Avoid Criminal Prosecution – IRS Introduces a Six Month Settlement Initiative For those with Unreported Foreign Accounts

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EXECUTIVE SUMMARY

On March 23, 2009, the IRS announced the creation of new voluntary disclosure program for undeclared foreign accounts. The IRS Offshore Income Reporting Initiative (the "Initiative") is only available for six months, or until September 23, 2009, and provides that those taxpayers who qualify will not be subject to criminal penalties or the civil fraud penalty. Taxpayers will have to file six years of tax returns, depending upon the circumstances, either amended or delinquent, and pay all taxes and interest due. Taxpayers will also incur an accuracy related penalty or a delinquency penalty, as well as a penalty of up to 20% on the highest aggregate balance held in the account during the six year period. Certain taxpayers may qualify for a reduced penalty of 5% on the highest aggregate balance in the foreign account.

FACTS

United States persons are responsible for filing tax returns and reporting their worldwide income, including income associated with foreign accounts. In addition, there are numerous informational returns that United States persons may be required to file, including TDF 90-22.1 (the "FBAR"). See LISI Message 1432 for the Top Ten International Compliance Issues for US Persons with Foreign Investments. There are significant penalties associated with a taxpayer's failure to file these informational returns, and in the case of the FBAR, the penalties are confiscatory. See LISI Message 1309 for a detailed summary of the FBAR filing requirements.

Beginning June 19, 2008 when the Justice Department announced that a former UBS banker, Bradley Birkenfeld, pled guilty to assisting UBS clients evade US reporting requirements on income in Swiss bank accounts, the ongoing controversy between the US, UBS and Switzerland has played out in the courts.[1] Birkenfeld's plea was quickly followed on July 1, 2008 when the US District Court in Florida authorized the IRS to serve "John Doe Summonses" upon UBS AG.[2] The summonses demanded that UBS turn over identifying information regarding US taxpayers who had created Swiss accounts with UBS and who elected to have their accounts remain hidden from the IRS.[3] It was later asserted that there are some 52,000 unreported accounts held by or on behalf of US persons in UBS alone. The US simply has no idea how many other foreign accounts with other Swiss institutions and in other jurisdictions remain unreported.

It is highly unlikely that taxpayers who fail to report their foreign accounts on an FBAR similarly fail to pay tax on the earnings. Related thereto, funds transferred to open the foreign accounts are often unreported income. While it is impossible to quantify how much of this income is unreported, IRS Commissioner Doug Shulman has publicly stated his belief that "offshore

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[1] DOJ Press Release No. 08-550
[2] DOJ Press Release No. 08-584
[3] DOJ Press Release No. 08-584

accounts harbor billions of dollars, and people should take notice that the secrecy surrounding these deals is rapidly fading."[4] Thus, the IRS continues to find ways to spur compliance while it fights with the Swiss over the information sought from the John Doe Summonses. The recently introduced Initiative is not limited to UBS accounts, and is designed to provide the IRS with a uniform approach for handling taxpayer disclosures of previously undeclared offshore issues.

IRS GUIDANCE

The IRS released the following three memoranda on March 23, 2009 related to the new Initiative:

- A memorandum from Deputy Commissioner for Services and Enforcement Linda E. Stiff to Deputy Commissioner Barry B. Shott, LMSB, and Deputy Commissioner Faris R. Fink, SB/SE ("Penalty Memorandum")[5];

- A memorandum from Deputy Commissioner Barry B. Shott, LMSB, Deputy Commissioner Faris R. Fink, SB/SE and Deputy Chief Victor Song, CI, to SB/SE Area Directors, LMSB Industry Directors, and CI Field Operations ("Routing Memorandum")[6]; and

- A memorandum from Deputy Commissioner Barry B. Shott, LMSB and Deputy Commissioner Faris R. Fink, SB/SE Deputy to SB/SE Area Directors and LMSB Industry Directors ("Case Development Memorandum")[7].

