OBER | KALER
Attorneys at Law

Fourth Annual Presentation – Important IRS and International Tax Issues

May 20, 2014

Tax Seminar, Jerusalem Ramada Hotel

Stuart M. Schabes, Esquire
Ober, Kaler, Grimes & Shriver
smschabes@ober.com
410-347-7696 (U.S.)
052-569-7938 (Israel)
www.usisraeltaxlaw.com

Agenda

- Impact of New FATCA Agreement/IGA - Model 1 Between US and Israel and IRS Notice 2014-33
  - Why should we care about it?
  - Will this lead to disclosure of the names of Americans living in Israel and abroad who have (or had) accounts in Israeli banks?
- New IRS international tax compliance initiatives including expanding IRS International Division, sub-area specialties, personnel and hot tax areas

Agenda

- Update on DOJ – Swiss Bank Tax Compliance Initiative
  - Category 1-4 and disclosure of account holder information
- PFIC's and responses to dramatic increase in IRS focus on PFIC's
- Latest on Current Voluntary Disclosure/FBAR program
  - Is it working?
  - What are advantages and possible pitfalls?
  - What are the alternatives—"noisy vs. silent" disclosure, use of Streamline or other possibilities?
  - *Multi-family OVDP participant cases and possible complications*

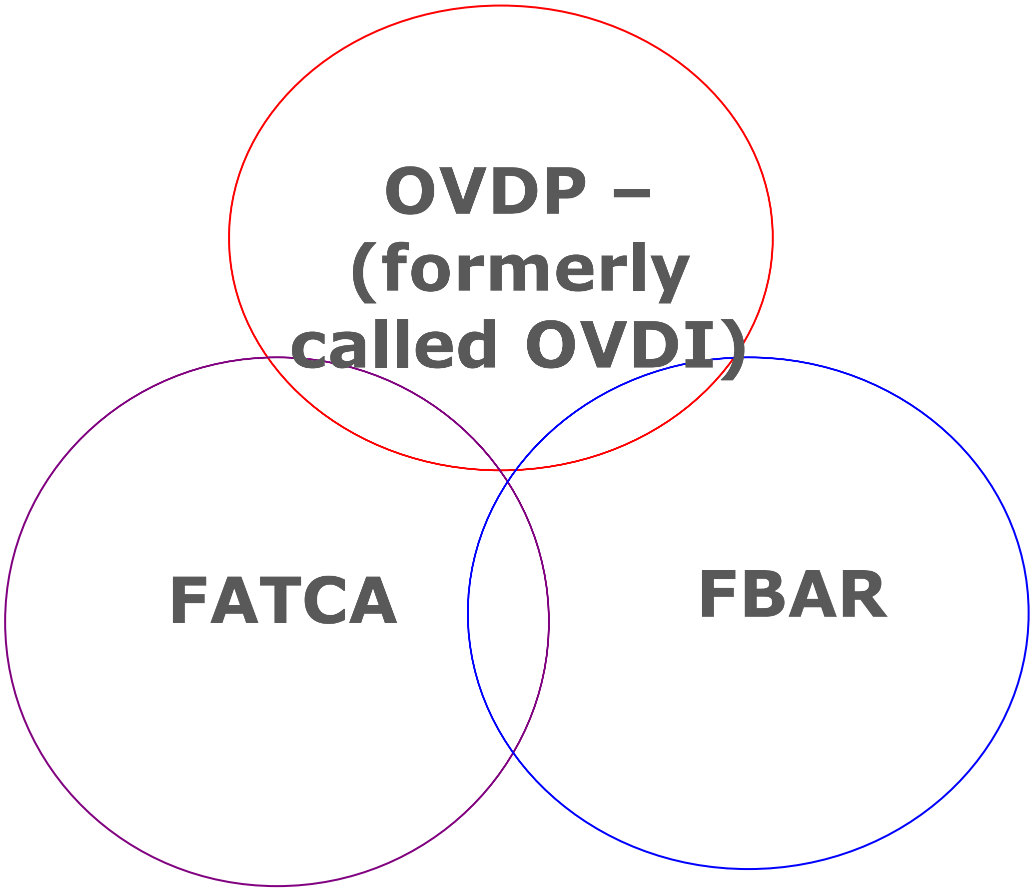
Agenda

- Updates on pre - 2012 OVDI tax cases that are still pending
- Opt Out
  - What does it mean?
  - Is it worth the risk?
  - How to try and establish taxpayer ‘reasonable basis’ or acting in a non-willful manner

