

# Deadline Looms to Come Clean on Offshore Accounts

*by Steven J. Mopsick and Betty J. Williams*

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Steven J. Mopsick and Betty J. Williams discuss the impending deadline for taxpayers to voluntarily disclose secret bank accounts abroad.

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American taxpayers with secret offshore accounts may miss a rare opportunity that expires on September 23. Those who take no action by that date may realize they missed a chance to save a lot of money -- and possibly time behind bars -- by not accepting the IRS's offer of its amnesty program.

On March 23, in an unprecedented move in terms of outreach, the IRS announced that criminal prosecution can be avoided for tax crimes committed between 2003 and 2008 by people who have enjoyed several years of tax-free dividends and interest accumulating in foreign bank accounts. The amnesty will be allowed even if the taxpayer has willfully hidden the existence of those accounts from the government for many years; failed to report that income on their tax returns; lied to their return preparers about the money; and filed false and fraudulent tax returns, sometimes for decades, by checking the "no" box on Schedule B of their Forms 1040 in answer to the question whether the taxpayer owns or has control over a foreign account.<sup>1</sup>

Those waiting until after September 23 to see if the IRS sweetens the deal with a more lenient offer shouldn't hold their breath. An amnesty program like this may not come around ever again. Even IRS Commissioner Douglas Shulman has chimed in on the subject, saying, "For taxpayers who continue to hide their heads in the sand, the situation will only become more dire."<sup>2</sup>

Until the September 23 deadline, American taxpayers with secret foreign bank accounts can avoid prosecution for false returns filed in the past six years<sup>3</sup> by following the instructions in two FAQs published by the IRS on May 6 and June 9 detailing the criteria for qualification. On July 29, to streamline the initiative and simplify the process, the IRS published an optional alternative offshore voluntary disclosure form on its Web site. It requires a disclosure to the IRS Criminal Investigation division (CI) of specific identification information, as well as a promise to cooperate with the IRS and pay the tax on the unreported income after submitting corrected amended tax returns and information returns<sup>4</sup> identifying the foreign bank. Only the disclosure form, not the amended return, must be submitted by September 23.

In exchange for taxpayers coming forward and providing their full cooperation, <sup>5</sup> the IRS will forgo any criminal prosecution of activities related to the secret account for the last six years if certain requirements are met. Those returns will be reviewed by a special agent who will then turn the matter over to the examination function. The examination function will audit the returns and offer to settle the case according to a precise formula set by the IRS National Office. The settlement requires the taxpayer to pay:

- the tax on the unreported income plus interest;
- a 20 percent accuracy-related penalty;<sup>6</sup> and
- a 20 percent penalty based on the highest aggregate account/asset value in lieu of the Report of Foreign Bank and Financial Accounts (FBAR) and other penalties that would otherwise apply.<sup>7</sup>

The amnesty program eliminates the risk of exposure to the onerous 75 percent civil fraud penalty, which has no statute of limitations.<sup>8</sup>

The program appears to be working well. Practitioners report that once they contact their local CI offices, the special agents have been willing to help the practitioners perfect the disclosure by referring him to a local IRS expert for additional consultation and assistance with the requirements for a voluntary disclosure as described in the Internal Revenue Manual.<sup>9</sup> The agents may also direct the practitioner to a special IRS voluntary disclosure<sup>10</sup> or FBAR hotline.<sup>11</sup> Anecdotal evidence suggests that the IRS is overwhelmed by the surge of inquiries and filings from taxpayers and practitioners who want to come clean before it is too late. A voluntary disclosure is considered timely if it is received before:

- A. the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence an examination or investigation;
- B. the IRS has received information from a third party (for example, informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance;
- C. the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or
- D. the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (for example, search warrant or grand jury subpoena).<sup>12</sup>

One could argue that the IRS is reading paragraphs B and C of the IRM somewhat liberally in light of the litigation between UBS and the Department of Justice regarding enforcement of the IRS summons, because any taxpayer with a foreign account at UBS is on notice that the investigation may include his account information. Similarly, the IRS could argue that the recent publicity put American UBS customers on notice that it is just a matter of time before they receive an audit notice and that anyone coming forward at this late date should have known that the IRS criminal investigation of UBS is "directly related to the specific liability of the taxpayer."

