Journal of Forensic and Investigative Accounting
Volume 14: Issue 2, July–December 2022

Tax Fraud Scheme Using Nonresidential Designation by U.S. Taxpayers in the Presence of Multinational Tax Jurisdictions

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Introduction

In this article, we outline a potential fraud scheme, which certain U.S. taxpayers, in the presence of multiple tax jurisdictions, could utilize to evade taxes on their worldwide earned income. We define these 'certain U.S. taxpayers' as U.S. individuals, households or families who hold U.S. residential status but may have social or economic connections to other country, based on holding a dual citizenship status. As we know, U.S. charges tax on individuals based on their citizenship as well as residency (in the absence of citizenship) regardless of the origin of the income. This position makes the U.S. system of taxation quite unique. For the purposes of this study, we address this 'target group' of U.S. tax residents who are either citizens or residents due to their permanent legal status or satisfying the green card timing test. In addition, these taxpayers would be holding citizenship status from another country. There might be circumstances, where we also could argue residential status might be sufficient in the second country. However, to facilitate the discussion in this article, we primarily focus on dual citizenship. In cases with dual citizenship, the determination of the residency is based on the specific tax treaty among the countries involved.

Most of these treaties use the economic and social interests as a key component in determining the residential state. In this article, we present a tax fraud scheme in which the U.S. residential taxpayer would fraudulently claim the other country as their residential state and avoid being considered residents per the U.S. tax code. This claim is fraudulent and provides an opportunity for taxpayer to evade being taxed on a higher rate on their worldwide earned income as well as to avoid certain U.S. financial disclosure requirements.

For the purposes of this article, our taxpayers would be earning income from worldwide sources. These could include international passive investments, international rental properties to name a few. Under the currently established rules, these taxpayers would need to pay taxes in the foreign country as well as in the U.S. In the U.S., they can claim foreign credits for the foreign taxes paid. However, in cases of significant discrepancies between the tax rates among the U.S. and the foreign country, such credits might be insufficient to cover the U.S. tax liabilities. This is especially the case with countries having lower effective tax rates in comparison to the U.S. Also, even without such tax discrepancies, tax credits might be insufficient as the foreign income would be the only source of income and therefore be charged at the initial lower marginal rates (in a progressive type of system). In the U.S., this would be an incremental income and therefore, most likely, it would incur higher marginal tax rates. As the result of this, many taxpayers would look for opportunities to lower their tax liability. Such taxpayers because of their origins might have still ties to their home countries and as the result make frequent travels. Social connections could be established by having permanent residence or family ties. Economic links could be based on the active or passive income generated, regardless of the source of the resources used.

The scheme in question consists of taxpayers selecting a lower tax jurisdiction as their residential state. As tax rates differ across countries, there are incentives for taxpayers to engage in tax evading schemes, reclassifying themselves as nonresidents in their home states when they are residents per tax law, to obtain a more favorable tax treatment. This is especially true in cases where tax rates of the initial residential state are higher than taxes in the potential 'tax evasion' states. Such a scheme could go undetected as there are no proper tools to prevent and/or detect it. U.S. Taxpayer holding a dual citizenship, living in the U.S., could hold that his/her social and economic ties are with the other country of citizenship. As the result, any earnings from that country or from other worldwide sources would be taxed on other country's rates rather than in the U.S. As such, the person could avoid being taxed in the U.S. The potential losses to governments, if the scheme is left unchecked, could be significant. Specifically, they could underscore taxing worldwide earned income as an effective

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tool for taxing residents. As some major countries tax their residents using such systems, the exposure to this fraud scheme has significant implications.

The article starts by identifying the key components necessary for this fraud scheme, as there is the failure to1 pay or a deliberate underpayment of taxes. These components follow a well-established fraud triangle theory. Next, we list steps that tax agencies could take to minimize the risks and impact of the identified fraud. We hope tax authorities take the necessary steps to reduce the likelihood of such occurrences. However, as we note later in the study, this prevention must be done on a broader international level to fulfill the tax compliance of governments. Finally, we provide recommendations for establishing tools for proper detection and prevention.

