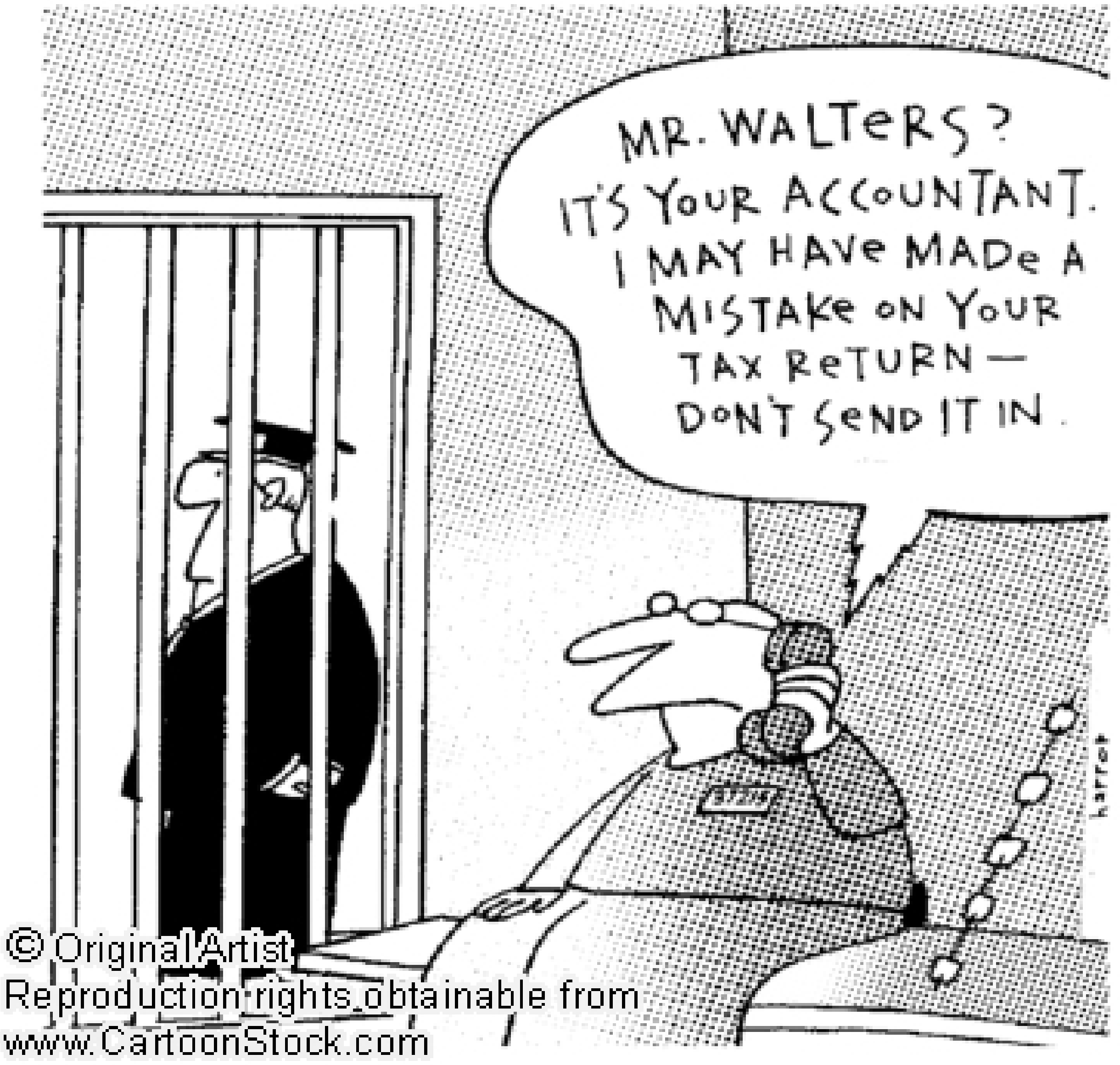
Basic International Tax, Information Reporting & Estate Issues to be Aware of that Could Lead to Malpractice if Overlooked by the Seasoned Tax / Estate Attorney and Lead to Criminal Charges for the Client

BY: DAVID W. KLASING ESQ. M.S.-TAX CPA

TAX LAW OFFICES OF
DAVID WARREN KLASING
ATTORNEY AT LAW
and CERTIFIED PUBLIC ACCOUNTANT

Tax Rescue™


MR. WALTERS?
IT'S YOUR ACCOUNTANT.
I MAY HAVE MADE A
MISTAKE ON YOUR
TAX RETURN —
DON'T SEND IT IN.

