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S Corporation Inadvertent Terminations

By James Oberholtzer

Once a corporation validly elects under §1362 to be an S corporation, the S election continues in effect throughout the corporation's existence until it is revoked or terminated.[1] No additional elections or consents need be filed, even if the corporation has substantial changes of ownership or of business. As the IRS may challenge the S status retroactively, all S corporations need to be vigilant about monitoring and maintaining their S status.

Termination of S status obviously ends the S treatment of the corporation and its shareholders going forward. If the revocation or termination is not as of the end of a tax year, it will also involve rules for the treatment of the corporation during the transition from S status to C treatment. For example, where S status is terminated mid-year, a short S and a short C year are created. Special rules provide for the allocation of income and loss items between the two short taxable years. In addition, other special rules permit the shareholders to utilize some of the benefits of S status, even after the corporation begins operating as a C corporation.

§1362(d) provides that S status can be ended in three ways: (1) voluntary revocation[2], (2) failure to meet the eligibility rules of §1361 for a small business corporation and (3) excess passive income when the corporation has earnings and profits (from its C corporation years).[3]

Small Business Corporation. An S corporation election automatically terminates[4] on the first date that one or more disqualifying events occurs.[5] Disqualifying events include: (1) having more than 100 shareholders, (2) having an ineligible shareholder (e.g., a corporation, partnership, ineligible trust, or nonresident alien), (3) having more than one class of stock, (4) becoming an ineligible corporation such as an insurance company, or DISC, (5) transferring place of incorporation to a foreign

1 *See generally* on this subject: Federal Taxation of S Corporations, 4th edition, James Eustice and Joel Kuntz, Warren Gorham & Lamont ("Eustice S Corp"); and Starr, Smith and Sobol, 730-3rd T.M., S Corporations: Formation and Termination, Bureau of National Affairs ("BNA TMP 730").

2 IRC §1362(d)(1). Intentional termination generally can be accomplished through filing with the IRS a statement of intention to revoke signed by persons owning more than one half of the shares of capital stock of the company. Reg. §1.1362-6(a)(3) and Reg. §1.1362-2(a)(2)(ii). *But see* PLR 9750036 (single shareholder taxpayer's written notation on tax return was acceptable for advising IRS of revocation of S election). A revocation is generally effective prospectively; however, if filed in the first two months and fifteen days of the year, it is effective retrospectively to the first day of the year. §1362(d)(1)(C); Reg. §1.1362-2(a)(2)(i). A revocation can be withdrawn before it is effective. Interestingly, the administrative dissolution and reinstatement of a corporation by the Washington Secretary of State does not revoke the S election. PLR 9411040.

3 It is uncertain if the three criteria for termination in §1362(d) are exclusive. In *Farmer's Gin, Inc. v. Comr.*, T.C. Memo 1995-25, the Tax Court held that §1362(d) does not set forth the exclusive list of events and held that an S corporation automatically lost its status as an S corporation when more than 50% of its stock had been transferred to new shareholders and the S corporation failed to change its taxable year to a permitted year under pre-1986 TRA §1378(c). *Contra: In re Stadler Assoc., Inc.* 95-2 USTC ¶50,589 (Bankr. S.D. Fla. 1995). *See also Mourad v. Comr.*, 121 T.C. No. 1 (2003).

4 A termination is prospective only as contrasted with a revocation that can be retroactive.

5 §1362(d)(2)(B); Reg. §1.1362-2(b)(2).

country (thus no longer qualifying as a domestic corporation) or (6) failure to use a permissible tax year under § 1378.

Of course, a disqualifying event can be as simple as a shareholder transferring shares to an obviously ineligible shareholder or it may be more subtle such as an S shareholder transfers stock to a form of joint ownership, resulting in more than 100 shareholders[6] because each joint owner, other than a family member, is a separate shareholder.[7] In order to prevent a disgruntled or maverick shareholder from independently terminating the S election, a shareholder agreement is recommended.[8]

When the S election terminates involuntarily, the corporation must attach to its tax return for the tax year in which the termination occurs a statement including notification that a termination has occurred and the termination date.[9] The box at H(5) ("S election termination or revocation") on page 1 of Form 1120S and the "Final K-1" box on Schedule K-1 should be checked to notify the IRS that this will be the final S corporation return.

An S corporation is required under §6037 to file an information return (U.S. Form 1120S) with the Service within two months and 15 days of the close of the corporation's taxable year.[10] Even though there is no tax imposed on the corporation, this starts the statute of limitations under Reg. §1.6037-1(c). Thus, on a subsequent determination that the corporation is not entitled to the benefits of S status because of an inadvertent termination, the statute of limitations on assessment and collection of any corporate tax which subsequently is found to be due will run from the date of filing the Form 1120S, even though a Form 1120 should have been filed for post-termination years. This generally means that only the last three years could be challenged. Deficiencies could not be assessed against closed years because of an earlier termination.

6 For purposes of the 100 shareholder limit, all members of a family and their estates are treated as a single shareholder.

7 Other interesting possibilities include: the successor beneficiary of a qualified Subchapter S trust (QSST) affirmatively refuses to consent to the original QSST election, which means the QSST is no longer an eligible shareholder or S corporation stock is pledged as collateral for a personal loan and, upon default, the stock is acquired by an ineligible shareholder pursuant to a foreclosure sale Ltr. Rul. 9138025; *see* BNA TMP 730 pp. 160 to 162 for private letter rulings on this subject.

8 A minority shareholder may be prevented by a state court imposing a fiduciary duty from transferring his stock to an ineligible shareholder if a valid shareholder's agreement is in place. *Chesterton Co., Inc. v. Chesterton*, 97-2 USTC ¶ 50,809 (1st Cir. 1997). *See also*: PLRs 201026006, 199935035.

9 Reg. 1.1362-2(b)(1).

10 IRC §6037 and Reg. §1.6037-1(b).

Excess Passive Income. If an S corporation carries accumulated earnings and profits for three consecutive years and has passive income in excess of 25% of its gross receipts for the three years, it ceases to qualify as an S corporation[11]. Note that a new business established as an S corporation (that was never a C corporation) will have no earnings and profits and cannot be disqualified based on its passive income. Passive income includes royalties, rents, dividends, interest and annuities and sales and exchanges of stock or other securities.

Waiver under §1362(f). If a corporation's S status is voluntarily or involuntarily terminated, the corporation cannot reelect S status until completion of five taxable years after the taxable year of termination, unless the IRS grants its consent to do so.[12] When the disqualifying event occurs inadvertently, and the corporation and its shareholders desire to retain S status, the IRS has the authority to waive the termination requirements[13].

