

# Coming in From the Cold: Undisclosed Foreign Income and Assets

WSBA Tax Section



Darek Jarski, Jarski Law PLLC:

Mr. Jarski represents clients in a wide range of tax controversy matters before the Internal Revenue Service. His cases include offshore and domestic voluntary disclosures, complex/sensitive IRS audits, domestic and international information return penalty matters. Mr. Jarski also advises clients regarding current and missed international information return requirements.

[djarski@jarskilaw.com](mailto:djarski@jarskilaw.com)  
206-333-0750



John Colvin, Colvin + Hallett:

John is a shareholder at Colvin + Hallett. John's practice focuses on federal tax controversy matters and federal white-collar criminal defense, including representing clients who face issues related to undisclosed foreign income and assets. In his practice, he helps all types of clients—individuals, businesses, and estates—resolve federal tax disputes.

[jcolvin@colvinhallettlaw.com](mailto:jcolvin@colvinhallettlaw.com)  
206-223-0800

# Context



- United States has a worldwide tax system
- Small percentage of taxpayers used the lack of information sharing between governments to evade tax
- Congress gave the IRS tools such as international information return requirements to combat international tax non-compliance
- Information return provisions carry significant penalties
- **IRS is enforcing the penalty provisions**
- IRS has limited resources thus it uses various compliance programs
  - Benefit to the IRS: more people come into compliance
  - Benefit to taxpayer: potentially lower penalties

# History



- History is important as it is a story of:
  - Erosion of bank secrecy
  - Increasing penalties
  - Decreased tolerance of non-compliance
- Closed Programs
  - Offshore Credit Card Program (OCCP) – early 2000’s
  - Offshore Voluntary Compliance Initiative (OVCI) – 2003
  - Last Chance Compliance Initiative (LCCI) – 2003-2009\*
  - 2009 Offshore Voluntary Disclosure Program (OVDP)
  - 2011 Offshore Voluntary Disclosure Initiative (OVDI)
  - 2012/2014 Offshore Voluntary Disclosure Program (OVDP)

# Current Options



- Voluntary Disclosure Program
- Streamlined Compliance Procedures
- Delinquent Filing Procedures
- Quiet Disclosure
- Future Compliance
- ~~“Do Nothing” Approach~~

# Voluntary Disclosure Program



- **Cooperation required**
  - November 2018 Revised Procedures: “The Service will provide procedures for civil examiners to request revocation of preliminary acceptance when taxpayers fail to cooperate with civil disposition of cases.”
  - Revocation = potential criminal prosecution
- Timeliness
- Level of protection from criminal prosecution
- 6-year lookback (generally)
- FBAR penalties – willful pursuant to guidance (50% of highest balance during disclosure period)
  - May argue for non-willful
- Fraud penalty (generally 1 year)
  - May argue for accuracy penalty
- Information return penalties – discretion/overall picture
- Appeals consideration available

# Streamlined Compliance Procedures



- Dual Programs
  - Streamlined Domestic Offshore Procedures (SDOP)
  - Streamlined Foreign Offshore Procedures (SFOP)
- Common Features of SDOP & SFOP
  - Prerequisites
    - Timely
    - Individual/estate
    - Non-willful

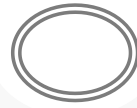
# Streamlined Compliance Procedures



- Common Features of SDOP & SFOP, cont'd
  - Requirements
    - 6 years of FBAR compliance (or less if TP did not have non-compliant foreign accounts for portion of period)
    - Up to 3 years of income tax and information return compliance
    - Payment of tax and interest with respect to the three years of returns
      - Significantly, no income tax penalties or foreign reporting penalties are imposed
    - Certification under penalty of perjury regarding non-willfulness (i.e. facts relating to the non-compliance)



# Streamlined **Domestic** Offshore Procedures (SDOP)



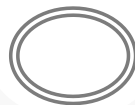
- Specific prerequisite – must have filed Forms 1040
  - IRS did not want this to be a program for “non-filers”
- 5% penalty based on a single highest year-end value of foreign financial assets with respect to which there was either income tax non-compliance, or FBAR non-compliance, or IRS international information return non-compliance
  - There are *significant* nuances to the penalty calculations (computations differ from those under the former OVDP program)

# Streamlined **Foreign** Offshore Procedures (SFOP)



- Specific prerequisite – must be considered a “non-resident” according to the rules of the program
  - U.S. citizens or permanent residents – must have been outside of the U.S. for 330 days during one of the three most recent years covered by the program
  - Non-U.S. citizens/permanent residents – must have been considered to be a non-resident alien under substantial presence during one of the three most recent years covered by the program
  - If joint returns filed, both spouses must meet “non-residency” requirement
- 0% penalty with respect to FBAR and IRS international information returns
- Significantly, income tax return non-filers may use SFOP

# Delinquent Filing Procedures



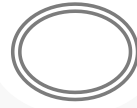
- Delinquent **International Information Return** Submission Procedures
  - Prerequisites
    - Timeliness
    - Reasonable cause and reasonable cause statement
  - What if there is additional tax on the return? Potentially not available.
  - Warning regarding Forms 3520 & 3520-A
- Delinquent **FBAR** Submission Procedures
  - Prerequisites
    - Timeliness
    - Reported income from accounts
    - Include explanation
    - No explicit mention of reasonable cause

# Quiet Disclosure



- Generally amounts to filing of delinquent or amended returns for past years without the use of an IRS program
- Taxpayers with willful or criminal exposure should be particularly cautious
- Professionals must understand the facts, the exposure and properly relay it to the client
- Now less attractive as an an option in light of streamlined/delinquent filing procedures
- Can present a viable alternative for certain taxpayers

# Future Compliance



- Getting it right going forward without fixing the past
- SOL issues
- Ethically, does the professional have a duty to advise the client that non-compliance should be corrected?
  - Attorney/CPA should not advise against correcting past non-compliance
- Client must be advised of the risks and exposure
- Client must be advised of alternatives
- This is something that a client may choose to do in light of all of the facts --not something the professional recommends

# ~~The “Do Nothing” Approach~~



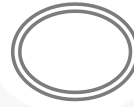
- Not correcting the past and **continuing** non-compliance
- Can lead to willful civil penalties and criminal exposure
- Tax professional should never recommend this and, in fact, should strongly recommend against it
- Consider whether you want to continue to represent the client
  - Can you do so ethically?
  - Will doing so create potential exposure?
- Generally, this client is rare and easy to spot

# Which Program Should I Use For My Client?



- It depends ...
- Preliminary question always is if there is **criminal** exposure?
  - Mitigating criminal exposure is typically the first priority
- Determine risk of FBAR penalties
- Determine the civil statutory penalty exposure?
  - Determine which Title 26 penalties apply and the extent thereof
  - Know the IRS penalty application environment
- Determine for which program (if any) the taxpayer qualifies
  - Largely determined by the nature of the conduct: criminal/willful/non-willful/reasonable cause
- Determine your client's desire for closure and anxiety level

# FBAR Filing Requirements



Who Must File the FBAR?

