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PROPOSED ADMINISTRATIVE CHANGES TO THE INTERNAL REVENUE SERVICE'S STREAMLINED FILING COMPLIANCE PROCEDURES

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[1] The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association.
[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this project.

EXECUTIVE SUMMARY

Under current law, United States taxpayers have various international information return reporting requirements incldluing: (1) foreign bank accounts (Foreign Bank Account Report or FBAR); (2) foreign specified assets (IRS Form 8938); (3) foreign corporations IRS Form 5471); and (4) foreign trusts, foreign trust beneficiaries, and large gifts received from foreign persons (IRS Forms 3520 & 3520-A).

The penalties for non-compliance with these requirements can be excessive, yet many taxpayers and practitioners are entirely unaware that the Service currently offers some programs for taxpayers to correct their past non-compliance as an alternative to merely filing delinquent Forms (known as a "quiet disclosure"). One such program is the Streamlined Filing Compliance Procedures. The Streamlined Procedures are available to individual taxpayers only and only for taxpayers who certify that their non-compliance was "non-willful". Other requirements include that the taxpayer cannot be under criminal investigation or civil audit (and that the taxpayer failed to report gross income from the non-compliant foreign asset(s).

In the authors' experience the Streamlined Filing Compliance Procedures provide the most practical closure for taxpayers and are a way to eliminate or substantially reduce penalty exposure. The Service, in the authors' experience, does not often audit the returns filed through the Streamlined Procedures, so long as everything is filed correctly, and all requirements are satisfied. Even where the Service opens the submission for audit, the issue is usually to determine willfulness.

There are many instances in which an individual taxpayer can have non-compliant foreign financial assets that result in no tax loss to the United States. For example, an individual can lose money for a foreign investment, have foreign tax credits that offset U.S. taxes, or be a signer on multiple non-interest bearing foreign bank accounts with an aggregate balance of more than $10,000. For hypothetical purposes, let's assume the aggregate balance of the accounts each year for the past three years was around $50,000 at its peak. Under the Streamlined Filing Compliance Procedures, if the individual is residing in the United States, they would face a maximum penalty of 5% of the highest aggregate value of the foreign bank accounts in the past three years, or $2,500. If the individual is not residing in the United States, they would owe nothing. Without the Streamlined Filing Compliance Procedures, the non-willful individual could face a penalty of $10,000 per year, or $30,000, simply for being a signer on non-interest bearing foreign bank accounts.

This paper proposes three administrative changes relating to the Internal Revenue Service's Streamlined Filing Compliance Procedures so that taxpayers and practitioners become knowledgeable for international reporting requirements and can appropriately enter into the procedures offered by the Service: (1) that the Streamlined Filing Compliance Procedures become permanent; (2) that additional questions be added to Form 1040 Schedule B to include questions regarding all Forms eligible for the Streamlined Filing Compliance Procedures; and (3) that the Service issue a publication or instruction sheet with the Streamlined Filing Compliance Procedures eligibility criteria and submission requirements.

DISCUSSION

I. INTRODUCTION

This proposal addresses and provides proposed changes to publicize the international information return filing requirements and make individuals and practitioner aware of the Streamlined Filing Compliance Procedures. This will benefit individual taxpayers whose unreported foreign financial assets result in no gross income or tax due to the United States.

Our proposal will make the penalties relating to the failure to file information returns for foreign financial assets/interests more equitable since taxpayers will be made aware of their filing requirements through the Form 1040. Further, our proposal will make the Streamlined Filing Compliance Procedures permanent and more taxpayer-friendly so that truly non-willful taxpayers can take the opportunity to obtain practical closure for their inadvertent non-compliance with the least amount of risk of systematic penalty assessment and having to incur significant legal costs to challenge the penalties.

II. THE CURRENT PENALTIES RELATING TO INTERNATIONAL INFORMATION RETURN PENALTIES ARE STEEP

In the authors' experience, the average U.S. taxpayer and tax practitioners who do not specialize in international tax matters are wholly unaware of U.S. reporting requirements relating to foreign financial assets and interests, as well as the substantial penalties that can be imposed as a result of failing to comply with these reporting requirements. Conceptually, many taxpayers we work with are confused on how steep penalties are assessed against for purely informational returns. Additionally, average individual U.S. taxpayers can be subject to U.S. reporting requirements by nature of their immigration to the United States or familial relationships abroad. Put another way, the reporting requirements to do not just impact sophisticated U.S. taxpayers with foreign investments for purposes of financial gain and strategic tax planning. As a result, lower and middle-class taxpayers also have significant penalty exposure and will usually incur legal and professional fees defending against such penalties after the fact. Many of these taxpayers simply cannot afford the penalties or the legal and professional costs to challenge the penalties after the fact.

