FOREIGN ACCOUNT REPORTING AND DISCLOSURE

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Cory is a partner at McLaughlinQuinn and leads the Tax Planning Practice Group. Working with businesses, business owners, and individuals, Cory develops creative tax planning strategies that eliminate, minimize, and defer federal, state, and local income, estate, and gift taxes. Cory advises closely-held businesses and high-net-worth individuals on tax and legal aspects of business and real estate activities. He also counsels clients in developing estate plans which protect them and their loved ones through the use of sophisticated planning techniques. Cory represents these taxpayers (individuals and businesses) before Federal and state taxing authorities in audits, appeals, litigation, and collection actions. Cory is a frequent speaker on tax topics throughout New England.

Prior to becoming a lawyer, Cory worked in the financial services industry and studied business management at Boston College. Cory's professional background gives him unique insight into the economic issues businesses and individuals face every day and flows directly into his ability to provide pertinent tax advice.

Outside of the law he pursues many outdoor activities ranging from snowboarding to surfing.

Representative Matters:

- Tax planning for real estate developers --- converting ordinary income into capital gains
- Sophisticated planning for 1031 Exchanges including drop and swaps, reverse exchanges, improvement exchanges, parking arrangements and Delaware Statutory Trusts
- Partnership and corporate tax planning.
- Represented Massachusetts real estate investment firm in connection with tax planning for the acquisition and development of large residential subdivision.
- Represented international investment bank in divestiture of leveraged partnership assets.
- Represented real estate developer in tax credit financing for mixed-use rehabilitation of historic building.
- Represented alternative energy developer and investor in tax planning for utility scale solar farm.

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I. THE FOREIGN BANK ACCOUNT FIASCO

A. The Problem – Who Knew?

1. U.S. citizens have always had foreign bank accounts, and no one thought much of it – until early 2009, when the United States Treasury and the Internal Revenue Service ("IRS") suddenly began to pursue aggressive enforcement of a series of reporting laws and disclosure requirements that had been on the books for many years (almost 40 years!) but that, until 2009, had been largely ignored by almost everyone – including the IRS.

2. The most prominent and intimidating of the then-existing rules (in 2009) was the obligation to report foreign bank accounts and related financial account assets – all required to be disclosed on the strangely numbered Form TD F 90.22-1, called the "Report of Foreign Bank and Financial Accounts," and referred to universally as the "FBAR". The FBAR rules, which had been on the books since 1970, specified that any U.S. taxpayer with one or more foreign accounts worth in the aggregate over $10,000 at any time in the course of the prior year was required to disclose all such foreign accounts on the FBAR and file it with the U.S. Treasury.

3. The FBAR is nominally filed with the Financial Crimes Enforcement Network ("FinCEN"), a branch of the U.S. Treasury, but since 2003 the IRS has taken over administration of the FBAR filings. Until recently, the FBAR was required to be mailed to a designated FinCEN address in Detroit, Michigan, and was due no later than June 30 (with no extensions) of the following year for each applicable calendar year.

4. The FBAR filing requirements were largely ignored for almost 40 years, until 2009, when FBAR filings suddenly became a prominent and contentious issue. This occurred as an outgrowth of aggressive U.S. governmental investigations focused on U.S. citizens with Swiss bank accounts (and bank accounts in other foreign jurisdictions, but the Swiss were front and center in the scandal). The investigations established that U.S. taxpayers held millions or billions of dollars of unreported financial assets in foreign accounts and that the investment income from such accounts – no big surprise here – was not always being reported on U.S. federal income tax returns.

B. The Proposed Solution – OVDP Program

1. In response to the burgeoning tax scandal involving secret Swiss bank accounts, the IRS in 2009 announced a special quasi-amnesty program for U.S. taxpayers with overseas banks accounts, called the Overseas Voluntary Disclosure Program (herein the "2009 OVDP").

2. <u>NOTE</u>: For reasons all its own, the IRS called this voluntary disclosure program a "Program" in 2009 and 2012, but an "Initiative" in 2011. The more common acronym in popular use appears to be "OVDP" and so that abbreviation will be used, even when it refers to the OVDI. This seems entirely appropriate, given that "FBAR" is an acronym for

"Report on Foreign Bank and Financial Assets."

3. In retrospect, the 2009 OVDP was perhaps the best possible way for the IRS both to publicize the widely ignored obligation to file the FBAR form, and to make it clear that U.S. taxpayers would face serious repercussions for failure to report income earned in foreign bank accounts. Merely announcing the intention to enforce the FBAR rules more vigorously going forward would have been one thing, but announcing an AMNESTY PROGRAM for a heretofore widely ignored filing requirement was truly a great way to catch everyone's attention, particularly the attention of tax preparers and other tax professionals, who immediately had a professional duty to tell their clients about the program and to help clients determine whether and how to participate in the OVDP.

4. The 2009 OVDP was a time-limited offer, and it was a VERY good deal for outright tax cheats (so long as they were not yet known to the IRS). The 2009 OVDP garnered so much publicity that, for the first time, a substantial number of tax preparers and other professional advisers were actually aware of the FBAR filing requirement, and also had a pretty strong incentive to warn clients about the perils of not reporting income from overseas accounts. Due to the perceived success of the initial OVDP, the IRS offered it again as a time- limited program in 2011, and then offered it a third time in 2012, this time as an open-ended program. The 2012 OVDP was then "refreshed" as the 2014 OVDP Program, which continues to be available today. According to the IRS, the 2014 OVDP Program has no set deadline for taxpayers to apply. However, the terms of this program could change at any time. See FAQ #1.

C. A Candid Assessment of the Problem

1. The size and magnitude of the under-reporting problem attributable to overseas accounts is difficult to gauge exactly, but it is perhaps a telling indication that the subsequently enacted FATCA, designed to impose massive U.S. information reporting obligations on virtually every foreign financial institution in the world, estimated that it would generate a relatively paltry $8.7 billion of revenue over the first 10 years, or about $870 million per year. To put this revenue amount into perspective, the United States federal government in 2011 spent about $435 million per hour (24 hours a day, 365 days a year), and therefore the annual increase in tax revenues from this allegedly massive underreporting problem would be enough to pay for a whopping two hours of the U.S. government's annual spending spree.

2. Meanwhile, the compliance costs imposed as a result of the new laws, including but not limited to FATCA, and well as actual enforcement of the FBAR requirements, is also very difficult to quantify, but it has been estimated to be extremely large and possibly gigantic.

3. The dominant theme in this tangled furor over foreign bank account reporting is that U.S. citizens are required to report almost every asset held abroad, both in foreign bank accounts and, increasingly, in investment assets and financial instruments not held in a financial account, or risk penalties that range from draconian to absurd. It is entirely possible that the penalties for FBAR noncompliance are so excessive and disproportionate to the underlying breach of law that the penalties may well be considered unconstitutional by a U.S. court, as a violation of the Eighth Amendment prohibition against unreasonable fines and

penalties.

4. Interestingly, and perhaps tellingly, the U.S. Treasury branch in charge of administering and enforcing the FBAR reporting requirements, which is nominally the FinCEN but since 2003 is actually the IRS, has thus far not been particularly aggressive in auditing, and especially and notably unaggressive in penalizing, U.S. taxpayers for their failure to comply fully with all of the FBAR filing and compliance requirements. (Income tax reporting, as will be discussed below, is a more complicated enforcement story.)

D. What the OVDP Program Tells Us Are the REAL IRS Priorities

1. Starting with the 2009 OVDP Program, the OVDP has offered an omnibus opportunity to compromise (a) past FBAR delinquency (technically a violation of the Banking Secrecy Act under United States Code Title 31 ("Title 31") rather than a violation of the Internal Revenue Code under United States Code Title 26 ("Title 26")) (b) all past under- reporting of federal income and (c) all non-compliance with Title 26 information reporting requirements, all in exchange for one omnibus penalty.

2. As will be discussed more fully below, starting with the very first OVDP Program in 2009, the OVDP has always provided the "Free Pass" or "Get Out of Jail Free Card," which is that if a taxpayer has reported all income from foreign accounts for all prior years, but has merely failed to file FBARs for those years, then the obscenely large FBAR penalties are entirely waived and a taxpayer is permitted to file all delinquent FBARs (by a certain date) without any penalty whatsoever.

3. On the other hand, the OVDP Program has always made it equally clear that if a taxpayer has failed to report income (and this is true EVEN if the failure to report foreign income did not result in an under-reporting of U.S. federal income tax liabilities, e.g., because the foreign taxes paid on the foreign income created a full foreign tax credit against U.S. tax liabilities) the FBAR "Free Pass" was not available, and a taxpayer was not allowed to file delinquent FBARs unless the taxpayer participated in the disclosure process under the OVDP Program (including the alternative of coming forward but "opting out" of OVDP) and accepted the resulting penalties or other audit outcomes.

4. The current OVDP continues to offer the same basic structure described above, namely, that a taxpayer who has reported all foreign income but has failed to file FBARs can go ahead and file the past six years of FBARS (now Form 114, filed electronically with the BSA E- Filing System) without penalty. However, if a taxpayer has failed to report all income from the foreign bank accounts in every year, then the Free Pass is not available and the taxpayer must evaluate the difficult choice between a "quiet disclosure" (heavily frowned upon by the IRS) or participate in either the OVDP Program or the Streamlined Filing Compliance Procedures.

5. In 2014, the IRS began promoting the "Streamlined Filing Compliance Procedures," as a less expensive alternative to the OVDP Program. The Streamlined Procedures are available to taxpayers certifying that their failure to report foreign financial assets and pay all tax due in respect of those assets did not result from *willful conduct* on their

part. The Streamlined Procedures are designed to provide to taxpayers in such situations with

(a) A streamlined procedure for fling amended or delinquent returns, and

(b) Terms for resolving their tax and penalty procedure for filing amended or delinquent returns, and

(c) Terms for resolving their tax and penalty obligations.

E. <u>When and How Best to Use the OVDP Program</u>

1. The early versions of the OVDP Program produced a very difficult set of choices and alternatives for U.S. taxpayers who were out of compliance in filing FBARs and/or income tax reporting for overseas investment income. Sorting out the choices and choosing the right strategy was complicated in 2009, and continues to be complicated today, although the Streamlined Procedures take a significant amount of the pain out of "innocent" non-compliance.

2. Many U.S. taxpayers in 2009 were intimidated by the suddenly aggressive IRS enforcement posture regarding overseas accounts, and elected to participate in the OVDP Program, even though such participation involved agreeing to the assessment of draconian penalties. The problem was that, under the strange and awkward FBAR filing rules, there was no way for a taxpayer to come into compliance retroactively if the taxpayer was not eligible for the Free Pass, and the threatened FBAR penalties were so enormous as to border on confiscatory.

3. Significantly, a report issued in February 2014 by the Taxpayer Advocate Office of the IRS (the "TA Report") severely chastised the OVDP Program, saying that the program has leveled exorbitant penalties on taxpayers who were guilty of, at worst, minor or inadvertent non-compliance, while offering a very good deal to genuine criminals. The TA Report noted that taxpayers who were represented by a tax advisor did much better than those who were not, and, also noted that taxpayers who opted out of the OVDP Penalty scheme and who instead invited an IRS audit, did much better than taxpayers who voluntary participated in the OVDP Program – although these "opt out" taxpayers were still socked with hefty penalties.

4. Other taxpayers, faced with no good alternatives, opted for a "quiet disclosure" approach by filing amended federal income tax returns for open tax years and by filing FBARs, sometimes retroactively but oftentimes only prospectively.

5. The IRS has made stern threats that it will come down harshly on taxpayers who engage in a "quiet disclosure" strategy. However, it is not clear whether the IRS will back up its aggressive rhetoric with actual aggressive enforcement, and, even more pertinently, it is not clear whether the courts will agree with and affirm the often excessive penalties levied by the IRS in connection with FBAR non-compliance.

F. <u>Purpose of this Seminar</u>

1. The purpose of this seminar is to carefully review all the reporting requirements imposed on U.S. taxpayers with respect to foreign bank accounts and to help

people sort out these obligations in a clear, intelligible fashion.

2. The number of U.S. taxpayers who have not yet come into compliance is substantial – it was estimated last year that about 90% of U.S. citizens with foreign bank accounts or reportable assets have not yet come into compliance!! This seminar will offer what will hopefully prove to be useful guidance and suggestions on how best to bring taxpayers into legal compliance with these admittedly burdensome and often unknown reporting rules.

3. As this seminar will address, the most typical situation at the present time involves taxpayers who are not in compliance with foreign bank account reporting rules, not because they are seeking to evade U.S. federal income tax laws but rather because of mistakes, inadvertence, poor advice (or no advice) from tax preparers, and a variety of other relatively minor errors and "foot faults" that are nonetheless capable of triggering, at least in theory, draconian penalty assessments.

4. This seminar will also note that the OVDP Program is actually a pretty good deal for people who did, in fact, try intentionally to evade their income taxes and who now are concerned about getting caught. The OVDP Program does exact rather significant penalties, but these penalties probably look pretty reasonable if the alternative is criminal indictment and a potential criminal conviction with a high likelihood of jail time. The IRS is out to make an example of foreign bank account tax cheats, and people who have knowingly violated the federal tax laws have plenty of reason to consider the OVDP Program as a possible "get-out-of-jail free" card.

5. Finally, thanks to important changes in the Streamline Procedures, it has become possible for taxpayers who are inadvertently out of compliance, and who might be subject to significant penalties if they come into compliance, to participate in the Streamline Program and clean up a messy history at a smaller (but often still significant) penalty cost.

G. <u>Structure of this Outline</u>

1. This Outline will begin by describing in significant detail the history and evolution of the FBAR rules, including the escalation in penalties beginning in 2005, and the peculiar and surprisingly inflexible compliance requirements. These include:

(a) The fact that FBARs were formerly required to be delivered to a unique geographic location (Detroit Michigan until June 30, 2013), and must now be delivered to a unique electronic filing location (the BSA E-Filing System) for all filings after that date,

(b) There is no "mail box" rule for FBARs; and

(c) There is presently no procedure for filing late FBARS that mitigates, in any way, the draconian FBAR penalties authorized by statute, other than the Free Pass or the OVDP/Streamline Programs.

2. The Outline will then discuss the relatively newer (since 2011) Form 8938, adopted as part of the FATCA legislation and required to be filed for tax years beginning in 2011.

There is huge duplication and overlap between FBAR and Form 8938, and this Outline will provide helpful guidance about what assets belong on each form (including the many assets that must be reported on both forms).

3. The Outline will then discuss the various issues arising from or related to U.S. income tax reporting of income from foreign accounts, and the related foreign tax credits that are often available.

4. The Outline will then walk through the litany of informational returns required to be filed with the IRS, IN ADDITION TO REPORTING OF INCOME, including Forms 926, 3520, 5471, 5472, 8865, and so forth.

