Dept. of Justice for criminal tax prosecutions for tax evasion, obstruction of tax collection and other tax crimes, and related 20 year felonies: money laundering, wire fraud and mail fraud.

1) Tax Evasion

US citizens and income tax residents are subject to US income tax on their worldwide income and must report all income earned on assets held in off-shore entities (offshore income does not defer or avoid US income tax for US individual taxpayers, unlike subsidiaries of multi-national corporations).

Please see my e-book <u>International Tax Evasion and Money Laundering</u> and related <u>ABA</u> article.

2) Tax Disclosure (Fincen Form 114)

US taxpayers must report annually over offshore accounts over \$10k (in which they either own or have control e.g. signature authority) by the filing of the FBAR form (Fincen form 114) due by 6/30 yearly.

These FBAR filings (Report of Foreign Bank Accounts) are due for individuals, trusts and estates, and LLCs/Corps owned by US individual taxpayers.

3) FATCA Compliance (IRS Form 8938)

Form 1040 US Taxpayer individual taxpayers must attach Form 8938 to their tax returns to disclose ownership in foreign financial assets over \$50k. Foreign bank accounts over \$50k require both an FBAR filing (Form 114) and a FATCA filing (Form 8938).

Please see my website, books button for my book on FBARs/FATCA (gp please list title)

4) US Shareholders/Foreign Corporations (Individual Tax Payers)

US taxpayers who as part of a shareholder group of 5 or fewer US shareholders, have tax reporting requirements for annual corporate net income as a Controlled Foreign Corp. ("CFC"/Form 5471) or

Passive Foreign Investment Company ("PFIC"/Form 8621). The CFC/PFIC rules are intended as an anti-tax deferral regime which minimizes tax deferral of certain types of income earned from foreign sources.

For more information on this subject, please see my e-book, <u>Offshore Tax Evasion: US Tax & Foreign Entities</u> (co-author Allen Walburn).

5) US Corporations/Foreign Corporations (More than 5 Shareholders)

US Corporations with more than 5 US shareholders (i.e. 10% owners) can take advantage of annual tax deferral by forming subsidiaries in countries where they do business. Foreign subsidiaries of US corporations are not classified as US corporations for US income tax purposes and their shareholder owners are not subject to current US income taxation on annual net income.

US corporate income tax applies when the corporation's offshore profits are repatriated to the US (e.g. issuance of dividend to US parent). The US parent company may be eligible for a tax credit for foreign taxes paid.

Tax Treaties

The US has numerous bilateral income tax treaties with many countries. Each treaty has its own terms and may offer tax-planning strategies which may include: US tax credits for foreign taxes paid, tax exemptions or reduced tax for certain types of income (e.g. dividends, interest) and to reconcile tax rate disparities between countries.

Chapter 5 – U.S. Treasury Department New Rules (2016)

In 2016 two epic events have made battling offshore tax evasion a key priority to the IRS. Both the Panama Papers, which disclosed how hundreds of thousands of wealthy clients of international banks used anonymous shell companies to hide assets from governments around the globe, and the implementation of the Foreign Account Tax Compliance Act ("FATCA"); under which over 150,000 foreign financial institutions in over 80 countries are disclosing Americans with off-shore holdings, are both galvanizing the IRS to expand the geographic scope of their hunt for undeclared offshore accounts.

The IRS, which has been focused on Switzerland as the biggest tax haven, is now looking at financial institutions in the Caribbean, the South Pacific, Hong Kong, India, Israel, Luxembourg and Panama. US taxpayers with accounts in these jurisdictions must be vigilant in their reporting.

After many years of delay FATCA is being implemented (it was first enacted in 2010). In 2016, under FATCA foreign banks/financial institutions must annually report to the IRS. On accounts over \$50k that are owned by US persons or be subject to a 30% withholding tax on certain US-source payments made to them. To enforce FATCA, the IRS has entered into disclosure pacts with many countries, whereby the foreign financial institutions disclose data on US account owners to their own governments, which will then provide the information to the IRS.

In response to the Panama Papers disclosures the US Treasury Dept. proposed regulations to eliminate foreign owners from hiding behind anonymous companies. The proposed regulations (which are not yet enacted until they are either adopted as temporary regulations or final regulations) will require foreign-owned single member US Limited Liability Companies to disclose their owner.

The proposed regulations would treat US LLCs that are 100% owned by a foreign person as corporations for the limited purposes of reporting and record disclosures and maintenance. The LLC would have to annually file Form 5472 to disclose transactions between the LLC and its owner(s) or other related parties, including sales, distributions, and Contributions. The IRS would turn the information over to foreign governments (under inter-governmental exchange agreements) and use the tax information for IRS purposes which may include tax audits and assessment of US taxes.

Chapter 6 - The IRS & Panama Papers: Lessons Learned

In a 7/7/16 Hearing before the House Oversight/Government Reform Committee, James B. Comey, FBI Director said: "We don't want to put people in jail unless we prove that they knew they were doing something they shouldn't do".

In 2016, the "Panama Papers" named hundreds of thousands of wealthy international investors with offshore accounts (set up by Mossack Fonseca) hidden behind a maze of anonymous companies set up in the tax havens (BVI the major destination) to conceal the true ownership of the companies. These companies may be implicated in international tax evasion and money laundering.

For the nearly 3000 US taxpayers named to date, they are now under a "spotlight" and face IRS and US Dept. of Justice investigation into their activities thru these companies. To the extent these companies invested in US assets (e.g. real estate, stocks and bonds) they may face IRS audit (for tax evasion) and US DOJ investigation into multiple felonies for money laundering, wire fraud and mail fraud (each of which have 20 year prison sentences as maximum criminal penalties).

For US taxpayers in this predicament the best approach is to immediately address these matters and not wait for an IRS tax audit. If these US taxpayers amend tax returns, declare income and pay tax as long as they were not criminal in their intent (i.e. they were not willful), and either had a mistaken good faith belief that the income was not subject to tax reporting or they were so advised by tax professionals (and they are not tax professionals) they may be safe from criminal prosecution for tax crimes and other related felonies.

The lessons learned from the Panama Papers include the following:

- 1) For the estimated up to 10m US taxpayers with offshore accounts, they must report annually to the IRS their worldwide income (both within the US and outside the US i.e. offshore).
- 2) Offshore accounts offer limited privacy since they may forced to be disclosed in the event of IRS tax audits, US DOJ criminal prosecution and US litigation (especially for divorcing spouses).
- 3) In a divorce action, both spouses must disclose under penalty of perjury all of their worldwide assets.4) In a divorce action, disclosure of US financial accounts may reveal prior transfers of assets to offshore entities. These assets may then be subject to either community property claims or equitable distribution laws.

5) In California, community property assets that are not distributed in a divorce remain community property and are subject to division as community property under a "Henn action".

California certainly requires spouses in a divorce to make written disclosure to each other of all assets and debts, worldwide, whether community property or separate property. Other states may or may not have the same requirement.

A fraudulent failure to disclose a known asset in a California divorce allows the judge to award up to 100% of the undisclosed asset to the defrauded spouse. See Marriage of Rossi (2001) 90 Cal App 4th 34. In that case wife failed to disclose winning lottery ticket. When (now ex) husband found out the judge awarded him 100% of the lottery winnings. Known as the "how to win the lottery without buying a ticket" case. Same principles would apply to fraudulent non-disclosure of offshore bank accounts. The IRS would take a bite, as would the defrauded spouse.

After the Henn case California passed Family Code Section 2556, which said the divorce court can divide "omitted assets" without the need for a new lawsuit.

- 6) If a US taxpayer is in bankruptcy, US Bankruptcy Courts (as federal courts) have jurisdiction over their worldwide assets. The bankruptcy court my issue a "turn-over" article relating to offshore assets and has the authority to hold a debtor in contempt, subject to jail if the debtor does not comply with the court order.
- 7) US taxpayers (both citizens and income tax residents who either have a green card, are in the US for 183 days in one year, 122 days per year for 3 years), or non-resident taxpayers who receive US source income are subject to income tax on world-wide income, and must report all income earned on assets held in offshore entities (the status of the income as earned off-shore does not defer or avoid US income tax subject to special rules for US corporations e.g. controlled foreign corporations).
- 8) US taxpayers must disclose offshore accounts over \$10k (in which they own or have control e.g. signatory authority) on the annual FBAR filing (Foreign Bank and Account Report; Fin Cen Form 114) due 6/30 each year. FBAR filings are due for all US individuals, and US LLCs, Corporations, Estates & Trusts.
- 9) US taxpayers must disclose all foreign financial assets over \$50k (FATCA filing form 8938, attached to Form 1040 for Individual taxpayers). Foreign bank accounts over \$50k require both Fincen Form 114 filing and Form 8938 filing.
- 10) US taxpayers who invest in offshore corporations are subject to tax compliance filings for Controlled Foreign Corporations (IRS Form 5471) or Passive Foreign Investment Companies (Form 8621).

The tax rules for CFC/PFIC are anti-tax deferral rules, which minimize the tax deferral of certain types of income from foreign sources. The CFC rules impose tax annually on certain types of "tainted income" known as Subpart F income. The PFIC rules impose tax on passive income. These tax rules were enacted by Congress to eliminate unlimited deferral of US income tax on a foreign corporation's undistributed income for the types of income covered by Subpart F and PFIC rules (generally passive investment income and income from certain transactions between a foreign corporation and a related party).

The CFC Subpart F rules only apply if more than 50% of the voting power of the foreign corporation's stock is owned collectively by US shareholders owning 10% or more of the voting power of the foreign corporation (i.e. 5 or fewer US shareholders). The PFIC rules apply to any US person owning shares in a foreign corporation if that corporation's passive income or passive assets exceed certain thresholds (i.e. at least 75 % of the income of which is passive or at least 50% of the assets of which produce passive income or are held of the production of passive income).

Both the CFC/Subpart F rules and the PFIC rules impose US income tax on US persons owning shares in a foreign corporation with passive income (e.g. interest, dividends, rents, royalties and gain on sale of assets which produce passive income), the Subpart F rules (but not the PFIC rules) also impose tax on US shareholders if the CFC has certain types of income from sales or services between the CFC and certain related persons.

- 11) US multi-national foreign corporations with more than 5 US shareholders (defined as a "10% owner") can take advantage of annual tax deferral by forming subsidiary companies in the foreign countries where they do business. Foreign subsidiaries of US corporations are not considered US corporations for US income tax purposes and their overseas profits are not subject to current US taxes. In this case, US tax applies when the offshore profits are repatriated to the US (e.g. issuance of a dividend to the US parent, who may be eligible for a tax credit for foreign taxes paid by the foreign subsidiary).
- 12) The US has Income Tax Treaties with a number of countries which contain tax planning opportunities for certain types of income (e.g. dividends, interest) and to reconcile tax rate disparities between countries.

Tax practitioners, both Attorneys and CPAs, who have tax clients who have committed tax crimes (e.g. Tax felonies: willful evasion of tax, obstruction of tax collection et al) may not have an attorney-client privilege for taxpayer communications to them. Since the attorney-client privilege belongs to the client, the client's intent determines whether the exception applies. For those tax practitioners, who continue representing non-tax compliant taxpayers (who remain non-tax compliant despite being informed of their legal obligations by the tax practitioner) they may subject themselves to IRS/CID

investigation and US Dept. of Justice criminal prosecution for two separate felonies: conspiracy to evade taxes (18 USC 371), and misprision of a felony (18 USC 4).

Under the crime-fraud exception to the attorney-client privilege, a client's communications to their attorney is not privileged if made with the intent of committing or covering up a crime or fraud which may include "tax crimes" including: willful evasion of tax, conspiracy to commit tax evasion, obstruction of tax collection, filing a false tax return et al. In the recent 2016 case of oil investor Morris Zukerman a Manhattan judge ordered his attorneys to appear before a grand jury to give testimony (which Trial court order was upheld by the US Court of Appeals 2d Circuit). In the face of his attorneys having to potentially appear before a grand jury and give adverse testimony (contrary to his interests), Zukerman plead guilty to two felonies for tax crimes: tax evasion, and obstructing tax collection and awaits sentencing.

Taxpayers who cheat on their taxes either by not filing tax returns, filing false/fraudulent tax returns, fail to disclose offshore bank accounts/ holdings and/or foreign financial assets if construed as willful tax evasion have no attorney-client privilege for their tax crimes (IRC Section 7525), have no attorney-client privilege for their continuing willful evasion of tax (crime-fraud exception). They place their tax advisors in harm's way for criminal prosecution for conspiracy to commit tax evasion, and misprision of a felony. In addition, dependent on their involvement for the purchase of assets, with the tax evasion proceeds, tax advisors may subject themselves to additional jeopardy for money laundering, wire fraud and mail fraud (each additional 20 year felonies). So, if there is no attorney-client privilege, and a risk of criminal prosecution what should a tax advisor do in response? Best plan is to get expert advise and if necessary withdraw from representation before it is too late.

Chapter 7 – IRS Offshore Tax Evasion: Criminal Matters

6-Year Statute of Limitations

1. Tax Evasion (Willful Evasion of Tax) (IRC Sec. 7201) up to five years in prison Fine: \$100,000 (individual) \$500,000 (corporation)

2. Obstruct (Impede Tax Collection) (IRC Sec. 7212) up to three years in prison Fine: \$5,000

3. Conspiracy to Impede Tax Collection (18 USC 371) separate charge of impeding Up to five years in prison

4. Failure to File Tax Return (IRC Sec. 7203) up to one year in prison Fine: \$25,000 (individual) \$100,000 (corporation)

5. File False Tax Return (IRC Sec. 7206(1)), up to three years in prison Fine: \$250,000

6. "FBAR Violation"
(31 USC Sec. 5322(b), 31 CFR 103.59(c))
Willful violation: up to ten years in jail and \$500,000 fine

Additional Criminal Penalties:

- 1. Perjury (U.S. taxpayers who fail to disclose foreign accounts under Form 1040/Schedule B, Part III, question 7(a))
- 2. FATCA Filings (i.e. Failure to disclose foreign financial assets on \$50,000/IRS Form 8938)
- 3. Money Laundering: Disguise of the nature or the origin of funds (18 USC Sec. 1956 and 1957)

Chapter 8 - Offshore Tax Evasion: IRS Tax Audit

For those US taxpayers committing offshore tax evasion i.e. not reporting foreign income, not disclosing offshore accounts, they face a myriad of IRS tax audit issues: Civil and Criminal Penalties, and a myriad of Statute of Limitations.

The IRS Civil and Criminal Penalty Issues include the following:

Civil Penalty Issues

- 1. Civil Tax Fraud (75% of tax due) (no statute of limitations).
- 2. Underpayment of Tax (25% of tax due).
- 3. For voluntary disclosures, under the IRS Offshore Voluntary Disclosure Program (2012), the values of foreign accounts and other foreign assets are aggregated for each year and the penalty is calculated during the period covered by the voluntary disclosure. Under the 2012/IRS Voluntary Disclosure, total penalties of up to 90% of unpaid tax, and 27.5% of highest balance total foreign bank accounts/foreign assets as follows:
- a. Failure to File a Tax Return (IRC Sec. 6651(a)(1), up to 25% tax due.
- b. Failure to Pay Tax (IRC Sec. 6651(a)(2), up to 25% tax due.
- c. Accuracy Related Penalty (IRC Sec. 6662), a 40% penalty for tax underpayment attributable to undisclosed foreign financial asset understatement.
- d. Title 26 Penalty 27.5% highest aggregate balance of foreign bank accounts, entities and assets.

Criminal Penalty Issues

- U.S. taxpayers with undisclosed offshore bank accounts and unreported income face criminal charges for:
- 1. Tax Evasion (IRC 7201), five years in jail, \$25,000 fine;
- 2. Filing False Tax Return (IRC Sec. 7206(1)), three years in jail, \$250,000 fine;
- 3. Failure to File Tax Return (IRC Sec. 7203), one year in jail, \$100,000 fine;

4. Willful failure to file FBAR or Filing False FBAR (31 USC Sec. 5322), ten years in jail, fines up to \$500,000 with related civil penalty the greater of \$100,000 or 50% of the total balance of the foreign account per violation (IRC Sec. 5321(a)(5).

In addition there are specialized tax, and other issues for offshore tax evasion:

- 1. The failure to file the Report of Foreign Bank and Financial Account ("FBAR", Fincen form 114, formerly TDF-90-22.1) can result in penalties that exceed the account balance e.g. the 50% yearly penalty imposed on the undisclosed account balance is imposed every year so if the FBAR report is not filed for 4 years the penalty is 200% of the account balance. So, if there was \$5M on account, after 4 years of no FBAR filings the penalty would be \$10M (which does not include the income tax on the unreported account earnings, additional penalties, see above, and interest);
- 2. An FBAR filing has a 6 year statute of limitations for imposition of the civil and related criminal penalty. These statutes do not begin to run until the FBAR is filed (this filing discloses all foreign bank and financial accounts over \$10k).

In addition until the FBAR is filed, and the foreign bank accounts are disclosed, the Statute of Limitations on the related tax year Form 1040 filing does not commence.

3. Effective Tax Year 2011, Form 8938 is required to be attached to Taxpayer's Form 1040 to disclose the aggregate value of all foreign assets over \$50k, which includes: Financial Accounts at foreign institutions, foreign stock, security, financial instrument or contract of interest in a foreign entity). Filing an FBAR does not eliminate the need to file Form 8938 to report foreign financial assets. For example, a US beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50% may still be required to disclosed the interest with his tax return if the \$50k threshold is met. As with the FBAR filing, failure to file the Form 8938 suspends the statute of limitations for the related tax year Form 1040, which does not commence until the Form 8938 (and any other information returns due are filed).

Statute of Limitations for IRS Audits

Civil and criminal tax proceedings have different statutes of limitation.

Civil Tax Fraud - For civil tax fraud (i.e. unreported income/undisclosed foreign bank accounts), there is no statute of limitations. The tax can be assessed at any time.

Criminal Tax Evasion - For criminal tax evasion (i.e. unreported income) the criminal statute of limitations is only on the prosecution of the crime of tax evasion, (not the assessment of the tax owed).

Offenses arising under the Internal Revenue laws generally have a 3-year period of limitation for prosecution (IRC Sec. 6531).

When the prosecution is for the offense of willfully attempting in any manner to evade or defeat any tax, the statute of limitations is 6-years (i.e. unreported Income).

IRC Sec. 6531(1): for offenses involving the defrauding or attempting to defraud the United States (whether by conspiracy or not, and in any manner);

IRC Sec. 6531(2): for the offense of willfully attempting in any manner to evade or defeat any tax;

IRC Sec. 6531(3): for the offense of willfully aiding or assisting in the preparation of a false or fraudulent tax return.

IRC Sec. 6531(4): for the offense of willfully failing to pay any tax or make any tax return.

IRC Sec. 6531(5): for offenses relating to false statements and fraudulent documents under IRC Sec. 7206(1) and Sec. 7207.

IRC Sec. 6531(8): for offenses arising under 18 U.S.C. 371, where the object of the conspiracy is to attempt in any manner to evade or defeat any tax.

Under IRC Sec. 6531, the 6-year statute of limitations shall be tolled, while the U.S. taxpayer who committed the offenses is outside the United States.

Generally, the IRS has 3 years from the date of the tax filing (Form 1040) to commence an audit. However, the 3 years are extended to 6 years if the Taxpayer:

- 1. Omitted more than 25% of gross income;
- 2. Omitted more than \$5000 of foreign income;
- 3. Failed to file the FBAR and disclose the foreign account (which is required under Form 1040/Schedule B, Part III, question (7)(a), and if not disclosed is both perjury and a felony for filing a false tax return with up to 3 years in jail), which 6-year statute does not commence until the FBAR is filed (due June 30 each year, for the prior year, no extensions, in 2014 required to be filed electronically i.e. no paper filing, no "lost in the mail excuses".)

As stated above, for the reasons specified the Statute of Limitations for the IRS to audit the Form 1040 may be extended from 3-6 years. Even if there is no understatement of income, if there is a failure to file information returns for offshore holdings/entities then

the Form 1040 Statute of Limitations is suspended until the complete Form 1040 is filed with all information filings due.

The following information filings are due annually for offshore holdings/entities:

- 1. FBAR for accounts over \$10k (due 6/30)
- 2. Form 8938 ("FATCA Filing" since 2011) for Foreign Financial Assets over \$50k (due 4/15, unless extension (with Form 1040).

Under Form 8938 (Statement of Specified Foreign Financial Assets): a 3-year statute of limitations for failure to report a specified foreign financial asset or failure to file Form 8938;

A 6-year statute of limitations for U.S. taxpayer's failure to include in gross income an amount relating to specified foreign financial assets and the amount omitted is more than \$5,000.

- 3. Form 3520-A to report annual foreign trust income; (with Form 1040)
- 4. Form 3520 to report transfers to the trust and distributions to trust beneficiaries; (with Form 1040)
- 5. Form 5471 for any US person who controls a foreign corporation. Control is defined as ownership of more than 50% of the outstanding stock or voting power for at least 30 consecutive days during that tax year. Control also includes: five or fewer US Persons who collectively own more than a 50% interest and individually own more than a 10% interest in the corporation.

A US person who becomes an Officer or Director of a foreign corporation and owns at least 10% of the corporation stock by vote or value, must also file Form 5471 (with Form 1040).

- Form 8865 Foreign Partnerships (same rules as Form 5471 re: control, filing dates);
- 7. Form 8858 for US persons who are owners of foreign disregarded entities (with Form 1040).

US Taxpayers with foreign income, entities should carefully review their annual tax filings due.

Chapter 9 – IRS Civil Tax Audits/Statute of Limitations

IRS civil tax audits generally have a 3-year statute of limitations which commences the later of:

- 1. Tax Return due date or,
- 2. Date of Tax Return Filing (evidenced by either electronic filing acceptance, or certified mail return receipt).

The 3-year statute of limitations is extended to 6 years if 25% or more of gross income received by the Taxpayer is omitted from the tax return. For this tax issue (i.e. omission of gross income), the Burden of Proof is on the IRS, but if their burden is satisfied all deductions are also subject to the IRS audit (not just the omitted income).

There is no Statute of Limitations if a tax return is not filed. There is no Statute of Limitations if Taxpayer commits tax fraud (however, the burden of proof is on the IRS).

The IRS often requests a statute extension if the statute will soon expire. If the statute is not extended the IRS will assess tax which can be a bad result (i.e. the tax is due) but have a good benefit (i.e. the audit is then terminated with no further tax disallowance issues to be raised by the auditor) with the taxpayer entitled to file a Notice of Protest and seek an IRS administrative appeal (to a separate division of the IRS/Appeals) without paying tax and no IRS tax lien filed or IRS collection instituted on the assessed tax (i.e. no IRS levy).

The only exception would be a jeopardy assessment if the IRS considers tax collection to be "at risk" (i.e. the Taxpayer hides assets, flees the US et al.) the IRS may seize the Taxpayer assets under a levy, "freezing these assets" pending resolution of the audit assessment.

Taxpayers who elect to file amended tax returns face the following statute of limitations issues:

- 1. The amended tax return/claim for refund must filed within 3 years of the filing of the original tax returns
- 2. If the amended tax return increases tax and is filed within 60 days of the statute expiration date, the IRS gets an additional 60 days to assess from the date of the amended tax return filing;
- 3. For unfilled tax returns the Taxpayer has 2 years from the date the tax was paid to file a tax refund claim.

Caveat:

If the amended tax return does not increase the tax due, the Statute of Limitations is not extended. For Taxpayers who wish to file a tax refund claim, it may be advisable to file the claim within 60 days before the statute expiration which may preclude IRS review and audit before the expiration of the Statute of Limitations so the Taxpayer receives an uncontested tax refund.

Chapter 10 – IRS Civil/Criminal Penalties: Willfulness

Under the IRS rules, the willfulness element essential for a criminal tax evasion charge is defined as follows: (see IRS Criminal Tax Division/Office of Chief Counsel Tax Crimes Handbook)

"Willfulness is the voluntary, intentional violation of a known, legal duty. (See: Cheek v. US 498 US 192, 200-201 (1991); US v. Pomponio 429 US 10,12 (1976); US v. Bishop 412 US 346, 360 (1973).

The subjective test is "A defendants' good faith belief that he is not violating the tax law, no matter how objectively unreasonable that belief may be, is a **Defense** in a **Tax Prosecution**, (See Cheek, supra).