In the author's experience, the most common U.S. international information return reporting requirements including: (1) foreign bank accounts (Foreign Bank Account Report or FBAR); (2) foreign specified assets (IRS Form 8938); (3) foreign corporations (IRS Form 5471); and (4) foreign trusts, foreign trust beneficiaries, and large gifts received from foreign persons (IRS Forms 3520 & 3520-A).

This paper will generally provide an overview of filing requirements relating to each of the above-mentioned forms and the applicable penalties for failing to file such forms. However, this paper will not discuss the details of each form, the applicable statute of limitations, or other details beyond the general filing requirements and penalties.

A. Foreign Bank Accounts

In general, U.S. persons having a financial interest in, or signature authority over, a bank, securities, or other financial account in a foreign country, whose aggregate balance exceeds $10,000 on any given day of the tax year, must file an FBAR. A U.S. person is also generally required to file FBARs for more than 50% ownership or beneficial ownership in corporations or entities. An FBAR is filed separately from a taxpayer's income tax return and is required to be electronically filed each year directly through the FinCEN system.

The penalties which the Service can impose for a taxpayer's failure to file an FBAR vary significantly based on the degree of culpability of the taxpayer and based on all of the facts and circumstances relating to the taxpayer's noncompliance. If the taxpayer can establish reasonable cause, there is no penalty. If there exists culpability, such culpability boils down to simply willful and non-willful. If the Service believes the filer is non-willful (including negligent) in their failure to timely file an FBAR, the penalty is limited to $10,000 per violation, though the Service may assert a penalty of less than $10,000. On the other end, if the Service believes that the failure to file the FBAR was "willful," the penalty is the greater of $100,000 or 50% of the balance of the account at the time of the violation.

B. Foreign Specified Assets

Taxpayers must file a Form 8938 to report interests in specified foreign financial assets. The Form 8938 reports much of the same information as an FBAR but has different and higher reporting thresholds than an FBAR. The Form 8938 is filed with a taxpayer's income tax return.

Under section 6038D of the Code, the penalty for not timely filing a Form 8938 is $10,000 per year. Where the Service sends the taxpayer a letter telling the taxpayer to file Form 8938, a continuation penalty may apply. This type of letter is often referred to as a "continuation letter" by practitioners. When the Service issues a continuation letter the taxpayer has 90 days to file the missing Form. Where the taxpayer fails to file the requested form within 90 days, an additional penalty of $10,000 applies for each 30-day period (or fraction thereof) during which such period continues. The maximum "continuation penalty" is $50,000, for an overall maximum penalty of $60,000 per year. Under section 6038D(g) of the Code, where a taxpayer can demonstrate reasonable cause for failing to file Form 8938, no penalty is imposed by the Service.

C. Foreign Corporations

U.S. persons who are shareholders and/or officers or directors of foreign corporations are required to file an information return reporting their role and the corporation's information on a Form 5471. A Form 5471 must also be filed for U.S. persons who own directly, indirectly and/or constructively at least 10% of the stock. A Form 5471 is required to be attached to a timely filed income tax return.

The penalty for not timely filing a Form 5471 is $10,000 per year. As with Form 8938, where the Service sends a taxpayer a continuation letter, and where the taxpayer fails to file

Form 5471 within 90 days of receiving the continuation letter, an additional penalty of $10,000 applies for each 30-day period (or fraction thereof) during which such period continues. The maximum "continuation penalty" is $50,000 for an overall maximum penalty of $60,000 per year.

D. Foreign Trusts, Trust Beneficiaries, and Recipients of Foreign Gifts

U.S. persons who own, are a beneficiary of, or interact with, a foreign trust, generally must file Form 3520 and/or Form 3520-A. The rules relating to reporting positions of foreign trusts are complex and fact-specific and will not be discussed in detail in this paper. Further, U.S. persons who receive "large" foreign gifts from non-U.S. persons must report receipt of the gift on a Form 3520. While the deadline for filing both Form 3520 is the same as the deadline for an individual's income tax return, including extensions, each form is technically filed separately from the income tax return. The Form 3520-A is due on March 15th for calendar year taxpayer and can be extended until September 30th.