5. The Outline will then walk through the history of the various OVDP Programs, including 2009 OVDP, the 2011 program ("2011 OVDP"), 2012 program (herein the "2012 OVDP"), and the ongoing, updated version of that program, referred to herein as the 2014 OVDP, that was substantially modified in July 2014 and that continues in place in 2016.

6. The Outline will then examine the Streamlined Program.

7. The Outline will also address, briefly, some of the FATCA issues that are likely to make it very difficult or impossible for U.S. taxpayers to "hide" assets in foreign bank accounts.

8. Finally, this Outline will examine some of the practical issues and practical strategies for addressing a variety of common situations.

II. <u>REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS – FBAR</u>

A. <u>Overview</u>

1. The Report of Foreign Bank and Financial Accounts,[1] known simply as the "FBAR," has been in the law of the land for what seems like an astounding period of time, dating back to 1970. The Bank Secrecy Act, first enacted in 1970, is technically part of Title 31 (Money and Finance) of the United States Code (USC). By contrast, the Internal Revenue Code (IRC) is Title 26 of the USC, and so the FBAR is not part of the IRC and is not even within the enforcement purview of the IRS – it is administered by FinCEN.

2. However, FinCEN delegated its FBAR enforcement authority to the IRS in April 2003. The IRS is now empowered to investigate potential violations, issue summonses, assess and collect civil penalties, issue administrative rulings, and take "any other action reasonably necessary" for the enforcement of the FBAR-related provisions.

3. The ostensive legislative purpose for the Bank Secrecy Act was to require

[1] The FBAR for years was enumerated and denominated as Form TD F 90.22-1. Starting in 2014, it became FinCEN Form 114. The differences between the old and new versions of the form are relatively small and largely cosmetic.

the creation of reports and the retention of financial records that would enable the U.S. government to conduct criminal, tax, and regulatory investigations.

4. A key section of the Bank Secrecy Act, Section 5314(a), provides as follows:

> [T]he Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency.

5. BSA Section 5314 technically imposes two distinct compliance requirements: (1) filing FBARs and (2) keeping and retaining certain records related to foreign accounts.

6. FBARs are described in 31 C.F.R. § 103.24, which mandates the following:

> Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the [IRS] for each year in which such relationship exists, and shall provide such information as shall be specified in a reporting form prescribed by the Secretary to be filed by such persons.

7. Concerning the record retention requirements, the BSA regulations provide considerable and detailed guidance covering exactly who must retain records, what these records must contain, when these records may be discarded, and where the records must be kept. In particular, the pertinent regulation at 31 C.F.R. § 103.32 states as follows:

> Records of accounts required by § 103.24 to be reported to the [IRS] shall be retained by each person having a financial interest in or signature or other authority over any such account. Such records shall contain the name in which each such account is maintained, the number or other designation of such account, the name and address of the foreign bank or other person with whom such account is maintained, the type of such account, and the maximum value of each such account during the reporting period. Such records shall be retained for a period of 5 years and shall be kept at all times available for the inspection as authorized by law.

8. The FBAR instructions indicate that a person must file an FBAR if *all* of the following elements are met:

(a) A "U.S. person,"

(b) Had a "financial interest" in, or "signature authority" over, or "other authority" over

(c) One or more "financial accounts"

(d) Located in a "foreign country,"

(e) The aggregate value of such account(s) exceeded $10,000,

(f) At any time during the calendar year.

As will be discussed below, the defined terms set forth above are not actually found in the law, and are derived almost entirely from the FBAR instructions.

9. The FBAR instructions state that a "U.S. person" means a U.S. citizen (including minor children), U.S. resident, domestic partnership, domestic corporation, domestic limited liability company, other entity formed in the United States, domestic estate, or domestic trust.

10. The process of evaluating whether a "U.S. person" has the requisite relationship with or to a foreign financial account is often confusing and complicated. In fact, ascertaining whether one has a "financial interest" in, "signature authority" over, or "other authority" over an account requires a careful analysis of the FBAR instructions.

11. The definition of "financial account" is likewise confusing and convoluted. According to the FBAR instructions, a financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund (i.e., a fund that is available to the general public with a regular net asset value determination and regular redemptions).

12. A "foreign financial account" is a financial account located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.

13. The term "foreign country" includes all geographical areas, except the United States, and its territories and possessions (e.g., American Samoa, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, Guam, and the United States Virgin Islands), and the Indian lands as defined in the Indian Gaming Regulatory Act.

14. A United States person has a "financial interest" in a foreign financial

account for which:

1. the United States person is the owner of record or holder of legal title, regardless of whether the account is maintained for the benefit of the United States person or for the benefit of another person; or

2. the owner of record or holder of legal title is one of the following:

a. An agent, nominee, attorney, or a person acting in some other capacity on behalf of the United States person with respect to the account;

b. A corporation in which the United States person owns directly or indirectly: (1) more than 50 percent of the total value of shares of stock or (2) more than 50 percent of the voting power of all shares of stock;

c. A partnership in which the United States person owns directly or indirectly: (i) an interest in more than 50 percent of the partnership's profits (e.g., distributive share of partnership income taking into account any special allocation agreement) or (ii) an interest in more than 50 percent of the partnership capital;

d. A trust of which the United States person: (i) is the trust grantor and (ii) has an ownership interest in the trust for United States federal tax purposes. See 26 U.S.C. sections 671-679 to determine if a grantor has an ownership interest in a trust;

e. A trust in which the United States person has a greater than 50 percent present beneficial interest in the assets or income of the trust for the calendar year; or

f. Any other entity in which the United States person owns directly or indirectly more than 50 percent of the voting power, total value of equity interest or assets, or interest in profits.

15. The FBAR Instructions discuss the "aggregate value" of accounts "at any time during the calendar year," and go on to state that this means the "maximum value" of each account at any time during the applicable year. Generally, the "maximum value" of an account is the largest amount of cash and non-monetary assets (*e.g.*, securities) that appear on any periodic account statement. For example, if account statements are issued monthly, this means the highest of the twelve monthly account statements.

16. The FBAR, from the outset, was almost uniquely designed to maximize the likelihood that taxpayers would fall out of compliance:

(a) FBARs were not well known or well publicized until the IRS announced the first OVDP Program in 2009.

(b) FBARs have been due on a strange date when no other IRS tax filing is due, namely, June 30 of each year for the prior calendar year.

(c) FBARs were mailed for years to a strange addressee (FinCEN) at a strange location (a post office box in Detroit, Michigan).

(d) For FBAR filings after July 1, 2013, FBARs must now be delivered to a unique electronic filing location (the BSA E-Filing System) for all filings after that date.

(e) There is no "mailbox rule" for FBARs, which is very unusual for an income tax form.

(f) There is no procedure for requesting an extension.

(g) There is no procedure for filing late FBARs that mitigates, in any way, the draconian FBAR penalties authorized by statute.

17. FBAR violations can result in both criminal and civil penalties. Although criminal penalties scare everyone, as a practical matter it is the exorbitant civil penalties that dominate the FBAR compliance and planning analysis.

B. The 2005 FBAR Penalty Increases

1. Sadly, and even pathetically, Congress was well aware that taxpayers were not filing FBARs during the 1990s and early 2000s periods. Instead of implementing an informational program, similar to the 2009 OVDP, or other practical strategy to encourage citizen compliance, the Congress decided to impose, in late 2004, absurdly large and draconian penalties for failure to file FBARs.

2. Under the law as it stood prior to October 22, 2004, FinCEN (and later the IRS) could impose a civil penalty on any person for "willfully" violating Title 31, Section 5314.103. This category of violation encompassed both a failure to file an FBAR and a failure to prepare and retain the necessary records related to foreign financial accounts. However, the burden was on the government to prove that the taxpayer acted "willfully."

3. Moreover, the penalty regime prior to October 22, 2004 was severe but not absurd. If the violation involved a "transaction," the maximum penalty was $25,000 or the amount of the transaction (not to exceed $100,000), whichever was greater. If the violation involved a "failure to report the existence of an account or any identifying information required to be provided with respect to such account," the maximum penalty was the greater of $25,000 or the account balance at the time of the violation (again, not to exceed $100,000). Therefore the penalties for "willful" violations were generally in the range of $25,000 to $100,000.

4. Unfortunately, following the terrorist attacks on the United States on September 11, 2001, Congress viewed the Bank Secrecy Act as yet another weapon in the war

on terrorism, and, after several years of revisions, discussions, and debates, a new approach was enacted as part of the American Jobs Creation Act of 2004 ("Jobs Act") on October 22, 2004 with huge consequences for the vast majority of U.S. taxpayers who are not terrorists.

5. Under the Jobs Act, the IRS is authorized to assess a civil penalty on any person who violates Title 31, Section 5314 (*i.e.*, conduct that includes both the failure to file an FBAR and the failure to retain the necessary records concerning foreign financial accounts).

6. In the case of *non-willful* violations, the IRS is now authorized to impose a maximum penalty of $10,000. Prior to the Jobs Act, only willful violations were subject to penalty, so the Act dramatically expanded the scope of the penalty to all manner of negligent, inadvertent, and unintentional non-compliance. However, the law provides an exception to the non-willful penalty if two conditions are met:

(a) the violation was due to "reasonable cause," and

(b) the balance in the account is properly reported.

7. The main "stick" contained in the Jobs Act was a much higher maximum penalty in the event of *willful* non-compliance. For a willful violation involving a "transaction," the IRS is now authorized to impose a penalty equal to the greater of $100,000 or fifty percent of the total amount of the transaction. For a failure to report the existence of an account or identifying information required to be provided with respect to an account, the IRS is authorized to impose a penalty equal to the greater of $100,000 or fifty percent of the total balance in the account at the time of the violation.

C. Case Law Interpreting Willful, Non-Willful and Reasonable Cause

1. So far there are a handful of cases that have shed light on the "willfulness" standard, the "non-willfulness" standard, and the "reasonable cause" standard, as applied in the context of FBAR penalties.

2. In U.S. v. Williams,[2] the 4th Circuit Court of Appeals found "willfulness" where the taxpayer did not read his tax return, signed it, and made a guilty plea in parallel criminal proceedings that acknowledged that the taxpayer willfully failed to report the existence of accounts as part of a larger scheme of tax evasion. On remand, the district court upheld the IRS's penalty assessment of $200,000 ($100,000 for each of two accounts—representing the maximum penalty assessment allowed under the pre-2004 rules) as properly determined within the agency's discretionary power. The court evaluated whether the IRS had abused its discretion in assessing a maximum penalty, and also addressed whether the maximum penalty allowed under the statute was unconstitutionally excessive under the Eight Amendment. Note that in Williams there was plenty of evidence of "willfulness," the amount of unreported income was on the magnitude of $7 million, and the maximum penalty was capped under the "old" pre-2004 rule, which set the cap at the greater of $25,000 or 50% of the

[2] 489 F.App'x 655 (4th Cir., 2012)

amount in the undisclosed account, up to a maximum of $100,000.

3. In U.S. v. McBride,[3] a federal district court in Utah stated that willfulness includes both knowing and reckless failure to file FBARs, which the court found existed in that case, based on a long list of factors. The McBride taxpayer had read promotional materials which explained his duty to report; reviewed a memo and newspaper article from an accountant that expressed concern about his financial plans; knew the plan was to reduce tax and was personally concerned about it; had the initial impression that the plan constituted "tax evasion;" did not seek a legal opinion or guidance from independent counsel; did not discuss his plan with either of his two accountants; lied and withheld information from the revenue agent during audit; made contradictory statements on the bench and during discovery; and Schedule B, Form 1040 contained a "plain instruction" regarding disclosure of foreign accounts.

4. In Moore v. United States, decided by a U.S. District Court in Washington, the issue involved the assessment of a maximum $10,000 "non-willful" penalty for each of four calendar years. Starting in 1989, Mr. Moore maintained a foreign account subject to FBAR requirements, but did not file an FBAR until 2010, for the 2009 calendar year. Moore originally opened an account at a Bahamian bank in about 1989 when he moved to The Bahamas. He opened that account in the name of a Bahamian corporation that he created (and solely controlled) for the purpose of investing in a resort in The Bahamas. He soon transferred the balance to an "investment account" with a Bahamian branch of a Swiss bank, again holding the account in the name of his Bahamian corporation. Mr. Moore moved back to the United States in 1990, but the account remained in The Bahamas. In about 2003, when the Swiss bank ceased its Bahamian operations, the account migrated to Switzerland, where it has remained ever since. At all relevant times, the balance in the account exceeded $300,000, but was less than $550,000.

5. The Moore case first addresses whether a federal court has the right to a de novo review of the penalty assessment, or whether its review is limited to determining whether the IRS penalty assessment was an abuse of discretion. The court more or less ducked answering that question, stating as follows:

> "No binding case law provides standards for judicial review of FBAR civil penalty assessments. The Government's proposal is as follows: the court should determine de novo whether Mr. Moore is subject to an FBAR penalty, but should review the IRS's determination of the amount of that penalty only for abuse of discretion. The court will adopt the first part of that proposal. It does so only because Mr. Moore has not objected to de novo review and because no standard of review is more favorable to him. The court therefore declines to decide whether a court must conduct de novo review of the IRS's assessment of a civil FBAR penalty."

6. The specific issue in Moore was whether there was a non-willful violation, or whether Moore's failure to file FBARs was excused based on reasonable cause. The Court noted that "reasonable cause" is nowhere defined in the Bank Secrecy Act or in

[3] 908 F.Supp. 2d 1186 (D. Utah (Cent. Div.) 2012)

regulations interpreting it. That phrase, however, appears repeatedly in statutes governing the IRS's tax assessment role. The court stated:

> "There is no reason to think that Congress intended the meaning of "reasonable cause" in the Bank Secrecy Act to differ from the meaning ascribed to it in tax statutes. As with the tax statutes, Congress entrusted enforcement of the Bank Secrecy Act to the Treasury Department. If it intended Treasury to interpret "reasonable cause" differently in the newer statute, it left no clues to which any party has pointed. The court thus takes guidance from tax statutes and authority interpreting them, and concludes that a person has "reasonable cause" for an FBAR violation *when he committed that violation despite an exercise of ordinary business care and prudence*." [Emphasis supplied]

7. The Court examined in detail Moore's conduct during the periods from 1989 to 2010, and found that he did not exercise the requisite care and prudence, stating as follows:

> "Mr. Moore did not, as a matter of law, have reasonable cause for his failure to file FBARs prior to 2009. Clinging to advice given in 1989 or 1990 that he admits had nothing to do with United States law is not an exercise of ordinary business care or prudence. Even if that were not the case, however, no fact finder could conclude that ignoring the question on Schedule B of his 2003 tax return was an exercise of ordinary business care or prudence. Again, that question asked if he had "signature or other authority over a financial account in a foreign country . . ." That phrase is not difficult to understand. As a matter of law, it placed Mr. Moore at least on notice that he should inquire further as to whether his corporation's foreign account was subject to disclosure. His decision to avoid further inquiry is not an exercise of ordinary business care or prudence."

