

Voluntary Disclosure of Foreign Assets: Current Challenges for Noncompliant U.S. Taxpayers

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Dennis Brager is a California State Bar Certified Tax Specialist and a former Senior Trial Attorney for the Internal Revenue Service's Office of Chief Counsel. In addition to representing the IRS in the United States Tax Court, he advised the Service on complex civil and criminal tax issues. He now has his own five-attorney firm in Westwood and has been featured as a Super Lawyer in the field of Tax Litigation by *Los Angeles Magazine*. He has been quoted as a tax expert by *US News* and *World Report*, *Business Week*, the *Daily Journal*, *The Daily Beast*, *USA Today*, the *Los Angeles Daily Journal*, *Tax Analyst*, *The Chicago Tribune*, *CNN Money*, *Bloomberg BNA*, *Cannabis Daily*, *Accounting Today*, *Tax Notes Today*, and *The National Law Journal*.

Having worked for the IRS for six years, he gained valuable insight into the inner workings of that organization. This not only helps in developing the right strategies, but facilitates working with the system quickly and efficiently. Mr. Brager has limited his practice to representing clients having disputes with the IRS, the Franchise Tax Board, the State Board of Equalization, and the Employment Development Department—both at trial and administrative levels.

He has appeared on ABC Television's Good Morning America, Fox Business News, ABC Eyewitness News, and TV One Access. He has also spoken and given webinars before the IRS sponsored Nationwide Tax Forum, the California Continuing Education of the Bar, the California Society of CPAs, the UCLA Tax Controversy Institute, the California State Bar Tax Section, the Consumer Rights Litigation Conference the California Trial Lawyers Association, the National Association of Consumer Advocates, the American Bar Association, the Warner Center Estate and Tax Planning Council, and the National Association of Enrolled Agents. Dennis Brager has been an instructor at Golden Gate University's Masters in taxation Program and a guest speaker at the University of Southern California. Mr. Brager has also testified as an expert witness on Federal tax matters and has been a guest on KFWB.

His articles have appeared in the *California Lawyer*, *Marijuana Venture*, *Daily Journal*, *Taxation for Lawyers*, *Los Angeles Lawyer*, *The Consumer Advocate*, *Family Law News*, *California Tax Lawyer*, *Journal of Tax Practice and Procedure*, *Journal of Taxation of Investments*, and *Accounting Today*. They include "Offshore Voluntary Disclosure – The Next Generation," "Partial Offshore Tax Amnesty – Voluntary Disclosure 2.0," "Anatomy of an OPR Case (Definitely Not R.I.P.)," "FBAR and Voluntary Disclosure," "The Tax Gap and Voluntary Disclosure," "Circular 230: An Overview," "Recent Developments in Tax Procedure," "Damages, Rescission and Debt Cancellation as Client Income," "The Taxpayer Bill of Rights—A Small Step Toward Reining in the IRS," "Challenging the IRS Requires a Cohesive Strategy," "The Innocent Spouse Defense," "IRS Guidelines for Installment-Payment Agreements," "IRS Tightens Inventory Rules for Marijuana Businesses," and "What a Practitioner Needs to Know About Tax Assessment Dates."

Mr. Brager received his undergraduate degree from Pace University (B.B.A., magna cum laude, 1975, Accounting/Finance), and his law degree from New York University (J.D., 1978). He is a former chair of both the Tax Compliance, Procedure and Litigation Committee of the Los Angeles County Bar Association and the California State Bar tax Procedure and Litigation Committee. He is admitted to practice before the U.S. Supreme Court, the Ninth Circuit Court of Appeals, U.S. Claims Court, U.S. Tax Court, U.S. District Court and the U.S. Bankruptcy Court.