Agenda

- General FBAR compliance and related matters
- Possible ways to address IRS imposed penalties and possible abatement strategies
- The IRS Streamlined Filing Compliance Procedures for non-resident/non-filer US taxpayers - is this a viable alternative?
- Expatriation and how to address Form 8854 related issues
- New Israeli trust tax laws - is there hope for US (or other taxable) entities under new rules
- Questions and Answers

Overlap



IGA Update

- Model 1 IGA – Disclosure between US and Foreign Government
  - 27 countries signed including:
    - Australia, Belgium, Canada, Cayman Islands, France, Germany, Isle of Man, Jersey, Luxemburg, Mexico, Netherlands, Spain & United Kingdom
    - Not all are the same
- Model 2 IGA – Disclosure between Individual Foreign Banks
  - 5 countries signed including:
    - Austria, Bermuda, Chile, Japan & **Switzerland**

IGA Update

- Model 1 IGA Agreements in Principle
  - 30 countries including:
    - **Israel**, Bahamas, BVI, Cyprus, Liechtenstein, India, Panama, Qatar, Singapore, South Korea & Sweden
- Model 2 IGA Agreements in Principle
  - 2 countries including:
    - Armenia & Hong Kong

U.S. – Israel Implement IGA Model 1

- Details not officially released yet
- Disclosure of Bank Account Information by Israeli Government to the U.S.
- Timing?
- Who is covered by this disclosure?
- Implementation – even if parliamentary law change is required, supposed to be an expedited process
- Not an issue of "if" information will be turned over – only "when"!
- This is a very serious matter as part of the global efforts for clamping down on tax avoidance/evasion.

DOJ – Swiss Bank Tax Compliance Initiative

- Banks must grade their compliance (Category 1-4)
- Category 1:
  - 14 banks under criminal investigation which appear to include:
    - Bank Frey, Bank Hapoalim (Switzerland), Bank Julius Baer, Basler Kantonalbank, Credit Suisse AG, HSBC Private Bank (Suisse), Liechtenstein Landesbank (Switzerland), Mizrahi Tefahot (Switzerland), Neue Zurcher Bank, Pictet & Cie, Rahn & Bodmer, Schroder & Co Banque SA and Zurcher Kantonalbank

DOJ – Swiss Bank Tax Compliance Initiative

- Category 2:
    - Execute non-prosecution agreement
    - Large group of non-compliant accounts
    - Bank pays 20-50% penalty of aggregate value of accounts
    - Penalty can be reduced by showing taxpayer's entrance into OVDP or regular compliance
    - Look back period from August 2008 and forward
        - Banks which appear to include: Bank Privee Edmond de Rothschild, Berner Kantonalbank, Edmond de Rothschild Group, Migros Bank AG, Rothschild Bank AG Zurich, St. Galler Kantonalbank, *Union Bancaire Privee*

DOJ – Swiss Bank Tax Compliance Initiative

- Category 3:
  - Not committed any criminal tax related offenses
  - Use of independent examiner
  - No penalty applies
  - Non target letter
    - Banks include: Bank am Bellevue, Notenstein Privatebank Ltd., Raieffesen, Valartis Bank (Switzerland)
- Category 4:
  - Threshold - less than 2% of non-compliant taxpayers as of December 31, 2009 and as of August 29, 2013.
    - Banks include: Acrevis Bank AG, AEK Bank 826, Appenzeller Kantonalbank, Glarus Bank

PFIC – Passive Foreign Investment Company

- Most foreign mutual funds
- Two tests:
  - Asset Test
  - Income Test
- CFC vs. PFIC
- Look through rules

Asset Test and Income Test

- Asset test – 50% or more of the assets held to generate passive income; or

- Income Test – 75% or more passive income

PFIC and Controlled Foreign Corporation (CFC)

- CFC depends on stock ownership (usually not assets or income of foreign entity)
- Corporation can be PFIC, even if foreign persons own virtually all stock
- A foreign corporation can be subject to both the PFIC and CFC (subpart F income) rule.