8. Having decided that Mr. Moore was subject to an FBAR penalty, the Court then addressed his challenge to the IRS's method of assessing the penalty and his challenge to the amount of that penalty. Again, the court determined that there was no binding case law on the standard that applies to judicial review of either issue in the context of FBAR penalties. The IRS asserted that the court review the amount of the penalty only for abuse of discretion. The Court determined that the Administrative Procedures Act (APA) provided a comprehensive guide to the court's review of the IRS's penalty assessments.

9. The Court did an extended analysis of the APA and the procedures that were – or were not – observed by the IRS, and basically required the IRS to provide a basis for its decision to assess the maximum $10,000 penalty for each of the four years in question. In a subsequent decision, the court upheld the assessment of a $40,000 penalty, but barred the IRS from assessing interest or penalties, and required the IRS to treat the date of assessment as the date of the court's decision.

10. Finally, the court addressed the Eighth Amendment argument that the FBAR penalties were "excessive" and violated Constitutional requirements. The court found the fines in question to be within Constitutional limits, but the discussion is quite interesting, and

so the entire discussion is reproduced below, as follows:

> "Finally, the court considers Mr. Moore's contention that the $40,000 penalty violates the Excessive Fines Clause of the Eighth Amendment. The court assumes without deciding that civil FBAR penalties are "fines" within the meaning of the Eighth Amendment, *i.e.* "punishment for an offense." *United States v. Bajakajian*, 524 U.S. 321, 328 (1998). Even under that assumption, the penalties are invalid only if they are "grossly disproportional to the gravity of the defendant's offense." *Id.* at 337. Although no rigid inquiry governs the court's proportionality inquiry, it should consider the "severity of the offense, the statutory maximum penalty available, and the harm caused by the offense." *Horne v. Dep't of Agriculture*, 673 F.3d 1071, 1081 (9th Cir. 2011), *rev'd on other grounds at* 133 S.Ct. 2053 (2013); *see also United States v. Mackby*, 339 F.3d 1013, 1016-19 (9th Cir. 2003).
>
> Mr. Moore falls well short of convincing the court that his FBAR penalties are disproportionate to his offense. He failed to report an account worth between $300,000 and $550,000. A small penalty is unlikely to serve as much deterrent for a person holding an account of that size. In *Bajakajian*, the defendant forfeited the entirety of about $350,000 in currency because he failed to report it before transporting it out of the country. *Id.* at 324-25. The Court found that to be an excessive fine. *Id.* at 337. The court has no reason to believe it would have reached the same conclusion as to a fine nearly an order of magnitude smaller. *Mr. Moore would forfeit about 10% of the value of his account for failing to report it. That does not strike the court as disproportional, much less grossly disproportional.* Admittedly, the Government has wholly failed to point out the harm that Mr. Moore's failure to report caused, and has given the court no basis to compare the severity of Mr. Moore's offense to similar violations. Nonetheless, Congress authorized both the FBAR reporting mandate and penalties of up to $10,000 without regard to the size of the unreported account. The court concludes that the Government's interest in enforcing its laws is at least roughly proportional to the penalty it imposed here. *See Mackby*, 339 F.3d at 1019 (noting the government's cost of enforcing the law against the person as justification for a fine). The court has no basis to conclude that Mr. Moore's $40,000 penalty is grossly disproportionate.
>
> 11. NOTE: In a footnote, the court also commented as follows:
>
> "Mr. Moore points out that his liability for the unpaid taxes on the account, even including penalties, was smaller than his FBAR penalty. That is beside the point. FBAR is not a tax requirement, it is a requirement that allows the Government to track accounts held abroad. Nothing prevents Congress or the IRS from choosing to penalize that reporting offense more harshly than underpayment of taxes."

D. <u>Constitutional Challenges to FBAR Penalties – the Zwerner Case</u>

1. The dramatic increase in the FBAR penalties adopted by Congress in late

2004 took effect for the FBARs due on June 30, 2005 for calendar year 2004. However, as noted above, the IRS did not do a good job of publicizing this change in the law – or of publicizing the filing obligation in general[4] – and therefore wide-spread non-compliance continued until 2009, when the first OVDP Program brought the filing obligation to the attention of tax preparers and therefore their clients. By that time, a huge swath of American taxpayers was already four years out of compliance under the new draconian penalty regime, and for the first time a significant number of people focused attention on the FBAR penalties. Questions were raised about whether the penalties were so severe that they were an unconstitutional violation of the Eighth Amendment prohibition against excessive fines.

2. The Eighth Amendment to the United States Constitution reads as follows: "Excessive bail shall not be required, *nor excessive fines imposed*, nor cruel and unusual punishments inflicted." (emphasis added).

3. A challenge to the constitutionality of FBAR penalties was asserted in the *Zwerner*[5] case, which (perhaps unfortunately) was settled between the government and the taxpayer in June 2014, without a formal ruling by the court on the Eighth Amendment issues. The salient facts in the *Zwerner* case include the following:

(a) Carl Zwerner, an 87 year old man in 2014, had opened a Swiss offshore account in the 1960s and professed that he did not learn of his reporting and tax obligations until 2008. The maximum balance in the account was a little under$1.7 million. Zwerner formed a "foundation" under Liechtenstein law in the late 1960s, and deposited into the foundation income that he earned overseas. Zwerner did not report the foreign income earned in the foundation account, and "actively managed" the account over the years, adding and withdrawing funds during his trips to Europe.

(b) After retaining an attorney in 2008, he properly reported income from the Swiss account on his 2007 federal income tax return. However, he did not file an FBAR for 2007.

(c) In early February 2009, his attorney contacted the IRS CID on a hypothetical basis (but not formally under the 2009 OVDP Program) and received a letter from CID, dated February 17, 2009, stating that no criminal prosecution would take place based on the hypothetical situation described. Mr. Zwerner then filed on March 27, 2009, three years of amended returns for tax years 2004, 2005 and 2006, and paid the corresponding tax and interest.[6]

(d) The ensuing IRS audit, begun in 2010, was very aggressive,

[4] In fairness to the IRS, during this period it did initiate and implement what was called the "Last Chance Compliance Initiative," which generally applied for tax years 2001 and after. The IRS would offer to taxpayers already under audit the equivalent of an early version of the OVDP Program – namely, come clean with a full disclosure, and we will assess taxes and some civil penalties, but not all. The LCCI program as it was known was also – theoretically – available to persons not already known to the IRS, but prior to 2009 the LCCI – and indeed the entire FBAR compliance obligation – was not well known, even among full-time tax practitioners.
[5] *United States v. Zwerner* (SD FL No. 13-cv-22082-CMA).
[6] Mr. Zwerner followed the old voluntary disclosure practice in IRM 9.5.11.9, Example 6(A).

with the IRS asserting a 75% civil income tax fraud penalty for each of the three amended years, 2004, 2005, and 2006.[7]

(e) Mr. Zwerner at that point in time sought to join the OVDP Program, but was denied on grounds that he was already under audit.

(f) Meanwhile, the IRS also assessed penalties for failure to timely file the FBAR with respect to the years 2004, 2005, 2006 and 2007 (the taxpayer filed his tax return but not his FBAR for 2007). The penalty for each year was assessed at 50% of the maximum balance in the account during each applicable year. The exact penalty assessments asserted by the U.S. government were as follows:

(i) for 2004, the penalty was $723,762;

(ii) for 2005, the penalty was $745,209;

(iii) for 2006, the penalty was $772,838; and

(iv) for 2007, the penalty was $845,527.

(g) The FBAR penalties were appealed by Zwerner, and the case went to a jury trial on May 19, 2014, before the United States District Court for the Southern District of Florida. The jury found that Mr. Zwerner's failure to file his FBARs was "willful" and, therefore upheld the government penalty, assessed in an amount equal to 50% of the high balance in his foreign financial account, for each of the years 2004, 2005, and 2006. The jury determined that Zwerner was not "willful" for calendar year 2007, and therefore the penalty was not assessed for that year. The cumulative penalty was $2,241,809, even though the highest balance of the account during the years in question had only been $1,691,054.

(h) Mr. Zwerner and the government were scheduled to argue the constitutionality of the FBAR penalties in court on June 6, 2014. In the court papers, Mr. Zwerner argued that the amount of FBAR penalties was grossly disproportionate to the originally underpaid tax (3,860%) and practically any other measure of penalties:

Class of Taxpayer	Maximum FBAR Penalty
Voluntary Disclosure - LCCI	50% of single year balance
Voluntary Disclosure- Mr. Zwerner	50% of *every* year balance
Voluntary Disclosure - 2009 VDP	20% of single year balance
Voluntary Disclosure - 2011 OVDP	25% of single year balance
Voluntary Disclosure - 2012 OVDP	27.5% of single year balance
Criminal Conviction after Plea or Trial	50% of single year balance

[7] Fortunately for Zwerner, these civil fraud penalties were subsequently abated, by the IRS Appeals Office for 2004 and 2005, and by the Tax Court for 2006. The IRS did not assert a fraud penalty for tax year 2007, for whatever reason.

(i) In contrast, the government asserted that "[t]he penalties are within the range of penalties prescribed by Congress, and even below the statutory maximum." Citing no authority, the government urged the court to consider (*i.e.* speculate as to) Mr. Zwerner's tax liability "during the previous decades." The government was presumably referring to years clearly barred under the FBAR statute of limitations.[8] The case was settled on June 5, 2014, the day before arguments. Tax practitioners are left to weigh the various factors involved in the case, including:

(i) The IRS was willing to assert the full FBAR penalty against an 87-year-old defendant;

(ii) The jury upheld the finding of a "willful" violation for 2004, 2005 and 2006; and

(iii) The IRS was willing to settle rather than have the constitutionality of its assessments litigated before the U.S. District Court.

(j) The Taxpayer Advocate[9] believes that the IRS has used the FBAR penalties in an excessive and unfair manner, including to intimidate taxpayers into entering the OVDP Program, although that intimidation has been significantly assuaged by the Streamline Procedures. As the ***Zwerner*** case vividly illustrates, the penalties under the FBAR statute can be absurdly high, and often dwarf the penalties potentially assessable under the Internal Revenue Code. For example, the IRS in the ***Zwerner*** case was unsuccessful in sustaining a penalty for civil fraud in any of the three years in question, 2004, 2005 and 2006. Tellingly, the penalty the IRS was not able to sustain was 75% of the unreported tax in each year. According to Zwerner, the FBAR penalty was equivalent to 3860% (meaning 38.6 times) the full amount of the unreported tax. The FBAR penalties assessed at that level are subject to legitimate and possibly even successful attack as "excessive fines" under the Eighth Amendment.

E. Procedural Anomalies Under FBAR Rules Compared to Tax Rules

1. The dramatic increase in the penalty provisions under Title 31 in October 2004 occurred about one year after the Treasury made the decision to delegate the FinCEN enforcement authority over Title 31 to the IRS, which occurred in April 2003.[10]

2. Subsequent Title 31 regulations, provided the IRS with regulatory authority to conduct investigations, issue summonses, assess and collect civil penalties, issue administrative rulings, and take "any other action reasonably necessary" for the enforcement of the FBAR-related provisions.[11]

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[8] See 31 U.S.C. § 5321(b)(1).
[9] Taxpayer Advocate Service, FY 2014 Objectives Report to Congress and Special Report to Congress 36 (2014), available at http://www.taxpayeradvocate.irs.gov/userfiles/file/FullReport/IRS-Offshore-Voluntary-Disclosure-Programs-Continue-to-Burden-Benign-Actors-and-Damage-IRS-Credibility.pdf.
[10] I.R.S. News Release, IR 2003-48 (Apr. 10, 2003).
[11] Originally issued as 31 C.F.R. § 103.56(g) (2005), these are now found at 31 C.F.R. § 1010.810(g).

3. Obviously, this dual authority means that the IRS will frequently review and identify FBAR issues in the course of a conventional federal income tax audit.

4. However, this delegation of authority raises some complicated and potentially extremely important administrative issues. Title 31, Section 5321(b), provides that the Secretary may assess a civil penalty under Section 5321(a). This authority is under Title 31, and is conspicuously different from the IRS's authority under Title 26, Section 6201(a) to make determinations and assessments of all taxes, including penalties, imposed by Title 26 "or accruing under *any former internal revenue law*."

5. Some immediate questions arise from this odd split in IRS administrative and procedural authorization. Should an assessment of an FBAR penalty be treated in the same manner as an assessment of a tax penalty, and subject to administrative appeal to the IRS Appeals Office? And does a taxpayer dissatisfied with an FBAR penalty assessment have a right to seek judicial review by petitioning the U.S. Tax Court?

6. The IRS appears to take the position that the various procedural safeguards for taxpayers under Title 26 do not apply in to FBAR penalties assessed under Title 31.

7. In all events, the statute of limitations rules, bankruptcy rules and many other procedural rules related to assessment, litigation and collection of FBAR penalties are very different from the conventional and familiar federal tax rules, as discussed more fully below.

F. Defending FBAR Penalty Cases

1. The starting point of any FBAR filing matter is (a) whether the taxpayer fully and properly disclosed in a timely manner all required information on the applicable FBAR return, and (b) if there is any problem or insufficiency in the filing, whether the taxpayer acted in good faith, acted non-willfully, or acted willfully in not complying with the FBAR requirements.

2. In case of an assertion by the IRS that the violation in question is a non-willful violation, the taxpayer can defend himself against any assessment of penalty by showing that there was "reasonable cause" for the violation.

3. In the case of an IRS assertion that that violation is a willful violation, the taxpayer must defend him or herself by proving that the violation was not, in fact, willful.

4. Although it is not technically a component of the FBAR statute or the applicable FBAR regulations, the IRS under the OVDP Program has provided (initially in FAQ #17, and more recently in its "Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets – Delinquent FBAR Submission Procedures") that if a taxpayer has failed to file FBARs, but has reported all the income in foreign bank accounts for each of the applicable years, then the taxpayer can simply file the delinquent FBARs and no penalty will be assessed.

Given the fact that the FBAR penalties are gargantuan, the most logical explanation for the "Free Pass" is that the IRS properly recognizes that FBAR compliance is intended primarily to promote and encourage the proper preparation, filing and disclosure of all income from foreign bank accounts. That, however, suggests in turn that the IRS is not administering the laws consistently. Indeed, the IRS is arguably vastly exceeding its authority when it uses the threat of FBAR penalties to coerce taxpayers into participating in the OVDP Program, which has been the IRS's operative strategy since 2009 and has been properly blasted by the Taxpayer Advocate. Free Pass rule not only suggests, but essentially confirms, that the FBAR penalties are out of line compared to the magnitude and importance of an FBAR violation by itself. If filing FBARs is such a gigantically important violation that it warrants huge penalties, then why is the penalty reduced to zero if there is no income tax underreporting?