Mental impairment can be a defense subject to a medical evaluation which may include; loss of memory from drug/alcohol addition, brain impairment from personal injury (e.g. car accident), or disease (Alzheimer's disease affected over 5m US people of all ages in 2015).

The key issue is whether there was a mental impairment at the time a tax crime was committed e.g. failure to declare an offshore account, failure to report income and other tax crimes.

For a U.S. taxpayer to avoid criminal prosecution, the tax rules are different than those tax rules for imposition of civil penalties. Tax crimes require "intent"; i.e. the U.S. taxpayer deliberately and intentionally pursued a criminal course of conduct.

The U.S. taxpayer must demonstrate that he had "a good faith belief" that he did not owe tax. If so, the U.S. taxpayer may be able to prevent a criminal conviction but not necessarily prevent being criminally prosecuted. The U.S. taxpayer must demonstrate that their "tax theory" (however misguided) was in "good faith" in order to negate the "intent element" of the crime of tax evasion.

For example, in the case of *Vernice Kuglin*, she successfully convinced a jury that the IRS's failure to respond to her written inquiry regarding the need to file a tax return or pay tax on over \$900,000 in U.S. taxable income was a "reasonable, good faith belief" and she was not convicted of tax evasion.

For example, in the 2007 case of Tom Cryer (an attorney in Louisiana) tax evasion charges were dropped and he was acquitted on charges of willfully failing to file a tax return. Cryer's defense was that the IRS refused to respond to his repeated demand that the government explain why his "tax theories" were not viable, instead they refused to respond to Cryer, stating his tax positions were "frivolous".

At trial, Cryer convinced jurors that he genuinely believed he owed no tax for the years in question, and without proof of criminal intent, he was acquitted.

In the case of the actor Wesley Snipes, he provided the IRS with a 600-page explanation of why he was a "non-taxpayer" which the IRS ignored as a "tax protester" manifesto. He was not convicted of tax evasion (i.e. a felony) but was convicted for failure to file a tax return (misdemeanor) and was sentenced to three one-year consecutive prison terms.

For civil tax penalties, U.S. taxpayers must demonstrate the key element for a penalty defense; i.e. reasonable reliance on counsel. In criminal courts, reliance on counsel is essential but the courts give wide latitude with respect to a willfulness defense and the taxpayer's "good faith belief".

In criminal cases, the prosecutor must prove beyond a reasonable doubt willfulness, or specific criminal intent, which means that the defendant:

- 1. Knew and understood the law; and
- 2. Intentionally set out to violate it; i.e. had the purpose of evading assessment or collection of taxes.

Regarding willfulness, the defendant may present a good faith defense, including good faith belief and reliance when reliance includes all that the defendant read and heard. According to the U.S. Supreme Court, good faith is a defense, no matter what the belief. However, the defendant is not allowed willful blindness; i.e. the defendant intentionally concealed the truth from himself.

Criminal penalties may be imposed for intentionally violating federal tax laws (i.e. willful violation). "Ignorance of the law excuses no one" is a legal principle holding that a person who is unaware of a law may not escape liability for violating that law merely because he or she is or was unaware of its content.

Under U.S. Model Penal Code Sec. 2.02(9), knowledge that at an activity is unlawful is not an element of an offense unless the statute creating the offense specifically makes it one.

In Cheek v. U.S. (1991), 498 U.S. 192, willfulness is required for federal tax crimes. In Cheek, the U.S. Supreme court reversed his conviction for willful failure to file a tax return.

Cheek's "tax theory" was that wages did not constitute income and he therefore failed to file a tax return. The U.S. Supreme Court held that Cheek was entitled to a good faith instruction to the jury; i.e. the jurors could acquit him if they found Cheek believed in good faith that he was not required to file. The prosecutor had to prove that Cheek did not rely in good faith on what he heard and read. Cheek was eventually convicted and served a year and a day.

In order to avoid criminal convictions, U.S. taxpayers must rely upon independent, competent counsel. In the case of U.S. v. Lindsey Springer, (Case No. 09 C.R. 043 JHP, Northern District of Oklahoma), the taxpayer and his

attorney each received a 15 year sentence for conspiracy to defraud the U.S. and evasion of taxpayer's taxes by use of the attorney's trust account to funnel client funds and from which account client expenses were paid.

Although the good faith belief and reliance arguments may be usable as a defense in a criminal tax case, often these off-shore situations involve "money laundering" (i.e. disguising the nature or origin of the funds), in which the government may criminally prosecute under the principal of "intentional blindness" or "ignoring what is reasonable" as a basis for conviction.

Bottom line: The best defense is a specific tax opinion letter from an independent, competent tax professional.

Chapter 11 – IRS Penalties – Reasonable Cause

Under Mortensen v. Commr., 440 F.3d 375, 385 (6th Cir. 2006), it was held that reasonable minds can differ over tax reporting, and under tax audits the IRS may disallow certain transactions.

The U.S. Congress was concerned that taxpayers would participate in the "audit lottery" and take questionable positions on their tax returns in the expectation of not being audited (See: H.R. Rep. No. 101-247, 1388 (1989). H.R. Rep. No. 101-247, as reprinted in 1989 U.S.C.C.A.N. 1906, 2858.

IRC Sec. 6662(b) imposes a civil penalty for substantial understatements of income, or liability overstatements (in addition, other civil penalties may be imposed for negligence and substantial valuation misstatements).

Under IRC Sec. 6064(c), no penalty will be imposed with "respect to any portion of an underpayment if it is shown that there was reasonable cause and the taxpayer acted in good faith."

Under Treasury Regulation Section 1.6664-4(b)(1), "reasonable cause" and "good faith" require courts to review the following taxpayer issues:

- 1. Experience;
- 2. Knowledge;
- 3. Sophistication;
- 4. Education;
- 5. Taxpayer reliance on a tax professional; and
- 6. Taxpayer's effort to assess the taxpayer's proper tax liability.

Under Treas. Reg. Sec. 1.6664-4(c), the IRS minimum requirements for determining whether a taxpayer reasonably relied in good faith on advice including a tax advisor's professional opinion.

The minimum requirements include:

- 1. The advice must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances:
- 2. The advice must not be based on unreasonable factual or legal assumptions;

- 3. The advice must not unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other person;
- 4. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed that the regulation in question is invalid (Treas. Reg. Sec. 1.6662-3(c)(2).

Under Treasury Regulation Sec. 1-6664-4(b)(1), reasonable cause and good faith are not necessarily established by reliance on the advice of a professional tax advisor.

However, under Treas. Reg. Sec. 1.6664-4(b)(2), a taxpayer may satisfy the "reasonable cause" and "good faith" exception because the taxpayer believed that the tax professional had knowledge in the relevant aspects of federal tax law.

In United States v. Boyle, 469 U.S. 241, 251 (1985), the U.S. Supreme Court held:

- 1. Taxpayers may not be sophisticated in tax matters, and that it is unrealistic for taxpayers to recognize errors in the substantive advice of an accountant or attorney;
- 2. To require the taxpayer to challenge the attorney, to seek a second opinion, or to try to monitor counsel would nullify the purpose of seeking the advice of a presumed expert in the first place.

Under Sklar, Greenstein & Scheer, P.C. v. Commr., 113 T.C. 135, 144-145 (1999) citing Ellwest Stereo Theaters of Memphis, Inc. v. Commr., T.C.M. 1995-610, the Tax Court established a three-prong test to prove reasonable cause, where a taxpayer is asserting a defense against an IRC Sec. 6662 penalty:

- 1. The tax advisor was a competent professional who had sufficient expertise for justifying reliance;
- 2. The taxpayer provided necessary and accurate information to the advisor;
- 3. The taxpayer actually relied in good faith on the advisor's judgment.

Under Treas. Reg. Sec.1-6664-4(b)(1), reliance on a tax advisor may be considered reasonable when the taxpayer knew that the tax advisor possessed specialized knowledge in the relevant aspects of federal tax law.

In the case Neonatology Assoc., P.A. v. Commr., 115 T.C. 43, 99 (2000), aff'd 299 F.3d 211 (3d Cir. 2002) the court held:

- 1. Taxpayer reliance on an insurance agent was found to be unreasonable because the insurance agent was not a tax professional;
- 2. The taxpayers were sophisticated and should have known that the tax benefits discussed were "too good to be true";
- 3. The court rejected the evidence the taxpayers presented that they also relied on tax attorneys and accountants.

In Stanford v. Commr., 152 F3d 450 (5th Cir. 1998) the court held:

- 1. Taxpayer could rely on a CPA with extensive experience in international banking law for advice regarding the taxpayer's controlled foreign corporation.
- 2. It was not reasonable to expect the couple to monitor their CPA to make sure he conducted sufficient research to give knowledgeable advice.
- 3. Intelligent investors have independent educated experts to advise them, particularly with respect to arcane matters of the law.
- 4. The Court vacated the penalty since the CPA was diligent in reviewing the taxpayer's business and tax records, and studying the statute, legislative history and regulations.

Chapter 12 - IRS Civil/Criminal Penalties: Willfulness (Case Law)

In Larson v. Commr., TC Memo 2002-295, 84 T.C.M. 608 (2002), the Court held that to satisfy the "reasonable cause" and "good faith" exception, the taxpayer must provide necessary and accurate information to the tax advisor.

In Larson, the taxpayer received an incorrect Form 1099 which due to a printing error, read \$1,891 (not \$21,891). Here, the "reasonable cause" and "good faith" exception did not apply since the taxpayer had reason to believe that the tax reported on the tax return was not accurate and the taxpayer should have made additional efforts to assess the proper amount of his tax liability.

In Woodson v. Commr., 136 T.C. 585 (2001), the court held that the taxpayer's reliance on a return preparer did not constitute reasonable cause, since to qualify for the "reasonable cause penalty exception" the taxpayer must rely in good faith on the tax advisor's judgment or advice.

In Woodson, the tax return failed to include a \$3.4M tax item and substantially understated the tax liability, the result of a "clerical mistake". Here the court did not apply the reasonable cause exception because the tax professionals did not provide advice to the taxpayers.

Under Treas. Reg. Sec. 1-6664-4(c)(2), tax advice constitutes analysis on the conclusions of a professional tax advisor. Here, the taxpayers did not provide evidence to show that a professional tax advisor's analysis or conclusions led to the omission of the item on the tax return. The taxpayers were not able to satisfy the "reasonable cause" and "good faith" defense as the taxpayers did not review the proposed return to ensure that the income items were included.

In Thomas v. UBS, 7th Cir. (2013), the court held that the Swiss Bank, UBS, is not liable to U.S. account owners for fines and interest paid when confessing to the IRS about their foreign accounts. The U.S. accountholders sued UBS, claiming the bank didn't give them accurate tax advice and should have kept them from breaking the law. The court threw out their lawsuit, saying they were tax cheats who didn't merit a day in court.

In Canal Corp. v. Commr., 135 T.C. 199 (2010), the court held that taxpayers may defend against the "accuracy-related" penalty, when the taxpayers rely on a tax professional, under a "three-prong test":

- 1. The taxpayer provided necessary and accurate information to the advisor.
- 2. The taxpayer acted in good faith on the tax professional's advice.
- 3. The tax advisor had apparent expertise to justify reliance.

In Canal the test was not satisfied and the court imposed accuracy-related penalties despite the taxpayer's reliance on a sophisticated advisor.

Taxpayers must not rely on tax professionals that provide tax advice that they personally know is incorrect or that they believe might not be correct based on their previous experience or business knowledge. Additionally, taxpayers should review any Form 1099s or other informational returns they receive to ensure they are complete and accurate.

In the case of U.S. v. Williams (U.S. App. Lexis 15017), (4th Cir. Va., July 20, 2012) (unpublished)), the 4th Circuit reviewed a District Court judgment that for civil penalty purposes Williams did not willfully fail to report his interest in two foreign bank accounts under 31 U.S.C. 5314.

The court held that Williams' conduct constituted "willful blindness" since:

- 1. He chose not to report the income;
- 2. He knew he had an obligation to report the existence of the Swiss accounts;
- 3. He knew what he was doing was wrong and unlawful;
- 4. On his Form 1040 tax return, he "checked no" on Schedule B regarding having an interest in foreign accounts.

The 4th Circuit ruled that Williams willfully violated 31 U.S.C. Sec. 5314 (to report two foreign bank accounts).

Civil Penalties (Tax Advice)

A U.S. taxpayer who relies on the advice of a tax professional may relieve the U.S. taxpayer from civil penalties if there has been no willful neglect. Under the IRC Sec. 6664: "No penalty shall be imposed... with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion ". Under related Treasury Regulations: "Reliance on an information return, professional advice, or other facts constitutes reasonable cause and good faith if under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith."

Under IRS Circular No. 230, U.S. taxpayers may now rely on tax opinions for relief from penalties only, if:

1. The tax opinion is based on a full legal and factual review and covers all the issues;

2. The drafter of the tax opinion may not be involved directly or indirectly with the "tax-shelter" promoter; i.e., it must be an independent tax opinion.

In the case of Canal Corp. v. Commr.,135 T.C. 199 (2010), the court held that the taxpayer could not rely upon Price Waterhouse Cooper's (PWC) tax opinion (for which they paid \$800,000) because of PWC's involvement with the "underlying structures"; i.e. the tax shelter.

A U.S. taxpayer may avoid civil penalties if the U.S. taxpayer;

- 1. Makes full disclosure;
- 2. To an independent tax professional;
- 3. Who is experienced in the area of law;
- 4. Receives, reviews and understands the advisor's tax opinion;
- 5. No "blind reliance" on the tax opinion; i.e. two tests: "You should know better", or "It's too good to be true".
- 6. The taxpayer must rely upon the opinion; and
- 7. The taxpayer must follow the plan and the opinion.

Chapter 13 – IRS Offshore Tax Evasion: Waiver of Criminal/Civil Penalties

- U.S. Taxpayers who commit offshore tax evasion are subject to serious civil and criminal penalties, which may include:
- 1. An FBAR civil penalty of up to 150% of the account balance (see: 5/14 case of Florida Taxpayer Carl Zwerner)
- 2. 20%-40% accuracy related penalty (on underpayment of tax due).
- 3. Civil Tax Fraud penalty (75% of tax due) and suspension of the IRS statute of limitations for civil tax audits

Criminal Penalties

Criminal Prosecution for Tax Crimes: Willful Evasion of Tax (5 years in jail; IRC 7201), Obstruction of Tax Collection (3 years in jail; IRC 7212), Conspiracy to Commit Tax Evasion (5 years in jail; 18 USC 371), Filing a False Tax Return (3 years in jail; IRC 7206), Failure to File FBAR (10 years in jail for each tax year not filed; Fincen form 114).

In addition, tax crimes may be linked to 3 separate 20 year felonies: mail fraud, wire fraud, and money laundering. Mail fraud requires the use of the postal system to effectuate a scheme to defraud (18 USC 1341). Wire fraud requires the use of a telecommunications facility to effectuate a scheme to defraud (18 USC 1343) and if the wire fraud affects a financial institution, the fine is up to \$1m and up to 30 years in prison.

Money Laundering is the use of illegal funds to purchase assets (hiding the origin of the illegal funds). These illegal funds may come from tax evasion. Tax evasion is a Specified Unlawful Activity ("SUA"), a predicate offense for money laundering under the Money Laundering Control Act, 18 USC 1956, 1957, as is wire fraud & mail fraud).

Tax evasion is a Specified Unlawful Activity in a financial transaction involving the proceeds of a specified unlawful activity with the intent to violate IRC Sec. 7201 (willful attempt to evade tax) or IRC Sec. 7206 (False tax return filed or false and fraudulent statements made to the IRS).

In addition to monetary penalties, violations of mail fraud, wire fraud and money laundering are punishable by civil and criminal forfeiture (18 USC 981(a)(1)(A): civil forfeiture 18 USC 982(a)(1)(A): criminal forfeiture.

Civil Penalties

For failure to file Fincen Form 114("FBAR") to report the off-shore account a penalty equal to the greater of \$100k or 50% of the balance in the account for each violation. In 2014 a Florida taxpayer, Carl Zwerner, lost at trial with the IRS for failing to file an FBAR and had a 150% of the account balance penalty imposed.

A 20-40% accuracy-related penalty for underpayment of tax.

A Civil tax fraud penalty (75% of tax due) and suspension of the IRS statute of limitations for civil tax audits.

Waiver Of Penalties/Good Faith Belief

Clearly, there is great risk for undeclared offshore accounts and unreported income. The key issue for the taxpayer to eliminate penalties is cited in IRC Sec. 6404(c) which states that no penalty will be imposed with respect to any portion of an underpayment if it is shown that there was reasonable cause and the taxpayer acted in good faith.

To avoid both criminal prosecution and criminal conviction the taxpayer must demonstrate that he had a "good faith" belief that he did not owe the tax. In Cheek v. US 1991(1991) 498 US 192 willfulness is required for federal tax crimes.

A good faith misunderstanding of the law, or a good faith belief that one is not violating the law negates the willfulness element of a tax evasion charge (See: Standard Federal Tax Reports Par. # 41.318.034; Tax Research Consultant Sec. 66.050, Practical Tax Explanations Sec. 40.245).

Chapter 14 – Is Mental Impairment a Basis to Claim "Non-Willful" Behavior? (Special Contribution by Sanford Millar, Esq.)

The Tax Crimes Handbook of the Office of Chief Counsel, Criminal Tax Division of the Internal Revenue Service defines "Willfulness" as follows:

"[a] Willfulness is defined as the "voluntary, intentional violation of a known legal duty." Cheek v. United States, 498 U.S. 192, 200-01 (1991); United States v. Pomponio, 429 U.S. 10, 12 (1976); United States v. Bishop, 412 U.S. 346, 360 (1973); United States v. Pensyl, 387 F.3d 456, 458-59 (6th Cir. 2004); United States v. George, 420 F.3d 991, 999 (9th Cir. 2005). 10

[b] Subjective Test. A defendant's good faith belief that he is not violating the tax laws, no matter how objectively unreasonable that belief may be, is a defense in a tax prosecution. Cheek v. United States, 498 U.S. 192, 199-201 (1991). See also, United States v. Grunewald, 987 F.2d 531, 535-36 (8th Cir. 1993); United States v. Pensyl, 387 F.3d 456, 459 (6th Cir. 2004)"

Whether a taxpayer's conduct is "willful" or not is particularly complicated when dealing with individuals who suffer from mental impairment. Recently, David Horton, acting deputy commissioner (international), IRS Large Business and International Division illustrated an approach to documenting a claim of "non-willfulness". The approach suggest the use of medical records to establish the taxpayer's cognitive impairment by way of third party circumstantial evidence.

According to the Alzheimer's Association " an estimated 5.3 million Americans of all ages have Alzheimer's disease in 2015." These are the diagnosed cases. Of those diagnosed cases the state of medical records will be somewhat imperfect, meaning that the defense of "non-willful" behavior might be difficult to sustain. This is particularly true when tax or foreign bank account reporting issues arise. The burden is on the taxpayer and his or her representative to establish the failure to file or failure to properly report income or foreign accounts was the result of mental impairment leading to the conclusion of non-willful action. This burden becomes exaggerated when the taxpayer is in a Conservatorship.

A Conservator is a fiduciary appointed by a state court judicial officer, who is charged with taking care of the health and well being and/or the financial affairs of an individual found no longer capable of doing so.

Often a psychiatric report and medical report are required to convince a court of the need for the appointment of a Conservator. The medical and psychiatric reports will usually focus on the immediate health and state of mind of the individual, which is the issue before the court. But the immediate moment is not the issue for tax and foreign account reporting. The state of mind that is at issue is what was the taxpayer's intent

when he or she signed the return or failed to file. This act could be six-eight years earlier or more. Establishing the state of mind of a taxpayer years earlier when the tax return or Report of Foreign Financial Account (FBAR) was due or filed, is or could be critical to a decision about whether the individual qualifies for the Domestic Streamline Procedure or whether the Conservator should muse the formal Offshore Voluntary Disclosure Program (OVDP). The financial difference to the Conservatorship Estate is or can be quite substantial.

Under the Domestic Streamline Procedure rules the taxpayer must pay a penalty of five percent (5%) of the prior six years highest foreign account balance and file three years of amended returns. Under the OVDP the taxpayer must pay a penalty of either 27.5% or 50% of the highest foreign account balances for the preceding eight years along with amended returns for the same period. The taxpayer must also pay a 20% accuracy related penalty on the unpaid tax. The 50% penalty applies if the taxpayer's account was at a financial institution listed by the Department of Justice under the Swiss Bank Program.

It is therefore very important for a Conservator to obtain the most comprehensive medical report possible to document the taxpayer's state of mind at the earliest possible date, not just the current moment. A skilled forensic psychiatrist should be able to help in this regard.

It is noteworthy to reiterate that a non-willful defense based upon mental impairment is a complex defense to build and can be expensive in terms of professional fees. But in the proper circumstances the time and effort are justified if measured by potential savings to the Conservatorship estate.

Chapter 15 – Attorney Client Privilege (General)

Under IRC Section 7525 (A) (enacted 7/22/98):

With respect to tax advice, the common law protections that apply to a communication between a taxpayer and an attorney applies to a communication between a taxpayers and any Federally Authorized Tax Practitioner ("FAPT") (which includes attorneys, CPAs, enrolled agents, see IRS Pub 947, and Treasury Dept. Circular 230) does not apply in criminal matters.

For those US Taxpayers who commit tax crimes (i.e. tax felonies: IRC 7201 Willful Evasion of Tax; IRC 7212 Obstruction of Tax Collection, 18 USC Sec. 371 Conspiracy to Commit Tax Evasion (a "Klein Conspiracy") and others (see below), they may not have an absolute attorney-client privilege.

Under IRC Sec. 7525, the FATP privilege may only be asserted in a "non-criminal tax matter before the IRS" and a "non-criminal tax proceeding in a Federal court brought by or against the United States (IRC Sec.7525(A).

The Bottom Line: Tax advice has a limited attorney client privilege only for "non-criminal tax matters".

In addition, anyone who has knowledge of a tax (or other) felony, who does not report this tax felony to a judge of a US court, or other person in a civil or military authority, may be held liable for misprision of a felony (18 USC Sec. 4) and imprisoned for not more than 3 years (18 USC sec. 4).

In addition to tax felonies, the taxpayer who willfully evades taxes may be liable for separate felonies for money laundering (if they use the tax evasion proceeds to buy assets or otherwise), wire fraud and/or mail fraud, all of which are separate 20 year felonies. The US Supreme Court in the Pasquantino case (544 US 349, 2005) held that tax evasion may also include the related crimes of wire fraud and mail fraud as well as money laundering, and further stated: that a taxpayer failure to pay taxes was an "embezzlement" from a national (state) treasury.

Please see list of criminal penalties below.

IRS/Offshore Accounts: Criminal Penalties

(6-Year Statute of Limitations)

1. Tax Evasion (Willful Evasion of Tax) (IRC Sec. 7201) up to five years in prison Fine: \$100,000 (individual) \$500,000 (corporation)

2. Obstruct (Impede Tax Collection)

(IRC Sec. 7212) up to three years in prison

Fine: \$5,000

3. Conspiracy to Impede Tax Collection

(18 USC 371) separate charges of impeding - up to five years in prison

4. Failure to File Tax Return

(IRC Sec.7203) up to one year in prison

Fine: \$25,000(individual) \$100,000 (corporation)

5. File False Tax Return

(IRC Sec. 7206(1)) up to three years in prison

Fine: \$250,000

6. FBAR Violation

(31 USC Sec. 5322(b)), 31 CFR 103.59(c) Willful Violation: up to ten years in jail

Fine: \$500,000

Additional Criminal Penalties:

- 1. Perjury: (U.S. taxpayer, who fail to disclose foreign accounts under Form 1040/Schedule B, Part III, question 7 (a))
- 2. FATCA Filings: (i.e. Failure to disclose foreign financial assets on \$50,000/IRS Form 8938).
- 3. Money Laundering: Disguise of the nature or the origin of funds (18 USC Sec. 1956 and 1957)

Chapter 16 – Attorney Client Privilege (Offshore Accounts)

Tax Advisors (Attorneys/CPAs) who render tax advice to a taxpayer for offshore accounts (or other tax matters) may have no attorney-client privilege and may themselves be subject to criminal penalties.

