INTERNATIONAL

Assessing Tax Liabilities is One Thing, Collecting Them Abroad is Another- New Case Shows International Reach of the IRS

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The district court's recent decision in Dewees can be used as an example to clarify several misunderstandings related to international tax law.
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People have many misconceptions when it comes to international tax. A recent case, Dewees, [1] highlights several common fallacies, including: (1) if a taxpayer enters into the Offshore Voluntary Disclosure Program (OVDP) in order to resolve past international tax noncompliance on the most favorable terms possible, the IRS will simply forget about such taxpayer if he or she later decides to stop participating in the OVDP; (2) the IRS will be compassionate in determining whether penalties for unfiled Forms 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, should be asserted; and (3) if a taxpayer lives abroad and lacks U.S. assets, then the IRS will not be able to collect any U.S. tax liabilities. This article analyzes and debunks these widespread myths, using Dewees as a point of reference.

OVERVIEW OF FORM FILING REQUIREMENT

The penalties at issue in Dewees result from unfiled Forms 5471. Thus, in order to understand the importance of the case, one must first have some knowledge about this international information return.

Four categories of U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations must file an annual Form 5471 with the IRS to report their relationships with the corporations.[2] These categories are summarized below.

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- A Category 2 filer is a U.S. individual (i.e., U.S. citizen or U.S. resident), who is either an officer or director of a foreign corporation, in which a U.S. person has acquired during the relevant year: (1) 10% or more of the stock of the corporation, or (2) an additional 10% or more of the stock of the foreign corporation.
- A Category 3 filer includes several types of persons, including any U.S. person who acquires stock in a foreign corporation, and when such stock is added to any stock that the U.S. person already owns, the U.S. person owns 10% or more of the stock of the corporation.

- A Category 4 filer is a U.S. person who had "control" of a foreign corporation for an uninterrupted period of 30 days during the relevant year, which means that such U.S. person held more than 50% of the stock of the foreign corporation, applying special ownership-attribution rules.
- A Category 5 filer is a "U.S. shareholder" who/that owns stock in a foreign corporation that is a controlled foreign corporation (CFC) for at least 30 uninterrupted days during the relevant year and who/that held the stock on the last day of the relevant year. For these purposes: (1) a "CFC" is a foreign corporation that has "U.S. shareholders" who/that own (directly, indirectly, or constructively) more than 50% of the foreign corporation on any day of the relevant year, and (2) a "U.S. shareholder" is any U.S. person who/that owns (directly, indirectly, or constructively) 10% or more of the foreign corporation.

Form 5471 is filed as an attachment to the U.S. person's federal income tax return.[3] If a person fails to file a Form 5471, files a late Form 5471, or files a timely but "substantially incomplete" Form 5471, the IRS can assert a penalty of $10,000 per violation, per year.[4] This standard penalty increases at a rate of $10,000 per month, up to a maximum of $50,000, if the problem persists after notification by the IRS.[5] The IRS will not impose penalties if there was "reasonable cause" for the Form 5471 violations.[6]

ANALYSIS OF THE RELEVANT CASE–DEWEES

The facts and arguments in Dewees are somewhat ambiguous, even after reviewing both the court's decision and the pleadings by the parties.[7] Below is an effort at deciphering what really occurred.

A Look at the Facts

The taxpayer is a U.S. citizen by birth. He moved to Canada for a job when he was approximately 30 years old and has remained there ever since. He has been a Canadian resident for nearly 45 years, married a Canadian, and raised his family in Canada. He worked as an employee in Canada for decades, and his wages were subject to automatic tax withholding in Canada. The taxpayer formed a Canadian corporation in 1979 in order to operate a consulting business. He worked with a Canadian accountant and always maintained full tax compliance in Canada. However, the taxpayer did not file U.S. tax or information returns while in Canada, presumably because he thought it was unnecessary.

In 2009, the taxpayer grew concerned about potential U.S. tax noncompliance, consulted a U.S. tax specialist, and then applied for the 2009 OVDP. According to the taxpayer in court pleadings, he filed Forms 1040, Forms 5471, and FBARs for 2003 through 2008 with the IRS as part of his OVDP application. What he submitted, and when, remains unclear. What is certain, though, is that after the IRS issued a preliminary acceptance letter to the taxpayer, and after some back and forth between the taxpayer and the Revenue Agent, the IRS proposed a penalty of approximately $252,000, which was later reduced to about $186,000, after rectifying some double-counting of funds in noncompliant foreign accounts. Presumably, this constituted the standard "offshore" penalty under the OVDP.

The taxpayer did not pay this "offshore" penalty, so the IRS sent him a letter threatening to remove him from the OVDP for lack of cooperation. About five months later, the taxpayer confirmed his "withdrawal from the OVDP based on the excessive amount of penalties owing."[8] The IRS then initiated an audit, consistent with OVDP procedures. The case mentions neither tax liabilities related to Forms 1040 nor FBAR penalties; the fight focuses solely on penalties triggered by the taxpayer's failure to file an annual Form 5471 to report details about his Canadian corporation. The IRS assessed the taxpayer $120,000 for this oversight, representing $10,000 per year, from 1997 through 2008.

The taxpayer appears to have filed a penalty-abatement request, arguing that there was reasonable cause for the unfiled Forms 5471. The IRS initially denied the request, and elevated the matter to the Appeals Office. Consistent with the earlier decision, the Appeals Office upheld the penalties because of an absence of reasonable cause. The taxpayer was steadfast in his refusal to pay, first the "offshore" penalty, and later the Form 5471 penalties. Approximately nine months after getting the negative news from the Appeals Officer, the taxpayer received gloomy news from the Canada Revenue Agency, too. He learned that he had a Canadian tax refund for 2014 waiting for him, but the Canada Revenue Agency would not release it because of a collection-assistance request from the IRS pursuant to the U.S.-Canada Income Tax Treaty (Treaty).[9]

The taxpayer then decided to pay the Form 5471 penalties, which had increased from $120,000 to around $134,000. Still believing that the IRS was unjustified in asserting the penalties, the taxpayer filed a claim for refund, which, unsurprisingly, the IRS disallowed in full.

Refund Litigation—Positions of the Parties

With vindication not yet attained, the taxpayer, approximately 75 years old,

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filed a refund suit with the proper District Court. Notably, the taxpayer did not claim in his refund suit, as one would anticipate, that the Form 5471 penalties were improper because he had reasonable cause for not filing. Instead, the Complaint alleged that the IRS should be obligated to return the $134,000 because the Form 5471 penalties triggered three constitutional issues: (1) They violated the Excessive Fines Clause because the amount of revenue of which the IRS was deprived due to the missing Forms 5471 (i.e., $0) was "significantly disproportional" to the size of the penalties (i.e., $134,000); (2) They violated the Equal Protection Clause because the taxpayer was not permitted to transition from the 2009 OVDP to the 2014 Streamline Foreign Offshore Procedure (SFOP), which would have involved an "offshore" penalty of $0; and (3) They violated the Due Process Clause because the taxpayer was unable to dispute matters in the U.S. on a pre-payment basis in the Tax Court, and because he was unable to challenge in Canada the seizure of his Canadian tax refund in accordance with the Treaty.

The IRS attempted to quickly dispense with the matter by filing a Motion to Dismiss the case for failure to state a claim upon which the court could grant relief to the taxpayer. The counterarguments presented by the IRS to the taxpayer's claims can be summarized as follows: (1) The Form 5471 penalties, of only $10,000 per year, are not considered “fines,” and even if they were, they are not “excessive;” (2) The taxpayer was not denied equal opportunity to transition from the OVDP to the SFOP because he voluntarily withdrew from the OVDP several years before the SFOP was even introduced and because he never even applied to transition; and (3) The taxpayer's ability to bring a refund suit in District Court to dispute the Form 5471 penalties is sufficient due process.