Who is a U.S. Person?

Who is a U.S. Resident?

What is a Financial Account?

When is an Account Foreign?

How to Calculate Value?

What is a Financial Interest?

U.S. Person

U.S. Citizen; U.S. Resident; U.S. Entity, Trust, Estate

Green card holder

Resident under IRC 7701(b), T31 definition of United States

Bank accounts and securities accounts

Commodity futures or options accounts

Insurance policies with a cash value

Mutual funds or similar pooled funds

Other accounts w foreign financial institutions

Located outside US (per Title 31 definition of United States)

Periodic account statements or any point during year (exchange rate 12/31)

U.S. person is owner of record or title owner

Owner of record is acting for U.S. person

Owner of record is corp/entity & U.S. person owns > 50% of stock or has > 50% of voting rights

Owner of record is pshp/entity & U.S. person owns > 50% of profits or has > 50% of capital

Owner of record is trust & U.S. person is grantor, owner (IRC 671-679), or > 50% present beneficial interest



# FBAR Filing Requirements (Cont.)

What is Signature Authority?

**Jointly Held Accounts?**

Limited Joint Filing by Spouses?

**Modified Reporting Requirements?**

Recordkeeping Requirements

**Due Date**

Filing

Authority to control disposition of assets

**Each person must report**

Non-filer accounts are joint w/ spouse

Filing spouse reports the joint accounts

**Financial interest in 25 or more accts (Part I, Item 14a)**

**Signatory authority over 25 or more accts (Part I, Item 14b)**

**USP officer/employee, outside US (only signatory authority)**

Name on account

Number or other designation of account

Name and address of foreign institution

Type of account

Maximum value of account during year

**April 15 following calendar year**

**Automatic Extension to Oct 15**

**Prior to 2016, June 30 following year**

E-Filing mandatory as of July 1, 2013

# FBAR Penalties

Violation	Civil Penalties	Criminal Penalties	Comments
Negligence	\$500	N/A	31 USC 5321(a)(6)(A); 31 CFR 1010.820(h); does not apply to individuals
Non-Willful	\$10,000	N/A	31 USC 5321(a)(5)(B)
Pattern of Negligence	In addition to penalty under 5321(a)(6)(A), not more than \$50,000	N/A	31 USC 5321(a)(6)(B); does not apply to individuals
Willful – Failure to File FBAR or retain records	Up to the greater of \$100,000 or 50% of account at time of violation	Up to \$250,000 or 5 years or both	31 USC 5321(a)(5)(C); 31 USC 5322(a); 31 CFR 1010.840 (criminal)
Willful – while violating other laws	greater of \$100,000 or 50% of amount in account at time of violation	Up to \$500,000 or 10 years or both	31 USC 5322(b)
Willfully Filing False FBAR	Up to the greater of \$100,000 or 50% of account at time of violation	\$10,000 or 5 years or both	18 USC 1001

# Challenges to Willful FBAR Penalty



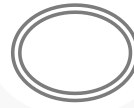
- Willfulness for purposes of Bank Secrecy Act requires a “voluntary violation of a known legal duty.” *Ratzlaf v U.S.*, 510 U.S. 135, 142 (1994) (criminal prosecution for structuring)
- Willfulness can be inferred based on a person’s conduct, including conscious avoidance - *U.S. v Sturman*, 951 F.2d 1466 (6th Cir. 1991) (circumstantial evidence, including reading Schedule B to Form 1040 but not attempting to learn of FBAR reporting requirements, supported conviction for criminal FBAR violation).
- Willfulness can be established by willful blindness or reckless conduct - *U.S. v. Garrity*, 304 F. Supp.3d 267 (D. Conn. 2018); *U.S. v. Williams*, 2010 WL 3473311; *U.S. v. Kelley-Hunter*, 281 F.Supp.3d 121 (D. D.C. 2017); *U.S. v. Katwyk*, 2017 WL 6021420 (C.D. Cal); *Bedrosian v. U.S.*, 2017 WL 4946433 (E.D. Pa.); *U.S. v. Bohanec*, 263 F. Supp.3d 881 (C.D. Cal. 2016); *U.S. v. Bussell*, 2015 WL 9957826 (C.D. Cal. 2015); *U.S. v. McBride*, 908 F. Supp.2d 1186 (D. Utah 2012).

# Indicia of Willfulness



- Use of a bank secrecy jurisdiction
- Motivation to hide from spouse or partner
- Failure to pay tax on the corpus or income
- Numbered account or pseudonym
- Use of entities or structures
- Hold mail
- Moving the account
- Use of cash or debit card
- Use of other non-reportable assets
- Failure to tell accountant or other advisor
- Failure to check the box

# Form 8938 - Statement of Specified Foreign Financial Assets



Authority: IRC 6038D; Treas. Reg 1.6038D-1 through -8

Who must file: A *specified person* (U.S.) that has an interest in *specified foreign financial assets* and the *value* of those assets is more than the applicable reporting threshold.