CFC

- US shareholders own more than 50% of the stock (by vote or value)
  - US shareholder: US person who own 10% or more of the stock
  - US shareholders' ownership interests are aggregated

CFC Takes Precedence Over PFIC - § 1296(f)

- If overlap of CFC and PFIC rules
  - U.S. shareholders relieved of complying with PFIC rule
  - Relief available for U.S. shareholder with QEF election
  - Most U.S. shareholders make QEF elections

- With most foreign mutual funds, U.S. shareholder is subject to PFIC rules and need to be reported on US tax returns

- With most other investments by foreign corporation, CFC with subpart F income under IRC Sect. 1296(f)

Subpart F Income Concerns

- CFC with passive investment income, subpart F income
  - Capital gains rate is not available
  - Losses cannot offset gains (until corporation is liquidated)

Avoiding Subpart F Income and Related Issues

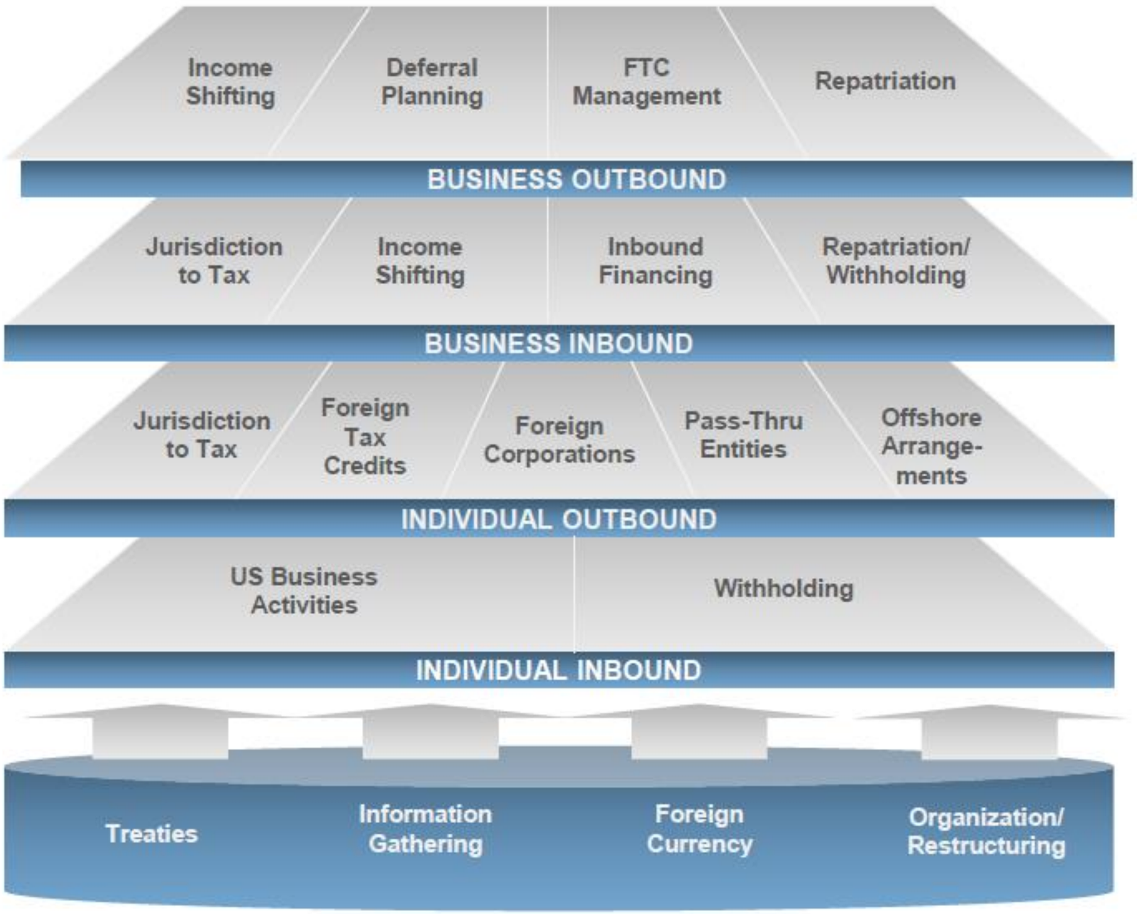
- Some foreign entity laws may provide that no owner has personal liability (and thereby classified as foreign corporation)
  - International business companies
  - Some LLCs (Nevis and Cook Islands and others)
- Perhaps file Form 8832 to elect:
  - Disregarded entity status for one owner
  - Foreign partnership for two or more owners