The IRS will waive certain inadvertent terminations and a corporation will be treated as continuing to be an S corporation following a disqualifying event if it:

previously made a valid S election and that election terminated;

establishes to the satisfaction of the IRS that the disqualifying event was inadvertent;

takes appropriate steps to correct the situation within a reasonable period after discovery of the disqualifying event;14 and

agrees (along with its shareholders) to any adjustments required by the IRS pertaining to the period that the corporation was in violation of the S corporation eligibility rules.

Before a waiver can become effective, the corporation must be brought back into compliance with all of the S corporation eligibility requirements. For example, this may require transferring shares among shareholders to ensure that all shareholders are eligible to own S stock or eliminating a deemed second class of stock.

11 IRC §1362(d)(3); Reg. §1.1362-2(c)(2); *See* BNA TMP 730 pp. 204-206 for private letter rulings on this subject.

12 IRC §1362(g).

13 IRC §1362(f); Reg. §1.1362-4; *see* Rev. Rul.92-37, 1992-2 C.B. 224, mistaken transfer of stock to a §408(a) IRA can be waived as an inadvertent error and Rev. Rul. 86-110, 1986-2 C.B. 150, majority shareholder transferred stock to two irrevocable trusts that did not qualify as S corporation shareholders can be waived because of reliance on advice of legal counsel and immediately rectified. *See also*, Rev. Proc. 2003-43 for the procedure for dealing with a similar issue, requesting relief from late elections such as ESBT elections, and QSub elections.

14 *See* PLRs 200533002 and 9829044, where the IRS granted S corporations permission to rescind stock transfers without jeopardizing the corporation's S status.

The next step is to request relief or waiver of the terminating event from the IRS under the inadvertent termination rule. The corporation has the burden of establishing that under the relevant facts and circumstances the termination was inadvertent.[15] The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, tends to establish that the termination was inadvertent.[16]

In its request, the corporation should set forth a detailed explanation of the event causing termination, when and how the event was discovered, and the steps taken to return the corporation to small business corporation status. In addition, the corporation's request should set forth the date of the corporation's election under §1362(a).[17]

The corporation and its shareholders must agree to any adjustments required by the IRS relating to the period that the corporation was not eligible for S status. If the termination took place because stock was transferred to an ineligible shareholder, that shareholder should also consent to the adjustments.

A waiver will not generally be effective until the corporation corrects the condition causing termination and removes the obstacle to the corporation qualifying for S status. The terminating event needs to be corrected within a reasonable period of time after it is discovered. There is no IRS definitive statement as to what time frame is reasonable. The IRS has issued private letter rulings where the time between discovery and correction was as long as nine months.[18] In practice, a 90-day period should be reasonable in most circumstances. Discovery of the terminating event may occur well after it actually occurred, sometimes even years later.

The IRS may require any adjustments that are appropriate and that, in general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the IRS.[19] The regulations indicate that the period for which the IRS can request adjustments may be retroactive either to all years for which the terminating event was effective, or only for the period in which the corporation again became eligible for subchapter S treatment.

S Termination Year. If an S election terminates under §1362(d) on a date other than the first day of a taxable year, the corporation's taxable year in which the termination occurs is referred to as the "S termination year," which consists of a short S and a short C year.[20] The "S short year" ends on the day before the occurrence of the terminating event, while the "C short year" begins on the termination date.[21]

The tax for the short C year is computed by annualizing the taxable income for the short period.[22] The S and C short years are treated as two separate years except that the S and C short years are treated as one year for purposes of determining the number of taxable years to which any item may be carried back or forward by the corporation.[23]

Allocation of Income and Loss Items. Income and loss items for a regular S corporation year pass through to shareholders on a pro rata basis.[24] In an S termination year, unless an election is made to close the books (described below), the amount of each item of income, deduction, loss, or credit is determined for the entire year and then allocated throughout the year on a daily basis.[25] Those amounts allocated to the short S termination year are then apportioned to the shareholders on a per-share, per-day basis.[26] As a result, the corporation's accounting books and records do not have to be closed on the date of termination.[27] Two exceptions to the general allocation rule are (1) where 50% or more of the corporation's stock is sold or exchanged in one or more transactions in a year[28] or (2) §338 recapture items when an acquiring corporation makes a §338 election.[29] Income or loss not allocated by the general allocation rule are assigned using the corporation's normal accounting methods.[30]

Per Books Election. The corporation may elect to not use the general allocation method and instead

15 Reg. §1.1362-4(b). *See also* PLRs 9236033, 9808018, 9808028, 200307079.

16 Reg. 1.1362-4(b).

17 Reg. §1.1362-4(c).

18 In PLR 9829044, the IRS granted an S corporation permission to rescind a stock transfer in the same tax year as the transfer, without jeopardizing its S corporation status. The IRS, citing Rev. Rul. 80-58, based its ruling on the fact that the rescission took place in the same taxable year as the stock transfer and the shareholders were restored to their relative positions as if the stock had never been transferred.

19 Reg. §1.1362-4(d).

20 §1362(e)(4); Reg. §1.1362-3(a).

21 §1362(e)(1); Reg. §1.1362-3(a). Compare a revocation where it is possible for the revocation to be retroactive to the beginning of the year and there is no S Termination Year for the last year.

22 §1362(e)(5); Reg. §1.1362-3(c)(2). The rules of §443(d)(2) (relating to the computation of the corporate minimum tax for short taxable years) will apply to a short C year. §1362(e)(5)(B).

23 §1362(e)(6)(A); Reg. §1.1362-3(c)(3) and (4).

24 §1377(a).

25 §1362(e)(2).

26 §1377(a)(1).

27 Reg. §1.1362-3(a).

28 §1362(e)(6)(D). Gifts of stock are not counted as being sold or exchanged in the year.

29 §1362(e)(6)(C).

30 Note there may be inconsistent treatment of the corporation and its shareholders under state or local income taxes.

use its normal tax accounting rules. The S corporation would close its books on the termination date and treat the two short years as separate accounting periods.[31] All shareholders during the short S termination year and all shareholders on the first day of the C year must consent to the election. Items attributable to the entire year (real estate taxes, insurance and the like) are allocated using the general allocation method.

S Corporations as Partners. Termination of an S election of a corporation that is a partner in a partnership because of ceasing to be a small business corporation or a revocation of the election is treated under §706(c) as a sale or exchange of the corporation's entire interest in the partnership if the general allocation method does not apply to the corporation and the tax year for the corporation will end during the short C corporation tax year.[32]

Timing of Pass Through Items. Income and loss items allocable to the S termination year are recognized by the shareholders in their tax year when the S corporation's year ends. In effect, for most shareholders, the income and loss is not reported until their year in which the entire final year for the corporation ends.