We provide this analysis and the application of this scheme from U.S. perspective. However, these schemes also could be applied to other countries, and therefore, the conclusions reached here, could have implications for other jurisdictions as well. It is important to note that there might be some discrepancies in the definitions, application, and tax treatment of 'residents' and 'nonresidents' terms per the tax code, case rulings and tax treaties, to name a few. In this paper, as part of our scope limitations, if we identify a person or household as 'resident' based on the tax code, same identifier also would be given/applied to the tax treaty and vice versa. That is, this article does not focus on the different interpretations of 'resident' and 'nonresident' based on the tax code, treaties, and case rulings. We assume, a resident under the tax code is a resident under the tax treaty (and vice versa), and based on this assumption, he/she would be entitled to file their respective tax return, based on this status. There might be circumstances where a resident and nonresident benefits (per tax treaty) would not entitle the person/household to claim their status. However, such circumstances would not be addressed in this study. We believe such are not significant to warrant different conclusions reached in this article.

Fraud and the Fraud Triangle

IRS (25.2511-3) defines fraud as "deception by misrepresentation of material facts, or silence when good faith requires expression, which results in material damage to one who relies on it and has the right to rely on it. Simply stated, it is obtaining something of value from someone else through deceit." IRS has further established specific definitions of fraud under the U.S. federal tax codes (26 U.S. Code 7206—Fraud and false statements). In this code, it lists the type of activities which would constitute tax fraud. In our paper, we believe the fraud scheme violates the following component as defined by the code (IRS 26.7206):

> I.R.C. § 7206(1) Declaration Under Penalties of Perjury:
>
> Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter.

As initially mentioned, the tax fraud scheme in consists of U.S. taxpayers reclassifying themselves as nonresidents when they are residents per tax law, to obtain a more favorable tax treatment. Such reclassification involves willfully making a statement or in our case filing nonresidential tax return, under the penalties of perjury, which ones believe are not true and correct. It is important to discuss the causation of this fraud, and such would be addressed in the next few paragraphs.

There have been many attempts to understand and define the origination of fraud. Researchers have looked at risks, opportunities, and rationale to understand why people commit the acts they do (Hiber, 2017; Kassem and Hugson, 2012; Lou and Wang, 2009). There is no single explanation that fits all. Rather, fraud requires a combination of factors present at any given time. The fraud triangle theory has been one of those attempts. Per this theory, for any fraud scheme to take place, we need to have the three components of a triangle at any given time (Schuchter and Levi, 2016). These three components are incentive, opportunity, and rationalization of the party involved in the scheme (Schuchter and Levi, 2016).

Rationalization

Rationalization looks at the inner self of the person committing the fraud (Schuchter and Levi, 2016). Once people commit any wrongdoing in life, they must justify it to themselves. They must be able to rationalize their actions. If a person lacks such capacity, feels guilty or has been brought up in a social environment where such actions would not be tolerated, it is highly unlikely, other things being equal, that he/she would commit the fraud. As usual, there are always exceptions to this assumption.

It is important to compare and contrast ability of external factors to minimize the exposure to the rationalization risk. For example, companies can design their hiring process to detect people lacking moral standards in the first place. However, this control has its limitations as it is only a snapshot in time. That is, control does not show the behavioral traits that a person would display over a longer period. There are also legal restrictions on the interview questions asked during the hiring process. Therefore, immoral people can fall through the cracks. Even if such personal traits are identified, a company lacks the capacity to modify them, and the only possible outcome is termination. Rather, a company can only modify the factors over which it has control. Rationalization is not one of them. However, in the case of an individual who commits fraud on his taxes, such rationalization and mitigation techniques would not apply. In addition, there are no external factors that could be minimize this risk. However, we do not analyze the rationalization of the individual. That is, we would assume it is present at the time when the potential fraud scheme could occur. We will, therefore, only analyze the incentives and opportunities to engage in this fraud scheme. It is important to pinpoint the potential users of this scheme. These are taxpayers who reside in more than one state and/or country during a given calendar year. In addition, to make this paper more relevant, we will use the United States (U.S.) as a baseline initial resident state. That is, all things being equal, an individual prior to this fraud scheme taking place, would be considered a resident of the U.S.