Decision by the Court

The District Court agreed with the IRS on all three points. With respect to the supposed violation of the Excessive Fines Clause, the District Court stated the following:

Tax penalties, by contrast, having been held to fulfill a remedial purpose are therefore not subject to the Excessive Fines Clause. The Supreme Court first articulated this principle almost 80 years ago . . . Since then, the lower courts have erected 'an insurmountable wall of tax cases' to support this proposition . . . A Bankruptcy Court recently applied this precedent in holding the same Form 5471 non-compliance penalties challenged here are not fines . . . The Court concludes likewise.[10]

Turning to the accusation that Form 5471 penalties contravened the Equal Protection Clause, the District Court identified one “fatal flaw” in the taxpayer's argument; that is, he never even alleged that he applied for the SFOP or that his application was denied by the IRS. He cannot prove that he had an actual injury, which means that he lacks legal standing to challenge the issue. If that were insufficient, the District Court then adds some dicta in a footnote, explaining that, even if the taxpayer had standing, he would have lost because of precedent precisely on point. The District Court referenced Maze,[11] which held that a taxpayer must remain in the OVDP in order to get the benefit of transitioning to the SFOP or its domestic counterpart. According to the District Court, it was the taxpayer's decision to leave the OVDP, and not the IRS's actions, which rendered him ineligible for the SFOP.

Finally, in regards to the charge that Form 5471 penalties are inconsistent with the Due Process Clause, the District Court summarized the relevant cases in this manner:

Mere postponement of an opportunity to challenge the imposition of a tax penalty is not a denial of due process, if the opportunity given for the ultimate judicial determination of the liability is adequate . . . Such delays are an 'inevitable consequence' of disputes between taxpayers and the IRS, and are not unconstitutional . . . Federal district courts have jurisdiction over lawsuits against the Government for the refund of tax penalties . . . Full payment of the amount owed followed by a lawsuit in a district court seeking a refund is a proper procedure for challenging [Form 5471] penalties assessed under § 6038.

INTERESTING ISSUES

Many will overlook Dewees, dispensing with it as a short case, in favor of the government, focused on constitutional issues, and lacking significant practical effect. However, a closer review of the case reveals that it triggers interesting issues, a few of which are discussed below.

Withdrawing or Being Removed from the OVDP

Taxpayers who start participating in the OVDP have three main options: (1) Proceed with the OVDP until the IRS issues the proposed Closing Agreement (Form 906, Closing

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Agreement on Final Determination Covering Specific Matters), execute it, pay any outstanding taxes, penalties, and/or interest, and permanently conclude the matter; (2) Wait for the IRS to issue the proposed Closing Agreement and then formally opt-out of the OVDP in order to seek penalty waiver or reduction on grounds that the U.S. noncompliance was not only non-willful, but also reasonable; or (3) Cease cooperation with the OVDP process, which might be characterized as a voluntary "withdrawal" from the OVDP by the taxpayer or an involuntary "removal" from the OVDP by the IRS, depending on the circumstances. Regardless of how one labels it, the result of the third option is the same, i.e., an audit by the IRS and an application of the normal tax rules, procedures, and penalties. Dewees is interesting because it involves the third option, the most infrequent of the bunch.

The IRS recently summarized the third option in the following manner:

A taxpayer who enters the OVDP may voluntarily withdraw from the program, at which point his case would be referred for an examination and all applicable taxes and penalties would be imposed. In addition, if a taxpayer who enters the OVDP stops cooperating with the agent assigned to his case, the [IRS] can involuntarily remove the taxpayer from the program and refer the case for examination.[12]

In 2011, the IRS issued more expansive advice to its personnel regarding withdrawal and removal, in a document referred to as the "Opt Out and Removal Guide."[13] The IRS acknowledged that removal from the OVDP would occur rarely, only in situations when the taxpayer or his or her representative are "demonstrably uncooperative," and the Revenue Agent determines that the case cannot be resolved within a reasonable timeframe.[14] Examples of this extreme level of uncooperativeness include cases where the taxpayer stopped communicating after filing the OVDP application and receiving a "pre-clearance letter" from the IRS; where the taxpayer did not respond within 60 days to specific requests from the Revenue Agent for documents or information; and where the taxpayer received the proposed Closing Agreement but refused to execute it or formally opt-out.[15] The IRS warned that withdrawal and removal have serious consequences, namely, that "the protection from criminal prosecution under the [OVDP] may be compromised."[16] The IRS further clarified that the withdrawal or removal "could result in a taxpayer owing more than the taxpayer would under the civil settlement structure of the

[OVDP].”[17]

Dewees demonstrates that those who voluntarily withdraw or allow themselves to be involuntarily removed from the OVDP could end up with a higher overall IRS bill. Here, the total “offshore” penalty (which satisfied all international information return penalties for all years covered by the OVDP) was approximately $186,000. After departing from the OVDP, the taxpayer paid $134,000 in Form 5471 penalties, and this figure does not include the largest potential penalty threat, FBAR penalties.

Congress enacted the Bank Secrecy Act in 1970.[18] One purpose of this legislation was to require the filing of certain reports, like the FBAR, when doing so would be helpful to the U.S. government in carrying out criminal, tax, and regulatory investigations.[19] Among the important provisions of the Bank Secrecy Act is 31 U.S.C. section 531431 U.S.C. section 5314. This statute, in conjunction with the underlying regulations and FBAR Instructions, requires the filing of an annual FBAR in cases where: (1) a U.S. person, including U.S. citizens, U.S. residents, and domestic entities, (2) had a direct financial interest in, had an indirect financial interest in, and/or had signature authority over, (3) one or more financial accounts, (4) located in a foreign country, (5) whose aggregate value exceeded $10,000, (6) at some point during the calendar year at issue.[20]

Because of the American Jobs Creation Act (Jobs Act) [21] passed in 2004, the IRS may now impose a civil penalty on any person who fails to file an FBAR when required. In the case of non-willful violations, the maximum penalty is $10,000,[22] but the IRS cannot assert this penalty if the violation was due to "reasonable cause.”[23] The Jobs Act calls for higher maximum penalties where willfulness exists. Specifically, in situations where a taxpayer deliberately fails to file an FBAR, the IRS may assert a penalty equal to $100,000 or 50% of the balance in the account at the time of the violation, whichever amount is larger.[24] Given the huge balances in some unreported foreign accounts, FBAR penalties under the Jobs Act can be enormous.

The IRS developed new rules relating to FBAR violations applicable to all cases resolved after 5/12/15. IRS Memorandum SBSE-04-0515-0025 identifies four levels of non-willful FBAR penalties, depending on the circumstances: (1) $0 penalties; (2) one $10,000 penalty for only one year (regardless of the number of unreported accounts); (3) one $10,000 penalty for each open year (regardless of the number of unreported accounts); and (4) one $10,000 penalty per unreported account for each open year.