IRS International Division

- Early 2013 – Foreign Payments Practice (FPP) formed (approximately) 70 personnel focused on:
  - administration and enforcement of provisions (FDAP withholding)
  - FATCA, Form 1099 reporting, and section 3406 (backup withholding) pertaining to payments to NRAs and foreign entities
  - FPP Director role – Ted Setzer
- September 2013 – Director of International Strategy was formed – 1st Director Diana Wollman

The International Matrix - IRS

- Integrated International Program



International Practice Networks

Business Outbound	Business Inbound	Individual Outbound	Individual Inbound	Crossover Areas
Income Shifting Outbound	Jurisdiction to Tax	Jurisdiction to Tax	U.S. Business Activities	Treaties
Deferral Planning	Income Shifting Inbound	Offshore Arrangements	Withholding	Foreign Currency
FTC Management	Inbound Financing	Foreign Tax Credits		Information Gathering
Repatriation	Repatriation / Withholding	Foreign Entities		Organizations / Restructuring

IRS Areas of Current Focus

(as per Senior IRS Representative at recent presentation)

- FATCA implementation
- Offshore non-compliance
  - Enforcement efforts
  - OVDP
- Exchange of information enhancements
- Mutual Agreement Program
- FTC creditability
- Transfer pricing compliance
- Withholding and information reporting compliance
- Form 1120F compliance

Brief History of US Offshore Enforcement Efforts

<u>IRS/DOJ Efforts</u>

- 2000-02 John Doe summonses - Offshore Credit Cards
- 2003 Offshore Voluntary Compliance Initiative
- 2008 John Doe summons to UBS
- 2009 UBS Deferred Prosecution Agreement ($780M Fine, Disclosure of 4,500 US-related accounts)
- Criminal prosecution of US accountholders and enablers
- 2009 Offshore Voluntary Disclosure Program
- 2011 Offshore Voluntary Disclosure Initiative
- 2012 Offshore Voluntary Disclosure Program
- 2013 US Swiss Bank Program
- US Correspondent Bank Forfeitures
- DPAs, NPAs, Non-Target Letters, Penalties

Results of US Offshore Enforcement Efforts to Date

- 43,000+ voluntary disclosures
- In excess of $6,000,000,000 in revenues and leads
- More than 100 criminal convictions
- Swiss Banks
  - 14 pending criminal investigations
  - 106 letters of intent under US Swiss Bank Program
- Focus shifts beyond Switzerland – **who's next**?
- 64 countries – 32 countries signed Bilateral FATCA IGAs and another 32 agreed in principle (including Israel)
- Global increase in tax enforcement
- OECD proposes global standard for multi-lateral financial info sharing to increase tax compliance

The following table provides IRS-CI's International Operations statistics over the past three fiscal years:

	FY 2013	FY 2012	FY 2011
Investigations Initiated	284	211	244
Prosecutions Recommendations	214	196	195
Indictments/Informations	184	153	149
Convictions	149	110	133
Incarceration Rate	70.4%	87.9%	70.6%
Average Months to Serve	51	71	61

Offshore Voluntary Disclosure Program Update

- Round 1
  - Pre-Clearance - takes 30-45 days for response from IRS
- Round 2
  - Bank account and taxpayer information disclosure (OVDP Letter and Attachments) – takes 30-45 days for response from IRS
- Round 3
  - Submission of 8 years tax returns (original or amended) and FBAR's for 2006 - 2013