It is important to remember that the disclosure is successful only after CI determines that the communication (verbal or written)<sup>13</sup> is truthful, timely, and complete, and when the taxpayer cooperates with the IRS in determining his correct tax liability.<sup>14</sup>

Before the publication on July 29, 2009, of a new "optional format" for making the disclosure, there did not appear to be any uniformity with the way CID was handling the program nationally. Up until the publication of the new "optional format" letter published on July 29, some local CID offices were working off a list of 31 probing questions to be propounded to the taxpayer either in person or through the representative. In our experience, and now with the new July 29 format our CID contacts have suggested that a personal interview with the client may now not be required. However, the very last line of the new form states, "IRS reserves the right to make further contacts with the taxpayer to clarify his/her submission."

With the new July 29 format CID is now prepared to give "preliminary acceptance" to the disclosure even before they have seen the amended returns. Now, apparently after CID receives the abbreviated information requested in the "optional letter" and runs a few computer checks on the taxpayers' Social Security number and passport number, CID is now willing to issue the preliminary acceptance letter even before the amended returns are tendered to the IRS. The preliminary acceptance letter essentially advises the taxpayer to sit tight and wait to be contacted by a revenue agent who will either conduct a full blown audit, accept the returns as submitted, or conduct some form of limited inquiry. However, an interview by CID cannot be ruled out.

Any practitioner familiar with the Fifth Amendment can envision the most daunting scenario in which questions, if answered truthfully, will hand the government a case against him on a silver platter. In a voluntary disclosure, the taxpayer admits that he has committed one or more serious felonies described in the code. However, CI cannot make its final determination or decline to prosecute until after the taxpayer confesses to the full extent of his criminal activity. Although a letter may be sent to the taxpayer informing him that CI has closed his file, he may also first learn CI has declined to pursue the matter criminally when he is contacted by an examining revenue agent signifying that CI has closed its file and passed the file along to the examination function.<sup>15</sup> If the taxpayer is to be questioned either in person or in writing, he can expect to be asked how often he went abroad to deposit or withdraw money, what was the source of the money, and whether he made any wire transfers in the name of another person. He may also be asked whether he violated other statutes regarding carrying cash on his return to the United States. The IRS will also want to know if the taxpayer ever engaged in a pattern of multiple deposits in amounts less than \$10,000 to avoid the bank's duty to file a currency transaction report. When the amnesty was first announced, anxiety swept through the practitioner community and guilty taxpayers who envisioned a lengthy, intrusive, in-person interrogation in which the Service demands to know the identity and contact information for the taxpayer's long-standing foreign financial adviser, as well as the names of everyone who advised and counseled the taxpayer to establish a secret foreign account. But some IRS offices have begun to relax the interview process and suggest that the Service may not need to meet with taxpayers or their representatives. Instead, questions can be sent through the mail or skipped altogether if the Service has sufficient information to properly review the case before passing it on to the examination function.

### **Criminal Prosecution**

Is criminal prosecution a certainty for taxpayers who fail to act by September 23? Many have raised this question and those who have come forward in a timely manner would feel vindicated watching their neighbors be hauled off to jail. The IRS would like to give the impression that failing to come clean before September 23 would mean an automatic criminal investigation, but realistically, that is probably not true.

The IRS has been adding enforcement personnel to its ranks in the examination, collection, and criminal investigation functions for the past several months, but that does not mean they are prepared to pursue every violation in this area. Therefore, a voluntary disclosure of previously unreported legal-source foreign earnings after September 23 will probably still qualify as a valid voluntary disclosure if all the other definitional prerequisites are met. For all the talk about the importance of breaking through the veil of tax haven bank secrecy and the need to promote voluntary compliance, the cornerstone of our self-assessment system, the IRS is not likely to squander its resources working a case against a person with legal-source unreported income from a foreign bank account if there are no other crimes involved.

It's one thing, and perhaps good government, to launch a publicity campaign encouraging the public to be honest, but it is another to divert criminal investigative resources away from far more egregious activity in the world of international financial crimes to prosecute a few American retirees who thought they had safely tucked away a small nest egg abroad.

