The IRS/Panama Papers: US Taxpayers with Offshore Entities

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The IRS/Panama Papers:
US Taxpayers with
Offshore Entities

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The IRS & Offshore Tax Evasion: U.S. Foreign Grantor Trusts

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Chapter 1 - Introduction: IRS Panama Papers Update

In 2016, the Panama Papers showed the worlds wealthiest people used offshore entities: corporations, trusts, foundations and nominees (i.e. "straw persons") to conceal ownership of trillions of dollars in assets. These offshore companies, though not illegal if formed for legitimate purposes (e.g. Privacy, confidentiality for assets) seem to be part of a worldwide corruption of political bribery, money laundering, tax evasion, terrorism financing, and illegal income (from drug dealing, arms sales, and human trafficking).

The fall-out has been explosive: the Prime Minister of Iceland resigned, the Prime Minister of Pakistan is under "fire", the former President of Argentina Nestor Kirchner, deceased, and former President his widow, Fernandez de Kirchner are embroiled in money laundering allegations as their top aide, Sergio Todisco (who Argentina prosecutors reveal had \$2000 per month income) spent nearly \$65m on ultra-luxury Miami condos, NY apartments and Florida strip malls without apparent funds needed to make these often all-cash purchases. Argentina's current President, Mauricio Macri has been linked to an offshore company in the Panama Papers. A judge in Argentina has ordered an inquiry into his tax returns.

International soccer star Lionel Messi (and father) were convicted in Spain of tax evasion and assessed multi-million dollar fines and sentenced to 21 months in jail based on evidence uncovered in the Panama Papers.

If the allegations were unsupported by evidence they could be easily ignored and dismissed as an "attack on the rich" or demonizing "political opponents. In the Panama Papers case, hundreds of international journalists (in nearly 80 countries, working in 25 languages, with more than 100 media companies around the world) reviewed 11.5m files leaked from Panamanian law firm Mossack Fonseca, and analyzed 2.6 terabytes of information: e-mails, financial information and spread sheets. They found hundreds of thousands of wealthy people set up hundreds of thousands of offshore companies (known as shell companies) with straw persons i.e. Nominees to act as Owners of record, company officers, directors and agents. The offshore tax havens in the British territories were the jurisdiction of choice for the companies e.g. Over 100,000 companies set up in the British Virgin Islands alone.

The Panama Papers links offshore assets, the world's wealthiest people, major tax and other crimes to money laundering where the illicit funds (whether from tax evasion, drug dealing, arms trafficking or other crimes) are used to purchase expensive assets with real estate being the "asset of choice". In the words of Charles Intriago, a former Federal Prosecutor and anti-money laundering expert "Real Estate is the major open territory for criminal, corrupt public officials, and money launderers.

The rewards are too great and the risks of being caught are too low."

For US taxpayers with offshore entities there are highly specialized, intricate US tax rules for disclosure and tax compliance required annually. The Foreign Grantor Trust, Controlled Foreign Corporations, and Passive Foreign Investment Company tax rules require extensive compliance and the risk of non-compliance are both serious Civil and Criminal penalties. In addition, for those US taxpayers in the "chain" of asset purchases with illicit funds used to launder money by buying expensive assets face a trilogy of felonies money laundering, wire fraud, and mail fraud (all 20 year felonies). If the US taxpayers involved in the asset purchases receive any funds from foreign Investors which were the subject of tax evasion in a foreign country, under a recent Supreme Court case Pasquantino (2005) they may be held liable for wire fraud (in this Case the wire fraud was an inter-state telephone call) as well as additional prosecution for money laundering (ie. Tax evasion as a predicate offense also known as an "SUA" specified unlawful activity for money laundering).

Chapter 2 – Offshore Tax Evasion: Cayman Islands & U.S. Taxpayers

In March, 2016 the US Dept. of Justice <u>announced guilty pleas</u> for Two Cayman Island Financial Institutions Cayman National Securities, Ltd. ("CNS") and Cayman National Trust Co., Ltd. ("CNT"). CNS and CNT are affiliates of Cayman National Corp., which provides investment brokerage and trust management services to clients including US Taxpayers. CNS & CNT pleaded guilty to a criminal Information charging them with conspiring with many of their US taxpayer-clients to hide more than \$130m in offshore accounts from the IRS and to evade US taxes on the income earned in the accounts. The plea agreements require the companies to produce account files of non-compliant US taxpayers and pay a total of \$6m in penalties which consists of the forfeiture of gross proceeds of their illegal conduct, restitution of the outstanding unpaid taxes from US taxpayers who held undeclared accounts at CNS & CNT and a fine. The guilty plea is the first conviction of a non-Swiss financial institution for tax evasion conspiracy.

From 2001-2011, CNS and CNT assisted US taxpayers in hiding accounts from the IRS and evading their US tax obligations. At their high-water mark in 2009, CNS & CNT had approximately \$137m in assets under management relating to undeclared account held by US taxpayer clients (on which they earned over \$3.4m in gross revenues).

The tax evasion conspiracy included the following:

- 1) Setting up sham Caymanian companies and trusts ("Cayman structures") to hide US taxpayer beneficial ownership of the accounts;
- 2) Using these Cayman structures to trade in US securities (treating them and not the US persons as the account holders) and failing to disclose to the IRS the identities of the US beneficial owners who were trading in US securities in contravention of CNS obligations under its Qualified Intermediary Agreement with the IRS.
- 3) After learning about the IRS investigation into UBS (Swiss bank) in 2008, for assisting US taxpayers to evade their tax obligations, CNS and CNT continued to knowingly maintain undeclared accounts for US taxpayer-clients.

The sham Cayman structures CNT set up for US taxpayer-clients included trusts, which were nominally controlled by CNT trust officers but which were in fact controlled by US taxpayer-clients. CNT managed companies acting as directors/officer, which were "shell companies" for which CNT provided a Cayman mailing address. CNS treated these sham companies as the account holders and then permitted the US taxpayer-clients to trade in US securities without requiring them to submit Form W-9s (IRS forms required that identify individuals as US taxpayers as CNS was obligated to do under its QI obligations for accounts held by US persons that held US securities. CNS & CNT agreed to maintain these structures for US taxpayer-clients after many of them expressed concern that their accounts would be detected by the IRS.

As part of their plea agreement CNS & CNT have agreed to provide documents and client files up to 95% of US clients they serviced. IRS Chief Richard Weber stated: "The veil of secrecy has been lifted from what was once a common place for criminals to hide their money offshore. The IRS and DOJ work aggressively to require banks to follow the laws and not turn a blind eye to criminal activity. When individuals and entities hide behind shell corporations and numbered bank accounts, they are not only cheating the US government, they are cheating the honest, taxpaying citizens who are obeying the law and doing the right thing".

Asst. Atty. General Stuart Goldberg said: "Today's convictions make clear that our focus is not on any one bank, insurance company or asset management firm, or even any one country. The Department of Justice and the IRS are following the money across the globe- there are no safe havens for US citizens engaged in tax evasion or those actively assisting them."

Manhattan US Attorney, Preet Bharara said: "The guilty pleas of these two Cayman Island companies today represent the first convictions of financial institutions outside Switzerland for conspiring with US taxpayers to evade their lawful and legitimate taxes. The pleas agreements require these Cayman entities to provide this Office with the client files, because we are committed to finding and prosecuting not only banks that help US taxpayers evade taxes, but also individual taxpayers who find criminal ways not to pay their fair share. We will follow them no matter how far they go to hide their accounts, whether it is Switzerland, the Cayman Islands or some other tax haven."

Chapter 3 – U.S. Treasury Department Expanding Hunt for Money Laundering in Real Estate

On 7/27/16 the US Treasury Dept. expanded its hunt for international criminals who launder money through all cash US real estate purchases. Beginning August 2016, the US Treasury has ordered title companies to report all cash buyers' identities for expensive US residential real estate (homes, condos) in major US cities.

The Treasury Program, seeking to unmask the individuals behind shell companies that buy US real estate, commenced in January 2016 for Manhattan and Miami-Dade County Florida.

Effective August 2016 the program is expanded to require reporting for all cash purchases at the following sales prices:

- 1) New York City: \$3m (Manhattan); \$1.5m other NYC boroughs
- 2) Florida: Miami-Dade County, Broward and Pam Beach counties (\$1m)
- 3) California: Los Angeles, San Francisco Bay Area and San Diego (\$2m)
- 4) Texas: San Antonio (\$500k).

As stated by US Treasury Dept. Financial Crimes Enforcement Network (FINCEN) Acting Director, Jamal El-Hindi: ""By expanding to other major cities we will learn more about the money-laundering risks in the national real estate markets".

For more info see: FinCEN Expands Reach of Real Estate "Geographic Targeting Orders" Beyond Manhattan and Miami

Chapter 4 - Paul Manafort and the Panama Papers

Paul Manafort, the campaign manager for Republican Presidential candidate, Donald Trump, has been linked to Ukrainian clients named in the Panama Papers. The anonymity offshore shell corporations provide individuals is a stated reason for their use in order to keep assets owned as confidential information. Although there are both legal and benign reasons for using these offshore shell corporations both the anonymity and lack of transparency into where their money originates and is invested makes them vehicles for funneling illicit gains into elite assets.

A recent World Bank Study of 213 major global corruption cases found that 70% of them involved the use of at least one secret corporation to hide true ownership. Currently, it is unknown whether Manafort had any involvement with these Ukrainian clients' shell companies since inquiries made by the publication Fusion requesting comment from Manafort and the Trump campaign were not returned.

Fusion.net (Adam Weinstein and Laura Juncadella) in 7/16 reported that Paul Manafort, Trump's campaign manager appears to be linked to pro-Russian politicians and Ukraine industrialists in his capacity as a political consultant. Manafort has advised former Ukraine President, Vitktor Yanukovych who won the Ukraine Presidency in 2010 and was then deposed in 2014 by a popular Ukraine uprising and now lives in Russia. Yanukovych and his Party of Regions were alleged to funnel government Money to his "family" of oligarchs and party supporters. A 2007 US embassy cable describes the Party of Regions inner circle 'Ukraine's history is marred with non-transparent privatizations that have benefitted a few well-connected insiders". Manafort was described by Boris Kolesnikov a Yanukovich party insider as "one of a lot of good people" consulting Ukraine's politicians.