US Taxpayers with undisclosed offshore accounts face a myriad of civil and criminal tax penalties. In addition, the Taxpayer may not have the attorney-client privilege for confidential communications if the professional services from legal counsel was for tax advice and the IRS investigates taxpayer for criminal tax evasion.

Under IRC Sec. 7525 (effective date 7/22/98), there is no attorney-client privilege for tax advice rendered if the IRS pursues a criminal tax investigation. The implications for the US Taxpayer and advisors include the following:

- 1. US Taxpayers with undisclosed offshore accounts and/or unreported income (from offshore or domestic accounts) may not be able to assert an attorney-client privilege if questioned by the IRS;
- 2. Their tax advisor (ie. Attorney or CPA), who rendered tax advice to them, may be unable to refuse to answer IRS inquiries or produce Taxpayer records;
- 3. Under 18 USC Sec. 371(conspiracy to commit tax evasion) when 2 or more parties collude to evade taxes due they may be held liable for a criminal tax conspiracy and face felony charges (5 years in jail), known as a "Klein conspiracy";
- 4. Under Treasury Dept. Circular #230 (the rules governing tax practice before the IRS), Sec 10.21 requires a tax practitioner, who is aware that a taxpayer is non-compliant with federal tax law to advise the taxpayer of both the taxpayer tax non-compliance and the penalties for continued tax non-compliance, or the tax practitioner faces suspension or disbarment for their tax practice before the IRS.
- 5. Under 18 USC Sec. 4, Misprision of a Felony: "Whoever has knowledge of actual commission of a felony.... must refer the matter to a judge or other civil or military authority... or is subject to "be fined, or imprisoned not more than 3 years or both (effective 6/25/48).

The term "tax advice" means advice given by an individual with respect to a matter that is within the scope of an individual's authority to practice (IRC Sec. 7525 (a) (3) (B). Under IRC Sec. 7525 (a)(1): "with respect to tax advice, the same common law protections of confidentiality, which apply to a communication between a taxpayer and an attorney, shall also apply to a communication between a taxpayer and any federally authorized tax practitioner ("FAPT"), to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney".

A FAPT (federally authorized tax practitioner) means an individual authorized under federal tax law to practice before the IRS where the practice is subject to federal regulation under 31 USC Sec. 330 (IRC Sec. 7525 (a)(3)(A). The term FAPT includes an attorney, CPA, an enrolled agent, or an enrolled actuary. The FAPT does not apply to accountants who are not CPAs (unless the accountant qualifies as an enrolled agent). See Treasury Dept Circular 230, IRS Pub 947).

Under IRC 7525 (a) (2), unlike the attorney-client privilege, the FAPT privilege does not apply in criminal tax matters and may only be asserted as a privilege in "noncriminal tax matter before the IRS" and in a "non-criminal tax proceeding in a Federal Court brought by or against the US". The legal effect is that tax advice rendered has a limited attorney-client privilege only for "non-criminal tax matters".

The FAPT privilege only applies to communications made on or after 7/22/98. The privilege does not apply to any written communication before 10/22/04 between a FAPT and a director, shareholder, officer, employee, agent, or representative of a corporation in connection with the promotion or the direct or indirect participation of such corporation in any tax shelter (the term tax shelter is defined in 26 USC Sec. 6662 (d) (2) (C).

IRC Sec. 7525 was amended by the American Jobs Creation Act of 2004, so that the privilege does not apply to written communications made on or after 10/22/04, involving a federally authorized tax practitioner with respect to the participation of any person (not just a corporation) in a tax shelter (Pu. L. No. 108-357).

The FAPT privilege applies only to tax advice not general business consultations or personal financial planning advice. The tax advice must be treated as confidential to be covered by the privilege. If the communication is divulged to 3rd parties, then, it is not confidential.

Current case law indicates that a communication in connection with tax return preparation is not covered or protected by the FAPT privilege. In US v. Gurtner (474 F.2d 297 (9th Cir. 1973) the US 9th Cir. Ct. of Appeals held that tax return preparation does not involve giving or receiving legal advice. In US v. Cote (456 F.2d 142 (8th Cir. 1972), the US 8th Cir Ct. of Appeals held that tax returns are not privilege based on the rationale that tax returns are intended for disclosure to a 3rd party (IRS) so there can be no expectation of confidentiality which defeats the claim that the tax return or pertinent communication is privileged.

Regarding the the rules of confidentiality of tax returns and tax return information held by the IRS or tax practitioner (IRC Sec. 6103, 7213, 7213A, 7216) the confidentiality protections in those rules do not render the communication confidential for purposes of the FAPT privilege.

Chapter 17 – Money Laundering: General

The US Attorney Criminal Resource Manual Sec. 2101, defines criminal conduct for which includes domestic money laundering transaction (18 USC 1956 (a) (1), and international money laundering transaction (18 USC 1956 (a)(2). To be criminally culpable for money laundering a defendant must:

- 1) Conduct (or attempt to conduct) a Financial Transaction;
- 2) Knowing that the property involved in the financial transaction represents the proceeds of some unlawful activity (Specified Unlawful Activity);
- 3) The property must be in fact derived from a Specified Unlawful Activity;
- 4) The defendant conducts the financial transaction with one of four specific intents (Specific Intents), which includes "intent to engage in tax evasion or tax fraud" (18 USC 1956 (a) (1) (A) (ii).

The property involved in the Financial Transaction (i.e. the actual source of funds) must be one of the specified forms of criminal activity identified by the statute in 18 USC 1956 (c) (7), or those incorporated by the RICO statute (18 USC sec. 1961 (1).

A "Financial Transaction" is defined under 18 USC 1956 (c) (4) as a Transaction which affects interstate or foreign commerce and:

- 1) Involves the movement of funds by wire or other means, or
- 2) Involves the use of a monetary instrument, or
- 3) Involves the transfer of title to real property, a vehicle, a vessel, or an aircraft or
- 4) Involves the use of a financial institution which is engaged in, or the activities of which affect interstate or foreign commerce.

Transaction is Defined: (18 USC 1956 (c) (3) as:

A purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition. With respect to a financial institution, a deposit, withdrawal, transfer between accounts, loan, exchange or currency, extension of credit, purchase or sale, any other payment, transfer or delivery by, through, or to a financial institution, or a safe deposit box.

In conducting the Financial Transaction, the defendant must have acted with one of the following four specific intents:

- 1) Intent to promote the carrying on of a Specified Unlawful Activity (18 USC 1956)(a)(1)(A)(i);
- 2) Intent to Engage in Tax Evasion or Tax Fraud (18 USC 1956)(a)(1)(A)(ii);
- 3) Knowledge that the transaction was designed to conceal or disguise the nature, location, source, ownership or control of proceeds of the specified unlawful activity (18 USC 1956)(a)(1)(B)(i)
- 4) Knowledge that the transaction was designed to avoid a transaction reporting requirement under federal or state law (e.g. in violation of 31 USC 5313 (currency transaction reports), or 31 USC 5616 (currency and monetary instrument reports) or 26 USC 6050 I (IRS Form 8300)

Chapter 18 - Money Laundering: Criminal Prosecution

Criminal prosecutions by the US Attorney pursuant to 18 USC 1956 (a) (1) for domestic money laundering transactions arise when the defendant was involved in a felony under federal, state or foreign law. To prove a violation of 18 USC 1956 (a) (1), the prosecutor must prove (either by direct or circumstantial evidence) that the defendant knew that the property involved was the proceeds of a felony.

The Prosecutor need not show that the defendant knew the specific crime from which the proceeds were derived. The Prosecutor must only prove that the defendant knew that the property was illegally derived in some way (18 USC 1956 (c) (1). The Prosecutor must prove that the defendant initiated or participated in a FINANCIAL TRANSACTION.

Each separate FINANCIAL TRANSACTION must be charged separately in a separate count (under the case of US v. Prescott 42 F.3d 1165 (8th Cir. 1994) which held that charging multiple financial transactions in a single count is duplicitous). For example:

- 1) Count #1: individual earns \$100k from criminal activity (1st offense)
- 2) Count #2: individual withdraws \$50k (2d offense)
- 3) Count #3: individual purchases an asset (e.g. car) with the withdrawn \$50k.
- 3 Separate Counts each transaction is charged in a separate count.

Violations of 18 USC 1956 have the following penalties:

- 1) A maximum 20 year prison sentence and a \$500k fine (or twice the amount involved in the transaction, which ever is greater)
- 2) Under 18 USC 1956 (b), a civil penalty may be pursued as a civil cause of action. The civil penalty is not more than the greater of \$10k or the value of the funds involved in the transaction.

Chapter 19 - Money Laundering: Statutes

The key federal criminal money laundering statute is 18 USC 1956 which outlaws four kinds of money laundering:

- 1) Promotional, concealment, structuring and tax evasion;
- 2) Laundering of the Proceeds (i.e. invest the proceeds transforming it into other assets);
- 3) Money generated by designated federal, state, and foreign underlying crimes (predicate offenses). In the case of *Pasquantino v. US* 544 US 349 (2005), defrauding a foreign government (i.e. Canada) of tax revenue was held to be a violation of the federal wire fraud statute (18 USC 1343 i.e. the use of interstate wires, in this case telephone calls, to "effect a scheme to defraud"). This crime of tax evasion in a foreign country may also be a predicate offense for money laundering.
- 4) Federal criminal money laundering committed or attempted under one or more of 3 jurisdiction conditions:
- a) money laundering of proceeds;
- b) certain financial transactions;
- c) international transfers.

The related companion statue is 18 USC 1957 which prohibits depositing or spending more than \$10k of the proceeds from an offense under 18 USC 1956. The penalties are different: violations under 18 USC 1956 are punishable by imprisonment for not more than 20 years, under 18 USC 1957 the maximum penalty is 10 years in prison. In addition the assets/property involved in either case is subject to confiscation.

The criminal misconduct which implicates parties under 18 USC 1956, 1957 my implicate them under other federal criminal statutes including:

RICO: Federal Racketeer Influenced and Corrupt Organization provisions which outlaws acquiring or conducting the affairs of an enterprise whose activities affect interstate or foreign commerce through the patterned commission of a series of federal or state crimes. The maximum penalty is 20 years in jail. Every RICO predicate offense (i.e. underlying crime known as a Specified Unlawful Activity. "SUA") including the federal crime of terrorism is automatically am 18 USC Section 1956 money laundering predicate offense.

The Travel Act (18 USC 1952) punishes: interstate or foreign travel/the use of interstate

or foreign facilities conducted with the intent to distribute the proceeds of other predicate offenses. The maximum penalty is 5 years in jail.

Other related federal statutes include:

- 1) Bulk cash smuggling;
- 2) Layering bank deposits to avoid reporting requirements;
- 3) Failure to comply with federal anti-money laundering provisions;
- 4) Conducting an unlawful money transmission business.

Chapter 20 - Money Laundering: Criminal Conduct

The US Attorney Criminal Resource Manual Section 2101 references 18 USC 1956 (a) which defines three types of criminal conduct:

- 1) Domestic Money Laundering transactions (18 USC 1956 (a) (1);
- 2) International Money Laundering transactions (18 USC 1956 (a) (2);
- 3) Undercover "Sting" Money Laundering Transaction (18 USC 1956 (a) (3).

To be criminally culpable under 18 USC 1956 (a) (1) a defendant must conduct or attempt to conduct a FINANCIAL TRANSACTION, knowing that the property involved in the financial transaction represents the proceeds of some unlawful activity with one of four SPECIFIC INTENTS, and the property must in fact be derived from a SPECIFIED UNLAWFUL ACTIVITY (see 18 USC 1956 (c) (7) for the source of funds from a criminal activity or under the RICO statute (18 USC 1961(1).

TRANSACTION/FINANCIAL TRANSACTION

A TRANSACTION is defined under 18 USC 1956 (c) (3) as a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition. With respect to a financial institution, a deposit, withdrawal, transfer between accounts, loan, exchange of currency, extension of credit, purchase or sale, safe-deposit box, or any other payment, transfer or delivery by, through, or to a financial institution.

A FINANCIAL TRANSACTION is defined under 18 USC 1956 (c) (4) as a transaction which affects interstate or foreign commerce and:

- 1) Involves the movement of funds by wire or other means;
- 2) Involves the use of a monetary instrument, or
- 3) Involves the transfer of title to real property, a vehicle, a vessel, or an aircraft; or
- 4) Involves the use of a financial institution which is engaged in, or the activities of which affect, interstate or foreign commerce.

SPECIFIC INTENTS

In conducting the financial transaction, the defendant must have acted with one of the following FOUR SPECIFIC INTENTS:

1) Intent to promote the carrying on of specified unlawful activity (18 USC 1956 (a) (1)

- (A) (i);
- 2) INTENT TO ENGAGE IN TAX EVASION OR TAX FRAUD (18 USC 1956 (a) (1) (A) (ii);
- 3) Knowledge that the transaction was designed to conceal or disguise the nature, location, source, ownership or control of proceeds, of the specified unlawful activity (18 USC 1956 (a) (1) (B) (i)
- 4) Knowledge that the transaction was designed to avoid a transaction reporting requirement under federal or state law. Examples include: Currency Transaction Reports (31 USC 5313), Currency and Monetary Instrument Reports (31 USC from 5316) or 26 USC 6050 I (Internal Revenue Service Form 8300).

Chapter 21 – International Taxation and Estate Planning

International tax and estate planning may lead to tax evasion (and additional crimes: money laundering, mail fraud, wire fraud) if the U.S. taxpayer either fails to pay tax due to federal, state or foreign governments. The U.S. taxpayer may be culpable for violations of U.S. wire fraud laws, money laundering laws or mail fraud laws, which may lead to asset forfeiture.

Income tax deficiencies (i.e. failure to pay tax due) which create "tax cheating" proceeds, when used to purchase assets or make investments may subject the taxpayer to separate felonies:

- 1. Tax Evasion (failure to pay the tax due);
- 2. Money Laundering The use of proceeds from a specified unlawful activity, i.e. tax evasion, to purchase or make investments in assets which transmute the original "illegal tax-cheating" proceeds into another asset;
- 3. Mail Fraud: The use of the postal system to effectuate a scheme to defraud (18 U.S.C. Sec. 1341);
- 4. Wire Fraud: the use of the telecommunications facilities to effectuate a scheme to defraud (18 U.S.C. Sec. 1341).

Money Laundering

Money laundering may be linked to tax evasion. A violation of the money laundering statutes includes a financial transaction involving the proceeds of a specified unlawful activity ("SUA") with the intent to either:

- 1. Promote that activity;
- 2. Violate IRC Sec. 7201 (which criminalizes willful attempts to evade tax);
- 3. Violate IRC Sec. 7206 (which criminalizes false and fraudulent statements made to the IRS).

The tax involved in the transaction (and which is avoided) may be any tax: i.e. income, employment, estate, gift and excise taxes (See: U.S. Dept. of Justice, Criminal Tax Manual, Chapter 25, 25.03(2)(a).

Under the money laundering statutes, the IRS is authorized to assess a penalty in an amount equal to the greater of:

- The financial proceeds received from the fraudulent activity, or
- \$10,000 (under 18 U.S.C. Sec. 1956(b)), the authority is granted by statute to the U.S. not the IRS, and is enforced either by a civil penalty or a civil lawsuit.

Violations of statutes for:

- Mail Fraud
- Wire Fraud
- Money Laundering

are punishable by monetary penalties, civil and criminal forfeiture. (See 18 U.S.C. Sec. 981 (a)(1)(A) which permits property involved in a transaction that violates 18 U.S.C. Sec. 1956, 1957 and 1960 to be civilly forfeited).

Civil forfeiture statutes include:

- 1. 18 U.S.C. Sec. 1956, which outlaws the knowing and intentional transportation or transfer of monetary funds derived from specified criminal offenses. For Sec. 1956 violations, there must be an element of promotion, concealment or tax evasion;
- 2.18 U.S.C. Sec. 1957, which penalizes spending transactions when the funds are contaminated by a criminal enterprise;
- 3. 18 U.S.C. Sec. 1960, which penalizes the unlicensed money transmitting business.

Under 18 U.S.C. Sec. 981(b)(2), seizures are made by warrant in the same manner as search warrants. Under 18 U.S.C. Sec. 981(b)(1), the burden of proof is by a preponderance of the evidence. The property may be seized under the authority of the Secretary of the Treasury when a tax crime is involved.

Under 18 U.S.C. Sec. 982(a)(1)(A), if the offense charged is a violation of the Money Laundering Control Act, and the underlying specified unlawful activity is mail or wire fraud, courts may order criminal forfeiture of funds involved in the activity on conviction.

The U.S. Dept. of Justice Tax Division policy requires U.S. attorneys to obtain Tax Division approval before bringing any and all criminal charges against a taxpayer involving a violation of the Internal Revenue Code. Absent specific approval, additional criminal charges for wire fraud, mail fraud and money laundering would not normally be included (U.S. Dept. of Justice Criminal Tax Manual, Chapter 25, 25.01). If the additional criminal charges are approved, the taxpayer risks having the trust assets seized or forfeited.

Regarding asset seizure, the U.S. government may seize assets pursuant to a violation of the money laundering laws. In addition, the IRS has authority for seizure and forfeiture under Title 26. Under IRC Sec. 7321, any property that is subject to forfeiture under any provision of Title 26 may be seized by the IRS.

IRC Sec. 7301 allows for the IRS to seize property that was removed in fraud of the Internal Revenue laws. IRC Sec. 7302 allows the IRS to seize property that was used in violation of the Internal Revenue laws.

In the case of transfer of funds to an offshore trust, it can trigger a violation of U.S. money laundering laws and lead to asset forfeiture. For example, tax counsel may recommend a tax planning strategy, and provide instructions by telephone, email or U.S. mail, which include client's transfer of funds pursuant to tax counsel's instructions. These combined actions may trigger a violation of U.S. money laundering laws and lead to asset forfeiture.

Chapter 22 – International Taxation and Tax Counsel

A U.S. taxpayer's failure to comply with U.S. tax law may implicate tax counsel in tax evasion. The IRS or the U.S. Dept. of Justice may allege that tax counsel aided and abetted the client in evading U.S. tax, if tax counsel:

- 1. Aided and assisted the U.S. taxpayer in the submission of materially false information to the IRS; IRC Sec. 7206(2), or
- 2. Assisted the client in removing or concealing assets with intent to defraud- (IRC Sec. 7206(4)).

For a U.S. taxpayer's transfer of assets to an offshore trust, despite receiving U.S. tax counsel's tax compliance recommendations, the U.S. taxpayer fails to comply with U.S. tax law, and tax counsel fails to ensure ongoing tax compliance, tax counsel may be implicated in money laundering.

If the U.S. taxpayer's tax noncompliance includes: tax evasion and transfer of the "tax evasion proceeds" to the offshore trust by wire transfer or U.S. mail, the transfer of funds may be classified by the IRS/U.S. Dept. of Justice as wire fraud or mail fraud, both of which are "specified unlawful activities" under the Money Laundering Control Act (18 U.S.C. Sec. 1956 and 1957), the U.S. taxpayer and their tax counsel may be criminally prosecuted for violation of the money laundering statutes.

Specified Unlawful Activities ("SUA") are listed in 18 U.S.C. Sec. 1956(c)(7). SUAs are the predicate offenses for money laundering and come in three categories:

- 1. State crimes:
- 2. Federal crimes; and
- 3. Foreign crimes.

If the U.S. client transfers funds to an offshore trust under a tax counsel's tax-planning strategy and the U.S. tax client is not in compliance with U.S. tax laws (despite tax counsel's recommendations) then tax counsel may be exposed to IRS penalties:

1. IRC Sec. 6694: imposes civil penalties on tax preparers;

2. IRC Sec. 7212: imposes criminal penalties for interfering with the administration of the Internal Revenue laws.

In addition, tax counsel may receive attention from the IRS/Treasury Dept. from the Office of Professional Responsibility in connection with Circular 230, which sets forth the rules to practice before the U.S. Treasury Dept. and is governed by regulations that appear in Title 31, Part 10 of the Code of Federal Regulations, which contains rules governing the tax professionals who represent taxpayers before the IRS, including attorneys, CPAs and enrolled agents.

A U.S. taxpayer risks having their trust assets seized or forfeited if the additional charges are approved; i.e. tax evasion/money laundering. Tax counsel may also be subject to asset seizures if their fees received come from illegal sources.

In Greenstein (superseding Indictment No. CR 08-0296 RSM, Western District of Washington at Seattle, United States Attorney's Office, Western District of Washington, News Release 6/9/09): the U.S. government sought criminal forfeiture in a tax shelter scheme by adding charges of wire fraud, mail fraud and conspiracy to launder monetary instruments. The Greenstein case also involved additional offenses such as ill-gotten professional fees not disclosed to investor clients.

In Daugerdas (Indictment No. 51 09 Cr. 581, So. Dist. N.Y., U.S. Attorney, So. Dist. of N.Y., Press Release 6/9/09) the U.S. government used a civil forfeiture in a tax shelter and Klein conspiracy prosecution under 18 U.S.C. 371.

In U.S. v. Velez, Kuehne and Ochoa, D.C. Docket No. 05-20770-CR-MGC (CA-11, 10/26/09), while the U.S. government lost, it still may prosecute counsel who received fees from a client if the funds being used to pay the fee come from illegal sources.

Tax counsel may be implicated in a "Klein conspiracy" (18 U.S.C. 371 is the general conspiracy statute). It makes it a crime for two or more persons to conspire to commit an offense against the U.S. by violating a specific statute or statutes, as well as two or more persons to agree to defraud the U.S.

A Klein conspiracy is a prosecution where the government must prove that there was agreement by two or more persons to impede the IRS and each person knowingly, willfully and intentionally participated in the conspiracy. Additionally, there is no attorney-client privilege for the crimes.

Chapter 23 – International Taxation and the Pasquantino Case

In the <u>Pasquantino</u> case, (96 AFTR 2d 2005-5392 (2005), the U.S. Supreme Court determined that a foreign government has a valuable property right in collecting taxes and that right may be enforced in a U.S. court of law.

Under the CRS Report for Congress, Money Laundering: An abridged overview of 18 U.S.C. Sec.1956 and Related Federal Criminal Law, Charles Doyle, Senior Specialist, American Law Division (7/18/08), specified unlawful activities ("SUAs") which are predicate offenses for money laundering offenses, include: state crimes, foreign crimes and federal crimes (SUAs are listed in 18 U.S.C. Sec. 1956(c)(7).

As stated in the U.S. Dept. of Justice Criminal Tax Manual, Chapter 25, 25.03(2)(a), tax evasion as a predicate offense for money laundering is a financial transaction involving the proceeds of specified unlawful activity with the intent either to promote that activity or to violate IRC Sec. 7201 (willful attempt to evade tax, IRC Sec. 7206), (false and fraudulent statements made to the IRS) with the tax involved in the transaction being any type of tax including but not limited to: income tax, employment tax, estate tax, gift tax and excise tax.

In <u>Pasquantino</u>, the defendants evaded Canadian excise taxes in a liquor smuggling scheme. The U.S. government prosecuted the taxpayers under a wire fraud statute, based on communications made within the U.S. In addition, it appears the defendants committed tax evasion in Canada, which under the cited authority (CRS Report for Congress, money laundering, the U.S. Dept. of Justice Criminal Tax Manual) would be predicate offenses (i.e. SUAs) for money laundering.

In the U.S. "wire fraud" is governed under 18 U.S.C. Sec. 1343 which provides: "whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than 20 years, or both. If the violation affects a financial institution, such person shall be fined not more than \$1M or imprisoned not more than 30 years, or both."

The wire fraud statute (18 U.S.C. 1343) forbids schemes to obtain "money or property" by fraud. If no property or money is involved, the statute does not reach the conduct in question.

The defendants in <u>Pasquantino</u> objected to being tried under the wire fraud statute on the grounds that uncollected Canadian taxes were not "property" for purposes of the wire fraud statute. The court disagreed, concluding that because the defendants would

have paid taxes had they disclosed the liquor to border officials, their failure to pay taxes inflicted economic injury on Canada "no less than had they embezzled funds from the Canadian treasury".