Incentives

The most commonly used tax systems are residential and territorial. If you live in a residential state, the individuals are being taxed on their worldwide income. Nonresident taxpayers in such system only are taxed on their earned income within the country. The territorial based system is location bound. As tax rates differ across countries, there are incentives for taxpayers to engage in tax evading schemes e.g., reclassifying themselves as nonresidents in their home states when they are residents per tax law, to obtain a more favorable tax treatment. This incentive is especially true in cases where tax rates of the initial residential state are higher than taxes in the potential 'tax evasion' states. The opportunity for 'saving tax money' is a great incentive for individuals to utilize such schemes. However, there are also other incentives that come with the attached "nonresident" status. For example, many jurisdictions tax the transfer of wealth differently for resident and for nonresident taxpayers (Gale and Slemrod, 2001). Thus, in the U.S., resident taxpayers are subject to gift and estate tax on the transfer of tangible and intangible property regardless of the situs (IRS 2501). In the case of nonresident taxpayers, these taxes are charged only on tangible property located in the U.S. (IRC 25.2511-3). Therefore, individuals could still engage in this scheme of hiding their resident status for the sole purpose of obtaining nonresident status, and after the reclassification, they could transition their wealth to intangibles located in the U.S. or simply to property located outside of the U.S. That is, U.S. taxpayers, either citizens or residents (green card holders, or due to 183 days stay in the country) who are also citizens of another country (thus dual citizens), could use tax treaties (without a proper oversight) and claim their economic and social ties lie with the other country of citizenship. There is no formal documentation for this analysis submitted to any jurisdiction. As such, a U.S. taxpayer who is also a Bulgarian Citizen, claim his/her economic ties lie with Bulgaria. On this case, he/she would be classified as Bulgarian resident and U.S. nonresident. This would allow U.S. person who hold nonresidential status now, transfer freely any assets (without U.S. citrus or any intangible assets even located in the U.S.) to anyone, including U.S. person without incurring any gift/estate reporting requirement. That is, they could freely transfer assets to resident taxpayers without incurring any gift and/or estate tax. The use of such schemes would prevent the Internal Revenue Service (IRS) from collecting due taxes (or maybe say "collecting the proper taxes due). Such transfer taxes would be well above the current exemptions of $11.58M for individuals and $23.16M for married couples, and therefore could provide a great incentive (IRS 709, 2020). The recipient of the gift must file form 3520 but technically they would not disclose the source of the gift.

Another key incentive for being classified as a nonresident is that the taxpayer would not be subject to completion of information returns such as the annual IRS Report of Foreign Bank and Financial Accounts (FBAR) and Foreign Account Tax Compliance Act (FATCA requirement. As we know, FBAR requires resident taxpayers to disclose interests in foreign financial institutions, such as bank deposits, to the Department of Treasury annually when above $10,000 (Sheppard, 2016). FATCA requires a similar disclosure, providing a more comprehensive list as to what constitutes foreign financial assets. The reporting threshold for FATCA is set at $50,000 annually (Dharmapala, 2016). The failure to file such forms carries large penalties for taxpayers. For instance, under FBAR, if the failure is found to be willful, the penalty could reach as high as $100,000 or 50 percent of the account balance on an annual basis (Sheppard, 2019). If it is unintentional, the penalties are reduced. In the last few years, the IRS has provided FBAR guidance as to how to assess penalties (IRS Interim Guidance Memorandum, 2015). The guidelines have reduced these penalties. That is, the penalties do not apply to every year but to the highest balance during a period. Regardless, they are still quite substantial. For FATCA, penalties usually start at $50,000 per year (Cooper and Barker, 2014). These penalties are kept separate from FBAR.

The reclassification to nonresident taxpayer status can help individuals avoid such penalties accumulating and going forward. By using this scheme, taxpayers can reclassify themselves as nonresidents and become exempt from FBAR and FATCA reporting. At that point, they can start running down the clock on FBAR and FATCA's statute of limitations and avoid these penalties altogether. If a person selects nonresident status, there are no triggers for the Department of Treasury to initiate any type of investigation of interests in foreign financial institutions. That is, the individual would not be subjected to any FBAR or FATCA reporting, and the U.S. Department of Treasury would have no reason of triggering an investigation. He or she would become one of the billions of classified nonresidents (outside of the definition of U.S. resident). The current statute of limitations is set at six years for FBAR (Toscher and Stein, 2003). For FATCA, it is three years, subject to adjustments to the circumstances of the taxpayer (Cooper and Barker, 2014). After these periods lapse, the person could switch back to resident status and be clear of any FBAR and FATCA penalties.

Opportunities

As a starting point, we need to identify the taxpayers who could utilize this tax scheme. We define these as individuals or households who have earned income in more than one tax jurisdiction and therefore might be eligible to be labeled as "residents" in at least two jurisdictions. Under most international tax systems, a resident is defined as someone who has a permanent establishment in a country (Herbert, 1983). This definition can take the form of a permanent home or place of stay. A person can have a permanent residence in more than one state. In this situation, we look at the actual time spent in each tax jurisdiction to determine which one is primary. If this step is inconclusive, we consider where the person has established deeper social and economic ties. This is more of a qualitative step, and it looks at family ties, work location, bank accounts, etc.: in other words, the place that the person "feels" more connected to.