A LITTLE ABOUT ME

- An Attorney & Certified Public Accountant with 20 years of professional tax, accounting and business consulting experience, with dual licenses to practice law and public accounting in California.
- Earned a master's degree in taxation with an emphasis in the gift and estate tax arena
- Completed over 100 offshore voluntary disclosures
- Intensely studied international taxation over the past 5 years.
- Clients located all over the world.
- My specialty is criminal tax defense and I'm going to be emphasizing the cross over between my world as a criminal tax defense attorney and that of the domestic estate planner in the face of international tax, estate and information reporting issues under the current international political climate.

OVERVIEW

- Common Malpractice Traps Related to Basic International Income, Estate, and Transfer Taxes
- International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)
- U.S. Income and Transfer Tax Planning for Non Resident Aliens
- Defining “Resident” status for U.S. Estate Tax Purposes based on Domicile and How it Differs from “Resident” Status for U.S. Income Tax Purposes
- Pre-Immigration Tax and Estate Planning for Temporary and Permanent Moves to the U.S.
- U.S. Income and Transfer Tax Planning for Non Resident Aliens and U.S. Residents with Foreign Assets
- Foreign Trust Planning and Compliance
- Basic U.S. Information Reporting Requirements
- FBAR
- Other Information Reporting Requirements
- 2012 Offshore Voluntary Disclosure Initiative

Common Malpractice Traps Related to Basic International Income, Estate, and Transfer Taxes

- Estate planners and advisors will encounter ethical challenges
  - Representing multiple clients
  - Potential to engage in the unauthorized practice of law
  - Fee splitting with non-admitted lawyers
  - Malpractice problems
    - May be able to limit through use of engagement letters
  - Choice of law and choice of forum
- There are a myriad of tax treaties and multi-jurisdictional tax rules which require strong background in international tax law
- Goal: insure that potentially conflicting laws do not interfere with the disposition of a client’s estate

Common Malpractice Traps Related to Basic International Income, Estate, and Transfer Taxes

- Issues to be aware of:
  - A client who is regularly in U.S. but does not claim residency
  - U.S. income tax withholding at source rules
  - Foreign Investors have different attitudes about payment of taxes and information reporting
  - Issues surrounding the use of foreign trusts in asset protection

- Conflict of Law Issues
  - Foreign jurisdictions have the ability to apply its own law, or that of another jurisdiction
  - Typically arise when:
    - Determining the validity or disposition of a will
    - Intestacy regulations
    - Rights of family members to a decedent's property.

Common Malpractice Traps Related to Basic International Income, Estate, and Transfer Taxes

- International Issues Surrounding Validity of a Will – Multijurisdcitional vs. Single Situs Wills
  - Disposition of assets can be accomplished through a single multijurisdictional will or separate situs wills that comply with the laws of each country where property is located.
  - Multijurisdictional Will drafting problems arise when the drafting attorney does not fully comprehend the laws of a foreign jurisdiction.
    - Worse yet, is when the attorney thinks he or she does!

Common Malpractice Traps Related to Basic International Income, Estate, and Transfer Taxes

- Advantages of Single Multijurisdictional Wills over Multiple Situs Wills
  - Major advantage of a single multijurisdictional will – elimination of the potential confusion and controversy that can result through use of multiple situs wills
  - Foreign and U.S. counsel may not always be on the same page in drafting multiple situs wills which can create conflict of laws issues and lead to expensive litigation.
  - Confusion in delineating which personal representatives are charged with a particular responsibility
  - One situs will may be interpreted to revoke the other, causing a portion at best, or the totality of decedent's property at worst, to pass through intestate succession.
  - Can help prevent forum-shopping

Common Malpractice Traps Related to Basic International Income, Estate, and Transfer Taxes

- Advantages of Single Situs Wills
  - Advantageous where a testator seeks to avoid or minimize the application of the laws of a particular country (i.e., forced heirship laws).
  - The U.S. estate planner should associate in counsel to determine the best options.
  - Separate situs wills also promote the privacy of the testator
  - Does not disclose the existence of assets in other countries
  - May be used to limit creditor claims by enabling the testator to isolate assets
  - Alleviate problems when country A and country B have wildly disparate requirements for formal will validity.