OVDP - Penalties

- Penalties – 27.5%
  - 27.5% - applies to assets "related in any way to tax non-compliance"
  - Includes financial accounts and assets like real estate artwork, patents and interest in a business
  - Assets are related to tax non-compliance if:
    - Taxpayer failed to report income from the asset, or
    - Failed to pay U.S. taxes on the money used to purchase the asset

OVDP - Penalties

- Penalties – 12.5%
  - Taxpayers whose offshore assets are valued at less than $75,000 for each OVDP year
  - Includes the following assets:
    - Value of interests in offshore entities
    - Assets purchased with improperly untaxed funds
    - Assets producing income if taxes were not paid on the income

OVDP – 5% Reduced FBAR Penalty

- Penalties – 5%: Three categories of taxpayers
- Category 1 – Taxpayer:
  - (a) did not open the account
  - (b) minimal, infrequent contact with the account
  - (c) did not withdraw more than $1,000 per non-compliant year
  - (d) U.S. taxes were paid on funds deposited in the account (only account earnings were non-compliant)

OVDP – 5% Reduced FBAR Penalty

- Penalties – 5%: Three categories of taxpayers
- Category 2 – Taxpayer:
  - (a) is a foreign resident
  - (b) did not know he/she is a U.S. citizen
  - If taxpayer knew he/she was a U.S. citizen but didn't know required to pay U.S. taxes, <u>not</u> eligible under this
  - Foreign residents -- should they consider the streamlined filing program? (more on this later)

OVDP – 5% Reduced FBAR Penalty

- Penalties – 5%: Three categories of taxpayers
- Category 3 – Taxpayer:
  - (a) is a foreign resident
  - (b) tax compliant in country of residence
  - (c) less than $10,000 U.S. sourced income per year
  - For taxpayers in this category only: penalty does not apply to business interests, real estate and other non-financial assets if applicable taxes were paid on the funds used to acquire the assets

OVDP

- Round I – Pre-clearance
  - Pre-clearance requests faxed to IRS Criminal Investigation Lead Development Center
  - Purpose is to check eligibility to enter OVDP
  - Fax name, date of birth, social security number and address to IRS, along with POA
  - IRS responds via fax, used to be 24-48 hours, then 5-7 business days and now **30-45** business days
  - After response, then **45** days to submit Round II

OVDP

- Round II – OVD Letter and Attachments
  - The OVD Letter asks general questions about the taxpayer, including estimate of high balance
  - One (1) attachment for **each** financial account
  - Clients may need assistance filling out the forms
  - Forms sent to Philadelphia, PA and reviewed by CI
  - CI will notify by mail or fax if *preliminarily* accepted
  - CI supposed to notify within 45 days
  - Within **90** days of notification, submit Round III

OVDP

- Round III – Full OVDP submission
  - Payment for tax, interest, 20 % accuracy-related penalty, and, *if applicable, the failure to file and failure to pay penalties*
  - Copies of previously filed tax returns, if any, for the past eight (8) years
  - Complete and accurate original or amended tax returns, if needed, for past eight (8) years, including
    - Schedules B, D, E and Forms 8938 and 5471 if applicable
  - Signed consents to waive statute of limitations to assess tax and to assess FBAR penalties

OVDP

- Round III – Full OVDP submission
  - Complete and accurate FBARs for the past eight (8) years
  - Foreign account or asset statements for each account or asset
  - Penalty computation indicating aggregate highest account balance for the past eight (8) years
  - If aggregate account balance is greater than $500,000 for even *one* (1) year, taxpayer must include copies of offshore financial account statements reflecting *all* account activity for *each* of the past eight (8) years
  - If aggregate account balance is less than $500,000, still need to have the statements available in case the IRS requests them

OVDP

- Round III – Full OVDP submission
  - What if you can't pay the full amount?
    - You can still enter the program. Submit proposed payment plan and Form 433-A
  - What if you need an extension?
    - You can request up to a **90** day extension
    - Submit as much information as possible and a statement of which information is missing and a request for an extension

OVDP – Post Submission

- Procedural Steps
  - The case will be assigned to an OVDP civil examiner
  - But not for **examination.** Instead, for **certification**. Certification is less formal than examination – but this too is changing!
    - Certification is for accuracy and completeness
    - Examiner may request additional documentation
    - Taxpayer does not have right to appeal the IRS' determination at this level – possible to opt out

