2017 WL 10774863 (D.Conn.) (Expert Report and Affidavit)
United States District Court, D. Connecticut.

UNITED STATES OF AMERICA, Plaintiff,
v.
Diane M. GARRITY, Paul G. Garrity, Jr., and Paul M. Sterczala, as fiduciaries of the Estate of Paul G. Garrity, Sr., deceased, Defendants.

No. 3:15-cv-243(MPS).
April 28, 2017.

Expert Report Howard B. Epstein of Howard B. Epstein, CPA

Case Type: Tax >> Federal
Jurisdiction: D.Conn.
Name of Expert: Howard B. Epstein, C.P.A.
Area of Expertise: Accounting & Finance >> Taxation

Representing: Defendant

I have been engaged to prepare this Report in connection with the above captioned litigation. I have been asked to opine on the general reporting requirements as they relate to Foreign Financial Accounts and Foreign Trusts as well as the general guidance published by the Internal Revenue Service, the Department of Treasury, and FinCen explaining the rules and reporting requirements to taxpayers and practitioners relating to such vehicles for the year the subject penalty is asserted (2005), as compared to years before and after.

I am a director of Freed Maxick CPAs PC in Buffalo New York and a certified public accountant with over 25 years of experience. My practice is heavily focused on international tax planning and compliance for clients ranging from multinational companies to individual taxpayers and I am qualified to render the opinions set forth herein. My curriculum vitae is attached hereto as Attachment 1. In developing my opinions I reviewed documents submitted relevant to the litigation including deposition testimony and documents relating to the subject trust. Defense counsel has provided me with access to all documents exchanged between the parties and procured in discovery in this matter, and I determined which materials were pertinent to my inquiry and opinion herein. I also reviewed various tax treatises and publications.

My firm's compensation is determined based on an hourly rate ($420) for my time expended on this engagement and is not contingent on any action or event resulting from my conclusions or the use of this report.

I have not provided expert testimony in any court within the previous four years.

I. Introduction

The defendant in this litigation, Paul G. Garrity, Sr., was an employee of a U.S. company, Garrity Industries, Inc. The complaint alleges that he established a Liechtenstein Stiftung for which he was the primary beneficiary in 1989. The complaint states that Mr. Garrity failed to report his ownership of the foreign bank account related to the Stiftung on a timely filed Form TD-F 90-22.1 Report of Foreign Bank and Financial Accounts ("FBAR") for the calendar year 2005 (due June 30, 2006). Mr. Garrity passed away in early 2008. The complaint asserts that Mr. Garrity should have

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known of the requirement to report his interest in the Stiftung as set forth above, and that his failure to report it or tell his accountant about it in 2006 was therefore willful or reckless. The complaint is seeking penalties and interest in the amount of $1,061,181 under 31 U.S.C., plus statutory accruals from February 20, 2015 until the liability is paid in full.

Since Mr. Garrity is deceased, the parties cannot ask him about his understanding of his filing requirements. The government asserts that Mr. Garrity should have known of his filing requirements and willfully or recklessly ignored them. The defense has asked me to opine on the state of published guidance and public awareness of such reporting requirements so as to provide an objective backdrop or perspective on the inquiry. In that context, my report focuses on the state of published guidance during the year at issue and how such guidance evolved in the years before and after the subject year, and how, in that climate, international tax compliance has been viewed and understood by practitioners and taxpayers during this time period. Based on this overview, I offer my professional opinion on whether an individual taxpayer could have been unaware of his filing foreign income and asset reporting requirements.

