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Taxation Section

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New §1031 Safe Harbor for "Dwelling Units"

By Jeffrey S. Tarr[1]

On February 15, 2008, the Internal Revenue Service (the "IRS") issued Revenue Procedure 2008-16[2], setting forth a safe harbor under which the IRS will not challenge whether a "dwelling unit" qualifies as property held for productive use in a trade or business or for investment under §1031 of the Internal Revenue Code of 1986, as amended ("§1031").

One of the basic requirements of §1031 is that both the relinquished property and replacement property must be held for productive use in a trade or business or for investment[3]. It has long been held that gain or loss from an exchange of property used solely as a personal residence may not be deferred under §1031 because a personal residence is not held for productive use in a trade or business or for investment[4]. While taxpayers have argued that exchanges involving personal residences should qualify for §1031 treatment because personal residences are expected to appreciate in value and thus are held for investment, the Tax Court has held that the "mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence"[5].

Notwithstanding the general rule that property used solely as a personal residence will not qualify for §1031 treatment, the IRS has recognized that many taxpayers own dwelling units primarily for the production of current rental income, and occasionally use such properties for personal purposes. The IRS issued Revenue Procedure 2008-16 to provide taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under §1031 even though a taxpayer occasionally uses the dwelling unit for personal purposes.

The safe harbor of Revenue Procedure 2008-16 applies to dwelling units that meet certain qualifying use standards. For purposes Revenue Procedure 2008-16, a "dwelling unit" is real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, a bathroom and cooking facilities.

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There are two sets of qualifying use standards, one set for relinquished property and the other set for replacement property. In the case of relinquished property, a dwelling unit will qualify as property held for productive use in a trade or business or for investment if: (i) the dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "relinquished property qualifying use period"); and (ii) within the relinquished property qualifying use period, in each of the two 12-month periods immediately preceding the exchange: (a) the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and (b) the period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

In the case of replacement property, a dwelling unit will qualify as property held for productive use in a trade or business or for investment if: (i) the dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "replacement property qualifying use period"); and (ii) within the replacement property qualifying use period, in each of the two 12-month periods immediately after the exchange: (a) the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and (b) the period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

Whether a taxpayer has used a dwelling unit for personal purposes is determined by the rules set forth in §280A(d)(2) of the Internal Revenue Code of 1986, as amended (taking into account §280A(d)(3), but not §280A(d)(4)).

Revenue Procedure 2008-16 is effective for exchanges involving dwelling units occurring on and after March 10, 2008.

At first blush, it appears that Revenue Procedure 2008-16 substantially increases the application of §1031 with respect to residences. However, after a careful review of the qualifying use standards set forth in Revenue Procedure 2008-16, taxpayers should recognize that while the IRS has added another safe harbor application of §1031, certainly a good thing for taxpayers, its usefulness has limits.

Endnotes

1 Jeffrey S. Tarr is a partner in the law firm of Sussman Shank LLP, and practices in the areas of tax law, business law, real estate law and estate planning.

2 Rev. Proc. 2008-16; 2008-1 C.B. 547; 2008-10 I.R.B. 547

3 §1031(a)(1)

4 Revenue Ruling 59-229, 1959-2 C.B. 180; Revenue Procedure 2005-14, 2005-1 C.B. 528; *Moore v. Commissioner,* T.C. Memorandum 2007-134; *Starker v. United States,* 602 F.2d 1341, 1350 (9th Cir. 1979)

5 *Moore v. Commissioner,* T.C. Memorandum 2007-134

Failures of IRC §1031 Exchange Qualified Intermediaries Highlight Risks and the Importance of Due Diligence When Selecting a Qualified Intermediary[1]

By Larry J. Brant[2] and Steven D. Nofziger[3], © 2009

The recent failures of two high profile companies that acted as Qualified Intermediaries for like-kind exchanges under Internal Revenue Code ("Code") Section 1031 should serve as a reminder to taxpayers, tax advisors and attorneys of the importance of performing due diligence when selecting a Qualified Intermediary.[4]

