



RECENT EXPERIENCES WITH AUDITS OF OVERSEAS TAXPAYERS AND FOREIGN ACCOUNTS

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I. Introduction - IRS Gets Aggressive

A. IRS Attitude in General - No more "kinder and gentler."

1. Tax shelter and foreign bank account initiatives.
2. Circular 230 changes.
3. Swing in pendulum.
4. Nasty and aggressive - collections, OICs, innocent spouse, attacks on the Tax Court's jurisdiction, exams being conducted by personnel outside the locality.

B. Recent Experience with Overseas Taxpayer Audit: Facts

1. U.S. citizen working in Hong Kong for a HK company, pays taxes on his compensation in HK, and has several other sources of income.
2. CPAs prepare the return based on HK tax return + plus additional income from U.S. sources.
3. CPAs are not informed about any other income.
4. Typical TP, comes in about 10 days from the extension deadline with a mish-mash of documents.
5. Information from computer-generated tax returns are carried forward and adjusted.
6. Client retires from HK company, but becomes a consultant to the company and receives compensation.
7. All is fine, until Client decides to change status from a sole proprietor consultant to an employee of the HK company.
8. Client files amended returns, claiming no self-employment taxes since he is really an employee of his old HK company, despite the change in title used by the company for retired workers, and reads as follows:

9. " The 200x federal tax return was amended to reclassify compensation earned by the taxpayers for services performed in Hong Kong as wages, not subject to self-employment tax, versus self-employment income. The taxpayer spent a substantial part of the year performing management services as an employee for XXX (a Hong Kong corporation) and its wholly owned Hong Kong subsidiaries. These wages were erroneously classified as US source compensation subject to self-employment tax. "
10. Thus, the only issue is a legal one: independent contractor vs. employee and there are Revenue Rulings on point, right?
11. Wrong! IRS immediately requests all books and records, including bank records from all U.S. and foreign banks.
12. The first Information Document Request from IRS includes:
 - a) Bank Statements and canceled checks that cover the period under examination.
 - b) Copies of any foreign bank or similar financial institution account(s).
 - c) All brokerage and other financial institution statements.
13. The issue presented is whether IRS is entitled to these documents, based on the amended return.

C. Problems with the Return

1. Form 1040 Schedule B line is not checked - client lives overseas for years and has several foreign bank accounts.
2. TD forms have been filed, but the information has not been updated to include all accounts.
3. IRS zooms in on these issues and starts a bank deposits reconstruction of income - **Note:** there are four foreign bank accounts and four U.S. bank accounts. Transfers from one currency to another are not readily traceable - thus, this audit becomes a major pain.

D. Major Lesson: Immediately double-check the Form 1040, Schedule B, Part III, lines 7 a and b, which read

1. At any time during 2xxx, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account or other financial account?
2. If "Yes," enter the name of the foreign country > _____

E. Foreign Bank Accounts (TD Form F90-22.1)

1. If 7 a is checked yes, then TD Form F 90-22.1, Report of Foreign Bank and Financial Accounts, must be filed separately with the U.S. Treasury, P.O. Box 32621, Detroit, MI 48232-0621, no later than June 30 of each calendar year.

2. New penalty for non-willful failures to file is now \$10,000.
3. Willful reporting violations are now the greater of \$100,000 or 50% of the balance in the account.
 - a) Not knowing the rules does not constitute reasonable cause for eliminating the penalty.
 - b) For violations amounting to criminal behavior, there are now penalties of up to \$500,000 as well as prison time.
4. **Note:** The time for filing the TD Form F90-22.1 is June 30th of the following year; there are no automatic extensions and this deadline is not tied to the filing of a tax return.
5. **Note:** Signature authority involving a foreign entity with a brokerage account, such as a Merrill Lynch account, may not be a foreign bank account and the foreign account reporting requirements may not apply.

F. IRS focuses on information provided to CPA.

1. Requests workbooks and all correspondence and documents.
2. Query - At what point does client-CPA privilege come into play?
3. IRS's questions are focused on the Client's intent - especially "why" he didn't check the right box re: foreign accounts.
4. CPA could become a witness against the client, so the situation can quickly become uncomfortable.