There are exceptions to these step-by-step determination rules. Certain countries, such as the U.S., determine the residential designation of a person based on his/her citizenship (Henderson, 2008). That is, if a person is a U.S. citizen, they automatically qualify as a resident of that jurisdiction. This classification also is true with people who have obtained permanent resident status. In such cases, the person is automatically qualified as a resident.

It is important to note that it is the taxpayer who makes the selection of his/her resident status. This has a critical implication, as it provides the grounds or the opportunity for a taxpayer to commit the fraud discussed here. In this process, the tax authority is a mere witness. That is, it confirms the 'inaccurate' filing status of the taxpayer once he/she has filed a tax return. To be fair to the process, there are tax treaties in place between countries, designed to avoid double taxation of income. They contain a section allowing taxpayers to identify their residential state. However, again, the application of these treaties is entrusted entirely to the taxpayer, without a proper control mechanism that could deter potential abuses. This has grave implications as it allows taxpayers to select a more favorable residential state without justifying their choice. It is especially true when there are significant differences in the respective tax rates. In such cases, an individual might select a lower tax jurisdiction as his/her residential state. Then he/she would pay taxes in both places, but the tax credit from the nonresidential state jurisdiction would be more than sufficient to cover the lower tax in the residential state. This creates a series of fraud opportunities for tax evasion on worldwide income. It would be unfair to say that there are no mitigating controls in place. They do exist, but they are highly ineffective in detecting or preventing this fraud scheme. For example, in the United States, the IRS requires taxpayers to complete Form 8833 to identify the steps taken to determine the nonresidential state (IRS 8833, 2020). The completion of this form entails a new set of complications: for instance, an individual who has chosen to be classified as a nonresident could be subject to exit tax (Dai, 2018). This tax applies to individuals who are long-term residents (have more than 8 years of permanent residency) or U.S. citizens (Dai, 2018). There is a net worth requirement of $2M (Dai, 2018). This rule acts as a deterrent for individuals selecting the nonresident option. However, as previously noted, it is highly ineffective in preventing this fraud scheme. Taxpayers can simply not complete this form altogether. This would not trigger the exit tax calculation. If we couple this with the three-year statute of limitations, a person would be able to shift income between periods without triggering any red flags to authorities. In addition, an individual who selects to be classified as nonresident, will not be subject to FBAR, FATCA, and on certain gift and estate taxes. One way to detect this would be an IRS audit. It is important to note that three years of statute of limitation does not completely protect the taxpayer. It may be that after three years, the chances of the IRS catching the missing form may occur. But if a taxpayer does not complete the Form 8833 and tax is underpaid or does not complete FBAR or FATCA, that may open to the six-year statute of limitations for substantial underpayment of income and if fraud can be proved or a return that was not filed, the IRS has no time limit. And if the unpaid tax is substantial enough and the circumstances warrant, it could become a criminal problem for the taxpayer and not just a civil one. This is simply running the clock and hoping the IRS would not trigger an investigation. We do not condemn such practice but there might be few taxpayers who might initiate this process.

If in the case of an audit, guilty parties do get caught, they will have to pay a small penalty of $1,000 for not completing this form (IRS, 8833, 2020). It is important to note that even though the IRS penalty is not significant per se, things can get quite complicated and more complex because it is not simply the Form 8833. For example, if the payor of income to a taxpayer is required to file Form W-8 BEN to know if the treaty rate applies or not. The payor is generally required to withhold 30 percent (rate may be different currently) if the payee cannot properly establish their reduced treaty rate such as not providing the Form W-8 BEN. If the payor does not properly withhold the back-up amount, the payor becomes responsible for the tax. So, a taxpayer could be caught by virtue of the web of forms and substantiation required by an IRS auditor who has many resources available and the authority to subpoena things like bank records. It also should be noted that the IRS picks hot issues to go after such as looking for U.S. taxpayers hiding their cash offshore like today, they are looking more into virtual currency. However, over their lifetime and using this scheme, they could evade a large portion of their tax liability. In such situations, tax jurisdictions could be losing potentially vast amounts of revenues from taxing worldwide income with progressive tax systems. In addition, the government would not be able to tap into estate and generation skipping taxes.