Importance of Qualified Intermediaries in Code Section 1031 Exchanges

Code Section 1031 allows taxpayers who exchange, rather than sell, certain like-kind property to defer recognition of any gain realized on the property relinquished in the exchange (the "relinquished property") until the time the taxpayer sells the property the taxpayer receives in the exchange (the "replacement property"). By deferring recognition of gain until the time the replacement property is sold, Code Section 1031 effectively provides taxpayers with an interest-free loan in the amount of income tax that would otherwise be due upon sale of the relinquished property.

In most Code Section 1031 exchanges, the purchaser of the taxpayer's relinquished property will not want to be responsible for acquiring replacement property and transferring it to the taxpayer. Rather, the purchaser typically desires to acquire the taxpayer's property and nothing more. In these situations, the taxpayer typically must utilize the services of an intermediary to assist in consummating the exchange. In the typical intermediary situation, the taxpayer transfers the relinquished property to the intermediary who then completes the transfer to the purchaser. To complete the first leg of the exchange, the purchaser transfers the purchase price to the intermediary, who holds the funds in an exchange account. In the second leg of the exchange, the intermediary acquires replacement property identified by the taxpayer using the funds in the exchange account and subsequently transfers the replacement property to the taxpayer.

When using an intermediary, a taxpayer must not create an agency relationship with the intermediary or obtain constructive receipt of the purchase price paid by the buyer of the relinquished property. If either an agency relationship is created or constructive receipt of the exchange funds occurs, the exchange will fail and the transaction will be deemed a taxable sale rather than a like-kind exchange qualifying for nonrecognition treatment.

To avoid the agency and constructive receipt problems, taxpayers must utilize the services of certain "Qualified Intermediaries" and all transfers must take place in accordance with the terms of a written "exchange agreement." Treasury Regulation Section 1.1031(k)-1(g)(4)(iii) defines a "Qualified Intermediary" as a person who is not the taxpayer or a disqualified person (as defined in Treasury Regulation Section 1.1031(k)-1(k)) who enters into a written exchange agreement with the taxpayer, pursuant to which the person (a) acquires the relinquished property from the taxpayer, (b) transfers the relinquished property to a buyer, (c) acquires the replacement property, and (d) transfers the replacement property to the taxpayer.

An entire industry of Qualified Intermediaries (often called "exchange accommodators") has grown out of the requirements of this Treasury Regulation. While financial service providers (*e.g.*, banks, brokers, trust companies and escrow companies) are highly regulated, there is virtually no regulation of Qualified Intermediaries. This lack of regulation has led to numerous cases where exchange funds have been misappropriated or stolen by Qualified Intermediaries, and, in recent years, exchange funds have been lost or tied up in the bankruptcy of

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Qualified Intermediaries. Two recent bankruptcies by Qualified Intermediaries are worth noting, as they are related to the recent meltdown in the housing and credit markets.

Failure of LandAmerica 1031 Exchange Services

LandAmerica 1031 Exchange Services Company, Inc. ("LAE") filed bankruptcy and terminated all operations on Friday, November 24, 2008. LAE immediately issued a statement that the total value of funds in its customers' Code Section 1031 exchange accounts is sufficient to cover the balance due to its customers; however, portions of customers' exchange funds were invested in now-illiquid auction rate securities backed by federally guaranteed student loans.

Auction rate securities are debt instruments (corporate or municipal bonds) with long-term nominal maturities for which the interest rates are regularly reset through a Dutch auction. Auctions are typically held every 7, 28, or 35 days. Many auction rate securities are AAA rated and tax exempt. For buyers, auction rate securities typically provide a slightly higher after-tax yield than money market instruments due to their complexity and increased risk over other money market securities.