II. Request for Bank Account Information

A. IRS Has Wide Latitude to Obtain Testimony and Books and Records

1. Congress has granted the IRS broad powers to compel the production of both documents and testimony necessary to ascertain tax liability or to collect tax. §7602(a) of the Internal Revenue Code permits the IRS, for any statutorily authorized purpose to:
 - a) Examine any books, papers, records or other data.
 - b) Summon a taxpayer or any other person, requiring him to appear, produce books, papers, records, or other data and give testimony under oath.
 - c) Take testimony under oath.

B. Limitations on Summons Power

1. IRS has no authority to compel production of documents or testimony other than that specifically granted by statute. U.S. v. LaSalle Nat'l Bank, 437 U.S. 298 (1978).
2. Under the so-called "Powell tests" [U.S. v. Powell, 379 U.S. 48 (1964)], a summons is generally enforced if:

- a) There is a legitimate purpose for the IRS examination.
 - b) The information summoned may be relevant to that purpose.
 - c) The information is not already in the IRS's possession.
 - d) IRS has complied with the administrative steps required by the Code and the regulations promulgated thereunder.
3. District courts have jurisdiction to enforce an administrative summons in an adversarial proceeding commenced by the filing of a complaint by the IRS.

C. Limitations on Bank Account Information

1. IRC Sec. 7602(e), effective June 22, 1998, states:
2. Limitation On Examination On Unreported Income -
3. "The Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of such unreported income."
4. Internal Revenue Manual 4.10.4.3.2 (06-01-2004) states as follows:
 - a) Minimum Income Probes: "Nonbusiness" Returns
 - b) "With regards to IRC section 7602(e), which addresses the use of Financial Status Audit Techniques, examiners should not routinely ask for bank statements, cancelled checks or deposit slips to complete the examination of income on nonbusiness returns. Requests for documentation supporting specific issues can be made and may include cancelled checks. There may be situations in which there is a reasonable indication of unreported income in the pre-contact stage of the examination; i.e., a grossly imbalanced Financial Status Analysis or Forms 1099 for business income not included on the tax return. In such situations, the initial information document request (IDR) may include a request for personal banking records, including bank statements, cancelled checks, and deposit slips."
 - c) Thus, IRS cannot automatically ask for bank account information under its summons power and the IRS Manual confirms this.
5. Unfortunately, it will take one or more court cases to determine the boundaries of IRS's power to summons bank accounts under IRC Sec. 9602(e), but this section provides a solid defense to the blanket request for bank information.
 - a) Of course, IRS can probably summons the information from domestic banks, but its access to foreign bank information could be limited.
6. Limitations on the Bank Accounts Method of Determining Income
 - a) The bank deposits analysis, an indirect method of accounting under IRC Sec. 446 (b), is authorized only when there is a showing that taxpayer's regular books and records were deficient.

- b) The bank deposits method has been used when taxpayer's had their own businesses and their books and records involving their business income were insufficient.
- c) Thus, the government is not supposed to use the bank accounts method to determine income unless there is some showing that a taxpayer's regular books and records were inadequate.
 - (1) **Note:** It is doubtful that one can prevent the government from obtaining bank records through its summons power, but use of those records may be challenged under this approach.
 - (2) This approach should be used in conjunction with the limitations under IRC Sec. 7602(e) to prevent access to bank account information in the first place.

III. Defensive Strategies

A. Amend the Returns

- 1. Amend the returns to properly check the foreign accounts box to "Yes."
- 2. Provide amended forms TD Form F 90-22.1.

B. Change of Address for Taxpayers?

- 1. If the taxpayers are living in Hong Kong, why have a California address as their principal address?
 - a) Issues with California residency and income payable to the State of California.
 - b) More importantly, IRC Sec. 7603 provides that an IRS summons must be served by delivering an attested copy in hand to the person to whom it is directed, or by leaving it at his "last and usual place of abode."
 - c) Changing the address to a foreign country makes it much more difficult for IRS to summons records from the taxpayer, since the place of appearance is the IRS local office or the taxpayer's place of business.
 - d) Because of the difficulty in obtaining foreign records, IRC Sec. 982 was enacted, which basically states that a taxpayer may not introduce documents as evidence at trial, if the taxpayer refuses to provide those documents to IRS.
 - (1) Under IRC Sec 982, if a taxpayer fails to substantially comply with any "formal document request" arising out of the examination of any item -
 - (a) a court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is at issue must, upon motion of the IRS, prohibit the introduction by the taxpayer of any foreign-based documentation covered by the formal document request.
 - (b) To avoid the sanction imposed by IRC Sec. 982, the taxpayer must comply with the formal document request before the 90th day after the mailing of the request, or such longer period of time as extended by the IRS or a court having jurisdiction over an action to quash the request.