II. Traditional Uses of Foreign Bank Accounts

To begin my analysis of reporting requirements for U.S. owners of foreign accounts, it is important to note that ownership of foreign financial accounts or foreign legal entities is not unlawful. There are many legitimate reasons why a U.S. person would choose to own a foreign entity and/or hold foreign financial assets. Those reasons include, but are not limited to, the following:

• To facilitate holding and managing property in another country

• Minimize domestic or international probate when you die

• Provide some asset protection

• Provide for investment diversification

• Operate an active business

• Dilute political risk

• Better access to funds in the event of a financial shock

• Currency diversification

• Higher interest rates for deposits

• Ensure access to medical care abroad

• Ease of transfer of money abroad

• Asset Protection

• U.S. citizens living and working abroad need local financial accounts

III. The Trust Vehicle at Issue in this Case

The subject vehicle in this case is a Liechtenstein Stiftung. A Stiftung is an institution or foundation through which a founder conveys assets or property to pursue a particular purpose, in many instances to ensure continuation of family assets. Generally, the founder will state the objective of the Stiftung and then appoint its administrators. All of this is typically set forth in the articles of association (also called "statutes"). So, the assets with which the foundation is endowed become part of a separate legal entity.

A Stiftung foundation can have beneficiaries, and in that way it is similar to a trust. The founder has the right to transfer or terminate the foundation, and he can authorize a power of attorney to act on his behalf with respect to the vehicle.

Stiftungs are relatively common and can be traced back to the time of Plato. Many U.S. citizens have established Foundations or Stiftungs in Liechtenstein. Stiftungs can be attractive financial vehicles because they offer:

• Preservation of property and capital for generations.

• Financial assistance to family members and may be set up to make regular payments to family members granting education, maintenance or housing - even when the founder is no longer alive.

• Ability to hold assets that would otherwise be inherited directly by minor children and grand-children until they reach the age of majority or other designated age for distribution.

• Ability to hold art collections or collections of other valuables so that the collection is kept together and not sold.

• Asset protection in the case of loss of mental capacity.

• A vehicle to carry on scientific, philanthropic, religious, or humanitarian purposes or to manage assets or funds to grant such activities.

• Protection of the assets of a founder against political and other instabilities.

• Protection of the assets against litigation or U.S. Court judgment

Liechtenstein had been a popular jurisdiction for U.S. investors because of its banking secrecy laws and discretion. However, due to increased international pressure, Liechtenstein made several revisions to its Foundations Law which were first proposed in 2004 and ratified in 2008. The new law increased requirements for transparency in reporting on activities and holdings to settlors and beneficiaries.

Perhaps the most difficult aspect for a U.S. taxpayer and their tax preparer is determining how to report the activity and holdings of a Liechtenstein Stiftung for U.S. tax purposes. In *Estate of Swan v. Commissioner of Internal Revenue,* 24 T.C. 829 (1955), acq.,1956-2 C.B. 8, aff'd in part and rev'd in part on other grounds, 247 F.2d 144 (2d Cir. 1957) the Tax Court found that Stiftungs organized in Liechtenstein (and Switzerland) should be treated as trusts for tax purposes. However, as recently as 2009 an IRS Chief Counsel Memo was issued stating their position that tax classification of a Stiftung must be done on a case by case basis but generally they would be classified as trusts. Office of Chief Counsel, Internal Revenue Service Memorandum Number: AM2009-012, Release Date: 10/16/2009; subject: Entity Classification of Liechtenstein Anstalts and Stiftungs. The Chief Counsel Memoranda illustrate to some degree the lack of certainty within even the IRS as to the treatment of the Stiftung.

IV. Foreign Bank Account Reporting ("FBAR") -An Overview and Brief History

The laws dealing with the disclosure of foreign bank or financial accounts took effect in 1970. These requirements were established by the Currency and Foreign Transaction Reporting Act of 1970 (a/k/a the Bank Secrecy Act), part of which is codified in Title 31 of the United States Code. Enforcement of these laws was originally the responsibility of the Financial Crimes Enforcement Network (FinCEN).

It wasn't until the Patriot Act was enacted in 2001 that the Federal government made the reporting requirements a higher priority. The Secretary of the Treasury had developed Form TD F 90-22.1 “Report of Foreign Bank and Financial Accounts” (commonly referred to as Foreign Bank Account Reporting or FBAR) as the vehicle that taxpayers should use to report their foreign bank or financial accounts.