Specified person includes:

1. Individuals; or
2. For 2016 and subsequent years, certain domestic corporations, partnerships and trusts if:
  - a. Asset value exceeds \$50k on last day or \$75k at any time during year
  - b. Closely-held domestic corporation or partnership if at least 50% passive income or assets
  - c. Closely-held if specified individual owns at least 80% (by vote or value, capital or profits) directly, indirectly or constructively
  - d. Certain trusts if specified individual or specified domestic entity

Specified foreign financial assets include:

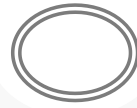
1. Financial accounts maintained by a foreign financial institution.
2. Following foreign financial assets if held for investment and not held in an account maintained by a financial institution:
  - a. Stock or securities issued by someone that is not a U.S. person
  - b. Any interest in a foreign entity, and
  - c. Any financial instrument or contract that has an issuer that is not a U.S. person

# Form 8938 – Penalty



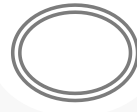
- **Initial Penalty** - The initial penalty is \$10,000 for each taxable year with respect to which such failure occurs. IRC 6038D(d)(1)
- The IRS can immediately assess the 8938 penalty.
- **Continuation Penalty** - If any failure continues more than 90 days after notice is mailed to the taxpayer (90-day period), additional penalties will apply. The continuation penalty is \$10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. The maximum continuation penalty is limited to \$50,000 per failure. IRC 6038D(d)(2)

# Form 8938 Penalty – Defenses and Abatement



- **Reasonable Cause**
  - IRC 6038D(g) provides that no penalty shall apply if the individual shows that the failure is due to reasonable cause and not to willful neglect.
  - No reasonable cause should be considered until taxpayer has filed all open years (not on extension).
  - An individual will not have reasonable cause merely because a foreign jurisdiction would impose a civil or criminal penalty on any person for disclosing the required information.
- **Best efforts protective filings** - *Beard v. Commissioner*, 793 F.2d 1139 (6th Cir. 1986), disclosing the information within the Taxpayer's possession and control with explanation for omissions
- **First Time Abatement Policy** - provisions (IRM 20.1.1.3.6.1(8)) generally do not apply to event-based filing requirements. However, if IRS issued a FTA for the related Form 1040, then it may abate the corresponding Form 8938 penalty.

# Form 5471



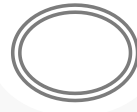
Authority: IRC 6038; Treas. Reg 1.6038-1,2

Who must file:

- U.S. persons described in *Categories of Filers* must complete the schedules, statements, and/or other information requested.
- If the filer is described in more than one filing category, do not duplicate information.
- Complete a separate Form 5471 and all applicable schedules for each applicable foreign corporation
- The Form 5471 is filed with the Taxpayer's Federal Income Tax Return.



# Form 5471

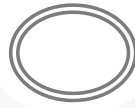


## FORM 5471 – Categories of Filers

### Category 1 Filer: \*\*\*NEW\*\*\*

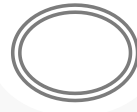
- A U.S. shareholder of a foreign corporation that is a section 965 Specified Foreign Corporation (SFC) (965 – 2017 Mandatory Inclusion of foreign deferred E&P)
- A U.S. shareholder is a U.S. person who owns (directly, indirectly, or constructively, within the meaning of sections 958(a) and (b)) 10% or more of the total combined voting power of all classes of voting stock of an SFC or, in the case of a tax year of a foreign corporation beginning after December 31, 2017, 10% or more of the total combined voting power or value of shares of all classes of stock of an SFC. See IRC 958(b)(allowing downward attribution and expanding potential SFCs).

# Form 5471 Penalties



- **Initial Penalty** - The initial penalty is \$10,000 per failure to timely file complete and accurate information on each Form 5471. The penalty is assessed for each form (of each foreign corporation) for each year that was not timely filed with complete and accurate information. IRC 6038(b)(1).
- **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The continuation penalty is \$10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. 6038(b)(2).
- **Maximum continuation penalty** for IRC 6038(b) is \$50,000 per required Form 5471

# Form 5471 – Reduction of FTC



- **IRC 6038(c)** provides for a reduction in **foreign tax credit** for a failure to furnish information with respect to a controlled foreign corporation (see IRC 957) or a controlled foreign partnership that is required to be filed under IRC 6038.
- **Limits** The foreign tax credit reduction is limited to the **greater** of \$10,000 or the income of the foreign entity for the applicable accounting period.
- **Coordination With IRC 6038(b).** The amount of the IRC 6038(c) penalty is reduced by the amount of the dollar penalty imposed by IRC 6038(b)

# Form 5471 Reduction of FTC (cont.)



- **Initial Penalties (Foreign Tax Credits):**
  - **IRC 901** - Taxes paid or deemed paid by US person are reduced by 10%. IRC 6038(c)(1)
  - **IRC 902 and IRC 960** - Taxes paid or deemed paid by each of the US person's controlled foreign corporations is reduced by 10%. IRC 6038(c)(2)
- **Continuation Penalties** - If such failure continues for more than 90 days after notice of such failure was mailed to the taxpayer, the reduction is increased by an additional 5% for each 3-month period, or fraction thereof, during which such failure continues
- **Limitation** - The foreign tax credit reduction for each failure to furnish information with respect to a foreign entity may not exceed greater of \$10,000, or income of the foreign entity for its annual accounting period

# Form 5471 Penalties - Defenses



- **Initial Penalties** - To show that **reasonable cause** exists, the person required to report such information must be in compliance with all open reporting years (not on extension) and must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement under the penalties of perjury. IRC 6038(c)(4)(B), Treas. Reg. 1.6038-2(k)(3)
- **Continuation Penalty** - no reasonable cause exception
- **Substantial Compliance Doctrine** – Treas. Reg. 1.6038-2(k)(3)(ii)

# Foreign Partnerships – Form 8865

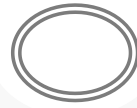


Authority: IRC 6038; Treas. Regs 1.6038-1,3; and also IRC 6046A

Who must file:

1. A U.S. person who controlled the foreign partnership at any time during the partnership's tax year.
2. A U.S. person who at any time during the tax year of the foreign partnership owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons each owning at least a 10% interest, or the value of the property contributed (when added to the value of any other property contributed to the partnership by such person, or any related person, during the 12-month period ending on the date of transfer) exceeds \$100,000.
3. A U.S. transferor who (i) contributes section 721(c) property to a section 721(c) partnership, and (ii) has reporting requirements pursuant to Temporary Regulations 1.721(c)-6T(b) (2).
4. A U.S. person that had a reportable event under section 6046A reportable events under section 6046A: (acquisitions, dispositions, and changes in proportional interests).

