Swiss Banks, Voluntary Disclosure, and Reverse Eggshell Audits

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Steven J. Mopsick and Betty J. Williams examine the voluntary disclosure program and how practitioners can get their clients into compliance with the IRS through the program.

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Recent IRS successes in gaining access to information about U.S. taxpayers' use of foreign bank and trading accounts has generated renewed interest in the long-standing policy of the Service and the Justice Department to refrain from prosecuting taxpayers for evasion or false returns as long as the taxpayers comes forward before the government finds out about them.1 Provided the income is not from an illegal source, these voluntary disclosures will allow a taxpayer to escape criminal tax prosecution in exchange for the taxpayer's promise to fully cooperate with IRS revenue agents in determining the correct amount of tax, interest, and penalties for all or a part of the years in which the taxpayer enjoyed the free use of the money.

Taxpayers are now eager to avail themselves of the opportunity to confess before the IRS discovers them,2 but the civil audit that follows the voluntary disclosure can prove to be far more daunting to the practitioner than the initial disclosure to the IRS Criminal Investigation Division that the taxpayer has been evading taxes, usually for many years. Before a practitioner advises the client to come forward, the client must be informed that a voluntary disclosure provides protection from prosecution only for tax crimes that are the subject of the disclosure. The statute of limitations for prosecuting most tax crimes is six years.3 However, the client must also be advised that there is no statute of limitations for the onerous 75 percent civil fraud penalty.4 The voluntary disclosure policy says nothing about any limitations regarding the civil fraud penalty. Thus a taxpayer can submit six years of amended tax returns and self-assess the amount of tax and interest due, but in the subsequent civil audit, a revenue agent can audit as far back as possible if there is evidence of fraud. That can subject the taxpayer to financial ruin after the heavy fraud and failure-to-pay penalties are added up.

These subsequent civil audits thus present an ironic twist on the standard "eggshell audit," so called because the taxpayer and his representative are walking on eggshells, hoping to resolve the civil audit with as little damage as possible, while worrying that the agent might discover evidence of fraud that could result in a referral to the CI Division. In the reverse eggshell audit, provided the taxpayer and his representative make no new false statements to the IRS during the follow-up audit, the Service has essentially agreed in advance to tentatively forgo criminal prosecution if there is cooperation, knowing that the revenue agent is free to conduct a full-blown fraud investigation for years well beyond the six-year criminal statute of limitations.

Assume the following scenario, which is common in these cases.5 Your client, having heard all the news

reports about whistle-blowers and secret Swiss bank disclosures, reveals that he inherited a substantial account in Switzerland that his mother set up in 1980. Although the client tells you he knew about the account before his mother died in 1990, he purposefully failed to disclose the foreign bank account to the estate tax return preparer while performing his duties as executor of his mother's estate. The client also says that he has arranged to take title to the account in his own name but that he has asked the Swiss bank to refrain from sending him any statements or other communications. To hide the account from the IRS, the client has made a practice of traveling to Switzerland every summer to withdraw the accumulated interest in cash, which he uses for travel and gift-buying abroad. He says that each time he returns to the United States, he is careful not to exceed the maximum restrictions on how much money he may bring into the country but adds that he has managed to enjoy this arrangement for a period of years. Of course, the client has never reported his substantial interest earnings on his annual Form 1040, nor has he advised his return preparer about the account.

Because all of the income is from a legal source -- that is, it was not earned from illegal activities such as narcotic sales or prostitution -- you advise your client that he is a candidate for the voluntary disclosure program. You can tell him he can make a "quiet disclosure" by filing amended returns with the appropriate IRS service center, or he can make a "noisy disclosure"6 by contacting his local CI Division office and presenting the amended Forms 1040 for the past six years with payment of the tax and interest.

Making the Voluntary Disclosure7

Any voluntary disclosure should be made with the advice of counsel familiar with criminal tax practice and issues. To protect the integrity of the attorney-client privilege, the return preparer should be engaged by legal counsel in a *Kovel*8 arrangement ensuring that all communications between the attorney, the client, and the preparer remain privileged.