5. Realistically, the most common "defense" to an FBAR case in recent years has been that the taxpayer was unaware of the FBAR-related filing requirements. Although ignorance of the law is not usually a particularly strong or favorable defense in connection with a failure to file income tax returns, the Internal Revenue Manual does recognize that ignorance of the law in conjunction with other facts and circumstances, such as the complexity of the tax or compliance issue, may constitute "reasonable cause." See the discussion of the FBAR cases, above, and the discussion of "reasonable cause" in the Internal Revenue Manual, below.

G. <u>IRM 20.1.1.3.2.2.6 (11-25-2011) Provides Guidance under Title 26 on the Topic of Ignorance of the Law</u>

1. In some instances taxpayers may not be aware of specific obligations to file and/or pay taxes. The ordinary business care and prudence standard requires that taxpayers make reasonable efforts to determine their tax obligations.

2. Reasonable cause may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances. For example, consider:

(a) The taxpayer's education,

(b) If the taxpayer has previously been subject to the tax,

(c) If the taxpayer has been penalized before,

(d) If there were recent changes in the tax forms or law which a taxpayer could not reasonably be expected to know, and

(e) The level of complexity of a tax or compliance issue.

3. Reasonable cause should never be presumed, even in cases where ignorance of the law is claimed.

4. The taxpayer may have reasonable cause for noncompliance due to ignorance of the law if:

(a) A reasonable and good faith effort was made to comply with the law, or

(b) The taxpayer was unaware of a requirement and could not reasonably be expected to know of the requirement.

5. In one of its pronouncements on the FBAR program, the IRS has stated: "[I]n order for there to be a voluntary intentional violation of a known legal duty, the accountholder would just have to have knowledge that he had a duty to file an FBAR, since knowledge of the duty to file an FBAR would entail knowledge that it is illegal not to file the FBAR. A corollary of this principle is that there is no willfulness if the accountholder has no knowledge of the duty to file the FBAR."

6. For many years, however, the obligation to file the FBAR was observed in the breach: few were aware of it, and even fewer complied with the law. There was, at various times, a box on the IRS Form 1040 that also asked whether a taxpayer maintained a foreign bank account, but this likewise was often ignored or overlooked by accountants and taxpayers alike, as well as their professional tax preparers.

7. In 2008 and 2009, following various scandals and disclosures involving European banks, the U.S. Government became generally aware that certain Swiss Banks, of which UBS was a prominent example, actively encouraged U.S. taxpayers to put their funds in Swiss Bank accounts, concealed by secrecy and banking privileges, and the income on these accounts had not been fully and properly reported on U.S. federal income tax returns by U.S. taxpayers.

8. This led to a heightened emphasis and visibility both on the FBAR filing requirements and on U.S. federal income tax reporting of the income.

H. Preparing and Filing an FBAR

1. The FBAR is a remarkably detailed and relatively complicated form that requires disclosure of all overseas financial accounts if a U.S. taxpayer has over $10,000 in such accounts at any time during a calendar year.

2. Certain Accounts Jointly Owned by Spouses. The spouse of an individual who files an FBAR is not required to file a separate FBAR if the following conditions are met: (1) all the financial accounts that the non-filing spouse is required to report are jointly owned with the filing spouse; (2) the filing spouse reports the jointly owned accounts on a timely filed FBAR; and (3) both spouses sign the FBAR in Item 44. Otherwise, both spouses are required to file separate FBARs, and each spouse must report the entire value of the jointly owned accounts.

3. The FBAR must be received by the Department of the Treasury on or before June 30th of the year immediately following the calendar year being reported. The June 30 filing date may not be extended. FBARs were formerly mailed to a FinCEN address in

Detroit, Michigan, but that address is no longer operative. Starting for the 2013 year, all FBARs must be filed electronically. Also, any FBARs filed for past years after June 30, 2013 must also be filed electronically. For the unsuspecting taxpayer who submits a paper report, "FinCEN may impose civil money penalties for noncompliance with our regulations, including $500 for each negligent currency transaction or suspicious activity reporting violation under 31 C.F.R. § 1010.820."

4. Who Must File an FBAR. A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year. Therefore, a person with signature authority over an account has a filing obligation even if the account is owned by another person.

5. Financial Account. A financial account includes, but is not limited to, a securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also includes a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund (*i.e.*, a fund that is available to the general public with a regular net asset value determination and regular redemptions).

6. Foreign Financial Account. A foreign financial account is a financial account located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account.

7. Joint Account. A financial account type listed above owned jointly by two or more persons.

8. Information Requested for each Account. For each foreign account, the FBAR requires the following information, here listed by the FBAR line number:

15 Maximum value of account during calendar year reported

16 Type of account a) Bank b) Securities c) Other—Enter type below

17 17 Name of Financial Institution in which account is held
18 Account number or other designation

19 Mailing Address (Number, Street, Suite Number) of financial institution in which account is held

20 City
21 State, if known

22 Zip/Postal Code, if known

23 Country

I. Form TD F 90-22.1 Became Form 114 for 2013

1. Starting with the 2013 tax year, the old Form TD F 90-22.1 has been replaced with the updated form, FinCEN Form 114.

2. FinCEN Form 114 is available for e-filing in the 2013 tax year and thereafter using the BSA E-Filing System.

3. Under the current BSA E-Filing System, a reporting person filing late FBARs for prior years, or amended FBARs for prior years, must use Form 114, even if amending a prior for Form TD F 90-22.1.

J. Statute of Limitations on FBAR Assessments Versus Income Tax Assessments

1. The FBAR statute of limitations rules under Title 31 are dramatically different from the statutes of limitations rules that apply under the Internal Revenue Code, Title 26.

2. The FBAR statute runs for six years from the filing due date, regardless of whether or not the FBAR was filed for a particular year.24[12]

3. By contrast, under Title 26, the statute of limitations does not begin to run until a return is filed.[13] If no return is filed, then the statute of limitations on that return literally runs forever. However, other statutes may come into play, ***e.g.***, the statutes of limitations on criminal actions may preclude criminal enforcement of a fraud case.

4. The "normal" statute of limitations for a U.S. income tax return is three-years from the filing due date (or the actual filing date, if later).[14]

5. The Title 26 statute of limitations is extended from three years to six years:

(a) If there is a substantial understatement of income, meaning that the correct amount of gross income that should have been reported on the

[12] 31 U.S.C. § 5321(b)(1).
[13] IRC § 6501(a).
[14] IRC § 6501(a).

return is more than 25% greater than the amount reported on the return.[15]

(b) If the taxpayer underreports $5,000 or more gross income from "specified foreign financial assets" under Section 6038D, a provision added by FATCA and which applies to report in years following FATCA's enactment in 2010.[16] Specified foreign financial assets are comprised of the following:

"any financial account (as defined in section 1471(d)(2)) maintained by a foreign financial institution (as defined in section 1471(d)(4)), and

any of the following assets which are not held in an account maintained by a financial institution (as defined in section 1471(d)(5))—

any stock or security issued by a person other than a United States person,

any financial instrument or contract held for investment that has an issuer or counterparty which is other than a United States person, and

any interest in a foreign entity (as defined in section 1473)."[17]

6. In the event of a false or fraudulent income tax return, the statute of limitations is unlimited,[18] but again subject to the general limitations statutes on criminal prosecution. By contrast, the statute of limitations for an FBAR filing runs six years from the due date of the applicable return, and runs whether or not the FBAR is ever filed.

7. The statute of limitations on FBAR criminal penalties is five years from the date the offense is committed.

K. Statute of Limitations for FBAR Collections.

1. The period of limitation on collection of FBAR penalties is found in 31 U.S.C. 5321(b)(2). The Secretary may commence a civil action to recover a civil penalty assessed under subsection (a) at any time before the end of the two year period beginning on the later of:

(a) The date the penalty is assessed; or,

(b) The date any judgment becomes final in any criminal action under section 5322 in connection with the same transaction with respect to which the penalty is assessed.

[15] IRC § 6501(e)(1)(A)(i). The Home Concrete case curtailed the IRS's ability to use this six-year period. In that case, the IRS attempted to use the six-year period where the taxpayer had overstated the basis of property sold, which resulted in an understatement of income of more than 25%. The Supreme Court held that the statute required an understatement of gross income, which the Court held did not occur merely as a consequence of an overstatement of tax basis.
[16] IRC § 6501(e)(1)(A)(ii).
[17] IRC § 6501(e)(1)(A)(ii).
[18] IRC § 6501(c)(1)-(2).

2. The date the FBAR penalty is assessed is the date that the IRS-designated official stamps IRS Form 13448.

3. However, this relatively short collections statute does not necessarily cut off the government's powers to pursue and collect the debt, thanks to the administrative powers conferred on the U.S. Treasury to collect debts owed to the U.S. government using the power to offset payments under 31 USC Section 3711.

4. Under that provision, the U.S. government has up to ten years from the date of assessment, or the date a judgment becomes final in any criminal matter, to pursue a variety of available offset remedies, including the following:

(a) Administrative offsets;

(b) Federal salary offsets;

(c) Non-federal employee wage garnishments,

(d) Tax refund offsets;

(e) Debt referred to private collection contractors.

5. As a practical matter, the IRS has six years in which to assess the tax, but has many alternative collection routes besides a civil collection action.

L. <u>Procedural Sequence in an IRS Audit that Identifies an FBAR Violation</u>

1. If a potential FBAR violation is identified in the course of a normal IRS audit, the IRS audit agent must have a manager sign a Related Statute Memorandum allowing the agent to use the FBAR information developed in the Title 26 exam, as required by Code Section 6103.

2. There are a whole series of procedural requirements and protocols described in the IRM 4.26.17, "Report of Foreign Bank and Financial Accounts (FBAR) Procedures." The most important, obviously, is if the IRS proposes to assess an FBAR penalty and the taxpayer (technically the "U.S. person") disagrees with the proposed assessment.

3. If an FBAR penalty is proposed but not agreed to, the examiner waits 45 days to see if the person will appeal as provided in Letter 3709.

4. In order to appeal:

(a) The person against whom an FBAR penalty is proposed must mail a written protest in duplicate to the examiner that is postmarked before the designated response date, which is listed in the Letter 3709.

(b) The protest must contain all the information required in Letter 3709.

(c) An appeal requires 180 days remaining on the assessment statute of limitations. The statute of limitations on assessment of a failure to file penalty is six years from the date when the FBAR should have been filed (which is June 30th of the year following the year for which the foreign financial account is being reported).

5. If there is no response from the person against whom an FBAR penalty is proposed, the penalty is assessed and the collection process begins.

6. If the taxpayer appeals the FBAR assessment, the case is forwarded to the IRS Appeals Office. The exact procedures will depend in part on whether there is also a related IRS tax assessment.

7. Appeals Officers will follow procedures outlined in "Foreign Bank and Financial Accounts Requirements Guidance for Appeal Officers" available on the Appeals web site. Appeals will close the FBAR case through DCC following the closing procedures for examiners found in this section.

8. In addition to the above procedures which are to be used in all appealed cases, where there is a related Title 26 case, the examiner, the group manager, and Appeals will discuss whether the examiner should hold the FBAR case until the Title 26 case is closed or forwarded to Appeals. The different statutes of limitation are important in this discussion.

9. If IRS Appeals Office does not settle or compromise the FBAR case, and recommend assessment of an FBAR penalty, the procedural path clearly diverges from any underlying IRS tax assessment. The U.S. Tax Court is the court that can exercise jurisdiction over an assessed tax prior to collections, but the U.S. Tax Court is also a court of limited jurisdiction, and assessments under Title 31 do not fall within the jurisdiction of the Tax Court.[19]

10. Likewise, the U.S. Bankruptcy Court in at least one case has held that FBAR penalties are not dischargeable in bankruptcy.[20]

11. For the FBAR assessment, a taxpayer can apparently either challenge the assessed penalty under the Tucker Act[21] or the Little Tucker Act,[22] provided that the taxpayer/U.S. person has paid at least part of the assessment. The jurisdictional threshold operates such that a payment of part of the assessment allows the person to maintain an action for relief from an illegal exaction either in the U.S. District Court (if the amount paid is $10,000 or less) or in the U.S. Court of Federal Claims. Note that the normal requirement applicable to Title 26 cases that the full amount of tax, interest and penalties must first be

[19] Williams v. Commissioner, 131 TC No. 6 (October 22, 2008).
[20] Simonelli, 102- AFTR 2d 2008-6577 (D. Conn. September 30, 3008).
[21] 28 USC § 1491.
[22] 28 USC § 1346.

paid in order to file a refund case in federal court (i.e., the Flora[23] rule) is not applicable because the FBAR is a penalty and not a tax.

12. The time period within which an action must be brought under either the Tucker Act or the Little Tucker Act is six years from the date the right of action accrues.[24]

M. New Proposed Filing Rules

1. For calendar year 2015, the FBAR due date continues to be June 30, 2016, with no extensions. However, thanks to legislation passed in 2015[25] the FBARs for calendar year 2016 and subsequent years will be due on April 15 of the following year, thereby putting FBAR reporting in alignment with Form 1040 reporting for individuals.

2. In addition, the new law provides for a six-month FBAR extension, extending the filing deadline to October 15, again consistent with filing deadlines for a Form 1040. This is a significant change because extensions were not available previously for filing of the FBAR forms. The law states that the new extension rules should operate "under rules similar to the rules in Treas. Reg. Section 1.6081-5." However, the actual mechanics have not yet been announced by the IRS.

3. The Act also formal authority for penalty relief for first time FBAR filers, stating that "[f]or any taxpayer required to file [an FBAR] for the first time, any penalty for failure to timely request for, or file, an extension, may be waived by the Secretary."

4. Comment: Given that the OVDP already provides for a complete "Free Pass" for FBAR non-compliance so long as all income was reported from assets in foreign accounts, it is none-too-clear what this adds, other than perhaps authority to waive FBARs even if there is income tax non-compliance. The IRS has not provided much further information on this new law at this point.

5. Further Comment: FBARs will no longer have the massive disconnect from Form 1040 filing dates, but so far as once can tell the IRS will continue to require that FBARs be filed electronically on the BSA website, while tax forms will be filed with the IRS, either by paper to the applicable IRS Service Center or electronically.

III. FATCA FORM 8938

A. Introduction

1. FATCA[26] introduced a requirement that U.S. taxpayers file a Form 8938 disclosure with respect to certain foreign financial holdings. Form 8938 went into effect for tax year 2011.

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[23] Flora v. United States, 362 U.S. 145 (1960).
[24] 28 USC §§ 2401(a), 2501.
[25] Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, PL 114-41.
[26] The Foreign Account Tax Compliance Act (FATCA) became law in March 2010.

2. Form 8938 is heavily duplicative of the reporting obligations with respect to foreign financial accounts required by the U.S. Treasury on Form TD F 90-22.1 and Form 114, Report of Foreign Bank and Financial Accounts, known as the FBAR which applies to foreign financial accounts with more than aggregate $10,000 of assets.

3. The IRS has announced that the "Form 8938 filing requirement does not replace or otherwise affect a taxpayer's obligation to file Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts). Individuals must file each form for which they meet the relevant reporting threshold."

B. <u>Form 8938 Requirements</u>

1. <u>Filing Thresholds.</u> Form 8938 applies if the taxpayer has specified foreign financial assets that exceed $50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad). By way of comparison, FBAR applies if the taxpayer has over $10,000 in foreign accounts at any time during the calendar year.

2. <u>Assets Covered</u>. Form 8938 covers a broader range of assets, including assets held offshore but not in a financial account. For example, foreign stock or securities not held in a financial account (*<u>e.g.</u>*, book-entry shares or dividend reinvestment plan shares) are reported on Form 8938 but not on FBAR. Likewise a foreign partnership interest, such as a foreign hedge fund or foreign private equity fund, is reported on Form 8938 but not FBAR.

3. <u>Assets Covered by FBAR but Not Form 8938</u>. FBAR picks up a few types of assets that Form 8938 does not cover, including the following:

(a) Financial accounts in a foreign branch of a U.S. bank or financial institution.

(b) Bank accounts over which a person has signature authority, even if the account is owned by or belongs to someone else.

4. <u>Filing Requirements.</u> Form 8938 is filed with the U.S. federal income tax return, Form 1040. By contrast, FBAR is a separate filing due by June 30 of each year for the prior year. Unlike the Form 8938, FBAR has no mailbox rule and no extension.

5. <u>Duplication of FBAR and Form 8938</u>. The Form 8938 is hugely duplicative of the FBAR, yet they are filed at difference times at different places (FBARs are filed with the U.S. Treasury in Detroit, MI). The entire regime makes very little sense. The two filing requirements should be merged into a single filing requirement, but at the moment there is no indication that this is likely to occur.

6. <u>Form 8938 Penalties Compared to FBAR Penalties</u>. Under Form 8938, the applicable penalties are up to $10,000 for failure to disclose and an additional $10,000 added for each 30 days of non-filing beginning 90 days after the taxpayer receives an IRS notice of a failure to disclose, up to a potential maximum penalty of $60,000; criminal

penalties may also apply. By contrast, the FBAR penalties for a non-willful failure to file is a penalty of up to $10,000; in the case of a willful failure to file, the penalty is up to the greater of $100,000 or 50-percent of account balances. Criminal penalties may also apply.

7. See Exhibit A for Further Details. For a more complete comparison of Form 8938 and FBAR reporting requirements, see the Chart Comparing FBAR to Form 8938, below.

C. Chart Comparing FBAR to Form 8938

	Form 8938, Statement of Specified Foreign Financial Assets	**Form 114, Report of Foreign Bank and Financial Accounts (FBAR)**
Who Must File?	Specified individuals, which include U.S. citizens, resident aliens, and certain non- resident aliens that have an interest in specified foreign financial assets and meet the reporting threshold	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold
Does the United States include U.S. territories?	No	Yes, resident aliens of U.S. territories and U.S. territory entities are subject to FBAR reporting
Reporting Threshold (Total Value of Assets)	$50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad)	$10,000 at any time during the calendar year

	Form 8938, Statement of Specified Foreign Financial Assets	**Form 114, Report of Foreign Bank and Financial Accounts (FBAR)**

When do you have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return	Financial interest: you are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title. Signature authority: you have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account. See instructions for further details.
What is Reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign non-account investment assets	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars.	Use periodic account statements to determine the maximum value in the currency of the account. Convert to U.S. dollars using the end of the calendar year exchange rate and report in U.S. dollars.
When Due?	By due date, including extension, if any, for income tax return	Received by June 30 (no extensions of time granted)

	Form 8938, Statement of Specified Foreign Financial Assets	Form 114, Report of Foreign Bank and Financial Accounts (FBAR)
Where to File?	File with income tax return pursuant to instructions for filing the return	Must be filed electronically at BSA E-Filing System
Penalties	Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply	If non-willful, up to $10,000; if willful, up to the greater of $100,000 or 50-percent of account balances; criminal penalties may also apply

Types of Foreign Assets and Whether They are Reportable		
Financial (deposit and custodial) accounts held at foreign financial institutions	Yes	Yes
Financial account held at a foreign branch of a U.S. financial institution	No	Yes
Financial account held at a U.S. branch of a foreign financial institution	No	No
Foreign financial account for which you have signature authority	No, unless you otherwise have an interest in the account as described above	Yes, subject to exceptions

	Form 8938, Statement of Specified Foreign Financial Assets	Form 114, Report of Foreign Bank and Financial Accounts (FBAR)
Foreign stock or securities held in a financial account at a foreign financial institution	The account itself is subject to reporting, but the contents of the account do not have to be separately reported	The account itself is subject to reporting, but the contents of the account do not have to be separately reported
Foreign stock or securities not held in a financial account	Yes	No
Foreign partnership interests	Yes	No
Indirect interests in foreign financial assets through an entity	No	Yes, if sufficient ownership or beneficial interest (*i.e.*, a greater than 50-percent interest) in the entity. See instructions for further detail.
Foreign mutual funds	Yes	Yes
Domestic mutual fund investing in foreign stocks and securities	No	No
Foreign accounts and foreign non-account investment assets held by foreign or domestic grantor trust for which you are the grantor	Yes, as to both foreign accounts and foreign non-account investment assets	Yes, as to foreign accounts
Foreign-issued life insurance or annuity contract with a cash-value	Yes	Yes
Foreign hedge funds and foreign private equity funds	Yes	No
Foreign real estate held directly	No	No

	Form 8938, Statement of Specified Foreign Financial Assets	**Form 114, Report of Foreign Bank and Financial Accounts (FBAR)**
Foreign real estate held through a foreign entity	No, but the foreign entity itself is a specified foreign financial asset and its maximum value includes the value of the real estate	No
Foreign currency held directly	No	No
Precious Metals held directly	No	No
Personal property, held directly, such as art, antiques, jewelry, cars and other collectibles	No	No

IV. <u>OTHER IRS INFORMATION RETURNS</u>

A. <u>Overview</u>

1. Although the FBAR and the Form 8938 are the most universally applicable information returns required to be filed by U.S. persons with the IRS and the U.S. Treasury, they are by no means the only information returns that can create serious non-compliance problems.

2. There are in fact at least six other information returns required by the IRS that can be related to the overseas activities of a U.S. person. These six forms are identified in the lettered sections, below.

B. <u>Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts</u>

1. Taxpayers must also report various transactions involving foreign trusts, including creation of a foreign trust by a United States person, transfers of property from a United States person to a foreign trust and receipt of distributions from foreign trusts under IRC § 6048. This return also reports the receipt of gifts in excess of $100,000 from foreign persons or entities under IRC § 6039F.

2. The penalty for failing to file each one of these information returns, or for filing an incomplete return, is the greater of $10,000 or 35 percent of the gross reportable amount, except for returns reporting gifts, where the penalty is five percent of the gift per

month, up to a maximum penalty of 25 percent of the gift.

C. **Form 3520-A, Information Return of Foreign Trust With a U.S. Owner**

1. Taxpayers must also report ownership interests in foreign trusts, by United States persons with various interests in and powers over those trusts under IRC § 6048(b).

2. The penalty for failing to file each one of these information returns or for filing an incomplete return is the greater of $10,000 or 5 percent of the gross value of trust assets determined to be owned by the United States person.

D. **Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations**

1. Certain United States persons who are officers, directors or shareholders in certain foreign corporations (including International Business Corporations) are required to report information under IRC §§ 6035, 6038 and 6046.

2. The penalty for failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

E. **Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business**

1. Taxpayers may be required to report transactions between a 25 percent foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by IRC §§ 6038A and 6038C.

2. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency.

F. **Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation**

1. Taxpayers are required to report transfers of property to foreign corporations and other information under IRC § 6038B.

2. The penalty for failing to file each one of these information returns is ten percent of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional.

G. Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships

1. United States persons with certain interests in foreign partnerships use this form to report interests in and transactions of the foreign partnerships, transfers of property to the foreign partnerships, and acquisitions, dispositions and changes in foreign partnership interests under IRC §§ 6038, 6038B, and 6046A.

2. Penalties include $10,000 for failure to file each return, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return, and ten percent of the value of any transferred property that is not reported, subject to a $100,000 limit.

H. Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund

1. A U.S. person that is a direct or indirect shareholder of a passive foreign investment company (PFIC) or qualified electing fund (QEF) files this form:

   (a) when they receive certain direct or indirect distributions from a PFIC,

   (b) recognize a gain on a direct or indirect disposition of PFIC stock, or

   (c) are making an election reportable in Part II of the form.

2. IRC § 1298(f) and the applicable regulations do provide for a specific penalty for failure to file Form 8621. However, the Form 8621 filing requirements are essentially co-extensive with the Form 8938 filing requirements. Under IRS § 6038D, a U.S. individual must disclose foreign financial assets on Form 8938 if the aggregate value of the individual's foreign financial assets exceeds the applicable threshold; however, this disclosure requirement does not apply to a foreign financial asset disclosed on another IRS information return, including a Form 8621. U.S. person who fails to disclose a PFIC ownership interest on either Form 8621 or Form 8938 is therefore subject to the $10,000 penalty under §6038D(d).

3. Another consequence of failing to file Form 8621 is the suspension of the statute of limitations with respect to the U.S. shareholder's entire federal income tax return until the shareholder files Form 8621. The suspension of the statute of limitations will be limited to the unreported PFIC interest and will not apply to other portions of the U.S. shareholder's tax return so long as the shareholder can show "reasonable cause" for the failure to file Form 8621.

V. OVDP PROGRAM

A. Background and Overview

1. The IRS and the U.S. government became aware in around 2006 that

various foreign banks, notably certain Swiss banks, were quietly but actively encouraging U.S. citizens to open bank accounts in foreign jurisdictions, and to rely on bank secrecy laws as an inducement that lead to non-compliance with U.S. income tax laws.

2. The investigations began to make front-page headlines around 2007 and 2008, and then were transformed into major tax news in 2009, when the IRS announced the first iteration of its "Overseas Voluntary Disclosure Program." OVDP is basically a program whereby U.S. taxpayers with overseas bank accounts can "come clean" by reporting all income for past years, and filing delinquent FBARs and other delinquent IRS information returns for past years, together with a specified penalty, which was initially set in 2009 at 20% of the "base amount" (the "base amount" is calculated in a quirky and sometimes patently unfair manner, as discussed more fully below in connection with FAQ 36).

3. The heavy response of U.S. taxpayers to the initial 2009 OVDP Program reportedly surprised the IRS, both by the number of foreign accounts disclosed and the amount of money collected, and lead to a second program, the 2011 OVDP, and then, starting in 2012, to a quasi-permanent OVDP Program that was given a substantial makeover in 2014. The OVDP penalties increased from 20% in 2009, to 25% for 2011 and then to 27.5% for 2012 and later years.

4. The 2009 OVDP, which closed on October 15, 2009, and 2011 OVDP, which closed on September 9, 2011, offered a uniform penalty structure for taxpayers who came forward voluntarily and reported their previously undisclosed foreign accounts and assets. These initiatives purported to offer consistent and centralized processing of offshore voluntary disclosures and allowed the IRS to resolve a substantial number of cases without examination.

5. The IRS and Department of Justice continue to pursue aggressive offshore enforcement efforts – including FATCA, discussed below – and this puts ever increasing pressure on taxpayers with undisclosed foreign assets to come into compliance. The current OVDP, including the parallel program called Streamlined Procedures, discussed blow, allows taxpayers who wish to voluntarily disclose their offshore accounts and assets to avoid prosecution and to limit or cap their exposure to civil penalties.

6. Unlike the 2009 OVDP and the 2011 OVDP, the 2012 OVDP (and its successor, the 2014 OVDP) has no set deadline by which taxpayers must apply. However, the terms of this program could change at any time going forward. The IRS can increase penalties or limit eligibility in the program for all or some taxpayers or defined classes of taxpayers – or could decide to end the program entirely at any point, although that seems increasingly unlikely, given the ongoing success of these programs in bringing U.S. citizens and taxpayers into compliance with these relatively complicated reporting requirements.

B. <u>Common Characteristics of all OVDP Programs</u>

1. The 2009 OVDP, 2011 OVDP, and 2012/2014 OVDP all have very strong similarities, and the purposes of this outline to clarify rather than confuse, so the

discussion of the 2009 OVDP and 2011 OVDP Programs will be brief and will highlight only a few key differences and changes.

2. The objective of the OVDP Programs has always been to bring taxpayers that have used undisclosed foreign accounts and foreign entities to avoid or evade tax, into compliance with United States tax laws. Nominally, OVDP is about helping intentionally non-compliant taxpayers to come back into the system and, in theory, should not be a trap for unknowing, inadvertent, or accidental non-compliance. However, distrust of the IRS caused many such taxpayers, in an abundance of caution, to participate in the early OVDP Programs in order to gain certainty that there would be no IRS enforcement efforts directed against them.

3. The 2014 OVDP introduced the "Streamlined Procedures" that are designed to address non-willful violations by providing a simplified procedure – and a much lower penalty – for persons who could comfortably certify that their non-compliance was "non-willful." As a result, a taxpayer seeking to come into compliance has three choices:

(a) If the taxpayer is likely to be found to have committed willful violations of the law, the OVDP program can be a very good deal;

(b) If the violations are non-willful, and the taxpayers want certainty of relief, the Streamlined Program is well-suited for their needs;

(c) If the violations are non-willful, and the taxpayer believes there is "reasonable cause," or otherwise believes that on any audit the assessment of penalties will be less than the Streamlined Program, then the taxpayer can opt for a "quiet disclosure" by coming into compliance, including with late filings and/or amended returns, and then see how the IRS responds.

4. The 2014 OVDP, like its predecessors, is actually laid out in the curious format of an extensive Frequently Asked Questions document, referred to herein as the "FAQ." All references are to the FAQ under the 2014 OVDP unless expressly noted to the contrary.

5. The 2014 OVDP continues to offer the "Free Pass" – meaning that taxpayers who are delinquent on their FBAR filing obligations, but who have reported all income from foreign sources for all years, have the opportunity to file delinquent FBARs retroactively without penalty.

6. Similarly, the IRS will not impose a penalty for the failure to file the delinquent Forms 5471 and 3520 if: (1) there are no underreported or unpaid tax liabilities; (2) the taxpayer has reasonable cause for not timely filing the form(s); (3) the taxpayer is not under a civil examination or a criminal investigation by the IRS; and (4) the taxpayer has not previously been contacted regarding an income tax examination or a request for delinquent returns. The taxpayer is permitted to file these late returns, but must include a statement of all facts establishing reasonable cause for the failure to file. As part of the reasonable cause statement, taxpayers must also certify that any entity for which the information returns are

being filed was not engaged in tax evasion.

7. The FAQ provides often detailed guidance on a host of procedures, including: (1) how to begin discussions with the IRS through a representative on an anonymous basis how to request "pre-clearance" prior to submitting the voluntary disclosure documentation, and how to make a submission jointly or separately from a spouse.

C. The Pre-Clearance Procedures Under OVDP

1. Before a Taxpayer submits to the IRS large amounts of what could be very damaging and even incriminating documents, it is important to make sure the Taxpayer will likely be accepted into the OVDP Program. The FAQ provides guidance and protocols for how to make sure the Taxpayer has a strong likelihood of being accepted.

2. To seek pre-clearance in the OVDP Program, FAQ #23 provides that the Taxpayer or his/her representatives can send a facsimile to the IRS – Criminal Investigation Lead Development Center (LDC) with the following information:

> (a) identifying information (name, date of birth, social security number and address) and
>
> (b) an executed power of attorney (if represented) to fax number (267) 941-1115 together with a request for pre-clearance before making an offshore voluntary disclosure. In the case of jointly filed returns, if each spouse intends to apply for OVDP, each spouse should request pre-clearance.

3. Criminal Investigation will then notify taxpayers or their representatives via fax whether or not they are cleared to make an offshore voluntary disclosure.

4. Taxpayers deemed cleared should follow the steps outlined below within forty-five days from receipt of the fax notification to make an offshore voluntary disclosure.

5. Pre-clearance does not guarantee a taxpayer acceptance into the OVDP. Rather, taxpayers must truthfully, timely, and completely comply with all provisions of the OVDP.

6. Taxpayers or representatives with questions regarding pre-clearance may call the IRS-CI OVDP hotline at (267) 941-1607. For all other offshore voluntary disclosure questions, taxpayers or representatives may call the IRS OVDP Hotline at (267) 941-0020.

D. How to Participate in OVDP

Under FAQ #7, a Taxpayer seeking to participate in the OVDP must do the following:

1. Provide copies of previously filed original (and, if applicable, previously

filed amended) federal income tax returns for tax years covered by the voluntary disclosure;

2. Provide complete and accurate amended federal income tax returns (for individuals, Form 1040X, or original Form 1040 if delinquent) for all tax years covered by the voluntary disclosure.

3. File complete and accurate original or amended offshore-related information returns, including FBARs, for tax years covered by the voluntary disclosure;

4. Cooperate in the voluntary disclosure process, including providing information on offshore financial accounts and signing agreements to extend the period of time for assessing Title 26 liabilities and FBAR penalties;

5. Pay 20% accuracy-related penalties under IRC § 6662(a) on the full amount of your offshore-related underpayments of tax for all years;

6. Pay failure to file penalties under IRC § 6651(a)(1), if applicable;

7. Pay failure to pay penalties under IRC § 6651(a)(2), if applicable;

8. Pay, in lieu of all other penalties that may apply, a "miscellaneous Title 26 offshore penalty" equal to 27.5% (or in limited cases 12.5% or 5%) of the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the period covered by the voluntary disclosure;

9. Submit full payment of all tax, interest, accuracy-related penalties or make good faith arrangements with the IRS to pay in full, the tax, interest, and these penalties;

Note: Even though FAQ #7 seems to say that a taxpayer should pay in full at the front-end to enter the OVDP, it may not be advisable to do so. Instead, the experience of practitioners suggests that taxpayers are not disadvantaged and can participate in OVDP by making the payments at the end of the OVDP Process, so long as they are pre-cleared by the IRS CI pursuant to FAQ #23 and submit an Offshore Voluntary Disclosure Letter. This is a sensible practice, since the OVDP disclosure process can last upwards of two years and the amount of prior years' tax due is often unclear even to the taxpayer at the beginning of that process.

10. Execute a Form 906, Closing Agreement on Final Determination Covering Specific Matters; and

11. Agree to cooperate with IRS offshore enforcement efforts by providing information about offshore financial institutions, offshore service providers, and other facilitators, if requested.

12. Note: There is also a special rule, addressed in FAQ #54, if the taxpayer has a Canadian registered retirement savings plan (RRSP) or registered retirement income fund (RRIF), did not make a timely election pursuant to Article XVIII(7) of the U.S. – Canada income tax treaty to defer U.S. income tax on income earned by the RRSP or RRIF that has

not been distributed, and would now like to make an election.

E. Periods for Which Information Must be Provided Under OVDP FAQ #9

1. For calendar year taxpayers, the voluntary disclosure period is the most recent eight tax years for which the due date has already passed. The eight-year period does not include current years for which there has not yet been non-compliance. Thus, for taxpayers who submit a voluntary disclosure prior to April 15, 2014 (or other 2013 due date under extension), the disclosure must include each of the years 2007 through 2014 in which they have undisclosed foreign accounts and/or undisclosed foreign entities.

2. Fiscal year taxpayers must include fiscal years ending in calendar years 2006 through 2013. For taxpayers who disclose after the due date (or extended due date) for 2011, the disclosure must include 2007 through 2014. For disclosures made in successive years, any additional years for which the due date has passed must be included, but a corresponding number of years at the beginning of the period will be excluded, so that each disclosure includes an eight year period.

3. For taxpayers who establish that they began filing timely, original, and compliant returns that fully reported previously undisclosed offshore accounts or assets before making the voluntary disclosure, the voluntary disclosure period will begin with the eighth year preceding the most recent year for which the return filing due date has not yet passed, but will not include the compliant years. For example, a taxpayer who had historically filed income tax returns omitting the income from a securities account in Country A, who began reporting that income on his timely, original tax and information reporting returns for 2001 and 2012 without making a voluntary disclosure, and who files a voluntary disclosure in January 2014, the voluntary disclosure period will be 2005 through 2010.

4. Comment 1: The OVDP Program has lots of incoherent aspects, but the treatment of how many years must be filed is one of the most complicated and problematical. First of all, the normal statute of limitations for income taxes is three years, and even with a substantial understatement of income it is six years, absent fraud. OVDP goes backwards eight years (and they do not even include the current year as one of the years!).

5. Comment 2: The IRS requires an OVDP Participant to sign an extension for the “open” tax years. However, even the IRS understands that neither the IRS nor the taxpayer can open a “closed year” merely by signing an “extension” form after the tax year is closed under the statute of limitations. Significantly, if a taxpayer applies for participation in the OVDP but then elects to “opt out” of the OVDP Penalty structure under FAQ #51, the IRS acknowledges that it cannot “open” any years that are already closed for federal income tax purposes.

6. Comment 3: Note that the FBAR statute of limitations under Title 31 is dramatically different than the statute of limitations for federal income taxes under Title 26 (*i.e.*, under the Internal Revenue Code). FBAR is a flat six-year period of time, running from the filing date of the applicable FBAR, and the statute of limitations runs (*i.e.*, is not tolled) even if there is a failure to file the FBAR. By contrast, a failure to file an income tax return

generally suspends the running of the statutory period.

F. Penalties Avoided by Participation in OVDP.

1. The FBAR penalties, discussed above, include a penalty for "willful" violations equal to the greater of $100,000 or 50-percent of the total balance of the foreign account per violation.[27] Non-willful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation.

2. The Form 8938 penalty for failing to file each return is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

3. The penalty for failing to file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. The penalty is the greater of $10,000 or 35-percent of the gross reportable amount, except for returns reporting gifts, where the penalty is five percent of the gift per month, up to a maximum penalty of 25-percent of the gift.

4. The penalty for failing to file Form 3520-A, Information Return of Foreign Trust With a U.S. Owner, is the greater of $10,000 or 5-percent of the gross value of trust assets determined to be owned by the United States person.

5. The penalty for failing to file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

6. The penalty for failing to file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

7. The penalty for failing to file Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, is ten percent of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional.

8. A penalty for failing to file Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, is $10,000 for failure to file each return, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return, and ten percent of the value of any transferred property that is not reported, subject to a $100,000 limit.

[27] *See* 31 U.S.C. § 5321(a)(5).

9. Fraud penalties are imposed under IRC §§ 6651(f) or 6663, where an underpayment of tax or a failure to file a tax return is due to fraud, for which the taxpayer is liable for penalties that essentially amount to 75-percent of the unpaid tax.

10. The "failure to file" penalty under IRC § 6651(a)(1) is 5-percent of the balance due, plus an additional 5-percent for each month or fraction thereof during which the failure continues, subject to a cap of 25-percent.The "failure to pay" penalty under IRC § 6651(a)(2) is 0.5-percent of the amount of tax shown on the return, plus an additional 0.5-percent for each additional month or fraction thereof that the amount remains unpaid, subject to a cap of 25-percent.

11. The accuracy-related penalty under IRC § 6662, is a 20-percent or 40-percent penalty based on the amount of under-reporting of taxes due.

G. Example of OVDP Penalty Compared to (Theoretical) Penalty for Non-Voluntary Disclosure – The IRS's Scary Bed-Time Story (from FAQ #8)

1. The values of foreign accounts and other foreign assets are aggregated for each year and the penalty is calculated at 27.5-percent of the highest year's aggregate value during the period covered by the voluntary disclosure.

2. If the taxpayer has multiple accounts or assets where the highest value of some accounts or assets is in different years, the values of accounts and other assets are aggregated for each year and a single penalty is calculated at 27.5-percent of the highest year's aggregate value.

3. For example, assume the taxpayer has the following amounts in a foreign account over the period covered by his voluntary disclosure. It is assumed for purposes of the example that the $1,000,000 was in the account before 2003 and was not unreported income in 2003.

Year	Amount on Deposit	Interest Income	Account Balance
2003	$1,000,000	$50,000	$1,050,000
2004		$50,000	$1,100,000
2005		$50,000	$1,150,000
2006		$50,000	$1,200,000
2007		$50,000	$1,250,000
2008		$50,000	$1,300,000
2009		$50,000	$1,350,000
2010		$50,000	$1,400,000

Note: This example does not provide for compounded interest, and assumes the taxpayer is in the 35-percent tax bracket, does not have an investment in a Passive Foreign Investment Company (PFIC), files a return but does not include the foreign account or the interest income on the return, and the maximum applicable penalties are imposed.

4. If the taxpayer in the above example comes forward and the voluntary disclosure is accepted by the IRS, the taxpayer would pay $518,000 plus interest. This includes:

(a) Tax of $140,000 (8 years at $17,500) plus interest,

(b) An accuracy-related penalty of $28,000 (*i.e.*, $140,000 x 20%), and

(c) An additional penalty, in lieu of the FBAR and other potential penalties that may apply, of $385,000 (*i.e.*, $1,400,000 x 27.5%).

5. If the taxpayer didn't come forward and then the IRS discovered his or her offshore activities, that taxpayer would face up to $4,543,000 in tax, accuracy-related penalty, and FBAR penalty. The taxpayer would also be liable for interest and possibly additional penalties, and an examination could lead to criminal prosecution.

6. The civil liabilities outside the Offshore Voluntary Disclosure Program potentially include:

(a) The tax, accuracy-related penalties, and, if applicable, the failure to file and failure to pay penalties, plus interest, as described above,

(b) FBAR penalties totaling up to $3,825,000 for willful failures to file complete and correct FBARs (2005 - $575,000, 2006 - $600,000, 2007 - $625,000, 2008- $650,000, and 2009 - $675,000, and 2010 - $700,000),

(c) The potential of having the fraud penalty (75-percent) apply, and

(d) The potential of substantial additional information return penalties if the foreign account or assets is held through a foreign entity such as a trust or corporation and required information returns were not filed.

7. Note that if the foreign activity started before 2003, the Service threatens that it may examine tax years prior to 2003 if the taxpayer is not part of the OVDP.

8. The FAQ contains no less than 11 questions-and-answers on how to calculate the 27.5% penalty and states that the penalty applies to all assets directly owned by the taxpayer, including: (1) financial accounts holding cash, securities or other custodial assets; (1) tangible assets such as real estate or art; and (3) intangible assets such as patents or stock or other interests in a U.S. or foreign business.

9. The FAQ further takes the position with respect to non-income producing assets (such as a foreign personal residence or artwork) that if offshore assets were acquired with funds that were subject to U.S. tax but on which no such tax was paid, the offshore penalty would apply regardless of whether the assets are actually producing income. Note: This broad definition of the assets which are included in the "base" on which the OVDP Penalty amount is calculated is sometimes referred to as a "taint" rule, and the assets acquired with funds from an improperly reported foreign account are informally referred to as "tainted assets." The taint rule means that foreign assets where ANY portion of the acquisition funds comes from an improperly reported foreign account can be included in the OVDP Penalty calculation, however unreasonable that may be.

10. There is no apparent basis in law for this massive and exorbitant penalty definition, and no logical reason why taxpayers should agree to it – other than the specter of the IRS applying the excessive FBAR penalties in an abusive manner and/or the threat of criminal prosecution.

H. The PFIC Storm

1. Section 521 of the Hiring Incentives to Restore Employment Act of 2010[28] ("HIRE Act") added new paragraph (f) to Section 1298, effective March 18, 2010. Section 1298(f) requires a U.S. person that is a shareholder of a PFIC to file an annual report containing such information as the Secretary may require. The HIRE Act also amended Section 6501(c)(8)[29] to extend the statute of limitations for assessment of tax for a shareholder that fails to comply with the reporting requirements of Section 1298(f).

2. The IRS has announced in OVDP FAQ #10 that a significant number of cases submitted under the 2009 OVDP and 2011 OVDP involve PFIC investments. A lack of historical information on the cost basis and holding period of many PFIC investments makes it difficult for taxpayers to prepare statutory PFIC computations and for the Service to verify them. As a result, resolution of voluntary disclosure cases could be unduly delayed. Therefore, for purposes of this program, the Service is offering taxpayers an alternative to the statutory PFIC computation that will resolve PFIC issues on a basis that is consistent with the Mark to Market (MTM) methodology authorized in Internal Revenue Code § 1296 but will not require complete reconstruction of historical data.

The terms of this alternative resolution are as follows:

3. If elected, the alternative resolution will apply to all PFIC investments in cases that have been accepted into this program. The initial MTM computation of gain or loss under this methodology will be for the first year of the OVDP application, but could be made after that year depending on when the first PFIC investment was made. In the example under FAQ #8 above, for the earliest disclosures under this program, the first year of the OVDP application will be the calendar year ending December 31, 2003. This will require a determination of the basis for every PFIC investment, which should be agreed between the

[28] Public Law 111–147, 124 Stat. 71.

[29] IRC § 6501(c)(8) was further amended by Public Law 111–226, 124 Stat. 2389.

taxpayer and the Service based on the best available evidence.

4. A tax rate of 20% will be applied to the MTM gain(s), MTM net gain(s) and gains from all PFIC dispositions during the voluntary disclosure period under the OVDP, in lieu of the rate contained in IRC § 1291(a)(1)(B) for the amount allocable to the current year and IRC §1291(c)(2) for the deferred tax amount(s) allocable to any other taxable year.

5. A rate of 7% of the tax computed for PFIC investments marked to market in the first year of the OVDP application will be added to the tax for that year, in lieu of the interest charge mechanism described in IRC §§ 1291(c) and 1296(j).

6. MTM losses will be limited to unreversed inclusions (generally, previously reported MTM gains less allowed MTM losses) on an investment-by-investment basis in the same manner as IRC § 1296. During the voluntary disclosure period under the OVDP these MTM losses will be treated as ordinary losses (IRC § 1296(c)(1)(B)) and the tax benefit is limited to the tax rate applicable to the MTM gains derived during the voluntary disclosure period (20%). MTM and/or disposition losses in any subsequent year on PFIC assets with basis that was adjusted upward as a result of the alternate resolution in voluntary disclosure years, will be treated as capital losses. Any unreversed inclusions at the end of the voluntary disclosure period will be reduced to zero and the MTM method will be applied to all subsequent years in accordance with IRC § 1296 as if the taxpayer had acquired the PFIC stock on the last day of the last year of the voluntary disclosure period at its MTM value and made an IRC § 1296 election for the first year beginning after the voluntary disclosure period. Thus, any subsequent year losses on disposition of PFIC stock assets in excess of unreversed inclusions arising after the end of the voluntary disclosure period will be treated as capital losses.

7. Regular and Alternative Minimum Tax are both to be computed without the PFIC dispositions or MTM gains and losses. The tax from the PFIC transactions (20% plus the 7% for the first year, if applicable) is added to (or subtracted from) the applicable total tax (either regular or AMT, whichever is higher). The tax and interest (*i.e.*, the 7% for the first year of the voluntary disclosure) computed under the OVDP alternative MTM can be added to the applicable total tax (either regular or AMT, whichever is higher) and placed on the amended return in the margin, with a supporting schedule.

8. Underpayment interest and penalties on the deficiency are computed in accordance with the Internal Revenue Code and the terms of the OVDP.

9. For any PFIC investment retained beyond the voluntary disclosure period, the taxpayer must continue using the MTM method, but will apply the normal statutory rules of section 1296 as well as the provisions of IRC §§ 1291-1298, as applicable.

10. Before electing the alternative PFIC resolution, taxpayers with PFIC investments should consult their tax advisors to ensure that the issue is material in their cases and that the alternative is in fact preferable to the statutory computation in their situation. If the taxpayer does not elect to use the alternative PFIC computation, the PFIC provisions of §§ 1291-1298 apply.

I. Taxpayer Advocate's Report (February 2014) on OVDP Program

1. The Taxpayer Advocate Service of the IRS issued a report in February 2014, entitled "IRS Offshore Voluntary Disclosure Programs Continue to Burden 'Benign Actors' and Damage IRS Credibility" (the "TA Report").

2. The TA Report said "[t]hese programs apply a one-size-fits-all approach designed for 'bad actors' to 'benign actors' who inadvertently violated the rules, requiring them to opt-in and then opt-out, and subjecting them to lengthy examinations and draconian civil and criminal penalties."

3. A Government Accountability Office (GAO) analysis showed that the offshore penalty paid by those with the smallest accounts (*i.e.* those in the 10th percentile with accounts of $78,312) was disproportionate – at least 575-percent of the tax, interest, and penalties on their unreported income. The penalty was also disproportionately greater than the amount paid by those with the largest accounts (*i.e.*, those in the 90th percentile with accounts of more than $4 million) who paid 86-percent or less. Moreover, the IRS initially processed applications from benign actors who are expected to opt out much more slowly than others, though it has recently begun to process them more quickly.

4. The National Taxpayer Advocate, the head of the Taxpayer Advocate Service, remains concerns that the IRS does not have a simple and easy method for allowing benign actors who are U.S. residents to resolve past filing delinquencies. Nor has the IRS provided clear guidance on key terms that it has used in its programs, such as when someone will be considered "high risk," how one may avoid a penalty (*e.g.*, by demonstrating "reasonable cause"), and when one will be subject to the lower penalty applicable to "non-willful" conduct. The uncertainty surrounding these terms and the consequences of opting out has likely prompted some benign actors to pay more than they should inside the OVDP Programs.

5. In addition, the IRS has reportedly revoked pre-clearance letters authorizing taxpayers to participate in the OVDP, even though some had already made disclosures, filed returns, and paid taxes and penalties in reliance on the IRS's letters. These reversals further erode the IRS's credibility, and are more likely to reduce rather than increase voluntary compliance.

6. Moreover, the IRS has not adopted the National Taxpayer Advocate's recommendation that the IRS send notices to educate those with foreign accounts about the requirements. Nor has it addressed the unnecessarily burdensome requirement to report certain accounts on both Form 8938 and the FBAR. In FY 2014, the National Taxpayer Advocate will continue to advocate for taxpayers experiencing problems with the IRS's OVDP Programs. In addition, the National Taxpayer Advocate will advocate for the IRS to stop unnecessarily burdening taxpayers who inadvertently failed to report foreign accounts on information returns, and to adopt more reasonable policies that will restore its credibility and be more consistent with its mission to promote voluntary compliance.

VI. STREAMLINED FILING COMPLIANCE PROCEDURES

A. Purpose of the Streamlined Procedures

1. The Streamlined Filing Compliance Procedures ("Streamlined Procedures") are available to taxpayers who can certify that their failure to report foreign financial assets and pay all tax due in respect of those assets did not result from *willful* conduct on their part.

2. The Streamlined Procedures are designed to provide taxpayers with the following opportunities and choices:

(a) a Streamlined Procedure for filing amended or delinquent returns;

(b) terms for resolving their tax and penalty procedure for filing amended or delinquent returns; and

(c) terms for resolving their tax and penalty obligations.

3. The Streamlined Procedures were first offered on September 1, 2012, and were expanded and modified in 2014 to accommodate a broader group of U.S. taxpayers. Major changes in 2014 to the Streamlined Procedures include:

(a) extension of eligibility to U.S. taxpayers residing in the United States;

(a) elimination of a minimum $1,500 tax threshold; and

(b) elimination of the risk assessment process associated with the Streamlined Procedure announced in 2012.

B. Eligibility for the Streamlined Procedures

1. The 2014 Streamlined Procedures are designed *only for individual taxpayers*, including estates of individual taxpayers.

2. The Streamlined Procedures are available to both U.S. individual taxpayers residing outside the United States and U.S. individual taxpayers residing in the United States. Descriptions of the specific eligibility requirements for the Streamlined Procedures for both non-U.S. residents (the "Streamlined Foreign Offshore Procedures") and U.S. residents ("Streamlined Domestic Offshore Procedures") are set forth below.

3. To participate in the Streamlined Procedures, taxpayers must certify that conduct was not willful. Taxpayers using either the Streamlined Foreign Offshore Procedures or the Streamlined Domestic Offshore Procedures, will be required to certify, in accordance with the specific instructions set forth below, that the failure to report all income, pay all tax and submit all required information returns, including FBARs (FinCEN Form 114, previously

Form TD F 90-22,1) was due to non-willful conduct.

4. *If the IRS has already initiated a civil examination* of taxpayer's returns for any taxable year, regardless of whether the examination relates to undisclosed foreign financial assets, the *taxpayer will not be eligible* to use the Streamlined Procedures. Taxpayers under examination may consult with their agent.

5. Similarly, a taxpayer under criminal investigation by IRS Criminal Investigation is also ineligible to use the Streamlined Procedures.

6. All returns submitted under the Streamlined Procedures must have a valid Taxpayer Identification Number. For U.S. citizens, resident aliens, and certain other individuals, the proper TIN is a valid Social Security Number (SSN).

7. NOTE: Individuals who are not eligible for an SSN or ITIN will not be processed under the Streamlined Procedures. However, for taxpayers who are ineligible for an SSN but do not have an ITIN, a submission may be made under the Streamlined Procedures if accompanied by a complete ITIN application.

C. Quiet Disclosures Must Be Disclosed

1. Taxpayers eligible to use the Streamlined Procedures who have previously filed delinquent or amended returns in an attempt to address U.S. tax and information reporting obligations with respect to foreign financial assets (so-called "quiet disclosures" made outside of the Offshore Voluntary Disclosure Program (OVDP) or its predecessor programs) may still use the Streamlined Procedures by following the instructions set forth below. However, any penalty assessments previously made with respect to those filings will not be abated.

D. Choosing Between OVDP or Streamlined Procedures

1. Taxpayers who are concerned that their failure to report income, pay tax, and submit required information returns may be characterized by the IRS as "willful" conduct face a difficult and challenging decision. If a taxpayer's conduct is likely to be determined to be willful, and the taxpayer wants assurance that s/he will not be subject to criminal liability and/or substantial monetary penalties, than the taxpayer should probably participate the Offshore Voluntary Disclosure Program instead. The IRS helpfully suggests on the irs.gov website that taxpayers "should consult with their professional or legal advisers."

E. General treatment under the Streamlined Procedures

1. Tax returns submitted under either the Streamlined Foreign Offshore Procedures or the Streamlined Domestic Offshore Procedures will be processed like any other return submitted to the IRS. Consequently, receipt of the returns will not be acknowledged by the IRS and the streamlined filing process will not culminate in the signing of a closing agreement with the IRS.

2. The IRS states that returns submitted under either the Streamlined Foreign Offshore Procedures or the Streamlined Domestic Offshore Procedures will not be subject to IRS audit automatically, but may be selected for audit under the existing audit selection processes applicable to any U.S. tax return and may also be subject to verification procedures in that the accuracy and completeness of submissions may be checked against information received from banks, financial advisors, and other sources. This means that returns submitted under the Streamlined Procedures may be subject to IRS examination, additional civil penalties, and even criminal liability, if deemed appropriate by the IRS.

3. Again, taxpayers who are concerned that their failure to report income, pay tax, and submit required information returns was due to willful conduct and who seek assurances that they will not be subject to criminal liability and/or substantial monetary penalties should consider participating in the Offshore Voluntary Disclosure Program.

4. After a taxpayer has completed the streamlined filing compliance procedures, he or she will be expected to comply with U.S. law for all future years and file returns according to regular filing procedures.

F. Choice between Streamlined Procedures and OVDP

1. Choosing between the Streamlined Procedures and the OVDP Program is an "either/or" choice. Once a taxpayer makes a submission under either the Streamlined Foreign Offshore Procedures or the Streamlined Domestic Offshore Procedures, the taxpayer may not participate in OVDP. Similarly, a taxpayer who submits to an OVDP voluntary disclosure letter pursuant to OVDP FAQ #24 on or after July 1, 2014, is not eligible to participate in the Streamlined Procedures.

2. A taxpayer eligible for treatment under the Streamlined Procedures who submits, or who has submitted, a voluntary disclosure letter under the OVDP (or any predecessor offshore voluntary disclosure program) prior to July 1, 2014, but who does not yet have a fully executed OVDP closing agreement, may request treatment under the applicable penalty terms available under the Streamlined Procedures.

3. NOTE: A taxpayer seeking such treatment does not need to opt out of the OVDP but will be required to certify, in accordance with the instructions set forth below, that the failure to report all income, pay all tax, and submit all information returns, including FBARs, was due to non-willful conduct. As part of the OVDP process, the IRS will consider this request in light of all the facts and circumstances of the taxpayer's case and will determine whether or not to incorporate the streamlined penalty terms in the OVDP closing agreement.

VII. FATCA

A. Overview of FATCA

1. Meanwhile, Congress at the behest of the IRS decided to provide a tremendous enforcement vehicle by passing the Foreign Account Tax Compliance Act, or

FATCA, in 2010.

2. The Foreign Accounting Tax Compliance Act ("FATCA") is a controversial U.S. law enacted in 2010, and includes a withholding tax that went into effect on July 1, 2014 (referred to sardonically as "F-Day"). FATCA is supposedly designed to address under- reporting of income by U.S. taxpayers by making it more difficult to "hide" unreported financial assets outside the U.S. However, it goes far beyond this "simple" purpose.

3. FATCA is comprised of three basic parts:

> (a) A requirement that foreign financial institutions (FFIs) report assets in accounts held by U.S. taxpayers, enforced by a withholding tax regime imposed on payment to FFIs if they fail to comply;
>
> (b) A reporting obligation imposed on U.S. taxpayers with respect to foreign accounts and certain other specified assets, now required to be reported annually on the Form 8938; and
>
> (c) A "loophole" closing provision that prevents foreign investors to avoid withholding tax on U.S. dividends by using swap contracts to create "dividend equivalents."

4. The comprehensive withholding/due diligence regime, which is the heart of FATCA, was originally scheduled to go into effect on January 1, 2013. However, full implementation was postponed several times, and the comprehensive F-Day withholding regime took effect on July 1, 2014. On May 2, 2014, the IRS cryptically announced[30] that it will consider 2014 and 2015 to be a "transition period" for FATCA enforcement regarding parties who have made "good faith efforts" to comply. The applicable notice does not go on to explain exactly what measures the IRS would consider to be "good faith efforts." Without further guidance, the true meaning of good faith (like the number of angels who can dance on the head of a pin) will be in the eye of the beholder.

5. FATCA Form 8938 imposes reporting requirements on individuals, and went into effect on January 1, 2012, effective for 2011. Taxpayers are required, starting for the 2011 tax year, to report foreign assets above a $50,000 threshold on Form 8938, which is filed each year as part of the Form 1040 federal individual income tax return. The information required for a Form 8938 is massively duplicative of the information already reported on the FBAR form, but both forms are required each year, even though they are filed at different times, to different places, with different (insanely draconian) penalties for each, and little difference in the information provided to the IRS.

6. Even though FATCA Form 8938 is, for all intents and purposes, duplicative of the FBAR form in most (potentially not all) material respects, FATCA created a separate violation within the purview of the IRS and the ambit of the Internal Revenue Code,

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[30] *See* Notice 2014-33.

to require reporting of additional (though again mostly duplicative) information about foreign bank accounts in foreign financial assets generally.