An auction fails if there are not enough orders to purchase all of the securities being sold at the auction. In that scenario, the interest rate is set to the maximum rate defined for the issuer (typically a multiple of LIBOR). The purpose of the higher rate is to compensate the holders who have not been able to sell their positions. Since February 2008, most of these auctions have failed, and the auction market has been frozen because many of the investment banks have declined to act as bidders of last resort during the recent credit market crisis.

Because of the frozen market for auction rate securities, LAE stated that it has been unable to sell or borrow against the value of the usually-liquid securities. Under the circumstances, LAE was forced to seek bankruptcy protection as it has been unable to meet the liquidity requirements created by its customers' withdrawal demands. Its customers' exchange funds are now frozen and claims must be filed with the bankruptcy court.

Failure of Summit 1031 Exchange

Summit Accommodators, Inc. ("Summit"), which operated under the name "Summit 1031 Exchange," filed for bankruptcy on December 19, 2008. Several days prior to filing bankruptcy, Summit issued a statement that it had ceased funding open exchanges and had curtailed daily operations to address significant financial issues.

In its December 19 statement, Summit explained that it had $27.8 million of open exchanges for customers, but only $13.6 million in its exchange accounts, a shortfall of $14.2 million. Summit's statement explained that it had other assets which it hoped would be sufficient to make up the shortfall; unfortunately, those other assets are illiquid and not immediately available to fund open exchanges.

As it turns out, Summit had been lending exchange funds to Inland Capital Corporation ("Inland") which, in turn, loaned money to parties involved in real estate investments in central Oregon. Inland and Summit are owned by the same principals and, in many cases, Inland loaned money to entities owned by its principals. Inland owes Summit over $13.7 million, but has been unable to repay the loans. News reports indicate that Summit's customers were led to believe that Summit had deposited their exchange funds in FDIC-insured bank accounts rather than investing their exchange funds in this manner.

Summit has replaced its management with Tyrell B. Vance LLC, run by Portland-based turnaround consultant Tyrell Vance. Summit's customers' exchange funds are frozen and claims must be filed with the bankruptcy court. The Oregon Division of Finance and Corporate Securities has begun an investigation into Summit's activities.

Impact of Exchange Funds Frozen In Bankruptcy

With their exchange proceeds frozen, taxpayers using LAE or Summit as their Qualified Intermediary for a Code Section 1031 exchange may be unable to complete their exchanges within the required 180-day exchange period. If so, the result is simple: a taxable transaction occurred when the relinquished property was sold. Consequently, taxpayers who are unable to complete their exchanges will end up with a tax liability due to the failed exchange. Worse yet, the tax liability will arise in the tax year in which the relinquished property was sold, but customers may have no money to pay the tax since their exchange proceeds will likely be tied up or lost in the bankruptcy proceedings.

If taxpayers are unable to recover their exchange proceeds in full, they may be able to claim a loss deduction for the unrecovered amount. Any loss deduction will not help the current tax sting, however, as it would likely be available only after the bankruptcy proceedings are final—a later tax year than the year of the taxable sale. In addition, the loss may be of a different character from the gain (*i.e.*, ordinary loss versus capital gain).

Additionally, taxpayers who recently completed a Code Section 1031 exchange using LAE or Summit as their Qualified Intermediary may be in for a rude surprise. Bankruptcy trustees have the power to commence "preference" actions against such taxpayers to void transactions and recover funds paid to creditors within 90 days prior to the bankruptcy filing. Consequently, LAE and Summit customers who completed an exchange within 90 days of the date these companies filed bankruptcy may potentially be required to pay over the amount of their exchange proceeds to the bankruptcy trustee! Many taxpayers in such a situation would not have liquid funds available to pay the bankruptcy trustee.

No Help From the IRS Yet

LAE and Summit are only two of many Qualified Intermediaries to fail recently. In September 2008, BNA reported that the IRS is working on guidance to address the failures of Qualified Intermediaries. The BNA report noted that IRS senior counsel, Stephen Toomey, stated in a speech to a committee of the District of Columbia Taxation Section that the IRS is considering a range of options to address these failures, including allowing taxpayers to complete open exchanges using substitute Qualified Intermediaries and providing other relief for taxpayers who lose their exchange funds. To date, however, the IRS has yet to issue guidance on these matters. Accordingly, LAE and Summit customers may be out of luck.