# Form 8865 Penalty



- **Initial Penalty** - The initial penalty is \$10,000 per failure to timely file complete and accurate information on each Form 8865. The penalty is assessed for each form (of each foreign partnership) for each year that was not timely filed with complete and accurate information. IRC 6679(a)(1), 6038(b)(1)
- **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The continuation penalty is \$10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. IRC 6679(a)(2), 6038(b)(2)
- **Maximum continuation penalty** for IRC 6038(b) is \$50,000 per required Form 8865

# Form 8865 – Penalty for Failure to Report Contribution to Foreign Partnership



- **Schedule O, Transfer of Property to a Foreign Partnership (IRC 6038B)**
- Failure to file the Form 8865 - With respect to transfers of property to a foreign partnership, the US person must recognize gain on the property. Treas. Reg. 1.6038B-2(h)
- US person must pay a penalty equal to 10% of the fair market value of the property on the date of transfer, not to exceed \$100,000, unless the failure was due to intentional disregard. Treas. Reg. 1.6038B-1(f), 1.6038B-2(h)



# Form 8865 – Reduction of FTC



- **IRC 6038(c)** provides for a reduction in **foreign tax credit** for a failure to furnish information with respect to a controlled foreign corporation (see IRC 957) or a controlled foreign partnership that is required to be filed under IRC 6038.
- **Limitation.** The foreign tax credit reduction is limited to the **greater** of \$10,000 or the income of the foreign entity for the applicable accounting period.
- **Coordination With IRC 6038(b).** The amount of the IRC 6038(c) penalty is reduced by the amount of the dollar penalty imposed by IRC 6038(b)

# Form 8865 - Penalties



- **Initial Penalties:**
  - **IRC 901** - Taxes paid or deemed paid by US person is reduced by 10%
  - **IRC 902 and IRC 960** - Taxes paid or deemed paid by each of the US person's controlled foreign corporations is reduced by 10%
- **Continuation Penalties** - If such failure continues for more than 90 days after notice of such failure was mailed to the taxpayer, the reduction is increased by an additional 5% for each 3-month period, or fraction thereof, during which such failure continues
- **Limitation** - The amount of the foreign tax credit reduction for each failure to furnish information with respect to a foreign entity may not exceed the greater of \$10,000, or the income of the foreign entity for its annual accounting period

# Form 8865 Penalties - Defenses



- IRC 6038B(c)(2) provides that no penalty shall apply to any failure if the U.S. person shows such failure is due to **reasonable cause** and not to willful neglect
- No **reasonable cause** should be considered until the taxpayer has filed all open years (not on extension)
- **Initial Penalties** - To show that **reasonable cause** exists, the person required to report such information must be in compliance with all open reporting years and must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement under the penalties of perjury. See Treas. Reg. 1.6038-3(k)(4).
- **Continuation Penalty** - no reasonable cause exception
- **Substantial Compliance Doctrine**
- **Best efforts protective filings** - *Beard v. Commissioner*, disclosing the information within the Taxpayer's possession and control with explanation for omissions

# Foreign Disregarded Entities & Branches – Form 8858



Authority: IRC 6038; Treas. Regs 1.6038-1,3

Who must file:

1. A U.S. person that is a tax owner of an FDE or operates an FB at any time during the U.S. person's tax year or annual accounting period.
2. A U.S. person that directly (or indirectly through a tier of FDEs or partnerships) is a tax owner of an FDE or operates an FB.
3. Certain U.S. persons that are required to file Form 5471 with respect to a controlled foreign corporation (CFC) or file Form 8865 with respect to a controlled foreign partnership (CFP), where such CFC or CFP is a tax owner of an FDE or operates an FB at any time during the CFC's/CFP's annual accounting period.
4. A U.S. partnership that directly (or indirectly through a tier of FDEs or partnerships) is a tax owner of an FDE or operates an FB.
5. A U.S. corporation that is a partner in a U.S. partnership, which is required to file a Form 8858 because the U.S. partnership is the tax owner of an FDE or an FB.

# Form 8858 Penalty



- **Initial Penalty** - The initial penalty is \$10,000 per failure to timely file complete and accurate information on each Form 8858. The penalty is assessed for each form (of each FDE) for each year that was not timely filed with complete and accurate information. IRC 6038(b)(1)
- **Continuation Penalty** - If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer (90-day period), additional penalties will apply. The continuation penalty is \$10,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period. IRC 6038(b)(2)
- **Maximum continuation penalty** for IRC 6038(b) is \$50,000 per required Form 8858

# Form 8858 – Reduction of FTC



- **IRC 6038(c)** provides for a 10% reduction in **foreign tax credit** for a failure to furnish information with respect to an FDE/FB that is required to be filed under IRC 6038.
- **Additional Reduction.** The foreign tax credit reduction is increased 5% for each three-month period (or fraction thereof) following the 90-day period after the date the IRS mails notice of the failure to the U.S. person.
- **Coordination With IRC 6038(b).** The amount of the IRC 6038(c) penalty is reduced by the amount of the dollar penalty imposed by IRC 6038(b)

# Form 8858 Penalties - Defenses



- IRC 6038B(c)(2) provides that no penalty shall apply to any failure if the U.S. person shows such failure is due to **reasonable cause** and not to willful neglect
- No **reasonable cause** should be considered until the taxpayer has filed all open years (not on extension)
- **Initial Penalties** - To show that **reasonable cause** exists, the person required to report such information must be in compliance with all open reporting years and must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement under the penalties of perjury. See Treas. Reg. 1.6038-3(k)(4).
- **Continuation Penalty** - no reasonable cause exception
- **Substantial Compliance Doctrine**
- **Best efforts protective filings** - *Beard v. Commissioner*, disclosing the information within the Taxpayer's possession and control with explanation for omissions

# Form 5472 - 25% Foreign-Owned U.S. Corporation/ Foreign-Owned U.S. DE or a Foreign Corporation Engaged in a U.S. Trade or Business

- Authority: IRC 6038A

- Who must file:

- ✦ *Reporting corporation* if it had a *reportable transaction* with a foreign or domestic related party.