Under section 6677 of the Code, the penalty for failure to file Form 3520-A is the greater of $10,000 or 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of that tax year if the foreign trust fails to file a timely Form 3520-A, or does not furnish all required information or provides incorrect information. If the Service issues a continuation letter, and a taxpayer does not file Form 3520-A within 90 days, an additional penalty of $10,000 for each 30-day period (or fraction thereof) may be assessed. The maximum penalty cannot exceed the gross reportable amount.

The penalty for failing to timely file Form 3520 with regard to a foreign trust is the greater of: (1) $10,000; (2) 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. Transferor to report the creation of, or transfer to, a trust; (3) 35% of the gross value of the distributions received from a foreign trust; or (4) 5% of the gross value of the portion of the foreign trust's assets treated as owned by a U.S. person under the grantor trust rules if the foreign trust fails to file a Form 3520-A or does not furnish all required information.

The penalty for failing to timely file Form 3520 with regard to a large gift or bequest from foreign individuals is five percent of the value of the gift for every thirty days the gift is not reported on Form 3520, up to twenty-five percent of the value of the gift.

III. OVERVIEW OF THE STREAMLINED FILING COMPLIANCE PROCEDURES

The Streamlined Filing Compliance Procedures are only available to individual taxpayers who certify that their non-compliance was "non-willful", and disclose any adverse facts per FAQ #13. The taxpayer cannot be under criminal investigation or civil audit and must have failed to report gross income from the non-compliant foreign asset(s). There are two types of submissions within the Streamlined Procedures, one for taxpayers residing in the U.S. and one for taxpayers residing outside the U.S.

If a taxpayer resides in the U.S. for purposes of the procedures, they are required to pay a miscellaneous offshore penalty equal to five percent of the value of the unreported foreign assets. If a taxpayer resides outside the U.S., they are not required to pay a penalty. All taxpayers are required to pay any unreported income tax due plus interest for the prior three (3) years.

In the authors' experience, the Service does not often audit the returns filed through the Streamlined Procedures, assuming the submission is filed correctly, and all requirements are satisfied. In circumstances where the Service opens the submission for audit, the issue is usually to determine willfulness.

The most recent statistics from the Office of Management and Business indicates annual Streamlined Filing Compliance Procedures submissions of approximately 14,300.[3] This is a substantially higher participation rate compared to the Voluntary Disclosure Program with annual submissions of approximately 222.[4] A contributing factor to the high participant rate in Streamlined Domestic and Foreign Filing Compliance Procedures is likely due to the fact that the program is relatively taxpayer friendly for the reasons discussed throughout this paper.

As also discussed throughout this paper, taxpayers and tax practitioners are often wholly unaware of international information return reporting requirements. Contributing factors to the lack of awareness likely include the fact that people subject to international reporting requirements include immigrants and the fact that international reporting requirements are not "popular" or regularly publicized in comparison to common tax credits or income tax return filing requirements even to many tax practitioners in the authors' experience.

Another reason for the lack of awareness is likely because the Form 1040 does not explicitly prompt or allude to all of the international reporting requirements and applicable forms. Presently, Form 1040 Schedule B lines 7a, 7b, and 8, prompt potential FBAR and Form 3520 filing requirements. A copy of the Form 1040 Schedule B is enclosed.

Schedule B does not prompt the filing of a Form 3520 in the context of a foreign gift, and does not otherwise prompt the potential filing requirements of Forms 8938, 5471, or 3520-A. It is also worth noting that a Schedule B is only completed if a taxpayer has $1,500 or more in interest or dividend income for the tax year.

IV. PROPOSED REMEDIES

A. MAKE THE STREAMLINED FILING COMPLIANCE PROCEDURES PERMANENT

Presently, the Streamlined Filing Compliance Procedures are a matter of administrative grace. The Internal Revenue Manual explicitly states:

> Streamlined Filing Compliance Procedures were made available beginning September 2012. However, the IRS significantly expanded the procedures

[3] OMB: 1545-2241
[4] *Id.*

effective July 1, 2014. These procedures accommodate taxpayers that acted non-willfully and do not need the protection from criminal prosecution offered by OVDP or the Voluntary Disclosure Practice. **Streamlined Procedures are approved by the Commissioner and may be changed or terminated at any time.**[5] *(Emphasis Added).*

There is little dispute amongst practitioners that the Streamlined Filing Compliance Procedures are beneficial to taxpayers and a positive offering by the Service. This especially rings true in the light of the alternatives such as Delinquent International Information Return Submission Procedures[6], entering into the Voluntary Disclosure Program[7], or "quiet disclosure". Permanently establishing the program would also reduce anxiety amongst taxpayers and practitioners who may hastily prepare their Streamlined Filing Compliance Procedures forms and narrative out of fear that the program may suddenly be terminated.