Two of the offshore Ukrainian clients have a US nexus:

- 1) Oleg Derispaska, a Russian oligarch, who has been called "Vladimir Putin's favorite industrialist" partnered with Manafort in 2007 to form a Cayman Islands based Investment company. Manafort's firm was reportedly paid \$7.4m in fees by Derispaska who then invested \$18.9m to buy a Ukranian telecom firm. Derispaka eventually pulled out, demanded his money back from Manafort which was never returned according to a lawsuit filed in Virginia by Cayman liquidators. The case is ongoing. Deripaska is barred from US travel over alleged organized crime ties, which he denies.
- 2) In another lawsuit against Manafort and several associates, former workers in a company he formed with an ex-Trump real estate employee allege that they didn't receive their promised salaries. According to court filings, the company set up a billion dollar US based property investment vehicle for Dmitro Firtash a Yanukovych insider and billionaire Ukrainian. The court filings allege that Manafort and Firtash worked together on other deals including an abandoned \$850m plan to buy the Drake Hotel in New York.

Firtash is wanted by authorities in Washington on suspicion of bribery and organized criminal activity, he was arrested in Austria in 2014 and the US seeks his extradition.

Whether Manafort is involved with any of the offshore dealings revealed by the Panama Papers is not currently known. What has been revealed is that Manafort has made Millions of dollars working for and with parties now being identified as owning shell companies offshore by the Panama Papers. Time will tell the extent of those ties.

Chapter 5 – Money Laundering and the Movie Business: The Wolf of Wall Street

On 7/20/16 the US Dept. of Justice moved to seize \$1B in assets including future proceeds from the 2013 film the Wolf of Wall Street, US luxury real estate and Old Masters art work in an international corruption investigation targeting officials who allegedly profited from misappropriating \$3.5B from a Malaysian sovereign wealth fund (including possibly the country's Prime Minister).

This asset seizure by the US DOJ is the largest ever and is authorized under the Kleptocracy Recovery Initiative. The complex case accuses corrupt Malaysian officials of conspiring to divert funds from a sovereign wealth fund (that was supposed to benefit Malaysia's economy) as assets for their "personal enrichment, entertainment and daily comfort."

Conspirators allegedly stole more than \$3.5B from 1Malaysia Development Berhad (1MDB) in a vast money-laundering scheme from 2009-2013. They used a network of shell companies in Singapore, Switzerland, Luxemburg and the US to buy US real estate (Beverly Hills Hotel L'Ermitage, New York hotel Park Lane, mansions in Beverly Hills, luxury condominiums in NYC) rights to EMI Publishing songs, and a bombardier jet. In addition they purchased paintings by Van Gogh and Monet and paid gambling expenses at Las Vegas casinos.

The co-founder of Hollywood Studio Red Granite Pictures, Riza Aziz, allegedly financed the Wolf of Wall Street using \$64m in 1MDB assets. The US DOJ is seeking to seize future profits from the film.

LA based US Attorney Eileen Decker stated: "We will not allow the US to become a playground for the corrupt". Balance Sheets for Red Granite Pictures allegedly showed no payments indicating any investment return to 1MDB from the Wolf of Wall Street (which as an irony the film depicted the real-life downfall for corruption of Wall Street stockbroker, Jordan Belfort).

Luxury real estate included: a Beverly Hills mansion with a 120 foot pool, a 7 bedroom duplex overlooking Central Park (\$35m), a 6 bedroom home on Oriole Drive in the Hollywood Hills (\$39m).

The funds stolen initially involved a purported investment in a joint venture between 1MDB and a private Saudi oil extraction company called PSI. An estimated \$1B in 1MDB funds allegedly flowed to a Swiss bank account held in the name of Good Star Limited. The account was beneficially owned by Low Taek Jho, a Malaysian national who laundered more than \$400m into the US for his personal gratification which included the purchase of L'Ermitage Hotel in Beverly Hills, \$12m to Caesars Palace, \$13.4m to Venetian hotel (Las Vegas).

Subsequent alleged diversions included \$2.5B in proceeds that 1MDB raised through two bond offerings (total \$6.5B) arranged and underwritten by US investment bank Goldman Sachs. The bonds were guaranteed by the Malaysian fund and an investment entity owned by the government of Abu Dhabi.

Officials of 1MDB wired approximately \$1.367B to a Swiss bank account belonging to a British Virgin Islands entity known as Aabar Investments, some of which funds were diverted to a Singapore bank account controlled by Tan K. Loong an associate of Low T. Jho and "distributed for the personal benefit of individuals".

In addition, officials of 1MDB and others allegedly diverted more than \$1.26B from a third bond offering Goldman Sachs arranged in 2013 which funds were diverted through a complex series of transactions involving shell companies and bank accounts in the US, Singapore, Luxembourg and Switzerland.

US Attorney General Loretta Lynch stated: "It should make clear to corrupt officials around the world that we will be relentless in our efforts to deny them the proceeds of their crimes" Lynch said the US government is currently seeking only about \$1B in assets because that's how much investigators have been able to conclusively trace while the rest may be traceable elsewhere or have been already dissipated.

FBI Deputy Director Andrew McCabe stated that the investigation is ongoing and others may be subject to civil or criminal charges.

Chapter 6 – Use of Shell Companies to Shield Identity Further Limited by Sanford Millar, Esq.

On July 27, 2016 the Financial Crimes Enforcement Network, (FinCEN) of the Department of the Treasury issued expanded Geographic Targeting Orders (GTO) that will: "temporarily require U.S. title insurance companies to identify the natural persons behind shell companies used to pay "all cash" for high-end residential real estate in six major metropolitan areas"

The areas now cover are:

"the GTOs announced today include the following major U.S. geographic areas: (1) all boroughs of New York City; (2) Miami-Dade County and the two counties immediately north (Broward and Palm Beach); (3) Los Angeles County, California; (4) three counties comprising part of the San Francisco area (San Francisco, San Mateo, and Santa Clara counties); (5) San Diego County, California; and (6) the county that includes San Antonio, Texas (Bexar County)."

The purposes of the GTO's is to assist law enforcement in tracking "the transactions covered by the GTOs (i.e., all-cash luxury purchases of residential property by a legal entity) which are highly vulnerable to abuse for money laundering."

There is a legitimate concern about money laundering through the use of "shell" companies, also referred to as single purpose vehicles (SPV's) when used to buy real property and open financial account using substantial sums of cash.

Example of the problem the GTO seeks to address. Taxpayer forms an offshore shell in a tax haven jurisdiction, (a country with a zero tax rate on out of country income). The shell is then funded often with unreported funds for U.S. tax purposes. The offshore company then forms a U.S SPV to acquire U.S. assets, such as real property. Often a "Nominee" officer and director is used to apply for an employer identification number for the SPV.

The SPV is then funded with funds from the offshore company and then the SPV completes the asset purchase. With the GTO title insurance companies will be required to obtain the identities of the ultimate beneficial owners of the offshore company. This

means that if a U.S. person (individual or company) is the ultimate beneficial interest holder that name must be disclosed.

The expectation is that the identities of tax cheats and money launderers will be discovered as the process is implemented. When the GTO's are added to the "know Your Customer" requirements of the Foreign Account Tax Compliance Act (FATCA) the IRS may have found a way of catching those U.S. taxpayers who still have undisclosed foreign financial accounts and are trying to us those fund in the U.S. The Offshore Voluntary Disclosure Program of 2014 is still open. However, some taxpayers will just not come forward, and for them, prosecution remains a true reality along with huge civil penalties.

Chapter 7 – Background History

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 8 – 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 9 – Panama Papers & The U.S. Government

The Obama Administration, the US Treasury Department and the IRS are waging an allout 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 10 - 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 offshore 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.

6) 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 11 – 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 12 - 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 13 - Foreign Trusts

A U.S. taxpayer who establishes a foreign trust is classified as the trust owner, under IRC Sec. 679, for those assets transferred to the trust, and must annually report foreign trust income (IRS Forms 3520-A/Form 1040), and asset transfers to the trust (Form 3520). U.S. beneficiaries must annually report distributions received from the foreign trust (Form 3520).

The U.S. grantor of the foreign trust must annually file Form TDF-90.22-1 ("FBAR") to report the trust foreign financial accounts over \$10,000 (which accounts they either own or control (i.e. signatory authority) and IRS Form 8938, to report ownership of foreign assets over \$50,000.

The U.S. grantor of the foreign trust's failure to file FBAR, Form 8938, report annual income on Forms 3520-A/Form/Form 1040, report trust transfers (Form 3520) and U.S. beneficiaries' failure to report trust distributions (Form 3520) have civil and criminal tax issues, including:

- 1. Money Laundering: (Disguise of the nature or the origin of funds (18 U.S.C. Sec. 1956 and 1957);
- 2. FBAR Issues: (See chart next chapter);
- 3. Unreported Income Issues: (See chart next chapter);
- 4. FATCA Issues: (See chart next chapter);
- 5. Perjury: (See chart next chapter).

Chapter 14 – 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 15 – 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 <u>Form 3520</u> ("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 16 - 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 17 - 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 18 - The IRS: Tax Evasion and Money Laundering

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).

Chapter 19 - 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:

- 1. The financial proceeds received from the fraudulent activity, or
- 2. \$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:

- 1. Mail fraud;
- 2. Wire fraud;
- 3. 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 20 - Tax Counsel and Tax Evasion

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. 206(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. <u>IRC Sec. 7212</u>: 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 <u>Greenstein</u> (<u>superseding Indictment No. CR 08-0296 RSM</u>, <u>Western District of Washington at Seattle</u>, <u>United States Attorney's Office</u>, <u>Western District of Washington</u>, <u>News Release 6/9/09</u>): 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 <u>Greenstein</u> case also involved additional offenses such as ill-gotten professional fees not disclosed to investor clients.

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

In <u>U.S. v. Velez, Kuehne and Ochoa, D.C. Docket No. 05-20770-CR-MGC (CA-11, 10/26/09)</u>, 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 21 - U.S. Money Laundering Law and Foreign Tax Evasion

In the *Pasquantino* 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 *Pasquantino*, 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 *Pasquantino* 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". (<u>United States v. Pierce</u>, 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."