In concluding that Canada had a property right in its attempt to collect tax, it states: "Petitioners used interstate wires to execute a scheme to defraud a foreign sovereign of tax revenue. Their offense was complete the moment they executed the scheme inside the United States; "the wire fraud statute punishes the scheme, not its success". (United States v. Pierce, 224 F.3d 158, 166 (CA-2, 2000); (internal quotation marks and brackets omitted). See <u>Durland</u>, 161 U.S. at 313 ("the significant fact is the intent and purpose"). This domestic element (i.e. the wire fraud in the U.S.) is what the government is punishing in this prosecution, no less than when it prosecutes a scheme to defraud a foreign individual or corporation, or a foreign government acting as a market participant."

Chapter 24 – International Taxation and Foreign Tax Evasion

For Money Laundering, 18 USC 1956 (a)(2) defines international money laundering transaction. The proceeds of a certain crimes committed in another country may constitute proceeds of a specified unlawful activity for purposes of money laundering.

Criminal prosecutions pursuant to 18 USC 1956 (a)(2) arise when monetary instruments or funds are transported, transmitted, or transferred internationally and defendant acted with the requisite criminal intent (i.e. promoting, concealing, or avoiding reporting requirements).

18 USC 1956 (c) (7)(B) includes in the list of specified unlawful activity certain offenses against a foreign nation. Proceeds of certain crimes committed in a foreign country may constitute proceeds of a specified unlawful activity for purposes of money laundering statutes.

The intent to engage in tax evasion in a foreign country may support a claim of a FINANCIAL TRANSACTION which the defendant knows is an unlawful activity (i.e. tax evasion), whose proceeds represent the proceeds of a AN UNLAWFUL ACTIVITY with the specific intent to commit tax evasion. The proceeds must be in fact derived from an unlawful activity.

The specific intent was the crime of foreign tax evasion (i.e. a foreign tax crime). Under 18 USC 1956 (a) (1)(A)(ii) the intent to engage in tax evasion is a specific intent, with the proceeds from the tax evasion is property involved in a financial transaction which represents the proceeds of some unlawful activity.

So if a foreign national commits tax evasion in their home country, takes the illegal tax evasion proceeds to the US and purchases US assets with the tax evasion proceeds then they may be liable for not only money laundering (a 20 year felony) but also for related felonies of wire fraud (20 year felony) and mail fraud (20 year felony) if they use the US inter-state wires to purchase the assets (e.g. wire transfer the funds or use the telephone to effectuate the transfers) or mail fraud if they use the US mails to mail the checks used to purchase the assets or other correspondence related to asset purchases in the US.

Chapter 25 – International Taxation and Foreign Persons

Under 18 USC 1956 (f), there is extraterritorial jurisdiction over the conduct prohibited if:

- 1) The conduct is by a US citizen, or, in the case of a non-US citizen, the conduct occurs in part in the US; and
- 2) The transactions or series of related transactions involves funds or monetary instruments of a monetary value exceeding \$10k.

Under 18 USC Sec. 1956 (b) the District Courts shall have jurisdiction over any foreign person, including any financial institution, authorized under the laws of a foreign country, against whom the action is brought, if service of process upon the foreign person is made under the Federal Rules of Civil Procedure, or the laws of the country in which the foreign person is found. For the District Court to have jurisdiction:

- 1) The foreign person commits an offense under 18 USC Sec. 1956 (a) involving a financial transaction that occurs in whole or in part in the US (18 USC 1956 (b) (1) (A); or
- 2) The foreign person converts, to his or her own use, property in which the US has an ownership interest by virtue of the entry of an order of forfeiture by a court of the US (18 USC 1956 (b) (1) (B); or
- 3) The foreign person is a financial institution that maintains a bank account at a financial institution in the US (18 USC 1956 (b) (1) (C).

A US court may issue a pre-trial restraining order or take any other action necessary to ensure that any bank account or other property held by the defendant in the US is available to satisfy a judgment under this 18 USC 1956 (see 18 USC 1956 (b) (3).

Chapter 26 - Tax Evasion and Money Laundering: Venue

Criminal prosecution for money laundering offenses under 18 USC 1956, 1957 may be brought:

- 1) In any district in which the financial or monetary transaction is conducted;
- 2) In any district where a prosecution for the underlying Specified Unlawful Activity ("SUA") could be brought, if the defendant participated in the transfer of the proceeds of the SUA, from that district to the district where the financial or monetary transaction is conducted (See 18 USC 1956 (i)(1).

Under 18 USC 1956 (i) (2), a prosecution for an attempt or conspiracy offense may be brought in the district where venue would be for the completed offense or in any other district where an act in furtherance of the attempt or conspiracy took place.

Under 18 USC 1956 (i) (3), a transfer of funds from one place to another, by wire or any other means, shall constitute a single, continuing transaction. Any person who conducts any portion of the transaction may be charged in any district in which the transfers take place.

For money laundering crimes the following definitions apply:

- 1) Under 18 USC 1956 (c) (9) the term "proceeds" means any property derived from or obtained or retained directly or indirectly through some form of unlawful activity including the gross receipts of such activity;
- 2) Under 18 USC 1956 (c) (1), "knowing that the property involved in a financial transaction represents the proceeds of some form of illegal activity". In this case, the person knew that the property involved in the transaction represented proceeds from an activity that constitutes a felony under federal, state or foreign law, which includes tax evasion and related tax crimes (regardless of whether or not such activity is specified in 18 USC 1956 (c) (7).

Chapter 27 – Tax Evasion and Money Laundering: U.S. Real Estate

On 1/13/16 the New York Times reported that the US Treasury Department will start tracking secret buyers of luxury real estate in New York City (residences over \$3m) and Miami-Dade County (residences over \$1m) under a new US Treasury Dept initiative effective March 2016-August 2016. If Treasury Dept finds many sales involving suspicious money they would develop permanent reporting requirements across America.

The Treasury Dept initiative is intended to disclose the real owners who make all-cash purchases thru shell companies that shield purchaser identities (shell cos. include: limited liability cos., partnerships and other entities). It is part of a broader US effort to increase the focus on money laundering in real estate.

According to the Treasury Dept. foreign (and other) purchasers use shell companies, pay all-cash, for luxury real estate, which becomes "a safe haven in the US for their money".

The US Government is requiring title insurance companies (which are involved in virtually all sales) to discover the identities of buyers and submit the information to the Treasury, which will then put the information into a database for law enforcement. According to the New York Times investigation, real estate professionals (especially in the luxury market) know little about their buyers and until now, were not legally required to identify them.

According to the NY Times, nearly 1/2 of the homes nationwide are purchased using shell companies (and in Manhattan and Los Angeles the figure is higher).

According to the NY Times, condominiums at Time Warner Center were found to have a number of hidden owners, who had been subject of investigations including: Russian Senators, British Financier(s), a Former Governor from Colombia, a businessman tied to the Malaysia Prime Minister and in Boca Raton, Florida a condominium tied to Mexico's top housing official (now running for Governing of the Mexico Southern State of Oaxaca).

Money Laundering

Money Laundering is the disguise of the nature or other origin of funds. It includes the transmutation of tax evasion proceeds into personal assets or 3rd party distributions. Money laundering is a felony with a 20-year jail term (18 USC 1956, 1957. If the funds are transferred by wire transfer or mail, each is a separate 20-year felony (wire fraud 18 USC 1341, mail fraud 18 USC 1341).

Taxpayers who either commit tax crimes 4 separate felonies for tax evasion/ total 16 years in jail (see IRC 7201 tax evasion, 5 years in jail, IRC Sec. 7212 obstruct tax

collection, 3 years in jail, 18 USC 371 conspiracy to commit tax evasion, 5 years in jail, or fail to intentionally file tax returns IRC 7206, 3 years in jail) or who conspire to commit tax evasion with another (known as a Klein conspiracy) face 5 years in jail.

The tax involved may be any tax due: income, employment, estate, gift or excise taxes (see US Dept of Justice, Criminal Tax Manual Chapter 25, 25.03(2)(a). Under the money laundering statutes the IRS is authorized to assess a penalty in an amount equal to the greater of the financial proceeds received from the fraudulent activity or \$10,000 (18 USC 1956 (b). This authority is granted by statute to the IRS and is enforced either by civil penalty or civil lawsuit.

Violation of statutes for mail fraud, wire fraud, and money laundering are punishable by monetary penalties, as well as civil and criminal forfeitures (See 18 USC 981 (a) (1) (A) which permits property involved in a transaction that violates the money laundering statutes 1956, 1957, 1960 to be civilly forfeited).

For those US taxpayers who either commit tax evasion, are involved with international tax evasion (with foreign persons) and money laundering (i.e. use the tax evasion proceeds to buy assets e.g.. real estate) they face criminal prosecution for tax evasion (16 years in jail for tax crimes i.e. 4 separate tax felonies), money laundering (20 years in jail), and wire/mail fraud (20 years in jail each).

In the US Supreme Court case *Pasquantino* (544 US 349/2005), the Court held that a foreign government has a valuable property right in collecting taxes, and that if the tax evasion proceeds are used to purchase assets the parties involved face criminal prosecution for tax crimes and money laundering, wire/mail fraud.

Under US laws, a violation of the money laundering statutes includes a financial transaction involving the proceeds of a specified unlawful activity (SUA), i.e. a "predicate offense" with the intent to:

- 1) Promote that activity;
- 2) Violate IRC sec. 7201 (willful attempt to evade tax);
- 3) Violate IRC sec. 7206 (which criminalizes false and fraudulent statements made to the IRS).

Under *Pasquantino*, the court held that "international tax evasion" (taxes due to a foreign governments) is a predicate offense (as well as taxes due the US or State governments), for money laundering and may be criminal prosecuted for all of the above (i.e. tax evasion, money laundering, mail/wire fraud). In Pasquantino the unpaid Canadian excise taxes and the purchase of assets (with those proceeds) are tax fraud,

which satisfy the SUA requirement for money laundering and may include criminal prosecution for wire/mail fraud.

See: NY Times 1/13/16 article by Louise Story, "<u>US Will Start Tracking Secret Buyers of Luxury Real Estate</u>"

Chapter 28 – IRS Offshore Accounts: Criminal Penalties

Each U.S. Person who has a financial interest in, or signature or other authority over, one or more foreign financial accounts (value over \$10,000, at any time during a calendar year) is required to report the account on Schedule B/Form 1040, and TD F 90-22.1 (Report of Foreign Bank and Financial Accounts (FBAR)), due by June 30 of the succeeding year (I.R.M. 5.21.6.1. (2/17/09)), superseded in 2014 by new Fincen Form 114.

Failure to file the required report or maintain adequate records (for 5 years) is a violation of Title 31 with civil and criminal penalties (or both). For each violation a separate penalty may be asserted.

		Civil Penalties	Criminal Penalties	Legal Authority
(1)	Non-Willful Violation	Up to \$10,000 for each violation.	N/A	31 U.S.C.§ 5321(a)(5)(A)
(11)	Negligent Violation	Up to the greater of \$100,000, or 35 percent of the greatest amount in the account.	N/A	31 U.S.C. §5321(a)(5)(C)
(11)	Intentional Violations Willful - Failure to File FBAR or retain records of account	Up to the greater of \$100,000, or 50 percent of the greatest amount in the account.	Up to \$250,000 or 5 years or both	31 U.S.C. § 5322(a) and 31 C.F.R. §103.59(b) for criminal
(2)	Knowingly and Willfully Filing False FBAR	Up to the greater of \$100,000, or 50 percent of the greatest amount in the account.	\$10,000 or 5 years or both	18 U.S.C. § 1001, 31 C.F.R. § 103.59(d) for criminal
(3)	Willful - Failure to File FBAR or retain records of account while violating certain other laws	Up to the greater of \$100,000, or 50 percent of the greatest amount in the account.	Up to \$500,000 or 10 years or both	31 U.S.C. § 5322(b) and 31 C.F.R. §103.59(c) for criminal

IRS/Offshore Accounts – (Criminal Penalties)

6-Year Statute of Limitations

1. Tax Evasion (Willful Evasion of Tax)

(IRC Sec. 7201) up to five years in prison

Fine: \$100,000 (individual) \$500,000 (corporation)

2. Obstruct (Impede Tax Collection)

(IRC Sec. 7212) up to three years in prison

Fine: \$5,000

3. Conspiracy to Impede Tax Collection

(18 USC 371) separate charge of impeding Up to five years in prison

4. Failure to File Tax Return

(IRC Sec. 7203) up to one year in prison

Fine: \$25,000 (individual) \$100,000 (corporation)

5. File False Tax Return

(IRC Sec. 7206(1)), up to three years in prison

Fine: \$250,000

6. "FBAR Violation"

(31 USC Sec. 5322(b), 31 CFR 103.59(c))

Willful violation: up to ten years in jail and \$500,000 fine

Additional Criminal Penalties:

- 1. Perjury (U.S. taxpayers who fail to disclose foreign accounts under Form 1040/Schedule B, Part III, question 7(a))
- 2. FATCA Filings (i.e. Failure to disclose foreign financial assets on \$50,000/IRS Form 8938)
- 3. Money Laundering: Disguise of the nature or the origin of funds (18 USC Sec. 1956 and 1957)

Chapter 29 - Foreign Trusts: U.S. Tax Compliance Issues

U.S. taxpayers who establish a foreign trust (i.e. a trust which either a U.S. court does not supervise trust administration, <u>or</u> a U.S. person does not control substantial trust decisions. See: IRC Sec. 7701(a)(30)(E) (31)(B), and funds the trust (i.e. transfers property to the trust), if the trust has a U.S. beneficiary, the trust will be treated as foreign "grantor trust" and the U.S. taxpayer will be treated as the owner "of that portion of the trust attributable to the property transferred" (IRC Sec. 678(b), 679).

Trust tax items of income, deduction or credit are for tax purposes treated as belonging to the trust grantor, and these tax items are reflected on the income tax return of the trust grantor; i.e. Form 1040 (originally declared on the Trust Tax Return, <u>Form 3520-A: Annual Information Return of Foreign Trust with a U.S. Owner</u>).

Based on a U.S. person funding the foreign trust, the IRS can presume that the trust has a U.S. beneficiary unless the U.S. person (i.e. transferor of trust assets) submits to the IRS any information that the IRS requires regarding the transfer and demonstrates to the IRS's satisfaction that:

- 1. Under the trust terms, no part of the trust's income or corpus may be paid or accumulated during the tax year, to or for the benefit of a U.S. person, even if that person's interest is contingent on a future event; and
- 2. No part of the trust's income or corpus could be paid to or for the benefit of a U.S. person if the trust were terminated at any time during the tax year.

Generally:

- 1. The U.S. taxpayer who transfers assets to the trust must ensure that the trust satisfies tax reporting requirements, and submit any information the IRS may require regarding the foreign trust (IRC Sec. 6048(b), 6677(a);
- 2. The U.S. grantor trust rules will not apply to any portion of a trust that would otherwise be deemed to be owned by a foreign person (IRC Sec. 672(f).

Under Treas. Reg. Sec. 1.671-2(e) a trust grantor is a person (either an individual or a non-natural person) who either creates a trust, or indirectly makes a "gratuitous transfer" of property to a trust.

A gratuitous transfer means a transfer made, other than a transfer for fair market value.

A U.S. taxpayer who creates a foreign trust faces a myriad of U.S. tax-reporting compliance issues.

- 1. If the foreign trust is irrevocable, the U.S. taxpayer faces a U.S. gift tax on funding. The U.S. taxpayer must file <u>Form 709</u> to report the gift, subject to the 2015: \$5.43m; 2016: \$5.45m gift tax exclusion. If the trust is revocable, the U.S. taxpayer must report any gifts (by filing Form 709) over \$14,000 per donee;
- 2. File Form 3520 ("Annual Return to Report Transactions with Foreign Trusts) to report transfers to the trust and trust ownership (IRC Sec. 671-679).
- 3. Form 3520-A is the annual information return of a foreign trust with at least one U.S. owner, which provides annual information about trust income/expense, its U.S. beneficiaries and any person treated as an owner of any portion of the trust. Each U.S. person treated as an owner of any portion of a foreign trust is responsible for ensuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.

Penalties for non-compliance

- a. Thirty-five percent (35%) of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust, or
- b. On an annual basis, 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the U.S. person to report the U.S. owner information.

The U.S. owner is subject to an initial penalty equal to the greater of \$10,000 or 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of that tax year, if the foreign trust either fails to timely file Form 3520-A or does not furnish all of the information required by IRC Sec. 6048(b) or includes incorrect information.

Criminal penalties may be imposed under IRC Sections 7203, 7206 and 7207 for failure to file on time and for filing a false or fraudulent tax return.

For both Forms 3520 and 3520-A:

- 1. Additional penalties will be imposed if the non-compliance continues after the IRS mails a notice of failure to comply with the required reporting.
- 2. Effective for taxable years beginning after 3/18/10, the IRC Sec. 6662 negligence penalty is increased from 20% to 40% if the deficiency is attributable to an unreported financial asset (See Sec. 512 of the 2010 HIRE Act).

Chapter 30 - U.S. Tax Reporting Foreign Financial Assets and Foreign Accounts ("FBAR")

USC Sec. 5314 of Title 31 (the Bank Secrecy Act) requires a U.S. person to file Form TDF 90-22.1- Report of Foreign Bank Account ("FBAR") to report all foreign bank and financial accounts in which they have a financial interest, or signatory authority, if the aggregate value of the accounts exceeded \$10,000 at any time during the year (31 USC Sec. 5314). A financial account includes a bank or financial account, a securities account, mutual fund or pooled investment fund.

A U.S. person has an indirect financial interest in an account owned by the trust and is required to file an FBAR report for foreign accounts held by the trust if they are the trust grantor (IRC Sec. 671-679) or they have a present beneficial interest in more than 50% of the trust assets or receive more than 50% of the trust income.

The U.S. Treasury Dept., division "Financial Crimes Enforcement Network" ("FINCEN") issued regulations providing that trust beneficiaries (other than those treated as owners under the grantor trust rules) do not have to file an FBAR report for financial assets held by trusts of which they are the trust beneficiary if the trust, trustee of the trust or trust agent is a U.S. person and files an FBAR report disclosing the trust's foreign financial accounts (31 CFR part 103, Sec. 103.24(g)(5), Federal Register Vol. 76, No. 37 at 10234 (Feb. 16, 2011). FINCEN delegates the authority to enforce the FBAR reporting requirement of the Bank Secrecy Act to the IRS (by a memorandum of agreement).

A trust discretionary or remainder beneficiary are not required to file FBARs (Fed. Register Vol. 76, No. 37 at 10234 (Feb. 16, 2011).

Chapter 31 - FATCA Overview

Section 511 of the 2010 HIRE Act added new Sec. 6038D to the Code, effective for taxable years beginning after 12/31/10.

Section 6038 D(a) requires any individual who holds any interest in a specified foreign financial asset during any taxable year to attach to his or her income tax return for that year the information described in Section 6038 D(c); i.e. <u>Form 8938</u>, if the aggregate value of all such assets exceeds \$50,000.

Specified foreign financial assets include: financial accounts, stock or security issued by a non-U.S. person, financial instruments or contracts held for investment that has an issuer or counter-party other than a U.S. person, and any interest in a foreign entity (which includes foreign trusts).

A person who is treated as the owner of a trust under the grantor trust rules is treated as having an interest in any foreign financial assets held by the trust (Treas. Reg. Sec. 1.6038(D)-2T(b)(3).

The value of a beneficiary's interest in a trust equals the sum of the amounts actually received in the taxable year plus the present value of a mandatory right to receive a distribution (Treas. Reg. 1.6038D-5J(f)(3). This valuation rule applies even if the trust is deemed to be owned by another person under the grantor trust rules. A foreign financial asset is subject to reporting even if the asset does not have a positive value (Treas. Reg. Sec. 1.6038D-2T(a)(5).

An FBAR and Form 8938 both have to be filed in full, and filed with different agencies. The penalty for failing to file Form 8938 is \$10,000 with additional penalties after notice is given to the taxpayer of \$10,000 per 30 day period, after expiration of the 90 day notice period (after notice given to the taxpayer, the penalty cannot exceed \$50,000).

The FATCA Form 8938 filing applies only to interests held directly by U.S. individuals (or indirectly through disregarded entities), but does not apply to U.S. entities.

For tax years beginning 1/1/11, the negligence penalty, if imposed by IRC Sec. 6662, is increased from 20% to 40% if the deficiency is attributable to an unreported foreign financial asset. (Sec. 512 of the 2010 HIRE Act.)

The statute of limitations will not commence to run until the return required (Form 8938) is filed, and is extended from three to six years if the taxpayer omitted more than \$5,000 from gross income and the omission is attributable to assets with respect to which a return was required by IRC Sec. 6038 D (IRC Sec. 650(c)(8)), as amended by Sec. 513 of the 2010 HIRE Act).

Chapter 32 - Grantor Trust

Grantor Trust Rules

(Subpart E of Subchapter J of Chapter 1 of Subtitle A IRC 1954)

IRC Sec. 671-679 determines whether a trust is a "grantor trust" for U.S. federal income tax purposes. If a trust is a grantor trust, all items of income, deduction and credit in respect of the trust property will be reported on the grantor's U.S. federal income tax return, and any income tax liability will be paid by the grantor and not from the trust (Treas. Reg. 1.671-3 (a)(1).

Grantor Trust Rules

IRC Sec. 673-679 identifies persons as "owners" of portions of trusts with which they have relationships. IRC Sec. 671 specifies the consequences of being treated as the owner [IRC Sec. 671: The neck of the funnel through which Sec. 673-678 passes].

T.R. Sec. 1.671-2(e)(1)

"A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust." (A Settlor is the person who intentionally causes the trust to come into existence.)

IRC Sec. 671 identifies a grantor as owner of any "portion" of a trust; items of income, deductions and credits attributable to that portion of the trust are taken into account in computing the grantor's taxable income and credits.

A "Portion" includes:

- 1. Ordinary income;
- 2. Income allocable to corpus;
- 3. An entire trust;
- 4. An undivided fractional interest in the trust;
- 5. An interest represented by a dollar amount;
- 6. Specific trust property.

IRC Sec. 671: Grantor Trust Status

The person designated by Subpart E as "owner" of a portion of a trust must take into account in computing their tax liability the items of income, deductions and credits attributable to that portion of the trust (that would otherwise be reportable by the trust itself).

Tax Compliance

IRC Sec. 6012(a)(4) requires an income tax return from "every trust having for the taxable year any taxable income, or having gross income of \$600 or over, regardless of

the amount of taxable income. Subpart E may attribute part or all of a trust's income to the grantor.

IRC Sec. 6501 statute of limitations protects a taxpayer against assessments occurring later than three years after the filing of the relevant tax return. For the statute of limitations, in the case of a grantor trust the statute begins to run only on the filing of the grantor's return (not the filing of any trust tax return). (See: <u>Lardas v. Commr.</u>, 99 T.C. 490 (1992); <u>Olson v. Commr.</u>, 64 T.C.M. 1524 (1992), <u>Bartol v. Commr.</u>, 63 T.C.M.2324 (1992), <u>Field Serv. adv. 200207007</u> (Nov. 6 2001).

Under Treas. Reg. 1.671-4(a), items attributed to a grantor are not to be reported by the trust on Form 1041; instead such items should be "shown on a separate statement attached to Form 1041, and reported by the grantor".

Grantor Trust

If the trust is a grantor trust for income tax purposes, a sale of assets to the trust by the grantor is disregarded. (See Rev. Rul. 85-13, 1985-1 C.B. 184).

If the non-contributing spouse has a discretionary interest as to both income and principal, the trust is a grantor trust under IRC Sec. 677(a)(1) to the contributing spouse. No income tax realization event occurs and the policy proceeds are excluded from both estates (Ltr. Rul. 9413045).

Intentionally Defective Grantor Trust

An "Intentionally Defective Grantor Trust" ("IDGT") takes advantage of the differences between the estate tax inclusion rules of IRC Sections 2036-2042, and the grantor trust income tax rules of IRC Sec. 671-678. An IDGT is an irrevocable trust that effectively removes assets from the grantor's estate. As a result, a sale of assets to an IDGT can freeze an individual's estate by converting appreciating assets into a non-appreciating asset with a fixed yield.

For income tax purposes, the trust is "defective" and the grantor is taxed on the trust's income. Accordingly, sale of assets between the IDGT and the grantor are not taxable. The grantor is treated for income tax purposes to have made a sale to himself eliminating capital gain tax on sale. (Additionally, interest payments by the IDGT to the grantor are not income.)