The Internal Revenue Manual (IRM) indicates that the IRS will apply the preceding FBAR penalty

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standards, if the following four “mitigation threshold conditions” are met: (1) The taxpayer has no history of criminal tax or Bank Secrecy Act convictions for the preceding ten years and no history of FBAR penalty assessments; (2) No money passing through any of the foreign accounts associated with the taxpayer was from an illegal source or used to further a criminal purpose; (3)

The taxpayer cooperated during the examination; and (4) The IRS did not determine a fraud penalty against the taxpayer for an income tax underpayment for the year in question due to the failure to report income related to any amount in a foreign account.[25]

Some simple math will give one an idea of how high the total penalties might be for the taxpayer in Dewees after withdrawing from the OVDP. The version of the OVDP in which the taxpayer participated featured a standard "offshore" penalty equal to 20% of the highest aggregate value of the noncompliant foreign financial assets during the eight-year OVDP period. According to the pleadings filed with the District Court, the taxpayer indicated that the IRS originally asserted FBAR penalties in the amount of about $252,000. This was later reduced significantly, presumably to eliminate double-counting of the same funds flowing through multiple unreported foreign accounts during the OVDP period, pursuant to the relevant Frequently Asked Question issued by the IRS. Assuming that $252,000 accurately represents 20% of the total, then the taxpayer in Dewees would have had accounts the aggregate balance of which reached $1.26 million. If the IRS were to determine that the failure to file FBARs was not due to reasonable cause (as it did with respect to the unfiled Forms 5471), and understanding that the highest penalty for willful FBAR violations under the Jobs Act can reach 50% of the highest balance of each offending account each year, the potential FBAR penalties the taxpayer faced in Dewees after relinquishing protection from the OVDP could be colossal. These calculations, of course, are speculation based on the limited specific information available in the court pleadings, but this does not diminish their ability to prove a point, i.e., a taxpayer's decision to withdraw or permit from the OVDP should be deliberate, after much analysis.

Collection Assistance Under Treaties

The reality is that many taxpayers have believed for a long time that the IRS has serious problems collecting U.S. tax liabilities (including tax-related penalties) once a taxpayer departs from the U.S. and takes up residence in another country. According to a fairly recent report by the Treasury Inspector General for Tax Administration (TIGTA Report), this is absolutely true.[26] The TIGTA Report, aptly titled "The Internal Revenue Service Needs to Enhance Its International Collection Efforts," explains why the IRS's track record abroad has been, for lack of a better word, poor. Here is a sample of the reasons highlighted in the TIGTA Report for the lackluster results: (1) As of 2014, there were only 39 international revenue officers; (2) The International Collection Program lacks adequate procedures, policies, and training to ensure that the international revenue officers can appropriately work the cross-border cases, lacks a case-selection process designed to ensure that cases with high probabilities of yielding revenue are prioritized, lacks performance measures reported separately from normal, domestic collection activities, and lacks a manner by which to determine whether the use of "custom holds" of taxpayers at the border is an effective enforcement tool; (3) Although the IRS developed and announced an International Collection Strategy in mid-2012, it has shown "no urgency" in implementing it; and (4) Because of the inability to locate a taxpayer, contact the taxpayer, and/or find his or her assets abroad, international revenue officers closed more than one-third of their cases, 36%, as "currently not collectible."[27]

Dewees is noteworthy in that it shows that the IRS has other, untraditional, more successful manners of hunting down its due when a taxpayer resides outside of the U.S. As explained above, the IRS asserted an "offshore" penalty of approximately $186,000 under the OVDP, the taxpayer refused to pay the penalty on grounds that it was too high, and then, after some nudging by the Revenue Agent, the taxpayer withdrew from the OVDP. As a result of the ensuing audit, the IRS assessed $120,000 in penalties for failing to file Forms 5471 for the Canadian corporation from 1997 through 2008. The taxpayer refused to pay these penalties, too, at least until the IRS enlisted the help of the Canada Revenue Agency, pursuant to the Treaty. It turns out that the IRS, coming to the conclusion that the taxpayer had no income or assets in the U.S. to seize, filed a mutual collection assistance request (MCAR) under Article XXVIA of the Treaty. The Canada Revenue Agency then withheld a Canadian income tax refund due to the taxpayer, prompting him to pay all Form 5471 penalties, which had risen to approximately $134,000 by that time.

The IRS has described an MCAR as the following:

MCAR is an agreement between the United States and the treaty partner to combat international tax avoidance and evasion. It is a mutual obligation to collect taxes on behalf of another country. The treaties provide that each contracting country can take whatever actions it would take to collect its own taxes in order to collect the taxes of a treaty partner. Each country uses its own unique collection tools to collect the tax of a treaty partner.[28]

These treaties [containing MCAR language] provide that each country, upon request by the United States, may take whatever actions it would take to collect its own taxes in order to collect on behalf of a treaty partner. This includes the collection of U.S. taxes through the treaty partner's bankruptcy proceedings.[29]

Article XXVIA of the Treaty, which was added as part of the third protocol to the Treaty in 1995, is titled "assistance in collection." It generally provides that the U.S. and Canada will assist each other in the collection of taxes, penalties, interest charges, and costs (Revenue Claim).[30] The U.S. government has explained the rationale for the MCAR provision in the following manner:

U.S. negotiators initially raised with Canada the possibility of including collection assistance provisions in the Protocol, because the [IRS] has claims pending against persons in Canada that would be subject to collection under these provisions. However, the ultimate decision of the U.S. and Canadian negotiators to add the collection assistance article was attributable to the confluence of several unusual factors. Of critical importance was the similarity between the laws of the United States and Canada. The [IRS], the Justice Department, and other U.S. negotiators were reassured by the close similarity of the legal and procedural protections afforded by the Contracting States to their citizens and residents and by the fact that these protections apply to the tax collection procedures used by each State. In addition, the U.S. negotiators were confident, given their extensive experience in working with their Canadian counterparts, that the agreed procedures could be administered appropriately, effectively, and efficiently. Finally, given the close cooperation already developed between the United States and Canada in the exchange of tax information, the U.S. and Canadian negotiators concluded that the potential benefits to both countries of obtaining such assistance would be immediate and substantial and would far outweigh any cost involved.[31]

To ensure broad applicability, Article XXVIA clarifies that, notwithstanding anything contrary in the Treaty, the provisions of Article XXVIA "shall apply to all categories of taxes collected by or on behalf of" the U.S. or Canada.[32] It further indicates that, upon filing an application for help collecting a Revenue Claim, the relevant country must certify that the Revenue Claim has been "finally determined" on home soil, which means that the country has the right under its own internal laws to collect, and all the taxpayer's administrative and judicial rights have either expired or been exhausted.[33] Once the U.S. or Canada has accepted an application for assistance in collecting a Revenue Claim, it treats the amount due as an assessment under its internal laws, with all that entails.[34] Lastly, the fact that the U.S. or Canada has agreed to cooperate in chasing down a debt owed to its neighbor pursuant to the Treaty does not create any additional rights for the taxpayer. Article XXVI clarifies that it cannot be interpreted "as creating or providing any rights of administrative or judicial review of the [Revenue Claim]."[35]

Again, despite the apparent ordinariness of the case, Dewees turns out to be interesting and instructive, particularly to taxpayers whose plans of avoiding payment of a U.S. tax liability include seeking refuge abroad. It is noteworthy that there are currently five treaties, with number six on the way, under which the IRS can make an MCAR in order to get help from the local tax authorities in collecting a U.S. liability. Specifically, the IRS has existing treaties with Canada, Denmark, France, the Netherlands, and Sweden, and the MCAR aspect of the treaty with Japan is awaiting the necessary approval.[36] In the words of the Treasury Department, "[c]ollection assistance provisions are included in several other U.S. income tax treaties . . . and in many U.S. estate tax treaties."[37]

Previous Form 5471 Authorities

The District Court held in favor of the IRS in Dewees based on its rejection of the three constitutional arguments presented by the taxpayer. Interestingly, although the taxpayer appears to have filed an earlier penalty-abatement request with the IRS claiming that there was "reasonable cause" for the non-filing of Forms 5471, he did not raise this position again during the refund litigation. Perhaps this is due to the fact that the circumstances were unfavorable to the taxpayer, because he was aware of the precedent (both IRS rulings and cases) setting high standards for penalty waiver, or both. Below is a glimpse of some of the authorities that the IRS likely would have raised to counter any arguments of reasonable cause by the taxpayer in Dewees.[38]

Chief Counsel Advice 200645023.