Counsel should work closely with the return preparer and impress on him and the client that the amended returns must be completely accurate and must fully disclose the amounts of all previously unreported income. An amended return that is false, misleading, or incomplete can result in a criminal investigation wholly separate from the underlying failure to report the income in the first place. The client's assistance will be needed in contacting the Swiss bank to obtain a complete set of records detailing all deposits and withdrawals from the account, as well as a record of all capital gains and dividends. As in any domestic financial institution, any significant sums held in offshore accounts are likely to have been managed by financial advisers and money managers who have invested the taxpayer's money in foreign or even U.S. companies and a variety of financial products and instruments. To prepare truthful and accurate amended returns, the client will have to request from the foreign banks a detailed accounting, including all capital gains and losses. The return preparer selected to prepare the amended returns will often have to compute the foreign exchange rates in effect during the periods at issue to accurately reflect the dollar amounts to be reported on the amended returns. Besides computing the tax due, the return preparer should also do an up-to-date interest computation and include that amount in the delinquent tax payment, which, ideally, should accompany the amended return.

Unfortunately, in addition to accurate amended income tax returns, the Service will also require that your client file Treasury Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts." The IRS has yet to determine the extent to which failure-to-file penalties and late filing penalties in connection with that form are assessed as provided by law. The current penalties in the law are draconian, including possible forfeiture of the entire contents of the foreign account.

The IRS is also asserting the applicability of Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," when unsuspecting U.S. taxpayers have followed their Swiss banker's advice that to fully comply with Swiss property succession laws, a handy "foundation" based in neighboring Liechtenstein should be formed to guarantee that the taxpayer's foreign funds ultimately make their way to the taxpayer's heirs and assigns. The client will also be surprised to learn that yet another form may be due, Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations."

The IRS is also certain to compute a late payment penalty as part of the subsequent civil audit.

The Civil Fraud Penalty

The first major issue to arise is whether the client will be subject to the accuracy-related penalty9 or the civil fraud penalty,10 which are mutually exclusive. The IRS cannot assert both.11

In deciding whether to make a noisy disclosure or a quiet disclosure, the practitioner must take into account his client's tolerance for uncertainty. If the amended or delinquent returns are filed quietly with the IRS service center, they may be processed as submitted and the client may or may not be contacted. The client will be assessed the late payment penalty and the substantial understatement penalty,12 and the matter will ultimately go to IRS collections if the client does not promptly pay the bill. What is more likely to happen is the returns will be reviewed by a CI representative at the IRS service center, who will make a preliminary determination about the adequacy of the voluntary disclosure. Assuming the CI Division accepts the disclosure and has no interest in the matter for criminal investigation purposes, the amended returns are likely to be sent to the examination function in the service center and then either surveyed or classified and assigned for audit. That may take months. The returns will be assigned to an auditor or examination specialist in the voluntary disclosure program to verify the accuracy of the disclosures and, most significantly, to determine whether to assert the 20 percent substantial understatement penalty, which may apply to three years or to six years if there is a greater than 25 percent omission of income on the amended returns.13

In a noisy disclosure made directly to the local CI Division office, the representative will have an opportunity to communicate with the group chief or a special agent and receive instructions on how the disclosure is to be made.

In either a quiet or a noisy disclosure, although the IRS will not send any communication or closing letter indicating that there will be no criminal investigation,14 a voluntary disclosure followed by contact from a revenue agent is tantamount to an acceptance of the disclosure, because long-standing IRS policy prohibits any involvement by the examinations function in an active criminal investigation when the CI Division is interested in developing a case for prosecution. Although practitioners can be assured that the IRS will not use a revenue agent as a stalking horse for CI, what many fail to realize is that the voluntary disclosure relieves the client of prosecution only for tax crimes committed before the date of the disclosure. The quid pro quo for acceptance of the voluntary disclosure is the client's promise to truthfully and adequately respond to, and work with, the agent as he seeks to verify the accuracy of the disclosure, determine the correct amount of the underpayment, and most significantly, determine what, if any, penalties are to be applied.