Since the IDGT is "defective" for income tax purposes, all of the trust's income is taxed to the grantor, which produces an additional "tax-free gift" to the IDGT (Rev. Rul. 2004-64, 2004-2(C.B. 7).

As a grantor trust, the IDGT:

1. Can be the owner of S-corporation stock (it is a permitted shareholder);

- 2. Can purchase an existing life insurance policy on the grantor's life, without subjecting the policy to taxation under the transfer for value rule;
- 3. The sale of the policy is a sale to the grantor-insured and the transfer for value exception under IRC Sec. 101 (a)(2)(B) should apply.

If the IDGT is structured as a "Crummey Trust," the contribution will qualify for the IRC Sec. 2503(b) gift tax annual exclusion. Under IRC Sec. 678(b), a grantor will be treated as the owner of the trust, rather than the beneficiary with respect to power over income (and corpus), which is subject to "Crummey Withdrawal" rights (See IRS PLR 200606006, 200603040, 200729005, 200942020).

Under an IDGT, Grantor Trust Status:

- 1. <u>Power of Substitution</u>: The Grantor (or spouse) has the power to reacquire trust assets in a non-fiduciary capacity (IRC Sec. 675(4); Treas. Reg. Sec. 1.675-1(b)(4). In Rev. Rul 2008-22, 2008-1 CB 796, the IRS ruled that a grantor's retained power, exercisable in a non-fiduciary capacity, to acquire trust property by substituting property of equivalent value will not by itself cause estate tax inclusion under IRC Sec. 2036 or 2038.
- 2. <u>Swapping Assets</u>: If the grantor sells assets to the IDGT, the trust assets are excluded from the grantor's estate at death, but the IDGT assets would not receive a tax basis step-up under IRC Sec. 1014. If the assets sold to an IDGT have a low basis, the lack of basis step-up is an income tax disadvantage which may be ameliorated by the grantor exchanging high-basis outside of the IDGT, with low-basis assets inside of the IDGT, achieving a "basis step-up". The swap of assets with an IDGT should not be treated as a gift for purposes of IRC Sec. 1014(e).
- 3. <u>Power to Make Loans without Adequate Security</u>: The power exercisable by a grantor or a non-adverse party that permits the grantor or the grantor's spouse to borrow trust property without adequate security (IRC Sec. 675(2). Grantor trust status is achieved if the grantor's spouse holds such power under IRC Sec. 672(e). Unlike Sec. 675(3), which requires an actual borrowing by the grantor, the existence of a power under IRC Sec. 675(2) may cause grantor trust status.

Even if the loan provides for adequate interest, grantor trust status is secured if the trustee has the power to lend unsecured. To avoid estate tax inclusion, the lending power should not include the authority to make loans without adequate interest. In order to minimize the risk of estate tax inclusion, the power to lend without security should be held by a non-adverse party and not the grantor (e.g. a trust protector).

1. <u>Power to Add Beneficiaries</u>: The power to add to the class of beneficiaries (other than the grantor's after-born or after-adopted children) to receive the trust's income or corpus held by the grantor, or a non-adverse party will cause grantor trust status. To

avoid estate tax inclusion, the grantor should not hold such a power, but the power could be held by the grantor's spouse without inclusion if the spouse did not contribute to the trust and is not controlled by the grantor. A marital agreement should be entered into in advance of the transfer to ensure that the spouse did not make a contribution to the IDGT. The IRS has privately ruled that the power to add beneficiaries held by a trustee triggers grantor trust status (IRS PLR 199936031; 9709001; 9010065).

2. <u>Payment of Life Insurance Premiums</u>: A grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of life insurance policies on the grantor or the grantor's spouse (IRC Sec. 677(a)(3). IRS Field Attorney Advice 20062701 F indicates that the power to purchase life insurance on the grantor's life results in grantor trust status. Treasury Regulations establish that the grantor is taxed on any trust income actively used to pay premiums. Under PLR 8852003, the IRS has privately ruled that the power to pay premiums is sufficient.

Income Tax - Transfer for Value (IRC Sec. 101(a)(2)

If insurance policy transferred for valuable consideration, unless exception applies, general rule that policy proceeds are not includable in gross income does not apply.

Not Income Tax Realization Event

- 1. Rev. Rul. 85-13 (1985-1 CB 184): Transfer between grantor and his grantor trust, not an income tax realization event;
- 2. IRC Sec. 1041: Transfers between spouses (if no NRA spouse), no income tax realization, transferee spouse "carry-over" income tax basis.

Exceptions from application of the transfer for value include transfers where the transferee takes a carry-over basis (IRC Sec. 101(a)(2)(A), transfers to the insured, a partner of the insured, a partnership in which the insured is a partner and a corporation in which the insured is a shareholder or officer (IRC Sec. 101(a)(2)(B).

Under Rev. Rul. 2007-13, 2007-11 IRB 684, a transfer to a grantor trust with respect to the insured qualifies as a transfer "to the insured" for purposes of the transfer for value rule. Under this Revenue Ruling, a grantor who is treated for federal income tax purposes as the owner of a trust (that owns a life insurance contract on the grantor's life) is treated as the owner of the contract for purposes of applying the transfer for value limitations under IRC Sec. 101(a)(2).

Grantor Trust - Avoids Application of Transfer for Value Rules

<u>Treas. Reg. 1.671-2 (e)(1)</u>: A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Under IRC Sec. 671-677, only a person who makes a gratuitous transfer to a trust can be treated as an "owner", necessary to engage in disregarded transactions with the trust.

The Trust Donor is treated as the owner for grantor trust purposes.

Grantor Trust Status

IRC Sec. 677 (a)(3): Trust is a grantor trust to the extent trust income may be used to pay premiums on insurance policies on the grantor's life, or the grantor's spouse. However, grantor trust status may apply only to the portion of the trust the income from which is currently used to pay premiums (See: Weil, 3TC 579 (1944); Iverson, 3 TC 756 (1944).

Grantor Trust Status

Settlor power, held in a non-fiduciary capacity, to substitute property of equivalent value under IRC Sec. 675(4)(C), causes a trust to be a grantor trust.

Estate Tax

Where trust assets consist of an insurance policy on the grantor's life, a power to substitute assets may not result in estate tax inclusion under IRC Sec. 2042(2), if the grantor held the power in a fiduciary capacity (See: Estate of Jordahl, 65 TC 92 (1975); Aug. 1977-1, (CB 1) (See: Ltr. Rul. 200603040).

IRS

Trust property may not be includable in the gross estate under IRC Sec. 2035, 2036, 2048 or 2039 if the power of substitution is held in a fiduciary capacity.

Grantor Trust Rules

(IRC Sec. 672(e): Grantor Trust Rules)

Spousal Unity Rule; i.e., grantor is treated as holding any power or interest held by the grantor's spouse.

Gift Tax

Creation of an irrevocable trust may subject the grantor to the gift tax: Treas. Reg. 25.2511-2(d).

Grantor Trust Status (ILIT)

A related and subordinate party could be named as trustee with the power to make discretionary distributions, not on an ascertainable standard, in order to make the ILIT a

grantor trust. If the grantor cannot remove and replace the trustee, the initial appointment of a related and subordinate party trustee may not cause the powers of the trustee to be attributed back to the grantor for estate tax purposes (Ltr. Rul. 9636033).

Grantor trust status confirmed if a person who is not a contributor to, or beneficiary of, the trust, has the power to add to the class of beneficiaries (e.g. charity or other descendants (IRC Sec. 674(b)(5), 674(b)(6). See: Madorin, 84 TC 667 (1985)).

<u>Grantor Trust - (Ownership of Assets)</u>

Under Rev. Rul. 85-13, and Proposed Treas. Reg. Sec. 1.671-2(f) "a person that is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion of the trust [See: REG- 209826-96, 1996-2 (C.B. 498)].

Termination Grantor Trust Status

A grantor trust loses its status as a grantor trust on the death of its grantor (<u>D.G. McDonald Trust</u>, 19 TC 672 (1953), acq. 1953-2 C.B.3 (<u>Chase Nat'l Bank v. Commr.</u>, 225 F.2d 621 (8th Cir. 1955)); Proposed Treas. Reg. Sec. 1.671-4(h)(2)).

Adverse Party

IRC Sec. 672(a) defines an "adverse party" as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust."

A trustee may be an adverse party if the trustee has the power to distribute all of the trust income and property to himself but is not an adverse party if the trust terms fix all the beneficial interests even if the trustee is a beneficiary (See: <u>Johnson v. Commr.</u>, 108 TC 448 (1957), <u>Floyd G. Paxton</u>, 57 TC 627 (1972).

Beneficiaries can be adverse parties if they have a power the exercise or non-exercise of which would adversely affect the beneficiary's own beneficial interest.

IRC Sec. 672(b) defines a "nonadverse party" as "any person who is not an adverse party".

A trust is classified as a grantor trust if more than half of the trustees are related or subordinate to the grantor.

IRC Sec. 674(a) provides that the grantor of a trust is to be treated as the owner of any portion of such trust, in respect of which the beneficial enjoyment of such portion is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.

IRC Sec. 674(c) provides an exception to the general rule of IRC Sec. 674(a) for distribution powers of the "independent trustee", none of whom is the grantor, and no more than half of whom are related or subordinate to the grantor or are subservient to the wishes of the grantor (IRC Sec. 672(c) defines: "related or subordinate party".)

Related or Subordinate Party

IRC Sec. 672(c) defines a "related or subordinate party" as any "non-adverse party" which includes:

- 1. IRC Sec. 672(c)(1): The grantor's spouse (only if they are living together);
- 2. <u>IRC Sec. 672(c)(2)</u>: Grantor's father, mother, children, brother, sister (including half-brothers/sisters). See: Rev. Rul. 58-19, 1958-1, CB 251);
- 3. IRC Sec. 672(c)(2): An employee of the grantor, or the grantor's corporation.

Not Related or Subordinate Party

Under IRC Sec. 672(c) the following are not related or subordinate parties:

- 1. Nieces, nephews, grandparents, spouses of children, spouses of grandchildren, spouses of brothers and sisters;
- 2. Partners of the grantor;
- 3. Director of a corporate grantor (i.e. stock holdings of the grantor and the trust are significant, re voting control). See: Rev. Rul. 66-160, 1966-1, CB 164;
- 4. The grantor's lawyer, accountant or trust company (See: Zand v. Commr., 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998); Estate of Hilton W. Goodwyn, 35 TCM 1026, 1038 (1976) re lawyers-trustees not "related or subordinate parties" and lawyer-trustees were independent trustees under IRC Sec. 674(c).

Power Subject to Condition Precedent

IRC Sec. 672(d) states that a person is deemed to have a power described in subpart E "even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power".

Grantor's Spouse

The Tax Reform Act of 1986 added IRC Sec. 672(e), which treats the grantor as holding any power or interest held by the grantor's spouse if the grantor's spouse was living with the grantor at the time of the creation of the power or interest (i.e., if the spouse and the grantor are eligible to file a joint return with respect to the period in question).

<u>Grantor as Foreign Person - ("Inbound Trusts")</u>

If a foreign person is an "owner" of any portion of a trust, and the trust has as a beneficiary a U.S. person who has made one or more gifts to that foreign person, IRC Sec. 672(f)(5) designates the U.S. beneficiary, not the foreign grantor-donee, as the owner of the trust to the extent of the gifts (with an exception for gifts that qualify for the annual exclusion under IRC Sec. 2503(b)).

IRC Sec. 672(f)(5) precludes foreigners immigrating to the U.S. from giving property to another foreigner, who agrees to use the property to fund a U.S. trust for the benefit of the immigrating foreigner, who then denies he was the grantor of the trust. Under IRC Sec. 672(f)(5), the immigrating foreigner receives the same treatment he would have received had he created the trust directly (Treas. Reg. Sec. 1.672(f)-5(a)(1)).

In the Small Business Job Protection Act of 1996, Congress expanded IRC Sec. 672(f) so that subpart E now generally applies only when its effect is to designate as owner of part or all of a trust a U.S. citizen, resident or domestic corporation (IRC Sec. 672(f)(1), a "controlled foreign corporation", defined in IRC Sec. 957 is treated as a domestic corporation. IRC Sec. 672(f)(3)(A).

IRC Sec. 672(f) reverses prior law under which subpart E designated non-resident aliens as owners of trusts, thereby allowing U.S. beneficiaries to receive the income from such trusts tax-free.

Grantor Trust - Co-ownership and Reversionary Interest

IRC Sec. 673(a) now treats the grantor who retains any reversionary interest as owner of the entire trust (Treas. Reg. 1.671-3(b)(3)); Priv. Ltr. Rul. 9519029 (Feb. 10, 1995). IRC Sec. 672(e) treats the grantor as owner of any interest their spouse owns. Unless the value of the reversionary interest at inception is less than 5% of the value of the property transferred. (IRC Sec. 673(b) excepts from the general rule any reversionary interest that follows the death before attaining age 21 of a lineal descendant of a grantor.)

A grantor who has retained a reversionary interest in the corpus of a trust is treated as owner of the corpus portion of that trust (Treas. Reg. Sec. 1.673(a)-1(a), 1.677(a)-1(g) Ex. (2).

Grantor Trust

(IRC Sec. 674: Powers over Beneficial Enjoyment)

IRC Sec. 674(a) treat any grantor as owner of any portion of any trust "in respect of which the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable by a grantor or non-adverse party, or both, without the approval or consent of any adverse party."

Grantor Trust

(IRC Sec. 674, 677: Power to Apply Income to Support of a Dependent)

A grantor is not subject to tax under neither IRC Sec. 677(b) nor Sec. 674(a) merely because in the discretion of another person, the trustee or the grantor (or the grantor's spouse, IRC Sec. 672(e)), acting as trustee, income may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain. Under IRC Sec. 677(a), the grantor is

treated as the owner of the income portion, to the extent of the grantor's obligation of support.

Grantor Trust

(Power to Distribute Corpus)

IRC Sec. 674(b)(5) provides two exceptions (to IRC Sec. 674) for powers to distribute corpus:

- 1. Power to distribute corpus to or for one or more beneficiaries if the power is limited by a reasonably definite standard in the trust instructions (IRC Sec. 673(b)(5)(A), i.e. a "clearly measurable standard under which the holder of a power is legally accountable (Treas. Reg. Sec. 1.674(b)-1(b)(5)(i)). Examples of reasonably definite standards are standards relating to a beneficiary's "education, support, maintenance or health", "reasonable support or comfort", to enable a beneficiary to maintain an "accustomed standard of living", to allow a beneficiary to "meet an emergency", or to pay a beneficiary's "medical expenses" (Treas. Reg. Sec. 1.674(b)-1(b)5(iii), Ex. (1)).
- 2. Power to distribute corpus to or for any "current income beneficiary", whether subject to a standard or not, if the distribution must be chargeable against the proportionate share of corpus held in trust for payment of income to the beneficiary "as if the corpus constituted a separate trust" (IRC Sec. 674(b)(5)(B).

Grantor Trust

Exception: (Independent Trustee)

Exceptions to the general rule of IRC Sec. 674(a) are contained in IRC Sec. 674(c), which provides exceptions if the powerholder is an "independent trustee"; i.e. not the grantor, grantor's spouse, no more than half of whom are related or subordinate parties who are subservient to the grantor's wishes.

The exceptions:

- 1. The power of a trustee to distribute, apportion or accumulate income to or for one or more beneficiaries (IRC Sec. 674(c)(1).
- 2. The power of a trustee to sprinkle corpus to or among one or more beneficiaries, regardless of whether they are income beneficiaries (IRC Sec. 674(c)(2).

Grantor Trust/Exception:

(Powerholder is a Trustee, other than the Grantor or the Grantor's Spouse)

IRC Sec. 674(d) protects a power to distribute, apportion or accumulate income to or for the beneficiaries if the power is limited by a "reasonably definite external standard" (Treas. Reg. 1.674(d)(1), 1.674(b)-1(b)(5) which "defines a reasonably definite standard"). The "standard" must be set forth in the trust instrument.

Grantor Trust

(Power to Remove Trustee)

Under Treas. Reg. Sec. 1.674(d)-2(a), W. Clarke Swanson, Jr. 1950 Trust, 33 TCM 296, 302 (1974), aff'd 518 F.2d 59 (8th Cir. 1975), if the grantor or the grantor's spouse has the power to remove the trustee and make either of them the trustee, neither the exception under IRC Sec. 674(c) or IRC Sec. 674(d) applies.

Grantor Trust

(Power to Add Beneficiaries)

A power to add beneficiaries does not qualify under IRC Sec. 674 exceptions if any person has the power to add to the group of beneficiaries, other than providing for after-born or after-adopted children. A power in a non-adverse party to add charitable beneficiaries or trigger IRC Sec. 674 (See: Madorin v. Commr., 84 TC 667 (1985). Priv. Ltr. Rul. 9838017 (6/19/98), Priv. Ltr. Rul. 9710006 (11/8/96), Priv. Ltr. 97090001 (11/8/96)).

IRC Sec. 675

Grantor Administrative Powers

IRC Sec. 675 contains provisions designed to prevent a grantor from maintaining dominion and control over a trust through certain types of administrative powers vested in either the grantor or others.

1. Power to Deal with Trust Property for Less Than Adequate and Full Consideration. IRC Sec. 675(1) describes a power exercisable by the grantor or any non-adverse party to enable the grantor or any person to "purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth."

2. Grantor Borrowing

IRC Sec. 675(2) relates to a power enabling a grantor to borrow without adequate interest or security. IRC Sec. 675(3) relates to actual borrowing.

Power to Borrow without Adequate Interest or Security

IRC Sec. 675(2) describes a power exercisable by the grantor or any non-adverse party to enable the grantor to borrow either principal or income "directly or indirectly, without adequate interest or adequate security". If so, grantor is treated as the owner of some portion of the trust. If the trustee (who is not the grantor or the grantee's spouse) has the power to lend on such terms to anyone, the power is disregarded for purposes of IRC Sec. 675(2). In addition, there are no other restrictions on the trustee's identity; even a related or subordinate party may serve as trustee.

Actual Borrowing

IRC Sec. 675(3) states that actual borrowing by the grantor causes grantor trust status, if the grantor has "directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year." IRC Sec. 675(3) does not apply to a loan to a grantor that provides for adequate interest and adequate security if made by a trustee "other than the grantor and other than a related or subordinate trustee subservient to the grantor". If a loan to a grantor provides for adequate interest and adequate security, and is made by a non-captive trustee, there are no grantor trust consequences.

In <u>Zand v. Commr.</u>, 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998), the court held that certain loans qualified under the exception of IRC Sec. 675(3) because they provided for adequate interest and security and a majority of the trustees who made them were neither related nor subordinate to the grantor under IRC Sec. 672(c), despite the fact these two trustees were also the grantor's lawyers.

General Powers of Administration

IRC Sec. 675(4) describes three powers of administration and treats the grantor as owner of a portion of the trust if any of these powers is exercisable in a "non-fiduciary capacity" by any person without the approval or consent of any person in a fiduciary capacity. Treas. Reg. Sec. 1.675-1(b)(4) limits the applicability of the provision to powers held by a "non-adverse party". If a power is exercisable by a trustee, it is presumed to be exercisable in a fiduciary capacity.

The three powers:

- 1. The power to vote or direct the voting of stock or securities of a corporation in which the holdings of the grantor and the trust are "significant from the viewpoint of voting control.
- 2. The power to control the investment of the trust funds either by directing investments or by retaining proposed investments "to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control".
- 3. The power to reacquire trust property by substituting other property of an equivalent value.

Revocable Trusts

If a trust is wholly revocable by the grantors, IRC Sec. 676 treats the grantor as owner of the entire trust because the grantor has the power to revest in himself all of the trust property.

IRC Sec. 677

Income for Benefit of Grantor or Grantor's Spouse

1. <u>Income Distributable to the Grantor or Grantor's Spouse</u>

If a grantor retains a mandatory income interest, or creates a mandatory income interest in the grantor's spouse, IRC Sec. 677 treats the grantor as owner of the income portion of the trust, under IRC Sec. 677(a)(1), the "income is distributed to the grantor or the grantor's spouse." IRC Sec. 677(a) requires that the income be distributed "without the approval or consent of any adverse party."

2. Income Accumulated for the Grantor or Grantor's Spouse

IRC Sec. 677(a)(2) applies if income may be accumulated without the consent of an adverse party for future distribution to the grantor or the grantor's spouse.

3. Income Applicable to Payment of Life Insurance Premiums

IRC Sec. 677(a)(3) applies if income is or may be applied without the consent of an adverse party to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse. The grantor is treated as the owner of some portion of any trust required or permitted to pay premiums on policies of life insurance on the life of either the grantor or the grantor's spouse. The courts have limited the amount of income on which a grantor is subject to taxation to that which the trustee actually uses to pay premiums on specified policies (Joseph Weil, 3 TC 579 (1944)).

4. Income Applicable to Discharge of Indebtedness

IRC Sec. 677(a) treats the grantor as owner of a portion of a trust if its income can be used to pay off debts of the grantor such as rent, household expenses or mortgage debt (See: Treas. Reg. Sec. 1.677(b)-1(d); <u>Jack Wiles</u>, 59 TC 289 (1972), <u>Jenn v. U.S</u>. 70-1 USTC Para. 9264 (S.D. Ind. 1970).

5. Income Applicable to Discharge of Support Obligations

IRC Sec. 677(b) is an exception to the general rule of IRC Sec. 677(a). According to IRC Sec. 677(b), IRC Sec. 677(a) does not apply if trust income may be "applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support".

Under Treas. Reg. Sec. 1.677(b)-1(f), if income must be applied in discharge of a support obligation of the grantor, IRC Sec. 677(b) does not apply; instead IRC Sec. 677(a) applies. For IRC Sec. 677(b) to apply, the power to use trust income to discharge the grantor's support obligations must be that of "another person, the trustee, or the grantor acting

as trustee or co-trustee". Under Treas. Reg. Sec. 1.677(b)-1(e), if the power is that of the grantor acting in a non-fiduciary capacity, the grantor is treated as owner of the trust's income, to the extent of his or her dischargeable obligations, regardless of whether the trust discharges them.

Under IRC Sec. 677(b), for trust distributions in discharge of a grantor's support obligations:

- 1. If a distribution comes out of current income, the grantor is treated as owner of the trust, but only to the extent of the obligation discharged (Brooke v. U.S., 300 F.Supp. 465 (D. Mont. 1969), aff'd 468 F.2d 1155 (9th Cir. 1972).
- 2. If the distribution comes out of either principal or accumulated income, IRC Sec. 677(b) treats the amount distributed as deductible by the trust under IRC Sec. 661(a)(2) and taxable to the grantor under IRC Sec. 662, (Rev. Rul. 74-94, 1974-1 C.B. 26); Treas. Reg. Sec. 1.677(b)-1(c).

IRC Sec. 678:

Non-Grantors Treated as Grantors

Under IRC Sec. 678, one other than the grantor is treated as owner of any portion of a trust that he can by exercise of a power exercisable by himself, vest in himself a portion of a trust.

Released or Modified Power

IRC Sec. 678(a)(2), applies if a person other than the grantor has "previously partially released or otherwise modified" a power described in IRC Sec. 678(a)(1), and "retains such control as would subject a grantor of a trust to treatment as the owner thereof", IRC Sec. 678(a)(2) treats anyone who has released or modified an IRC Sec. 678 power as though he created a continuing trust.

Obligations of Support

IRC Sec. 678(a), if a powerholder can direct a trust to expend either its income or its principal to discharge a legal obligation, he is treated as the powerholder, if principal or accumulated income is used to discharge the powerholder's support obligation, the powerholder is treated as a beneficiary who receives a taxable distribution under IRC Sec. 661 and 662.

Chapter 33 - Foreign Trusts with US Beneficiaries ("Outbound Trusts") ("IRC Sec. 679)

If a U.S. person transfers property to a foreign trust that has one or more U.S. beneficiaries, IRC Sec. 679 treats the transferor as owner of the portion of the trust attributable to the property transferred (IRC Sec. 679(a)(1)).

There are exceptions:

- 1. A transfer by reason of the death of the transferor (IRC Sec. 679 (a)(2)(A));
- 2. A transfer "in exchange for consideration of at least the fair market value of the transferred property" (IRC Sec. 679(a)(2)(B).