In CCA 200645023, the taxpayer was a U.S. corporation, which was the parent of a group that conducted global operations through numerous foreign subsidiaries. As part of a complicated transaction, the taxpayer acquired and then controlled a foreign corporation for approximately four months. The taxpayer received tax advice from a U.S. tax professional, indicating that the taxpayer should file a Form 5471 for each of the three foreign subsidiaries held by the foreign corporation. The taxpayer disagreed with this advice, believing that it was not obligated to file

Forms 5471 because, under a substance-over-form analysis or the step-transaction doctrine, the taxpayer never really owned the foreign corporation. Nevertheless, the taxpayer filed Forms 5471 in a timely

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manner. The Forms 5471 were incomplete in that they failed to attach Schedules O, Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock, and they failed to report certain items in U.S. dollars and in accordance with U.S. generally accepted accounting principles (GAAP). The IRS penalized the taxpayer.

The taxpayer argued that the Forms 5471 were substantially complete because: (1) they were based on the best data available at the time of filing, and (2) the only substantive deficiency, not converting foreign financial statements into U.S. dollars and then presenting them using GAAP, was not done because it would have been a "monumental costly task for it to do so."

With respect to the substantially compliant/complete issue, the IRS said that reporting of Schedules C (Income Statement) and F (Balance Sheet) in accordance with GAAP, and the reporting of Schedules C and E (Income, War Profits, and Excess Profits Taxes Paid or Accrued) amounts in functional and U.S. currencies are "significant pieces of required information" and thus "substantial" for purposes of Form 5471.

The IRS then acknowledged, by reference to Section 6651, that high administrative costs might be a defense, but only if the task at hand (i.e., completing a certain aspect of Form 5471) would cause "undue hardship" for the taxpayer. The regulations under Section 6651 state that a late payment will be considered due to reasonable cause where "the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship . . . if he paid on the due date."[39] The regulations go on to explain that the term "undue hardship" means more than a mere inconvenience; the taxpayer must show that it would suffer a substantial financial loss if it were required to complete the relevant tax duty.[40]

After declining the substantially compliant/complete argument, the IRS characterized a seemingly positive fact for the taxpayer as a negative. The taxpayer contended that its filing of complete, timely Forms 5471 in past years should mitigate penalties for deficient Forms 5471 in the present. The IRS stated its "you-should-know-better" position in the following manner:

[T]he fact that [the taxpayer] has a strong compliance history in filing Forms 5471 for its non-U.S. affiliates indicates that the failure to file complete Forms 5471 in this case was not inadvertent because [the taxpayer] was familiar with the proper manner in which to complete Forms 5471 for its non-U.S. affiliates.

Non-Docketed Significant Advice Review 20167.

The taxpayer in NSAR 20167 filed timely Forms 1120, U.S. Corporation Income Tax Return, and enclosed Forms 5471; however, they were missing certain data. Specifically, the taxpayer had not completed Schedule A (Stock of the Foreign Corporation), Schedule B (U.S. Shareholders of Foreign Corporation), Schedule C (Income Statement), Schedule E (Income, War Profits, and Excess Profits Taxes Paid or Accrued), Schedule F (Balance Sheet), Schedule H (Current Earnings and Profits), Schedule J (Accumulated Earnings and Profits), and Schedule M (Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons). Nearly every page of the Forms 5471 stated that the taxpayer would be willing to furnish additional information upon request. The IRS penalized the taxpayer for filing "substantially incomplete" Forms 5471.

The taxpayer argued that the penalties were unwarranted because the incomplete Forms 5471 had no impact on the taxpayer's U.S. tax liability (i.e., all income was properly reported on Form 1120) and the taxpayer disclosed to the IRS the existence of the foreign corporation. Because there was no dispute that the Forms 5471 were incomplete, the IRS rejected the taxpayer's position on grounds that no "reasonable cause" existed for not providing the required data in numerous Schedules to Forms 5471. The IRS also noted that "the fact there is no tax impact here is of no consequence."

Field Service Advice33381431.

In FSA 33381431, taxpayer was a large multinational manufacturer that filed timely Forms 5471. The IRS discovered as part of an audit that some of the Forms 5471 contained incomplete or inaccurate information with respect to certain items, such as sales with related companies and intercompany loans.

The IRS penalized the taxpayer, and the taxpayer disagreed. The taxpayer defended itself on two main theories. First, it contended that the Forms 5471 were substantially complete. Second, even if they were not, the taxpayer explained that sanctions would be inequitable in light of guidance from the IRS in News Release 90-58[41] about Forms 5471.

With respect to the substantially compliant/complete defense, the taxpayer stated that any errors or omissions were minor relative to the large amount of data supplied on Forms 5471. The IRS acknowledged that the taxpayer included most of the required information on Forms 5471 for each of its foreign subsidiaries, it filed timely Forms 5471 as attachments to annual Forms 1120, and it quickly took corrective actions with the IRS when the issues were raised during

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audit. Despite this, the IRS explained that Form 5471 penalties are appropriate when "significant pieces of required information [are] inaccurately reported or omitted," particularly when the majority of the data shown on Forms 5471 is routine and changes infrequently. The IRS emphasized that the taxpayer failed to accurately report major transactions with related parties, inserting either $0 or a small figure on Form 5471, when they actually involved millions of dollars. The IRS then rejected what it calls the "aggregate approach" to analyzing Form 5471 compliance because, under that method, a taxpayer could supply two-thirds of the required information (omitting the key one-third) and then claim that it was immune from penalties as a result of the substantially-complete defense. The IRS stated that it was more appropriate to analyze the issue on a "significant item by significant item basis" for each separate Form 5471.

The IRS also discarded the equity argument raised by the taxpayer. News Release 90-58 stated that “taxpayers who fail to file complete and timely Forms 5471 will be notified in writing from the Philadelphia Service Center as to what is needed to avoid being penalized. Taxpayers should send the missing information promptly or establish reasonable cause for failing to do so.” The taxpayer construed this to mean that the IRS would contact those filing substantially incomplete Forms 5471 before asserting penalties. Since the IRS never notified the taxpayer of any problems related to its timely Forms 5471, it understood that no news was good news. The IRS characterized this interpretation of the News Release as unreasonable, explaining that the items described by the IRS that would trigger a warning were all “conspicuous errors” that could easily be detected by Service Center personnel and immediately addressed with a taxpayer. According to the IRS, the taxpayer's failures were extensive and not amenable to preliminary detection by Service Center personnel. Moreover, the IRS pointed out that the taxpayer had committed similar violations in past years, for which it had been penalized. In summary, the IRS concluded that the taxpayer's supposed reliance on News Release 90-58 was unjustified given the “consistency, magnitude, and persistence of such errors over the preceding years.”

Flume.

Flume was recently decided by the Tax Court, in January 2017. The facts of the case, as well as the positions of the parties, have been cobbled together using multiple sources.[42]

Mr. Flume (Husband) and Mrs. Flume (Wife) are U.S. citizens who moved to Mexico in 1993. Before heading south, Husband worked as an urban planner and real estate developer in the U.S. Husband was engaged in the same type of activities in Mexico, operating a real estate company that developed land, sold lots, and built high-end homes.

In 1995, Husband and another U.S. individual, Norwick Adams, formed a corporation in Mexico called Franchise Food Service de Mexico S.A. de C.V. (Franchise Food). They started as equals, each owning 50%, i.e., 25,000 of the 50,000 total shares. Husband was also the president. Franchise Food was created to operate Mexican locations of Whataburger and Fanny Ice Cream. These two establishments were sold in 1998, but Franchise Food remained in existence. Husband claimed that he sold 20,500 of his shares in 2002 to the wife of Mr. Adams, who was a Mexican citizen and resident. The sale had the effect of reducing Husband's ownership in Franchise Foods to 4,500 shares, which was 9%.