A Voluntary Disclosure Puts the Client at Risk

The transmittal letter with the amended tax returns should contain no admissions of wrongdoing or long-winded explanations about why the client has been evading U.S. taxes for so many years. Assuming the amended returns provide a complete disclosure of all previously unreported income for the prior six years, the transmittal letter should simply follow the Internal Revenue Manual15 and state that the client wishes to make a voluntary disclosure, along with the taxpayer's name, tax ID number(s), and mailing address. The practitioner should list the types of returns involved and the tax periods. The communication must also include a brief description of all omitted income, the tax "scheme"16 used by the taxpayer, and a dollar estimate of the total taxes owed. In most cases, the letter should simply say that the taxpayer is willing to cooperate with the IRS in determining the correct tax liability. Ideally, the client is in a position to make a full payment or significant partial payment. Not surprisingly, the IRS is only too happy to receive a check for payment drawn directly on the secret Swiss account. Once the correct amount of tax, interest, and penalties is determined, the client should be advised not to get his hopes up for an offer in compromise.17 The IRM suggests that the taxpayer has the option of submitting amended returns or waiting to submit amended returns until after the CI Division evaluates the communication and makes a recommendation to the Small-Business/Self-Employed Division. Because a representative would be ill-advised to proceed with a voluntary disclosure before the return preparer computes the full extent of the amount of taxes and interest due, filing amended returns with the letter is the better course of action.

The IRM also requires that the taxpayer be asked to provide the reasons why he is making the disclosure. The best response is as brief as possible -- for example, "the taxpayer wishes to be fully compliant with all of his federal tax obligations." The voluntary disclosure itself is an admission of guilt. The practitioner should avoid the temptation to mitigate the client's guilt by any explanations that may be unsupportable.

Dealing With the Revenue Agent

As noted above, the quid pro quo for the Service's forbearance from criminal prosecution is the taxpayer's complete cooperation in the civil audit to determine the correct amount of tax, interest, and penalties. One of the agent's primary objectives is to determine whether the disclosure is complete and truthful. Assume in the scenario described above that the transmittal letter with the six years of amended returns simply states that the taxpayer is voluntarily disclosing his underreporting of income from a Swiss account he inherited from his mother in 1990. No reason for the underreporting is offered. The practitioner can reasonably anticipate that the agent will have scrutinized the amended returns in search of leads for related entities. For example, there may have been name changes to the title of the taxpayer's accounts. During the 1990s, Swiss bankers were advising their clients to establish foundations in Liechtenstein, another tax haven, to ensure that their holdings squared with Swiss succession laws enabling U.S. taxpayers to transfer their foreign holdings to their children by operation of law, without the need for any U.S. testamentary documents. These foundations are nothing more than trusts. Most U.S. clients of Swiss banks simply complied with their Swiss financial advisers' instructions and signed all the pertinent documents to effect those transfers, unknowingly creating yet another U.S. filing requirement to report foreign trusts. As the names on the accounts were changed to reflect the new ownership by the foundations, they began appearing on the U.S. taxpayers' Swiss bank statements. The revenue agent conducting the follow-up audits to the voluntary disclosures will dutifully request those backup documents, anticipating additional leads with which to prove fraud by the U.S. taxpayer.

The difference in dollars between the substantial understatement penalty and the civil fraud penalty in those cases can be in the hundreds of thousands of dollars. It is also safe to assume that a gung-ho revenue agent will do his best to sustain the fraud penalty, which is equal to 75 percent of the amount of the underpayment. Also, the government has the burden of proving fraud in the Tax Court, and as mentioned above, there is no statute of limitations on the civil fraud penalty, while the statute of limitations on a deficiency and the substantial understatement penalty is three years or six years, depending on whether there was more than a 25 percent omission of income.

While a discourse on civil fraud is well beyond the scope of this article, the agent will be looking for "badges of fraud" --- a term of art used in the IRM -- which are essentially affirmative acts done by the taxpayer that are circumstantial proof of willfulness, the key element in any fraud case. Thus the agent will seek, and demand from the taxpayer, as much evidence as possible to establish badges of fraud. That in turn raises the question of how far back in time the agent will go to attempt to establish fraud.