Importance of Conducting Due Diligence When Selecting a Qualified Intermediary

The failures of LAE and Summit are a reminder of the importance of conducting due diligence when selecting a Qualified Intermediary. Taxpayers should review several Qualified Intermediaries, and tax advisors should thoroughly research companies, before proceeding with an exchange.

Most taxpayers would be reluctant to allow an investment advisor to manage their retirement funds without a thorough due diligence review of the advisor and his/her investment company. The same logic should apply when taxpayers park their exchange proceeds with a Qualified Intermediary and ask the Qualified Intermediary to facilitate a very complex transaction. Due diligence is even more important in light of the fact that there is little regulation of Qualified Intermediaries.

Generally, when performing due diligence, taxpayers and tax advisors should ask the Qualified Intermediary and obtain satisfactory answers to at least the following questions:

- What is your financial condition?
- Are you affiliated with a bank, title insurance company or other business? If so, are the exchange proceeds maintained in accounts separate and apart from other accounts of the affiliate or affiliates? How many persons have access to the exchange funds, and how many signatures are required to access such funds? What is the financial condition of the affiliate or affiliates? Is a guarantee by the affiliate or affiliates available?
- What is the annual volume of exchanges you handle in terms of dollars?
- Do you maintain a fidelity bond? If so, for how much and with which insurance company? Does the bond cover theft, embezzlement or misappropriations? Is the bond coverage "per occurrence" or merely "in the aggregate"? Does the bond only cover the Qualified Intermediary or are the coverage limits shared with affiliates?
- Do you perform background checks on your employees? Do you maintain employee theft

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insurance? If so, for how much and with which insurance company? Does the insurance only cover the Qualified Intermediary or is the coverage shared with affiliates?

- Do you maintain errors and omissions insurance? If so, for how much and with which insurance company? Does the insurance only cover the Qualified Intermediary or is the coverage shared with affiliates?
- What is the expertise of your staff? Are they attorneys, accountants, certified exchange specialists, etc.? Do you have continuing staff training programs?
- How long have you been in this line of business?
- Has a qualified tax practitioner thoroughly reviewed your exchange documents? If so, who performed the review and when was the last review performed?
- Are you annually audited by an independent auditor? If so, who is your auditor?
- Additionally, the LAE and Summit bankruptcies highlight the importance of separate accounts and the liquidity of the exchange funds held by the Qualified Intermediary. Taxpayers should inquire as to the manner in which the Qualified Intermediary will hold the exchange funds and the nature of the investments into which the Qualified Intermediary will invest the funds. Taxpayers should require the Qualified Intermediary to, at minimum, segregate and hold exchange funds in an account separate from the Qualified Intermediary's general account, and to deposit their exchange funds only in FDIC-insured accounts at banks which have been pre-approved by the taxpayer.

Additional Information Regarding IRC §1031 Exchanges

If you have questions about Code Section 1031 exchanges or due diligence issues surrounding Qualified Intermediaries, please contact Larry Brant or Steve Nofziger for more information.

Endnotes

1 This Article is for educational purposes only and should not be construed as legal advice relative to any specific situation. IRC §1031 is a complex area of the tax code. Many issues beyond the scope of this Article exist. A qualified tax practitioner should thoroughly review any proposed exchange before it is pursued.

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4 Versions of this Article appear in additional publications, including *In Brief* (a publication of the Professional Liability Fund) and *The Oregon Certified Public Accountant.*

Your Clients' Foreign Connections: a Primer on the FBAR Filing Obligations

By Natalia Yegorova[1]

In early 2008, the IRS announced that it was initiating enforcement action against more than 100 Americans who had financial accounts with the LGT Group, a Liechtenstein bank owned by the Princely House of Liechtenstein.[2] Until then a virtually impenetrable offshore financial center for the world's wealthy clientele, LGT Group was compromised when a former bank employee stole the financial data and sold it to various national tax authorities, including the IRS.

Besides criminal and civil penalties for evading tax on income earned overseas, the unfortunate U.S. clients of the LGT Group face additional penalties and possible jail time under a little–known section of the Bank Secrecy Act of 1970 which requires U.S. taxpayers to report to the U.S. government their interest in foreign bank and financial accounts (commonly known as "FBAR").

If your clients have a foreign financial account the balance of which at any time during the year exceeded $10,000, in the aggregate they may find themselves in an unenviable position not unlike that of the Americans currently being investigated by the IRS in the Liechtenstein affair.

Form 1040, Schedule B, Line 7a, asks a taxpayer whether he or she has an interest or signature authority over a financial account (such as a bank or securities account) located in a foreign country. Line 7a further directs the taxpayer to the instructions for Form 1040 to determine if the taxpayer needs to file Form TD F 90-22.1.

All too often, taxpayers with foreign accounts simply check the box on Schedule B and stop there. When the taxpayers (or their accountants) are diligent, they will report on their tax return income they earned from the foreign financial account. Sometimes, they will ignore the box, and/or fail to report income earned abroad on their tax return. This alone can result in penalties and interest for understated income. (This article does not consider whether income generated abroad generates a tax liability to the United States; generally speaking, however, all income earned by a U.S. person (see discussion of the definition below) must be reported on the taxpayer's U.S. tax return, but a foreign tax credit or provisions of an applicable treaty may avoid or reduce double taxation.)

What is the FBAR Law All About?

The FBAR reporting requirement, 31 USC Sec. 5311 et seq., and related regulations, 31 CFR Sec. 103.24, et seq., was enacted, in part, to create additional incentives for U.S. taxpayers to report their worldwide income; while U.S.-based financial institutions report income earned by the taxpayers directly to the IRS, the government cannot as easily monitor income earned by U.S. taxpayers on money deposited abroad. Also, an increasing number of jurisdictions (especially low tax jurisdictions), under pressure from U.S. law enforcement authorities, have been signing financial data exchange agreements allowing U.S. authorities to access financial data of U.S. taxpayers. This trend is bound to continue, considering the rise of terrorism, globalization of criminal activities, and the resulting need to monitor U.S. taxpayers' financial activities overseas in an effort to limit money laundering.

To ease the burden on the U.S. government in monitoring U.S. taxpayers' financial interests abroad, the FBAR law and regulations require that a U.S. person report any financial interest, and any signature authority in a foreign financial account, on Form TD F 90-22.1, if the aggregate accounts in which the person has interests exceed $10,000 at any time during the taxable year. That is, if a U.S. citizen has two accounts with the maximum account balances of $9,000 and $2,000, he or she must file Form TD F 90-22.1 and report both of the accounts on the form.

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The definition of "financial account" is broad, and covers a cash account, a secured credit card account, a brokerage account, or a foreign mutual fund.[3] Because a U.S. person is required to report any interest that he or she has in any account, the FBAR requirement also covers financial accounts of any LLC, partnership or corporation that has foreign bank accounts and in which a U.S. person owns more than 50% of the stock. Canadian citizens residing in the U.S. who have interests in Registered Retirement Savings Plans (RRSPs), in addition to filing Form 8891 to report contributions to an RRSP, distribution from an RRSP, and elections to defer recognition of income, must also file Form TD F 90-22.1, and report their financial interests in the accounts.

A "U.S. person" includes a U.S. citizen (even one who permanently resides outside the United States), a U.S. resident (either because the taxpayer has a green card, or because he or she meets a physical presence test[4]), domestic partnership, domestic corporation, association, estate or trust. The law, therefore, covers not only persons who reside in the U.S. long-term, or are U.S. citizens, but also those persons who are here temporarily on a work assignment for a few years and who meet the substantial presence test (e.g., NAFTA TN workers and H-1B, L-1A workers).

If there is more than one owner to the account, all parties must independently file Form TD F 90-22.1. Note, however, that a taxpayer who has an interest in an account of her spouse by virtue of residing in a community property state (Washington, for instance), and who is not a joint owner of that account, is exempt from the filing requirement. A person who has signing authority, but no financial interest, in a foreign financial account may be exempt from filing an Form TD F 90-22.1 if he or she is an officer or employee of a federally-regulated bank, or a federally-regulated publicly traded corporation.[5] In all other circumstances, the person must file the form. This means that a manager of an Oregon company with a Canadian subsidiary who has signing authority over a Canadian bank account will have to file a Form TD F 90-22.1 disclosing the account.

When and Where to File?

The report must be received by the IRS on or before June 30th of each calendar year with respect to foreign financial accounts maintained during the previous calendar year.[6] All records relating to the filed Form TD F 90-22.1 TD Form 90-22.1 must be kept for a period of five years. This includes the name in which the account is maintained; the number of the account; the type of the account; the name and address of the foreign bank; and the maximum value of each account during the reporting period.[7]

Advisors should be aware that on September 30, 2008, the IRS issued a revised Form TD F 90-22.1, which should be used for filings in 2009.

The taxpayers must file Form TD F 90-22.1 with the Detroit Service Center, or (a development from prior years) may hand-deliver it to the local IRS office.

Statute of Limitations

The statute of limitations on assessment of civil FBAR penalties is six years from the date of the transaction.[8] The statute of limitations on assessment of criminal FBAR penalties is five years from the date the offense is committed.[9] In the case of the filing violation, the date of the transaction is the due date for filing the FBAR- June 30th of the calendar year following the year to be reported. In the case of a recordkeeping violation, the date of the transaction is the date that the examiner first requests the records required by 31 CFR Sec. 103.32.[10]

Failure to file an Form TD F 90-22.1 can subject your client to civil and/or criminal penalty.

Civil Penalties

The maximum civil penalty for <u>willful</u> failure to report a foreign financial account is the greater of $100,000, or 50% of the balance of the account at the time of the violation.[11] A willful violation occurs when the taxpayer knows about his or her obligation to file Form TD F 90-22.1 and fails to do so. The IRS has a burden to establish willfulness by clear and convincing evidence.[12] The maximum penalty for a <u>non-willful</u> failure to file an FBAR is up to $10,000.[13] The taxpayer can mitigate the penalty amount if the relevant amount of money generated from the foreign account is reported on a taxpayer's Form 1040 (Schedule B).[14]

Criminal Penalties

Willful failure to file an FBAR report can also result in criminal penalties. The IRS has the burden of proof to show willfulness beyond reasonable doubt.[15] The penalty can include a fine up to $250,000, imprisonment for up to five years, or both.[16]

Enforcement of the FBAR Reporting Requirement

In April, 2003, FinCEN ("Financial Crimes Enforcement Network") delegated FBAR enforcement authority to the IRS, with the discretion to decide whether to impose the FBAR penalty and in what amount. The Internal Revenue Manual provides that an examiner, upon completion of an FBAR examination, may issue a warning letter to the violator, if the examiner determines that a violation occurred but no penalty is warranted. (Presumably, the taxpayer who received a warning letter will be put on a watch list with the IRS and may be subject to a follow-up FBAR examination in subsequent years.)[17]

In a memo issued by the IRS in January 2006, the IRS division counsel provided some guidance on the application of civil FBAR penalties. The guidance memo[18] confirms that the revenue agent handling the case has complete discretion not to impose a penalty, and provides considerable detail on the issue of imposing a civil FBAR penalty in cases where it is inappropriate:

> There appears to be a concern that the civil FBAR penalty must be asserted in every situation identified. The penalty statute, however, provides for discretion in asserting penalty. The purpose for the penalty, and the reason for the flexibility Congress provided in asserting the penalty, is to encourage compliance. There is no requirement to assert a separate FBAR penalty for every possible technical violation encountered and doing so could lead, in some cases, to an absurd result.[19]

The Service occasionally creates a short-term amnesty program permitting delinquent taxpayers or those in non-compliance to avoid certain penalties. The first such program was the Offshore Voluntary Compliance Initiative ("OVCI") (which expired on April 15, 2003), under which the FinCEN granted a complete waiver of civil penalties for those taxpayers who complied with the program's terms and conditions. Concurrent with the OVCI and continuing beyond the program is the Last Chance Compliance Initiative (LCCI), in which the Service offers certain identified taxpayers an opportunity to minimize their exposure to penalties. The LCCI, however, does not offer complete amnesty from civil penalties as the OVCI did.

In the absence of a new amnesty program, the non-complying taxpayer is at the IRS's mercy in deciding on the appropriate penalty for non-filing of the FBAR form. In the internal IRS guidelines for calculating FBAR civil penalties for <u>willful</u> violations, the IRS lists four conditions for penalty mitigation. The penalty will be limited if: (1) the taxpayer has no history of FBAR violations; (2) the funds passing through the undisclosed foreign financial accounts were not from an illegal source and/or used for criminal purposes; (3) the taxpayer cooperated during the examination; and (4) the IRS did not assert a civil fraud penalty on the taxpayer based on the failure to report income derived from the undisclosed foreign financial account.

The penalty for <u>non-willful</u> violation of FBAR reporting can be avoided if: (1) the violation was due to reasonable cause; and (2) the amount of the transaction or the balance in the account at the time of the transaction was properly reported.[20]

What Does it Mean for Your Client?

If your client has foreign financial accounts, ask him or her about compliance with the FBAR reporting requirements. A surprisingly large number of otherwise sophisticated clients are unaware of their obligation to report their financial interests abroad to the U.S. government. If you discover that your client has not complied with the reporting requirement in the past, do not despair. Our advice to clients in that situation has been to file the FBAR forms for all the years within the statute of limitations period during which the client had a foreign financial account, and to attach an explanation to Form TD F 90-22.1 stating that the client has filed the FBAR forms as soon as he or she became aware of his or her obligation to do so. The key is to file the report before the IRS comes knocking on your client's door asking questions regarding his or her financial holdings abroad.

The good news is that while there is no official "amnesty" program for non-compliers that eliminates the penalty, in our experience the Department of Treasury has not been prosecuting non-filers where it is apparent that the non-filing was due to the taxpayer's ignorance of the law, rather than purposeful evasion, and the taxpayer voluntarily files the Form TD F 90-22.1 before the IRS starts asking questions. However, from the author's conversation with the IRS National Office, the lenient approach to treating delinquent filers may be changing and the IRS will start pursuing penalties more aggressively, without regard to the filer's *mens rea*.

It is likely that the IRS will use FBAR non-compliance and possible penalties as an additional weapon against a taxpayer whom the IRS suspects of underreporting income. Because the procedural rights normally available to a taxpayer under Title 26 are not available in the context of FBAR enforcement (which is governed by Title 31), prosecuting a taxpayer for failing to report a foreign bank account is an attractive bonus to the old-fashioned tax collection proceedings. Prosecution has become easier since the Tax Court's decision in *Williams v. CIR*, 131 TC No. 6 (Oct. 2, 2008), where the court found that its limited jurisdiction did not extend to consider taxpayer's alleged liability for FBAR penalties.

In advising a client, practitioners should also consider whether the client has reported the foreign-earned income on the tax return, and correctly checked Line 7a on Schedule B of Form 1040. While it is unclear how forceful the IRS will be in prosecuting a non-compliant taxpayer for failing to timely file Form TD F 90-22.1, failure to report foreign income may result in charges of understanding income and resulting interest and penalty accruals.

One option that is not available to the practitioners and their clients is ignoring the requirement to report the offshore financial account. Identifying taxpayers with unreported foreign accounts has become a priority for the IRS, and as more countries sign information exchange agreements with the United States, hiding assets offshore will become increasingly difficult. The sooner your client complies with the FBAR reporting requirement, the less chance there is that he or she will be in the position in which the hundred U.S. clients of LGT Group found themselves last year.

Endnotes

1 Natalia Yegorova is an attorney at Black Helterline LLP. She focuses on international business and tax issues pertaining to inbound and outbound business activities.

2 IR-2008-26, Feb. 26, 2008, available at http://www.irs.gov/newsroom/article/0,,id=179366,00.html.

3 IRS News Release 2007-15

4 IRC Sec. 7701(b)(3)

5 IRS News Release 2007-15

6 31 CFR §103.27(c)

7 31 CFR §103.32

8 31 USC §5321(b)(1)

9 I.R.M. Sec. 4.26.17.5.5.4, 18 USC Sec. 3282 (general criminal statute of limitations for non-capital offenses otherwise not provided for in the Code).

10 I.R.M. Sec. 4.26.17.3.1(2)(d)

11 31 USC §5321(a)(5)(C)

12 IRS Chief Counsel Advisory 200603026

13 31 USC §5321(a)(5)(B)(i)

14 31 USC §5321(a)(5)(B)(ii)

15 IRS Chief Counsel Advisory 200603026

16 31 USC §5322(a)

17 I.R.M. Sec. 4.26.17.4.2

18 Chief Counsel Advisory memo is available at 2006 WL 148700.

19 IRS Chief Counsel Advisory 200603026

20 31 USC §5321(a)(5)(B)(ii)

Corporate Cash Payments to Directors Are *Not* Subject to Unemployment Taxation

By Dan Eller[1]

In August 2007, the Oregon Court of Appeals determined that cash payments made to corporate directors for their service on the board are subject to unemployment taxation.[2] On July 24, 2008, the Oregon Supreme Court reversed that decision.[3]

In *Necanicum*, the subject corporation paid each of its corporate directors $6,000 in director's fees. Necanicum did not include those payments in its taxable payroll, nor did it remit unemployment taxes on those amounts. Upon audit, the Oregon Employment Department determined those payments to constitute "wages" for "employment" (as those terms are defined in ORS chapter 657 regarding unemployment insurance), and issued a notice of tax assessment to the corporation for approximately $700. Necanicum appealed this determination to an administrative law judge ("ALJ"), who held in favor of the Department. The Oregon Court of Appeals affirmed the ALJ's decision.

In its decision, the Oregon Supreme Court noted that both the ALJ and the Court of Appeals "apparently assumed that the directors were 'employees' of the corporation, and therefore focused their analysis on whether the payments to the directors were wages subject to unemployment taxation." As the Oregon Supreme Court explained, however, the threshold focus should have been on whether a corporate director, when serving in his or her capacity as a director, is an "employee" of the corporation within the meaning of the relevant statutes. The Oregon Supreme Court ruled such individuals are not employees because the legislature's definition of the nature of the relationship between directors and corporations is not one between an employer and an employee. As a result, to the extent a director is acting in the capacity of a director, corporate payments to the director are not payments subject to unemployment compensation. In dicta, the Oregon Supreme Court discussed whether other "non-director" type services performed by a corporate director may be subject to unemployment taxation, noting that such payments could be subject to unemployment taxation if those payments were for employment-related services, such as officer compensation.

As a result, if a corporation pays its directors for their services as directors, those payments are not subject to unemployment taxation.

Endnotes

1 Dan Eller is an attorney at Schwabe, Williamson & Wyatt in Portland, Oregon.

2 *Necanicum Inv. Co. v. Employment Dep't,* 214 Or. App. 385 (2007).

3 *Necanicum Inv. Co. v. Employment Dep't,* 345 Or. 138 (2008).

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