Information Document Request ("IDR")

- Sample requests from an IDR received from the IRS after a Round III submission
  - Copies of offshore financial account statements reflecting all account activity for each of the tax years covered by your voluntary disclosure. These statements should reflect the corresponding income, deductions, asset and liability balances reflected on the tax returns. Explain any differences between the amounts reported on the account statements and the tax returns.
  - Complete copies of all foreign tax returns filed

Information Document Request ("IDR")

- Sample request from an IDR received from the IRS after a Round III submission.
  - Capital Gains/Losses: Complete financial statements should contain the details of capital gains (not just net amounts). All Passive Foreign Investment Companies (PFIC) should be identified for each year and detailed computation provided and included in the amended (if applicable, original) US Individual Income Tax Returns. Provide a statement if the applicant chooses to elect the alternative to he statutory PFIC computation that resolves PFIC issues on a basis that is consistent with the mark to market (MTM) methodology authorized in IRC § 1296 but does not require complete reconstruction of historical data.

Note: All documents are to be provided in English and foreign tax returns are to have official translations.

Multi-Family Party OVDP Cases

- Are all parties participating?
- If not, why?
- Are non-participating parties at risk?
- Is the information submitted correct? (How does one know what is actually submitted?)
- How to deal with conflicts.
- FBAR Penalty – to be applied only once to the same funds.
- May be able to use FAQ 17 to solve some issues.

Some Alternatives to the OVDP

- Do Nothing – Ignore the Issue
- Noisy vs. Quiet Disclosure
- Use of Streamlined Procedure
- Prospective Tax Compliance Only
- FAQ 17/FAQ 18

Noisy Disclosure

- Approach IRS (CID) and explain merits of case:
  - Why client is not participating in OVDP
  - Why not FBAR penalty
  - Need to establish reasonable basis for non-compliance
- <u>Advantages</u>
  - No potential FBAR Penalty
- <u>Disadvantages</u>
  - No OVDP program protection

Quiet Disclosure

Reasons to Consider:

- IRS OVDP is voluntary and OVDP penalties are substantial
- OVDP may require taxpayer to address closed years
- No requirement under Internal Revenue Code to amend returns
- Amending returns/filing delinquent FBARs can show good faith
- Qualified Amended Returns avoid accuracy-related penalties
- Filing amended returns could start the period of limitations on assessment where it has not begun to run under IRC 6501

Risks:

- IRS takes a dim view of quiet disclosures – GAO Report
- Amended returns and delinquent FBARs are admissions
- No protection from or cap on civil penalties
- No protection from criminal investigation/prosecution

Non-Resident/Non-Filer Streamlined Filing Compliance Program

Eligibility Requirements:

- Individual must have resided outside of the U.S. since January 1, 2009
- Individual must not have filed a U.S. tax return from 2009 to current (exception is for amended returns where the sole purpose of amending is to include a Form 8891)
- Individual does not owe more than $1,500 in U.S. tax on any tax returns being submitted
- Individual is deemed a "low compliance risk"

Non-Resident/Non-Filer Streamlined Filing Compliance Program

<u>Factors Raising "compliance risk":</u>

- Returns submitted claiming a refund
- Material economic activity in the United States
- Failure to declare all income in his/her country of residence
- Pending audit or investigation by the IRS
- Previous assessment of FBAR penalties or receipt of FBAR warning letter
- Financial interest or authority over a financial account(s) located outside country of residence
- Financial interest in an entity or entities located outside country of residence
- U.S. source income
- Indications of sophisticated tax planning or avoidance

FAQ 17

- Use FAQ 17 filing to correct:
  - Failure to File FBAR - where only have signature authority (Part IV of the FBAR document)
  - No unreported income and no FBAR filed.

FAQ 18

- Question 17 states that a taxpayer who only failed to file an FBAR should not use this process. What about a taxpayer who only has delinquent Form 5471s or Form 3520s but no tax due? Does that taxpayer fall outside this voluntary disclosure process?