In our hypothetical scenario, the client knew about the Swiss account before his mother died in 1990. Arguably, the client caused a false federal estate tax return to be filed because he failed to disclose the Swiss account to the estate tax return preparer. While the criminal statute of limitations on filing a false estate tax return has long since passed, theoretically, the agent could seek to establish fraud as far back as the date of filing the false federal estate tax return. The simple checking of the "no" box in answer to the question about an interest in a foreign bank account would clearly constitute a false statement and an affirmative act and a badge of fraud. Because the government has the burden of proof in fraud cases, expect the agent to ask for a copy of his mother's federal estate tax return and her will. Mindful of the fact that making a false statement to a revenue agent is a badge of fraud and actionable in and of itself, the practitioner must think hard about making the client available to be interviewed by the agent and precisely how the responses to the agent would be framed.

The practitioner should also anticipate a detailed information document request asking for copies of the taxpayer's passports. A grossly negligent person could have forgotten about a foreign bank account inherited many years ago, but annual trips to Switzerland documented by the stamps in a valid passport are excellent badges of fraud in the eyes of the agent. The Swiss bank records will show the details of the client's annual cash withdrawals of income. Annual trips to Europe may present a tempting pattern of conduct that the agent may use to build a fraud case.

Conclusion

Recent IRS incursions behind the wall of Swiss bank secrecy may prove to be a windfall for the Service's newly revitalized international enforcement efforts, but the reality is that the IRS has insufficient resources and little interest in making every U.S. taxpayer with an offshore account the subject of a criminal investigation. The voluntary disclosure program is surely the vehicle for practitioners to get their clients with offshore accounts into tax compliance. That said, the voluntary disclosure may be the easy part. Before any client is advised to proceed down that road, the possible civil ramifications in the subsequent reverse eggshell audits must be fully explored.

FOOTNOTES

1 Randall Jackson, "Voluntary Disclosure Is Key to Addressing Offshore Tax Cheats," *Tax Notes*, Dec. 15, 2008, p. 1238, *Doc 2008-25638*, *2008 TNT 236-6* .

2 David D. Stewart, "Voluntary Disclosure of Offshore Accounts Increasing," *Tax Notes*, Dec. 15, 2008, p.

1255, *Doc 2008-25870*, *2008 TNT 239-9* .

3 Section 6531.

4 Section 6501(c).

5 This scenario is imaginary and represents a fictitious person.

6 "'Noisy' disclosure means having a conference with the IRS. 'Quiet' disclosure means having the individual
file tax returns and hoping for the best." Lee A. Sheppard, "How Do U.S. Holders of Swiss Accounts Come Clean?" *Tax Notes*, Sept. 29, 2008, p. 1255, *Doc 2008-20521*, *2008 TNT 188-5* .

7 *Tax Notes*, Sept. 29, 2008, p. 1255, Internal Revenue Manual 9.5.11.9 Voluntary Disclosure Practice (Sept. 9, 2004).

8 *Kovel v. United States*, 296 F.2d 918 (1961).

9 Section 6662.

10 Section 6663.

11 Section 6662(b).

12 Section 6662(d).

13 Section 6501(e)(1)(A).

14 However, a negative evaluation will generate a letter stating that the taxpayer is ineligible to participate in
the IRS program. *See* IRM 9.5.11.9.9 Negative Evaluations (Sept. 9, 2004):
(1) If the SAC determines that a disclosure does not meet all IRS voluntary disclosure criteria, a letter will be sent to the taxpayer informing them of the reason(s) he/she is ineligible to participate. . . . It is not necessary to cite specific reasons for the rejection if it would compromise an ongoing investigative matter.
(2) Criminal investigation will evaluate the criminal potential of all negative evaluations. If the matter is not acceptable for investigation, it will be forwarded to [examination] for whatever action they deem appropriate.

15 IRM section 9.5.11.9.6 Voluntary Disclosure Communication (Sept. 9, 2004).

16 *Id.*, section 6(5).

17 Even though section 7122 authorizes the IRS to compromise "any civil or criminal case," the Service has in recent years attempted to write offers in compromise out of the code and will usually look for any reason to reject an offer in compromise.

END OF FOOTNOTES

Tax Analysts Information

Code Section: Section 6501 -- Limitations on Assessment
Section 6631 -- Interest Notice
Section 6662 -- Accuracy-Related Penalty
Section 6663 -- Fraud Penalty
Jurisdiction: United States
Subject Area: Information disclosure
Penalties
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