The U.S. "Fraud Enforcement and Recovery Act" (S. 386), 94 DTR G-3, codified the definition of the term "proceeds" in the money laundering statute to make clear that the proceeds of specified unlawful activity includes the gross receipts of the illegal activity, not just the profits of the activity. The "Fraud Enforcement and Recovery Act" overruled the U.S. Supreme Court ruling in the <u>Santos</u> case (<u>128 S.Ct. 2020 (2008)</u>), defining proceeds as "net proceeds" (not gross proceeds, which Supreme Court decision limited the reach of money laundering statutes to "profitable crimes"), which was also held by the 11th Circuit in <u>Khahani</u>, 502 F.3d 1281, 1296-97 (CA-11, 2007) which stated: "proceeds does not contemplate profits or revenue indirectly derived from labor or from the failure to remit taxes".

The 3rd Circuit in Yusuf (536 F.3d 178 (CA-3, 2008) held that the government could use the mail fraud statute in support of an international money laundering charge. The Yusuf case dealt with a scheme to defraud the U.S. Virgin Islands out of a gross receipts tax. The tax at issue in this case was not an income tax, but a tax on a straight percentage of sales. In addition to holding that the retained taxes were the proceeds of mail fraud, the 3rd Circuit further held that the retained taxes amounted to profits.

The IRS and the U.S. Dept. of Justice have significant legal authority to treat international tax evasion as a predicate offense to money laundering. On 10/29/04, the Dept. of Justice Tax Division amended Tax Division Directive 128 so that domestic tax offenses may be charged as mail or wire fraud (emphasis added). Tax offenses are predicate offenses for a money laundering violation include: state, federal or foreign taxes. These tax evasion offenses may arise as an adjunct to an international estate plan because of the attendant income and transfer taxes that may be due incident to the implementation or ongoing maintenance of an estate plan.

For example, a taxpayer who mails a false state income tax return may be a subject to both mail fraud (and tax evasion). See: <u>Helmsley</u>, 941 F.2d 71, 68 AFTR 2d 91-5272 (CA-2, 1991), <u>cert</u>. <u>den</u>. 502 U.S. 1091 (1992).

Tax Division Directive No. 128 permits the Dept. of Justice to bring mail fraud or wire fraud charges in tax-related schemes if:

- 1. There is a large loss related to fraud;
- 2. There is a significant benefit to bringing such charges.

Tax Division Directive No. 128 does not apply in routine tax prosecutions but does apply to fraud charges. If there is "significant benefit", fraud charges will be considered:

- 1. At the charging order stage to ensure that there is support for forfeiture of the proceeds of a scheme to defraud;
- 2. At trial, all relevant evidence will be admitted;
- 3. At sentencing, to ensure full restitution, promoters of tax schemes are particularly targeted [See USAM G-4.210].

The U.S. Dept. of Justice, Tax Division policy will not authorize prosecution for money laundering "where the effect would merely be to convert routine tax prosecutions into money laundering prosecutions, as the statute was not intended to provide a substitute for traditional Title 18 and Title 26 charges related to tax evasion, filing of false returns or tax fraud conspiracy" (U.S. Dept. of Justice Criminal Tax Manual, Ch. 25, 25.01). The U.S. government may seize taxpayer assets under either tax evasion or money laundering charges.

In *Ianniello*, 98 TC 165 (1992) taxpayers were convicted of mail fraud and tax evasion for \$666,667 in restaurant profits that had been illegally skimmed. The IRS assessed a fraud penalty for failure to include skimmed profits in taxable income.

The taxpayers' defense was that the skimmed receipts were not income because they were forfeited to the government. The court held that the receipts were income: "A taxpayer obtains possession, custody and control of proceeds he acquires unlawfully, despite a statutory forfeiture provision that tests legal title to the proceeds in the United States, on the date he acquires such proceeds (See: Wood, 863 F.2d 417), 63 AFTR 2d 89-709 (CA-5, 1985); Gambino, 91 TC 826 (1988); Holt 69 TC 75 (1977); Bailey, TCM 1989-674, aff'd 929 F.2d 700 (CA-6, 1991).

The U.S. Supreme Court held: ("IRC Sec. 61 provides that gross income means all income from whatever source derived"). "Gross income includes all accessions to wealth, clearly realized and over which the taxpayers have complete dominion (James v. U.S. 213, 7 AFTR 2d 1361 (1961), quoting Glenshaw Glass Co., 348 U.S. 426, 47 AFTR 162 (1955).)

Tax evasion may expose U.S. taxpayers to additional crimes: money laundering, mail fraud and wire fraud, which can expose the taxpayer to violations of U.S. criminal law, forfeiture of assets, and exposure of counsel to violations of U.S./state criminal laws, IRS Circular 230 and claims for malpractice, when a client's assets are seized or forfeited.

Chapter 22 - 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);
- IRC Sec. 672(c)(2): 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 23 - Foreign Trusts with U.S. 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:

- 1. 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)).
- 2. 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); Haeri v. 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 24 - 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 25 - 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 updated Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers again on 6/26/12.

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 August 3, 2012.

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 updated Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers on 6/26/12

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.

*The IRS updated the FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR) — Filing Requirements on August 3, 2012.

Chapter 26 - Penalty Regime for Foreign Bank Account Filing

By Gary S. Wolfe, Published in The California Tax Lawyer (Summer 2009 Edition)

Penalty Regime for Foreign Bank Account Filing (FBAR)

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).

Chapter 27 - Tax Practitioners and Professional Responsibility

U.S. Taxpayers, who fail to file FBAR's to disclose foreign bank accounts, may seek a reasonable cause exception based on their "tax preparer's" failure to file the FBAR.

Tax Practitioners (Attorneys, CPA's) must comply with the FBAR rules as part of their due diligence (as to accuracy) obligation under IRS Circular 230 (Section 10.22).

The FBAR (TD F 90-22.1) is not a tax return. The FBAR is an information report required under the Bank Secrecy Act (BSA) 31 USC 5314 (and related regulations CFR 103.24, 103.27). Related records are required under 31 CFR 103.24 and 103.32.

The Practitioners' professional responsibility does not require that the Practitioner "audit" their client.

The Practitioner must:

- 1. Make reasonable inquiries in response to Taxpayer's information of overseas accounts/transactions.
- 2. A Practitioner may rely on information provided by a client in good faith.
- 3. The Practitioner must make reasonable inquiries if information appears incorrect, inconsistent or incomplete.

Chapter 28 - FBAR Annual Filing Requirements and Reasonable Cause Exception

In April 2003, the Financial Crimes Enforcement Network delegated authority of the TD F 90-22.1 form (i.e., FBAR form) to the Internal Revenue Service (see IR 2003-48 (4/10/03); 31 CFR §103.5(6)(b)(8)). The IRS enforces all penalties associated with the FBAR with the same power it enforces tax reporting and payment compliance.

The IRS has been given the authority to enforce the filing rules and audit the reports as appropriate.

The FBAR filing is due by June 30th of the year following the year of the report with no provisions for extensions. The due date means the date it must be received by the US Treasury. Mailing it on the date it is due will result in a late filing. The FBAR form, filed separately from the income tax, must be mailed to US Department of Treasury, PO Box 32621, Detroit, Michigan 48232-0621.

If there is an emergency, the form can be hand-delivered to a local IRS office for forwarding to the Treasury Department in Detroit.

An amended FBAR may be filed by completing a revised FBAR with the correct information writing the words "Amended" at the top of the revised FBAR and stapling it to a copy of the original FBAR. For Taxpayers amending a late-filed FBAR, they should include a statement explaining their reasons for a late filing (i.e., request a reasonable cause exception from penalty).

A failure to file a FBAR has civil and criminal penalties (which are in addition to any income tax penalties if the income is not reported). The IRS must assess the civil penalties within 6 years of the FBAR violation (31 USC 5321(b)(1)).

For a willful failure to file, the civil penalty increases from \$10,000 (non-willful failure to file) to the greater of \$100,000 or 50% of the account balance in the foreign account for the tax year.

The civil penalties for non-willful failure to file may be waived by the IRS if the Taxpayer can show reasonable cause. If the Taxpayer has a reasonable cause exception, the FBAR should be filed with an explanation (i.e., the reasonable cause, with an express request for waiver of penalties).

The waiver of civil penalties for a reasonable cause exception may include among other factors:

1. All the income from the foreign account was included on the US Taxpayer's return.

- 2. The Taxpayer was unaware of the requirement to file (for example, lack of understanding of what constitutes a financial interest).
- 3. Once the Taxpayer became aware of the filing requirements, he filed all delinquent reports (up to 6 years).

Chapter 29 – FBAR Civil and 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).

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. 31 U.S.C.§ 5321(a)(5)(A)

(II) Negligent Violation

Civil Penalty – Up to the greater of \$100,000, or 35 percent of the greatest amount in the account. 31 U.S.C.

(III) Intentional Violations

- 1) Willful Failure to File FBAR or retain records of account Civil Penalty -Up to the greater of \$100,000, or 50 percent of the greatest amount in the account. Criminal Penalty -Up to \$250,000 or 5 years or both. 31 U.S.C. §5321(a)(5)(C), 31 U.S.C. § 5322(a) and 31 C.F.R. §103.59(b) for criminal
- (2) Knowingly and Willfully Filing False FBAR
 Civil Penalty Up to the greater of \$100,000, or 50 percent of the greatest amount in the account. Criminal Penalty \$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

Civil Penalty – Up to the greater of \$100,000, or 50 percent of the greatest amount in the account. Criminal Penalty – 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

Chapter 30 - Criminal Penalties: Willful Failure to File (Defenses)

Under IRS Form 1040, at the bottom of Schedule B, Part III, on Page 2, Question 7(a) states: "at any time during the previous year, did you have any interest in or signatory or other authority over a financial account in a foreign country, such as a bank account, a security account, or other financial account? The answer is either yes or no. If yes, Question 7(b) requires the name of the foreign country (with the account). Question 8 requires confirmation of receipt of distribution from the account, or if the Taxpayer was a grantor of, or transferor to a foreign trust (which requires filing Form 3520).