Post Termination Transition Period. After the termination or revocation of an S election, the corporation may continue to use two of its S election benefits: (1) previously suspended losses may be taken to the extent of basis[33] and (2) distributions may be taken tax free of the balance of the accumulated adjustments account ("AAA").[34] The balance of the AAA may be distributed tax free to the shareholders to the extent that each shareholder has basis.[35]

31 §1362(e)(3); Reg. §1.1362-3(b)(1).

32 Reg. §1.1362-3(c)(1) and Prop. Reg. 1.706-1(c)(2)(iii).

33 §1366(d)(3).

34 If a shareholder lacks basis to use suspended losses, the losses are treated as incurred by the shareholder on the last day of the post-termination transition period. This allows the shareholder to use the losses if he can restore basis during the period. Note, there is no post termination adjustment period for a reorganization of one S corporation with another under §381(a)(2).

35 §1371(e)(1).

Welcome to Washington: Expanded Nexus in an Age of Fiscal Uncertainty

By Jesús Miguel Palomares and Valerie Sasaki

On April 23, 2010, Governor Christine Gregoire of Washington signed Senate Bill 6143 (the "Tax Act") into law, which is projected to raise $794 million for the state's general fund. The Tax Act made two significant changes to Washington's Business and Occupation ("B&O") tax statutes. First, the new B&O tax rules temporarily (through June 30, 2013) raise the tax on gross revenue from services from 1.5 percent to 1.8 percent. Second, and more significantly, Washington adopted a new "economic nexus" standard to determine whether a taxpayer has substantial nexus with the state. By eliminating the old physical-presence requirement and establishing the new economic-presence threshold, Washington exposed many out-of-state service providers to B&O tax liability.

What Is Economic Nexus?

A state's ability to tax nonresidents is limited by the U.S. Constitution's Commerce and Due Process Clauses. These clauses require a state wanting to tax a nonresident to demonstrate that the nonresident has substantial nexus, or a meaningful connection, with the benefits provided to that nonresident. In the case of a sales tax, the U.S. Supreme Court held that a nonresident must have physical presence in order to have substantial nexus. Public Law 86-272 also creates a safe harbor for income taxes for a taxpayer whose activities are limited to sales solicitation. These protections do not extend to gross receipts or franchise taxes, such as Washington B&O tax.

State revenue authorities all over the country are concerned that their existing revenue laws are not responsive to recent changes in how businesses operate. A physical-presence standard made sense when sales were conducted by "drummers" going from jurisdiction to jurisdiction with samples of goods to sell. Recently, various states began identifying activities that constitute a nonresident's "purposeful availment" of a market and are sufficient to create an economic presence for the nonresident in that jurisdiction. Reflecting this trend, the Multistate Tax Commission ("MTC") promulgated model "bright line" nexus standards. Several states, including Washington, have adopted some variation of the MTC standards.

When Do You Have Nexus With Washington?

Under the Tax Act, a service provider's B&O tax liability attaches if the provider has an economic presence in the state,[1] without regard for whether any physical presence exists.[2] Specifically, a nonresident taxpayer establishes an economic nexus with Washington by having any of the following:

- More than $50,000 of real or intangible property in the state;
- More than $50,000 of payroll made to employees in the state;
- More than $250,000 of receipts from Washington customers; or
- At least 25 percent of the business's total property, total payroll, or total receipts in the state.[3]

Once nexus is established, there is a rebuttable presumption that it lasts for the current and following tax years.[4] This "trailing nexus" provision is an improvement from Washington's prior law. Under the prior law, nexus was presumed to last for four years following the year that nexus was conclusively established. In other words, an out-of-state service provider that previously did not pay Washington taxes may now face tax liability if its business dealings are significantly related to the state.

Washington's move to adopt an economic-nexus standard reflects a recent trend in state tax law. Although the MTC standards articulated the framework for these new laws, the Supreme Court's denial of certiorari in *Tax Comm'r v. MBNA America Bank*[5] opened the floodgates for states to adopt economic-nexus statutes. In that case, MBNA was incorporated in Delaware and had no physical presence in West Virginia.[6] Instead, the bank's only connection was issuing credit cards to West Virginia residents and servicing the cards.[7] When the state assessed both franchise and corporate income taxes against MBNA, the bank sued because it did not have a physical presence in West Virginia.[8] In upholding the tax, the West Virginia high court ruled that the physical-presence requirement did not apply to business franchise or corporate income taxes.[9]

The *MBNA* court offered several points for limiting the physical-presence requirement to sales and use taxes. Significantly, the court distinguished sales and use taxes from income and franchise taxes, stating that the latter's regulation was simpler and thus enforcement did not place an undue burden on interstate commerce.[10] Also, the court stated that a physical-presence requirement no longer made sense, given the modernization of today's business world.[11]

Opponents of broader adoption of economic-nexus standards base their opposition on two main points. First, adopting a substantial-nexus requirement based on less than physical presence violates the Commerce Clause because earlier cases emphasized the need for separate Due Process and Commerce Clause analyses, and an economic-nexus test would look to economic connections for both. Second, an economic-nexus standard based solely on the economic benefits derived from a state risks allowing taxation by multiple states and thus would be an undue burden on interstate commerce.

The adoption of an economic-nexus standard is attractive to state lawmakers because it expands a state's tax base beyond the boundaries of the state to (nonvoting) nonresidents who do not have any physical connection with the state. As we have seen with other states, in these economic times, state revenues are stagnant or declining, so there is a significant incentive to tap new revenue sources. Washington's budget deficit for the 2009-2011 biennium is expected to be at least $2.6 billion. The Tax Act's economic-nexus provisions alone are expected to raise $260.9 million by the end of 2012, or about 10 percent of the projected shortfall.[12]

1 2009 Wash SB 6143, sec 104, at 3-4 (amending RCW ch 82.04).

2 2009 Wash SB 6143, sec 103, at 3 (amending RCW ch 82.04).

3 2009 Wash SB 6143, sec 104(1)(c), at 4 (amending RCW ch 82.04).

4 2009 Wash SB 6143, sec 102(2), at 3 (amending RCW ch 82.04.220).

5 640 SE2d 226 (W Va 2006).

6 *Id.*, at 227.

7 *Id.*, at 227-228.

8 *Id.*

9 *Id.*, 232.

10 *Id.*, at 233-34.

11 *Id.*, at 234 ("we believe that the mechanical application of a physical-presence standard to franchise and income taxes is a poor measuring stick of an entity's true nexus with a state").

12 Washington State Office of Financial Management Fiscal Note Summary for SB 6143 2ESSB AMC Conf H5847.5, at 10 (Apr. 19, 2010).