In addition to Franchise Food, Husband and Wife formed at least two other foreign corporations, one of which was Wilshire Holdings, Inc. (Wilshire Belize). This entity was formed in 2001, in Belize, with just two bearer shares. Certificate 1, worth 25,000 shares, was assigned to Husband. Certificate 2, also worth 25,000 shares, pertained to Wife. Husband denied this ownership throughout the tax dispute, alleging that on the same day that Wilshire Belize was formed in 2001, “amended” Articles of Association took effect, which changed the original ownership structure to the following: (1) Certificate 3 showed that a Mexican citizen and resident, and, coincidentally, the spouse of the architect who worked for Husband in his Mexican real estate business, owned 36,500 shares, or 73%; (2) Certificate 4 showed that Husband owned 4,500 shares, or 9%; (3) Certificate 5 showed that Wife owned 4,500 shares, or 9%; and (4) Certificate 6 showed that the daughter of Husband and Wife owned 4,500 shares, or 9%. Husband offered no proof of this new ownership structure other than the “amended” Articles of Association, which he ultimately admitted had been "backdated."

In 2005, Wilshire Belize opened an account at UBS in Switzerland. Several documents and communications related to such account undermined Husband's position that he was a minor owner of Wilshire Belize. For instance, Husband and Wife opened the Swiss account using the original Articles of Association (showing Husband and Wife as 50/50 owners) and not the "amended" Articles of Association described above; Husband and Wife were listed as the "beneficial owners" of the account; Husband signed account-related documents in his capacity as "First Director" of Wilshire Belize; Husband and Wife controlled the investment activity in the account; and

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Husband and Wife signed the wire-transfer orders in 2008 and 2009, as "Directors" of Wilshire Belize, to empty the Swiss account and remit all funds to a U.S. account.

Husband and Wife filed timely Forms 1040 for 2001 through 2009, but they did not attach any Forms 5471 for Franchise Food or Wilshire Belize. The IRS started an audit in 2012, presumably as a result of data that the IRS received from UBS in connection with its criminal investigation of UBS. Ultimately, the Revenue Agent assessed a total of $110,000 in Form 5471 penalties, as follows: (1) $20,000 for each of 2001 and 2002, for penalties related to Franchise Food and Wilshire Belize; and (2) $10,000 for each of 2003, 2004, 2005, 2006, 2007, 2008, and 2009 for penalties related only to Wilshire Belize.

Husband did not voluntarily pay the Form 5471 penalties, so the IRS eventually sent him the pre-levy notice in December 2013, indicating that the IRS intended to start seizing assets in order to satisfy the penalties and notifying Husband of his right to request a collection due process (CDP) hearing. Husband filed a timely request for a CDP hearing, claiming, among other things, that: (1) the Forms 5471 for 2001 and 2002 for Franchise Foods, filed with the Revenue Agent approximately a decade late and only in response to a letter from the Revenue Agent warning of imminent penalties, sufficed to satisfy the filing duty, and (2) Husband was not required to file Forms 5471 for Wilshire Belize for 2001 through 2009 because he had only a 9% ownership interest, and thus was not a "U.S. shareholder," or Category 5 filer.

The IRS Settlement Officer conducting the CDP hearing rejected the first argument on grounds that the Forms 5471 for Franchise Food were filed years after the fact and, in all events, were "inaccurate and incomplete" because they were filed under the wrong Category and had "$0" or "unknown" written in several boxes. The Settlement Officer also rejected the second argument, pointing out that the Revenue Agent had obtained "compelling third-party documentation" from UBS showing that Husband and Wife were owners, officers, and directors of Wilshire Belize from 2001 through 2009. Husband did not provide the Settlement Officer with a narrative explaining why "reasonable cause" existed for the violations and did not present a collection alternative, such as an offer-in-compromise or installment agreement. Accordingly, the Settlement Officer issued his Notice of Determination concluding that the IRS was free to proceed with the proposed levy of assets.

Husband was not willing to go down without a fight; he filed a timely Petition with the Tax Court challenging the conclusions reached by the Settlement Officer in the Notice of Determination.

This Petition was brief, completed using the fill-in form available on the Tax Court website. Husband summarized his entire case for the Tax Court in the following manner: “Taxpayer has complied with Form 5471 reporting requirements as required by law and has filed the appropriate tax forms” and “Taxpayer has documents and IRS filings indicating proper filing of tax forms in accordance with ownership of tax reporting entities.”

The Tax Court reduced this case to its essence in making its ruling. With respect to Franchise Food, the Tax Court concluded that: (1) Husband was a Category 5 filer in 2001 and a Category 3 filer in 2002, thus obligated to file a Form 5471 for each year, and (2) the argument that the Forms 5471 filed in 2013, years after the deadline and as a part of the audit, should be given “retroactive effect” lacks merit.

Regarding Wilshire Belize, the Tax Court noted that Husband was a Category 4 and Category 5 filer for 2001 through 2009, and Husband “merely provided self-serving testimony and a backdated document to support his claim that he maintained only a 9% ownership interest during the tax years in issue.”

Finally, the Tax Court rejected the notion that Husband should be relieved of Form 5471 penalties under a reasonable-reliance theory because Husband was unable to demonstrate that his return preparer in Mexico had sufficient qualifications and expertise, and Husband never gave the preparer information about Franchise Food and Wilshire Belize during the relevant years.

Late Forms 5471 and Automatic Penalties.

In Dewees, the taxpayer initially participated in the OVDP, later withdrew as a refusal to pay the “offshore” penalty, and then was audited and penalized by the IRS. It is important to note that, if the taxpayer had decided not to apply for the OVDP and filed late Forms 5471 instead, he would have been penalized just the same. Here is why.

The IRS has been automatically imposing Form 5471 penalties for several years.[43] Since 2009, if a U.S. tax return is filed after the deadline and Forms 5471 are attached, then the IRS will automatically assess a $10,000 per-violation penalty and immediately start the collection process. This is true regardless of whether the taxpayer includes an eloquent, thorough, and persuasive statement of “reasonable cause” with the late Form 5471.[44] Indeed, recent guidance issued by the Large Business and International division of the IRS stated the following: “For Form 1120s filed late after December 31, 2008, the [IRS] automatically assesses an Initial Penalty of $10,000 for each Form 5471 attached. It is assessed even when a request for reasonable cause was submitted with the Form 1120.”[45]

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First-Time Abate Policy No Help with Forms 5471.

Dewees did not provide details about the penalty-abatement request filed by the taxpayer or the reasons for the rejection by the IRS. Therefore, it is uncertain whether the taxpayer sought relief of Form 5471 penalties under the first-time-penalty-abatement policy. It is important to understand that, had the taxpayer advanced this argument, he likely would have lost for the following reasons.

The IRS's general first-time-penalty-abatement policy states that it will grant abatement with respect to virtually all delinquency penalties in situations where a taxpayer has not been required to file a certain return before, or where the taxpayer has no prior penalties of this type.[46] If the taxpayer meets these criteria, then the IRS normally issues a letter to the taxpayer confirming that waiver is being granted solely on the basis of the first-time-penalty-abatement policy, not because the taxpayer has demonstrated that it had reasonable cause for the violation.[47]

The first-time-penalty-abatement policy is bittersweet, though, because it does not apply to: (1) "returns with an event-based filing requirement," and (2) "information reporting that is dependent on another filing, such as various forms that are attached [to an income tax return]."[48] Many IRS personnel deny requests for abatement of international information return penalties, like those related to Forms 5471, because they are triggered by an event and/or because they must be enclosed with a tax return.

Violations Keep Assessment Periods Open.