The Penalty Memorandum explains the penalty framework for disclosures submitted pursuant to the Initiative. Procedurally, Criminal Investigation ("CI") must screen the taxpayer disclosure to determine if the submission is eligible for a voluntary disclosure. If so, then CI will forward the disclosure to the Philadelphia Offshore Identification Unit ("POIU") for processing by examiners who specialize in offshore examinations. Once these examiners have completed their review, the Deputy Commissioners are authorized to enter into closing agreements resolving the taxpayer liabilities provided the resolution includes the following:

- The filing of six years of amended or delinquent tax returns, including informational returns, and the FBAR. Because the FBAR is specifically identified after the reference to informational returns, the Initiative would appear to permit taxpayers to also resolve noncompliance involving non foreign accounts, such as the failure to File Form 5471 and/or the omission of subpart F income. It would appear that the Initiative is now the only means by which offshore noncompliance may be resolved especially because the IRS has revoked the Last Chance Compliance Initiative in the Case Development Memorandum;

- The payment of six years of all tax and interest due;

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[4] DOJ Press Release No. 08-579

[5] IRS Memorandum: Authorization to Apply Penalty Framework to Voluntary Disclosure Requests, March 23, 2009.

[6] IRS Memorandum: Routing of Voluntary Disclosures, March 23, 2009.

[7] IRS Memorandum: Emphasis on and Proper Development of Offshore Examination Cases, March 23, 2009.

- The payment of a 20% accuracy related penalty under IRC 6662 for income previously omitted from a tax return, ***or*** the 25% delinquency penalty under IRC 6651 for failure to timely file. These penalties are mandatory and apply for each of the six years in which the omission occurred. No longer is reasonable cause a defense to the imposition of these penalties as the Penalty Memorandum specifically excludes reasonable cause; and

- The payment of a one time 20% penalty in the year with the highest aggregate account balance including all offshore accounts. This penalty is in lieu of all other available penalties including the penalty for not filing the FBAR.

There are two limitations on these rules, the first of which is that if the foreign account was opened within the six year period, then taxes, interest and all penalties will begin from the date the account was opened. The second limitation is a reduction of the 20% penalty to 5% of the highest aggregate balance. The 5% penalty will only apply if the taxpayer: (i) did not open or create the foreign account, (ii) has never withdrawn money from the foreign account or added money to the foreign account, and (iii) all US taxes have been paid on the funds which were deposited into the account. Thus, the only noncompliance that may exist on the part of the taxpayer is not reporting the income earned on the foreign account. Of course, the third requirement may be the most difficult to satisfy as it only applies to persons who either inherited a foreign account or received a foreign account as a gift. If a taxpayer inherited the account from a foreign relative, it is likely no US taxes would have been paid, and possible that the taxpayer failed to report the receipt of the foreign gift on a Form 3520. If a taxpayer inherited the account from a US relative, it may be unclear as to whether taxes were paid on the funds contributed to the account.

The Penalty Framework memorandum states that all voluntary disclosures that have been submitted to the IRS and which are *not yet resolved* will be subject to the new penalty framework. It is unclear as to how the IRS intends to define *not yet resolved*. Is the determining factor whether all offending returns have been processed? Whether the taxpayer proceeded with a voluntary disclosure prior to the Initiative? Whether the taxpayer received a closing agreement? Whether the tax involved and previously unreported was significant? If a taxpayer previously filed amended returns through a voluntary disclosure, as well as paid all tax and interest due, but no closing agreement was received, is the case *unresolved* for purposes of the Initiative*?* If so, will the examiners in POIU treat such taxpayers differently than those who come forward through the Initiative? It would appear that taxpayers who previously submitted a voluntary disclosure should benefit from preferential treatment when compared to those taxpayers who waited for the Initiative to be introduced. After all Commissioner Shulman and other IRS officials have been publicly stating for months that taxpayers should submit a voluntary disclosure, rather than wait for any future amnesty programs like the recently introduced Initiative.[8]

[8] March 17, 2009, Prepared Testimony of Doug Shulman, Commissioner Internal Revenue Service, Before the Senate Finance Committee on Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation; March 6, 2009, statement by Kevin Dowling, a senior litigator with the DOJ Tax Division, at the annual Federal Bar Association tax law conference; and February 25, 2009 statement by Commissioner Shulman at a conference sponsored by the Tax Council Policy Institute.