Taxation of Oregonians Living and Working Abroad

*By Eric Kodesch**

In 1999, former (and now current) Governor Kitzhaber signed into law an amendment to the definition of "resident" for Oregon personal income tax purposes.[1] The amendment added ORS 316.027(1)(b),[2] which provides an exception to the definition for an individual working abroad. In crafting the amendment, the Oregon Legislature referred to IRC § 911, an income exclusion provision. By linking a definitional provision to a federal income exclusion provision, however, the Oregon Legislature made Oregon personal income tax law more favorable than federal income tax law for an individual otherwise subject to taxation on worldwide income.

Federal and Oregon Taxation of Worldwide Income

Federal income tax law and Oregon personal income tax law have a similarly broad scope with respect to taxing individuals from the applicable jurisdiction. With respect to federal income tax, such an individual generally is referred to as a "US individual." For Oregon purposes, such an individual generally is referred to as an "Oregon resident." Each is subject to federal income tax or Oregon personal income tax, as applicable, on worldwide income, regardless of source.[3]

Federal and Oregon income tax law also adopt similar tax credit concepts to mitigate the potential double taxation that can occur with respect to income earned by a US individual or an Oregon resident outside the applicable jurisdiction. Federal income tax law generally allows a US individual a foreign tax credit for taxes paid to a foreign country or a US possession.[4] Limitations apply to ensure that the foreign tax credit does not exceed the total federal income tax the individual otherwise owes on his or her foreign-source income, and to prevent other abuses or manipulation.[5] Oregon also allows credits for other taxes, except that these tax credits are limited to net income taxes paid in another state, Puerto Rico, or any US territory or possession; a tax credit is not allowed for taxes paid to another country.[6] Detailed rules have been adopted to prevent abuse and misuse of this credit.[7]

Although similar in some respects, federal and Oregon law have significant differences with respect to the definitions of "US individual" and "Oregon resident." In addition, with the enactment of ORS 316.027(1)(b), federal and Oregon tax law treat US individuals and Oregon residents living and working abroad entirely differently.

Definition of a "US Individual" and an "Oregon Resident"

The federal and Oregon definitions of an individual subject to taxation on worldwide income are similar in that each incorporates two alternative tests: a status test and a mathematical day count test. Differences in the status test, however, cause the Oregon definition to be administratively more cumbersome.

An individual is a US individual if the individual is a US citizen or a US resident.[8] A US resident is an individual who is a lawful permanent resident (i.e., a green card holder) or is treated as substantially present pursuant to a day count test.[9] An individual generally is a US resident pursuant to the day count test if the individual (i) is physically present in the United States for 30 days during the current year and (ii) is treated as present in the United States for 183 days by counting (a) all of the days in the current year, (b) 1/3 of the days in the prior year, and (c) 1/6 of the days of the second preceding year.[10] There is no domicile test for purposes of determining an individual's federal income tax status.[11]

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1 Or Laws 1999, ch 1096, § 1.

2 Unless otherwise indicated, references to "ORS" are to the 2009 edition of the Oregon Revised Statutes; references to "OAR" are to the Oregon Administrative Rules as of February 2011; references to "IRC" are to the Internal Revenue Code of 1986, as amended; and references to "Treas Reg" are to the Treasury Regulations promulgated thereunder.

3 *See* IRC § 61(a); ORS 316.037(1)(A) (imposing tax on resident's "entire net taxable income"; ORS 316.048 (defining "entire taxable income" as starting with federal taxable income). Although possible, it is unlikely that a person would be treated as an Oregon resident, but not a US individual. This possibility is not further discussed in this article.

4 *See* IRC § 901. US possessions include Puerto Rico and American Samoa. *See* IRS Pub No. 514 at 6 (2010).

5 *See, e.g.,* IRC § 904.

6 *See* ORS 316.082(1) (allowing credit); (7)(d) (defining "state" to include a "territory or possession of the United States"). The lack of a credit for taxes paid to a foreign country is logical, given that no Oregon credit is allowed for federal income tax.

7 *See* ORS 316.082(2); OAR 150-316.082(1)-(A), (1)-(B), (2), (3).

8 *See* IRC § 7701(a)(30)(A).

9 *See* IRC § 7701(b)(1)(A).

10 *See* IRC § 7701(b)(3). For example, an individual present in the United States for 120 days each year would not be treated as substantially present because the individual would be treated as present for only 180 days (120 + 40 + 20). Even if an individual generally would be treated as substantially present, exceptions may apply and it may be possible for the individual to elect not to be treated as a US resident.

11 *Compare* Treas Reg § 20.0-1(b)(1) (imposing federal estate tax on "a decedent who, at the time of his death, had his domicile in the United States") (emphasis added).

Accordingly, pursuant to these tests an individual is a US individual if he or she (1) has the status of being a US citizen or a permanent resident or (2) is treated as substantially present pursuant to a day count test.

An individual generally is an Oregon resident if the person is domiciled in Oregon, unless the individual (i) does not have a permanent place of abode in Oregon, (ii) maintains a permanent place of abode in another location, and (iii) is not present in Oregon for more than 30 days in the tax year.[12] In addition, an individual not domiciled in Oregon nonetheless generally is an Oregon resident if the individual maintains a permanent place of abode in Oregon and is present in Oregon for more than 200 days in the tax year, unless the individual's presence in Oregon was for a temporary or transitory purpose.[13] That is, an Oregon resident generally is an individual who (1) has the status of being domiciled in Oregon or (2) satisfies a day count test.

The federal and Oregon day count tests often are relatively formulaic in application and in many circumstances require little factual development, other than determining the individual's physical location throughout the tax year. Key differences arise, however, between the federal and Oregon status-based tests.

The nature of US citizenship or permanent residence makes the federal status test relatively simple to administer. Determining an individual's domicile, on the other hand, is highly fact sensitive.

As a general matter, US citizens and permanent residents do not lightly relinquish such status, and federal income tax law generally imposes an exit tax on US citizens and certain permanent residents who abandon their US citizenship or permanent resident status.[14] By contrast, there are no barriers to obtaining or abandoning an Oregon domicile similar to those involved in relinquishing US citizenship or permanent residence.

Once an individual has the status of being a US citizen or permanent resident, that individual is a US individual regardless of any other facts (e.g., there is no requirement of minimum presence in the United States). This means that, absent other relief, US citizens and permanent residents cannot structure their lifestyle to avoid US taxation while living and working abroad.

12 *See* ORS 316.027(1)(a)(A).

13 *See* ORS 316.027(1)(a)(B).

14 *See* IRC § 877A. This exit tax applies only to a permanent resident who has had a green card for at least eight of the 15 years prior to giving up the green card. *See* IRC § 877(e).

Federal Income Taxation of Foreign Earned Income

Perhaps in part due to the general stability of an individual's status as a US individual based on US citizenship or having a green card, as well as the lack of a minimum presence requirement, federal income tax law has provided some type of exclusion for foreign-source income earned by a US individual while living and working abroad since the Revenue Act of 1926. This exclusion provision currently is contained in IRC § 911.