FAQ 18 - Answer

- A taxpayer who has failed to file tax information returns, such as Form 5471 or Form 3520, but reported and paid tax on all taxable income on related transactions, should file delinquent information returns with the appropriate service center and attach a statement explaining why the returns are filed late. (The Form 5471 should be submitted with an amended return showing no change to income or tax liability.)
- Include at the top of the first page of each information return "OVDI - FAQ #18" to indicate that the returns are being submitted under this procedure.
- The IRS will not impose a penalty for failure to file the delinquent Forms 5471 and 3520 if there are no underreported tax liabilities and no previous contact by the IRS regarding an income tax examination or a request for delinquent returns.

Opt Out Guidance

- "The decision to opt out of the civil settlement structure is irrevocable…[A]fter certain procedures are followed, the voluntary disclosure case is removed from the civil settlement structure and an examination is initiated."
- "…there may be instances in which the results under the applicable voluntary disclosure program appear too severe…[t]here will be other instances where this is less clear. …[in] these cases, it is expected that full scope examinations will occur if opt out is initiated…to the extent that issues are found upon a full scope examination that were not disclosed, those issues may be the subject of review by the Criminal Investigation Division."
- "An opt out could result in a taxpayer owing more…[or] less. Moreover, the scope of any resulting examination may change from being limited to offshore accounts."

Opt Out Procedure

- Centralization of program – 2 locations (Milwaukee and St. Paul)
- IRS sends Letter 4728 ("Program Status Report") with status of the voluntary disclosure, any documents outstanding, and if known, tax, penalties and interest under OVDP
- If taxpayer does not provide documents within 30 days (or request additional time), IRS issues a Letter 4564 ("the Written Warning") directing taxpayer to provide a written statement of their case and penalty recommendation within 20 days
- Taxpayer submits a formal written decision to opt out and makes their written case as to what penalties should apply
- OVDP examiner summarizes case, noting whether non-willful FBAR penalty should apply, and recommending scope of audit
- Centralized Review Committee (IRS managers) reviews summary, considers OVDI penalty, and determines scope of audit
- In a full-scale audit, the revenue agent must interview taxpayer and review all open years

What else is going on at the IRS and DOJ?

- On February 26, 2014, Swiss Investment Advisor and former UBS banker, Martin Luck plead guilty to tax evasion
- On May 1, 2014, indictment of ex-Mizrahi Tefahot Banker – Shokrollah Baravavian involved in back-to-back loans, similar to indictment for account holders at Mizrahi and Bank Leumi
- On May 5, 2014, Swiss Partners Group agreed to pay $4.4M and turn over 110 US taxpayer client files to the US Government

What else is going on at the IRS and DOJ?

- Senators Levin and McCain urge DOJ to seek extradition of fugitive Swiss Bankers
- Beanie Babies creator Ty Warner pleaded guilty to one of largest tax frauds in Chicago area and received 2 years probation.
- OECD published standard for automatic exchange of tax information among governments – closely follows FATCA but includes, by way of example, setting a $250,000 initial threshold for due diligence requirements.

Expatriation Updates

- Significant increase in the number of people giving up US citizenship
- Need to determine if Exit Tax applies for expatriation on or after June 16, 2008 - § 877A
  - Average annual net income tax for the five years ending before the date of expatriation (e.g. $155,000 for 2013);
  - Net worth is $2.0M or more; or
  - Failed to certify on Form 8854 that you have complied with all Federal tax obligations for five years proceeding the date of expatriation
- Form 8854 and potential complications

New Israeli Taxation of Trusts

- On March 9, 2014, ITA published "transitional" arrangements for Israeli resident beneficiary trusts
- New tax on trust income where the settlor is a non-resident or non-resident upon his/her death and at lease one of the beneficiaries is, or was in the past, an Israeli resident
- Effects trusts created before and after January 1, 2014
- Effects earnings between January 1, 2006 and December 31, 2013 (or may use adjusted value of Trust's capital on December 31, 2013 under special circumstances, possible step up of value of trust assets as of January 1, 2014)
- What about US Grantor Trusts where settlor was Israeli resident? Does use of complex trusts help create a "better match" of foreign tax credits in Israel?

- Questions and Answers