A willful failure to file a FBAR can lead to a felony of up to 10 years in jail and a \$500,000 fine. The IRS must prove willfulness in order to assert the \$500,000 monetary penalty and the imprisonment for up to 10 years (see 31 USC 5321(a)(5)(B); CCA 200603026; Eisenstein, 731 F.2d 1540 (CA - 11, 1984)).

Willfulness must be proven by the IRS under the standard of clear and convincing evidence. If the Taxpayer knew about the requirement to file, it would affect his defense. If the Taxpayer failed to report the foreign account interest or other income on his income tax return, it would affect his defense.

If a failure to file is deemed to be part of a criminal activity involving more than \$100,000 in a 12-month period, the penalty limit increases to \$500,000 with up to 10 years in jail. The issue of whether a failure to file is willful or non-willful is based on the facts of each case. Willfulness has been defined as the voluntary, intentional violation of a known legal duty, see Cheek 498 US 192, 67 AFTR 2d 91-344 (Supreme Court 1991).

A Taxpayer's good faith belief that he does not have to file (or even his negligent failure to file) can be a defense to the charge of willful failure to file (i.e., a defense to criminal charges).

A defense may include that the Taxpayer was advised by his advisor that no FBAR was required.

Failure to maintain adequate records of the foreign account for the years the FBAR filing is due may result in additional civil and criminal penalties.

Chapter 31 -A Primer on Passive Foreign Investment Companies and Comparison to Controlled Foreign Corporations(Co-Author: Allen B. Walburn, Esq.)

Introduction

Generally, under the U.S. Internal Revenue Code (the "Code")1, the U.S. shareholders of a C corporation (including a foreign corporation) do not pay U.S. income taxes on the corporation's income unless the corporation makes distributions to its shareholders.2 A U.S. shareholder is also subject to U.S. income tax on the sale of corporate shares at a gain. A foreign corporation not engaged in a trade or business in the U.S. and not having any U.S.-source income is generally not subject to U.S. income tax on its income.3 The fact that U.S. shareholders of a foreign corporation and the foreign corporation itself generally do not pay U.S. income tax on the foreign corporation's undistributed foreign-source income is often referred to as "deferral."4

The United States generally taxes income under two principles: the residence of the taxpayer or the source of the taxpayer's income. 5 Under U.S. federal income

1 Unless otherwise expressly stated, (i) all references in this article to the term "Code" refer to the U.S. Internal Revenue Code of 1986, as amended, and (ii) all references in this article to "Section" or "Sections" shall refer to the Code

2 See Section 11 (imposing corporate income taxes). In contrast to a C corporation, an S corporation generally does not pay U.S. federal income tax at the corporate level, but, rather, its shareholders are taxed directly on their respective shares of the S corporation's taxable income. See Sections 1361 through 1379 and the Treasury Regulations thereunder for the rules on the taxation of S corporations. Under Section 1361(b)(1), only a U.S. domestic corporation (and not a foreign corporation) may be an S corporation. The rules on eligibility to elect to be taxed as an S corporation are set forth in Section 1361 and the Treasury Regulations thereunder.

3 Section 11(d) provides that U.S. income tax is imposed on a foreign corporation only as provided in Section 882. Sections 881 and 882 tax a foreign corporation on income effectively connected with the conduct of a U.S. trade or business and non-trade or business income from U.S. sources. See also Katz, Plambeck and Ring, 908-2nd T.M., U.S. Income Taxation of Foreign Corporations, at A-1.

4 Deferral of U.S. income tax on undistributed foreign-source income of a foreign corporation is generally beneficial to a U.S. shareholder, particularly if the rate of foreign income tax in the foreign corporation's home country is less than the rate of tax that the U.S. would impose if the U.S. shareholder were taxed currently on the foreign corporation's undistributed income.

5 See Katz, Plambeck and Ring, supra note 3 at A-1.

tax law, the residence of a corporation is considered to be its country of incorporation.6 Section 7701(a)(4) of the Internal Revenue Code (the "Code") defines a U.S. domestic corporation as one organized under the laws of the U.S. or the laws of any U.S. state. A foreign corporation is any corporation that is not a U.S. domestic corporation.7

There are, however, two primary regimes under U.S. income tax law which impose tax on a U.S. shareholder's share of a foreign corporation's undistributed income under certain circumstances, thus eliminating the benefits of deferral. These are the controlled foreign corporation ("CFC")/subpart F income ("Subpart F") regime8 and the passive foreign investment company ("PFIC") regime.9 As explained in greater detail below, these regimes were enacted because Congress believed that unlimited deferral of U.S. income tax on a foreign corporation's undistributed income was inappropriate for the types of income covered by the Subpart F and PFIC rules (generally passive investment income and income from certain transactions between a foreign corporation and a related party).10

CFC/Subpart F Income Rules

This article focuses on the PFIC rules, but, first, a brief discussion of the Subpart F rules is appropriate because the objectives of both sets of rules are similar in many respects and there is overlap between the two sets of rules in some circumstances. 11

As explained in greater detail below, the Subpart F rules only apply if more than 50% of the voting power of the foreign corporation's stock is owned collectively by United States shareholders owning 10% or more of the voting power of the foreign corporation, while the PFIC rules apply to any U.S. person owning shares

6 *Id*.

7 Section 7701(a)(5). Essentially, a foreign corporation is any corporation organized in a foreign country or other jurisdiction outside of the United States. Section 7701(a)(9) defines the United States to include only the fifty states and the District of Columbia.

- 8 Sections 951 through 965.
- 9 Sections 1291 through 1298.

10 See, e.g., Lee and Smiley, Taxation of Passive Foreign Investment Companies: Current Rules, Problems, and Possible Solutions, Journal of Corporate Taxation (Nov./Dec. 2011) at p. 39.

11 See footnotes 44, 45, 56, 57, 62, 76, 77 and 78, *infra*, and accompanyingtext for discussion of certain areas of overlap.

in a foreign corporation if that corporation's passive income or passive assets exceed certain thresholds (regardless of the percentage of a U.S. person's ownership of the foreign corporation or the aggregate percentage ownership of all U.S. shareholders). While both the Subpart F and PFIC rules impose U.S. income tax on U.S. persons owning shares in a foreign corporation with passive income (e.g., interest, dividends, rents, royalties and gain on sale of assets which produce such passive income), the Subpart F rules (but not the PFIC rules) also impose tax on Untied States Shareholders (defined below) if the CFC has certain types of income from sales or services between the CFC and certain related persons.

Definition of Controlled Foreign Corporation

Section 951(a)(1) requires a United States Shareholder (as defined below) of a CFC to report as gross income its ratable share of (i) the CFC's Subpart F income and (ii) any increase in the CFC's investment of earnings in U.S. property as determined under Section 956.12 Under Section 957(a), a foreign corporation is a CFC if more than 50% of the total combined voting power of all classes of stock of such corporation entitled to vote, or more than 50% of the total value of the stock of such corporation, is owned (including stock indirectly or constructively owned, as determined under Section 958), collectively by United States Shareholders on any day during the taxable year of such foreign corporation. A "United States Shareholder" with respect to any foreign corporation is a "United States person" as defined in Section 957(c)13 who owns ten percent or more of the total combined voting power of all classes of voting stock of a foreign corporation.14 For this purpose, a United States person is considered to own such person's proportionate share of the stock actually owned by a foreign corporation, foreign partnership, foreign estate or foreign trust (see Section 958(a)) and the stock owned by certain related family members, trust, estates and entities (see Section 958(b)).

U.S. taxation of a United States Shareholder of a CFC under Section 951(a)(1) applies for a particular taxable year of a foreign corporation only if the foreign corporation is a CFC (under the tests described in the preceding paragraph) for an uninterrupted period during the year of at least 30 days. It applies to a particular shareholder of a CFC only if, on the last day of the year in which the foreign corporation is a CFC, the shareholder is a United States Shareholder and owns some of the CFC's stock, either directly or indirectly through foreign

12 Section 956 sets forth the rules concerning taxation of a CFC's investment in U.S.

property. A discussion of Section 956 is beyond the scope of this article.

13 A United States person is generally an individual who is a citizen or resident of the U.S., a U.S. domestic partnership, a U.S. domestic corporation, or a U.S. estate or trust, but not including certain individuals which are described in Sections 957(c)(1) and (2).

14 Section 951(b).

entities. A United States Shareholder is taxed under Section 951(a)(1) on a CFC's Subpart F income and earnings invested in U.S. property allocable to shares actually owned by the United States Shareholder and shares owned indirectly by the United States Shareholder through foreign entities, but not on amounts allocable to shares only owned constructively.15 Under the indirect ownership rule of Section 958(a), stock owned by a foreign entity (but not stock owned by a U.S. domestic entity) is attributed ratably to the entity's shareholders, partners, or beneficiaries—successively through a chain of foreign entities until the stock reaches a U.S. person or a nonresident alien. 16

Subpart F Income

A CFC's Subpart F income generally consists of the sum of its insurance income and foreign base company (FBC) income.17 FBC income is the sum of four types of gross income—foreign personal holding company (FPHC) income, FBC sales income, FBC services income, and FBC oil-related income, less expenses and subject to various other adjustments.18 The concepts of FPHC income, FBC sales income and FBC services income are explained further below.

As defined in Section 954(c), FPHC income generally consists of a CFC's income in the form of dividends, interest, annuities, rents, royalties, net gains on dispositions of property producing any of the foregoing types of income, net gains from commodities transactions, net gains from foreign currency transactions, income from notional principal contracts, and amounts received under certain personal service contracts.19

The Senate Finance Committee explained the inclusion of FPHC income as follows: Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or

¹⁵ See, e.g., Textron, Inc., v. CIR, 117 TC 67 (2001).

¹⁶ Section 958(a)(2).