The most significant consequence of not filing international information returns generally is not the monetary penalty; rather, it is time. Specifically, the importance centers on the amount of time that the IRS has to conduct an audit and impose additional taxes, penalties, and interest charges. A relatively obscure procedural provision, Section 6501(c)(8)(A), contains a powerful tool for the IRS. It generally states that where a taxpayer fails to file in a timely manner a long list of international information returns (e.g., Forms 926, 3520, 3520-A, 5471, 5472, 8621, 8858, 8865, and 8938) the assessment period remains open "with respect to any tax return, event, or period" to which the information return relates, until three years after the taxpayer ultimately files the information return.[49] Thus, if the taxpayer never files the requisite international information return, then the general three-year assessment period never begins to run against the IRS. This prevents taxpayers with international information return violations from running out the clock on the IRS.

The effect of Section 6501(c)(8) was felt in Dewees in the sense that, when the taxpayer was in the OVDP, the years at issue were limited to 2003 through 2008. However, after the taxpayer withdrew from the OVDP, the IRS initiated an audit, expanded the scope an additional six years, and assessed Form 5471 penalties from 1997 through 2008.

Form 8938 Penalties.

Dewees is noteworthy in that it is a reminder that, had the years at issue not been limited to 1997 through 2008, the taxpayer likely would also have been subjected to Form 8938, Statement of Specified Foreign Financial Assets, penalties.

Section 6038D, which mandates the filing of Form 8938, was enacted in 2010 as part of the Foreign Account Tax Compliance Act (FATCA).[50] The general rule in Section 6038D(a) can be divided into the following parts:

- any specified person (SP)
- who/that holds an interest
- during any portion of a tax year
- in a specified foreign financial asset (SFFA)
- must attach to his/her/its timely tax return
- a complete and accurate Form 8938
- if the aggregate value of all SFFAs
- exceeds the applicable filing threshold

Holding an interest in an asset means different things in different contexts. When it comes to Form 8938, an SP generally holds an interest in an SFFA if any income, gains, losses, deductions, credits, gross proceeds, or distributions attributable to the holding or disposition of the SFFA are (or should be) reported, included, or otherwise reflected on the SP's annual tax return.[51] The regulations clarify that an SP has an interest in the SFFA even if no income, gains, losses, deductions, credits, gross proceeds, or distributions are attributable to the holding or disposition of the SFFA for the year in question.[52] The regulations also indicate that an SP must file a Form 8938, despite the fact that none of the SFFAs that must be reported affect the U.S. tax liability of the SP for the year.[53]

For purposes of Section 6038D, the term SFFA includes two major categories: (1) Foreign financial accounts,[54] and (2) Other foreign financial assets, which are held for investment purposes.[55] The second category includes stocks or securities issued by a non-U.S.-person, financial instruments or contracts held for investment purposes whose issuer or counterparty is a non-U.S.-person, and any interest in a foreign entity.[56] The regulations enlarge and clarify the categories, identifying the following items as SFFAs: (1) stock issued by a foreign corporation; (2) a capital interest or profits interest in a foreign partnership; (3) a note, bond, debenture, or other form of debt issued by a foreign person; (4) an interest in a foreign trust; (5) an interest swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty; and (6) any option or other derivative instrument with respect to any of the items listed as examples or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.[57]

If an SP fails to file the Form 8938 in a timely manner, then the SP “shall” pay a penalty of $10,000.[58] The penalty increases to a maximum of $50,000 if the SP does not rectify the problem quickly after contact from the IRS.[59] An SP who

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unintentionally fails to file a timely, accurate Form 8938 can avoid penalties under Section 6038D if the SP can demonstrate that the violation was due to reasonable cause and not due to willful neglect.[60]

Dewees only addresses Form 5471 violations from 1997 through 2008, and the Form 8938 filing requirement did not take effect until 2011. However, had the case involved later years, one can assume that the IRS would also have asserted penalties of $10,000 per year for the failure by the taxpayer to report on Form 8938 all of his SFFAs, such as his Canadian corporation and Canadian accounts.

Potential Loss of Passport.

Dewees indicated that, until the taxpayer paid the penalties to the IRS after the Canada Revenue Agency agreed to withhold a Canadian tax refund pursuant to the MCAR under the Treaty, he had a liability ranging from $120,000 to $134,000. The taxpayer likely did not realize that, had the liability still existed in 2017, the IRS might have delivered another type of "encouragement" to payment: revocation of his U.S. passport.

Congress enacted a law in December 2015 authorizing the IRS, with help from the State Department, to deprive certain individuals with tax debts of a U.S. passport. This new passport-denial-and-revocation power, found in Section 7345, was part of the Fixing America's Surface Transportation (FAST) Act. To date, the IRS has not yet issued regulations, a Revenue Procedure, a Notice, or anything else clarifying and/or expanding on the language in Section 7345. However, the IRS's website was recently updated to indicate that the IRS will begin enforcing the new law "in early 2017."[61]

The general rule under Section 7345(a) is that, if the IRS determines that an individual taxpayer has a seriously delinquent tax debt (SDTD), then it will send a "certification" to the Secretary of the Treasury, who, in turn, will send the "certification" to the Secretary of State, who will then deny, revoke, or limit the U.S. passport of the individual, as appropriate.

Section 7345(b)(1) defines the term SDTD to mean: (1) a federal tax liability, (2) which has been assessed, (3) that remains unpaid, (4) that is more than $50,000, and (5) with respect to which either the IRS has filed a NFTL and the administrative rights under Section 6320, including the right to request a CDP hearing, have been exhausted or lapsed, or the IRS has levied.[62]

For its part, Section 7345(b)(2) provides several exceptions to the general definition, explaining that the following types of tax debts are not considered SDTDs: (1) A debt that the taxpayer is paying in a timely manner pursuant to an installment agreement under Section 6159; (2) A debt that the taxpayer is paying in a timely manner pursuant to an offer-in-compromise under Section 7122; (3) A debt with respect to which the IRS has suspended collection activity because the taxpayer filed a proper request for a CDP hearing and such hearing is still pending; (4) An individual has elected innocent spouse relief under Section 6015(b) or Section 6015(c); and (5) An individual has requested innocent spouse relief under Section 6015(f).

Section 7345(c) addresses reversal of the SDTD certification, which some refer to as "decertification." Section 7345(c)(1) explains that the IRS Commissioner must notify the Secretary of the Treasury, who will then notify the Secretary of State, in three circumstances: (1) If any certification is later found to be erroneous; (2) If the individual "fully satisfies" the debt that triggered the certification; or (3) The debt is no longer an SDTD as a result of Section 7345(b)(2), as described in the preceding paragraph. In other words, notice of "decertification" must occur when the original certification was unwarranted, the individual completely pays off the SDTD, the individual enters into an installment agreement, the individual resolves matters through an offer-in-compromise, or the individual has properly sought innocent spouse relief from the liability.[63]

Section 7345(b)(1) indicates that an SDTD is a federal tax liability that exceeds $50,000, but it does not clarify the components of the calculation. To find this answer, one must look to the legislative history. The congressional conference report states that an SDTD generally includes any "outstanding debt for federal taxes in excess of $50,000, including interest and any penalties," for which a post-lien notice or a pre-levy notice has been filed.[64] Likewise, the so-called Bluebook issued by the U.S. Joint Committee on Taxation states that an SDTD entails taxes and "interest and any penalties."[65]

Section 7345(b)(1) explains that an SDTD is a "federal tax liability" greater than $50,000, and the legislative history indicates that this term covers not only the federal income taxes related to Forms 1040 of an individual taxpayer, but also corresponding

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penalties and interest. What remains murky is whether "assessable penalties" will be considered part of an SDTD.