Common Malpractice Traps Related to Basic International Income, Estate, and Transfer Taxes

- Appointment of U.S. Executor
  - Another benefit to utilizing separate situs wills is the use of executors with ease of access to local counsel familiar with the law within each situs.

- In summary:
  - A single multijurisdictional instrument will generally be more effective in carrying out testator's intent by reducing the potential for drafting errors.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- The failure of an estate planning attorney to engage in adequate due diligence when advising clients of their income, transfer tax, and information reporting compliance responsibilities in the international arena can easily lead to malpractice exposure for the attorney and disastrous civil and criminal consequences to their client.

- The more sophisticated the international planning and implementation of an estate plan the higher the probability of tripping on a foreign or domestic income & transfer tax or information reporting induced civil or criminal complications.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- Both state and federal tax offenses can easily arise in relation to an international estate plan because of the income and transfer taxes that arise incident to either the implementation or ongoing maintenance of the estate plan.

- The most commonly charged advisor tax crimes include
  - Aiding and abetting
  - Presenting a false, fictitious, or fraudulent claim to the government
  - Consipiracy
  - Making false statements to a U.S. agency
  - Mail fraud
  - Bribery
  - Forgery

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- A domestic estate plan may violate foreign law
- A client's subsequent actions, if not closely monitored, may lead to U.S. or Foreign income and transfer tax evasion or information reporting civil and criminal penalties.

What the International Estate Planning Attorney Should Know About Money Laundering

- Money laundering basics the estate planning attorney should be aware of:
- Mail and wire fraud and income tax evasion are predicate offenses for money laundering.
- Wire fraud basically only requires the use of telecommunications facilities to effectuate a scheme to defraud.
- Mail fraud basically only requires the use of the postal system to effectuate a scheme to defraud.
- Mail and wire fraud carry sentences ranging up to 20 years (30 where a financial institution is affected) and fines of up to $1,000,000.
- Money laundering is punishable by a fine of up to $500,000 or twice the value of the monetary instruments involved, whichever is greater, or imprisonment of up to 20 years, or both.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- A real malpractice danger to international estate planners is that there are specific circumstances under which an estate plan can result in violations of U.S. money laundering laws and result in forfeiture of the assets involved along with criminal exposure to both the attorney and client

- Note: IRC 7201 can be violated through the attempt to evade any type of federal tax, including income tax, employment tax, **estate tax, gift tax**, and excise tax.

- Following 9/11, United States law enforcement authorities, including those in the IRS, have doubled their efforts to prosecute taxpayers and advisors guilty of money laundering.

- *United States v. Tarkoff*
  - the attorney acted knowingly in conducting a financial transaction which involved funds that were the proceeds of some form of unlawful activity, and that the transaction involving the defendant was intended to conceal or disguise the nature, location, source, ownership or control of the proceeds of unlawful activity.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- *United States v. Abbell*
  - Commingling of "clean" and "unlawful" moneys will irrevocably taint the "clean" money for purposes of the money laundering statutes.
- Current Expansion of U.S. Money Laundering Laws to Enforce Violations of Foreign Law
  - Commentators have written at length about the ramifications of *Pasquantino v. U.S.* 544 U.S. 349 (2005) in which the Supreme Court held that Canada had a valuable property right in collecting excise taxes on liquor, and that foreign property rights may be enforced in a U.S. court of law.
  - This ruling will have a far reaching slippery slope impact on practitioners who counsel clients with international issues.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- Some commentators on *Pasquantino* see the potential for the application of the case's holding to international estate planning attorneys where a U.S. estate plan purposely or inadvertently leads to evasion of foreign transfer and or income taxes.
  - This exposure can be limited by engaging foreign counsel

- U.S. Advisors are simply not capable of competent service across national lines.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- Directive No. 128 seems to be common knowledge of IRS district counsel as reflected by how often this author has heard IRS personnel state that "money laundering is merely income tax evasion in progress."
- *Pasquantino* commentators interpret the case as creating new policy problems for tax practitioners and clients alike, which is viewed as expanding over time as worldwide governments become more aggressive in their tax and information gathering activities.
- In short, the most expansive view of *Pasquantino* is that the case stands for the proposition that criminal prosecution can be brought in the United States for the violation of a foreign jurisdiction's laws.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- **In Sum**
  - As demonstrated above, the planning and implementation of a complex international estate plan can expose the client to violations of U.S. criminal laws and the potential for asset forfeiture.
  - International Estate Planning Counsel can simultaneously face violations of, U.S. criminal laws (i.e. aiding and abetting), codes of professional responsibility, and Circular 230.

