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Fiduciary Liability & Undisclosed Foreign Bank Accounts: Don't Get F-BARred!

Presented by:

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October 18, 2012

Greater Miami Estate Planning Council

Banker's Club, Miami

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INTRODUCTION

Introduction

IR-2012-64, June 26, 2012

WASHINGTON — The Internal Revenue Service today announced that its **offshore voluntary disclosure programs have exceeded the $5 billion mark** and released new details regarding the voluntary disclosure program announced in January, including tightening the eligibility requirements.

"We continue to make strong progress in our international compliance efforts that help ensure honest taxpayers are not footing the bill for those hiding assets offshore," said IRS Commissioner Doug Shulman. **"People are finding it tougher and tougher to keep their assets hidden in offshore accounts."**

Shulman said the IRS offshore voluntary disclosure programs have so far **resulted in the collection of more than $5 billion in back taxes, interest and penalties from 33,000** voluntary disclosures made under the first two programs. In addition, **another 1,500 disclosures have been made under the new program** announced in January.

INTRODUCTION

Terrorism?

Black market operations?

Money laundering?

Estate Tax!

PART I
FOREIGN BANK & FINANCIAL ACCOUNT REPORTING

THE BANK SECRECY ACT

The concept of foreign account disclosure was first introduced when Congress passed the Bank Secrecy Act in 1970 as the first laws to fight money laundering in the United States. The goal was to identify, detect and deter money laundering whether it is in furtherance of a criminal enterprise, terrorism, tax evasion or other unlawful activity.

The Internal Revenue Service is a partner in the U.S. National Money Laundering Strategy. The IRS seeks to achieve a balance between enforcement of the money laundering laws and education.

INTRODUCTION
FBAR FORM

Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (the “FBAR”), is used to report a financial interest in or signature authority over a foreign financial account. The FBAR must be received by the Department of the Treasury on or before June 30th of the year immediately following the calendar year being reported. The June 30th filing date may not be extended.

WHO MUST FILE AN FBAR

A United States person that has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the foreign financial accounts exceeds $10,000 at any time during the calendar year.

GENERAL DEFINITIONS

- Financial Account
- Foreign Financial Account
- Financial Interest
- Person
- Signature Authority
- United States
- United States Person
- United States Resident

PENALTIES FOR FAILURE TO FILE
POTENTIAL CIVIL PENALTIES

- $10,000 per violation
- A person who willfully fails to report an account or account identifying information may be subject to a civil monetary penalty equal to the greater of $100,000 or 50 percent of the balance in the account at the time of the violation.
- Potential penalty for failure to file Form 3520, 3520-A, 5471, 5472, 926, 8865
- Fraud penalties imposed under IRC §§ 6651(f) or 6663.
- A penalty for failing to file a tax return imposed under IRC § 6651(a)(1).
- A penalty for failing to pay the amount of tax shown on the return under IRC § 6651(a)(2).
- An accuracy-related penalty on underpayments imposed under IRC § 6662.

Penalties for Failure to File
Potential Criminal Penalties

- Possible criminal charges related to tax returns include tax evasion (26 U.S.C. § 7201), filing a false return (26 U.S.C. § 7206(1)) and failure to file an income tax return (26 U.S.C. § 7203).
- Willfully failing to file an FBAR and willfully filing a false FBAR are both violations that are subject to criminal penalties under 31 U.S.C. § 5322.
- A person convicted of tax evasion is subject to a prison term of up to five years and a fine of up to $250,000.
- Filing a false return subjects a person to a prison term of up to three years and a fine of up to $250,000.
- A person who fails to file a tax return is subject to a prison term of up to one year and a fine of up to $100,000.
- Failing to file an FBAR subjects a person to a prison term of up to ten years and criminal penalties of up to $500,000.

PART II
FIDUCIARY LIABILITY

FIDUCIARY LIABILITY

IRC 6903: Rights and obligations of fiduciary.

Upon notice to the Secretary that any person is acting for another person in a fiduciary capacity, such fiduciary shall assume the powers, rights, duties, and privileges of such other person in respect of a tax imposed by this title (except as otherwise specifically provided and except that the tax shall be collected from the estate of such other person), until notice is given that the fiduciary capacity has terminated.

FEDERAL CLAIMS STATUTE

31 U.S.C. 3713:

"A representative of a person or an estate . . . paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government." 31 U.S.C. § 3713(b).

FEDERAL CLAIMS STATUTE

Case Law 3-Part Test:

1. Fiduciary must have paid a debt of the estate;

2. Fiduciary's distribution must have rendered the estate insolvent; and

3. The distribution must have taken place after the executor had *notice* of the government's claim.

FEDERAL CLAIMS STATUTE
FIRST ELEMENT

Fiduciary must have paid a debt of the estate

- Broadly construed to secure adequate revenue for the U.S. Treasury and
- Courts have interpreted this statute quite liberally (U.S. v. Coppola).
- Very low threshold for definition of "paid a debt."
- Exception for "administrative expenses."

FEDERAL CLAIMS STATUTE
SECOND ELEMENT

Fiduciary's distribution must have rendered the estate insolvent

- General Threshold - Due to the executor's actions, the estate must contain insufficient funds to meet the U.S.'s tax demands

- Recent Clarification - CCA 201212020 (2012). clarified the insolvency requirement and states that the Federal Claims Statute will not render an executor personally liable for income or estate taxes even in the case of unauthorized distributions, so long as the estate remains solvent at the time when the United States makes its claim.

FEDERAL CLAIMS STATUTE

THIRD ELEMENT

The distribution must have taken place after the executor had notice of the government's claim.

- The most contested of the three elements.
- Very liberal interpretation.
- No actual personal knowledge of taxes owed to the U.S. necessary at the time of distribution.

<u>FEDERAL CLAIMS STATUTE</u>

<u>United States v. Coppola</u>, 77 AFTR 2d 96-2477, 85 F3d 1015 (2d Cir.1996):

For executor liability to attach, "the executor must have knowledge of the debt owed by the estate to the United States or *notice of facts that would lead a reasonably prudent person to inquire as to the existence of the debt owed before making the challenged distribution or payment.*"

<u>William D. Little v. Commissioner</u>, 113 TC 474 (1999):

". . . the knowledge requirement of section 3713 may be satisfied by either actual knowledge of the liability or notice of such facts as would put a reasonably prudent [fiduciary] on [notice] as to the existence of the unpaid claim of the United States."

FEDERAL CLAIMS STATUTE

Rev. Rul. 66-43, 1966 -1 CB 291, 293:

"If the trustee has knowledge of the debt, it matters not how that knowledge was obtained. The trustee cannot disregard or ignore the debt, and if he does, his breach of duty renders him liable personally."

Rev. Rul. 79-310, 1979-2 CB 404:

The IRS has ruled that **unassessed amounts** and amounts for which a formal claim has not been filed in probate court constitute a debt due the United States.

The debt to the United States arises at the close of the taxable year in which income was earned, regardless of whether the Service was aware of such income or a return was filed by the decedent.

The IRS has ruled that where the decedent had income in prior years, and thus owed tax, **but had not filed federal tax returns or had had other unpaid federal tax debts, the executor can be liable for the unpaid taxes even though the liability had not been assessed at the time of death.**

Penalties Associated with Unpaid Tax Liability

Penalties for unpaid taxes may also be assessed against the executor.

Because the Service has discretion with respect to assessment of penalties, it is reasonable to think that the executor had no reason to know of such liabilities before actual assessment.

However, in *Leroy K. New*, 48 TC 671 (1967), an executor was found liable for delinquency and negligence penalties that had not been assessed at the time of the executor's distribution. According to the court, the assessment of penalties was at least somewhat predictable.

<u>STATUTE OF LIMITATIONS</u>

<u>IRC § 6901(c)(3):</u>

- Provides that the period of limitations for assessment against a fiduciary is "not later than 1 year after the liability arises or not later than the expiration of the period for collection of the tax in respect of which such liability arises, whichever is the later."

- While the general rule under § 6501(a) is that tax must be assessed within three years after the return is filed, 6501(c) allows for an unlimited statute of limitations on assessment in the case of fraudulent returns or where no return was filed.

  – See *Espiona*, TC Memo 2000-66 (where the Tax Court upheld an assessment in the context of transferee liability for taxes due after 15 years where the transferor had never filed income tax returns).

Indemnification

Agreements among executors and beneficiaries may not be sufficient to excuse the executor from liability under 31 U.S.C. 3731(b).

United States v. Johnson, 109 AFTR 2s 2012-2253 (2012) - executor entered into an agreement with the estate's beneficiaries whereby the beneficiaries agreed to pay the estate's tax liabilities as they came due. The agreement also released the executor from personal liability. Holding that the executor was personally liable under the Federal Claims Statute the court stated, "Section 3713 does not recognize such shifts in liability. In other words, personal representatives cannot divest themselves of statutory liability through a contract with others."

Similarly, in ***Coppola***, an estate had been assessed estate taxes. Rather than paying the estate taxes, an executor distributed the estate's assets to himself and two other relatives. As part of the distribution, the parties entered into an agreement that required each of them "to pay any estate taxes due in proportion to the value of the assets each received." *Id.* at 1017. Nevertheless, the trial court held that the executor was personally liable because the distributions depleted the estate's assets in violation of section 3713(b).

CO-FIDUCIARY LIABILITY

Cases have also held that the unilateral actions of one co-executor can bind non-participating executors to an extension of the statute of limitations on assessment.

John Christopher Singleton, TC Memo 1996-249 (1996). Tax Court held that the unilateral execution of an agreement to extend the statute of limitations on assessment could not bar the Service from making a 31 U.S.C. 3713(b) assessment against a co-executor. The court held that "A waiver of the period of limitations for assessment of Federal tax executed by an executor is not rendered invalid by provisions of any State law." Thus, one co-executor may bind an estate irrespective of State law requirements."

INTERESTING CASES

NOTICE & KNOWLEDGE

Estate of Kenneth Leigh, 72 TC 1105, 09/17/1979

Petitioner was administrator of an estate and employed an attorney to represent the estate in the probate proceedings and tax matters. A few days before petitioner's final accounting was filed and approved by the probate court, the attorney asked petitioner to sign an amended estate tax return reporting additional tax due as a result of after-discovered assets. Petitioner was apparently not told by the attorney to pay the additional tax, and petitioner distributed all of the assets of the estate without paying the additional tax.

Held*:* Under 31 U.S.C. sec. 192, petitioner is personally liable for the additional tax. He had knowledge or notice that the tax was due the United States at a time when he had possession of sufficient assets of the estate to pay the tax, and it was his non-delegable duty to see that the tax was paid.

NOTICE & KNOWLEDGE

Beckwith, David, (1995) TC Memo 1995-20

District court properly found that executor was personally liable for estate's unpaid taxes under 31 USC 3713(b), because he was aware of estate's potential tax liability when he entered Agreement that disregarded decedent's will and transferred decedent's interest in family businesses to himself and other family members. Also, court properly ordered that assets be returned to the estate: transfers under the Agreement, plus transfers of other property to executor at discounted value pursuant to foreclosures, which executor could have avoided, showed deliberate fraudulent scheme to place estate's assets beyond creditor's reach.

Reliance on Attorney – No Liability

William D. Little, 113 TC 474

P was the personal representative of D's estate. During administration of the estate, P received information indicating possible income tax liabilities of the estate. P gave this information to the estate's lawyer, who erroneously and repeatedly advised P that the estate had no tax liabilities and advised P to make disbursements and distributions. P, acting in good faith, followed this advice and eventually closed the estate without paying the estate's income tax liabilities. R determined that P is liable for the estate's unpaid income tax liabilities under 31 U.S.C. sec. 371 3(b) (1994), which generally imposes personal liability on a fiduciary who pays others before paying claims of the United States. Liability under 31 U.S.C. sec. 3713(b) has been judicially limited to situations where a fiduciary knowingly disregards debts due to the United States.