If a foreign trust accumulates income during a year in which it has no U.S. beneficiary, if the trust acquires a U.S. beneficiary in a later year, a U.S. transferor (who would have been treated as owner of a portion of the trust during the prior year, but for the fact that it had no U.S. beneficiary) is taxable in the first year IRC Sec. 679 applies, on additional income equal to the trust's undistributed net income for all prior taxable years (to the extent such undistributed net income remains in the trust at the end of the taxable year immediately prior to applicability of IRC Sec. 679) attributable to the portion to which IRC Sec. 679 applies (IRC Sec. 679(b).

Direct/Indirect Transfers

Under the IRC Sec. 679(a)(1) a U.S. person's transfer to a foreign trust includes both indirect and direct transfers, either of which classifies the U.S. person as the owner of the trust attributable to the property transferred if the foreign trust has one or more U.S. beneficiaries.

Indirect transfers include:

- A transfer by either a foreign or domestic entity in which a U.S. person has an interest "may be regarded as an indirect transfer to the foreign trust by the U.S. person if the entity merely serves as a conduit for the transfer by the U.S. person or if the U.S. person has sufficient control over the entity to direct the transfer by the entity rather than himself." (S. Rep. 938, 94th Cong., 2d Sess. 219 (1976)).
- If a foreign trust borrows money or property and a U.S. person guarantees the loan, the U.S. person is making an indirect transfer to the trust.
- 3. An intermediate transfer to either another person or an entity that makes the actual transfer to the foreign trust is to be disregarded "unless it can be shown that the ultimate transfer of property to the trust was unrelated to the intermediate transfer. In such a case, the person making the intermediate transfer would be treated as having made the ultimate transfer directly." See: Haeri v. Commr., 56 TCM 1061 (1989) (transfer by agent). Treas. Reg. Sec. 1.679-3 provides elaborate guidance with respect to indirect transfers.

IRC Sec. 679: U.S. Persons

IRC Sec. 679 applies only to a "U.S. person" which IRC Sec. 7701 (a) (30) defines as "a citizen or resident of the U.S.", including a resident alien (See: Treas. Reg. Sec. 1.679-1(d); Harriv.commr., 56 TCM 1061 (1989); Rev. Rul. 90-106, 1990-2 (B162)). A "U.S. person" includes: a U.S. partnership or corporation, any estate other than a foreign estate (defined in IRC Sec. 7701(a)(31)(A). A U.S. person includes a "U.S. Trust" (i.e. a domestic trust) which is a trust if "a court within the U.S. is able to exercise primary supervision over the administration of the trust", and "one or more U.S. persons have the authority to control all substantial decisions of the trust". (Treas. Reg. Sec. 301.7701-7(a)(1).

IRC Sec. 679 only applies to transfer to a "foreign trust" (i.e. not a domestic trust) only if a trust has a U.S. beneficiary. (IRC Sec. 7701(a) (31)(B) defines a foreign trust as any trust that does not qualify as a U.S. person.

U.S. Beneficiary

Under IRC Sec. 679(c), a foreign trust always has a U.S. beneficiary unless "under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person (IRC Sec. 679(c)(1)(A). Under Treas. Reg. Sec. 1.679-2(a)(2)(i), this determination is independent of whether there is an actual distribution of income or corpus to a U.S. person during the year. If the trust authorizes accumulations for possible distributions to any U.S. person in the future, the trust has a U.S. beneficiary throughout the intervening period. Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 2). Even if the only interest a U.S. person has a right to receive is corpus upon termination, the trust has a U.S. beneficiary. Treas. Reg. 1.679-2 (a)(2)(iii), Ex (3).

In addition, a foreign trust always has a U.S. beneficiary if "no part of the income or corpus" of the trust could be paid to or for the benefit of a U.S. person "if the trust were terminated at any time during the taxable year". (IRC Sec. 679(c)(1)(B).

If any person has the authority to distribute trust income or corpus to unnamed persons generally or to any class of persons which include "U.S. persons", the trust has U.S. beneficiaries (Treas. Reg. 1.679-2(a)(2)(i), this determination is independent of whether a U.S. person's trust interest is contingent).

If any person has a power of appointment pursuant to which income or corpus may pass to a U.S. person, the trust has U.S. beneficiaries (Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 11).

If any person has the power to amend the trust so as to include U.S. persons as beneficiaries, the trust has U.S. beneficiaries (S. Rep 938, 94th Cong., 2d Sess. 219 (1976)).

Under Treas. Reg. 1.679-2(a)(4), the determination of whether income or corpus may be paid to or for the benefit of a U.S. person, the IRC consults "writings, oral agreements between the trustee and persons transferring property to the trust, local law, and the trust instrument".

IRC Sec. 679(c)(2) provides attribution rules that can cause income paid to or accumulated for a foreign corporation, partnership, trust or estate to be treated as though it were paid to or accumulated for the benefit of a U.S. beneficiary: these attribution rules apply if a corporation is a controlled foreign corporation, as defined in IRC Sec. 957(a) (See: IRC Sec. 679(c) (2)(A).

If a U.S. person is a partner of a foreign partnership (IRC Sec. 679(c) (2) (B), or if a U.S. person is a beneficiary of a foreign estate or trust (IRC Sec. 679(c)(2)(C). See: Treas. Reg. Sec. 1.679-2(b)(2) and (3), (Ex. 4 & 5).

A foreign trust has U.S. beneficiaries the day after the trust beneficiaries move to the U.S. (Treas. Reg. Sec. 1.679-2(a)(3)(ii), (Ex 1). Under IRC Sec. 679(c)(3), a beneficiary who first becomes a U.S. person more than 5 years after the date of a transfer to a foreign trust is not a U.S. person with respect to that transfer (See: Treas. Reg. Sec. 1.675-2(d)(3)(ii), (Ex 2).

The determination whether a trust has a U.S. beneficiary for purposes of IRC Sec. 679 occurs on an annual basis (Treas. Reg. 1.679-2(a)(1).

If a foreign beneficiary becomes a U.S. person, IRC Sec. 679 begins to apply with the transferor's first taxable year in which the foreign beneficiary is a U.S. person. The U.S. transferor has "additional income" pursuant to IRC Sec. 679(b) in the taxable year in which the trust acquires a U.S. beneficiary. Treas. Reg. 1.679-2(c)(1)(3), (Ex 1).

When a trust ceases to have any U.S. beneficiaries, the U.S. transferor continues to be treated as owner until the beginning of the following taxable year (Treas. Reg. Sec. 1.679-2(c)(2)(3), (Ex 2).

Under IRC Sec. 679, with respect to a foreign trust, to which no U.S. resident has ever transferred anything, if a non-resident alien becomes a U.S. resident within 5 years of an actual transfer (Treas. Reg. 1.679-5), it is a U.S. grantor trust.

If a non-resident alien transfers property to a foreign trust and during the succeeding 5 years becomes a U.S. resident, IRC Sec. 679 applies as though the transferor had, on that later date, transferred "an amount equal to the portion of such trust attributable to

the property actually transferred". (IRC Sec. 679(a)(4)(A), which includes undistributed net income of the trust for periods before the transferor became a U.S. resident (IRC Sec. 679(a)(4)(B).

If a U.S. trust becomes a foreign trust, under IRC Sec. 679 the trust becomes a foreign grantor trust (Treas. Reg. 1.679-6) and IRC Sec. 679 applies as though the grantor had on that date transferred "an amount equal to the portion of such trust attributable to the property previously transferred (IRC Sec. 679(a)(5), including undistributed net income of the trust for periods before the trust became a foreign trust." (IRC Sec. 679(a)(5)).

Chapter 34 - FATCA Summary

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. 111-147) (The "Act"), which included the Foreign Account Tax Compliance Act containing new foreign account tax compliance rules.

Under the Act, new reporting and disclosure requirements for foreign assets was phased in between 2010 – 2014:

- 1. Foreign Institutional Reporting: Foreign Institutions have new reporting and withholding obligations for accounts held by U.S. Persons (generally effective after 12/31/12, commencing 1/1/13).
- 2. Foreign Financial Assets (\$50,000): Individuals with an interest in a "Foreign Financial Asset" have new disclosure requirements. If foreign financial assets are valued in excess of \$50,000, the U.S. Taxpayer must attach certain information to their income tax returns for tax years beginning after March 18, 2010. (U.S. Taxpayers are not required to disclose interests that are held in a custodial account with a U.S. financial institution).

The penalty is substantial (\$10,000, plus additional amounts for continued failures, up to a maximum of \$50,000 for each applicable tax period). The penalty may be waived if the individual can establish that the failure was due to reasonable cause and not willful neglect.

- 3. 40% Penalty: A 40% accuracy-related penalty is imposed for underpayment of tax that is attributable to an undisclosed foreign financial asset understatement. Applicable assets are those subject to mandatory information reporting when the disclosure requirements were not met. The penalties are effective for tax years beginning after March 18, 2010.
- 4. 6-Year Statute of Limitations: Statute of limitations re: omission of income in connection with foreign assets: The statute of limitations for assessments of tax is extended to six (6) years if there is an omission of gross income in excess of \$5,000 attributable to the foreign financial asset. The six-year statute of limitations is effective for tax returns filed after March 18, 2010, as well as for any other tax return for which the assessment period has not yet expired as of March 18, 2010.
- 5. Passive Foreign Investment Companies: The Act imposes an information disclosure requirement on U.S. Persons who are PFIC shareholders. A PFIC is any foreign corporation if:
- a. 75% or more of the gross income of the corporation for the taxable year is passive income; or

- b. The average percentage of assets held by such corporation during a taxable year which produce passive income or which are held for the production of passive income are at least 50%.
- 6. Foreign Trusts with U.S. Beneficiaries: The Act clarifies if a foreign trust is treated as having a U.S. Beneficiary, an amount accumulated is treated as accumulated for the U.S. Person's benefit even if that Person's trust interest is contingent.

The Act clarifies that the discretion to identify beneficiaries may cause the trust to be treated as having a U.S. Beneficiary. This provision is effective after March 18, 2010.

- 7. Rebuttable Presumption/Foreign Trust U.S. Beneficiary: The Act creates a rebuttable presumption that a foreign trust has a U.S. Beneficiary if a U.S. Person directly or indirectly transfers property to a foreign trust (unless the transferor provides satisfactory information to the contrary to the IRS). This provision is effective for property transfers after March 18, 2010.
- 8. Uncompensated Use of the Foreign Trust Property: The Act provides that the uncompensated use of the foreign trust property by a U.S. Grantor, a U.S. Beneficiary (or a U.S. Person, related to either of them), is treated as a distribution by the trust. The use of the trust property is treated as a distribution to the extent of the fair market value of the property's use to the U.S. Grantor/U.S. Beneficiary, unless the fair market value of that use is paid to the trust.

The loan of cash or marketable securities by a foreign trust, or the use of any other property of the trust, to or by any U.S. Person is also treated as paid or accumulated for the benefit of the U.S. Person. This provision applies to loans made and uses of property after March 18, 2010.

9. Reporting Requirements, U.S. Owners of Foreign Trusts: This provision requires any U.S. Person treated as the owner of any portion of a foreign trust to submit IRS-required information and insure that the trust files a return on its activities and provides such information to its owners and distributees.

This new requirement imposed on U.S. Persons treated as owners is in addition to the current requirement that such U.S. Persons are responsible for insuring that the foreign trust complies with its own reporting obligations. This provision is effective for taxable years beginning after March 18, 2010.

10. Minimum Penalty re: Failure to Report Certain Foreign Trusts: This provision increases the minimum penalty for failure to provide timely and complete disclosure on foreign trusts to the greater of \$10,000 or 35% of the amount that should have been reported.

In the case of failure to properly disclose by the U.S. Owner of a foreign trust of the year-end value, the minimum penalty would be the greater of \$10,000 or 5% of the amount that should have been reported. This provision is effective for notices and returns required to be filed after December 31, 2009.

Foreign Financial Assets

U.S. Taxpayers who hold any interests in specified foreign financial assets during the tax year must attach their tax returns for the year certain information with respect to each asset if the aggregate value of all assets exceeds \$50,000. An individual who fails to furnish the required information is subject to a penalty of \$10,000. An additional penalty may apply if the failure continues for more than 90 days after a notification by the IRS to a maximum of \$50,000. The penalty may be avoided if the Taxpayer shows a reasonable cause for the failure to comply.

The Joint Committee on Taxation, Technical Explanation of the Hiring Incentives to Restore Employment Act (JCX-4-10) clarifies that although the nature of the information required to be disclosed is similar to the information disclosed on an FBAR, it is not identical.

For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50%, may still be required to disclose the interest with his tax return if the \$50,000 value threshold is met. In addition, this provision is not intended as a substitute for compliance with the FBAR reporting requirements, which remain unchanged.

For purposes of IRC Code §6038(D) as added by the HIRE Act, a specified foreign financial asset includes:

- 1. Any depository, custodial, or other financial account maintained by a foreign financial institution, and
- 2. Any of the following assets that are not held in an account maintained by a financial institution:
- a. Any stock or security issued by a person other than a U.S. Person
- b. Any financial instrument or contract held for investment that has an issuer or counterparty other than a U.S. Person, and
- c. Any interest in a foreign entity (IRC §6038(D)(b) as added by the 2010 HIRE Act).

The information required to be disclosed with respect to any asset must include the maximum value of the asset during the tax year (IRC §6038(D)(c) as added by the 2010 HIRE Act).

For a financial account, the Taxpayer must disclose the name and address of the financial institution in which the account is maintained and the number of the account.

In the case of any stock or security, the disclosed information must include the name and address of the issuer and such other information as is necessary to identify the class or issue of which the stock or security is a part.

In the case of any instrument, contract, or interest, a Taxpayer must provide any information necessary to identify the instrument, contract, or interest along with the names and addresses of all issuers and counterparties with respect to the instrument, contract, or interest.

Under these rules, a U.S. Taxpayer is not required to disclose interests held in a custodial account with a U.S. financial institution. In addition, the U.S. Taxpayer is not required to identify separately any stock, security instrument, contract, or interest in a disclosed foreign financial account.

An individual who fails to furnish the required information with respect to any tax year at the prescribed time and in the prescribed manner is subject to a penalty of \$10,000 (IRC §6038(D)(d) as added by the 2010 HIRE Act). If the failure to disclose the required information continues for more than 90 days after the day on which the notice was mailed (from the Secretary of Treasury), the individual is subject to an additional penalty of \$10,000 for each 30-day period (or a fraction thereof) with the maximum penalty not to exceed \$50,000.

In addition to the \$10,000 penalty (up to \$50,000) under IRC §6038(D) a 40% accuracy-related penalty is imposed on any understatement of tax attributable to a transaction involving an undisclosed foreign financial asset.

The statute of limitations for omission of gross income attributable to foreign financial assets (omission of gross income in excess of \$5,000 attributable to a foreign financial asset), is extended to six years.

The IRC §6038(D) penalties are not imposed on any individual who can show that the failure is due to reasonable cause and not willful neglect. (IRC §6038D(g), as added by the 2010 HIRE Act.)

The information disclosure with respect to foreign financial assets supplements the FBAR reporting regime. The HIRE Act broadens reporting requirements and extends the rules to ownership of foreign assets such as foreign stocks, securities, interests in foreign companies not covered by the FBAR reporting. The threshold reporting requirement amount for FBARs (\$10,000) is increased to \$50,000. While the FBAR reporting covers those having signatory or other authority, the new reporting regime focuses on ownership

IRS Form 8938: Statement of Specified Foreign Financial Assets

"FATCA" Tax Reporting

Under the Foreign Account Tax Compliance Act ("FATCA") for tax years beginning after March, 18, 2010, specified persons (i.e. U.S. Citizens, resident aliens), who have an ownership interest in specified foreign financial assets (i.e. foreign financial accounts, foreign stock, any interest in a foreign entity) must file Form 8938 (attached to their form 1040 tax return) if the value of the foreign financial assets exceeds applicable "reporting threshold".

The value of a specified foreign financial asset, for Form 8938 reporting purposes is the asset's fair market value.

For Individuals: more than \$50,000 on the last day of the tax year, more than \$75,000 at any time during the tax year. If living abroad; \$200,000 on the last day of the tax year or more than \$300,000 at any time during the tax year.

For Married Taxpayers: more than \$100,000 on the last day of the tax year, more than \$150,000 at any time during the tax year, if living abroad: \$400,000 on the last day of the tax year, or more than \$600,000 at any time during the tax year.

The IRS anticipates issuing regulations that will require domestic entity to file Form 8938, if it holds specified foreign financial assets whose value exceeds the applicable reporting threshold. Until the IRS issues such regulation, only individuals must file Form 8938.

Foreign Trusts

The value of an interest in a foreign trust, during the tax year, (if taxpayer doesn't know its fair market value is the Maximum Value of the interest in the foreign trust calculated as the sum of the following amounts:

- 1. The value of all of the cash (or other property) distributed during the tax year from the trust to the beneficiary, plus
- 2. The value (using the IRC§7520 Valuation Tables) to receive mandatory distributions as of the last day of the tax year;

Foreign Grantor Trusts

A U.S. Taxpayer, who is the owner of a foreign grantor trust, does not have to report specified financial assets, held by the trust if:

1. The US Taxpayer reports the trust on a timely filed form 3520 for the same tax year;

- 2. The trust timely files Form 3520-A (Annual Information Return of Foreign Trust with a U.S. owner) for the same tax year;
- 3. Taxpayer identified on form 8938 how many of these forms they filed.

Specified Foreign Financial Assets

Foreign financial accounts include any depository (or custodial) account maintained by a foreign financial institution, any equity or debt interest in a foreign financial institution including any financial account maintained by a financial institution organized under the laws of a U.S. possession (America Samoa, Guam, The Northern Mariana Islands, Puerto Rico or the U.S. Virgin Islands)

A foreign financial institution is any financial institution that is not a U.S. entity, and satisfies one of the following conditions:

- 1. It accepts deposits;
- 2. It holds financial assets for the account of others;
- 3. It is engaged in the business of investing or trading in securities, partnership interests, or commodities;
- 4. It includes investment vehicles such as foreign mutual funds, hedge fund and private equity funds.

Interests in Specified Foreign Financial Assets

A U.S. Taxpayer:

- 1. Has an interest in a specified financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distribution from asset dispositions is required to be reported on U.S. income tax returns;
- 2. Who is the owner of a disregarded entity, has an interest in any specified foreign financial assets owned by the disregarded entity;
- 3. Who has an interest in a financial account that holds specified foreign financial assets, do not have to report the assets held in the account;
- 4. Does not own an interest in any specified foreign financial asset held by a partnership, corporation or estate, as a result of their status as a partner, shareholder or beneficiary;
- 5. Who is the owner, under the grantor trust rules of any part of a trust, has an interest in any specified foreign financial asset held by that part of the trust;

6. Does not have an interest in a foreign trust or a foreign estate specified foreign financial asset, unless they know (or have reason to know) of the interest. If they receive a distribution from the foreign trust or foreign estate, they are considered to know of the interest.

Exceptions to Tax Reporting (Form 8938)

- U.S. Taxpayers do not have to report a specified foreign financial asset on Form 8938:
- 1. If the financial account is maintained by a U.S. payer which includes: a U.S. financial institution, a domestic branch of a foreign bank or insurance company, a foreign branch or subsidiary of a U.S. financial institution;
- 2. If the U.S. Taxpayer reports the specified foreign financial asset on timely filed IRS forms:
- a. Form 3520: Annual Return to Report Transactions with Foreign Trusts and Receipt of certain foreign Gifts
- b. Form 5471: Information Return of U.S. Persons with Respect to Certain Foreign Corporations
- c. Form 8865: Return of U.S. Persons with Respect to Certain Foreign Partnerships

Civil Penalties (Form 8938)

- 1. Failure to File Penalty: A penalty of \$10,000 for each 30 day period not filed, (within 90 days after the IRS notifies of the failure to file) after the 90 day period has expired, up to \$50,000 maximum penalty.
- 2. Accuracy-Related Penalty: A 40% penalty on a tax underpayment as a result of an undisclosed specified foreign financial asset.
- 3. Fraud: A 75% penalty on a tax underpayment, due to fraud.

Criminal Penalties (Form 8938)

Criminal penalties may be imposed for:

- 1. Failure to file Form 8938;
- 2. Underpayment of tax;
- 3. Failure to report asset.

Statute of Limitations

1. For failure to file Form 8938, failure to report a specified foreign financial asset, the statute of limitations remains open until 3 year after the date Form 8938 is filed.

2. For failure to include in gross income, an amount relating to one or more specified foreign financial assets, and the amount omitted in more than \$5,000, any tax owed for the tax year, can be assessed at any time within 6 years after the tax return is filed.

Foreign Financial Institutions

U.S. Source Income (U.S. Accounts)

Under the new law with respect to each U.S. account (any financial account held by one or more specified U.S. persons or U.S. owned foreign entities (IRC §1471(d)(1)(A)), the foreign financial institution must provide information about account gross receipts and withdrawals.

U.S.-Source investment income is subject to U.S. information reporting and tax withholding.

Every person engaged in a trade or business in the United States must file with the IRS a Form 1099 information return for payments totaling at least \$600 that it makes to a U.S. Person in the course of its trade or business (IRC §6041).

To avoid 28% back-up tax withholding (IRC §3406), a U.S. Person must furnish the payor with Form W-9 establishing that the payee is a U.S. Person (T.R. §32.3406(d)-1 and T.R. §32.3406(h)-3).

The combination of Form 1099 tax reporting and 28% back-up tax withholding is intended to ensure that U.S. Persons pay tax on investment income.

U.S. source income amounts, paid to foreign persons, are exempt from Form 1099 information reporting because they are subject to non-resident withholding rules.

A non-resident investor who seeks withholding tax relief for U.S. source investment income must provide certification on the appropriate IRS Form W-8 to the withholding agent to establish foreign status and eligibility for an exemption or reduced tax rate.

A withholding agent making payments of U.S. source amounts to a foreign person is required to report the payments, including any U.S. tax withheld, to the IRS on Forms 1042 and 1042-S by March 15th of the year following the year that the payment is made (T.R. §1.1461-1(b) and (c)). If the withholding agent withholds more than is required, the payee may file a claim for refund.

A non-financial foreign entity that is a beneficial owner of a withholdable payment must certify that it has no substantial U.S. owners or provide identifying information for each substantial U.S. owner.

Withholding Agents

The Foreign Account Tax Compliance Act (The "Act") expands withholding rules and additional reporting requirements for foreign financial institutions and non-financial foreign entities.

Under U.S. tax law, a withholding agent must deduct or withhold a tax equal to 30% on any withholdable payment (e.g., interest, dividends, rents, salaries, wages, premiums, annuities, compensations, and other fixed or determinable annual or periodical gains, profits and income from sources within the United States) made to a foreign financial institution or to a non-financial foreign entity (unless specific reporting requirements are met).

For each U.S. account maintained by the foreign financial institution, the institution must provide identifying information for each account holder that is a specified U.S. Person or substantial U.S. owner, the account number, the account balance, and gross receipts and withdrawals from the account.

A non-financial foreign entity that is a beneficial owner of a withholdable payment must certify that it has no substantial U.S. owners or provide identifying information for each substantial U.S. owner.

Every person required to deduct or withhold any tax to enforce reporting on certain foreign accounts is liable for the tax and is indemnified against claims and demands of anyone for the amount of the payments. (IRC §1474(a), as added by the 2010 HIRE Act.)

Six-Year Statute of Limitations

Under the new law, the statute of limitations is extended to six years if there is an omission of gross income in excess of \$5,000 and the omitted gross income is attributable to a foreign financial asset.

Taxes are generally required to be assessed within three years after a Taxpayer's return was filed, whether or not it was timely filed. A special rule extends the three-year limitation period in the case where there is a substantial omission of income.

If a Taxpayer omits substantial income on a return, any tax with respect to that return may be assessed and collected within six years of the date on which the return was filed.

In the case of income taxes, there is a substantial omission of income if the Taxpayer omits from gross income an amount that was properly includible in gross income and that is in excess of 25% of the amount stated on the return.

The state of limitations period will be suspended if the Taxpayer failed to timely provide information with respect to foreign financial assets required to be reported. The

limitation period will not begin to run until the information required has been furnished to the IRS.

The new six-year statute of limitations applies not only to returns filed after March 18, 2010 on which the Taxpayer fails to report income in excess of \$5,000 attributable to foreign financial assets, but also to returns filed on or before the date for which the statute of limitations is still open on March 18, 2010 (Act §513(d) of the HIRE Act [PL 111-147]).