17 Section 952(a).

18 Section 954(a).

19 The inclusion of certain of the foregoing types of income as FPHC income is subject to exceptions. See, e.g., 954(c)(2) (excepting rents and royalties derived in the active conduct of a trade or business and received from a person other than a related person) and Section 954(c)(6) (excepting dividends, interests, rents and royalties received or accrued from a related CFC which is attributable to or properly allocable to income of the related CFC which is neither Subpart F income nor income effectively connected with a trade or business conducted in the United States).

where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated. 20

FBC sales income 21 is income from transactions in personal property where a person related to the CFC is either the buyer or seller, subject to certain exceptions.22 A CFC's gross profit on a sale of personal property is usually FBC sales income if the CFC acquired the personal property by purchase and either bought the personal property from, or sold it to, a related person. FBC sales income is limited to income from transactions involving related persons because Congress was concerned with income of a selling affiliate that has been separated from manufacturing activities of a related corporation primarily to obtain a lower rate of tax for the sales income in a low tax jurisdiction.23

FBC services income consists of income from services transactions involving related persons,24 including "technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services."25 FBC services income may be compensation for the CFC's performance of services or a commission or fee received for arranging for a service to be performed by another party.26 Income is not FBC services income to the extent it is compensation for services performed in the foreign country under the laws of which the CFC is organized.27 Income that would otherwise be FBC services income of the CFC is excluded if the services are "directly related" to the CFC's sale of goods it manufactures, produces, grows, or extracts and are performed before the sale occurs or are directly related to an "offer or effort" to sell such goods.28

20 S. Rep. No 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 703, 789.

21 FBC sales income is defined in Section 954(d).

- 22 See, e.g., Section 954(d)(1) and Treas. Reg. § 1.954-3(a)(3) (same country exception) and Section 954(d)(1) and Treas. Reg. §1.954-3(a)(2) (manufacturing exception).
- 23 S. Rep. No. 1881, 87th Congress, 2d Sess., reprinted at 1962-3 C.B. 703, 790.
- 24 See Sections 954(a)(3) and 954(e).
- 25 Section 954(e)(1).
- 26 Treas. Reg. § 1.954-4(a).
- 27 Section 954(e)(1)(B).
- 28 Section 954(e)(2).

Section 1248

Section 1248 provides that gain recognized by a United States shareholder on the taxable sale or exchange of stock in a CFC is treated as a dividend (rather than gain on the sale of the stock) to the extent of the earnings and profits of the CFC attributable to the stock sold or exchanged.29 Section 1248 generally applies only to U.S. persons who owned 10% or more of the voting stock of a foreign corporation at any time during the previous five years when the foreign corporation was a CFC.30

Currently, individuals are taxed at a 20% U.S. federal income tax rate on both qualified dividend income and long-term capital gain.31 Therefore, under current law, to the extent that the deemed Section 1248 dividend taxed as qualified dividend income at a 20% rate, the difference between characterization as a dividend under Section 1248 or long-term capital gain may make little difference to an individual shareholder.32 However, deemed dividend treatment can be beneficial to corporate shareholders, because deemed paid foreign tax credits can be used to reduce or eliminate U.S. tax on the portion of the gain recharacterized as dividend income which credits would not be available if the sale were treated as giving rise to capital gain rather than dividend income.33

PFIC Rules

The PFIC rules generally apply to U.S. persons owning shares of a foreign corporation 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 for the production of passive income.34 For this purpose, "passive income" means any income which is of a kind which would be

29 Section 1248(a) and Treas. Reg. 1.1248-1(a)(1). The remaining portion of any capital gain is taxed under the general rules for taxing gain on the sale of property. This rule is designed to tax a United States shareholder at ordinary income rates on earnings of a CFC that it had not been previously subject to U.S. taxation under Subpart F. Section 1248, however, does not create income in excess of the amount of the gain recognized.

- 30 Section 1248(a)(2).
- 31 See Section 1(h).
- 32 Amounts treated as dividends under Section 1248 are "qualified dividend income" provided that the CFC is otherwise a "qualified foreign corporation" under Section 1(h)(11)(C). See IRS Notice 2004-70, 2004-2, C.B. 724.
- 33 Yoder and Kemm, 930-2nd T.M. CFcs-Sections 959-965 and 1248, at A-58

34 Section 1297(a). Under Section 1297(e)(1), the passive assets test is normally applied by reference to the fair market values of the corporation's assets if the corporation is "publicly-traded." A corporation is publicly-traded if its stock is regularly traded on a national securities exchange registered with the Securities and Exchange Commission, on a national market system established under Section 11A of the Securities and Exchange Act of 1934 (e.g., NASDAQ), or any other exchange or market that the Treasury Department finds "adequate to carry out the purposes of this subsection." Section 1297(e)(3). However, if the corporation is (i) not publicly-traded and (ii) it is a CFC or it elects to use the adjusted basis of its assets in lieu of fair market value, then the corporation's assets are valued using the corporation's adjusted bases for purposes of determining earnings and profits. Section 1297(e)(2). For earnings and profits rules affecting adjusted basis, see Sections 312(k) and 312(n).

FPHC income as defined in Section 954(c).35 However, certain types of income specified in Section 1297(b)(2) are specifically excluded from the definition of "passive income."36Under a look-through rule, foreign corporations that own subsidiaries primarily engaged in active business operations are not treated as PFICs.37 Under this rule, if a foreign corporation owns 25% or more of another corporation (a "subsidiary"), the passive income and asset tests are applied by treating the foreign corporation's income and assets as including a pro-rata share of the subsidiary's income and assets.38 For example, if a foreign corporation's only assets are stock and debt instruments of subsidiaries primarily engaged in active business operations and the foreign corporation's income consists of dividends and interest from the subsidiaries, the corporation is not a PFIC because (i) its income is deemed to include the subsidiaries' non-passive business income, not the dividends and interest received from the subsidiaries and (ii) its assets are deemed to include the subsidiaries' operating assets, not the stock and debt of the subsidiaries that the foreign corporation owns.39

A newly-organized foreign corporation is given a one-year reprieve from classification as a PFIC if it meets the passive income or passive assets tests because of temporary investments in connection with the startup of its

35 Section 1297(b). See text accompanying footnotes 19 and 20, *supra*, for a discussion of FPHC income.

36 These excluded types of income include income derived in the active conduct of certain banking or insurance businesses, income which is interest, dividends, rents or royalties received or accrued by the foreign corporation from a related person to the extent such amount is properly allocable to income of such related person which is not passive income, or income which is "export trade income" of an "export trade corporation" (as defined in Section 971).

37 Section 1297(c).

38 Id.

39 HR Rep. No. 841, 99th Cong., 2d Sess. II-644 (Conf. Rep. No. 99-841, 1986).

business.40 This reprieve applies to the first year that the foreign corporation has gross income, which is referred to as the "start-up year."41 To qualify, (i) the IRS must be satisfied that the foreign corporation will not be a PFIC for either of the two taxable years immediately following the start-up year, (ii) the foreign corporation must not in fact be a PFIC for either of those two years and (iii) the foreign corporation must not be a successor to another corporation that was a PFIC.42 Another exception is made for foreign corporations that hold passive assets as temporary investments while reinvesting the proceeds from the sale of one or more active trades or businesses.43

In addition, a foreign corporation is not a PFIC with respect to a shareholder for any period after 1997 during which the shareholder is a United States Shareholder and the corporation is a CFC.44 As a result of this exclusion, a United States Shareholder that is required to include Subpart F income in its U.S. gross income with respect to the stock of a PFIC that is also a CFC generally is not also subject to income inclusion under the PFIC provisions with respect to the same stock. The PFIC provisions continue to apply, however, to shareholders of the PFIC that are not subject to Subpart F (i.e., to shareholders that are U.S. persons but are not United States Shareholders because they own directly, indirectly, or constructively, less than 10% of the foreign corporation's voting stock).45

The PFIC rules apply only to shareholders who are U.S. persons (i.e., individuals who are U.S. citizens or residents and U.S. domestic corporations, partnerships, trusts, and

estates).46 However, unlike the CFC/Subpart F rules discussed above, no minimum share ownership by U.S. shareholders is required in order for the PFIC rules to apply to a U.S. shareholder.47 Thus, a U.S. person owning

40 Section 1298(b)(2).

41 Id.

42 Id.

43 See Section 1298(b)(3) for the requirements to qualify for this exception.

44 See Section 1297(d). See text accompanying footnote 13, *supra*, for the definition of a United States Shareholder.

45 Staff of Joint Comm. On Tax'n, 105th Cong., 1st Sess. General Explanation of Tax Legislation Enacted in 1997 at 310 (Dec. 17, 1997).

46 See, e.g., Sections 1291(a)(1) and 1293(a) (PFIC excess distribution and QEF rules apply to U.S. persons owning PFIC stock).

47 As discussed above, the rules requiring inclusion of undistributed Subpart F income of a CFC in a U.S. shareholder's income apply only to United States Shareholders (*i.e.*, those U.S. persons directly, indirectly, and constructively owning 10% or more of the voting power or value of a foreign corporation's stock) and only if United States Shareholders collectively own more than 50% of the total combined voting power of all classes of stock of the foreign corporation or of the total value of the stock of the foreign corporation.

PFIC stock is subject to these rules even if the U.S. person holds only a very small percentage (e.g., less than 1%) of the foreign corporation's outstanding shares and all other shareholders are unrelated foreign persons.48 If a foreign corporation is a PFIC at any time while a U.S. person is a shareholder, the shareholder may be subject to

PFIC rules even after the corporation ceases to be a PFIC.49

The U.S. taxation of PFIC shareholders can fall under three possible alternative regimes. One regime defers U.S. tax until dividends are distributed by the PFIC or the U.S. shareholder sells the PFIC stock, but that regime often imposes interest on the tax when it is finally imposed.50 The other two regimes, which apply only when elected by the U.S. shareholder, either tax undistributed PFIC income to the U.S. shareholders as it is

earned by the PFIC (the QEF election regime) or tax U.S. shareholders annually on appreciation or depreciation in the stock's value during the year (the mark-to-market regime).51

Under the first of these three regimes, a special tax computation and interest charge apply whenever a U.S. shareholder in a PFIC receives an "excess distribution" from the PFIC or recognizes gain on selling all or a portion of the U.S. shareholder's PFIC stock.52 In general, (i) an excess distribution or gain on sale is spread on a pro rata basis over all years after 1986 during which the U.S. shareholder held the PFIC stock, (ii) the U.S. shareholder is taxed on amounts allocated to years before the taxable year in which the excess distribution or sale occurred at the highest ordinary income rates in effect for those years, and (iii) the U.S. shareholder is required to pay interest (compounded daily) to the IRS as though these amounts had actually been taxed in such prior years and

48 Bittker & Lokken: Federal Taxation of Income, Estates, and Gifts ¶ 70.1.1. 49

49 Section 1298(b)(i); Prop. Treas. Reg. §1.1291-1(b)(1)(ii). This is sometimes referred to as the "once a PFIC, always a PFIC" rule.