The Patriot Act also required the Secretary of the Treasury to provide annual reports on methods to improve compliance with FBAR reporting. In the initial report provided in April 2002, the Secretary of the Treasury reported that FBAR compliance was potentially below 20% and that enforcement was virtually nonexistent.

The Treasury report provided recommendations for improving compliance such as:

• Update and improve the FBAR form and instructions

• Review filing and processing procedures

• Enhance outreach and education to tax practitioners

• Establish a joint task force on enforcement

• Consider delegating penalty authority form FinCen to the IRS

In early 2003, FinCen delegated its authority to enforce FBAR provision to the IRS. The IRS also assumed the responsibility of updating and improving the FBAR form and instructions, reviewing and improving the processing procedures of FBAR forms, and improving outreach and education to practitioners.

In March 2009, the IRS announced the “2009 Offshore Voluntary Disclosure Program” (2009 OVDP). The OVDP was open only through October 15, 2009. In the 2009 OVDP the IRS received 15,000 disclosures prior to the October 15 closing date that year. It resulted in the collection of $3.4 billion in back taxes, interest and penalties. It also led to another 3,000 disclosures after the closing date. The 2009 OVDI provided for a standard miscellaneous penalty of 20% percent on the highest aggregate value of unreported offshore accounts but the IRS, in processing cases, allowed for reduction or full concession of any penalties depending upon the taxpayers' circumstances and tax owed as a result of the disclosure.

In February 2011 the IRS announced the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI). Generally, this Program provided for a 25% miscellaneous offshore penalty on the highest aggregate value of unreported offshore accounts from 2003 to 2010. In addition, some participants were eligible for 5%, 12.5% penalties, or full concession of the penalties, depending on their circumstances or on the severity of their noncompliance. The 2011 OVDI drew 15,000 disclosures and resulted in the collection of $1.6 billion in back taxes, interest and penalties for the cases that were closed that year.

In January 2012 the IRS announced the 2012 Offshore Voluntary Disclosure Program (2012 OVDP).This Program extended the 2011 Program indefinitely and increased the miscellaneous penalty to 27.5% of the highest aggregate value of unreported assets. The reduced penalty regime remained in effect for certain taxpayers who qualified. Effective July 2014, the IRS updated the penalty regime to allow for a 50% penalty in circumstances involving certain foreign financial

institutions that had been publicly identified as being under investigation or were cooperating with a government investigation.

As the Programs progressed, many taxpayers and practitioners voiced concern over the rigidity and applicability of these programs to their circumstances. For example, many U.S. citizens have resided abroad for years, been diligently filing returns and paying taxes in their country of residence, and had no knowledge of their requirements to file U.S. tax returns and FBARs concurrently with their foreign filings. This feedback increased the IRS' awareness that many taxpayers were not necessarily negligent or willful in their failure to report foreign bank accounts, and that the penalties associated with the previous Programs caused taxpayers with reasonable cause to believe that the Programs did not apply to them. So, in June 2012, the IRS added an option that enabled some U.S. citizens and others residing abroad to come into compliance with their reporting and filing requirements with no penalty at all if they owed little or no back taxes. This option, the “Offshore Streamlined Program,” took effect in September of that year. The IRS later added a similar option for non-willful taxpayers residing in the U.S. This option, called the “Domestic Streamlined Program,” offers a miscellaneous penalty of 5% of the highest aggregate balance of the unreported accounts. The IRS also instituted a protocol for so-called Delinquent Taxpayers (individuals who had no unreported income but failed to file FBARs or other informational returns such as 3520's, 3520-As, 5471's, etc.) whereby such taxpayers may simply file the information returns and reports without entering a specific program and thereby avoid penalties.