### **Why Not Wait?**

If there is a good chance that CI will not prosecute a voluntary disclosure after September 23, why not wait until things settle down and apply for a voluntary disclosure when a better deal might be available? Taxpayers with undisclosed foreign accounts should be well advised that waiting is unwise. While it is almost certain that legal-source unreported income would still be a good voluntary disclosure after September 23, and that CI will have no interest in the case for prosecution purposes, the IRS will likely not risk losing its credibility by offering a better deal after that date. What likely will happen is that the IRS will no longer provide a formal settlement offer and will give examining agents the green light to work the case as they would any other. At that point the only certainty on which a taxpayer can rely will be the assurance of no criminal prosecution. That also means a multitude of civil penalties, including the fraud penalty, will be possible. Consider the following example: In 1990 a taxpayer inherits a Swiss bank account and a foreign trust in which the taxpayer's ancestor has accumulated and grown a handsome, diverse portfolio of international stocks, bonds, and other investments. Assume the taxpayer travels every year to Switzerland to consult with his Swiss financial adviser, makes some changes to his portfolio, withdraws a large amount of cash for a fun vacation in Europe, and returns to the United States with the balance of the recently withdrawn cash in his pocket. Years ago, the taxpayer may have advised his Swiss bankers to refrain from sending him any correspondence, including monthly statements, so that he could maintain a low profile. Assume this taxpayer makes a valid voluntary disclosure after September 23 and CI passes favorably on the case and sends it to the examination function for audit of the amended returns. Note that the six-year period described in the recent IRS notices is 2003 through 2008.

After September 23 a revenue agent assigned to audit the amended returns believes this will make a good fraud case and his manager approves a full-blown fraud investigation. Because there is no statute of limitations for the civil fraud penalty under section 6663, the agent is free to summon all the financial records of the taxpayer, starting with 1990, the year the taxpayer inherited the money. Under our facts in the example, there are several "badges of fraud," affirmative acts on which the IRS relies to prove the taxpayer willfully sought to defraud the IRS, for example, by checking the "no" box on Schedule B of Form 1040 for many years denying an interest in a foreign account, failing to report the earnings, asking the bank to refrain from sending mail to the taxpayer in the United States, etc.

Numbers 12 and 15 of the most recent FAQs describe the penalty framework assuming a late-filed request for a voluntary disclosure passes the CI hurdle and is referred to the examination function for audit. It is clear from that list of penalties that a taxpayer who does not disclose his offshore account before September 23 risks losing not only the entire contents of his foreign accounts, but any domestic assets necessary to pay the full liability of tax, penalty, and interest.

Note that the example in question 12 shows how a taxpayer could owe \$386,000 plus interest with a timely disclosure or \$2,306,000 on the same facts if the IRS discovered their offshore activities first.

After September 23, the taxpayer is potentially at risk for:

- A penalty for failing to file Form TD F 90-22.1 (FBAR). Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of \$100,000 or 50 percent of the total balance of the foreign account per year. See 31 U.S.C. section 5321(a)(5).
- Assuming a taxpayer set up a foreign trust, a penalty for failing to file Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." The penalty for failing to file this information return, or for filing an incomplete return, is 35 percent of the gross reportable amount, for example, for each year, 35 percent of the balance in the trust.
- A penalty for failing to file Form 3520-A, "Information Return of Foreign Trust With a U.S. Owner." The penalty for failing to file this information return or for filing an incomplete return is 5 percent of the gross value of trust assets determined to be owned by the U.S. person.
- A penalty for failing to file Form 5471, "Information Return of U.S. Person With Respect to Certain Foreign Corporations." The penalty for failing to file this information return is \$10,000, with an additional \$10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of \$50,000 per return.
- A penalty for failing to file Form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business." The penalty for failing to file this information return, or to keep certain records regarding reportable transactions, is \$10,000, with an additional \$10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of \$50,000 per return.
- A penalty for failing to file Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation." The penalty for failing to file this information return is 10 percent of the value of the property transferred, up to a maximum of \$100,000 per return, with no limit if the failure to report the transfer was intentional.
- A penalty for failing to file Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships." U.S. persons with certain interests in foreign partnerships use this form to report interests in and transactions with the foreign partnerships, transfers of property to the foreign partnerships, and acquisitions, dispositions, and changes in foreign partnership interests under sections 6038, 6038B, and 6046A. Penalties include \$10,000 for failure to file each return, with an additional \$10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of \$50,000 per return, and 10 percent of the value of any transferred property that is not reported, subject to a \$100,000 limit.
- Fraud penalties imposed under sections 6651(f) or 6663. When an underpayment of tax or a failure to file a tax return is due to fraud, the taxpayer is liable for penalties that, while calculated differently, essentially amount to 75 percent of the unpaid tax.
- A penalty imposed under section 6651(a)(1) for failing to file a tax return. The penalty can be as high as 25 percent.
- A penalty under section 6651(a)(2) for failing to pay the amount of tax shown on the return. If a taxpayer fails to pay the amount of tax shown on the return, he may be liable for a penalty of 0.5

percent of the amount of tax shown on the return, plus an additional 0.5 percent for each additional month or fraction thereof that the amount remains unpaid, not to exceed 25 percent.