Generally, a "qualified individual" may elect to exclude from federal gross income certain amounts of foreign earned income and foreign housing costs.[15] As a practical matter, this is done by making an adjustment to federal taxable income, as reported on a US individual income tax return.[16] For this purpose, a qualified individual is (i) a US citizen whose tax home is in a foreign country and who is treated as a bona fide resident of a foreign country or (ii) a US citizen or US resident who is present in one or more foreign countries for 330 or more days during any consecutive 12-month period.[17] With respect to the bona fide residence, there is no statutory definition for determining whether an individual is a bona fide resident of another country. Further, the applicable Treasury Regulation does not provide much guidance on the matter.[18] Nonetheless, it is possible for an individual to be both domiciled in Oregon and a bona fide resident of a foreign country.[19]

There are significant limitations related to the type or amount of income to which IRC § 911 applies. For example, the amount of foreign earned income excluded by IRC § 911 is an inflation adjusted amount that is $92,900 for 2011.[20] Another example relates to gain from the sale of publicly traded stock. For federal income tax purposes, such gain generally is sourced to the country of residence of the seller – if the seller is a US individual, the gain is US-source income subject to US federal income tax, regardless of the country in

15 IRC § 911(a).

16 *See* Form 2555, Foreign Earned Income, line 45; Form 2555-EZ, Foreign Earned Income Exclusion, line 18.

17 *See* IRC § 911(d)(1). Although the Code limits the bona fide residence test to US citizens, income tax treaties extend the benefit to US residents who also are citizens or nationals of a treaty country.

18 *See* Treas Reg § 1.911-2(c).

19 *See* Foreign Earned Income Exclusion – Bona Fide Residence Test, Internal Revenue Service, http://www.irs.gov/businesses/small/international/article/0,,id=96960,00.html (last visited February 24, 2011). This article does not provide further guidance for determining whether an individual is a bona fide resident of a foreign country. As described below, however, the issue may be of greater importance for Oregon personal income tax purposes than federal income tax purposes.

20 *See* IRC § 911(b)(2)(D); Rev Proc 2010-40 § 3.19, 2001-46 IRB 663.

which the individual is living at the time of the sale.[21] This gain generally is not foreign earned income for IRC § 911 purposes. Any income that does not qualify as foreign earned income or that exceeds the IRC § 911 limit is included in a US individual's federal taxable income.

There are potential adverse federal income tax consequences a US individual should consider before deciding to elect the income exclusion allowed by IRC § 911. Generally, a stacking principle applies so that income not excluded pursuant to IRC § 911 is taxed at the same marginal rates that would have applied absent the income exclusion.[22] In addition, an individual's foreign tax credit is reduced by foreign taxes paid on income excluded by IRC § 911.[23] Accordingly, an IRC § 911 election may not be advantageous if the person is subject to an effective foreign tax on the income excluded by IRC § 911 that is greater than the effective federal tax on the income, using the initial federal tax brackets (and not the last federal marginal tax rate). For example, if a US individual who files a joint federal income tax return uses the IRC § 911 exclusion to exclude $92,900 in 2011, the individual's federal income tax liability will be reduced by $15,475 (the effective federal income tax rate on the excluded income would have been approximately 16.66%). If the individual (i) has additional federal taxable income taxed at a higher federal marginal rate and (ii) is subject to an effective foreign tax rate on the $92,900 of income greater than 16.66%, the value of the lost foreign tax credit would exceed the $15,475 of federal income tax savings. Accordingly, the individual generally would choose to forgo the IRC § 911 exclusion.

Oregon Impact of an IRC § 911 Election Before the Enactment of ORS 316.027(1)(b)

As described above, the Oregon taxable income of an Oregon resident generally is based on federal taxable income, which takes into account the IRC § 911 exclusion. Therefore, prior to the enactment of ORS 317.027(1)(b), an IRC § 911 election would affect the Oregon taxable income of an IRC § 911 qualified individual who retained his or her Oregon domicile (an "Oregon-domiciled qualified individual"). An example of such an individual is an employee living, working, and domiciled in Oregon who is transferred to work in Europe for a temporary period (e.g., three years), but who intends to return to Oregon after the assignment. An Oregon-domiciled qualified individual's Oregon taxable income would be reduced by the IRC § 911 exclusion. Nonetheless, if an Oregon-domiciled qualified individual had foreign earned income in excess of the IRC § 911 limit (e.g., a salary while working abroad of $250,000) or other income that was not foreign earned income (e.g., gain from the sale of publicly traded stock), the individual would have significant federal and Oregon taxable income.

The difference in the federal and Oregon status-based tests, however, resulted in greater complexity in determining whether an IRC § 911 qualified individual remained an Oregon resident (i.e., whether the individual retained an Oregon domicile). That is, the individual generally would remain a US individual, but would assert that the Oregon domicile had been abandoned. After all, none of the foreign earned income or capital gain from the sale of the publicly traded stock would be taxable by Oregon, if earned by a nonresident.[24] It appears that this led to a significant number of costly Oregon audits, prompting the legislature to resolve the issue by enacting ORS 316.027(1)(b), and making it retroactive to 1995 (the retroactive date generally resolved pending audits and cases).[25]

Excluding IRC § 911 Qualified Individuals from the Definition of a "Resident"

As described above, ORS 316.027(1)(b) limits the definition of a "resident" for Oregon personal income tax purposes. It provides:

> "(b) 'Resident' or 'resident of this state' does not include:
>
> "(A) An individual who is a qualified individual under section 911(d)(1) of the Internal Revenue Code for the tax year;
>
> "(B) A spouse of a qualified individual under section 911(d)(1) of the Internal Revenue Code, if the spouse has a principal place of abode for the tax year that is not located in this state; or
>
> "(C) A resident alien under section 7701(b) of the Internal Revenue Code who would be considered a qualified individual under section 911(d)(1) of the Internal Revenue Code if the resident alien were a citizen of the United States."

21 IRC § 865(a)(1).

22 *See* IRC § 911(f). If the IRC § 911 election is made, federal tax liability generally equals (i) federal tax liability absent the IRC § 911 election less (ii) federal tax liability owed if the only income were the amount excluded by IRC § 911. The effect of this calculation is that an election deprives the individual of the benefits of the lower tax brackets.

23 *See* IRC § 911(d)(6).

24 *See* ORS 316.127(2)(b), (3).

25 Or Laws 1999, ch. 1096, § 2(a); Tape Recording, H Comm on Revenue, SB 874-A, Mar. 23, 1999, Tape 69, Side A (statement of David Kessler: "The Department of Revenue is currently examining a number of individuals as to whether they are domiciled overseas or in the State of Oregon. The determination is lengthy and expensive, if the measure were retroactive it would save time and money.").