We must make a clear distinction between residential and domicile states. Sometimes, these terms are used interchangeably. The place of residence is the state where a person lives or spends time (Abdrakhmanova and Nyssanbekova, 2013). An individual might spend time in more than one place and therefore could be eligible for resident classification in more than one state. On the other hand, a domicile can only be one location. The domicile is defined as the place where the individual intends to stay as a permanent home (Abdrakhmanova and Nyssanbekova, 2013). To determine the domicile, rather than looking at the past places where a person has stayed, we need to look forward and identify the place where he/she intends to stay and call home in the future. However, the presence of residential classification is important to support the selection of the domicile state. If it is absent, a person can choose domicile states without properly justifying his/her choice. It is important to note that for the purposes of income tax, countries determine the residence rather than the domicile. This determination makes sense, as there needs to be a proper documentation trail, and the residential selection provides such a trail. The domicile is future-oriented and therefore more likely to be manipulated.

Steps for Governments to Undertake

There are certain steps that governments can undertake to reduce the losses incurred by this fraud scheme. They involve more international tax audits on nonresident tax returns, which specifically focus on the way in which the nonresident status was determined. The use of an auditing tool combined with significant penalties could act as a deterrent for people willing to embrace this practice. This is especially true if the audit rate of nonresident tax returns increases in proportion to all audits conducted. However, this increase in audits must be done across the board in all countries involved. That is, an audit of this scheme in a single country would not meet the detection goals in full. This increase in audits needs to be multi-tax jurisdictional.

An alternative and more effective option would be for tax jurisdictions to require the completion of a new tax form as a prerequisite for nonresident tax return. The completion of such a form should include the reasoning used by the taxpayer to select his/her resident status. This form should be subjected to greater scrutiny. If a person does not complete such a form, he/she should be deemed to not have filed a tax return, and the statute of limitations would not start to run. In addition, failure to fill in this form should lead to draconian penalties. These should be like the FBAR fines imposed by the U.S. Department of Treasury. For example, not filling this form, IRS could impose a fine of $10,000 for unwilful and $100,000 per willful offence. The definitions of unwilful and willful offense with examples among the two, should clearly be provided. However, these penalties should be subjected to the discretion of the IRS and the facts and circumstances surrounding the case. In addition, there should be a limitation on such penalties. We believe that it would be quite unfair, if penalties exceed the total net income generated after paying the appropriate taxes. Therefore, even though penalties should be put in place, there should be the appropriate limitations on their application scope to ensure fairness to the system. That is, there should be a balance between fairness and imposing or setting an example on the parties involved. This would allow the government to put the brakes on such practices and resolve some of these issues. In addition, it might be useful to establish a point system to determine the previously discussed "social and economic interest" status used to determine residency. This would allow clearer identification of the residential state.

A potential measure to prevent this fraud scheme is the creation of an international agency empowered by the national governments to monitor the proper selection of the resident status of taxpayers. There has been an existing effort by the Organization for Economic Co-operation and Development (OECD), an international organization that seeks to shape governmental policies. One of their main priorities is to attempt to make reporting uniform amongst multinational corporations and requiring country-by-country reporting. Their main objective is the issue of transfer pricing amongst international corporations. However, this organization might need to further refocus and require tax sharing of information among international jurisdictions for individuals to ensure proper reporting. Once such sharing agreements are in place, tax authorities need to establish the proper triggers or 'red flags' to single out tax returns utilizing this scheme. Such triggers might involve using information provided by Boarder securities on travel stays within a country to verify residential status. Even though this might seem like a reasonable prevention approach, we do not fully support it. We believe that if such international agencies are created, they would further fuel this fraudulent practice, since people willing to commit fraud, if presented with obstacles, would always try to evade them.

Conclusion

In this paper, we analyzed two of the major components of the fraud triangle involving a potential fraud scheme that certain taxpayers, in the presence of multiple tax jurisdictions, could utilize to evade taxes on their worldwide earned income. Per this scheme, taxpayers select a lower tax jurisdiction as their residential state, which would allow them to avoid paying the actual higher taxes on their worldwide income. This creates a series of fraud opportunities for tax evasion. In the present paper, we identified steps that governments could undertake to reduce the risk of such fraud schemes. This includes but it is not limited to having more international audits of nonresident tax returns and creating a new information tax return as a prerequisite for filing taxes. These steps need to be taken, since the potential losses to governments could be significant, if this scheme is left unchecked. Specifically, they could undermine the system of worldwide taxation as an effective tool for taxing residents. As many developed countries tax their residents using such systems, the exposure to this fraud scheme has significant implications.

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