- ✦ *Reporting corporation:*

- 25% foreign-owned U.S. corporation or foreign-owned U.S. disregarded entity; or

- Foreign corporation engaged in a trade or business within the U.S.

- ✦ *Reportable transaction:*

- Comprehensive but not all-inclusive list of transactions



# Form 5472 - Penalties



- **Authority: IRC 6038A(d)**
  - Penalty applies to both:
    - ✦ Failure to furnish a substantially complete form; and
    - ✦ Failure to maintain records.
  - Penalty amount:
    - ✦ **Initial Penalty:** \$25,000;
    - ✦ **Continuation Penalty:** \$25,000 for each 30-day period or fraction thereof that non-compliance continues following the 90-day period after notification of the failure by the IRS.
      - **Note:** No stated dollar limit on the continuation penalty.
  - Penalty Relief:
    - ✦ Reasonable cause and other unique penalty relief provisions available.

# Form 926 – Transfer of Property to Foreign Corporation



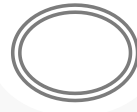
Authority: IRC 6038B; Treas. Regs 1.6038B-1,3

Who must file:

1. A U.S. person must Form 926 to report certain transfers of property to a foreign corporation that are described in sections 6038B(a)(1) (A), 367(d), and 367(e). See section 6038B and Regulations sections 1.6038B-1 and 1.6038B-1T for more information.
  - A. Transfers of cash. A U.S. person that transfers cash to a foreign corporation must report the transfer on Form 926 if
    1. immediately after the transfer, the person holds, directly or indirectly, at least 10% of the total voting power or the total value of the foreign corporation; or
    2. the amount of cash transferred by the person to the foreign corporation during the 12-month period ending on the date of the transfer is more than \$100,000.
  - B. Transfers of stock or securities for which a gain recognition agreement (GRA) is filed.

A U.S. transferor must file a Form 926 with respect to a transfer of stock or securities in all cases in which a GRA is filed under Regulations section 1.367(a)-8

# Form 926 – Penalty and Defenses



- US person must pay a penalty equal to **10% of the fair market value of the property on the date of transfer**, not to exceed \$100,000, unless the failure was due to intentional disregard. IRC 6038B(c)(1), Treas. Reg. 1.6038B-1(f), 1.6038B-2(h)
- IRC 6038B(c)(2) provides that no penalty shall apply to any failure if the U.S. person shows such failure is due to **reasonable cause and not to willful neglect**
- No **reasonable cause** should be considered until the taxpayer has filed all open years (not on extension)
- **Substantial Compliance Doctrine**

# Form 3520-A - Annual Report of Foreign Trust with US Owner



Authority: IRC 6048

Who must file:

1. A foreign trust with a U.S. owner
2. Each U.S. person treated as an owner of any portion of a foreign trust under the grantor trust rules (sections 671 through 679) 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.
3. Note: Exceptions for certain Canadian tax-advantaged accounts

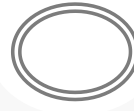
Under IRC 7701(a)(30)(E), a trust is a U.S. person if:

- (i) a **court** within the U. S. is able to exercise primary supervision over the administration of the trust, **and**
- (ii) one or more U. S. persons have the authority to **control** all substantial decisions of the trust.

3520-A Filing:

Internal Revenue Service Center, P.O. Box 409101, Ogden, UT 84409  
15th day of the **3rd month** after the end of the trust's tax year, e.g., 3/1 rather than 4/15.

# Form 3520-A – When Incomplete



- US owner or beneficiary is not timely provided with the required statements.
- Foreign trust without a US agent does not provide all required attachments, e.g., summary of the terms of the trust, copies of trust documents or amendments to trust documents, and other required information. See IRM 20.1.9.14.1(7)
- US agent does not provide information with respect to the trust after request in writing as required by the US agent agreement. Reasonable cause does not apply to the penalty for failure to provide information when requested.
- Form 3520-A does not contain substantially all required information on the return, e.g., amount of contributions and distributions, amount deemed as owned by each US person, balance sheet and income statement information

# Form 3520-A - Penalties



- **Initial Penalty** - Greater of \$10,000 or 5% of gross reportable amount at close of year treated as owned by US person. IRC 6677(b) (penalty), (c) (gross reportable amount)
  - Penalty applies only to extent transaction is not reported or reported inaccurately
  - If return is not filed and IRS assesses a penalty based on available information, adjustments can be made if additional information is received.
- **Continuation Penalty**—If any failure continues more than 90 days after the day on which the notice of such failure was mailed to the taxpayer, additional penalties will apply. The continuation penalty is \$10,000 for each 30-day period (or fraction thereof).
- The **maximum penalty** (both initial penalty and continuation penalty) for failure to file Form 3520-A is the gross value of the portion of the trust owned by the US person.
- **Income Inclusion** – failure to turn over records results in distribution treated as accumulated distribution includible in gross income of distributee (IRC 6048(c)(2)(A))

# Form 3520-A – Defenses to Penalty



- IRM: No **reasonable cause** should be considered until Taxpayer files complete and accurate information required for all open years
- IRC 6677(d) provides **specific exceptions to reasonable cause**, Notice 97-34 provides:
  - US owner is responsible for ensuring Form 3520-A is timely and accurately filed. Failure of trustee or agent to do so or provide information is not reasonable cause
  - No reasonable cause merely because a foreign country would impose a civil or criminal penalty for disclosing required information
  - Refusal by foreign trustee to provide information for any reason, including difficulty in producing required information or provisions in trust instrument that prevent disclosure of required information, is not reasonable cause

# Form 3520 – Transactions with Foreign Trusts and Receipt of Large Foreign Gifts

Authority: IRC 6048; Notice 97-34, Treas. Reg 1.679-1 through -7 and 1.684-1 through -5

Who must file:

1. A responsible party for reporting a reportable event:
  - a. The creation of a foreign trust by a U.S. person;
  - b. The transfer of any money or property, directly or indirectly, to a foreign trust by a U.S. person, including a transfer by reason of death.
  - c. The death of a citizen or resident of the U.S. if decedent was treated as the owner of any portion of a foreign trust, or any portion of a foreign trust was included in the gross estate.
2. A U.S. person who transferred property (including cash) to related foreign trust in exchange for an obligation;
3. A U.S. person who is treated as the owner of any part of the assets of a foreign trust. (IRC 671 - 679);
4. A U.S. person who received (directly or indirectly) a distribution from a foreign trust, or a foreign trust made a loan of cash or marketable securities or uncompensated use of trust property;
5. Receipt of gifts: U.S. person who, during the current tax year, received either:
  - a. More than \$100,000 from a nonresident alien individual (NRA) or a foreign estate that you treated as gifts or bequests (must aggregate gifts from related NRAs & foreign estates); or
  - b. More than \$16,076 from foreign corporations or foreign partnerships.