- The War on the Fraudulent Use of Tax Havens by United States Persons
  - Evidence gathered under the Offshore Voluntary Disclosure Programs proves that a large number of U.S. Taxpayers have utilized offshore tax havens to evade U.S. taxes.
  - Income tax evasion is defined, including under IRC § 7201, as follows: Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.

- The Patriot Act
  - The Act broadened the application of Federal anti-money laundering regulations as to banks and financial institutions, investment advisors, casinos and brokers, to an increasing range of professional advisors such as estate planners.
  - The Treasury Department's Financial Crimes Enforcement Network (FinCEN) has publicly encouraged the American Bar Association and the American College of Trust and Estates Counsel (ACTEC) to develop guidelines that will apply the money laundering provisions of the Patriot Act in the discipline of their members.

International Estate and Income Tax Issues that Can Lead to Criminal Exposure for the Client (and Possibly the Advising Attorney)

- The Foreign Account Tax Compliance Act (FATCA)
  - FATCA generally requires U.S. taxpayers, banks, brokers and foreign financial institutions that have failed to enter into an information sharing agreement with the Internal Revenue Service (IRS), to withhold 30 percent of certain payments made to a foreign entity.

- United States Bilateral Income Tax Exchange of Information Agreements with Tax Haven Nations
  - FATCA has, to date, been implemented largely through information sharing agreements with foreign nations.
  - 13 Bilateral exchange of information agreements
  - 31 others not yet ratified

"I got 2 years for filing false returns, but I did save a bundle by doing my own taxes."

U.S Income and Transfer Tax Planning for Non Resident Aliens

- Seeking, Retaining or Relinquishing U.S. Permanent Residence Status or Citizenship Should Only be Contemplated After First Evaluating Tax and Estate Considerations!
  - It is important to be aware of the tax and estate law issues which are associated with the change in status.

- Income and Transfer Tax Consequences Associated with Immigration Decisions
  - All worldwide income will be subject to U.S. taxation.
  - Be aware of double or triple taxation from other countries.
  - Foreign tax credit may provide relief.
  - Applicability of transfer taxes include gift, estate & generation-skipping taxes.
  - Applicability of U.S. inheritance taxes for gratuitous transfers.
  - Non-U.S. citizen spouse is not subject to the unlimited marital transfer exemption.

- If the foreign national engages in pre-immigration estate planning, they may be able to take affirmative steps before becoming a U.S. domicile for transfer tax purpose and thus avoid the imposition of some or all U.S. transfer taxes.

U.S Income and Transfer Tax Planning for Non Resident Aliens

- The Exit Tax
  - The U.S. imposes an "Exit" or "Expatriation" tax on permanent residents who give up their green cards and on U.S. citizens who renounce their citizenship.
  - Includes both an income and inheritance tax element.

" That's the way Dad does it on his income tax. "

Defining “Resident” Status for U.S. Estate Tax Purposes Based on Domicile and How it Differs from “Resident” Status for U.S. Income Tax Purposes

- The Reach of U.S. Transfer Taxation to U.S. Residents (U.S. Domicile) and U.S. Citizens
  - All property interests, wherever situated in the world, must be included in the gross estate of a U.S. citizen or resident.
  - Gift tax apply to all gratuitous transfers made by a U.S. citizen or resident.

- Regulatory Definition of Domicile
  - Congress has not specifically defined transfer tax definitions for the terms “resident” and “nonresident.” The internal revenue regulations rather define the concept of “domicile.”
  - For transfer tax purposes, domicile is acquired by living in a place with the present intent of remaining indefinitely.
  - The regulations state that a person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing themselves therefrom.

Defining "Resident" Status for U.S. Estate Tax Purposes Based on Domicile and How it Differs from "Resident" Status for U.S. Income Tax Purposes

- The Difference Between Income and Transfer Tax Definitions of Residency
  - The income tax and transfer tax residency definitions are completely different. The transfer tax sense of the term "resident" focuses on the "squishy" concept of "domicile" within the United States, whereas the income tax definition of "resident alien" focuses on an objective set of finite standards defined under IRC §7701(b). A single individual may simultaneously be a resident alien for income tax purposes but not a resident for transfer tax purposes, and vice versa.

- Tax Treaty, Visa Based and Special Rules for Canadian and Mexican Resident Overrides to the 7701(b) Substantial Presence Test
  - A resident alien under 7701(b) may be reclassified as a non-resident alien for income tax purposes under "tie-breaker" rules.
  - Occurs during year alien moves into or out of U.S.