50 Discussed *infra* in footnotes 52 through 59 and accompanying text.

51 Bitker & Lokken, *supra*, note 46 ¶ 70.1.1.

distribution or sale occurs.53

OFF election was in effect.

(\$1,000 less 125% of \$500).

52 Section 1291(a). The tax and interest charge is calculated on IRS Form 8621.

the U.S. shareholder had failed to pay the tax until the year in which the excess

Pursuant to Section 1298(b)(1), these rules apply to an excess distribution or gain on sale if, at any time during the U.S. shareholder's holding period for the PFIC stock, the

foreign corporation (or any predecessor to the foreign corporation) was a PFIC and no

Section 1291(b)(2)(A) defines an "excess distribution" as the amount by which(i) distributions received by the U.S. shareholder from the PFIC during the taxable year exceed (ii) 125% of the average of the distributions received by the U.S. shareholder from the PFIC over the preceding three taxable years (or, if shorter, the portion of the U.S. shareholder's holding period for the PFIC's shares before the taxable year in which the excess distribution occurred). For example, if a U.S. shareholder receives distributions from the PFIC during the year of \$1,000 and received average annual distributions over the three preceding tax years of \$500, the excess distribution is \$375

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Under Section 1291(b)(2)(B), distributions received by a U.S. shareholder during the year the PFIC stock is acquired are not excess distributions, regardless of the amount of the distributions. Generally, any "actual or constructive transfer of property or money by a [PFIC] with respect to its stock" is considered a distribution for purposes of the excess distribution rules unless the transfer is treated as received in exchange for stock (e.g., a stock redemption treated as a sale or exchange).54 A distribution is counted for this purpose even if it is not a dividend for federal income tax purposes due to a lack of earnings and profits.55 However, if the U.S. shareholder has been taxed on undistributed income of the PFIC under the Subpart F or QEF rules (see discussion of QEF rules below), some of the distributions received during the current year or during the averaging period might be excluded from the U.S. shareholder's income as distributions of previously taxed income.56 Excess distributions are determined as though these excluded amounts have not been distributed.57

A non-excess distribution is a PFIC distribution that is not an excess distribution (i.e., does not exceed 125% of the average PFIC distributions). A non-excess distribution is taxed to a U.S. shareholder under the general rules of U.S.

53 See Bitker & Lokken *supra* note 48 ¶ 70.1.3.

54 Prop. Treas. Reg. § 1.1291-2(b)(1).

55 Prop. Treas. Reg. § 1.1291-2(c)(1).

56 Sections 959(a) (Subpart F rules) and 1293(c) (PFIC rules).

57 Section 1291(b)(3)(F); Prop. Treas. Reg. § 1.1291-2(b)(2)(i).

corporate income taxation.58 However, a PFIC non-excess distribution (as well as an excess distribution) will not qualify for the 20% tax rate on qualified foreign dividends because a PFIC is not a "qualified foreign corporation."59

Under one of the alternative regimes mentioned above, a U.S. shareholder may elect to treat a PFIC as a qualified elected fund ("QEF").60 A shareholder making a QEF election is required to include its pro rata share of the ordinary earnings and net capital gain of the PFIC in its U.S. gross income currently.61 Under Section 1295(b)(1), once a QEF election is made with respect to any foreign corporation, the election shall apply to all subsequent tax years of the U.S. shareholder making the election with respect to such foreign corporation unless revoked by the U.S. shareholder with IRS consent. If the QEF is also a CFC, exceptions to the pass-through of income by the QEF to U.S. shareholders under the QEF rules are provided for income of the QEF that is U.S. source effectively-connected income and income that is subject to a high foreign tax rate.62

The basis of a U.S. shareholder's QEF stock is increased by any amount included in the shareholder's income under Section 1293 with respect to that stock, and decreased by any amount distributed with respect to that stock that is excluded as previously taxed income.63 Thus, a shareholder who elects QEF treatment is not subject to any additional tax upon receipt of distributions out of earnings previously included in the shareholder's income.64 Gain on the sale of PFIC stock with respect to which a QEF election is in effect for all of the PFIC's post-1986 tax years is not subject to tax under the PFIC excess distribution rules under Section 1291, but instead is subject to the regular U.S. tax rules.65If a PFIC is a QEF for some, but not all, tax years in a U.S. shareholder's holding period for the PFIC stock, the PFIC is treated as an "unpedigreed QEF."66

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58 Prop. Treas. Reg. §1.291-2(e)(1).
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In such case, the shareholder remains subject to the PFIC excess distribution/interest charge regime to the extent it receives any excess distributions from the PFIC or realizes gain on the disposition of the PFIC stock.67 This PFIC taint may be purged, however, if the U.S. shareholder elects to include in income as an excess distribution (i) in the case of a U.S. shareholder holding stock of a PFIC that is also a CFC, its pro rata share of the PFIC's post-1986 undistributed earnings and profits as of the qualification date68 or (ii) in all other cases, any built-in gain with respect to the PFIC shares as of the qualification date.69 For this purpose, a U.S. shareholder's pro rata share of post-1986 undistributed earnings and profits does not include any amount that has previously been included in the U.S. shareholder's gross income pursuant to another provision of U.S. income tax law (e.g., Subpart F).70

⁵⁹ Section 1(h)(11)(C)(iii).

⁶⁰ Section 1295; Treas. Reg. § 1.1295-1.

⁶¹ Section 1293(a).

⁶² Section 1293(g)(1).

⁶³ Section 1293(d).

⁶⁴ Section 1293(c).

⁶⁵ Staff of Joint Comm. on Tax'n., 99th Cong. *General Explanation of the Tax Reform Act of 1986* at 1030 (May 4, 1987).

⁶⁶ Prop. Treas. Reg. § 1.1291-1(b)(2)(iii).

The third alternative regime is one which allows a U.S. shareholder to elect to market-to-market such shareholder's PFIC stock. Under Section 1296, a mark- to-market election may be made by a U.S. person or CFC that owns marketable PFIC stock.71 PFIC stock is considered "marketable" for this purpose if it is "regularly traded...on a qualified exchange or other market."72 Stock may also be considered "marketable" for purposes of this rule if it meets all of the requirements set forth in Treas. Reg. § 1.1296-2(d)(i). Mark-to-market gains and losses are reported as ordinary income or ordinary loss.73 In addition, gain on the sale or disposition of stock subject to a mark-to-market election is ordinary income, and loss on a sale or other disposition is deducible as an ordinary loss to the extent it does not exceed the unreversed inclusions attributable to the stock.74

67 Section 1298(b)(1); Prop. Treas. Reg. §§ 1.1291-1(b)(2)(iii) and (c)(2).

68 "Qualification date" is defined as the first day of the PFIC's first tax year as a QEF. Treas. Reg. §§ 1.1291-9(e) and 1.1291-10(e).

69 Section 1291(d)(2).

70 Treas. Reg. § 1.1291-9(a)(2)(ii)(B).

71 Section 1296(a); Treas. Reg. § 1.1296-1(b)(1).

72 Section 1296(e) and Treas. Reg. § 1.1296-2(a)(1). A qualified exchange or other market is a national securities exchange registered with the SEC, the national market system established under § 11A of the Securities Exchange Act, or a foreign securities exchange meeting all of the requirements set forth in Treas. Reg. 1.1296- 2(c)(1). Treas. Reg. § 1.1296-2(c)(1).

73 Section 1296(c).

74 Section 1296(c)(1) and Treas. Reg. §§ 1.1296-1(c)(2) (concerning gains) and 1.1296-1(c)(4)(i) (concerning losses). Section 1296(d) defines "unreversed inclusions" as an amount, with respect to any stock in PFIC, equal to the excess, if any, of (i) the amount included in the gross income of the shareholder under the mark-to-market rules under Section 1296(a)(1) for prior taxable years, over (ii) the amount allowed as a deduction to such shareholder under the mark-to-market rules with respect to such stock for such prior taxable years under Section 1296(a)(2).

If a taxpayer elects the mark-to-market regime after the year during which stock is acquired, the excess distribution regime under Section 1291 applies to distributions with respect to the stock and dispositions of the stock during year of the mark-to-market election and to the mark-to-market income for that year unless a QEF election was in

effect during the taxpayer's entire holding period of the stock.75 Under Section 1296(k), once made, a mark-to-market election shall apply to the tax year for which the election is made and all subsequent tax years unless the stock ceases to be marketable stock or the IRS consents to the revocation of the election.

Additional Coordination Rules

Certain CFC/PFIC coordination rules are discussed supra in the text accompanying footnotes 44, 45, 56, 57 and 62. In addition, as explained below, the Code contains other coordinating rules designed to eliminate double taxation where both the PFIC rules and the Subpart F rules apply. Different rules apply where a U.S. shareholder has made a QEF election and where a QEF election is not made. If a U.S. shareholder that is a corporation has made a QEF election, Section 1293(f) provides that, for purposes of Section 960 (dealing with indirect foreign tax credits), if an item of income is includable in the gross income of a U.S. shareholder under both the Subpart F rules under Section 951(a)(1)(A)(i) and the QEF rules under Section 1293, the item is includable only underSection 951(a), thus allowing indirect foreign tax credits to the U.S. corporate shareholder if the shareholder would have been allowed indirect foreign tax credits on actual dividend distributions not paid out of Subpart F income.