# Form 3520 – Penalties re: Transactions with Trusts



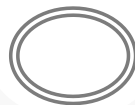
- **Initial Penalty** - The greater of \$10,000 or the following:
  - 35% of gross reportable amount of any property transferred to a foreign trust for failure by a US transferor to report the creation of, or transfer to, a foreign trust;
  - 35% of gross reportable amount of the distributions received from a foreign trust for failure by a US person to report receipt of the distribution; or
  - 5% of gross reportable amount of the portion of the trust's assets treated as owned by a US person for failure to report the US owner information (this penalty is imposed under IRC 6677(b) and is discussed further in IRM 20.1.9.14) (Form 3520-A).
- **Continuation Penalty**—If any failure continues more than 90 days after notice, additional penalties will apply. The continuation penalty is \$10,000 for each 30-day period (or fraction thereof).
- Maximum penalty for failure to file Form 3520 is the gross reportable amount each year
- **Gross Reportable Amount**: Transfer of any money or property (directly or indirectly) to a foreign trust by a US person, or aggregate amount of distributions received from such trust during such taxable year. IRC 6677(c)

# Form 3520 – Penalty re: Failure to Report Foreign Gifts



- IRC 6039F imposes a penalty of 5% per month of the amount that should have been reported, up to a maximum of 25%
- Penalty does not apply if **reasonable cause and not willful neglect**

# Reasonable Cause – IRM Provisions



Reasonable cause is based on all the facts and circumstances in each situation and allows the IRS to provide relief from a penalty that would otherwise be assessed. Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care and prudence in determining their tax obligations but nevertheless is unable to comply with those obligations.

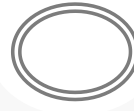
\* \* \*

Taxpayers have reasonable cause when their conduct justifies the non-assertion or abatement of a penalty. Each case must be judged individually based on the facts and circumstances at hand. Consider the following in conjunction with specific criteria identified in the remainder of this subsection:

- What happened and when did it happen?
- During the period of time the taxpayer was non-compliant, what facts and circumstances prevented the taxpayer from filing a return, paying a tax, and/or otherwise complying with the law?
- How did the facts and circumstances result in the taxpayer not complying?
- How did the taxpayer handle the remainder of their affairs during this time?
- Once the facts and circumstances changed, what attempt did the taxpayer make to comply?

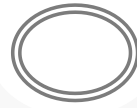
I.R.M. 20.1.1.3.2(1) and (5).

# Reasonable Cause – I.R.M. (Cont.)



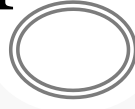
- Ignorance of the law, in and of itself, does not constitute reasonable cause. I.R.M. 20.1.1.3.2.2.6(1). However, reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances. I.R.M. 20.1.1.3.2.2.6(2).
- Some factors to be considered in this regard include the following: the taxpayer's education, if the taxpayer has been previously subject to the tax, if the taxpayer has been penalized before, if there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know, and the **level of complexity** of a tax or compliance issue. *Id.*
- The taxpayer may have reasonable cause for non-compliance due to ignorance of the law if either (1) a reasonable, good-faith effort was made to comply with the law, or (2) the taxpayer was unaware of a requirement and could not be reasonably be expected to know of the requirement. I.R.M. 20.1.1.3.2.2.6(4).
- In evaluating reasonable cause, also important are the taxpayer's compliance history, especially the preceding three years (I.R.M. 20.1.1.3.2.2(2)(b)), as well as the length of time between the non-compliance and the subsequent compliance. I.R.M. 20.1.1.3.2.2(2)(c).

# Increased Accuracy Penalty re: Undisclosed Foreign Income



- **Accuracy-related penalty of 40%** of the understatement of tax due to “any undisclosed foreign financial asset understatement.” I.R.C. 6662(b)(7),(j)(3)
- “Undisclosed foreign financial understatement” is “for any taxable year, the portion of the understatement for such taxable year which is attributable to any transaction involving an undisclosed foreign financial asset,” which includes reportable interests required to be reported on Forms 8938, 3520, and 3520-A and other foreign information returns.
- Taxpayers can avoid this penalty by showing that they acted with reasonable cause and in good faith.
- Accuracy-related penalties are subject to deficiency procedures. IRM 20.1.5.13(2) (12-13-2016).

# Extended Statute of Limitations re Foreign Income/Asset Reporting



- Congress gave the IRS more time to deal with foreign-asset related omissions
- **IRC 6501(c)(8)** extends the statute for assessment on the related income tax return regarding items related to the information required to be reported until 3 years after the information required by IRC 6038, 6038A, 6038B, 6038D, 6046, 6046A, and 6048 is furnished to the IRS.
- The 2010 HIRE Act amendments to IRC 6501(c)(8) expanded the statute of limitations to the entire return, not just those items associated with the failure to file, unless Taxpayer can show reasonable cause. In the case of a taxpayer who demonstrates reasonable cause, only those items related to the failure to file will be subject to the longer period under IRC 6501(c)(8).
- Also, if a taxpayer omits more than \$5,000 of income *attributable* to an asset that is reportable on Form 8938, such omission is a “substantial omission” and the six-year statute of limitations applies, even if the asset was reported on the Form 8938. IRC 6501(e)(1)(A)(ii)(II).