Defining "Resident" Status for U.S. Estate Tax Purposes Based on Domicile and How it Differs from "Resident" Status for U.S. Income Tax Purposes

- Although intention constitutes a state of mind, the courts look to objective criteria to make the determination.
- Among the factors to consider are the locations of:
  - The person's business;
  - Where the person is licensed to drive;
  - Where he belongs to church, social or communal organizations;
  - Where he has declared his residence to be in, for example, a Will or Trust, an application for a visa or for permanent residence, or tax declarations;
  - Where he owns a burial plot;
  - Any residence or residences owned by the person (and their degree of use by the person);
  - The person's family and close friends, and;
  - The person's personal possessions.

Pre-Immigration Tax and Estate Planning for Temporary and Permanent Moves to the U.S.

- Note: Whenever a foreigner become classified as a resident alien or a newly minted U.S. citizen and has a direct or indirect ownership or beneficial interest in any kind of foreign asset, entity or account such as foreign trusts, partnerships, mutual funds, bank accounts, income producing assets or receives foreign gifts, the applicable
- U.S. reporting rules should always be carefully considered <u>as potential financially devastating and draconian penalties and associated criminal exposure for income tax evasion and willful non reporting can quickly arise **long before** the foreigner acclimates to the U.S. tax and reporting regimes.</u>
- To compound matters only the most sophisticated of U.S. tax advisors will be aware of these requirements so be aware of the negligent referral litigation that has transpired in the past not to mention <u>**your own exposure as immigration attorneys.**</u> This is the hottest issue before the IRS at present!

Pre-Immigration Tax and Estate Planning for Temporary and Permanent Moves to the U.S.

- **Planning for the Exposure to Estate Tax during a Temporary Stay in the U.S.**
  - Temporary stay estate tax planning often involves forming a foreign holding vehicle, entity, trust or company to own any U.S.-situs assets prior to beginning the temporary stay in the U.S.
  - The use of foreign holding companies for estate planning purposes can lead to adverse U.S. income tax complications where the non-domiciled alien owner of the foreign holding company unexpectedly becomes a resident alien for income tax purposes during a temporary stay in the U.S via the substantial presence test.
  - The foreign holding company will become subject to the U.S. anti-tax deferral regimes governing controlled foreign corporations and passive foreign investment companies found in Subpart F of the internal revenue code.
  - When a non-domiciled alien transfers U.S.-situs property into a properly structured and maintained foreign trust, the assets transferred should be protected from estate tax if he or she dies unexpectedly during his U.S. stay because the assets are not in his or her own name at the time of his or her death.

Pre-Immigration Tax and Estate Planning for Temporary and Permanent Moves to the U.S.

- Gift Tax Risk if Grantor Transfers U.S.-Situs Tangible Property to a Foreign Holding Vehicle
  - The non-domiciled alien grantor should be careful when transferring any U.S. situs property to a foreign holding company, entity or trust that could be subject to U.S. federal gift tax at the time of the transfer.
  - Gift tax can be imposed inadvertently in several situations such as where a non-domiciled alien funds a trust before, during or after a temporary U.S. stay. For example prior, during or after, the temporary stay in the U.S., a non-domiciled alien may transfer U.S.-situs tangible property titled in his own name into a foreign trust.
  - Where U.S.-situs property is already owned by the non-domiciled, non-resident alien prior to a temporary stay in the U.S., it may be possible to avoid gift tax through advance planning. If after moving to the United States the grantor of a foreign trust wishes to buy a personal residence in the name of the foreign trust, he or she could first contribute cash to the trust and then arrange for the trust to buy the U.S. personal residence in its own name.

Pre-Immigration Tax and Estate Planning for Temporary and Permanent Moves to the U.S.

- Planning to Ensure Non-Domiciled Alien Status
  - Note: It may not be desirable for an alien to be classified as a non-domiciled alien in all situations. For example, where a non-domiciled alien dies and owns only U.S.-situs property in his own name, only the first $60,000 is exempt from estate tax under IRS §§2101–2102, whereas if the alien is considered a domiciled alien for estate tax purposes, a $5,250,000 estate tax exemption will apply

Pre-Immigration Tax and Estate Planning for Temporary and Permanent Moves to the U.S.