As an initial matter, ORS 316.027(1)(b) goes beyond IRC § 911 by applying the bona fide residence test to US residents who are citizens or nationals of a country with which the United States does not have an income tax treaty. More importantly, the provision is favorable to an Oregon-domiciled qualified individual.

Pursuant to ORS 316.027(1)(b), an IRC § 911 qualified individual is not an Oregon resident, and is subject to Oregon personal income tax only as a nonresident (i.e., to the extent of the individual's Oregon-source income).[26] As described above, an Oregon-domiciled qualified resident could have significant federal taxable income that would have been subject to Oregon tax if the individual were treated as an Oregon resident. Accordingly, because ORS 316.027(1)(b) treats the individual as a nonresident, the individual obtains a significant Oregon tax savings.

Further, ORS 316.027(1)(b) applies with respect to a qualified individual, or a permanent resident who would be a qualified individual if the individual were a US citizen, regardless of whether the individual makes the IRC § 911 election. As described above, a qualified individual may not make the federal election because the election could increase federal taxable income. Nonetheless, the individual would receive the full benefit of the ORS 316.027(1)(b) exception to the definition of Oregon resident.

Conclusion

The domicile test for Oregon residency creates administrative burdens with respect to applying Oregon tax law to Oregonians living and working abroad. The Oregon legislature simplified the matter by generally treating these individuals as nonresidents. To accomplish this, the legislature used a federal income exclusion provision to limit the Oregon definition of a resident. This results in Oregon tax law being more favorable than federal law.

26 *See* ORS 316.037(3).

The Husband and Wife Qualified Joint Venture Filing Option: Proper Social Security and Medicare Crediting and Simplified Tax Reporting

By Jason Faas

The Qualified Joint Venture Filing Option

A husband and wife who co-own and co-operate a trade or business may be eligible to file their tax returns as a Qualified Joint Venture ("QJV"). The potential benefits to the spouses electing to do so are (i) proper Social Security and Medicare crediting and (ii) simplified tax reporting.

Why the QJV Filing Option?

The Partnership Approach

An unincorporated business jointly owned by a married couple is generally treated as a partnership for federal tax purposes. As a tax partnership, the couple must complete and file at least seven federal tax forms and schedules for their business (see table below). Form 1065 and the Schedules K-1 can be difficult and expensive to prepare.

The Sole Proprietorship Approach

To avoid the burden of preparing partnership returns, many married couples treat their jointly-owned businesses as sole proprietorships. Under this approach, a couple may only have to file three federal tax forms and schedules for their business (see table below), including one Schedule C or F and one Schedule SE. Because a Schedule SE is filed for only one spouse, the other spouse does not receive Social Security and Medicare credit for his or her share of self-employment earnings from the business.

The QJV Filing Option Election ("QJV Election")

To remedy the imbalance between the two approaches, Congress enacted Internal Revenue Code ("Code") Section 761(f), which provides for the QJV Election. Under the QJV Election, a married couple may elect to treat their qualifying business as a QJV and file federal tax forms and schedules as if they were each sole proprietors (see table below). Each spouse files a Schedule C or F and a Schedule SE with the couple's joint Form 1040, which ensures both spouses receive proper Social Security and Medicare credit. No partnership tax forms or schedules are required. In this manner, the QJV Election provides a "best of both worlds" approach: simplified tax reporting and full Social Security and Medicare crediting.

Filing Option	Forms / Schedules	Advantages	Disadvantages
Sole Proprietorship	- 1 Form 1040 - 1 Schedule C or F - 1 Schedule SE	- Taxpayer only files one form and two schedules.	- Only one spouse receives Social Security and Medicare credit.
Qualified Joint Venture	- 1 Form 1040 - 2 Schedules C or F - 2 Schedules SE	- Taxpayer does not have to file Form 1065 or Schedules K-1. - Both husband and wife receive Social Security and Medicare credit.	- Increased burden to file an additional Schedule C (or F) and Schedule SE.
Partnership	- 1 Form 1065 - 2 Schedules K-1 - 1 Form 1040 - 1 Schedule E - 2 Schedules SE	- Both husband and wife receive Social Security and Medicare credits.	- This option requires the highest number of forms and schedules.

What Type of Business Qualifies as a QJV?

A QJV is defined as a trade or business where: (1) the only members of the business are a husband and wife; (2) the husband and wife file a joint tax return and elect not to be treated as a partnership under Code Section 761(f); and (3) both spouses materially participate in the business, as defined under Code Section 469(h) and the corresponding Treasury Regulations, without regard to Code Section 469(h)(5).

Making the QJV Election

Spouses make the QJV Election by dividing all items of income, gain, loss, deduction and credit between each other in accordance with their respective interests in the business. Each spouse then reports these items on Schedule C (or Schedule F in the case of farming activities). The spouses must also file separate Schedules SE.

The QJV Election is effective for as long as the business meets the QJV requirements. It may only be revoked with IRS approval. However, if the QJV requirements are not met in a given year, the business will be treated as a partnership, and a new QJV Election will be necessary if the spouses desire to file as a QJV in a future year in which the QJV requirements are met.

Additional Considerations

State Law Entities – As noted above, a business owned in the name of a state law entity (e.g., a general partnership, limited partnership or a limited liability company ("LLC")), cannot qualify as a QJV.

Trade or Business – The spouses must be engaged in a trade or business to qualify as a QJV. Mere co-ownership of property is not enough. Consequently, the QJV Election is not available to spouses who merely co-own rental or investment real estate which does not rise to the level of a trade or business.

Partnerships Making the QJV Election – If the spouses operate their business as a partnership and make the QJV Election, the IRS has stated only the partnership filing requirement is terminated, not the partnership itself. If partnership returns were previously filed for the business, the partnership's EIN is not used when filing as a QJV. Rather, the EIN remains with the partnership and should be used by the partnership in any future year in which the requirements of a QJV are not met.

Employer Identification Number (EIN) – Because spouses are treated as sole proprietors under the QJV Election, they are not required to obtain an EIN unless otherwise required by the rules for sole proprietors, i.e., if the sole proprietorship is required to file excise, employment, alcohol, tobacco, or firearms returns. For obvious privacy reasons, however, obtaining an EIN may be warranted.

LLCs in Community Property States – Although the QJV Election is not available if spouses own a business through an LLC, if spouses live in a community property state and own an LLC as community property, they may elect to treat the LLC as a disregarded entity and file tax returns accordingly. *See* Rev. Proc. 2002-69.

Tax Advice – Prior to making a QJV Election, a careful analysis of both spouses' tax situation is warranted.

Conclusion

Married couples who co-own and operate businesses should be informed of the QJV Election. The election can eliminate the additional time and expense of preparing partnership tax returns while ensuring both spouses receive full Social Security and Medicare credit.