The term "assessable penalties" refers to those items found in Section 6671 through Section 6725. For its part, Section 6671(a) expressly states that "assessable penalties" will be paid by the taxpayer on notice and demand by the IRS, and "shall be assessed and collected in the same manner as taxes." It goes on to clarify that any reference in the Code to the term "tax" shall include "assessable penalties."[66]

Consider how this might play out, understanding that Section 7345 speaks to "federal tax liabilities" and Section 6671 explicitly states that "assessable penalties" are considered "taxes." Because the Form 5471 penalty is $10,000 per violation, because such penalties are rooted in Section 6679 (i.e., within the list of "assessable penalties"), and because it is not uncommon for individuals to be required to file multiple Forms 5471 per year, a noncompliant individual could quickly find himself facing Form 5471 penalties in excess of $50,000. This is like the taxpayer in Dewees, who overnight got hit with Form 5471 penalties of $120,000. Assuming that unpaid "assessable penalties," alone, could trigger an SDTD certification, and assuming that they remained outstanding in 2017, the taxpayer in Dewees might have been deprived of his international mobility.

Custom Holds and Historical Travel Information.

Along with being subjected to the passport-denial-or-revocation rules of Section 7345 if the liability had existed in 2017, the taxpayer in Dewees might also have found himself detained and questioned at the U.S. border pursuant to what is commonly called a "Customs Hold."[67]

The TIGTA Report and IRM explain this enforcement mechanism in the following way.[68]

International revenue officers can request that a Customs Hold be inputted into the Treasury Enforcement Communication System (TECS) for delinquent taxpayers. After the IRS places a taxpayer on the TECS, the U.S. Department of Homeland Security (DHS) notifies the IRS when such taxpayer travels into the U.S., and the international revenue officer uses the data obtained during the interview of the taxpayer, conducted during the Customs Hold, to locate the taxpayer and/or his or her assets. Many of the taxpayers entered into the TECS are international because they reside abroad, but domestic taxpayers can be included, too, if the IRS has been unable to locate them and there is evidence that they often travel outside the U.S., beyond the jurisdiction of U.S. courts.[69] International revenue officers are encouraged to utilize the TECS early and often. Indeed, in situations where a taxpayer fails to provide collection-related information by a deadline and the case meets the relevant criteria, the IRM advocates placing the taxpayer on the TECS "early in the case."[70]

According to the TIGTA Report, the Customs Hold is "one of the most effective enforcement tools available to [international revenue officers] in dealing with delinquent international taxpayers."[71] This tool has been in place for nearly 25 years, since 1993, though few seem to be aware of it.[72] Below are two examples from the IRS of how custom holds are designed to function:

Example. A domestic revenue officer [RO] has a balance due taxpayer in his inventory and he notices a foreign address . . . in Norway . . . The International RO contacts Taxpayer in Norway and accepts transfer of the case. Taxpayer states that he does not owe the taxes for tax years 2010 and 2011 as he is not a U.S. citizen. Taxpayer did, however, state that he travels to the U.S. quite often for business purposes. RO informs Taxpayer that he is liable for the taxes. As the RO is securing a 433A, Collection Information Statement, TP says he will never pay and hangs up the phone. The international RO then requests Taxpayer be placed on TECS by submitting a Form 6668 to his general manager [GM]. One month later, Taxpayer travels to the U.S. and initially arrives at an airport in New York. Upon Taxpayer's arrival, DHS informs the TECS coordinator of the following: Taxpayer's ultimate destination; how long Taxpayer plans to stay in the U.S.; and Taxpayer's flight itinerary. Taxpayer will be staying in Phoenix for four months. DHS also secured Taxpayer's address and cell number in Phoenix. The international RO issues [an order] to a domestic RO in Phoenix to meet with Taxpayer to secure full pay and/or a 433A with documentation. The RO secures a partial payment and a completed 433A and closes out the [case]. The International RO conducts further research once he or she is aware of the Phoenix nexus. He or she discovers Taxpayer has real property held in the name of a trust and files a nominee lien.[73]
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Example. An international [RO] has a balance due taxpayer located in Hong Kong. The international RO is unable to make contact with the Taxpayer and Taxpayer has no assets in the U.S. Taxpayer meets the requirements to be placed on TECS, and RO closes the case as International . . . Two years later, Taxpayer travels to the U.S. and arrives in Miami, FL. [DHS] informs the TECS coordinator that Taxpayer will be staying at the hotel in Miami for three days and will then depart to Mexico. No additional information was given by [DHS]. The TECS coordinator informs the international GM about the TECS lookout. The international GM issues an [order] to a domestic RO in Miami to meet with Taxpayer and secure full pay and/or a 433A. The international GM contacts the domestic GM in Miami, stating that Taxpayer will be departing Miami in three days. The domestic RO meets Taxpayer at the hotel and secures full payment for the balance due.[74]

In addition to using the TECS to effectuate a customs hold of a delinquent taxpayer, it can also be utilized by international revenue officers to obtain historical travel information. The TECS purportedly has “extensive records” of commercial airline flight arrivals and departures, sea travel, border crossings, and more, which could lead to the discovery of a taxpayer's country of residence, business activity, and location of assets.[75] Below are two examples from the IRS about how historical travel information, accessible via the TECS, can facilitate collection from taxpayers living abroad.

Example. [RO] requests TECS historical travel information to learn how a taxpayer living in India paid for airline tickets. Up to this point, the RO has not been able to identify any levy sources for this uncooperative taxpayer. The RO discovers that the payment was made from a bank account in the U.S. The U.S. bank account is in the name of a family trust. By performing further case investigation, the RO verifies that the family trust is not authentic. The RO coordinates with Advisory and Area Counsel to prepare a transferee assessment, nominee lien, and nominee levy, which results in collection of part of the balance due. Then the taxpayer contacts the RO to discuss resolution of the remaining balance.

Example. [RO] requests TECS historical travel information because he or she is unsure where the taxpayer resides. The case currently has an address of record in Florida, but the RO has not been able to contact the taxpayer. The RO believes the taxpayer may often be out of the U.S. Historical information in the case file shows the taxpayer once resided in Great Britain. The TECS historical travel information reveals that the taxpayer visited Canada three times in the last 18 months. Through subsequent investigation, the RO learns that the taxpayer is now residing permanently in Canada but continues to use the Florida address as a mail drop. This information leads the RO to refer the case for an outgoing MCAR to request assistance from Canada, our treaty partner. The MCAR results in the collection of the outstanding liabilities via levy.

Conclusion

Dewees seems like an insignificant case at first blush, but it actually provides some valuable lessons: (1) If a taxpayer applies for the OVDP and later withdraws or gets removed, the IRS likely will initiate an audit, expand the assessment periods under Section 6501(c)(8), and then assert potentially large international information return penalties; (2) The standards for obtaining abatement of Form 5471 penalties are high; (3) The IRS can enlist the assistance of many of its treaty partners in collecting U.S. tax liabilities from taxpayers living in foreign countries; (4) The IRS can revoke or deny a U.S. passport to certain taxpayers with U.S. tax liabilities, thereby prohibiting international travel; and (5) The IRS coordinates with the DHS to obtain important collection-related data when a delinquent taxpayer enters the U.S. or engages in other travel. These lessons will be increasingly important as the world becomes more globalized and larger quantities of U.S. individuals seek opportunities (or sanctuary from tax liabilities) abroad.[76]

[1] 120 AFTR2d 2017-5429 (DC D.C., 2017).

[2] Section 6038; Reg. 1.6038-2; Section 6046; Reg. 1.6046-1; Section 6679; Reg. 301.6679-1; Instructions to Form 5471.

[3] Section 6038(a)(2); Reg. 1.6038-2(i).

[4] Section 6038(b)(1); Reg. 1.6038-2(k)(1)(i); Section 6046(f); Reg. 1.6046-1(k).

[5] Section 6038(b)(2); Reg. 1.6038-2(k)(1)(ii); Section 6046(f); Reg. 1.6046-1(k).

[6] Regs. 1.6038-2(k)(3)(i) and (ii).

[7] Complaint filed 8/3/16; Motion by United States to Dismiss the Complaint filed 10/28/16; Statement of Points and Authorities in Support of the Motion by the United States to Dismiss filed 10/28/16; Opposition to the Motion to Dismiss the Complaint filed 12/9/16; Reply in Support of the Motion by the United States to Dismiss the Complaint filed 12/19/16; Dewees, Note 1., supra.

[8] Complaint filed 8/3/16, p. 5.

[9] Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital signed on 9/26/80, as amended by protocols signed on 6/14/83 (First Protocol), 3/28/84 (Second Protocol), 3/17/95 (Third Protocol), 7/29/97 (Fourth Protocol), and 9/21/07 (Fifth Protocol).

[10] Dewees, at p. 3.

[11] 206 F. Supp. 3d 1 120 AFTR2d 2017-5191 (DC D.C., 2016), aff'd 862 F.3d 1087 (CA-D.C., 2017).

[12] CCA 201719026 (emphasis added).

[13] OSINC 20110601—Memorandum by Steven T. Miller, Deputy Commissioner for Services and Enforcement (6/1/11), www.irs.gov/pub/newsroom/

2011_ovdi_opt_out_and_removal_guide_and_memo_june_1_2011.pdf; See also Frequently Asked Question #51.

[14] Id.

[15] Id.

[16] Id.

[17] Id.

[18] P. L. 91-508, Title I and Title II, 10/26/70.

[19] Id. at section 202.

[20] 31 U.S.C. section 531431 U.S.C. section 5314; 31 C.F.R. section 1010.350(a).

[21] P. L. 108-357, 10/22/04; 31 U.S.C. section 5321(a)(5)(A)31 U.S.C. section 5321(a)(5)(A).

[22] 31 U.S.C. section 5321(a)(5)(B)(i)31 U.S.C. section 5321(a)(5)(B)(i).

[23] 31 U.S.C. section 5321(a)(5)(B)(ii)31 U.S.C. section 5321(a)(5)(B)(ii).

[24] 31 U.S.C. section 5321(a)(5)(C)(i)31 U.S.C. section 5321(a)(5)(C)(i).

[25] IRM section 4.26.16.6.6.1 (11/6/15).

[26] Treasury Inspector General for Tax Administration, "The Internal Revenue Service Needs to Enhance Its International Collection Efforts," 9/12/14.

[27] Id. at p. 3.

[28] IRM section 5.21.7.4 (11/13/15).

[29] IRM section 5.21.3.7 (1/7/16).

[30] Treaty, Article XXVIA(1).

[31] Technical Explanation to Treaty.

[32] Treaty, Article XXVIA(9).

[33] Treaty, Article XXVIA(2).

[34] Treaty, Article XXVIA(4).

[35] Treaty, Article XXVIA(5).

[36] IRM section 5.21.3.7 (1/7/16); IRM section 5.21.7.4 (11/13/15).

[37] Technical Explanation to Treaty.

[38] Many of these authorities were cited by the IRS in recent guidance issued by the Large Business and International division to its personnel. See "Failure to File the Form 5471—Category 4 and 5 Filers— Monetary Penalty," International Practice Unit, www.irs.gov/pub/irs-utl/FEN9433_01_06R.pdf (updated as of 10/7/15).

[39] Reg. 301.6651-1(c)(1); Reg. 1.6161-1(b).

[40] Id.

[41] IR-90-58, 3/29/90.

[42] The author obtained and reviewed the following documents in describing the case: Petition filed 7/7/14 (enclosing Notice of Determination dated 6/3/14); Answer by IRS filed 8/27/14; First Stipulation of Facts filed 9/30/15; First Supplemental Stipulation of Facts filed 9/30/15; Pre-Trial Memorandum by Taxpayer filed 9/11/15; Pre-Trial Memorandum by IRS filed 9/30/15; Opening Brief by IRS filed 1/15/16; Answering Brief by Taxpayer filed 3/9/16; Reply Brief by IRS filed 4/8/16; and Flume, TCMemo 2017-21 .

[43] U.S. Treasury Inspector General for Tax Administration, "Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed," (May 2006); U.S. Treasury Inspector General for Tax Administration, "Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement," (9/25/13).

[44] IRM section 21.8.2.20.1 (10/1/14).

[45] "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty," International Practice Unit (updated as of 10/7/15). Emphasis added.

[46] IRM section 20.1.1.3.6.1(7) (8/5/14).

[47] Id.

[48] IRM sections 20.1.1.3.6.1(8) and (9) (8/5/14).

[49] Section 6501(c)(8)(B) contains a limitation, stating that the assessment period will remain open only with respect to "the item or items" related to the late international information return if the taxpayer can demonstrate that the delinquency was due to reasonable cause and not due to willful neglect.

[50] P. L. 111-147, Hiring Incentives to Restore Employment Act, section 511, 3/18/10.

[51] Reg. 1.6038D-2(b)(1).

[52] Id.

[53] Reg. 1.6038D-2(a)(8).

[54] Section 6038D(b)(1); Reg. 1.6038D-3(a)(1).

[55] Section 6038D(b)(2); Reg. 1.6038D-3(b)(1).

[56] Id.

[57] Reg. 1.6038D-3(d).

[58] Section 6038D(d)(1); Reg. 1.6038D-8(a).

[59] Section 6038D(d)(2); Reg. 1.6038D-8(c).

[60] Section 6038D(g); Reg. 1.6038D-8(e)(1).

[61] www.irs.gov/businesses/small-businesses-self-employed/revocation-or-denial-of-passport-in-case-of-certain-unpaid-taxes, as of 2/16/17. The website states the following: "The IRS has not yet started certifying tax debt to the State Department [but] certifications to the State Department will begin in early 2017."

[62] Section 7345(f) indicates that the $50,000 threshold will be adjusted annually for inflation and rounded to the nearest multiple of $1,000.

[63] Legislative history states that, "[i]n the case of a claim for innocent spouse relief, the decertification is only with respect to the spouse claiming relief, not both." See H. Rep't No. 114-357, 114th Cong., 1st Sess., 12/1/15, p. 532.

[64] Id. at p.531. Emphasis added.

[65] Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 2015," JCS-1-16 (March 2016), p. 92.

[66] Section 6671(a); Reg. 301.6671-1(a).

[67] See also IRM section 5.21.3.4 (1/7/16), which discusses another, more aggressive tool with a similar name, the "Customs Order" or "Prevent Departure Order."

[68] Treasury Inspector General for Tax Administration, "The Internal Revenue Service Needs to Enhance Its International Collection Efforts" (9/12/14), pp. 13-14; IRM section 5.1.18.14 (6/10/15).

[69] IRM section 5.1.18.14.1 (06-10-2015).

[70] Id.

[71] Treasury Inspector General for Tax Administration, "The Internal Revenue Service Needs to Enhance Its International Collection Efforts," (9/12/14), pp. 13-14.

[72] Id. at pgs. 13-14, footnote 7. Despite custom holds and other tools, nonpayment of taxes by U.S. persons residing abroad is pervasive. The TIGTA Report indicates that there are approximately 1,700 taxpayers with a Customs Hold, representing approximately $1.6 billion in tax-related liabilities.

[73] IRM section 5.1.18.14.1 (6/10/15).

[74] Id.

[75] IRM section 5.1.18.14.8 (6/10/15).

[76] This article will also appear in a slightly different format in the Journal of International Taxation