For example, a 2006 tax return (filed in 2007), on which the Taxpayer failed to report more than \$5,000 of income attributable to a foreign financial asset and which is otherwise subject to the three-year limitations period, will be subject to the new sixyear statute of limitations.

HIRE Foreign Account Tax Compliance: 40% Penalty

The HIRE Act gives the IRS assessment and collection remedies unavailable with respect to the FBAR penalty.

A 40% accuracy-related penalty is imposed for underpayment of tax attributable to transactions involving undisclosed foreign financial assets. Undisclosed foreign financial assets include foreign financial assets that are subject to information reporting but the required information was not provided by the Taxpayer.

The 40% accuracy-related penalty is imposed for underpayment of tax that is attributable to an undisclosed foreign financial asset understatement (IRC §6662(b)(7) and (j) as added by the HIRE Act 2010). An undisclosed foreign financial asset understatement for any tax year is the portion of the understatement for the year that is attributable to any transaction involving an undisclosed foreign financial asset.

In contrast to the FBAR penalty, which is limited to collection through the U.S. Financial Management System (which collects non-tax debts for the government), the HIRE Act penalties give the IRS the ability to assess and collect these new penalties through its administrative powers (including tax levy and tax lien).

The new penalties under the HIRE Act are for the understatement of tax and impose a lesser burden of proof and threshold for imposition of the penalty than the willful FBAR penalty.

Penalty for Failure to Report

The minimum amount of penalty for failure to report information or file returns for foreign trusts is increased to \$10,000.

If any notice or return required to be filed under IRC §6048 is not filed on or before the due date, or does not include all the information that is required, or includes incorrect information, then the person required to file such notice or return must pay a penalty equal to the greater of:

- 1. \$10,000, or
- 2. 35% of the gross reportable amount (5% for U.S. Persons treated as owners of the trust) (IRC §6677(a), as amended by the 2010 HIRE Act).

Prior to these revisions, the penalty for failure to provide the required information or file a return with respect to certain foreign trusts was 35% of the gross reportable amount (5% for U.S. Persons treated as owners of the trust).

With the new minimum amount, the IRS will be able to impose a \$10,000 penalty even when there is not enough information to determine the gross reportable amount.

The maximum amount of the penalty has changed. The penalty for failure to report information or file a return with respect to certain foreign trusts cannot exceed the gross reportable amount (IRC §6677(a)).

To the extent that the aggregate amount of penalties exceeds the gross reportable amount, the IRS must refund the excess to the Taxpayer (IRC §6677(a), as amended by the 2010 HIRE Act).

Uncompensated Use of Foreign Trust Property

The uncompensated use of foreign trust property by a U.S. Grantor, a U.S. Beneficiary, or a U.S. Person related to either of them is treated as a distribution by the trust for non-grantor trust income tax purposes (which also includes the loan of cash or marketable securities by a foreign trust or the use of any other property of the trust).

The distribution treatment of foreign trust transaction has been expanded to include the uncompensated use of property by certain U.S. Persons. The treatment of foreign trusts as having U.S. beneficiaries for grantor trust purposes has been expanded to include loans of cash or marketable securities or the use of any other trust property to or by a U.S. Person.

If a foreign trust permits the use of any trust property by a U.S. Grantor, a U.S. Beneficiary, or any U.S. Person related to either of them, the fair market value of the use of such property is treated as a distribution by the trust to the Grantor or Beneficiary (IRC §643(i)(1), as amended by the 2010 HIRE Act).

This treatment does not apply to the extent that the trust is paid the fair market value of such use within a reasonable time (IRC §643(i)(2)(E), as added the 2010 HIRE Act). If distribution treatment does apply to the use of trust property, the subsequent return of

such property is disregarded for federal tax purposes (IRC §643(i)(3), as amended by the 2010 HIRE Act).

Foreign Trusts Treated as Having U.S. Beneficiaries

For purposes of treating a foreign trust as a grantor trust, there is a rebuttable presumption that the trust has a U.S. beneficiary if a U.S. Person transfers property to the trust. An amount is treated as accumulated for a U.S. Person even if that person has a contingent interest in the trust.

A foreign trust is treated as having a U.S. beneficiary if any person has discretion to make trust distributions, (unless none of the recipients are U.S. Persons). An amount will be treated as accumulated for the benefit of a U.S. Person even if that person's interest in the trust is contingent on a future event (IRC §679(c)(1) as amended by the 2010 HIRE Act).

If any person has the discretion (by authority given in the trust agreement, by a power of appointment or otherwise, of making a distribution from the trust to or for the benefit of any person), the trust will be treated as having a beneficiary who is a U.S. Person, unless the trust terms specifically identify the class of person to whom such distribution may be made and none of those persons are U.S. Persons during the tax year (IRC §679(c)(4) as added by the 2010 HIRE Act).

If any U.S. Person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding that may result in trust income or corpus being paid or accumulated to or for the benefit of a U.S. Person, that agreement or understanding will be treated as a term of the trust (IRC §679(c)(5) as added by the 2010 HIRE Act). The agreement or understanding may be written, oral or otherwise.

The provision creating a rebuttable presumption allowing the IRS to treat a foreign trust as having a U.S. beneficiary if a U.S. person directly or indirectly transfers property to the trust applies to transfers of property after March 18, 2010. (Act Section 532(b) 2010 HIRE Act.)

Reporting Requirements for U.S. Persons Treated as Owners of a Foreign Trust

A U.S. Person who is treated as the owner of any portion of a foreign trust under the grantor trust rules, must submit any information required by the IRS with respect to the foreign trust (in addition to the current requirement that such U.S. Persons are responsible for insuring that a foreign trust complies with his own reporting obligations) (see IRC§6048(b)(1), as amended by the 2010 HIRE Act). This requirement to supply information about the trust applies to tax years beginning after March 18, 2010 (Act §534(b) of the 2010 HIRE Act).

The current reporting obligations of the foreign trust include making a return for the year and providing certain information to each U.S. Person who is treated as the owner of any portion of the trust, or who receives a direct or indirect distribution from the trust (IRC §6048(b)(1)(A) and (B)).

FATCA/Foreign Financial Institutions

The task of gathering the information will be borne by the banks and financial institutions who are seeking to pass the cost of FATCA compliance on to their customers. The U.S. and the respective countries will focus on tax transparency and seek to find out where these taxpayers are hiding their unreported money.

FATCA contains two principal operative provisions, one applying to "Foreign Financial Institutions" ("FFIs") and the other to all other foreign entities receiving payments from U.S. sources, either on their own behalf or acting as an intermediary. FFIs and other foreign entities that receive payments from U.S. sources under the provisions of FATCA (signed into law March 2010, under the "HIRE Act") are being compelled to promote compliance with U.S. law requiring the U.S. persons to report income from non-U.S. accounts.

"Foreign Financial Institutions" are defined to include any entity not resident in a U.S. state or possession that:

- 1. Accepts deposits in the ordinary course of a banking or similar business;
- 2. Engages in the business of holding financial assets for the account of others; or
- 3. Engages primarily in the business of investing, re-investing or trading in securities, partnership interests, commodities or any interests in securities, partnerships or commodities.

Foreign Financial Institutions - U.S. Tax Withholding

Any "withholdable payment" by a U.S. withholding agent to any FFI would be subject to 30% tax withholding unless the FFI enters into a reporting agreement with the IRS.

"Withholdable payments" include:

- 1. U.S. source investment income;
- 2. U.S. source proceeds from the sale of any property "of a type which can produce interest or dividends";

3. While gains from the sale of property are generally not includable in U.S. income, for non-residents FATCA subjects sale proceeds to withholding.

FFIs may avoid U.S. tax withholding if they execute an IRS agreement, under which they would be required to:

- 1. Obtain information regarding each holder of each account maintained by the FFI to determine which accounts are U.S. accounts and comply with IRS' verification and due diligence procedures;
- 2. Annually report information with respect to any U.S. account held at the FFI;
- 3. Deduct and withhold 30% of any "pass thru payment" to a 'recalcitrant account holder' or FFI not subject to an agreement (or elect to be withheld upon);
- 4. Comply with IRS information requests;
- 5. If under FFI's domestic law, the FFI would be prohibited from reporting the required interaction, the FFI must obtain a waiver of such prohibition or lose the account.

FFIs that are subject to an agreement and are required to report the name, address and TIN of account holders include:

- 1. Any specified U.S. person included in the account (i.e. any U.S. resident with the exception of publicly-traded corporations, banks, R.E.I.T.s and RICs).
- 2. A "substantial U.S. owner" (i.e. any person owning more than a 10% interest in any entity) or in case of payees primarily in the business of trading, anyone who owns any interest in the entity, including a profits-only interest.

Non-FFIs

A payee of U.S. source income who is a non-FFI is not permitted to enter into an IRS non-withholding agreement.

A withholding agent is required to withhold 30% of any withholdable payment to a non-FFI, regardless of whether the payee is the beneficial owner of the payment.

To avoid withholding, the payee would either have to:

- 1. Certify that the beneficial owner of any payment have no "substantial U.S. owners", or
- 2. Provide the name, address and TIN of each beneficial owner.

3. Report to the IRS all payee information received.

Exceptions to withholding:

- 1. Beneficial owners that are publicly traded;
- 2. Certain members of affiliated groups;
- 3. Residents of U.S. possessions.

The withholding agent would have to withhold if the agent has any reason to know any payee certifications or representations are false.

FATCA Effective Dates

Most FATCA requirements would apply to payments made after 12/31/12.

On 4/8/11, the IRS issued FATCA guidance instructing FFIs on the steps required for them to identify U.S. accounts among their existing account holders.

The 4/8/11 notice includes:

- 1. "A private banking test" for private bankers to attempt to find U.S. connections among account holders.
- 2. Details on the definition of pass-through payments.
- 3. Provides for a certification process for "deemed compliant" FFIs.
- 4. Provides that FFIs have to report only year-end balances to the IRS, and does not have to report basis on investment transactions.

In IRS Notice 2011-76, the IRS provided a new timeline whereby FFIs have until 6/30/13 to enter into a FATCA agreement with the IRS, and they will not be required to report on U.S. account holders until 2014.

On 2/8/12 the IRS issued additional FATCA guidance, including an agreement among the U.S., France, Germany, Italy, Spain, Switzerland and the UK to cooperate on implementing FATCA and arranging an automatic bilateral information exchange with the U.S. through the existing treaty structure.

The information sharing arrangement takes one of two forms:

- 1. FFI to U.S. government direct, or
- 2. FFI to foreign government and then to U.S. government.

FATCA Information Disclosure

U.S. taxpayers (individuals, not corporations, partnerships, or limited liability companies) are required to attach Form 8938: Statement of Specified Foreign Financial Assets to their Form 1040 tax returns if the aggregate value of such assets is greater than \$50,000.

Specified Foreign Financial Assets include: depository or custodial accounts at FFIs, stocks or securities issued by foreign persons, a financial instrument or contract held for investment issued by a foreign country or party and any interest in a foreign entity.

The civil penalty for failure to supply this information is \$10,000 with an additional \$10,000 penalty up to a maximum of \$50,000, after notice from the IRS (IRC Sec. 6038D(g).

Any understatement of tax attributable to an undisclosed foreign asset is subject to a 40% penalty (IRC Sec. 6662(j)).

Statute of Limitations

FATCA (IRC Sec. 6501(c)(8)(e) extends from three years to six years the period of assessment for understatements attributable to failure to report foreign accounts on the date such information is actually provided to the IRS.

When a taxpayer fails to report certain foreign asset information, the statute is tolled for a period including the taxpayer's non-compliance plus three years; the extended statute applies to the taxpayer's entire tax return, not just to foreign assets. This provision is effective for any year open on the date of enactment (March 2010) and to returns filed after enactment.

FATCA Foreign Trusts

FATCA clarifies foreign trust reporting as follows:

- 1. An amount is treated as accumulated for the benefit of a U.S. beneficiary of a foreign grantor trust even if the U.S. beneficiary's interests are contingent on a future event (IRC Sec. 679(c)(10)).
- 2. If any person, such as a trustee or protector, has the power to add beneficiaries, the trust shall be considered to have U.S. beneficiaries unless a specific list is provided and no beneficiary is a U.S. person (IRC Sec. 679(c)(4).
- 3. Any agreement or understanding, such as a letter of wishes, may result in a U.S. person benefiting from the trust, and will be considered a trust term (IRC Sec. 679(c)(5).

- 4. It imposes new reporting requirements on any U.S. person treated as an owner of any portion of a foreign trust and creates a presumption that a foreign trust has a U.S. beneficiary, unless the beneficiary submits information that no part of the income or corpus of the trust may be paid or accumulated for the benefit of a U.S. person, and if the trust were terminated during the taxable year, no part of the income or corpus could be paid for the benefit of a U.S. person (IRC Sec. 679(d)).
- 5. Cash and securities, if provided or loaned to a beneficiary, are considered distributions, the fair market value of any use of property owned by the trust, such as real estate, is treated as a trust distribution (IRC Sec. 643(i)).

Chapter 35 – FBAR

Ownership of Accounts

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

- 1. A U.S. person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non-U.S. persons. If an account is maintained in the name of two persons jointly, or if several persons own a partial interest in an account, each of those U.S. persons has a financial interest in that account.
- 2. U.S. person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is:
- a) A person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person;
- b) A corporation in which the U.S. person owns directly or indirectly more than 50 percent of the total value of shares of stock;
- c) A partnership in which the U.S. person owns an interest in more than 50 percent of the profits (distributive share of income); or
- d) A trust in which the U.S. person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.

Signature Authority

For purposes of Form TD F 90.22-1, a U.S. person is considered to have signature authority over a foreign financial account if such person can control the disposition of money or other property in the account by delivering his or her signature (or his or her signature and that of one or more other persons) to the bank or other person maintaining the account.

In addition, a U.S. person has "other authority" subject to FBAR reporting if such person can exercise comparable power over an account by direct communication to the bank or other person maintaining the account, either orally or by some other means.

Exceptions & Mechanics of Filing

Exceptions

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

- 1. An officer or employee of a bank which is subject to the supervision of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, or the Federal Deposit Insurance Corporation need not report that he has signature or other authority over a foreign bank, securities or other financial account maintained by the bank, if the officer of employee has NO personal financial interest in the account.
- 2. An officer or employee of a domestic corporation whose equity securities are listed upon national securities exchanges or which has assets exceeding \$10 million and 500 or more shareholders of record need not file such a report concerning the other signature authority over a foreign financial account of the corporation, if he has NO personal financial interest in the account and he has been advised in writing by the chief financial officer of the corporation that the corporation has filed a current report, which includes that account.
- 3. As noted above, a U.S. person is not required to report any account maintained with a branch, agency, of other office of a foreign bank or other institution that is located in the United States, Guam, Puerto Rico, and the Virgin Islands.

Mechanics of Filing

Reporting on Form TD F 90-22.1 is required for each calendar year that a U.S. person maintains such interest or authority over foreign financial accounts. Persons having a financial interest in 25 or more foreign financial accounts are required only to note that fact on the form, i.e. a general statement indicating that information on all such accounts will be available upon request. (31 CFR § 103.24 Such persons will be required to provide detailed information concerning each account when so requested by the Secretary or his delegate.)

The Form TD F 90-22.1 is filed with the U.S. Department of the Treasury, P.O. Box 32621, Detroit, MI 48232-0621, or it may be hand carried to any local office of the Internal Revenue Service for forwarding to the Department of the Treasury in Detroit, MI. The Form TD F 90¬-22.1 must be filed on or before June 30 each calendar year. An extension for filing one's U.S. income tax return does not extend the deadline for making a TD F 90-22.1 filing.

Additional Issues

Each U.S. person subject to this reporting requirement must also maintain records showing, (1) the name in which each such account is maintained, (2) the number or

other designation of such account, (3) the name and address of the foreign bank or other person with whom such account is maintained, and (4) the type of such account, and the maximum value of each such account during the reporting period (31 CFR §103.32). These records must be retained for a period of 5 years and must be kept at all times available for inspection as authorized by law.

Artwork and Foreign Land

*On 6/24/09, the IRS updated their Voluntary Disclosure FAQ clarifying the FBAR reporting requirements for foreign land and artwork owned in the taxpayer's own name.

In FAQ #37, the IRS confirmed that the FBAR filing for foreign land and artwork owned in the taxpayer's own name, is due once the asset becomes income-producing (i.e., yields current income, or gain from the sale).

If the foreign land/artwork is held in an entity, the taxpayer is required to file tax information returns (Trust: Form 3520) (Corporation: Form 5471).

Re: FAQ 20 A taxpayer owns valuable land and artwork located in a foreign jurisdiction. This property produces no income and there were no reporting requirements regarding this property. Must the taxpayer report the land and artwork and pay a 20 percent penalty?

FAQ 20 relates to income producing property for which no income was reported. Under those circumstances, no distinction is made between assets held directly and assets held through an entity in computing the 20 percent offshore penalty. However, if the taxpayer owns non-income producing property in the taxpayer's own name, there has been no U.S. taxable event and no reporting obligation to disclose. The taxpayer will be required to report any current income from the property or gain from its sale or other disposition at such time in the future as the income is realized. Because there has as yet been no tax noncompliance, the 20 percent offshore penalty would not apply to those assets. If the foreign assets were held in the name of an entity such as a trust or corporation, there would have been an information return filing obligation that may need to be disclosed.

*The IRS posted <u>Offshore Voluntary Disclosure Program Frequently Asked Questions</u> and <u>Answers</u> and updated 6/08/16.

Domestic Corporations and Foreign Accounts

In the IRS Workbook on the Report of Foreign Bank and Financial Accounts, the IRS advised that a domestic (e.g., NY) corporation that has foreign accounts:

- 1. The corporation must file a FBAR for the corporations' accounts.
- 2. A majority shareholder (over 50% of the value of the stock), must also file a FBAR.

For a domestic corporation with foreign accounts, both the corporation and the majority shareholder must each file a FBAR to report the foreign account (owned by the domestic corporation).

Reporting Foreign Life Insurance Policy

In response to my inquiry, the IRS clarified (by FAQ) that a foreign life insurance policy is a foreign financial account if it includes a cash surrender value. The IRS 7/31/09 response:

1. Is a foreign life insurance policy with cash surrender value a financial account for FBAR reporting purpose?

A financial account, as defined in the FBAR General Instructions, includes "savings, demand, checking, deposit, time deposit, or any other account maintained with a financial institution or Other Person engaged in the business of a financial institution." An insurance policy with cash surrender value can "store" cash, available for withdrawal at a later time, and for this reason is treated as a financial account with a financial institution for FBAR purposes. If the insurance policy is located in a foreign country and has cash surrender value, the policyholder may have to report the policy on a FBAR. For FBAR reporting purposes, the cash surrender value of the policy is the value of the account. Insurance policies that are issued by a foreign-owned company but that are acquired through an insurance agent located in the United States is not a foreign financial account and is not required to be reported on an FBAR.

If the foreign life insurance policy is owned by a trust with two or more beneficiaries, a beneficiary of more than 50% of trust assets must file the FBAR (on account of the trust).

Filing Requirements for Gold or other Non-Cash Assets

Under IRS FAQ's regarding Report of Foreign Bank and Financial Accounts (FBAR), the IRS confirmed:

- A FBAR must be filed whether or not the foreign account generates any income;
- 2. A FBAR is required for account maintained with financial institutions located in a foreign country if the account holds gold (or other non-cash assets).

Hedge Funds

After the landmark agreement between the U.S. and Swiss government over secret (UBS) Swiss bank accounts, held by U.S. Citizens, the IRS is now focusing on hedge funds in the Cayman Islands. Recently, IRS officials advised that certain U.S. investors in offshore hedge funds must file a FBAR.

On June 12, 2009, an IRS official stated that the term "financial interest" (which requires a FBAR filing) includes hedge funds that "function as mutual funds".

It appears the IRS and Justice Department will identify U.S. Taxpayers who evade U.S. taxes, by investing with offshore hedge funds. The IRS and Justice Department are pressing foreign financial institutions to provide them with information about Americans with "foreign, secret bank accounts."

Trusts

Each US Trustee of a trust account must file a FBAR (even if the beneficiary of the trust is not a US Person). If the owner of an account gave someone the power of attorney over the account, both the owner and the attorney-in-fact must file a FBAR (if both are US Taxpayers).

If a trust that holds a foreign financial account provides for a Protector, whose powers include directing distributions if the Protector is a US Person, the Protector must file a FBAR.

If several members of the same family have accounts, the FBAR rules apply to each account holder individually. The IRC §318 attribution rules do not apply to filing the FBAR.

Under the grantor trust rules (IRC §679) any US Person who establishes a foreign trust (which holds the foreign financial account), established by a US Person for any US beneficiary, the US Settlor is responsible for filing a FBAR for the trust accounts (even if the US Settlor of the trust is not a beneficiary, has no authority over the trust or any of the trust accounts). Under US tax rules, he is treated as the owner of the trust (for US income tax purposes) because the trust is deemed a grantor trust which makes him responsible to file the FBAR form.

Financial interest may be present even if there is no signatory authority. If a trust holds an account and the US Taxpayer has a present beneficiary interest in more than 50% of the trust assets, receives more than 50% of the trust assets, or receives more than 50% of the current trust income, he must file a FBAR.

If a trust has 2 or more beneficiaries and none of the beneficiaries has more than a 50% interest in the income of principal, then none of them needs to file a FBAR (although each US Trustee who is a US Taxpayer must file the FBAR). Regarding the rules for a

discretionary trust, if a US Taxpayer receives distributions of more than 50% of trust income or principal in any given year, it requires filing the FBAR.

Foreign Bank Accounts: Definitions

Each U.S. person having a financial interest in, or signature or other authority over, any foreign financial accounts with an aggregate value exceeding \$10,000 at any time during the calendar year must report such relationship by filing Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR").

In addition, they have to disclose the foreign account filing requirement on Schedule B of Form 1040 and including the income from these accounts on the United States person's U.S. federal income tax return.

Who Must File

Form TD F 90.22-1 is required to be filed by every U.S. person for each calendar year in which such person has a financial interest in, or signature or other authority over, any foreign financial accounts with an aggregate value exceeding \$10,000 at any time during the calendar year. The test is based in the alternative – financial interest in or signature authority over the account.

Definitions

For purposes of FBAR, the term "United States person" means (1) a citizen or a resident of the United States, (2) a domestic partnership, (3) a domestic corporation, or (4) a domestic estate or trust.

The term "financial account" generally includes any bank, securities, securities derivatives or other financial instrument accounts, (including any accounts in which the assets are held in a commingled fund, and the account owner holds an equity interest in the fund), savings, demand, checking, deposit, time deposit, or any other account maintained with a financial institution (or other person engaged in the business of a financial institution).

Any of the financial accounts described above is considered to be a foreign financial account for purposes of FBAR, if it is located outside the United States, Guam, Puerto Rico, and the Virgin Islands. The situs of a financial account is determined by the location where the branch is, not the location of the institution's home office.

The Element of Control

Under the FBAR instructions, signatory authority may be present and a FBAR may be required when there is an indirect element of control. The FBAR instructions state:

"Authority exists in a person who can exercise comparable power over an account by direct communication to the bank or other person with whom the account is maintained, either orally or by some other means."

If a foreign corporation holds a foreign account and a US Person owns more than 50% of the shares, a FBAR must be filed. US Persons who are officers or directors of foreign corporations and have signatory authority over foreign corporate accounts must also individually file a FBAR whether or not they own shares of the corporation (certain publicly traded corporations and banks under US control are exceptions to this rule).

For partnerships owning foreign accounts, if the US Taxpayer holds more than a 50% interest in the partnership profits, they are required to file a FBAR.

If the US Person is the owner of a foreign life insurance policy or a foreign annuity contract with cash surrender value in excess of \$10,000, he must file a FBAR. The owner of the contract has no direct authority over the accounts in which the premiums are deposited or invested. However, the owner has the authority to withdraw cash from the policy or contract.

The owner has a financial interest in the policy or contract and has an indirect financial interest in the underlying accounts.

Financial Interest Signatory Authority

The FBAR is not a tax return. The FBAR is a financial disclosure (i.e., a report of the Taxpayer's foreign financial accounts). The FBAR must be filed even if the reported accounts generate no interest or other taxable income. All income earned on the foreign account must be reported on the tax return of the beneficial owner which is an entirely separate reporting from the FBAR. However, once a Taxpayer discloses a foreign account on their Form 1040 Schedule B, the FBAR must be filed.

The FBAR form is designed to disclose the US Taxpayer's connection to a foreign financial account. The form details the US Taxpayer (e.g., name, address, identification number and balance held in the account over \$10,000). The form asks for the name of the financial institution, the country and the account number for each account, if more than one. If there are joint owners, their names and identification numbers are requested and if the person who is reporting claims to have no financial interest in the account (such as a person holding a power of attorney or a corporate officer who has no shares in the corporation), then the name and the identification number of the beneficial owner must be disclosed.

Any US Person who has a financial interest in, or signatory authority over, any financial accounts in a foreign country if the total value of such accounts exceeds \$10,000 at any time during the calendar year must file a FBAR. The accounts in Puerto Rico, Guam, and

the Northern Mariana Islands, American Samoa, and the US Virgin Islands are exceptions to this rule (see Workbook on the Report of Foreign Bank and Financial Accounts (FBAR)

US Taxpayers include resident aliens and other foreign individuals who are considered US Persons under the Substantial Presence Test (i.e., because of the time spent in the US in a given year [IRC §§7701(b)(1)(A)(ii) and 7701(b)(3)]). (FBAR rules also apply to a domestic trust, estate, partnership or corporation.)

A US Taxpayer has a required financial interest in an account if they:

- 1. Are the owner of the account.
- 2. Have legal title to the account (even if it is for someone else's benefit).

Both financial interest and the signatory authority generate the requirement to file the FBAR. When the account is in joint names, all joint owners must file their own FBAR (even though the funds may belong to only one of them). An exception to the joint account rule applies only if the joint owners are husband and wife (if they live together).

U.S. Taxpayer Tax Compliance Issues

FBAR 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."

Taxpayers who fail to disclose the account on their Form 1040 could be subject to criminal sanctions for filing a false tax return.

The FBAR report is due on June 30th. This due date is not subject to extensions. 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. 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 may be subject to these rules.)

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.

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. Accounts held by U.S. Persons in these areas are not foreign accounts subject to FBAR reporting.

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, exceeds \$10,000.

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. 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.

Taxpayers may transfer an appreciating asset to a foreign account, such as stock or securities. As these assets increase in value, they may trigger an FBAR reporting requirement.

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. In 2009, 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.

The penalty for willful violations is far more severe. It is equal to the greater of \$100,000 or 50 per-cent 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).

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

Form TD F 90-22.1

*In FBAR FAQ #26 (posted on 6/24/09), the IRS confirmed that the revised version of Form TD F 90-22.1 (revised October 2008) should be used to report foreign accounts (including prior delinquent years):

If I had an FBAR reporting obligation for years covered by the voluntary disclosure, what version of the Form TD F 90-22.1 should I use to report my interests in foreign accounts?

Taxpayers should use the current version of Form TD F 90-22.1, (revised in October 2008), to file delinquent FBARs to report foreign accounts maintained in prior years. The

taxpayer may, however, rely on the instructions for the prior version of the form (revised in July 2000) for purposes of determining who must file to report foreign accounts maintained in 2008 and prior calendar years.

Although the FBAR was revised in October 2008, IRS News Release IR-2009-58 (June 5, 2009) and IRS Announcement 2009-51, both available at the IRS website, permit the use of the definition of "United States person" in the prior version of the FBAR in determining who must file FBARs that are due on June 30, 2009. Accordingly, for all FBARs that are due in the current and prior years, the term "United States person" means (1) a citizen or resident of the United States; (2) a domestic partnership; (3) a domestic corporation; or (4) a domestic estate or trust.

With regard to interest charged (on penalties) under FAQ #36, the IRS confirmed:

- 1. For accuracy-related and delinquency penalties, interest runs from the due date of the Form 1040 (tax return) at issue.
- 2. For all other penalties, interest runs from the date of the assessment of the penalty.

*The IRS updated the <u>FAQs Regarding Report of Foreign Bank and Financial Accounts</u> (FBAR) – Filing Requirements on June 14, 2016.

Revised Form TD F 90-22.1

In October 2008, the IRS issued a revised version of TD F 90-22.1 "Report of Foreign Bank and Financial Accounts ("FBAR").

The revised FBAR form states: "Do not use previous editions of this form after December 31, 2008". All FBAR's due for Tax Years 2008 (forward) and back year FBAR's (unfiled) are to be reported on the new form.

The revised FBAR form includes new provisions designed to facilitate IRS off-shore enforcement. Specific new provisions are included for:

1. Foreign Trusts (Trust Protector)

If a U.S. person appoints a Trust protector, for a foreign account held by a Foreign Trust, the U.S. person has a financial interest in the account and must file a FBAR.

2. Foreign Trusts (Trust Beneficiaries)

Trust beneficiaries do not have a FBAR filing requirement unless they are a U.S. person who is the beneficiary of more than 50% of a Trust holding a foreign account.

3. Debit Card (Prepaid Credit Cards)

Reportable financial accounts include debit cards and prepaid credit card accounts.

4. Foreign Persons

Foreign persons in and doing business in the U.S. are required to provide identifying information (i.e., "foreign identification number", such as foreign passport number) and file FBAR's.

5. Account Value

Instead of an account value range, U.S. taxpayers must fill in the exact value of the account during the calendar year.

6. Foreign Account Owners

U.S. persons, with signature authority over the account (who file the FBAR) must identify the account's foreign owner.

7. Joint Filing for Married Taxpayers

Previously, married taxpayers had to file separate FBAR's for a jointly owned account. The new FBAR allows joint filing. The new FBAR requires the filer to provide the identifying information for the "principal joint owners".

8. Record Retention

The new FBAR explicitly states the records must be kept for a period of 5 years and must be kept at all times available for inspection.

Currency Transaction Report (CTR) & Suspicious Activity Report (SAR)

U.S. financial institutions file Currency Transaction Reports (CTR) and Suspicious Activity Reports (SAR) with the IRS Detroit Computing Center (uploaded into the IRS/DCC Currency Banking and Retrieval System database at the IRS/DCC).

The combined CTR/SAS currency transaction reports provides a paper trail (or roadmap) for investigations of financial crimes and illegal activities including: tax evasion, embezzlement and money laundering. Between 1994 – 1997, the IRS Criminal Investigation Division initiated 1030 investigations as a result of CTR/SAR (Currency Transaction Reports).

Report/Requirements

Currency Transaction Report (CTR) – Filed by financial institutions that engage in a currency transaction in excess of \$10,000.

Currency Transaction Report Casino (CTRC) – Filed by a casino to report currency transactions in excess of \$10,000.

Report of Foreign Bank and Financial Accounts (FBAR)

Filed by individuals to report a financial interest in or signatory authority over one or more accounts in foreign countries, if the aggregate value of these accounts exceeds \$10,000 at any time during the calendar year.

IRS Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business – Filed by persons engaged in a trade or business who, in the course of that trade or business, receives more than \$10,000 in cash in one transaction or two or more related transactions within a twelve month period.

Suspicious Activity Report (SAR) – Filed on transactions or attempted transactions involving at least \$5,000 that the financial institution knows, suspects, or has reason to suspect the money was derived from illegal activities. Also filed when transactions are part of a plan to violate federal laws and financial reporting requirements (structuring).

Family Ownership Attribution Rules

IRC §318 constructive ownership of stock rules attribute ownership to family members who maintain common ownership in an entity (e.g., trust). If 2 or more family members are Trust beneficiaries (or any one act as Trustee), the issue is whether IRC §318 Family Attribution Rules (i.e., greater than 50% ownership interests) require any Trust beneficiary to file a FBAR to disclose foreign bank accounts owned by the Trust.

Under IRS §318(a)(1)(A)(i)(ii), an individual shall be considered as owning the stock owned, directly (or indirectly), by or for:

- 1. His spouse.
- 2. His children, grandchildren and parents.

The IRS has advised:

A US Taxpayer, who is a Trustee, is required to file a FBAR for the Trust if the US Trustee has either:

- a. A financial interest, or
- b. Signature authority over a foreign account.

On 8/21/09 the IRS confirmed to my law offices: A beneficiary of more than 50% of trust assets must file the FBAR on account of the trust.

As the IRS clarified (8/21/09) U.S. Taxpayer Family Trusts may hold Foreign Bank (and Financial) accounts, and unless one of the Trust beneficiaries has a more than a 50% interest in income or principal, none of the Trust beneficiaries are required to file a FBAR (to disclose the foreign bank [financial] account).

On 8/21/09, the IRS confirmed:

- 1. If the trust has a discretionary class of two or more beneficiaries, and none of the beneficiaries has a more than a 50% interest in income or principal, none of the beneficiaries need to file a FBAR to report foreign bank accounts.
- 2. The "ownership" attribution rules of Title 26 (IRC §318) are not applicable to a FBAR (filing) (which includes a discretionary class of beneficiaries [i.e., family trusts]).

Foreign Accounts with Multiple Signatories

*On 6/24/09, the IRS updated their Voluntary Disclosure FAQ clarifying the FBAR reporting requirements for foreign accounts with multiple signatories:

If parents have a jointly owned foreign account on which they have made their children signatories, the children have an FBAR filing requirement but no income. Should the children just file delinquent FBARs as described by FAQ 9 and have the parents submit a voluntary disclosure? Will both parents be penalized 20 percent each? Will each have a 20 percent penalty on 50 percent of the balance?

Only one 20 percent offshore penalty will be applied with respect to voluntary disclosures relating to the same account. In the example, the parents will be jointly required to pay a single 20 percent penalty on the account. This can be through one parent paying the total penalty or through each paying a portion, at the taxpayers' option. For those signatories with no ownership interest in the account, such as the children in these facts, they may file delinquent FBARs with no penalty as described in FAQs 9 and 41. However, any joint account owner who does not make a voluntary disclosure may be examined and subject to all appropriate penalties.

If there are multiple individuals with signature authority over a trust account, does everyone involved need to file delinquent FBARs? If so, could everyone be subject to a 20 percent offshore penalty?

Only one 20 percent offshore penalty will be applied with respect to voluntary disclosures relating to the same account. The penalty may be allocated among the taxpayers making the disclosures in any way they choose. The reporting requirements for filing an FBAR, however, do not change. Therefore, every individual who is required to file an FBAR must file one.

*The IRS posted <u>Offshore Voluntary Disclosure Program Frequently Asked Questions</u> and <u>Answers</u> on 6/26/12 and updated 6/08/16.

U.S. Trustee Foreign Non-Grantor Trust

A U.S. trustee of a foreign non-grantor trust must file Form TD F 90-22.1 if the Trustee has a financial interest in or signature authority or other authority over any financial

accounts, including bank, securities, or other types of financial accounts in a foreign country if the value of such accounts exceeds \$10,000. A person has a financial interest in any such account if she has legal title to it.

Trustees generally have legal title to accounts in which trust funds are invested. In addition, if legal title to an account is held by a corporation or partnership and the trustee owns more than 50% of the corporation or partnership, the trustee will be treated as having a financial interest in such account.

A person has signature authority over an account if she can control the disposition of account property by the delivery of a document signed by her and one or more other persons. A person has other authority over an account if she can control such disposition by direct communication to the person with whom the account is maintained.

Form TD F 90-22.1 must be filed by June 30th of the year following the year in which the U.S. person had such financial interest or signature or other authority.

Amended Tax Returns (Voluntary Disclosure)

U.S. Taxpayers who fail to report offshore accounts by filing FBAR (TD F 90.22-1) face criminal and civil penalties:

1. Failure to Report Income

(3 Felonies and 1 Misdemeanor) up to 14 years in jail, plus 75% Civil Tax Fraud Penalty, 25% Failure to Pay Tax Penalty.

2. Failure to File FBAR's

(a maximum annual penalty of 50% of the account balance, up to 10 years in jail a \$500,000 fine).

3. Perjury

Taxpayers Form 1040/Schedule B must declare whether Taxpayers have any authority over, or interest in foreign accounts with a total of more than \$10,000.

In the IRS 6/24/09 FAQ update the IRS stated:

What is the distinction between filing amended returns to correct errors and filing a voluntary disclosure?

An amended return is the proper vehicle to correct an error on a filed return, whether a taxpayer receives a refund or owes additional tax. A voluntary disclosure is a truthful, timely and complete communication to the IRS in which a taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining the taxpayer's correct tax liability and makes arrangements in good faith to fully pay that liability. Filing

correct amended returns is normally a part of the process of making a voluntary disclosure under IRM 9.5.11.9. Taxpayers and practitioners trying to decide whether to simply file an amended return with a Service Center or to make a formal voluntary disclosure under the process described in IRM 9.5.11.9 and the March 23, 2009 memoranda should consider the nature of the error they are trying to correct.

Taxpayers with undisclosed foreign accounts or entities should consider making a voluntary disclosure because it enables them to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution. Making a voluntary disclosure also provides the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues. It is anticipated that the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts and assets. However, there will be some cases, such as where a taxpayer has reported all income but failed to file the FBAR (FAQ 9), or only failed to file information returns (FAQ 42), where it remains appropriate for the taxpayer to simply file amended returns with the applicable Service Center (with copies to the Philadelphia office listed in FAQ 9).

The IRS stated position is that a Taxpayer's voluntary disclosure entitles the Taxpayer to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution.

In reality, a taxpayer who makes a voluntary disclosure may:

- 1. Spotlight their "tax crimes"
- 2. If the voluntary disclosure is not accepted, jeopardize them and subject them to criminal prosecution

The IRS SBSE 3/23/09 memorandum, Subject: Routing of Voluntary Disclosure Cases, which addresses a change in the processing of voluntary disclosure requests containing offshore issues.

- 1. Such requests will continue to be initially screened by Criminal Investigation to determine eligibility for voluntary disclosure, and, if involving only domestic issues will be forwarded to Area Planning and Special Programs for Civil Processing;
- 2. Voluntary disclosure eligibility for offshore issues will be initially screened by Criminal Investigation and forwarded to the Philadelphia Offshore Identification Unit (POIU) for processing.

Voluntary Disclosure risks include:

- 1. Heightened risk of criminal prosecution (since initial screening is by the IRS Criminal Investigation Division);
- 2. A voluntary disclosure may be used as an evidentiary admission of Taxpayer's unreported income;
- 3. A voluntary disclosure may waive Taxpayer's 5th Amendment right against self-incrimination;
- 4. While a voluntary disclosure is pending the IRS may request more information, commence an audit or initiate criminal prosecution.

As an alternative strategy to a voluntary disclosure, the "quiet filing" (for the Tax Years at issue) of an amended tax return (or original tax return) may instead:

- 1. Pre-empt criminal charges for the failure to file FBAR returns, Form 1040 tax returns and failure to pay tax;
- 2. Pre-empt a 75% civil tax fraud penalty, for failure to file or pay tax and a 25% failure to pay tax penalty;
- 3. If the income is properly reported (i.e., no substantial understatements which are subject to a 6 year statute of limitations), the tax filing will commence the 3-year statute of limitations (for each year) for IRS audit.

Statute of Limitations

On 6/24/09, in FAQ #31, the IRS confirmed they would be able to assess taxes under a 6-year statute of limitations if the IRS can prove a substantial omission of gross income:

How can the IRS propose adjustments to tax for a six-year period without either an agreement from the taxpayer or a statutory exception to the normal three-year statute of limitations for making those adjustments?

Going back six years is part of the resolution offered by the IRS for resolving offshore voluntary disclosures. The taxpayer must agree to assessment of the liabilities for those years in order to get the benefit of the reduced penalty framework. If the taxpayer does not agree to the tax, interest and penalty proposed by the voluntary disclosure examiner, the case would be referred to the field for a complete examination. In that examination, normal statute of limitations rules will apply. If no exception to the normal three-year statute applies, the IRS will only be able to assess tax, penalty and interest for three years. However, if the period of limitations was open because, for example, the IRS can prove a substantial omission of gross income, six years of liability may be assessed. Similarly, if there was a failure to file certain information returns, such as Form

3520 or Form 5471, the statute of limitations will not have begun to run. If the IRS can prove fraud, there is no statute of limitations for assessing tax.

Chapter 36 - Penalty Regime for Foreign Bank Account Filing By Gary S. Wolfe, Published in The California Tax Lawyer (Summer 2009 Edition)

Each U.S. person who has a financial interest in, or signature or other authority over, one or more foreign financial accounts (valued over \$10,000, at any time during a calendar year) is required to report the account on Schedule B/Form 1040, and TD F 90-22.1 (Report of Foreign Bank and Financial Accounts (FBAR)), due by June 30 of the succeeding year (I.R.M. 5.21.6.1. (2/17/09)). The IRS has six years to assess a civil penalty against a taxpayer who violates the FBAR reporting rules.

Failure to file the required report or maintain adequate records (for 5 years) is a violation of Title 31, with civil and criminal penalties (or both). For each violation a separate penalty may be asserted.

- (I) Non Willful Violation: Civil Penalty Up to \$10,000 for each violation.
- (II) Negligent Violation: Civil Penalty Up to the greater of \$100,000, or 35 percent of the greatest amount in the account.
- (III) Intentional Violations -
- (1) Willful Failure to File FBAR or retain records of account: (a) Civil Penalty Up to the greater of \$100,000, or 50 percent of the greatest amount in the account; (b) Criminal Penalty Up to \$250,000 or 5 years or both.
- (2) Knowingly and Willfully Filing False FBAR: (a) Civil Penalty Up to the greater of \$100,000, or 50 percent of the greatest amount in the account; (b) Criminal Penalty \$10,000 or 5 years or both.
- (3) Willful Failure to File FBAR or retain records of account while violating certain other laws: (a) Civil Penalty Up to the greater of \$100,000, or 50 percent of the greatest amount in the account; (b) Criminal Penalty Up to \$500,000 or 10 years or both.

Failure to File Penalties

A willful violation of the Form TD F 90.22-1 requirements (i.e., failure to file Form TD F 90.22--1, failure to supply information on the report, or filing a false or fraudulent report) could result in the imposition of civil and/or criminal penalties. (The instructions for Form TD F 90.22-1 specifically provide that criminal penalties for failing to comply with FBAR are provided in 31 U.S.C. § 5322(a) and (b), and 18 U.S.C. § 1001. In addition, civil penalties for failure to comply are generally provided in 31 U.S.C. § 5321.)

Civil Penalties

If any U.S. person willfully violates the Form TD F 90.22-1 filing requirement, such person may be liable to the U.S. government for a civil penalty of not more than \$25,000 (31 U.S.C. § 5321. Section 5321 generally provides that if a U.S. person willfully violates a regulation, such person may be liable for a civil penalty of not more than the greater of the amount (not to exceed \$ 100,000) involved in the transaction (if any) or \$25,000.

With respect to reporting on Form TD F 90.22-1, a U.S. person is not reporting a transaction but, rather, reporting his interest or signature authority over a foreign financial account. Thus, the maximum amount of potential civil penalty is \$25,000.):

Criminal Penalties

If a U.S. person willfully violates the reporting requirement, such person may be subject to a fine of not more than \$250,000, or imprisoned for not more than 5 years, or both (31 U.S.C. § 5322(a)); and

If a U.S. person willfully violates the reporting requirement while violating another law of the United States, or as part of a pattern of any illegal activity involving more than \$100,000 in a 12-month period, such U.S. person may be subject to a monetary fine of not more than \$500,000, or imprisoned for not more than 10 years, or both (31 U.S.C. § 5322(b)).

If a U.S. person, with respect to Form TD F 90.22-1, (1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact, (2) makes any materially false, fictitious, or fraudulent statement or representation, or (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry, such person may be fined, or imprisoned for not more than 5 years, or both (18 U.S.C. § 1001).

About the Author – Gary S. Wolfe, Esq.



Gary S. Wolfe received his Juris Doctorate from Loyola Law School in 1982, where he was President of the Tax Law Society.

From 1982 through the present, Gary has been in private practice in Beverly Hills and Los Angeles.

Gary is an international tax attorney representing clients for IRS audits, international tax planning, and asset protection.

Previously, Gary was the managing partner of a tax and business law firm, which represented Fortune 500 companies (IBM, ITT) and financial institutions (Sterling Bank, First Charter Bank.) Gary now provides case management for international litigation.

In 1997, Gary completed the Team Beverly Hills civic leadership training.

From 1997-1999 Gary was Vice-President and Member of the Board of Trustees of The Greystone Foundation, Beverly Hills, California.

From 1995-2001, Gary was the Chief Financial Officer and a Member of the Board of Directors of the Le Faubourg Honore Homeowners Association, Beverly Hills, California.

Since 2004, Gary has been conducting private seminars throughout California on the IRS, International Tax and Asset Protection.

Since 2004, Gary has been researching the IRS and International Tax (and other issues).

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles, and has received 14 international tax awards from five different Global expert societies.

Awards:

- 14) ACQ5 Global Awards 2016 CA/US International Tax Planning Law Firm of the
- 13) ACQ5 Global Awards 2016 CA/US Real Estate Finance Law Firm of the Year
- 12) ACQ5 Global Awards 2016 CA/US International Asset Protection Law Firm of the Year
- 11) ACQ5 Global Awards 2016 CA/US Client Care Law Firm of the Year
- 10) Global 100 (2016) (KMH Media Group) CA/US International Tax Planning Law Firm of the Year (Voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries.)
- 9) ACQ5/Acquisition Finance Magazine 2016 CA/US International Tax Planning Law Firm of the Year
- 8) Corporate International Magazine 2016 CA/US International Tax Planning Law Firm of the Year
- 7) Global Law Experts 2015 CA/US International Tax Planning Law Firm of the Year
- 6) M&A (Mergers & Acquisitions) Today 2016 International Tax Planning Law Firm of the Year (USA)
- 5) M&A (Mergers & Acquisitions) Today 2016 International Asset Protection Law Firm of the Year (USA)
- 4) M&A (Mergers & Acquisitions) Today 2016 International Real Estate Finance Law Firm of the Year (USA)

- 3) M&A (Mergers & Acquisitions) Today 2015 International Tax Planning Law Firm of the Year (USA)
- 2) M&A (Mergers & Acquisitions) Today 2015 International Asset Protection Law Firm of the Year (USA)
- 1) M&A (Mergers & Acquisitions) Today 2015 International Real Estate Finance Law Firm of the Year (USA)

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- 26. <u>Criminal Tax Evasion Part 2, Offshore Accounts and Willfulness</u> California CEO Magazine (May 2016)
- 25. <u>International Investors & California EB-5 Visas, Taxes</u> California CEO Magazine (May 2016)
- 24. <u>Billionaires and Off-Shore Trusts: The Wyly Case</u> California CEO Magazine (May 2016)
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- 16. <u>EB-5 Investors & the Perils of U.S. Estate and Gift Taxes</u> with Mark Ivener EB-5 Investors Magazine (Winter/2014 Edition)
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- 13. <u>U.S. Based Hedge Funds and Offshore Reinsurance</u> with Allen Walburn ABA/The Practical Tax Lawyer
- 12. <u>International Tax Evasion and Money Laundering</u>
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- 11. <u>International Tax Planning for U.S. Exports (IC-DISC)</u> with Ryan L Losi ABA/The Practical Tax Lawyer (Summer 2013)
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- 9. <u>Learning From Gandolfini's Estate Plan 'Disaster'</u> by Anthony Greco Private Wealth Magazine (July 2013)
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- 14. IRS Tax Audits and Collections (2015)
- 13. Asset Protection 2015: IRS Tax Audits and Lawsuits (2015)
- 12. Tax Planning for U.S. California Wine Exports (2015)
- 11. The IRS & Defrauded Investors: Theft Tax Loss (2015)
- 10. Offshore Tax Evasion: The IRS and Swiss Banks (2015)
- 9. Expatriation: The IRS & U.S. Taxes (2014)
- 8. <u>EB-5 Visas: International Investors & U.S. Taxes</u> (2014) with Ryan Losi, CPA and Mark Ivener, Esq.
- 7. U.S. Pre-Immigration Tax Planning (2014)
- 6. <u>Tax Planning for U.S. and State Exports: IC-DISC</u> (2013) with Ryan Losi, CPA and Allen Walburn, Esq.
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- 1. Offshore Tax Evasion: U.S. Tax & Foreign Entities (2013) with Allen B. Walburn, Esq. For more information please see website: gswlaw.com

For more information please see website, http://www.gswlaw.com