

Authored by G. Michelle Ferreira and Travis J. Logghe

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IRS OFFERS A TEMPORARY REDUCED PENALTY STRUCTURE FOR VOLUNTARY DISCLOSURE OF OFFSHORE ACCOUNTS

"My goal has always been clear — to get those taxpayers hiding assets offshore back into the system." - IRS Commissioner Douglas Shulman on the issue of offshore income

Commissioner Shulman's goal not only echoes the long-standing position of the IRS, it has been pursued ambitiously in the IRS's recent effort to crack down on U.S. taxpayers hiding assets overseas. Fortunately for taxpayers, the IRS has recently implemented new disclosure guidelines and a penalty structure intended to encourage taxpayers to voluntarily disclose U.S. assets held in offshore accounts. The program offers those who comply the chance to avoid criminal prosecution and a barrage of significant penalties.

Background

Over the past year, the IRS has aggressively attempted to locate undisclosed offshore bank accounts of U.S. taxpayers. On July 1, 2008, a federal judge in Miami issued an order authorizing the IRS to request information from Switzerland-based UBS AG about U.S. taxpayers who may be using Swiss bank accounts to evade federal income taxes. The order authorized the IRS to service what is known as a "John Doe" summons on UBS. A John Doe summons is a means for the IRS to obtain information about possible tax fraud by people whose identities are unknown. A typical John Doe summons may direct a bank to produce records identifying U.S. taxpayers with foreign bank accounts who have taken steps to have their accounts remain hidden from the IRS. The IRS is also searching for U.S. merchants who are diverting assets into offshore accounts. On April 15, 2009, a Colorado federal court issued a John Doe summons to a company, which is related to the IRS's investigation of merchants who use offshore accounts to evade U.S. taxes.

As the IRS's quest for information about U.S. taxpayers with offshore assets intensifies, the IRS has also sought compliance through the recent Offshore Voluntary Disclosure Initiative. On March 26, 2009, the IRS announced its implementation of a new penalty structure designed to encourage taxpayers with offshore assets to come into its voluntary disclosure program, offering those who comply the chance to avoid criminal prosecution and additional penalties. Recently, on May 6, 2009, the IRS released a list of thirty frequently asked questions and answers (FAQs) on the new penalty structure.

Overview of Voluntary Disclosure Program and New Penalty Structure

Under the voluntary disclosure guidelines, the IRS will look back six years (2003 through 2008), and taxpayers must pay taxes, interest, and an accuracy or delinquency penalty for all such years. In lieu of all other penalties, taxpayers will be assessed a penalty equal to 20 percent of the amount in foreign bank accounts and entities in the year with the highest aggregate account/asset value. Penalties offered under the new voluntary compliance initiative have no defenses. In other words, the 20 percent penalty will apply regardless of whether the taxpayer had reasonable cause defenses for failing to report the income tax consequences of the foreign bank account. The new penalty structure is set to expire on September 23, 2009.

Why Should Taxpayers Make a Voluntary Disclosure?

As the IRS's FAQs state, voluntary disclosure is desirable for taxpayers because "it enables them to become compliant, avoid substantial civil penalties and generally eliminates the risk of criminal prosecution." If taxpayers do not come in under the voluntary disclosure program

HRO CONTACTS

Corporate
Private Client Services
Practice Groups

G. Michelle Ferreira
Partner
michelle.ferreira@hro.com
415-268-1905

Travis J. Logghe
Associate
travis.logghe@hro.com
303-866-0209



Holme Roberts & Owen LLP.
Attorneys at Law

and are later detected by the IRS, they may be subject to substantial civil penalties, including the fraud penalty and penalty for failing to file Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, commonly known as an "FBAR"). Fraud penalties can amount to 75 percent of unpaid tax, while the 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. Possible criminal charges related to tax returns include tax evasion, filing a false return, and failure to file an income tax return, all of which carry significant prison terms and fines.

Requirements of Voluntary Disclosure

In general, a voluntary disclosure occurs when the communication is truthful, timely and complete, and when a taxpayer cooperates with the IRS in determining a correct tax liability. The FAQs provide that taxpayers should send a letter to the nearest IRS Criminal Investigation office, with all identifying information, including name, address, Social Security number or other taxpayer identification number, passport number, and date of birth. The letters should include an explanation of any previously unreported or underreported income or incorrectly claimed deductions or credits related to undisclosed foreign accounts or entities, including the reasons for the errors or omissions. If taxpayers are represented, they should include a power of attorney form. A voluntary disclosure is applicable only if the IRS has not already begun a civil or criminal investigation of the taxpayer and before the IRS is in possession of information that will implicate the taxpayer. In the UBS investigation, taxpayers who want to participate in the new voluntary disclosure program must not be on certain identifying lists supplied to the IRS.

"Quiet" Disclosures

In the past, taxpayers have attempted "quiet" disclosures under which they file amended returns with Internal Revenue Service Centers and pay any related tax and interest for previously unreported offshore income without otherwise notifying the IRS directly. Most taxpayers do not report past income tax reporting errors through "noisy" disclosures, by identifying their incorrect reporting positions with the Criminal Investigation Division. The FAQs state that taxpayers must identify their foreign bank account reporting errors through a "noisy" voluntary disclosure by contacting their local Criminal Investigation Division office. The FAQs state that "taxpayers who have already made 'quiet' disclosures may take advantage of the penalty framework applicable to voluntary disclosure requests regarding unreported offshore accounts and entities." Such taxpayers must send previously submitted documents to their local IRS Criminal Investigation office by September 23, 2009.

Conclusion

U.S. taxpayers who have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade U.S. federal tax should immediately seek the advice of a competent tax attorney. The IRS's voluntary disclosure program may allow taxpayers to avoid harsh penalties and prosecution, but is only available until September 23, 2009. As IRS Commissioner Shulman has stated, "for taxpayers who continue to hide their head in the sand, the situation will only become more dire." Moreover, the central concept of the voluntary disclosure program is that the taxpayer must come forward and self-identify before the IRS opens an investigation of that person or has otherwise received information related to the taxpayer from third parties, such as a foreign bank. As the FAQs provide, once "the IRS has initiated a civil examination, regardless of whether it relates to undisclosed foreign accounts or undisclosed foreign entities, the taxpayer will not be eligible" for the voluntary disclosure program. In this respect, taxpayers should be aware that the IRS continues to receive information from whistleblowers and will likely pursue more John Doe summons against other foreign banking institutions in the future. Before approaching the IRS for a voluntary disclosure, it is advisable for a tax attorney to review all appropriate facts and circumstances with a taxpayer to determine whether he or she qualifies for the voluntary disclosure program.

Readers of this Alert should feel free to contact the authors of this Alert to discuss their eligibility for the voluntary disclosure program.

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