From 2009 forward the IRS has published guidance to taxpayers wanting to enter into these various programs in the form of Frequently Asked Questions and Answers (FAQs). These FAQs provide an outline of the terms and conditions of the programs, guidance on the application of various components of the programs, explanations of the treatment of certain investment vehicles and assets under the programs, and instructions on how to make disclosures under the programs. Concurrenlty, the IRS has updated its Internal Revenue Manual provisions providing its Revenue Agents with very specific guidelines in proposing statutory penalties for non-filing of an FBAR and guidance relating to the determination that a non-filing was due to reasonable cause. In this regard, an IRS examiner has the ability to either issue an “FBAR warning letter” and assert no penalty, or, alternatively, assert a penalty. IRM 4.26.16.6. The Internal Revenue Manual expressly directs IRS Agents to assert penalties only to promote compliance with the FBAR reporting obligations, and that the examiner should use discretion to determine whether or not a penalty would be appropriate to ensure further compliance. IRM 4.26.16.6. While Internal Revenue Manual protocol does not rise to the level of law, these and other Manual directives illustrate the IRS' acknowledgement that penalties - particularly the harsh willfulness penalty which is at issue here - should be asserted thoughtfully and with full consideration of all of the taxpayers' facts and circumstances.

Indeed, in order to administer the OVDP and its related programs, the IRS and practitioners geared up with substantial training in this area to alert and help IRS Revenue Agents and practitioners understand what is reportable and how to report it. As people learned, compliance increased and people gradually found their way into the right programs. These programs are still in place today to facilitate compliance and the proof is evident in the sheer increase in the number of filings. According to government statistics, the number of FBARs filed has increased from around 116,000 in 1991 to 280,000 in 2005 to over 1,163,000 being filed in 2015. In light of the above, the IRS and practitioners agree that the combination of enhanced and globally-published technical guidance and training on foreign bank account reporting, Voluntary Disclosure Programs to facilitate taxpayers who wish to become compliant, and enhanced enforcement regarding non-compliant taxpayers have contributed to the recent dramatic and sustained increase in FBAR reporting.

V. Foreign Trusts and U.S. Tax Reporting

Trusts In General

Generally, a trust is an arrangement whose purpose is to vest in a trustee the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility. A trust that is

organized in a foreign country and governed by that country's laws and courts is a foreign trust. Determining whether a foreign entity is taxed as a trust or corporation can be difficult. Facts and circumstances must be reviewed to determine the entity's proper tax classification

For U.S. tax purposes, trusts are taxed as grantor or non-grantor trusts. When the settlor or grantor retains an incidence of ownership over the assets transferred to a trust, it is treated as a grantor trust under IRC Sec. 671-679. If a trust is a grantor type trust, its income and capital gains will be taxed to the grantor as if the assets had never been transferred. When the settlor gives up all incidence of ownership over assets transferred to a trust, the trust is taxed as a non-grantor trust. A non-grantor trust is taxed in a manner similar to individuals, whether it is a domestic or a foreign trust. A foreign trust may be taxed as a grantor or non-grantor trust.

Foreign Trust Reporting

Transactions with and income from foreign trusts are reported on Forms 3520 and 3520-A. As with FBARs, Congress and IRS recognized that compliance of U.S. citizens with IRC regulations for reporting ownership of and income from foreign trusts was lacking. In order to improve compliance in reporting of foreign trusts, the 1996 Small Business Act significantly enhanced and modified reporting requirements and penalties for not filing for Forms 3520 and 3520-A.

Transfers to foreign trusts by U.S. persons and annual trust income and expenses must be reported by U.S. owners and beneficiaries on Form 3520. The trustee or U.S. agent must file form 3520-A for foreign trust with a U.S. owner. The foreign trust's income statement is reported in Part II of

Form 3520-A, and must reasonably reflect the trust's income under U.S. income tax principals. Part III of Form 3520-A requires reporting on a fair market value the balance sheet of the trust assets and liabilities. It is often difficult to obtain information regarding income statements and balance sheets as other countries do not have reporting requirements compatable with those in U.S.. This was especially true in the pre-FATCA world and is still a concern today when a U.S. taxpayer is required to prepare a Form 3520-A for a foreign trust. Even now, depending on where a taxpayer's investments are held, it is sometimes impossible to get information needed for proper U.S. tax reporting. This issue arises very often in the context of resolving matters under the OVDP procedures referenced above and often requires practitioners and IRS Revenue Agents working cooperatively to procure information from foreign financial institutions and determine taxable income, if any, under IRS tax principals.