# IRS Compliance Efforts – LB&I Campaigns



- LB&I campaigns primarily feature issue-based examinations, but sometimes also employ other compliance processes, including so-called “soft letters.”
- To date, LB&I has initiated approximately 50 campaigns, about half of which involve foreign issues. On October 30, 2018, which identified 5 additional campaigns; 3 of which involve foreign issues:
  - Offshore Service Providers
  - FATCA Filing Accuracy
  - 1120F Delinquent Returns

# PRIOR LB&I CAMPAIGNS WITH FOREIGN ISSUES – INDIVIDUAL

Campaign	Description/Subject Matter	Treatment stream(s)
<b>Individual foreign tax credit (Form 1116)</b>	Individuals who incorrectly compute the foreign tax credit limitation on Form 1116.	Variety, including exams
<b>Foreign earned income exclusion campaign</b>	Individuals who did not meet the requirements to qualify for the foreign earned income exclusion and/or the foreign housing exclusion or deduction.	Variety, including exams
<b>Individual FTC – Phase II</b>	Same as above	Variety, including exams
<b>Verification of Form 1042-S credit claimed on Form 1040NR</b>	Before a refund is issued or credit is allowed, verify the withholding credits reported on the Form 1042-S.	Variety, including exams
<b>NRA – Schedule A and other deductions</b>	Some NRA misunderstand the rules governing Schedule A deductions and/or fail to maintain records to substantiate expenses.	<ol style="list-style-type: none"> <li>1. Outreach and education</li> <li>2. Traditional exams</li> </ol>
<b>NRA Tax Treaty Exemptions</b>	Focus on compliance by NRAs with treaty exemption claims re: ECI and FDAPI	<ol style="list-style-type: none"> <li>1. Outreach and education</li> <li>2. Traditional exams</li> </ol>
<b>NRA Tax Credits</b>	NRAs erroneously claim dependent credits and education credits by improperly filing Form 1040, rather than Form 1040NR	<ol style="list-style-type: none"> <li>1. Outreach and education</li> <li>2. Traditional exams</li> </ol>



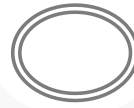
# Prior LB&I Campaigns with Foreign Issues - Corporate

Campaign	Description/Subject Matter	Treatment stream(s)
<b>Repatriation (mid-market)</b>	Strategies resulting in tax-free repatriation – mid-market	<ol style="list-style-type: none"> <li>1. Improved issue selection</li> <li>2. Issue-based exams</li> </ol>
<b>Inbound Foreign Distributors</b>	Inbound transfer pricing – too little being paid to US distributors, not commensurate with functions performed and risks assumed	Issue-based exams supported by comprehensive training strategy
<b>Form 1120-F Chapter 3 and Chapter 4 withholding campaign</b>	Verify withholding at source for Forms 1120-F that claim refunds before the claim for refund or credit is allowed	Variety, including exams
<b>Corporate direct foreign tax credit (FTC) – Section 901</b>	Domestic corporate taxpayers that in an excess limitation position re: FTC	Issue-based exams
<b>Section 956 avoidance</b>	A CFC makes a loan to US parent, but does not include a section 956 amount in income.	Issue-based exams
<b>Section 965 Transition Tax</b>	One time tax with respect to cumulative CFC E&P as of end of 2017	Outreach to raise awareness
<b>Form 1042 / 1042-S Compliance</b>	Withholding agents who did not meet all of their compliance duties	Variety, including exams
<b>Repatriation via Foreign Triangular Reorgs</b>	Notice 2016-73 concerning “tax-free” repatriation of basis and untaxed CFC earnings following certain reorgs	<ol style="list-style-type: none"> <li>1. Assist examiners how to identify</li> <li>2. Issue-based exams</li> </ol>

# Prior LB&I Campaigns – OVDP Related

Campaign	Description/Subject Matter	Treatment stream(s)
<b>OVDP Declines- Withdrawals</b>	Denied or withdrawn - qualified applicants should reapply	<ol style="list-style-type: none"> <li>1. Soft Letters (Letter 4935) giving streamline and other options, requesting filing of Form 15023 in response</li> <li>2. Issue-based exams</li> </ol>
<b>Swiss bank program campaign</b>	Using information obtained in the US Department of Justice Swiss Bank Program, the IRS will verify compliance by identified US persons with reporting of beneficial ownership of foreign financial accounts.	Variety, including exams
<b>Forms 3520 / 3520-A</b>	IRS wants to improve compliance with respect to timely and accurate filing of these returns related to ownership of and transactions with foreign trusts.	Examinations and penalties assessed by the campus when forms are late or incomplete

# LB&I – 2018 Foreign Campaigns



Campaign	Description	Treatment stream
<b>Form 1120-F Delinquency and Waiver</b>	Encourage foreign entities to timely file Forms 1120-F and address compliance risk for delinquent Forms 1120-F.	<ol style="list-style-type: none"><li>1. Soft Letter (Letter 5958)</li><li>2. Examinations</li></ol>
<b>FATCA Accuracy Initiative</b>	Focus on FFIs and NFFEs who do not meet FATCA filing obligations.	Variety, including “termination of the FATCA status.”
<b>Offshore Service Providers</b>	TPs who engaged offshore service providers to create entities and tiered structure to conceal beneficial ownership of accounts and assets for purposes of tax evasion	Issue-based examinations

# Offshore Service Providers (OSP) Campaign



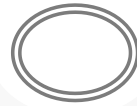
“The focus of this campaign is to address U.S. taxpayers who engaged Offshore Service Providers that facilitated the creation of foreign entities and tiered structures to conceal the beneficial ownership of foreign financial accounts and assets, generally, for the purpose of tax avoidance or evasion. The treatment stream for this campaign will be issue-based examinations.”

# OSP – Sources of Information: Insiders, Whistleblowers, the Press



- In 2008, the German government paid \$6 million to a LGT Bank employee for a computer disk with 1,400 depositor names, leading to investigations in Germany, UK, Canada, Spain, and the U.S.
- International Consortium of Investigative Journalists (ICIJ)
  - Panama Papers (Mossack Fonseca law firm – 11.5 million docs) 2016;
  - Paradise papers (Appleby law firm in Bermuda, Asiaciti trust service co.) in 2017 and 2018;
  - Offshore Leaks (122,000 offshore companies, 12,000 intermediaries), primarily in BVI, Cook Islands, and Singapore; entities incorporated through Portcullis and Commonwealth Trust Limited (2013);
  - Bahamas Leaks (1.3 million files, 38 GB, 175,000 companies) from corporate registry of the Bahamas in 2016;
  - Lux Leaks (complicated structures mostly for multi-nationals).