The IRS 2011 Offshore Voluntary Disclosure Initiative: The IRS Serves Up an Additional (Final?) Round of FBAR Relief

By Dan Eller[1]

On February 8, 2011, the Internal Revenue Service ("IRS") announced a new special initiative aimed at continuing its compliance goals with respect to foreign bank account reporting[2] it had started approximately three years ago.[3] The prior program – the 2009 Offshore Voluntary Disclosure Program ("2009 OVDP") – expired in late 2009, and it was believed in the months following its expiration that many additional taxpayers did not come forward. This belief was supported by the fact that in addition to the approximately 15,000 taxpayers who came forward under the 2009 OVDP, an additional approximately 3,000 taxpayers subsequently disclosed FBAR failures to the IRS.[4] The IRS launched the 2011 Offshore Voluntary Disclosure Initiative ("2011 OVDI") to permit those who will come forward before August 31, 2011, to resolve FBAR failures without the threat of criminal prosecution and subject to, in some cases, substantially reduced penalties. Those who fail to come forward under the 2011 OVDI, however, IRS Commissioner Doug Shulman warned that "more is in the works … [and] the time to come in is now. The risk of being caught will only increase."[5]

How the 2011 OVDI Functions

At the same time the IRS announced the 2011 OVDI, it also provided a comprehensive roadmap on its website (the "2011 OVDI Website").[6] The 2011 OVDI Website is a one-stop shop for all of the pertinent information regarding the 2011 OVDI. The IRS set up at least nine additional language-specific websites to assist taxpayers for whom English is not their primary language.[7] On the 2011 OVDI Website, taxpayers can find a number of helpful reference materials, including instructions; forms and documents; and frequently asked questions ("FAQs").[8]

The FAQs provide the substance of the 2011 OVDI. The FAQs are written in plain English, and answer most questions a "straightforward" FBAR client will likely ask. As such, if you intend to provide FBAR advice between now and the end of the 2011 OVDI, you should familiarize yourself with the FAQs, the 2011 OVDI Website and the various forms and other materials located therein.

Important Issues Resolved by the FAQs

The first half-dozen FAQs set forth the IRS's intended policy and warn of the panoply of penalties available to the IRS if it discovers noncompliant taxpayers. For example, FAQ 5 warns noncompliant taxpayers that FBAR penalties can be as high as the greater of $100,000 or 50 percent of the aggregate balance of the foreign account – per violation. This means that a taxpayer who failed to file FBARs for six years could face a civil penalty equal to three times the balance in the taxpayer's account (not taking into account fluctuations in the balance over time). Other penalties may apply as well. As discussed in detail below, the potential to obtain "only" a 25-percent penalty under the 2011 OVDI can present a nominal savings in respect of the otherwise available civil penalty. The IRS also reminds taxpayers that FBAR failures can be criminally punished.[9] Indeed, in the days after the 2009 OVDP was launched to the present, the IRS has successfully prosecuted noncompliant FBAR taxpayers.

FAQ 14 reminds taxpayers that the 2011 OVDI fundamentally remains – as its name suggests – a "voluntary" program. This means that taxpayers who are

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1 Dan Eller is an attorney in the Portland office of Schwabe, Williamson & Wyatt.

2 The foreign bank account report – TD F 90-22.1 Report of Foreign Bank and Financial Accounts – is commonly referred to as an "FBAR." Although the FBAR must be filed with respect to certain foreign bank and financial accounts, for purposes of this article the term "bank account" will be used to describe all such accounts. Additionally, the act of foreign bank account reporting will also be described under the moniker "FBAR," as the context permits.

3 For a discussion of the IRS's prior compliance program – dubbed the "2009 OVDP" for purposes of this article – please refer to Your Clients' Foreign Connections: a Primer on the FBAR Filing Obligations by Natalia Yegorova, which appeared in the Winter 2009 issue of the Oregon State Bar Taxation Section Newsletter. Additional information is available at http://www.irs.gov/newsroom/article/0,,id=206012,00.html.

4 Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 Deadline, IR-2011-14 (Feb. 8, 2011), available at http://www.irs.gov/newsroom/article/0,,id=235695,00.html.

5 *Id.*

6 *See* http://www.irs.gov/newsroom/article/0,,id=234900,00.html.

7 *Id.*

8 *Id.* For purposes of this article the term "FAQ" refers only to the 2011 OVDI frequently asked questions, which are available at http://www.irs.gov/businesses/international/article/0,,id=235699,00.html. This website should be consulted from time to time because the IRS continues to update the FAQs. The IRS issued frequently asked questions regarding the 2009 OVDP as well.

9 FAQ 6.

under examination (or, presumably, have been otherwise detected) are not eligible to participate. This is true even if the examination does not relate to FBAR matters. This does not mean, however, that taxpayers who attempted a "quiet" disclosure[10] in days and months since the IRS launched the 2009 OVDP are not eligible. To the contrary, FAQ 15 "strongly" encourages taxpayers who quietly disclosed to participate in the 2011 OVDI. The IRS will be reviewing amended income tax returns for quiet disclosures, and, if the IRS discovers a quiet disclosure, it can open the amended return on audit and expose the taxpayer to the traditional FBAR civil and criminal penalties.[11]

Some taxpayers reported income in respect of their foreign accounts but failed to include the form of FBAR with their returns. FAQ 17 makes it clear that those taxpayers will not be subject to FBAR penalties if, by August 31, 2011 (except for the 2010 FBAR, which is due June 30, 2011), they file delinquent FBARs for each year in which they previously failed to file FBARs.12

FAQs 49 and 50 also make it clear that the 2001 OVDI is a "package" settlement and if it is unacceptable, the case will be examined and all applicable civil penalties will be assessed, and the IRS reviewer will have no authority to reduce those penalties. This is a notable change from the normal process of which you should take note. If you are accustomed to requesting administrative penalty relief or a waiver based on reasonable cause, those avenues are foreclosed. Thus, you should be expected to temper your initial advice to your client accordingly. If you do not, you will run the risk of disappointing your clients if they first disclose before running through the penalty calculations or if you promise the ability to reduce those civil penalties through traditional means.

The 2011 OVDI Process

Taxpayers electing to participate in the 2011 OVDI must start by mailing an "Offshore Voluntary Disclosure Letter"[13] to the IRS's Offshore Voluntary Disclosure Coordinator in Philadelphia, PA.[14] In the author's experience, the IRS is responding to such Letters within as few as two weeks. This is important because it provides your client some assurance upon starting the process that the IRS has "tentatively accepted" the client into the 2011 OVDI. Often this assurance can calm a client who is honestly worried about threats of criminal prosecution or substantial civil penalties.