- Planning for a Permanent Stay in the U.S. for Income and Transfer Tax Purposes
  - If a high net worth non-U.S. citizen plans to move permanently to the United States, he or she will generally have the same objectives discussed above as the individual who plans to only move temporarily to the United States. They universally desire to shelter his or her pre move foreign income or excludable U.S. income from U.S. federal income and transfer tax for as long as possible so the structure he or she forms will ordinarily have to remain in place until he or she dies or longer
  - A foreign holding company or entity generally will not be effective to protect him or her from U.S. transfer or income taxes once he has becomes a domiciled resident alien.
  - The most effective way to avoid U.S. transfer taxes (but not income taxes) will be if while he or she is still a non-domiciled non-resident alien a trust if funded in a manner where its corpus will not be included in his or her gross estate upon death.
  - As a result of this exposure, the noncitizen immigrant will have to give up substantial legal control over the assets funded to the trust, and can never regain full control over the trust corpus or income

U.S Income and Transfer Tax Planning for Non-Resident Aliens and U.S. Residents with Foreign Assets

- Rule of thumb: Anyone who is a resident non-citizen, who is married to a non-citizen, or who has property located in more than one country needs international estate planning!

- **Non-Tax Considerations in International Estate Planning for Non-Resident Aliens and U.S. Resident with Foreign Assets:**
  - A will or trust prepared under the laws of the United States may not be effective to dispose of the client's property that is located in another country.
  - A client ordinarily prefers to have members residing in their foreign home country serve as executor, logistical issues and language barriers can make such service impractical in which case the U.S. estate planning attorney is encouraged to name back-up fiduciaries.
  - Where a U.S. court has initial jurisdiction over the guardianship of minor children, it will require a local resident to serve as guardian

- **Ramifications of Having a Non-Citizen Spouse:**
  - Disallowance of Federal Estate Tax Marital Deduction
    - Can only be claimed if property passes to the non-resident alien through the use of a Qualified Domestic Trust (QDOT)
  - Gift Splitting Considerations – Non-Citizen Spouse
    - depends upon citizenship or residence of both spouses at the time of the gift where only citizens or transfer tax residents can gift split
  - Loans to Non-Citizen Spouses
    - A loan by a U.S. citizen or resident to a non-citizen spouse may result in a U.S. gift tax liability to the U.S. spouse.

- **Estate and Gift Tax Unified Credit Limitation of Nonresident Aliens:**
  - Nonresident alien estates are entitled to a unified credit equal to the amount of tax due on a $60,000 estate. <u>No</u> gift tax unified credit is available to nonresident aliens.

Foreign Trust Planning and Compliance

- **U.S. Taxation of Grantor Trusts:**
  - An irrevocable foreign trust created by a U,S. person will be subject to special "grantor trust" rules. A U.S. person who transfers property to a foreign trust with a U.S. beneficiary, will be considered the owner of that part of the trust which can be traced to the property transferred.
  - The grantor trust rule will also apply where a nonresident alien individual becomes a U.S. resident within the five years prior to attaining U.S. resident status and where a domestic trust formed by a U.S. person later becomes a foreign trust during the trustor's lifetime.

Basic U.S. Reporting Requirements

- **Currency Transaction Reporting by U.S. Residents Brining Money into the U.S. from Offshore:**
  - A Currency Transaction Report filed on Form 4789 must be completed by any U.S. person who receives, transports, mails or ships currency or any other monetary instrument into or outside the United States in excess of $10,000

- **Notice by U.S. Persons of Large Gifts Received From Non-U.S. Persons:**
  - $100,000 from individuals and in excess of $14,723 for gifts from corporations or partnerships

FBAR

- **Who Must File**
  - United States persons are required to file an FBAR if:
    - The United States person had a financial interest in or signature authority over at least one financial account located outside of the United States; and
    - The aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year to be reported
- **Penalties for Failure to File an FBAR**:
  - Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign account per violation. See 31 U.S.C. § 5321(a)(5). Non-willful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation.
  - A penalty for failing to file Form 3520, Annual Return to Report is the greater of $10,000 or 35 percent of the gross reportable amount

FBAR

- Penalties for Failure to File an FBAR:
  - Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign account per violation. See 31 U.S.C. § 5321(a)(5). Non-willful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation.
  - A penalty for failing to file Form 3520, Annual Return to Report is the greater of $10,000 or 35 percent of the gross reportable amount
  - A penalty for failing to file Form 3520-A -- $10,000 or 5 percent of the gross value of trust assets determined to be owned by the United States person
- Examples of Reporting Penalties
  - 5471, 5472, and 8865
    - The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency