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High Net Worth Family TAX REPORT

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Member of Limited Liability Company Gets Better Treatment than a Limited Partner for Purposes of Passive Activity Loss

Not all partners are created equal. There are various places in the tax law where limited partners are treated differently from general partners. Yet neither the Internal Revenue Code ("Code" or "IRC") nor the regulations defines the different types of partners.

One place where the type of partner makes a difference is under the passive activity loss rules. Generally, an individual's losses from a passive activity are only deductible against the individual's passive activity income (which does not include compensation or portfolio income such as interest and dividends). Activities are generally considered passive if the taxpayer does not materially participate in the activity under any of seven tests set forth in Temporary Regulations. However, IRC Section 469(h)(2) provides that a limited partner in a limited partnership is presumed passive unless regulations provide to the contrary. The regulations allow only three of the seven tests to be used to determine whether a limited partner materially participates in the activity of the limited partnership. The main one of the three is whether he devotes at least 500 hours to the activity each year. Moreover, active participation may cause him to lose the limited liability protection that is accorded limited partners.

The question raised in *Garnett v. Commissioner*, 132 T.C. No. 19 (2009), is whether this same presumption applies to a member of a limited liability company. Although the Temporary Regulations define a limited partnership interest broadly to include an interest where the holder's liability for obligations of the entity is limited under State law (and therefore includes a limited liability company), they do not define when a member holds such interest as a limited partner. Analyzing the legislative history of the passive activity rules, the Tax Court concluded that the presumption was applied to a limited partner because under State law his limited liability was conditioned on not participating in the partnership's business.

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A member in a limited liability company, on the other hand, does not face such limitation. Limited liability is not lost merely because the member is active in the business. As a result, the court found the presumption does not apply, and whether the taxpayer materially participated in the limited liability company's business must be determined by applying the full seven factor test.

Shortly thereafter, the United States Court of Federal Claims reached the same conclusion. The court found that the definition of a limited partnership under the regulations on which the government relied – that "a partnership interest shall be treated as a limited partnership interest if ... the liability of the holder of such interest for obligations of the partnership is limited, under the laws of the State in which the partnership is organized" – literally requires that the entity be a partnership under state law. Moreover, the court agreed with the Tax Court's analysis in *Garnett* that, for purposes of IRC Section 469(h)(2), the hallmark of a limited partner is that a limited partner is entitled to limited liability protection only if it does not actively participate in the business. Unlike a limited partner, a member of a limited liability company has limited liability even if he participates in the management of the business.

The lesson of these cases is that if you wish to use an entity that provides a liability shield but still not be considered a passive activity, you should use a limited liability company rather than a limited partnership.

Still No Estate Tax Reform

As of the date of this newsletter, Congress has not acted on estate tax reform. In 2009, the estate tax exemption is $3,500,000, but the gift tax exemption is only $1,000,000. The maximum estate tax rate is 45%. In 2010, the estate tax is scheduled to be eliminated, but the gift tax exemption remains at $1,000,000. **Do not make gifts on the assumption that there is no transfer tax.** In 2011, the estate tax returns, with a $1,000,000 exemption and a 55% maximum estate tax rate. Common wisdom appears to be that Congress will simply extend the 2009 rules to 2010 until it focuses on a more complete reform package.

It has been anticipated that the complete package will address the estate tax exemption, the disconnect between the estate and gift tax exemptions, the estate tax rate, and the subject of discounts in the context of family businesses. At the moment, the plan favored by President Obama would provide a $3,500,000 exemption amount indexed for inflation, but not portable between spouses. He would leave the lifetime gift tax exemption amount at $1,000,000. The top rate would be 45%. His current proposal does not seek to limit valuation discounts. We will keep you posted.

Taxpayers Continue to Avoid Six Year Statute of Limitations for Overstated Tax Basis

In November of 2007 (Vol. 2 No.2) we reported on the Tax Court case of *Bakersfield Energy Partners, L.P. v. Commissioner*, where the court held that if a taxpayer erroneously overstates the tax basis of an asset he sold, the IRS has only 3 years rather than 6 years to assess additional tax. The IRS normally has three years after an income tax return is filed to audit the return and assess any additional tax it believes is due. However, if the taxpayer omits from the return an amount of gross income that exceeds 25% of the amount of gross income reported on the return, then the IRS has six years to assess additional tax. Many popular tax shelters of the past decade resulted in the creation of artificially high basis in assets that were later sold to create supposed tax losses.

The Tax Court found for the taxpayer, determining that overstating basis is not the same thing as omitting gross income. Two United States Courts of Appeals have now agreed with the Tax Court. First, the Ninth Circuit (which includes California) affirmed the Tax Court's holding in *Bakersfield Energy Partners*. The court rejected the argument of the IRS that the result differed depending on whether the asset was used in a trade or business or simply held for investment. More recently, the Federal Circuit reached the same conclusion in *Salman Ranch Ltd. v. United States (July 30, 2009)*. Shortly after the Ninth Circuit's decision in *Bakersfield Energy Partners*, the issue again came before the Tax Court in *Beard v. Commissioner (August 11, 2009)*. As expected, the Tax Court held that this issue is resolved in the Ninth Circuit. The six year statute of limitations does not apply to the overstatement of the tax basis of an

asset. Taxpayers have generally not fared well in the litigation over tax shelter types of transactions. However, on this procedural issue, so far they are doing very well.

IRS Clarifies Income Tax Consequences of Sale of Life Insurance Policy

A large market has developed for the purchase and sale of life insurance policies. An individual who has a life insurance policy he believes he no longer needs may be able to sell the policy to investors that are interested in holding the policy as an investment and ultimately collecting the death benefit. The investors pay all premiums due on the policy after their purchase. Depending upon the age of the insured at the time of the sale, he may receive a significant percentage of the death benefit amount as the sales price. You generally have to be over 65 years of age for a financial buyer to be interested and of course, the older you are, the more the buyer will pay because they will expect to collect the death benefit sooner. Until recently, there was uncertainty as to how the tax law applied to these sales transactions. The major issue was whether any gain recognized by the seller was capital gain or ordinary income.

The IRS recently issued guidance on these issues. In *Revenue Ruling 2009-13*, the IRS addressed the income tax consequences of both surrendering a policy back to the insurer and selling it to an investor group. Where the policy is surrendered to the insurer, any payment received that is in excess of the insured's tax basis in the policy is treated as ordinary income. For these transactions, the insured's tax basis is the full amount of the premiums he has paid on the policy up to the time of the surrender, reduced by any untaxed amounts that he had withdrawn from the policy.

The treatment of sale transactions is different. First, the IRS said that the insured's basis in the policy must also be reduced by the portion of the premiums paid that is attributable to the "cost of insurance" under the policy. Many tax experts believe this position on the part of the IRS is not correct. The portion of the insured's gain that does not exceed the cash surrender value of the policy at the time of sale is taxed as ordinary income. Any gain above that amount is treated as long term capital gain. The ruling illustrates these principles with an example. The insured had paid total premiums of $64,000 on the policy, out of which the cost of insurance was $10,000. He had not received any distributions. The cash surrender value was $78,000 and he sold the policy for $80,000. The IRS said his tax basis was the premiums paid of $64,000 reduced by the cost of insurance of $10,000 leaving a tax basis of $54,000. This resulted in tax gain of $26,000. Of this amount, $14,000 was ordinary income, determined as the difference between the cash surrender value of $78,000 and the total premiums paid of $64,000. The remaining gain of $12,000 was capital gain. On the facts of the ruling it was long term capital gain because the insured had held the policy for more than one year.

The conclusion by the IRS that the gain in excess of the cash surrender value amount is capital gain is of course what everyone connected with this industry, as well as those who have sold policies or may be contemplating such sales, had been hoping would be the result. The certainty that capital gain is available to the sellers may make these transactions even more attractive for those who have life insurance policies they no longer need.

> Where a policy is sold to a third party, any gain in excess of the cash surrender value is taxed as capital gain.

New York City Tax Changes

Here are a few recent changes to various New York City ("NYC") taxes:

NYC has amended its business income taxes to apportion income to NYC based on a single sales factor. The change will be phased in over 10 years beginning in 2009. When fully phased in, this will be consistent with the New York State apportionment rule.

- Beginning in 2009, combined NYC general corporation tax returns are required where there are substantial inter-company transactions among related corporations, even if those transactions are at arm's length. The $300 dollar minimum tax

is being replaced with a graduated minimum tax (from $25 to $5,000) based on the corporation's gross receipts allocable to NYC. The maximum tax on capital has been increased from $350,000 to $1,000,000.

- Additional NYC tax credits eliminate any NYC unincorporated business tax on unincorporated businesses with taxable income under $100,000 and reduce the tax on those businesses with taxable income under $150,000.
- The NYC sales tax rate was increased to 4.5%, bringing the total sales tax rate in NYC to 8.875%.
- Finally, a REMINDER that the first New York Metropolitan Commuter Transport Mobility Tax payment is due on November 2, 2009. Earlier this year, New York adopted the Metropolitan Commuter Transportation Mobility Tax, which imposes a 0.34% tax on an employer's payroll for employees whose services are allocated to the Metropolitan Commuter Transportation District (consisting of NYC, and Rockland, Nassau, Suffolk, Orange, Putnam, Dutchess and Westchester counties). The tax also applies to an individual's self-employment income that is allocable to these areas. The first payment of such tax is due on November 2, 2009, with respect to the first three-quarters of 2009, and the balance is due on February 1, 2010. A partnership is required to make the payment (with respect to partnership income) on behalf of any nonresident partner unless the payment is $300 or less, the partner is included in the partnership's group filing, or the partner submits to the partnership a Form MTA-405-E, Certificate of Exemption from Partnership Estimated Metropolitan Commuter Transportation Mobility Tax paid on Behalf of Nonresident Individual Partners (not yet available) certifying that the partner is paying the tax individually.

California Budget Contains Minor Tax Changes

As part of its attempt to narrow the budget gap, rather than raising tax rates which would have been politically unpopular, the California legislature enacted measures to allow the State to collect income taxes more rapidly. Beginning November 1, 2009, the wage withholding tables will be revised to increase the withholding amounts by 10%. For supplemental wages (*i.e.*, overtime, commissions, retroactive salary increases), the withholding rate will increase from 6.0% to 6.6% and for stock options and bonuses, the withholding rate will go from 9.3% to 10.23%.

Estimated tax payments are also accelerated. In 2009, the quarterly payments (April, June, September and January) are 30%, 30%, 20% and 20%. Beginning in 2010, they will be 30%, 40%, 0% and 30%.

The income tax brackets in California are indexed for inflation. The Franchise Tax Board has just reminded us that this can work both ways. Because the California Consumer Price Index showed a deflation rate of -1.5%, the brackets have been adjusted for 2009 so that the threshold where a taxpayer begins to pay tax at the next higher rate is lower than it was for 2008. The amount of the standard deduction, also inflation indexed, declined as well. For 2009, the standard deduction amount is $7,274 for a joint return, compared to $7,384 for 2008.

A Reminder: Partners Must Pay Tax on Partnership Income Whether or Not Cash Is Distributed to Them

A recent Tax Court case provides an important reminder of an issue that can be overlooked. A partnership is a very different tax animal than a corporation. A corporation pays its own tax on its taxable income and its shareholders do not pay any tax except to the extent that the corporation makes dividend distributions to them. Such is not the case with partnerships. Partnerships do not pay any income tax. Instead, their partners each include their share of the partnership's taxable income on their own tax returns and must pay any additional income tax that results.

In *Les Hicks v. Commissioner, (May 7, 2009)*, the taxpayer was a member of a limited liability company that was treated as a partnership for income tax purposes. His share of the company's taxable income was $54,819 but he did not receive any cash distributions from the company. He did not include this amount on his 1040 for that year. He argued in court that he should not have to pay tax since he did not receive any distribution. The court told him that the law is clear that he did have to pay tax and upheld the tax assessment and the assessment of the 20% accuracy penalty.

There is nothing new or unique about this case as this has always been the law. It does however, provide an important reminder. If you ever invest as a partner in a partnership that you do not control, you should insist that the partnership agreement contain a provision that requires the partnership to make cash distributions each year of an amount at least sufficient to enable the partners to pay their taxes on their shares of the partnership's taxable income. These provisions are called "tax distribution clauses" and while they are very important, they can also be very complex and can cause unintended consequences if they are not properly drafted. This is an area where you need competent legal advice.

If you ever invest as a partner in a partnership that you do not control, you should insist that the partnership agreement contain a provision that requires the partnership to make cash distributions each year of an amount at least sufficient to enable the partners to pay their taxes on their shares of the partnership's taxable income.

Sale of Excess Lots Resulted in Capital Gain

A recent Tax Court case addressed a situation we have seen on several occasions. In *Rice v. Commissioner (June 16, 2009)*, the taxpayers bought 14.4 acres of property in Austin, Texas to build their "dream home." While they initially intended to retain the entire parcel, the wife later decided she would feel too isolated living on such a large property. They subdivided the parcel into 10 smaller lots and built their home on one of them. They sold one of the excess lots to friends in 2000. In 2002, they placed a wooden sign at the entrance to their subdivision advertising lots for sale. This was the only advertising they did and their subsequent sales were mostly through word of mouth. In 2004, they sold three more lots to friends and to the wife's sister and her husband. By 2008, they had sold the remaining lots to friends and acquaintances, after reserving one lot for their daughter. The taxpayers claimed capital gain treatment for all of these sales.

The IRS claimed that the lots sold in 2004 gave rise to ordinary income because the sales were made in the ordinary course of the taxpayers' trade or business. The Tax Court held in favor of the taxpayers that they were entitled to report their gain as capital gain. Several factors went into the court's reasoning: i) they originally intended to use the entire property for their own residence; it was not purchased with a view to subdividing it; ii) between 2000 and 2008, they sold on average only one lot per year; iii) they engaged in only very limited advertising and marketing activities; and iv) they both had full time jobs and devoted little time to the sale of the excess lots.

If you are in this situation, you obviously will enhance your chances of obtaining capital gain treatment if you can minimize the marketing and advertising that you do to sell the excess lots. Sales by word of mouth to friends or acquaintances are clearly preferable. Stretching the sales out over multiple tax years will also be helpful.

Charitable Lead Trust's Use of Stock to Pay Annuity to Charity Results in Taxable Gain to the Grantor

The IRS recently addressed in a private ruling *(PLR 200920031)* the income tax consequences of a charitable lead annuity trust ("CLAT") using appreciated property to make one of the annual required annuity payments to the charity. The taxpayer had set up a lifetime grantor CLAT which provided that a charity was entitled to receive an annual payment for 20 years that was equal to a stated percentage of the initial value of the assets transferred to the trust. The ruling does not say what happened to any trust assets remaining after 20 years but normally they would go to the taxpayer's children.

The trust instrument provided that the taxpayer reserved the right to withdraw property from the trust without the consent of any other party and replace the property with other property of equivalent value. This power caused the trust to be treated as a "grantor" trust under IRC Section 675(4). A grantor trust is one where the trust's items of income and deductions are reported by the grantor of the trust on his own tax

return, as though he still owned the assets that gave rise to the income and deduction items.

Lifetime charitable lead trusts are usually set up to be grantor trusts because IRC Section 170(f)(2)(B) provides that the grantor of the trust is not entitled to any income tax deduction attributable to the property he puts into the trust unless the trust is a grantor trust. If the trust is a grantor trust, as this one was, the grantor receives an income tax deduction equal to the actuarial value of the term interest the charity will receive over the 20 years. The grantor gets his deduction in the year he transfers the property to the trust, and then each succeeding year he must report the trust's income and deductions on his own tax return and does not receive any further charitable contribution deduction. In effect, he gets a large deduction in the first year and then pays it back by reporting the trust's income over the term of the charitable interest.

The value of the remainder interest is a taxable gift to his children, but where the charitable lead interest goes on for 20 years, the gift amount is usually very small. If the trust assets grow at a rate in excess of the discount rate that was required to be used to determine the value of the remainder when the trust was created, there will be an untaxed surplus remaining for the children upon the termination of the charitable lead interest.

In his ruling request to the IRS the taxpayer/grantor asked the IRS to rule that he would not have to recognize any capital gain if the trust transferred an appreciated asset to the charity to satisfy one of the annual payments. For authority, the taxpayer relied on Rev. Rul. 55-410 which held that the use of an appreciated asset to satisfy a pledge to a charity did not cause the donor to recognize a capital gain as though he had sold the property. However, the IRS did not believe this was the same case. The IRS said the key to Rev. Rul. 55-410 was that the pledge to the charity did not constitute a debt of the taxpayer. Here, the charity has a claim against all of the trust's assets and the IRS said that is the same thing as a debt. If appreciated property is used to satisfy one or more of the payments, the trust and its grantor will be required to recognize any resulting capital gain.

The lesson here is simply that the trust should not use appreciated assets to make the annual annuity payments to the charity. If the trust does not have enough cash to make the payment to the charity, the grantor can use his power of substitution to take out assets and put in cash of an equivalent amount. The withdrawal of assets by the grantor does not cause capital gain to be recognized because the grantor of the trust is already treated as the owner of those assets for income tax purposes.

More Mixed Results in Litigation of Family Limited Partnership Cases

The enormous tax dollars at stake in connection with valuation discounts for estate and gift tax purposes is evidenced by the never ending stream of family limited partnership cases. The cases we report on here all came out since our last edition was published in May.

Taxpayers lost two cases in the United States District Court in Washington State that, frankly, they should have lost. They simply tried to do everything too quickly. In both *Linton v. United States (July 1, 2009)* and *Heckerman v. United States (July 27, 2009)*, the taxpayers transferred assets to family limited partnerships and then made gifts of interests in the partnerships on the same day. Under these circumstances, the taxpayers were unable to conclusively prove that what they had given away was a partnership interest rather than the underlying assets themselves. You simply must allow some time to pass between the transfer of assets to the partnership and the gift of partnership assets. The cases have taught us that more time is required for assets whose value is not very volatile than it is for assets whose value is highly volatile.

In *Estate of Miller v. Commissioner (May 27, 2009)*, the taxpayer got a mixed result in the Tax Court. The case did not involve the valuation of a gift but instead the value of a retained partnership interest in a decedent's estate. The estate claimed a 35% discount for the value of the partnership interest. The IRS did not challenge the amount of the discount but instead argued that the underlying assets the decedent had transferred to the partnership should be brought back into the decedent's estate pursuant to IRC Section 2036(a). This section requires a decedent's estate

to include for estate tax purposes the value of any asset the decedent had transferred during his lifetime but retained: i) the right to receive income from the property; ii) the right to possession or enjoyment of the property; or iii) the right to designate the persons who will have the right to receive income from or possess or enjoy the property. There is an exception for transfers that constitute bona fide sales for adequate and full consideration. In order for a transfer to a partnership to qualify for the bona fide sale exception, the courts require the existence of a legitimate and significant non-tax reason for the creation of the partnership. Much of the recent litigation has focused on this very issue.

In order for a transfer to a partnership to qualify for the bona fide sale exception, the courts require the existence of a legitimate and significant non-tax reason for the creation of the partnership.

In this case, the transfers at issue were made by the decedent at two different times. The first transfers were made in April of 2002 when the decedent was in good health for her age. The second transfers were made in May of 2003 when the decedent was hospitalized for congestive heart failure. She died on May 28, 2003. The Tax Court found that the April 2002 transfers qualified for the bona fide sale exception to IRC Section 2036(a) because at that point the purpose of the partnership and the purpose of her transfer of additional assets to the partnership was to provide for a continuation of her late husband's investment approach and philosophy. However, the court found that the May 2003 transfers were simply an acknowledgement of her rapidly declining health and a desire to try to capture an estate tax discount with respect to the assets transferred. As with the cases discussed above, it mostly came down to a question of timing.

More recently, in *Pierre v. Commissioner (August 24, 2009)*, the Tax Court addressed for the first time the question of how to treat the gift of an interest in a single member limited liability company. For income tax purposes, a limited liability company with only one member is disregarded as an entity separate from its owner. Its owner is treated as the tax owner of any assets that are actually owned by the limited liability company. Does the same rule apply for estate and gift tax purposes? If it does, then no fractional interest discount would be available where the decedent or the donor owned or transferred an interest in a limited liability company.

In this case of first impression, the Tax Court held that for gift tax purposes, the asset to be valued was the interest in the limited liability company rather than the underlying assets. The court based its decision on the 1940 decision by the United States Supreme Court in *Morgan v. Commissioner*, where the Court held that you look to state law to determine the nature of the underlying property rights and then you apply principles of federal tax law to determine the consequences of transactions involving such property rights. Under state law, the taxpayer owned an interest in a limited liability company; she did not own the underlying assets after they were transferred to the limited liability company.

The taxpayer is not yet home free, however. The Tax Court left an important timing question for a separate, yet to be issued opinion. The taxpayer transferred cash and marketable securities to the single member limited liability company on September 15, 2000. Twelve days later on September 27, 2000, she made gifts of interests in the company to trusts for her children and sold additional interests to the trusts. She claimed, based upon an appraisal, a 30% valuation discount for both the gifts and sales. The IRS claims that the step transaction doctrine should be applied to essentially ignore the transfer of the cash and securities to the limited liability company and simply treat the gift as being of those assets. The second opinion will also address the propriety of the 30% discount.

This case establishes an important concept. That is, although the entity classification rules apply for all federal tax purposes, they do not determine the nature of the property rights that are subject to estate and/or gift taxes. You must still look to state law to identify the underlying property rights. This case was considered by the full court and it was a split decision. A total of ten judges voted for the result but the other six, including the current chief judge, thought that the single member limited liability company

should also be disregarded for purposes of identifying the assets that were transferred.

> Although the entity classification rules apply for all federal tax purposes, they do not determine the nature of the property rights that are subject to estate and/or gift taxes.

State law also loomed large in the final case on which we report. In *Keller v. United States (August 20, 2009)*, the United States District Court for the Southern District of Texas handed a Texas taxpayer a huge victory. The case deals with the substantial estate of Mrs. Maude O'Connor Williams. Mrs. Williams had signed a limited partnership agreement in her hospital room shortly prior to her death. She had not signed any document or other writing that transferred any assets into the partnership. A corporation was the general partner of which she was the initial sole shareholder. She also signed the organization documents for this corporation in her hospital room. The two limited partners were trusts of which she was the trustee. In other words, Mrs. Williams was the only party who signed the limited partnership agreement.

Upon Mrs. Williams' death, her advisors initially believed that the partnership had not been funded and that no discount could be claimed on her estate tax return attributable to the partnership. Her accountant later changed his mind about this when he attended an estate planning seminar. Although no discount was claimed on the original estate tax return, the estate subsequently filed an amended return and claimed a refund of estate tax based upon taking a valuation discount for the partnership interests. The estate filed suit when the IRS refused to grant the refund. The estate probably adopted the strategy of claiming the discount by way of a refund claim to avoid the imposition of penalties if it lost the case.

The court found that the bona fide sale exception was applicable as the partnership was formed for significant non-tax purposes, the principal one of which was to protect the family assets from spouses in the case of divorce proceedings. This, however, was not the most significant holding of the case. The court also held that the record in the case clearly established that Mrs. Williams intended to transfer a bond portfolio to the partnership, even though she never signed anything to do so. Under Texas law, the court said that if someone intended an asset to be owned by a partnership, it was then owned by the partnership. The court cited several Texas court decisions but did not cite any statutory authority for this proposition. Then, the court found that Mrs. Williams had a contractual obligation (apparently oral) to transfer the stock of the corporate general partner to certain of her children and grandchildren. The fact that she was not treated as owning or controlling the general partner no doubt resulted in a larger discount.

In a further victory for the taxpayer, the court also allowed a deduction from the gross estate for all of the interest that would become due on a loan the partnership made to the estate to enable it to pay its estate taxes. This type of loan is commonly called a *Graegin* loan, after the first case that approved the estate tax deduction for the interest.

It is hard to even imagine the creative (abusive?) uses tax advisors may try to make of a holding like this. It took the judge two and one-half years to come out with his decision after the trial concluded, so maybe he struggled with the result. The IRS can appeal this decision to the United States Court of Appeals for the Fifth Circuit. It remains to be seen whether this happens and whether the District Court's holding stands up. It is also not clear how many states other than Texas have a law that permits a partner to "will" property to be owned by the partnership.

Foreign Bank Account Reports – Impending September 23, 2009, Deadline for Certain Delinquent Filings

In our High Net Worth Family Tax Report of August 13, 2008, we reminded you of the filing requirement of Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR"), for U.S. persons with a financial interest in, or signature authority over, foreign bank and financial accounts that have aggregate balances over $10,000 at any time during a calendar year. Much has transpired over the past year with respect to the FBAR and we want to summarize for you the noteworthy events.

In October 2008, the IRS published a revised FBAR form and instructions. Some of the more significant changes or clarifications included in the revised form are: (1) broadening the definition of a U.S. Person required to file (which had been limited to U.S. citizens, residents, or domestic entities) to include anyone (U.S. or non-U.S.) "in and doing business in the United States"; (2) providing that a U.S. settlor of a trust (U.S. or non-U.S.) for which a trust protector has been appointed is considered to have a financial interest in each foreign financial account for which the trust is the record or legal title holder (with trust protector defined as "a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee"); and (3) requiring that a U.S. person with signatory authority over a foreign account in which a non-U.S. person has a financial interest identify the person with the financial interest.

In March 2009, the IRS created a new penalty framework for those eligible persons who voluntarily disclose previously unreported foreign financial accounts and entities. This framework, referred to here also as the Voluntary Compliance Initiative, can significantly reduce the civil penalties that may be imposed for failing to disclose foreign accounts or foreign activities for eligible persons who voluntarily come forward by September 23, 2009. The IRS has stated that those who voluntarily file under the Voluntary Compliance Initiative generally eliminate the risk of criminal prosecution. To take advantage of the penalty framework, taxpayers who meet the eligibility requirements must: (i) pay all taxes and interest on their offshore accounts going back six years; (ii) file or amend all relevant information returns (including the foreign bank account report); (iii) pay either an accuracy-related penalty or a delinquency penalty on all six years; and (iv) in lieu of all other applicable penalties, pay a 20 percent penalty (reduced to 5% in certain cases) on the amount in the foreign bank account in the year with the highest aggregate account or asset value. The IRS recently released on its Web site an optional offshore voluntary disclosure form designed to streamline the process for applying under the Voluntary Compliance Initiative.

The IRS "strongly encourages" those taxpayers who have previously filed amended returns for previously unreported offshore income without otherwise notifying the IRS directly (a so-called "quiet disclosure") to come forward under the Voluntary Compliance Initiative, suggesting that those who do not may be subject to examination and possibly criminal prosecution.

On May 6, 2009, the IRS released a list of frequently asked questions ("FAQ") about its Voluntary Compliance Initiative, and has updated it several times. The FAQ can be found at http://www.irs.gov/newsroom/article/0,,id=210027,00.html. The Voluntary Compliance Initiative applies to taxpayers who failed to report taxable income from the foreign accounts and entities. In the FAQ, the IRS has made it clear that taxpayers who properly reported all taxable income but merely failed to file FBARs should not use the Voluntary Compliance Initiative process, but the IRS will not assess penalties for the failure to file the FBARs if the delinquent FBARS, presumably back to the 2002 calendar year, are filed by September 23, 2009. In the FAQ, the IRS "strongly encourages" those taxpayers who have previously filed amended returns for previously unreported offshore income without otherwise notifying the IRS directly (a so-called "quiet disclosure") to come forward under the Voluntary Compliance Initiative, suggesting that those who do not may be subject to examination and possibly criminal prosecution.

On June 5, 2009, the IRS temporarily suspended the FBAR filing requirement for those persons who are not U.S. citizens, residents, or domestic entities. Also in June, the IRS officially came forward with their position that investments in foreign hedge funds and private equity funds are "commingled funds" that are reportable for FBAR purposes. This came as a surprise to most tax practitioners and was considered to be a departure from previous IRS practice and not supported by the FBAR instructions, which is essentially the extent of the written guidance avail-

able. Unofficial comments made by IRS personnel also suggest that the IRS believes interests in foreign partnerships and foreign corporations used by investors to commingle funds for investments are reportable financial interests regardless of the ownership percentage. The tax bar as a whole made a concerted effort to seek guidance from the IRS on this topic before the filing due date for 2008 FBARs.

On June 24, 2009, the IRS announced that it would extend the due date for 2008 FBARS from June 30, 2009, to September 23, 2009, for filers who (1) have "only recently learned" of their FBAR filing obligation, (2) have "insufficient time to gather the necessary information to complete the FBAR," and (3) have reported and paid the tax on all their 2008 taxable income (or will report and pay the tax if the return is not due before the extended filing date). While it is unclear who would qualify as having "only recently learned" of the FBAR filing obligation, arguably, persons with interests in foreign hedge funds or foreign private equity funds should qualify, given the previously held position of, and advice given by, many within the tax community that such interests are not reportable accounts. Persons eligible for this extended due date should not be assessed FBAR penalties if the FBARs are properly completed and filed by September 23, 2009.

Most recently, on August 7, 2009, the IRS issued Notice 2009-62 (the “Notice”), which provided a further extension to June 30, 2010, for FBARs relating to 2008 and earlier calendar years for (i) persons with signature authority over, but no financial interest in, a financial account; and (ii) persons with a financial interest in, or signatory authority over, a foreign financial account in which the assets are held in a commingled fund. These “foreign commingled funds” likely include an offshore hedge fund or a U.S. feeder fund investing in an offshore hedge fund. Treasury intends to publish regulations clarifying the FBAR filing requirements pertaining to persons covered by the Notice and has requested comments from practitioners. Persons eligible for this extended due date should not be assessed FBAR penalties if the FBARs are properly completed and filed by June 30, 2010.

The federal civil penalties for the willful failure to file the FBAR are severe – they can be as high as the greater of $100,000 or 50% of the amount in the account at the time of the violation, and for each year the FBAR is not filed. Some states may have similar penalties. There are also criminal penalties for willful violations. The civil penalties for the non-willful failure to file an FBAR, not due to reasonable cause, may be as high as $10,000 for each non-willful violation. The FBAR penalties are in addition to the tax penalties that could apply if taxable income from such unreported (or any reported) accounts were not properly included on the taxpayer’s U.S. tax returns.

The Voluntary Compliance Initiative may provide significant relief as to both FBAR and tax penalties for taxpayers that are entitled to its provisions and, as discussed above, the IRS has provided for FBAR penalty relief in certain other cases. The deadline for filing under the Voluntary Compliance Initiative and for some taxpayers filing delinquent FBARS is approaching quickly – September 23, 2009. Those taxpayers who want to participate in the Voluntary Compliance Initiative but cannot get all of the information together to file the required amended returns by the due date can still participate by notifying the IRS before September 23, 2009. The IRS will give those persons reasonable time to submit their information and file returns.

If you have questions about the application of the Voluntary Compliance Initiative, the announcements or the Notice discussed above, or you think you may have unreported taxable income from foreign accounts and/or entities or just unreported foreign financial accounts for 2008 or prior tax years, we suggest that you contact your accountant to review your potential filing obligation and the filing options available to you.

As a reminder, most states require taxpayers who file an amended federal tax return to also file an amended state return. The IRS and the states have an information sharing arrangement under which the IRS shares information with the states and vice versa. Accordingly, any taxpayer who files amended returns under the Voluntary Compliance Initiative to correctly report income related to offshore bank accounts or other offshore activity should also be filing amended state tax returns at the same time.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

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