- Specified persons must report interests in “specified foreign financial assets” (SFFAs) for tax years after March 18, 2010
- Who must file?
 - “Specified persons” with “specified foreign financial assets” greater than \$50,000 at year-end or \$75,000 at any point during the year
- When & how to file?
 - Attach Form 8938, *Statement of Specified Foreign Financial Assets*, to tax return by due date (with extension)

Specified Foreign Financial Assets Reportable on Form 8938

- Foreign Financial Accounts. E.g. Bank accounts, securities accounts
- Stock or securities issued by someone that is not a U.S. person
- Any interest in a foreign entity
- Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person
- Examples of other specified foreign financial assets include the following, if they are held for investment and not held in a financial account.
 - Stock issued by a foreign corporation.
 - A capital or profits interest in a foreign partnership.
 - A note, bond, debenture, or other form of indebtedness issued by a foreign person.
 - An interest in a foreign trust or foreign estate.

- Treasury Regulations under I.R.C. § 6038D finalized on Dec. 12, 2014, adopt a number of changes to Form 8938:
 - Dual resident taxpayers now exempt from filing Form 8938 if, in essence, the individual qualifies as a nonresident alien and claims treaty benefits;
 - Definition of “financial account” now excludes certain accounts that are subject to the reporting requirements of a Model 1 or Model 2 intergovernmental agreement;
 - Jointly owned specified foreign financial assets must now report the entire value of each jointly owned asset (regardless of marital status); and
 - Nonvested property rights under I.R.C. § 83 must be reported as of the first date the property is substantially vested in the person, unless an I.R.C. § 83(b) election is made, in which case, it must be reported as of the date the property is transferred.

- Additional Treasury Regulations under I.R.C. § 6038D finalized on Feb. 23, 2016, Require “Specified Domestic Entities” (SDE) to File Form 8938:
 - Effective for Taxable years beginning in 2016, i.e. the 2017 filing season
 - SDE are domestic entities that are formed or availed of for the purpose of holding directly or indirectly SFFAs
 - A corporation or partnership meets this test if it is “closely held” by a specified individual, and at least 50% of the gross income is “passive income”, or at least 50% of the assets held by the entity are assets that produce or are held for the production of passive income.
 - The percentage of assets held is a weighted average percentage

- Definitions:
 - Closely Held. 80% of the voting power, or total value
 - Constructive Ownership Rules of I.R.C. Section 267 (c) are applied, and also includes spouses
 - Passive income.
 - Dividends
 - Interest
 - Rents and Royalties, other than those derived in the active conduct of a business
 - Annuities
 - Capital gains from passive assets
 - Capital gains from commodities transactions
 - Certain other income

- Domestic Trusts are considered “formed or availed of” only if:
 - It has one or more specified persons as a “current beneficiary”
 - “Current beneficiary” means, with respect to the taxable year, any person who at any time during such taxable year is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust
 - “Current beneficiary” also includes any holder of a general power of appointment, whether or not exercised, that was exercisable at any time during the taxable year, but does not include any holder of a general power of appointment that is exercisable only on the death of the holder.
 - Grantor trusts owned by one or more specified persons do not need to file

- Specified Domestic Entities Do Not Include:
 - Publicly traded stock
 - REITs
 - RICs
 - Banks
 - IRAs
 - Exempt Organizations under I.R.C. 501(a)
 - the United States government or any wholly owned agency or instrumentality thereof,
 - any State, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing
 - any common trust fund (as defined in section 584(a)), and
 - any trust which is exempt from tax under section 664(c), or is described in section 4947(a)(1).

- Penalties (I.R.C. § 6038D)
 - Generally, \$10,000, but may increase up to \$50,000 for failure after notice
 - \$10,000 per month continuation penalty
 - Reasonable cause defense available
 - Able to be reviewed in CDP proceedings, **if there has been no prior opportunity to dispute the penalty.**

Form 5471

Foreign Corps.

- U.S. citizens and residents (including entities) who are officers, directors, or shareholders in foreign corporations may need to file Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*. See I.R.C. §§ 6038, 6046.
 - Officer or director if there are certain 10% changes in ownership by a U.S. person,
 - Shareholders with certain 10% ownership changes in their own holdings
 - Control person in a CFC for at least 30 days;
 - A 10% or more owner of a CFC who owns stock for an uninterrupted period of 30 days or more during the tax year, AND who owned that stock on the last day of the year.
- When to file?
 - Attach to timely filed return of the affected person
- Penalties I.R.C. §§ 6038(b); 6038B(c)
 - \$10,000 per foreign corporation plus a \$10,000 per month continuation penalty to a maximum of \$50,000
 - Reasonable cause defense available
 - CDP available **if there has been no prior opportunity to dispute the penalty**
- IRS imposing continuation penalties due to lack of complete information going back many years

Form 3520

For Trusts & Gifts

- Grantors or beneficiaries with reportable transactions with foreign trusts or estates must file Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*. See I.R.C. §§ 679(c), 6048(a),(b).
 - Many reportable transactions; e.g. formation of a foreign trust; transfer of property to a foreign trust; loans to a foreign trust; the receipt of any distribution by a U.S. beneficiary
 - aggregate gifts or bequests from an NRA or foreign estate greater than \$100,000 during a calendar year
 - Gifts from foreign partnerships or foreign corporations of more than \$15,601
- When to file?
 - Due April 15th ; If the U.S. person gets an extension then the due date is Oct. 15th.
 - It is filed with Ogden, UT Service Center. It is **not** attached to the tax return
- Penalties I.R.C. § 6677
 - Greater of \$10,000 or 35% of the gross value of the distribution received from or transferred to a foreign trust
 - 5% per month of the amount of foreign gifts or inheritances, up to 25%
 - Reasonable cause defense available
 - CDP available **if there has been no prior opportunity to dispute the penalty**

Form 3520-A

For Trusts - U.S. Owner



- A foreign trust with a U.S. owner pursuant to the grantor trust rules must file Form 3520-A, *Annual Information of Foreign Trusts With a U.S. Owner*. See I.R.C. §6048(b).
 - Note: Trust obligation, but penalty falls on U.S. person.
- When to file?
 - Generally by March 15th. A separate request on Form 7004 is required to obtain an extension.
 - File with the Ogden, UT Service Center
- Penalties. I.R.C. § 6677
 - Greater of \$10,000 or 5% of the gross value of the portion of the trust assets treated as owned by the U.S. person
 - Continuation penalty of \$10,000 per month may be imposed up to \$50,000
 - The penalty is imposed on the U.S. owner, not the foreign trust. I.R.C. Section 6677(b)
 - Reasonable cause defense available
 - CDP available **if there has been no prior opportunity to dispute the penalty**

- Certain U.S. persons who own a foreign disregarded entity must file Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities*. I.R.C. §6038B.
 - A foreign DRE is an entity that is not created or organized in the U.S. and is disregarded as an entity separate from its owner for U.S. tax purposes. See Treas. Reg. Section 301.7701-2 and 3.
- When to file?
 - Attach to timely filed return of the owner of the foreign DRE
- Penalties I.R.C. § 6038(b)
 - \$10,000 per foreign disregarded entity plus a \$10,000 continuation penalty per month, not to exceed \$50,000.
 - Also, subject to a 10% reduction of the available foreign tax credit. I.R.C. Section 6038(c)
 - Reasonable cause defense available
 - CDP Available (maybe)

Form 8865

Foreign Partnerships

- Certain U.S. persons who own or engage in transactions with certain foreign partnerships must file Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*. See I.R.C. §§ 6038, 6038B, 6046A.
 - U.S. person who, at any time: directly owned more than 50% interest in partnership's capital, profits, or losses; indirectly owned a 10% or greater interest in partnership's capital, profits, or losses; or contributes, acquires, disposes, or has a substantial change in proportionate interest. Numerous exceptions.
- When to file?
 - Attach to timely filed return of the affected person
- Penalties I.R.C. §§ 6038; 6038B
 - For Category 1, 2 and 4 filers. \$10,000 per foreign partnership plus a \$10,000 per month continuation penalty. Maximum of \$60,000
 - Reduction of Foreign Tax Credits
 - For Category 3 filers. 10% of the FMV of the property contributed to the partnership
 - Limited to \$100,000 unless due to intentional disregard. In addition, the transferor must recognize gain on the property as if it had been sold for FMV.
 - Reasonable cause defense available
 - CDP available (maybe)

- U.S. citizens, corporations, and estates and trusts must report certain transfers of property and cash to foreign corporations.
 - I.R.C. 351 incorporation transactions; I.R.C. § 361 reorganizations; I.R.C. § 355 spin-offs; I.R.C. § 367(d) and (e) transactions
- When and how to file?
 - U.S. transferor must file Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*, with return for year of transfer.
- Penalties for failure to report transfers of property to a foreign corporation begin at 10% of the value of the property transferred to the corporation and can reach a maximum of \$100,000 per return. If due to intentional disregard the penalty can exceed \$100,000.
 - Reasonable cause defense available
 - CDP available

Increased FBAR Civil Penalties

- Assessed After Jan 15, 2017
 - Nonwillful \$12,663. Up from 10k
 - Subject to reasonable cause defense.
 - Willful. Minimum \$126,626 per violation. Up from a minimum of \$100,000
 - Maybe Not! U.S. v. Colliot AU-16-CA-01281-SS (WD TX May 16, 2018)

FBAR Mitigation Guideline For Smaller Accounts Threshold Requirements. IRM 4.26.16.6.6.1 (11-06-2015)

- The taxpayer has no history of past FBAR penalty assessments.
- No money in the accounts was from an illegal source or used to further a criminal purpose.
- The taxpayer cooperated during the examination.
- The IRS did not sustain a civil fraud penalty against the taxpayer for an underpayment for the years in question due to the failure to report income related to any amount in a foreign account.
- No history of criminal tax or BSA convictions for the preceding 10 years.

FBAR Non-Willful Penalty Mitigation Guideline (Smaller Accounts)

- If the aggregate of all accounts held during the year does not exceed \$50,000, then the penalty for each violation is \$500, not to exceed a total of \$5,000.
- If the aggregate of all accounts is over \$50,000, but less than \$250,000, the penalty is, per violation, the lesser of \$5,000 or 10% of the highest balance in the account during the year for which the account should have been reported.
- For violations regarding an account exceeding \$250,000, the penalty per violation is the statutory maximum of \$10,000 (12,663?).

FBAR Willful Penalty Mitigation Guidelines (Smaller Accounts)

- If the maximum aggregate balance for all accounts to which the violations relate does not exceed \$50,000, the penalty is the greater of \$1,000 per violation or 5% of the maximum account balance in the calendar year.
- If the maximum aggregate balance is more than \$50,000, but does not exceed \$250,000, the penalty is the greater of \$5,000 per violation or 10% of the maximum account balance.
- If the maximum aggregate balance is greater than \$250,000 and less than \$1,000,000, the penalty is the greater of 10% of the maximum account balance or 50% of the closing balance in the account on the last day for filing the FBAR.
- If the account exceeds \$1,000,000, the penalty is the greater of \$100,000 or 50% of the balance of the account on the last date for filing the FBAR.

IRM Guidelines Limiting Non-Willful FBAR Penalties

IRM 4.26.16.6.4.1 (post May 12, 2015)

- IRS examiners are instructed to use their best judgment when preparing FBAR penalties, taking into account all the available facts and circumstances of each case.
- In “most cases” the non-willful penalty will be limited to one \$10,000 (12,663?) per year, regardless of the number of accounts.
- The examiner, with group manager approval, and after consultation with the an Operating Division FBAR Coordinator may assert a single \$10,000 (12,663?) penalty in a multi-year case.
- In no event will the total amount of the penalties for non-willful violations exceed 50% of the account balances.

IRM Guidelines for Willful FBAR Violations (post May 12, 2015)

- In “most cases”, the total penalty amount for all years under examination will be limited to 50% of the highest aggregate balance of all unpaid foreign financial accounts during the years under examination. Examiners may recommend an amount which is higher or lower than 50%.
- The total penalty should not exceed 100% of the highest aggregate balance.

Delinquent FBAR Submission Procedures: Who is Eligible?