If a QEF election has not been made for a PFIC that is also a CFC, for purposes of calculating "excess distributions" under the PFIC rules, distributions include deemed distributions under Section 956 (investments in U.S. property), which are includable in a United States Shareholder's income under

Section 951(a)(1)(B).76 Income that is or has been included in the gross income of a United States Shareholder under both Subpart F rules under Section 951(a) (the Subpart F rules for CFCs) is treated as previously-taxed income under Section 959(a), and is disregarded for purposes of determining the amount of any "excess distribution" or gain that is subject to interest charges Section 1291.77

75 Section 1296(j)(1); Treas. Reg. §§ 1.1296-1(i)(1) and 1.1296-1(i)(2). The purpose of this rule is to ensure that the taxpayer does not avoid the interest charge under Section 1291 with respect to amounts attributable to periods before such mark-to-market election. *General Explanation of Tax Legislation Enacted in 1997, supra note 45 at 313*

76 Section 1298(b)(8).

If the CFC is a PFIC but not a QEF, all gain on the sale or other disposition of the CFC stock is treated as ordinary income. Section 1248 (discussed above in this article) does not apply to a non-QEF PFIC.78

Conclusion

The PFIC rules are designed to ensure that U.S. shareholders of a foreign corporation cannot defer U.S. income taxes on the undistributed earnings of the foreign corporation where the foreign corporation's income consists primarily of passive investment income or its assets consist primarily of assets which produce passive investment income. In enacting the PFIC rules, Congress believed that deferral of U.S. income tax was not appropriate, as a policy matter, in those circumstances. The PFIC rules overlap, to some extent, with the rules on Subpart F income for U.S. Shareholders of CFCs. The Code and Treasury Regulations contain rules that coordinate the application of the two sets of rules where there is overlap.

77 Section 1291(b)(3)(F); Prop. Treas. Reg. § 1.1291-2(b)(2).

78 Sections 1291(g)(2)(C) and 1248(g)(2); Prop. Treas. Reg. § 1.1291-3(i).

Chapter 32 – U.S. Based Hedge Funds an Offshore Reinsurance

(Co-Author: Allen B. Walburn, Esq.)

Introduction

U.S.-based hedge funds are establishing offshore reinsurance companies to exempt their hedge fund earnings from annual U.S. income taxes. The hedge funds "ship" investment capital offshore to a newly-established reinsurance company, which is in the "business" of selling reinsurance (i.e. they sell insurance to insurance companies). Since there are no specific rules on how much insurance must be sold, the U.S. hedge fund may capitalize the offshore reinsurance company (e.g. \$500M) and sell de minimis insurance (e.g. \$8M in the case of John Paulson's hedge fund), leaving almost 100% of the initial \$500M in capital available to reinvest in the U.S. hedge fund (the \$500M is sent on a "round-trip trip transfer"; i.e. from the U.S. to the "offshore reinsurance", back to the U.S.). The hedge fund earnings, held in the offshore reinsurance company compound tax-free annually. The U.S. imposes no tax on those hedge fund earnings. The only U.S. taxes imposed is when the hedge funds sell their shares in the reinsurance company (taxed at capital gains tax rates on the sale of the shares).

Active or Passive Business

For tax purposes, the "tax loophole" is whether the U.S.-owned offshore reinsurer is an "active" or "passive" business. If it is an active business, i.e. insurance, there is no tax due on annual earnings. If the business is a passive business (and the income is passive income, e.g. interest, dividends, rents, royalties, classified at foreign persons' holding company income within the meaning of IRC Sec. 954(c), see IRC Sec. 1297(b)), the earnings are subject to annual tax due.

A passive foreign investment company ("PFIC") is a foreign corporation that meets one of two tests:

- Seventy-five percent or more of the gross income of the corporation is "passive income" IRC Sec.1297(a)(1), or
- The average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50% (IRC Sec. 1297(a)(2).

The PFIC taxes do not apply to a U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation ("CFC") (IRC Sec. 1297(e), PLR 2009 43004). The CFC rules accomplish Congress' anti-tax deferral objections. Since the CFC shareholder is currently taxable on their share of the CFC's Subpart F income, it is not necessary to subject them to the PFIC tax regime.

Regarding taxation of distributions from a PFIC:

- 1. "Non-excess" distributions are taxed to the shareholder as a dividend taxable at ordinary income tax rates (the distribution does not qualify for the 15% tax rate on qualified foreign dividends because a PFIC is not a "qualified foreign corporation (IRC Sec. 1(h) (11)(C)(iii)).
- 2. "Excess distributions" are taxed at ordinary income rates (not subject to the favorable qualified foreign dividend tax rates), for the current tax year and pre- PFIC tax years, with the portion of the excess distribution allocated to other years in the taxpayer's holding period (the "PFIC years") subject to deferred tax and interest as separate line items on their individual income tax return (IRC Sec. 1291(a)(1)(c).

Current Tax Issues: U.S. Hedge Funds and Offshore Reinsurers

In Zachary Mider's excellent article: "Hedge Fund Execs Beach their Tax Bills" (Bloomberg Business Week, Feb. 25-March 3, 2013 Pages: 36-37) he describes how U.S. hedge funds have launched Bermuda reinsurers to exempt hedge fund earnings from annual U.S. income taxes (no tax is paid until the hedge fund investors sell their shares in the reinsurer, creating in an indefinite tax deferral on hedge fund income, which compounds annually tax-free).

Since 2011, prominent U.S. hedge funds: Paulson & Co. (John Paulson), SAC Capital Advisors (Steve Cohen) and Third Point (Dan Loeb) have circulated billions of dollars of investment assets through Bermuda reinsurers to indefinitely defer U.S. tax on their hedge fund income. In 2012, these three hedge funds circulated a combined \$1.7 billion through their Bermuda reinsurers to be reinvested through their U.S.-based hedge funds. (See Bloomberg Business Week, Feb. 25-March 3, 2013).

For example, in April 2012, top executives of billionaire hedge fund manager John Paulson's New York firm sent \$450M to a reinsurance company called PaCRE they set up in a Bermuda reinsurer. By recycling this \$450M through Bermuda, which has no corporate income tax, and reinvesting these funds in their U.S. hedge funds, they reduced their personal income taxes on their hedge fund earnings by indefinitely deferring their tax due.

In 2013, U.S. taxpayers who invest in hedge funds pay either: 39.6% tax rate for ordinary income on their profits, or 20% long-term capital gains rate (depending on whether the securities holding period is 12 months or less), plus an additional 3.8% tax surcharge (on net investment income) under the Affordable Care Act.

When investors circulate their money into a Bermuda-based reinsurer, which invests in the U.S. hedge funds, profits go to the reinsurer which does not owe U.S. tax on their earnings. U.S. investors defer taxes until they sell their stake in the reinsurer. Until then, the earnings compound tax-free and the tax savings increase the ultimate investment return.

Investing \$100 million in a hedge fund that returns 10% annually for five years, and paying the top federal/California "blended" ordinary income tax rate (2013: 51%) on profits, creates a net after-tax return of \$24,450,000 (i.e. \$50M earnings less \$25,500,000 tax). If a Bermuda reinsurer holds the same investment, the gain is \$61,060,000 (which is the net after-tax compounded return). The projected tax savings is \$36,610,000.

If the U.S. hedge fund was based in Bermuda there would be no tax advantage, since it would be taxed under the "Passive Foreign Investment Company" rules. However, for an insurance company (i.e. a reinsurer which provides insurance coverage for other insurers, not the general public) tax on these "same hedge fund earnings" would be tax-deferred.

Insurance company earnings are not subject to tax under the "PFIC" rules; instead they are not taxed, since the insurance company is an "active (not passive) business" (i.e. PFICs have "passive" not "active" income)

In a 2003 report, the IRS stated some "offshore reinsurance arrangements were shams, either because they were not selling enough insurance or because the insurance they reported selling was not insurance (i.e. it was illusory).

The IRS has apparently not challenged the claimed tax treatment for the offshore reinsurers. However, the extant issue is what qualifies an insurance company as exempt from tax as an "active" business. To qualify as an active business, the reinsurance companies can't have a pool of capital greater than what is required to capitalize the insurance they sell. The IRS has never specified the amount of capital reserve required (to sequester) to capitalize the insurance sold. The tax issue is whether the reinsurer is an actual business (i.e. an active business which sells reinsurance) or a "tax dodge" (i.e. sells nominal insurance and uses the investment capital to make "tax-deferred" hedge fund and other investments).

Whether these U.S.-hedge funds- Bermuda owned reinsurance- are an actual insurance company, or a "tax dodge" is a fact-dependent case-by-case basis. However, John Paulson's reinsurance company PaCRe is illustrative.

PaCRe [Bermuda]:1. Has no employees;

- 2. Its listed legal address is actually the office of another reinsurance (to whom it outsources its underwriting);
- 3. From 4/12-12/12 PaCRe sold about \$8M of reinsurance coverage (i.e. 1.6% of its \$500 million startup capital).
- 4. PaCRe invested the entire \$500 million in startup capital in four Paulson & Co. hedge funds. Through 12/31/12, those investments lost about \$19 million in value. These

losses were not passed through to their investors.

Please see the following summary of the anti-deferral tax rules:

Tax Compliance – CFC/PFIC

The Internal Revenue Code limits tax-deferral on foreign-based income realized by U.S. shareholders of foreign corporations. Undistributed foreign corporation income is taxed either annually, or upon investment sale.

There are two primary anti-tax deferral regimes: Controlled Foreign Corporation ("CFC") and Passive Foreign Investment Company ("PFIC")

Controlled Foreign Corporation ("CFC") Annual Tax

U.S. shareholder pays annual income tax on pro-rata share of CFC's income, and files IRS Form 5471.

A U.S. shareholder of a foreign corporation, that is a "controlled foreign corporation" (CFC) for an uninterrupted period of 30 days or more during the tax year, and is a shareholder on the last day of the CFC's tax year, must include in gross income its proportionate share of the CFC's "Subpart F income" (whether distributed or not) (IRC Sec. 951).

A CFC's Subpart F income is limited for any tax year to its total earnings and profits for that year. The income is treated as a deemed dividend.

A foreign corporation is a CFC if more than 50 percent of its total voting power or value is owned by U.S. shareholders (IRC Sec. 957). A "U.S. shareholder" is any U.S. person (citizen, resident, domestic corporation, partnership, estate or trust) that owns 10 percent or more of the total combined voting power of the foreign corporation. Ownership may be direct, indirect, or constructive with certain exceptions (IRC Sec. 958).