- An accuracy-related penalty on underpayments imposed under section 6662. Depending on which component of the accuracy-related penalty is applicable, a taxpayer may be liable for a 20 percent or 40 percent penalty.

### **Conclusion**

It should be obvious to anyone with an undisclosed foreign bank account and years of unreported earnings from foreign sources, that an open window is about to snap shut on September 23. Even as we concluded that CI would likely not prosecute a voluntary disclosure after that date, the additional penalties and interest the taxpayer may owe and the potential to lose everything he owns if an agent can make a case for the fraud penalty and the confiscatory FBAR penalties, should motivate anyone in that position to make the disclosure before the IRS offer to settle expires.

Bank secrecy is dead. It is only a matter of time before the IRS receives the names of those who have gotten away with years of tax-free interest and dividends. The real question is not whether those people are going to jail, because CI doesn't have the resources to prosecute that many tax fraud cases. The real question is what will be the financial cost of not coming forward now. While some will be prosecuted because of the egregiousness of their acts, most taxpayers who elect not to participate in this program are gambling that they will not be caught and risking owing tremendous sums, including their life savings, in potential penalties.

### **FOOTNOTES**

1 This article was written with the most common fact pattern in mind: A U.S. person either inherited a foreign account or stashed money abroad but was not involved in organizing or promoting offshore tax avoidance schemes or using the account to hide illegal-source income such as drug money, laundered money, aid terrorists, or other nefarious acts.

2 Statement of IRS Commissioner Douglas Shulman on offshore income, Mar. 26, 2009.

3 The statute of limitations for filing a false return or evasion is six years. Section 6531.

4 Form TD F 90-22.1.

5 Internal Revenue Manual 9.5.11.9 A.

6 Section 6662(a).

7 The FBAR penalty may be reduced to 5 percent if, when the accounts or entities formed, (a) the taxpayer did not open them or cause them to be opened or formed, (b) there has been no activity during the period the accounts/entities were controlled by the taxpayer, and (c) all applicable U.S. taxes have been paid on the funds in the accounts/entities (in which only the earnings have escaped U.S. taxes).

8 See IRS FAQ 12. Section 6662(b) makes the fraud penalty under section 6663 and the accuracy-related penalty under section 6662(a) mutually exclusive.

9 A voluntary disclosure is made by following the procedures described in IRM

9.5.11.9. Tax professionals or individuals who want to initiate a voluntary disclosure should call their local CI office. For a list of CI offices, see <http://www.irs.gov/compliance/enforcement/article/0,,id=205909,00.html>.

10 The number of the IRS Voluntary Disclosure Hotline is 215-516-4777.

11 FAQ 45 says:

If a taxpayer is uncertain about whether he is required to file an FBAR with respect to a particular foreign account, how can the taxpayer get help with this question? Help with questions about FBAR filing requirements is available on the FBAR Hotline at 1-800-800-2877. When the call is answered, select option 2. You can also submit written questions about the FBAR rules by e-mail addressed to [FBARQuestions@irs.gov](mailto:FBARQuestions@irs.gov). The instructions to the FBAR form are available at <http://www.irs.gov>. Do not call the Voluntary Disclosure Hotline with questions about whether you have an FBAR filing requirement. The purpose of the Voluntary Disclosure Hotline is to answer questions about how to make voluntary disclosures and what penalties apply, assuming a taxpayer was required to file.

12 IRM 9.5.11.9 para. 4.

13 IRM 9.5.11.9.1 (Sept. 9, 2004), Voluntary Disclosure Protocol 1. All voluntary disclosures must meet the requirements contained in subsection 9.5.11.9 above. The voluntary disclosure practice does not specify any particular format for voluntary disclosure communications as long as those requirements are met. The taxpayer or his representative may provide information verbally or in writing.

14 *Id.*

15 One can be assured that the IRS will not use a revenue agent as a stalking horse for CI. Once CI refers a matter to the examination function, it will close its file and CI will lose jurisdiction over the matter.

## END OF FOOTNOTES

### Tax Analysts Information

**Code Section:** Section 6531 -- Criminal Prosecution Limitations

Section 6651 -- Failure to File or Pay

Section 6662 -- Accuracy-Related Penalty

Section 6663 -- Fraud Penalty

**Jurisdiction:** United States

**Subject Area:** Foreign source income

Information reporting

Penalties

Practice and procedure

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