Perhaps the biggest procedural difference between the 2009 OVDP and 2011 OVDI is the manner in which your client will make its submission to the IRS. Upon receipt of the "tentative acceptance letter" from the IRS, the taxpayer participating in the 2011 OVDP is required to submit a voluntary disclosure package, including payment, to the IRS's Austin Campus.[15] By comparison, the taxpayer participating in the 2009 OVDP would provide documents to the IRS only upon request from the IRS. In some cases, that could lead to substantial time delays.[16]

The 2011 OVDI voluntary disclosure package must include copies of original and amended tax returns; a "Foreign Account or Asset Statement"; a Foreign Financial Institution Statement, if the highest aggregate account balance was $1,000,000 or more in any year; a Taxpayer Account Summary With Penalty Calculation; account statements (in certain cases); forms to extend the applicable statutes of limitation; and a check payable in the amount of the taxes, penalties and interest.[17]

Computation of the 2011 OVDI Penalty

The most significant substantive differences between the 2009 OVDP and the 2011 OVDI are the increase in the penalty and the manner in which it is calculated. Unlike the 2009 OVDP which provided for 5-percent and 20-percent penalties, the 2011 OVDI increases the top penalty rate to 25 percent. Several other important changes are made. First, the penalty-computation period is now 2003 to 2010.[18] This means the taxpayers who waited and saw increases in their highest account balance during 2009 and/or 2010, may see both an increase in the percentage of the penalty (e.g., from 20 percent to 25 percent) and the amount against which it is applied.

---

10 Some taxpayers attempted to circumvent the 2009 OVDP's penalty regime by amending and filing tax returns and paying taxes and interest on previously unreported offshore income without otherwise notifying the IRS. *See* FAQ 15 for a discussion of how taxpayers who previously made quiet disclosures may take advantage of the 2011 OVDI.

11 *See* FAQ 16.

12 FAQ 17 does not inform taxpayers with many years of FBAR noncompliance as to which unfiled FBARs must be filed. The 2011 OVDI measures its penalty based on the years 2003 to 2010 (discussed in detail below). The author suggests a prudent course is to file FBARs for those years. FAQ 17 requires the taxpayer to "attach a statement explaining why the reports are filed late." Under the correct facts, the taxpayer may describe the fact that additional FBARs (before 2003) were not filed.

13 A form of this Offshore Voluntary Disclosure Letter is available at http://www.irs.gov/newsroom/article/0,,id=235584,00.html.

14 FAQ 24.

15 FAQ 25.

16 Indeed, the author continues to represent clients who participated in the 2009 OVDP who have yet to complete that process. The author is hopeful that the IRS will move more quickly under the 2011 OVDI to issue a closing agreement.

17 FAQ 25. These forms are available at http://www.irs.gov/newsroom/article/0,,id=235584,00.html.

18 *See* FAQ 34.

Second, the penalty may be applied against assets other than those held in the foreign bank accounts.[19] This is particularly noteworthy, and you should review the relevant FAQs if your client has foreign assets that are not held in bank accounts, such as tangible personal or real property. FAQ 36 makes its clear that if the taxpayer derived unreported foreign income from foreign rental property, the value of that property will be included in the penalty calculation. The effect of this cannot be understated. Recall that the law underlying FBAR reporting applies to foreign bank accounts. The obvious concern is that the IRS has overstepped its authority. Perhaps the justification, however, is that the IRS is offering a reduced penalty so it can measure that reduced penalty against anything it wants, even assets that are not in foreign bank accounts. Although that may be the case, care should be taken to assess your client's penalty computations. For example, if your client has substantial foreign real property holdings, a penalty in the amount of 25 percent of those holdings may exceed the otherwise available FBAR penalty under the right facts. In that case, you should counsel your client about the propriety of participating in the 2011 OVDI.[20]

Third, the 2011 OVDI widens, albeit narrowly, the availability for the imposition of the 5-percent penalty. In the author's experience, the IRS reluctantly, if ever, applied the 5-percent penalty under the 2009 OVDP. The IRS usually justified its decision by finding some technical default. The most common default cited by the IRS was taxpayer "activity" in respect of the account. Under the 2009 OVDP, the taxpayer who inherited a foreign bank account and stopped by the bank on vacation to sign an account-signature card would be prohibited from obtaining the lowest penalty available. The 2011 OVDI provides a limited opportunity for certain taxpayers who: (1) did not open the account; (2) had minimal or infrequent contact with the financial institution; (3) can prove that the funds in the account were taxed in the United States; and (4), importantly, withdrew less than $1,000 from the account during the years covered by the 2011 OVDI (e.g., 2003 to 2011). These taxpayers may qualify for the reduced 5-percent penalty.[21] Moreover, this special rule applies to taxpayers who participated in the 2009 OVDP. Thus, if you have any clients who have entered into closing agreements under the 2009 OVDP, you should consider whether this de minimis exception may be applied to their matters.

Conclusion

For clients who have unreported foreign bank account reports, the 2011 OVDI may provide a valuable opportunity to return to compliance. Clients should prepare themselves for a penalty equal to 25 percent of the aggregate value of foreign bank accounts and other foreign assets for the year with the highest aggregate value during their years of noncompliance (back to 2003). In all cases that penalty computation should be compared to other penalties available under the law, such as if the client does not participate in the 2011 OVDI. Given Commissioner Shulman's commentary upon the release of the 2011 OVDI, potential clients assessing whether to participate in the 2011 OVDI should be properly counseled regarding the substantial risks related to continued noncompliance.

19 FAQ 35.

20 FAQ 50 recognizes this potential dilemma and provides that under no circumstances will taxpayers be required to pay a penalty greater than what they would be liable under existing statutes (i.e., the normal FBAR penalty). Additionally, if you are faced with this dilemma, do not forget the potential criminal penalties.

21 FAQ 52.

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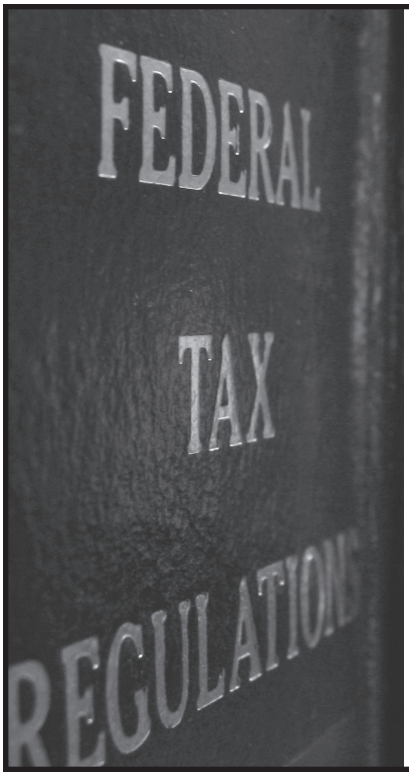

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