While the 3520 Forms were in existence prior to enactment of the Small Business Act of 1996, compliance was limited. A 2002 Statistics of Income (SOI) report illustrates that in 1990 only 133 Forms 3520 and 291 Forms 3520-A were filed. By 2002, there were 4,676 Forms 3520 and 2,550 Forms 3520-A filed. While this increase represents a significant percentage increase in the number of Forms 3520 filed, it is likely that these numbers still represent a relatively small percentage of the universe foreign trusts with U.S. owners/beneficiaries in existence at that time. However, as with FBAR reporting, increased education, compliance programs, enforcement, and IRS outreach to taxpayers and practitioners significantly increased awareness and compliance with the filing of these forms.

Despite the IRS compliance efforts on foreign trust reporting, there remains substantial uncertainty. Even in 2017, there is much disagreement and confusion among practitioners, due to a lack of clear guidance from IRS, on how to report interests in foreign financial vehicles that could be classified as trusts (see, e.g., debate and discussions on vehicles such as Canadian RESPs and TFSAs as well as Australian Superannuations).

VI. The United States' Presumption that Paul Garrity, Sr. should have known of the U.S. filing requirements with respect to the Lion Rock Foundation

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Lion Rock Foundation

Paul Garrity Sr. established Lion Rock Foundation in 1989 with BIL Corporation as trustees. Upon review of the agreement and by-laws, it is my opinion that the entity established is a Stiftung, as discussed above. The by-laws of Lion Rock Foundation state that Mr. Garrity is the lifetime income beneficiary of the foundation and that he retained the right to amend and revoke the agreement at any time during his life. Upon his death it was to become irrevocable. Because he retained the ability to alter the agreement during his lifetime, the transfer of assets to the Stiftung would not have constituted a completed transfer for gift for U.S. gift tax purposes and no gift tax return would have been required to be filed by Mr. Garrity in 1989 as a result the transfer of assets to Lion Rock Foundation.

Based on the fact that Mr. Garrity retained control over the assets transferred to Lion Rock Foundation, it is my opinion that the entity would have been treated as a grantor type trust for U.S. tax purposes. Further, because the trust is governed by the laws of Liechtenstein, it would have been considered a foreign trust when it was established in 1989. The trustee or U.S. agent of the trust should have reported the trust's annual income and expenses as well as balance sheet on Form 3520-A for years beginning with 1989 and should have complied with the additional reporting requirements that were brought about in 1996 as discussed above. Based on additional information provided, Mr. Garrity was not appointed U.S. Agent of the trust until December of 2004. Therefore, until 2004, U.S. compliance would have been the responsibility of BIL Corporation and certain of its employees over time who comprised the Board of trustees in Liechtenstein. There is no evidence that those trustees filed any forms 3520 or 3520-A for Lion Rock Foundation.

In 2004, Lichtenstein was tightening its laws in light of increased scrutiny by the United States. It appears that, in that same year, LGT had Mr. Garrity sign a form designating him as U.S. Agent but apparently never told him of the responsibilities his status as U.S. Agent entailed, which includes filing the forms 3520-A -- tasks which the Board of trustees had failed to perform. Had the bank or trustees informed Mr. Garrity of the various reporting responsibilities, their significance, the consequences of failing to perform such responsibilities, and their failure to meet the U.S. filing responsibilities for the trust in previous years, he could have been made aware that, *inter alia,* there existed no protection of a statute of limitations on the issue. Furthermore, had the trustees performed their responsibilities, the Forms 3520-As filed would have alerted the IRS and Mr. Garrity of his filing requirements relating to the trust such as Form 3520 and FBAR. Absent the required IRS forms or some other form of communication from the bank or trustees regarding a U.S. person's filing requirements in relation to their foreign financial holdings, it is difficult to see how an individual would know he was supposed to file additional forms with IRS. To illustrate, starting in tax year 1996, the trustees should have supplied Mr. Garrity with a Grantor Tax Information document from Lion Rock Foundation, and he should have reported the trust's net income, if any, as reported on that document, on Form 3520 and filed that form with his annual tax returns.

It appears that Paul Garrity Sr. was becoming less involved in his business matters around 1990. Documents reviewed in relation to the litigation indicate that Paul Garrity Sr. began divesting himself of ownership in Garrity Industries in favor of his three sons beginning around 1987 and completely released ownership to his sons in or around 1993. In 1994, Mr. Garrity also signed a Power of Attorney allowing his son Kevin to act on his behalf in all matters relating to Lion Rock Foundation. Kevin Garrity was also, along with his two brothers, a beneficiary of Lion Rock.

Should Paul Garrity Sr. have known of his requirements to report the Stiftung?

As illustrated in the statistics presented above regarding the few Forms 3520 and 3520-A filed in 1990, the foreign trust filing requirements were not well-known when Lion Rock Foundation was established in 1989. Even in 2004, when Mr. Garrity was designated U.S. agent of Lion Rock Foundation, tax reporting for foreign trusts was not as well-known as it would be by the late 2000's. The number of Forms 3520 and 3520-A nearly doubled from 2002 to 2006. By 2006 almost 4,000 3520-A's and 8,000 3520's were filed. The number of these forms filed has continued to increase, with around

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14,000 filed in 2014. The IRS attributes this dramatic increase to its efforts as described above, which include education to practitioners and taxpayers as well as enforcement. In my extensive experience of working with clients and their tax professionals in Voluntary Disclosures to the IRS, my observations confirm Treasury's understanding that education was lacking among even the most experienced tax practitioners. Consequently, taxpayers and tax professionals in general were largely not aware of foreign trust filing requirements until widespread, IRS published guidance regarding FBAR compliance, the onset of FATCA legislation and the various Offshore Voluntary Disclosure initiatives and programs brought foreign financial asset reporting to the forefront of information available for tax compliance to practitioners and taxpayers.

It is my understanding that the United States contends in this matter that Mr. Garrity should have known of these reporting requirements and that he was willful or reckless in failing to report such interest or in failing to bring such interest to the attention of his accountant in 2006. Mr. Garrity is deceased and, consequently, we cannot ask him these questions or inquire about the details of his knowledge. We do know that Mr. Garrity was a well-educated man who, for much of his adult life, owned and managed a profitable multi-national business. However, it is important to understand that the determination of Treasury and the IRS that published guidance and education is necessary to curb the dramatic lack of compliance on foreign bank account reporting was in fact substantially directed at tax practitioners and business people. Indeed, in my OVDP practice group, I have had literally hundreds of contacts from practitioners and business people from 2009 through the present who had been unaware of these requirements- Many of them well educated and successful business people. In my experience, the IRS Revenue Agents I deal with understand this and understand that taxpayer awareness and intent must be determined on a case by case basis premised on the circumstances of each case. There is no presumption of willfulness, recklessness or even negligence, but, rather, that determination must be established through detailed investigation by the case agents, which includes extensive Information Documents Requests and, importantly, interviews with the taxpayers. The training materials that I reviewed as part of this case appear to be consistent with this premise. Moreover, the testimony of the Revenue Agent in this case indicates that many of the facts that she referenced in her submissions to IRS Appeals and referenced in the Complaint as supporting willfulness or recklessness are actually not facts her personal undocumented conjecture.

In light of the above, it is my opinion that, under the applicable published guidance and in practice, the IRS should not and does not determine -- without specific supporting evidence -- that a taxpayer should have known of his foreign bank account reporting requirements. Moreover, the specific Programs, published guidance, articles, and Chief Counsel opinions relied upon herein and discussed above illustrate the state of public awareness of the reporting requirements regarding foreign accounts and foreign trusts as it existed and evolved during 2006, and during the years before and after 2006. Moreover, given the record in this case and the allegations made by the United States, I do not believe that the information presented in this Report is inconsistent with the record or with allegations made by either the Plaintiff or the Defendant in this case.

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