The Routing Memorandum discusses the routing of voluntary disclosure cases, and makes clear that the processing of voluntary disclosure requests is mandatory. CI is instructed to continue screening all submissions to determine if the taxpayer qualifies for a voluntary disclosure. If so, and the submission involves offshore matters, then CI will forward the disclosure to POUI for examination. If the submission only pertains to domestic issues, then CI will forward the disclosure to either SB/SE or LMSB. The memorandum also mandates that any voluntary disclosure cases currently in inventory which involve offshore issues must be transferred to POUI for processing.

The Penalty Framework memorandum reiterates that the Initiative will remain in effect for six months (through September 22, 2009). Commissioner Shulman says that the IRS will re-evaluate its options after the six month period, and warns taxpayers "who continue to hide their head in the sand, the situation will only become more dire." By comparison, with recent settlement initiatives, the IRS has taken various approaches. For example, on November 17, 2006, the IRS introduced a settlement for US based employees and former employees of foreign embassies, foreign consular offices and international organizations to resolve outstanding US tax matters related to their employment. When the Embassy Settlement was introduced, the deadline was February 20, 2007, but it was later extended to June 30, 2007. This, however, contrasts with the Offshore Voluntary Compliance Initiative, which was introduced on January 14, 2003, and which ended on April 15, 2003. There were no extensions for taxpayers to come forward subsequent to the deadline. More recently, in the context of tax shelters, in Announcement 2002-2, the IRS advised taxpayers to disclose their investment in a Son of Boss transaction. For those taxpayers who did so disclose, when the Son of Boss Settlement was introduced in Announcement 2004-46, the taxpayers did not incur an accuracy related penalty. Taxpayers who did not initially disclose the transaction incurred either a 10% or 20% penalty depending upon the facts. And, for those taxpayers who did not take advantage of the settlement, the IRS imposed the maximum applicable penalty of 40%.[9] Of course all taxpayers had to concede 100% of the claimed tax losses. Therefore, even if the Initiative is extended, taxpayers should not expect the terms to remain the same.

In a wide ranging statement announcing the Initiative on March 26, 2009, Commissioner Shulman stated "[w]e have instructed our agents to resolve these taxpayers' cases in a uniform, consistent manner. Those who truly come forward will pay back taxes, interest and a significant penalty, but can avoid criminal prosecution. … We believe the guidance represents a firm but fair resolution of these cases and will provide consistent treatment for taxpayers. The goal is to have a predictable set of outcomes to encourage people to come forward and take advantage of our voluntary disclosure practice while they still can. … my goal has always been clear – to get those taxpayers hiding assets offshore back into the system."[10]

VOLUNTARY DISCLOSURE

When determining whether a taxpayer's voluntary disclosure submission qualifies for the Initiative, the Routing Memorandum instructs CI to refer to IRM Section 9.5.11.9. Taxpayers need to be aware that not all voluntary disclosure submissions will qualify for the Initiative, and

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[9] IR-2005-37, March 24, 2005
[10] Statement dated March 26, 2009 from Commissioner Shulman on Offshore Income.

thus, criminal prosecution is a potential outcome from a disclosure which does not qualify for the Initiative.[11] Cases involving illegal source income will not qualify.[12]

The Internal Revenue Manual defines a voluntary disclosure as having taken place when the taxpayer's communication is truthful, timely, and complete.[13] These terms require that the taxpayer show a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability, and the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.[14]

Disclosures are timely if they are received before:

1. The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.

2. The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance.

3. The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.

4. The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).[15]

It appears that the Initiative is loosening the importance of step 2, and permitting taxpayers whose names appear on lists the IRS received to qualify for a voluntary disclosure. Whether any of the other steps have been loosened, such as permitting a taxpayer under civil investigation to make a disclosure, is unclear.