B. Reporting Obligations of FFIs and NFFEs

1. At the financial institutions level, FATCA puts in place a huge and complicated reporting regime imposed on foreign financial institutions (FFIs) and on non-financial foreign entities (NFFEs), requiring them to report information on all U.S. account holders (in the case of an FFI) or on all U.S. equity holders (in the case of an NFFE). These reporting requirements are designed to ferret out information about foreign investment holdings, although in a hugely burdensome and highly controversial manner.

2. FATCA generally imposes a reporting requirement on foreign financial institutions (FFIs) similar to the Form 1099 reporting requirements imposed on U.S. banks and financial institutions. FFIs are required to report to the IRS certain information on accounts held for or on behalf of U.S. taxpayers, or face a 30-percent withholding tax penalty.

3. The 30-percent withholding tax is required to be withheld on all "U.S. source income" paid to a non-compliant FFI. U.S. source income includes interest income paid on loans to a U.S. borrower or to any other borrower that is deemed to be "U.S. source income" under the applicable sourcing rules.

4. FATCA withholding will apply to loans and other transactions entered into after the effective date, July 1, 2014. Loans entered into before that date (*e.g.*, loans from an FFI to a U.S. borrower) will not be subject to FATCA withholding, unless materially modified after that date.

5. To avoid FATCA's onerous withholding regime, an FFI must either:

(a) Be located in a jurisdiction with an Inter-Governmental Agreement (IGA) with the U.S., in which case the FFI will automatically be deemed a "participating FFI" (PFFI); or

(b) Enter into an FFI Agreement with the IRS, and thereby qualify as a PFFI.

6. FATCA defines "foreign financial institution" very broadly and includes not only banks, but every entity that, as a substantial part of its business, holds financial assets for the account of others, or engages primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities, or any interest (such as futures contracts, forward contracts, or options) therein.

7. The categories of payments subject to withholding under FATCA are defined very broadly, and, as a practical matter, the Act will make impossible for any foreign bank or other serious foreign financial institution to conduct financial relationships with persons in the United States unless it enters into an FFI Agreement.

C. <u>Withholding Obligations of U.S. Withholding Agents.</u>

1. There are two basic categories of payments subject to FATCA penalty withholding:

(a) Withholdable Payments and

(b) "Passthru Payments." <u>Note:</u> The word "passthru" is the actual spelling used in the Code; someone please get Congress a dictionary.

2. Withholdable Payments are defined to include (take a deep breath) payments of: interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and (my personal favorite) a catch-all category, "FDAP income," meaning other fixed or determinable annual or periodic gains, profits, and income, if such payment is from sources within the United States and is not effectively connected with the conduct of a U.S. trade or business. Withholdable Payments also include the gross proceeds from the sale or other disposition of property that can produce interest or dividends from sources within the United States. In this latter case, withholding is based on the gross proceeds, regardless of the amount of gain that is realized with respect to the disposition.

3. The FATCA Final Regulations succinctly render the rather lengthy definition of "Withholdable Payment" into at least a more cogent phrasing by stating that a Withholdable Payment is: "any payment of U.S. source FDAP income; and [f]or any sales or other dispositions occurring after December 31, 2016, any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends that are U.S. source FDAP income."[31]

4. FDAP income includes virtually all common income items, including: interest, OID, dividends, rents, salaries, wages, compensation, pensions and annuities, and royalties. The phrase "U.S. sources" means that the payment is derived from sources within the United States.

5. The FATCA withholding obligation applies to the gross amount of the income payment (*<u>i.e.</u>*, it is not reduced by any offsets or deductions). Significantly, the FATCA Final Regulations state that a withholding agent who is unable to determine the payment source at the time of payment is required to treat the payment as U.S. source income.[32]

6. It is important to recognize that FATCA generally overrides the normal withholding exceptions allowed for U.S. source FDAP income under other Internal Revenue Code sections. For example, portfolio interest or U.S. bank interest are exempt from withholding under normal rules, but are subject to FATCA withholding.

[31] Treas. Reg. § 1.1473-1(a)(1).
[32] Treas. Reg. § 1.1471-2(a)(5).

7. Under the FATCA Final Regulations, "gross proceeds" subject to withholding are defined as an amount from the "sale, exchange, or disposition or property . . . that requires recognition of gain or loss under Section 1001, determined without regard to whether the owner of such property is subject to U.S. federal income tax with respect to such sale, exchange, or disposition."[33]

8. Withholding on gross proceeds is scheduled to go into effect for property disposed of after December 31, 2016, except for proceeds from sale of a grandfathered obligation (*i.e.*, an obligation that was outstanding on January 1, 2014 and is disposed of after December 31, 2016).

D. Criticism of FATCA.

1. FATCA has been the subject of withering criticism from a wide variety of sources, both U.S. and international.

2. The projected revenue gain from FATCA was estimated to be only $8.7 billion over a ten-year period, or about $870 million per year. The U.S. government, meanwhile, spent on average $435 million per hour in FY 2011, meaning that FATCA will pay for approximately two hours of U.S. government each year. Compliance costs are expected to dwarf the projected revenues.

E. Latest IRS Announcements on FATCA Enforcement

1. On May 2, 2014, the IRS announced in Notice 2014-33 that 2014 and 2015 would be regarded as "transition" years for FATCA enforcement.

VIII. 2014 OVDP: THE STREAMLINED PROCEDURES

A. IR-2014-73 Announced 2014 OVDP

1. On June 18, 2014, the IRS released IR-2014-73 and related documents, which continue the 2012 OVDP but make significant modifications that are effective July 1, 2014.

2. The revised OVDP Program is now being called the "2014 OVDP." However, to remain consistent with the nomenclature of this Outline, it will be referred to herein as "2014 OVDP."

3. Broadly speaking, the 2014 OVDP does two things:

(a) First, it expands the category of taxpayers who can participate in streamlined procedures for OVDP (Streamlined Domestic Offshore procedures and Streamlined Foreign Offshore procedures [sic.]), which entail a much smaller penalty but no protection from criminal investigation.

(b) Second, it increases the penalties and compliance burden for

[33] Treas. Reg. § 1.1473-1(a)(3).

taxpayers who apply to the 2014 OVDP but do not qualify for the streamlined procedures.

B. Streamlined Procedures under 2014 OVDP.

1. Reduced Penalty for U.S. Residents. U.S. residents who participate in streamlined procedures pay a Title 26 miscellaneous offshore penalty equal to 5-percent of the highest aggregate balance/value of the taxpayer's foreign financial assets that should have been, but was not, reported on an FBAR during: (1) each of the most recent 3 years for which the U.S. tax return due date has passed and (2) each of the most recent 6 years for which the FBAR due date has passed. *However*, under the streamlined procedures, a taxpayer will not be subject to accuracy-related penalties, information return penalties, or FBAR penalties unless a subsequent audit determines that the original return was fraudulent and/or the FBAR violation was willful.

2. Reduced Penalty for Nonresidents. As was the case before IR-2014-73, nonresident U.S. taxpayers who participate in the streamlined procedures to OVDP must pay the omitted tax and interest but are not subject to further penalties. Specifically, the taxpayer will not be subject to failure-to-file and failure-to pay penalties, accuracy-related penalties, information return penalties, or FBAR penalties unless a subsequent audit determines that the original return was fraudulent and/or the FBAR violation was willful. Any previously assessed penalties will not be abated.

3. Non-U.S. Retirement and Savings Plans. The taxpayer is also allowed to retroactively elect to have income deferral on certain foreign retirement and savings plans where the deferral is permitted under a treaty.

4. Eligibility before July 1, 2014. Under the rules prior to IR-2014-73, a taxpayer was eligible for the streamlined procedure only if: (1) the taxpayer was nonresident in the U.S. and (2) the IRS deemed the taxpayer to be low compliance risk. To be considered low compliance risk, the taxpayer had to submit a risk questionnaire and generally had to specify a tax liability below $1,500 in each of the previous three years.

5. Eligibility on and after July 1, 2014. To qualify for streamlined procedures, U.S. resident taxpayers must: (1) qualify for OVDP (2) have previously filed a U.S. tax return (if required) for each of the most recent 3 years for which the U.S. tax return due date (or properly applied for extended due date) has passed, (3) failed to report gross income from a foreign financial asset and pay tax as required by U.S. law, and may have failed to file an FBAR and/or one or more international information returns[34] with respect to the foreign financial assets, and (4) such failures resulted from non-willful conduct. Non-willful conduct is defined as negligence, inadvertence, or mistake, or conduct that is the result of a good faith misunderstanding of the requirements of the law.

[34] Such as Forms 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts); 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner); 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations); 5472 (Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business); 8938 (FATCA); 926 (Return by a U.S. Transferor of Property to a Foreign Corporation); and 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund).

6. Procedures. U.S. residents under streamlined procedures must: (1) file amended returns for each of the most recent 3 years; (2) include at the top of the first page of each amended tax return "Streamlined Domestic Offshore" written in red; (3) complete and sign a Certification by U.S. Person Residing in the U.S.; (4) pay all tax due, interest, and Title 26 miscellaneous offshore penalty under the streamlined procedure; (5) file delinquent FBARS electronically at FinCEN for the most recent 6 years. Nonresident taxpayers follow an analogous procedure, differing in respects such as including at the top of the first page of each delinquent or amended tax return and at the top of each information return "Streamlined Foreign Offshore."

C. Modifications under 2014 OVDP

1. Increased Penalties. The offshore penalty is increased from 27.5-percent to 50-percent if the taxpayer does not submit a pre-clearance before there has been a "public disclosure" that a financial institution where the taxpayer holds an account is under investigation, cooperating with, or identified in a court-approved issuance of a summons by the IRS or the Department of Justice. Examples of a public disclosure event include a public filing of a judicial proceeding or a public disclosure by the Department of Justice regarding a Deferred Prosecution Agreement or Non-Prosecution Agreement with a financial institution or other facilitator.

2. Accelerated Payment of Penalties. Taxpayers under the 2014 OVDP will need to pay the OVDP offshore penalty at the time of the OVDP application. Under the OVDP FAQ effective prior to July 1, 2014, taxpayers were already required to pay omitted tax, interest, accuracy-related penalties, and, if applicable, failure-to-file and failure-to-pay penalties on that date. However tax practitioners had found that the IRS generally allowed taxpayers to participate in 2012 OVDP and make payments of omitted taxes, interest, and penalties at the end of the OVDP Process. Whether the IRS will loosely or strictly apply this requirement in the context of 2014 OVDP is yet to be seen.

3. Elimination of Reduced Penalties. In coordination with the expanded 2014 OVDP Streamlined Procedures, the reduced penalties for certain non-willful taxpayers have also been eliminated. 2012 OVDP previously reduced the offshore penalty to 5-percent while leaving other penalties in place for highly specific and fact-dependent categories of non-willful taxpayers.[35]

4. Additional Information Required. Applicants to the 2014 OVDP Program will have to submit additional information to apply for preclearance by IRC CI. These include identifying information as to the applicant, all financial institutions at which undisclosed OVDP

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[35] These included:
Taxpayers who (a) did not open or cause the account to be opened, (b) exercised minimal, infrequent contact with the account, (c) except for a withdrawal closing the account and transferring the funds to an account in the U.S., had not withdrawn more than $1,000 from the account in any year for which the taxpayer was non- compliant, and (d) can establish that all applicable U.S. taxes have been paid on funds deposited to the account;

(1) taxpayers who are foreign residents and who were unaware they were U.S. citizens; and

(2) taxpayers who are foreign residents and who: (a) reside in a foreign country, (b) have made a good faith showing that he or she has timely complied with all tax reporting and payment requirements in the country of residence, and (c) have $10,000 or less of U.S. source income each year. FAQ #7.

assets were held, and all foreign and domestic entities through which the undisclosed OVDP assets were held by the taxpayer. Taxpayers must also submit account statements for all foreign financial accounts at the time of the OVDP application, regardless of account balance.

5. Electronic Filing Option. In a small concession to taxpayers, voluminous documents not requiring original signatures may be submitted on CD, DVD, or USB removable storage device.

D. Conclusion

1. The 2014 OVDP can best be described as a mixed blessed for taxpayers who have been made aware of and wish to come into compliance with U.S. tax and reporting obligations.

2. The streamlined procedures under 2014 OVDP entail a much smaller price tag in penalties, but also do not assure the taxpayer against further penalties if the IRS subsequently decides to commence an audit and determines that the original return was fraudulent and/or the FBAR violation was willful. Likewise, the streamlined procedure provides no protection against a criminal prosecution. As discussed above, the case law interpreting "willful" for FBAR penalty purposes is still relatively sparse and under-developed, but there is a concern that the IRS may argue that a failure to file an FBAR can be deemed willful by the mere fact that the taxpayer signed and filed a tax return that year.

3. WARNING: A taxpayer who qualifies for 2014 OVDP and does not opt into the streamlined procedures now faces both more onerous procedures and possibly much heavier penalties.

4. Comment: In this latest carrot-and-stick maneuver, the IRS is quick to emphasize the smaller penalties and expanded eligibility for taxpayers who elect to participate under the streamlined procedures provided by the 2014 OVDP. However, taxpayers who try to participate in the streamlined procedures but who are actually ineligible because of fraud and/or willful failure to file FBAR lose all OVDP Protection. Therefore, taxpayers with serious risk or fraud exposure/willful exposure may well choose to participate in OVDP but not elect the streamlined procedures.

IX. CASE STUDIES OF FOREIGN BANK ACCOUNT REPORTING MISTAKES

Hypothetical #1

Taxpayer A is a U.S. citizen whose mother is an Irish citizen residing in Ireland. The mother has no desire to leave Ireland and maintains a financial account with an Irish bank. The financial account contains $1 million, her life savings. In 1998, while Taxpayer A was visiting his mother in Ireland, she insisted that he become a signatory on her account, so that he could write checks for her benefit in case she became incapacitated. Taxpayer A has not filed any FBARs during any prior year, and just discovered information about the filing obligations.

Hypothetical #2

Taxpayer B is a U.S. permanent resident who inherited a large portfolio of stocks on the passing of his father in 1990, now worth over $10 million. The stocks are all publicly traded stocks in foreign Country X, and are held in a Country X financial account. The dividend income is subject to tax in Country X, where the income tax rate on dividends is significantly higher than the U.S. tax rate on qualified dividends. Taxpayer B was told back in 1990 that he would get a full tax credit for all the Country X taxes paid, and would owe no additional tax. The accountant at the time recommended leaving the foreign dividend income off the return, since it added a lot of extra income and extra foreign tax credits and resulted in no additional US income tax liabilities.

Hypothetical #3

Taxpayer C has quietly deposited money into a secret Swiss bank account for years, starting in 2000, and has not reported the income earned in the Swiss bank account in any year since the account was opened.

The account has a current balance of $1 million. It generates investment income of about $10,000 per year.

Hypothetical #4.

Taxpayer D illegally sells drugs and puts his drug profits into a secret bank account in a country located in Central America. The account currently has a balance of $5 million.