- Haven't filed a FBAR
- Have properly reported and paid all tax on, the income from the foreign financial accounts reported on the delinquent FBARs,
- Are not under a civil examination or a criminal investigation by the IRS, and
- Have not already been contacted by the IRS about the delinquent FBARs
- Have not contacted by the IRS about a request for delinquent returns for the years for which the delinquent FBARs are being submitted.

Delinquent FBAR Submission Procedure: How to do it

- FBARs must be submitted online.
- Include a short statement as to why the FBARs are late.
- No penalty will be imposed if the taxpayer meets the previously listed guidelines.
- No Automatic Audit

Delinquent International Information Return Submission Procedures: Who is Eligible?

- Have not filed one or more required international information returns
- Are not under a civil examination or a criminal investigation by the IRS and
- Have not already been contacted by the IRS about the delinquent information returns
- No penalty only IF there is reasonable cause for not timely filing the information returns

Delinquent International Information Return Submission Procedures: How to Do It

- All delinquent international information returns other than Forms 3520 and 3520-A should be attached to an amended return. Submit a statement of reasonable cause with a statement of all.
- Must include a certification that the entity for which the return is being submitted did not engage in tax evasion.
- c.f. OVDP FAQ 32 and 35 excepting from penalties accounts and assets which generated no gross income.

Quiet vs. Noisy Disclosure: What's the Difference?

- The lines have blurred.
 - Pre-OVDP a noisy disclosure included a meeting/tel. conf. with CI.
 - We now prefer the term “IRM Part 9 Voluntary Disclosure”
- Quiet = Amended Filings Only
- Noisy for Domestic Purposes requires that certain information be disclosed on an IRS form.
- Currently (post OVDP) no comparable noisy offshore procedure.

Voluntary Disclosures: IRM 9.5.11.9.

- It is currently the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended.
- This voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel.

Voluntary Disclosures: IRM 9.5.11.9. (Cont'd)

- Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution.
- A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. This practice does not apply to taxpayers with illegal source income.

Elements of a Voluntary Disclosure

- A communication from the taxpayer which is timely, truthful, and complete
- The taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and
- The taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable

Examples of an IRM Part 9 Voluntary Disclosure

- A letter from an attorney which encloses amended returns from a client which are complete and accurate (reporting legal source income omitted from the original returns), which offers to pay the tax, interest, and any penalties determined by the IRS to be applicable in full and which meets the timeliness.
- The letter is an essential part of a Voluntary Disclosure.

Are Quiet Disclosures Still Viable?

- In 2014, the GAO released a report critical of the IRS for failing to follow-up and audit taxpayers who had filed quiet disclosures.
- IRS appears to be systemically assessing penalties on all late-filed foreign information reporting forms.

Prospective Disclosures

- Filing accurate 2018 tax returns, and/or FBARs, but not self correcting prior years
- Advantages Over Quiet Disclosure
 - Less Chance of scrutiny
 - Lower transactional costs
- Advantages Over Streamlined
 - No 5% Streamlined penalty for domestic taxpayers
- Disadvantages
 - More chance of criminal exposure if discovered
 - 20% Accuracy Penalty will be imposed if there is no reasonable cause
 - SOL on most foreign information reporting forms including Form 8938 also remains open until 3 years after the form is filed

Best Practices For Advising Non-Compliant Taxpayers

- Understand the law including recent case law, and IRS guidelines if any
- Make sure you carefully question your client about the facts.
- Advise clients of the potential criminal risks
- Each year of a multiple year case must be addressed
- Prepare a spreadsheet of possible penalties under different alternatives
- Alert the client to worst case scenarios

Best Practices in Advising Non-Compliant US Taxpayers

- Do not rely on the unverified facts set forth by your client. Instead review all back-up documentation including prior tax returns, relevant bank statements, and emails
- Obtain copies of any organizer that your client filled out, and sent back to the tax preparer
- Tax into account unlimited SOL for most Foreign Information Reporting Forms, as well as other SOL issues
- Each year of a multiple year case must be addressed
- If you're client states that she relied on a third party – interview that person (usually the tax preparer)
- File a Freedom of Information Act (FOIA) Request if an appeal is necessary, or sometimes during audit

Questions?



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