The authors believe that the program fosters goodwill with taxpayers by providing relative closure of an often complex and unfair set of circumstances. The program still generates revenue for the Service while minimizing costs for the Service to discover non-compliance through examinations. Practically speaking, future compliance would be a reasonable expectation after individuals enter into the Streamlined Filing Compliance Procedures as well since through the program, taxpayers have the opportunity to correct the pat and learn for the future.

As such, the Streamlined Filing Compliance Procedures should be a permanent program offered by the Service.

B. INCORPORATE ADDITIONAL QUESTIONS RELATING TO FOREIGN FINANCIAL INTERESTS ON FORM 1040 SCHEDULE B

As noted throughout, it is common for taxpayers to learn of their non-compliance after the fact and after exposure to penalties has already accrued. In an effort to mitigate the lack of the awareness, we propose that the following questions be added as questions 9, 10, 11, and 12 on the Form 1040 Sch. B.

9. At any time during the tax year, did you receive a gift or bequest for a foreign entity or individual valued over $100,000? *See Form 3520 Instructions.*
10. At any time during the tax year, did you have an interest in any foreign financial assets valued over $50,000? See *Form 8938 Instructions.*
11. At any time during the tax year, were you the owner, beneficiary, or trustee of a Foreign Trust? *See Form 3520-A Instructions.*
12. At any time during the tax year, were you a shareholder and/or officer or director of a foreign corporation? *See Form 5471 Instructions.*

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[5] I.R.M.section 6.63.1.1.1 (04-27-2021)

[6] https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures

[7] https://www.irs.gov/compliance/criminal-investigation/irs-criminal-investigation-voluntary-disclosure-practice

It is worth noting that the above-mentioned questions, alone, do not encompass the complex reporting requirements associated with each of the referenced forms. However, the goal of the questions is to prompt further review by taxpayers based on the minimal circumstances that require the filing of each form.

C. ISSUE A FORMAL PUBLICATION OR INSTRUCTION SHEET RELATING THE STREAMLINED FILING COMPLIANCE PROCEDURES

At the most basic level, in addition to completing either Form 14654 (Certification by U.S. Person Residing in the U.S.) or Form 14653 (Certification by U.S. Person Residing Outside of the U.S.), taxpayers must also complete the following steps:

1. File amended income tax returns with the delinquent information returns included for the prior three years for which the filing deadline has passed (including extensions);
2. File amended or original FBAR for the past six years for which the filing deadline has passed (if applicable);
3. Pay additional income tax and interest owed for each of the three years for which amended income tax returns are filed;
4. For taxpayers residing in the U.S., such taxpayers must have filed original returns and pay the Title 26 5.0% miscellaneous offshore penalty; and
5. Mail all forms and payment to the IRS Service center for Streamlined Filing Compliance Procedures.

Although the requirements may appear simple, there are a variety of sub-instructions and circumstance specific decisions that are addressed across six different IRS web pages. Attached are screenshots of the various instruction pages and FAQs section that taxpayers and practitioners are expected to rely on.

For example of the complexity of some criteria, residency is determined under two tests, one for citizens and lawful permanent residents, and the other for non-citizens and non-permanent residents. For citizens and lawful permanent residents, a taxpayer is a non-resident if in one or more of the three years including in the Streamlined Procedures submission, the taxpayer did not have a U.S. abode and was physically outside the United States for at least 330 full days. Where there are joint taxpayers, both spouses must satisfy this non-residency requirement. The non-residency requirement for non-citizens and non-permanent residents is different. They satisfy the non-residency requirement if in one or more of the three years included in the Streamlined Procedures submission, they did not satisfy the substantial presence test under section 7701(b)(3) of the Code. For joint taxpayers both spouses must satisfy this non-residency requirement.

We recommend that the Service have one consolidated publication or instruction page outlining all requirements and FAQs for the Streamlined Filing Compliance Procedures for taxpayers residing in the U.S. and outside the U.S.

V. CONCLUSION

There are programs for taxpayers to resolve their non-compliance relating to international information returns, though these programs have requirements and nuances which may require the assistance of a tax professional. We propose that the Service keep this program available to taxpayers indefinitely and take steps to mitigate non-compliance in general.