C. Make a Protective Election to Claim the Earned Income Exclusion

1. Additional compensation income that was not initially reported may be covered by the foreign income exclusion, IRC Sec. 911, but remember, the benefits of this provision must be affirmatively elected. IRC Reg. §1.911-7(a)(2)(i)(D)(2).
2. The exclusion may be elected on an amended return, but, in general, this must occur before IRS "discovers" that taxpayer failed to make the election.
 - a) Therefore, a pre-emptive strike - amending the returns to make a protective election of the exclusion in case IRS, during an audit, determines there is additional income, may preserve the exemption, provided the amendment is made promptly and before IRS discovers the issue.
3. **Note:** The earned income exclusion is currently \$82,400, although there have been major changes regarding the housing allowance portion section of the exclusion.
4. **Note:** Green card holders electing the exclusion must be careful they do not abandon their green card status and subject themselves to the expatriation tax rules of IRC Sec. 877.

D. Constructive Dividends

1. Constructive dividend treatment used to lead to a bad outcome, a result IRS pushed when characterizing additional income received by taxpayers from corporations in which they had an ownership interest. Usually, the taxpayers claimed the amounts were non-taxable corporate advances or loans.
 - a) Currently, the tax rate on dividends that meet certain requirement is 15% federal and there are no employment taxes payable on the income.
 - b) Surprisingly, there are a number of foreign countries whose companies meet the requirements for the 15% dividend rate.
2. Do not overlook constructive dividend treatment for unreported amounts received from a foreign corporation.

E. Gifts

1. Unreported income found in bank accounts may be explained by gifts from foreign family members. This used to be a favorite explanation prior to the gift-tax reporting requirements imposed on U.S. donees.
 - a) Remember, gifts from a non-resident alien are not taxable to the donor or the recipient.
 - b) However, there is a major stumbling block: the U.S. recipient, under certain circumstances, must report the gift on Form 3520, or be subject to a potential maximum penalty of 25% of the gift amount.
 - c) Therefore, recharacterizing unexplained income as gifts may avoid income taxes at the cost of gift-tax reporting penalties.

- d) **Note:** If a person receiving the gift holds a green card, but is domiciled outside the U.S., there could be an argument that the gift-tax reporting does not apply since the recipient is not a U.S. person under the gift and estate-tax law, which uses the concept of domicile (generally, the location of one's permanent home), rather than physical presence, to determine residency for gift and estate tax purposes.

F. Repayment of Loans or Advances

1. If the facts fit, this could be the best alternative to explaining and then eliminating unreported income.
2. The key is the actual repayment of some, if not all, of the amounts loaned or advanced to the taxpayer. This can occur during the audit.
3. While the courts look at a number of factors to determine whether a loan or advance was disguised compensation, evidence that the obligation has been repaid is persuasive evidence that it was a loan or advance.

G. Gambling Winnings and Losses

1. Do not overlook the possibility that unreported income may include gambling winnings, which may be offset to the extent of gambling losses. IRC Sec. 165(d).
 - a) Since many clients may be reluctant to admit to gambling losses, approach this issue carefully.
2. Professional gamblers report gambling winnings and deductions on Schedule C, subject to the limitation regarding the deduction of gambling losses under IRC Sec. 165(d).
 - a) Therefore, professional gamblers engaged in a trade or business should be able to apply some or all of the foreign income tax exclusion of IRC Sec. 911 to their excess gambling winnings.
3. Account Reimbursements
 - a) Unreported income may take the form of reimbursements for advances made by an employee for meals, travel and lodging.
 - b) Generally, use of standard meal and travel allowances will be considered reasonable, unless the employee is related to the employer, using IRC Sec. 267(b), but substituting a 10% ownership test.
 - c) Regardless of whether the employee is related to the employer, reimbursement using the standard mileage is allowable.