# OSP – Example of IRS Use of Leaked Data



- In *LaRue v. U.S.*, No. 3:15-cv-00705, (D. Or. Dec. 22, 2015), the IRS issued a Formal Document Request (FDR) to the LaRues. The IRS sought documents related to foreign trusts, entities, and accounts potentially related to the federal income tax liabilities of Petitioners for 1997 through 2009 and 2011 through 2013.
- The IRS claimed “that the petitioners used Portcullis Trustnet Group to facilitate a scheme where the petitioners set up offshore trusts to improperly avoid U.S. income tax.”
- Portcullis Trustnet Group is one of the offshore service providers identified in the ICIJ database, and LaRue could be linked to a Cook Islands trust via publicly available documents on the ICIJ website.
- The LaRues filed a petition to quash the FDR and the IRS filed a motion to deny the petition to quash.
- On December 22, 2015, the court granted the IRS’s motion to deny the petition to quash the FDR

# OSP – Sources of Information: Treaties, TIEA & International Cooperation



- Treaty Requests or Tax Information Exchange Agreements (TIEA)
  - The U.S. has issued John Doe summonses on behalf of some Treaty partners (Norway, the Netherlands), and some partners may be in a position to reciprocate.
- In June of 2018, the U.S., U.K., Canada, Australia, and the Netherlands formed new “Joint Chiefs of Global Tax Enforcement.” (J5)
  - Focus includes enablers as well as cypto-/cyber-crime
- On the criminal side of the IRS, the new (2017) National Coordinated Investigations Unit (NCIU) has proven successful, and one of its focuses is international tax enforcement

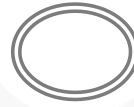
# OSP – Sources of Information – Exchange of Information (TIGTA Report)



- TIGTA Report dated September 11, 2017, Ref. No. 2017-30-077
- Goals of EOI Program:
  - Carry out effective Exchange of Information in a timely manner in accord with Treaties and other international instruments;
  - Assist examiners and investigators in securing tax info from other countries;
  - Follow disclosure laws re: taxpayer info;
- EOI Program does not publish business results due to restrictions under section 6105.
- TIGTA looked at:
  - Automatic Exchange of Information (AEOI) Program – regular and systemic;
  - Mutual Collection Assistance Request (MCAR) Program – U.S. and other countries collecting each other's taxes;
  - Spontaneous Exchange of Information Program.



# OSPs – Potential Sources of Information: Automatic Exchange of Information (TIGTA)



- Generally FDAPI-type info (interest, dividends, etc.)
- TIGTA analyzed receipt of AEOI data – 2011 to 2015
- Received data from 28 countries (OECD members):
  - 7 of the 28 sent data every year;
  - 6 of the 28 sent data for four years;
  - 8 of the 28 sent data for three years;
  - 4 of the 28 sent data for two years; and
  - 3 of the 28 sent data for just one year.
- IRS Spent \$2.5 million to process and upload data into searchable database, but some records cannot be uploaded/searched.
- In 2012, IRS paused AEOI to update processes IRS employs in evaluating whether exchange partners have appropriate legal framework to safeguard exchanged info.
- U.S. AEOI remained paused until at least 2016.
- Seven treaty partners paused after 2012 or 2013 in light of the reciprocal nature of the obligations.

# OSPs – Potential Source of Information: Issues with AEOI Data (TIGTA)



- **AEOI Data Not Widely Shared**
  - Only a small number of IRS employees have access to data
    - 36 RAs (only one from LB&I GHW Group)
    - 25 ROs (7 from SB/SE International Collection group)
  - TIGTA recommends broader access for groups with high- wealth/international area – change likely coming
- **IRS Fails to Circle Back When Data Fails to Upload**
  - TIGTA identified 5 countries where the IRS failed to upload 80% of the data received (47.5% to 76%)
- **Some data appears to be unfindable despite records indicating that it had been uploaded (309,559 records from 2 countries)**

# OSPs – Potential Source of Information: Spontaneous Exchange of Information (TIGTA)



- Incoming – reviewed by analysts (only one analyst available from September 2015 forward) or CI
- New Criteria in 2016:
  - Most incoming routed to appropriate divisions/functions
  - Exception: LB&I Business Compliance Group – only accepted if potential tax adjustment of \$500,000 or more (or \$200,000 for non-filers)
  - Still working out kinks: 22 of 46 forwarding memos in the January to April 2016 timeframe contained errors about underlying information
  - New protocol for translations (Advance Pricing group for short docs and W&I Multilanguage Office for longer docs)

# OSP – Potential Source of Information: FinCEN’s Targeted GTOs



- FinCEN has issued Geographic Targeting Orders (GTOs) requiring U.S. title companies to identify the natural person(s) behind shell companies used to pay for high-end real estate (without a bank loan) covering several metropolitan areas, updated most recently on November 8, 2019
- What is covered?
  - Residential real property, designed for occupancy of 1-4 families, purchased by privately-held entity without bank loan or other external financing;
  - Any part of purchase price paid by currency, cashier’s check, certified check, traveler’s check, personal or business check, money order, funds transfer, or **virtual currency**.
- Title companies are required to obtain identifying documentation about (1) the person responsible for the purchasing entity; and (2) any beneficial owner(s) having a more than 25% interest in the entity.
- Current coverage – purchase price of more than \$300,000:
  - NY – Manhattan, Brooklyn, Queens, Bronx, Staten Island (NY City)
  - FL – Miami-Dade, Broward, and Palm Beach Counties
  - CA – Los Angeles, San Diego, San Francisco, San Mateo, and Santa Clara counties
  - TX – Bexar (San Antonio), Dallas, and Tarrant (Fort Worth) counties
  - HI – City and County of Honolulu
  - NV – Clark County (Las Vegas)
  - [WA – King County \(Seattle\)](#)
  - IL – Cook County (Chicago)
  - MA – Suffolk and Middlesex Counties (Boston)