WHY COME FORWARD?

Practitioners should take note that filing stealth returns to correct noncompliance with the hope that taxpayers will achieve a better result, specifically no penalties, as a result of the returns sliding through, appears to no longer be an option. While not part of an IRS memorandum, on Friday, March 27, 2009, a special trial attorney in SB/SE stated that examination has been told to closely review all amended and/or delinquent returns for offshore activities. If a return reflects such activities, the return will automatically be forwarded to POIU. It is unclear whether the return will then be dealt with more harshly.

Even though the penalties under the Initiative may cause some financial difficulties, taxpayers should not lose sight of what they avoid by submitting a disclosure consistent with the Initiative. While not a complete summary of potential penalties, those that follow are some of the most common:

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[11] IRM 9.5.11.9.2
[12] IRM 9.5.11.9.2
[13] IRM 9.5.11.9.3.
[14] IRM 9.5.11.9.3.A and B.
[15] IRM 9.5.11.9.4.

- criminal prosecution;
- The civil fraud penalties under IRC 6651(f) and 6663, which can amount to penalties of 75% of the unpaid tax;
- Failure to pay penalties under IRC 6651 (a)(2) and (a)(3);
- Failure to file penalties under IRC 6651;
- Penalties for failure to file foreign corporation information returns (Form 5471 and or Form 5472), which begin at $10,000 and can run as high as $50,000 per return;
- Penalties for failure to report transfers of property to a foreign corporation (Form 926), which begin at 10% of the value of the property transferred to the corporation and which can reach a maximum of $100,000 per return;
- Penalties for failure to file a Form 3520 reporting the transfer of funds to a foreign trust or receipt of a distribution from a foreign trust, which begins at 35% of the amount transferred to or received from the foreign trust;
- Penalties for failure to file a Form 3520 to report the receipt of a gift or inheritance from a foreign person or estate, or a gift received from a foreign corporation or partnership, which begins at 5% of the value of the gift and can reach as high as 25% of the value;
- Penalties for failure to file Form 3520-A reflecting ownership of a foreign trust under the grantor trust rules, which consists of a penalty of 5% of trust assets;
- Penalties for failure to file foreign partnership information returns (Form 8865), which start at $10,000 and can reach a maximum of $50,000 per return, plus up to $100,000 of the value of property transferred to the foreign partnership; and
- Penalties for failure to file FBARs, which can reach as high as 50% of the account balance, and in certain situations jail.

If avoiding the imposition of the above penalties is not a significant enough carrot for taxpayers, they should understand that the situation will not get any better. IRS agents have been instructed by Commissioner Shulman that if the taxpayer did not self report through a voluntary disclosure, they are "to fully develop these cases, pursuing both civil and criminal avenues, and consider all available penalties including the maximum penalty for the willful failure to file the FBAR report and the fraud penalty."[16]

Furthermore, the Case Development Memorandum reflects that the IRS Strategic Plan for 2009-2013 is focused on international tax administration and allocating the resources necessary to focus on both existing and emergency risk areas. Not only does the Case Development Memorandum revoke the Last Chance Compliance Initiative, and provide for managerial oversight of offshore cases, but it reinforces proper development of offshore examinations, and

[16] Statement dated March 26, 2009 from Commissioner Shulman on Offshore Income.

emphasizes the need for such examinations to receive priority treatment. Furthermore, Treasury Secretary Timothy Geithner has expressed his view that increasing funding for IRS enforcement is a necessary part of closing the tax gap."[17]

The memorandum reminds examiners that they should use the full range of information gathering tools to develop the facts in an investigation, with special emphasis on detecting unreported income. Available tools include taxpayer interviews, making third party contacts, issuing summonses to taxpayers and third parties, and seeking information through applicable treaties. "In particular, examiners should request foreign-based information through exchange of information under applicable treaties and tax information exchange agreements in any cases where the taxpayers have accounts or transactions in countries with such agreements." The memorandum concludes with a summary of the numerous filing obligations that may exist and the penalties available for each such failure. As a result, taxpayers should no longer expect in an audit to encounter a revenue agent who solely focuses on domestic issues and overlooks offshore activity.