The U.S. shareholders of a CFC are taxed on earnings, which are undistributed, if the CFC earns "tainted income", (i.e., Subpart F Foreign Base Company Income). CFC Subpart F income is the sum of the corporation's insurance income, foreign base company income, boycott income, illegal payments and income from countries not diplomatically recognized by the U.S. government (IRC Sec. 952).

CFC income does not include income from sources within the U.S. that is effectively connected with the conduct of a trade or business by the corporation in the United States, unless that income is exempt from tax or taxed at a reduced rate pursuant to a treaty.

Subpart F income is limited to the CFC's total earnings and profits for that year, and may

be reduced in certain circumstances to accumulated deficits of earnings and profits.

Foreign Base income of a CFC is made up of income from foreign personal holding company (FPHC) and foreign base company sales, services and oil- related income (IRC Sec. 954).

FPHC income is the major component of foreign base income. FPHC income includes: dividends, interest (including otherwise tax-exempt interest), rents, royalties and annuities.

FPHC income does not include rents and royalties from an active trade or business.

Tainted CFC Income attributed to U.S. shareholders includes:

- 1. Foreign Personal Holding Company Income (IRC Sec. 954(c)): dividends, interest, royalties and other types of passive income, including gains from stock and commodity sale.
- 2. Foreign Base Company Sales Income: (IRC Sec. 954(d)(3)); i.e. sale of personal property sold for use outside the CFC's country of incorporation.
- 3. Foreign Base Company Services Income: (IRC Sec. 954(c)): income from the performance of technical, managerial, engineering or commercial services performed outside the CFC's country of incorporation for a related person.
- 4. Foreign Base Company Income includes: shipping and oil-related income.
- 5. Increase in Earnings Invested in U.S. Property: Excess of CFC earnings invested in U.S. property at year end, over earnings so invested at the beginning of the year (IRC Sec. 956).

Regarding FHPC Income, the sale of a partnership interest by a CFC is treated as a sale of the proportionate share of partnership assets attributable to that interest (including subpart F income).

U.S. shareholders of a CFC are taxed on their pro-rata share of the CFC's earnings which are invested in U.S. property during the tax year and which are not distributed or otherwise taxed (IRC Sec. 956). The amount of earnings invested in U.S. property is a "dividend deemed paid" to the corporation's U.S. shareholder. U.S. property includes: tangible real or personal property located in the U.S., stock of domestic corporations, obligations of U.S. persons, and the right to use a patent, copyright or invention in the U.S.

If a U.S. shareholder sells CFC stock, recognized gain will be included in taxpayer's gross income as an ordinary dividend to the extent of the foreign corporation's earnings and profits allocable to the stock (IRC Sec. 1248). Any gain exceeding the CFC's earnings and

profits is treated as capital gain. The shareholder may claim a foreign tax credit for the taxes the CFC paid on the income.

Every U.S. person (i.e. taxpayer) who is a U.S. shareholder of a CFC must file an annual Form 5471 (IRC Sec. 6038) or be subject to penalties and a reduced foreign tax credit.

CFC investments in U.S. property include: tangible property, stock of a domestic corporation an obligation of a U.S. person.

Investments not included: U.S. bonds, U.S. bank deposits, debts arising in the ordinary course of business from the sale of property.

"Repatriated" earnings of offshore corporation will be deemed taxable subpart F income.

To prevent double taxation, the basis of the U.S. shareholder's CFC stock, (and basis in property the shareholder is considered owning through the CFC), is increased by the amount of subpart F income required to be included in income and decreased by any distribution that is excluded from income (IRC Sec. 961).

A U.S. shareholder of a CFC that is a domestic corporation is allowed a foreign tax credit for any foreign taxes paid (or deemed paid) by the CFC for income that is attributed or distributed to it as a U.S. shareholder (IRC Sec. 960).

Effective for tax years beginning after December 31, 2010, the credit is limited to taxes that would have been deemed paid if the foreign corporation had made an actual distribution to the domestic corporation.

A "deemed-paid' credit is available to any individual U.S. shareholder who elects to be taxed at domestic corporate rates on amounts included in gross income (IRC Sec. 962).

Passive Foreign Investment Company ("PFIC")

- U.S. shareholder of a PFIC pays income tax plus interest (based on value of tax deferral):
- a. Upon sale of PFIC investment
- b. Upon receipt of PFIC "excess distribution" (i.e. distribution which is greater than 125% of the average distribution received by the shareholder during the preceding 3 tax years).

A PFIC is any foreign corporation who has:

- c. At least 75% of its gross income from passive investments or
- d. At least 50% of its assets produce passive income (IRC Sec. 1297)

A Special tax regime applies when a U.S. shareholder receives a PFIC distribution (unlike the normal rules of U.S. federal corporation income taxation, a PFIC's earnings and profits are not relevant to the taxation of a PFIC distribution).

PFIC distributions fall into 2 categories: "excess" and "non-excess" distributions. An excess distribution is the PFIC distribution that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the 3 preceding years or if held for less than 3 years the shareholders holding period. (IRC§1291(b)(2)(A)).

A non-excess distribution is a PFIC distribution that is not an excess distribution (i.e. does not exceed 125% of the average PFIC distributions). A non-excess distribution is taxed to the U.S. shareholder under the rules of U.S. corporate income taxation, which is taxed as a dividend (Prop. Treas. Reg. §1.291-2(e)(1)). A PFIC non-excess distribution will not qualify for the 15% tax rate on qualified foreign dividends because a PFIC is not a "qualified foreign corporation" (IRC§1(h)(11)(C)(iii)).

A PFIC excess distribution is subject to a special tax regime. The taxpayer must first allocate the distribution pro rata to each day in the shareholder's holding period for the shares (IRC§1291(a)(1)(A)). Whether the PFIC had earnings and profits in those years is irrelevant. The portion of the excess distribution allocated to the current year and the pre-PFIC years (prior 3 years) is included in the taxpayer's income for the year of receipt as ordinary income (IRC§1291(a)(1)(B)(i)(ii)). These PFIC excess distributions are not qualified foreign dividends subject to the 15% tax rate.

The portion of the excess distribution allocated to the other years in the taxpayers holding period (the "PFIC years") is not included in the taxpayer's current income. Rather, this portion is subject to a special "deferred tax" that the taxpayer must add to his tax that is otherwise due (IRC§1291(c)).

To compute the deferred tax, the shareholder first multiply the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year (IRC§1291(C)(1)). The shareholder then aggregates all "unpaid tax amount" for the PFIC years (IRC§1291(c)(2).

The shareholder must then compute interest on those increased tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal tax underpayment rate (IRC $\S1291(c)(3)$). The taxpayer includes the deferred tax and interest as separate line items on their Form 1040 individual tax returns (IRC $\S1291(a)(1)(C)$).

A U.S. taxpayer's sale of PFIC shares is an "excess PFIC distribution" to the extent the sole proceeds exceed the seller's basis in the PFIC shares (IRC§1291(a)(2)). The gain is treated as ordinary income realized rationally over the seller's holding period with deferred tax and interest on the amount allocated to prior years.

Passive Income (under the gross income test) includes: dividends, interest, royalties and other types of passive income.

There are no U.S. shareholder ownership requirements for the entity to be considered a PFIC.

If "Qualified Election Fund" status is elected, the shareholder is taxed currently on undistributed earnings. If the election is made, the shareholder must include in gross income each year as ordinary income its pro rata share of earnings of the corporation, and as long-term capital gain, its pro rata share of the net capital gain of the corporation. (IRC Sec. 1293 and Sec. 1295).

The inclusions are made for the stockholder's tax year in which the QEF's tax year ends. Once made, the QEF election is revocable only with the IRS's consent and is effective for the current tax year and all subsequent tax years. The U.S. shareholder can elect to defer payment of the tax on any undistributed earnings of the QEF (IRC Sec. 1294).

A U.S. shareholder of a PFIC who receives an "excess distribution" with respect to its stock, and disposes of its PFIC stock during the tax year, must allocate the income or gain ratably to each day they held the stock unless the shareholder elects to treat the PFIC as a "Qualifying Electing Fund" (QEF) or makes a mark- to-market election (IRC Sec. 1291).

Under the default method, the amount allocated to the current tax year, and to any prior tax year during the shareholder's holding period in which the corporation was not a PFIC, is taxed as ordinary income. The amount allocated to any other year in the shareholder's holding period is taxed at the highest rate applicable for that year, plus interest from the due date for the taxpayer's return for that year.

An excess distribution is any part of a distribution received from the PFIC which is greater than 125% of the average distribution received by the shareholder during the three preceding tax years, or, if shorter, during the period the shareholder held the stock.

Each U.S. shareholder of a PFIC must file an annual report on Form 8621, effective March 18, 2010. The requirement to file a report may also meet the requirements for disclosing information for specified foreign financial assets (Form 8938).

A U.S. shareholder of a PFIC may avoid the additional tax, or the deferral of income by making a mark-to-market election on their PFIC stock, and annually including in gross income, as ordinary income, an amount equal to the excess of the fair market value of the PFIC stock, as of the close of the tax year, over its adjusted basis. If the stock declines in value, an ordinary loss deduction is allowed, limited to the net amount of gain previously included in income.

The PFIC rules do not apply to a U.S. taxpayer who is also a 10% shareholder of a controlled foreign corporation IRC§1297(e); PLR200943004. Since the shareholder is currently taxable on their share of the CFC's subpart F income it is unnecessary to tax them under the PFIC tax regime. The CFC rules accomplish the anti-deferral tax objective.

Earnings of a foreign subsidiary of a US-based business are generally not subject to US Federal Income Tax until they are distributed, US tax deferral, on foreign subsidiary income, is limited by the CFC/PFIC rules. Even if share ownership can be structured to avoid CFC status, the foreign corporation may still be a PFIC subject to an interest charge on the tax attributable to PFIC gains or distributions, which eliminates the tax deferral benefits.

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 September 2016, Gary Wolfe has internationally published 16 books and 40 articles, and has received 14 international tax awards from five different Global expert societies in LONDON/UK.

Awards:

- 14) ACQ5 Global Awards 2016 CA/US International Tax Planning Law Firm of the Year
- 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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