Held: A fiduciary who reasonably and in good faith relies on an attorney's legal advice that there are no debts due to the United States before paying other claims has not knowingly disregarded debts of the United States. P is not liable for the income tax liabilities of the estate under 31 U.S.C. sec. 3713(b).

ACTUAL KNOWLEDGE

Singleton, John, (1996) TC Memo 1996-249

IRS did not dispute that the fiduciary had no actual knowledge of the estate's income tax liabilities at the time that he made the disbursements and distributions from the estate. However, IRS argued that the fiduciary was personally liable for the unpaid tax liabilities because the fiduciary's receipt of Forms W-2 and 1099 and later notices would have put a reasonably prudent person in the fiduciary's position on inquiry as to the existence of the debts due for unpaid income taxes.

Co-Executor Liability

Huddleston, Albert J., (1994) TC Memo 1994-13

Co-executor and beneficiary of decedent's estate was personally liable for estate's unpaid estate taxes as fiduciary under 31 USC 371 3(b) and Treas. Regs. §20.2002-1: co-executor distributed the estate to beneficiaries, including himself, even though he had actual or constructive knowledge that federal estate taxes had not yet been paid.

Fiduciary Liability

***U.S. v. Coppola, James M. Jr., (1996, CA2) 77AFTR 2d 96-2477, affd (1994, DC NY) 74 AFTR 2d 94-7507*.**

Estate executor/attorney was personally liable for unpaid estate taxes and interest under 31 USC 3713(b): he distributed assets to sole beneficiary and paid creditors before paying estate taxes. Payments he made while estate contested tax liability weren't excused by alleged difficulty communicating with IRS; as an attorney, he should have known payments made before estate tax return was filed were at his peril; and distributions, not disallowed theft loss, left estate with inadequate funds to pay tax. But executor's liability for accrued interest on unpaid taxes wasn't extended beyond mailing date of fiduciary liability notice because he wasn't transferee.

Liability for Penalties

Singleton, John, (1996) TC Memo 1996-249

Estate's personal representative was personally liable for full amount of unpaid estate tax, interest and penalties under 31 USC 3713(b): taxpayer distributed all of estate's assets to himself; estate became insolvent upon distribution; he knew estate owed estate taxes when he made distribution; and value of assets distributed to him exceeded estate's debt to govt.

Knowledge of Debt

Allen, David, (1999) TC Memo 1999-385

Estate executor/sole heir's personal liability under 31 USC 371 3 for decedent's unpaid income tax, penalty and interest debts was upheld on partial summary judgment: executor distributed property to himself while knowing of decedent's outstanding debts; and distribution rendered estate insolvent. But, extent of his liability wasn't determinable where genuine fact issues remained regarding property's value and debt amount as of distribution date.

Recovery of Assets

U.S. v. Bartlett, Elizabeth, (2002, DC IL) 89 AFTR 2d 2002-1049, 186 F Supp 2d875.

Pursuant to agreed judgment, executor/trustee's personal liability under 31 USC 3713 for estate's unpaid estate tax and interest debts was upheld; and tax lien was foreclosed against certain estate properties, with sale proceeds to be applied to estate's debts. Also, proceeds of any foreclosure sale of property estate transferred to decedent's great grandchild were also to be applied to subject debts; and any monies executor or trust received from certain corps. were to be turned over to govt.

Knowledge

U.S. v. Miller, Harold Wade, (2002, DC TX) 89 AFTR 2d 2002-2695. Later proceeding at (2002, DC TX) 89 AFTR 2d 2002-2818.