CONCERNS

The Initiative eliminates the reasonable cause exception for failure to file the FBAR and assumes that all such failures are attributable to the taxpayers' willfulness. This is a complete reversal with how FBAR submissions were previously handled. This conclusion is contrary to the Bank Secrecy regulations that permit a reasonable cause defense.[18] Reasonable cause will be assumed if the amount of the transaction or the balance of the foreign account is reported on the taxpayer's Form 1040.[19] Similarly, the IRS website page dealing with frequently asked FBAR questions still provides that reasonable cause is a defense to the failure to file the FBAR. See question 18 which asks, "[w]hat happens if an account holder is required to file an FBAR and fails to do so?" [20] The answer provided is "[f]ailure to file an FBAR when required to do so may potentially result in civil penalties, criminal penalties, or both. If you learn you were required to file FBARs for earlier years, you should file the delinquent FBAR reports and attach a statement explaining why the reports are filed late. No penalty will be asserted if the IRS determines that the late filings were due to reasonable cause. Keep copies, for your record, of what you send."[21]

What is even more troubling than the elimination of a reasonable cause defense is the IRS' determination that all such failures to file the FBAR are now deemed willful in nature. This conclusion ignores the statutory civil penalty of up to $10,000 for a nonwillful failure to file the FBAR that was enacted subsequent to the American Jobs Creation Act of 2004.[22] While the government will achieve consistency in penalties through this Initiative, the facts and circumstances analysis which often dictated how FBAR penalties would be assessed, appears to be terminated.

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[17] Statement at House Budget Committee hearing on President Obama's proposed 2010 budget.
[18] 31 USC § 5321(a)(5)(b)(ii).
[19] 31 USC § 5321(a)(5)(B)(ii).
[20] http://www.irs.gov/businesses/small/article/0,,id=148845,00.html.
[21] http://www.irs.gov/businesses/small/article/0,,id=148845,00.html.
[22] 31 USC § 5321(a)(5)(B)(i).

Willfulness generally requires a voluntary, intentional violation of a known legal duty. Another problem with ignoring the regulations by automatically assessing the 20% penalty through this Initiative is that the IRS is also changing precedence. The IRS Chief Counsel's Office previously stated in guidance that the term "willful violation" should be interpreted in the same way for either a civil or criminal penalty.[23] Chief Counsel Advice 200603026 states that "in order for there to be a voluntary and intentional violation of a known legal duty, the accountholder would just have to have knowledge that he had a duty to file an FBAR, since knowledge of the duty to file an FBAR would entail knowledge that it is illegal not to file the FBAR. A corollary of this principle is that there is no willfulness if the accountholder has no knowledge of the duty to file the FBAR."[24] The IRS indicated its belief in the CCA that the willfulness requirement must be proved by the same clear and convincing evidence required when imposing a civil fraud penalty under Section 6663.

CONCLUSION

Taxpayers with offshore noncompliance regardless of the whether it involves unreported foreign accounts, failure to properly account for subpart F income, or failure to file an informational return should take advantage of the Initiative to come forward now. While the penalties may appear to be severe, as Commissioner Shulman stated, taxpayers now have consistency and predictability on their side. More importantly, taxpayers will also avoid criminal prosecution and imposition of the civil fraud penalty.

Taxpayers only have one opportunity to make a submission, and failure to qualify for the Initiative, depending upon the fact, may lead to criminal prosecution. Consequently, taxpayers should seek the assistance of a qualified tax attorney with particular knowledge and experience in submitting voluntary disclosures. This is a standard CPAs should also follow consistent with AICPA Statement on Standard for Tax Services no.6 when contacted by a taxpayer who wishes to pursue a voluntary disclosure.

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[23] CCA200603026 issued on March 6, 2006.
[24] Id.

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