Govt. was granted summary judgment that personal representative was personally liable under 31 USC 3713(b) for decedent's outstanding income tax debts to extent of her transfers to non-Code Sec. 6323 preferred creditors: govt. clearly showed that representative knew of tax debts at time she made insolvency-causing transfer of estate's only asset/condominium to herself. Also, representative's argument that govt. was foreclosed after filing lien notice and revocation from proceeding under 31 USC 3713 misapprehended nature of statute and its interplay with Tax Lien Act; and her attempt to limit her liability with respect to condominium association fees was rejected.

PART III
COMPLIANCE OPTIONS

COMPLIANCE OPTIONS

FULL VOLUNTARY DISCLOSURE

- **Circumstances**
  - Failure to report on FBAR; and
  - Unreported tax liability associated with the foreign financial or bank account.
    - De-Minimis situation
- **Eligibility**
  - Timeliness and completeness.
  - So long as you have not been identified by the IRS or DOJ prior to submitting your pre-clearance
- **Framework**
  - Must report ALL foreign financial assets (cannot exclude any)
  - Must fully cooperate with the IRS and DOJ as requested
  - Prepare 8 years of amended returns and delinquent FBARs
  - Complete all informational disclosures per the OVDI submission requirements

COMPLIANCE OPTIONS

FULL VOLUNTARY DISCLOSURE

- **Penalties**
  - No criminal prosecution.
  - Income Tax: Normal penalties associated with the unreported or underreported income (generally 20%) plus interest thereon
  - FBAR:
    - Traditional 27.5% (FAQ generally)
    - Reduced 12.5% (for beneficial interest under $75,000) (FAQ 53)
    - Special 5% (must meet the requirements) (FAQ 52)
- **Observation**
  - This is the option for the "guilty" client. For that client, this is a phenomenal deal.
  - Can avoid penalties for failure to file Form 5471 or 3520 through this program.

COMPLIANCE OPTIONS

QUESTION 17 SUBMISSION

- **Circumstances:**
  - Failure to report on FBAR, but no unreported income arising from the financial account or deposited in the account – therefore, no unreported tax liability associated with the foreign financial or bank account.

- **Eligibility:**
  - Failure to report on FBAR; but
  - NO unreported tax liability associated with the foreign financial or bank account.

- **Framework:**
  - Must report ALL foreign financial assets (cannot exclude any)
  - Prepare 8 years of amended returns and delinquent FBARs.
  - File above returns and forms along with a letter of explanation

COMPLIANCE OPTIONS

QUESTION 17 SUBMISSION

- **Penalties:**
  - No penalties
- **Observation:**
  - Can avoid penalties for failure to file Form 5471 or 3520 through this program.
  - Best option if your client qualifies.

COMPLIANCE OPTIONS

STREAMLINE PROCEDURE

- **New procedure introduced on June 26, 2012.**
- **Circumstances**
  - Designed for taxpayers that present a low compliance risk. For those taxpayers presenting low compliance risk, the review will be expedited and the IRS will not assert penalties or pursue follow-up actions.

- **Eligibility:**
  - Non-resident U.S. taxpayers who have resided outside of the U.S. since 1/1/09 and who have not filed a U.S. tax return during the same period.
  - Compliance risk is determined based on information provided on the returns filed and based on additional information by the taxpayer.
  - Low risk will be predicated on simple returns with little or no U.S. tax due. Absent any high risk factors, if the submitted returns and application show less than $1,500 in tax due in each of the years, they will be treated as low risk and processed in a streamlined manner.

COMPLIANCE OPTIONS

STREAMLINE PROCEDURE

- **Framework:**
  - file delinquent tax returns, with appropriate related information returns (e.g. Form 3520 or 5471), for the past three years and to file delinquent FBARs (Form TD F 90-22.1) for the past six years. Payment for the tax and interest, if applicable, must be remitted along with delinquent tax returns.
- **Penalties:**
  - No penalties beyond the regular penalties for unreported/underreported income tax
- **Observation:**
  - Great option if your client qualifies

COMPLIANCE OPTIONS

OTHER UNOFFICIAL APPROACHES

- **Quiet Disclosure**
- **Modified Quiet Disclosure**


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