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Hot Issues Alerts

"Tax Amnesty" Is Still An Option: IRS Offers A "Second Chance" To Taxpayers With Undeclared Foreign Accounts And Holdings

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On January 26, 2011, the IRS "moved East" in its attack on foreign banks and their U.S. customers with undisclosed offshore accounts. The Department of Justice indicted Vaibhave Dahake, an Indian-American businessman in New Jersey, for conspiring with several bankers at an "International Bank" to maintain undisclosed accounts with the bank's offshore division, and thereby avoid his U.S. tax obligations. Press reports have identified the "International Bank" as global banking giant HSBC, which has substantial operations in India. Many observers have long suspected that Asia (particularly India, Hong Kong, Singapore and Korea) as well as Israel and other places outside Europe were now "where the money is" and the number of accounts/account holders in these places dwarfs even the 52,000 who reportedly had accounts at UBS. IRS is also said to be sifting through the information provided by taxpayers who made voluntary disclosures already to identify other banks to which some UBS accounts were transferred. These institutions are apparently also under scrutiny.

Shortly after Mr. Dahake's indictment on February 8, 2011, IRS Commissioner Douglas Shulman announced a second voluntary disclosure program for those U.S. taxpayers who still have undisclosed foreign holdings. In early March the IRS posted information about the new Program in eight languages, including Hindi and Korean.

Like the program which ended October 15, 2009, the new program not only provides a means to avoid criminal prosecution but also gives those who participate certainty as to their maximum civil penalty exposure.

Is the 2011 Offshore Voluntary Disclosure Initiative ("OVDI") "as good a deal" as the 2009 version? *It is not, and IRS expressly intended to ratchet up the cost of non-compliance*.

The penalty structure is modestly higher, and the IRS imposed very tight deadlines for completing the disclosure process, including filing all amended or delinquent filings by August 31, 2011. It has also indicated that the offshore penalty would be applied to even foreign assets not subject to a Report of Foreign Bank and Financial Accounts ("FBAR") or other reporting if acquired with funds the taxpayer cannot prove were previously reported. However, half a loaf is better than none and when all the options are evaluated, one must conclude that participation in the 2011 OVDI is the only viable option for a U.S. taxpayer with still undisclosed foreign holdings.

I. Key Parts of New Program

Eligibility

Any taxpayer whose source of income is a legal business or investment, who is not currently the subject of IRS audit, collection or Criminal Investigation Division activity and whose foreign account activity has not yet come to IRS's attention, can participate.

How do I start?

1) Apply for "pre-clearance" by faxing the client's identifying information to a central IRS Criminal Investigation Division (IRS-CI) office in Philadelphia.

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2) IRS-CI checks the taxpayer's name through its various databases and advises within 30 days if it is "clear." If so, the taxpayer must then submit a signed and sworn to "Offshore Voluntary Disclosure Letter" ("OVDL") providing basic details of the taxpayer's foreign accounts/activities to the IRS Offshore Voluntary Disclosure Coordinator in Philadelphia. *This document has significant self-incrimination potential, so anyone considering participating in the 2011 program needs competent legal advice about participating before applying for preclearance and certainly before submitting the OVDL.*

3) IRS-CI will review OVDL and advise if the client's voluntary disclosure has been "preliminarily accepted." If so, for all practical purposes, the client has *defacto* immunity from criminal prosecution for his/her prior IRS crimes but has a duty to continue to cooperate.

What happens after "preliminary acceptance"?

The client has to file eight years of amended returns as well as FBARs and any other required information returns regarding foreign assets or transactions such as Form 5471 and Form 3520 by August 31, 2011.

What if I miss the deadline?

If the client has gotten a "preliminary acceptance" letter from IRS-CI, he/she has protection against criminal prosecution but, according to IRS, will not qualify for the civil penalty protections available under the program.

What are the penalties?

The penalty on the additional tax due on the amended returns is still 20 percent of the additional tax for each year, *and* the one-time "offshore penalty" for not filing FBARs and other required information returns based on the highest value in all offshore accounts and the highest value of any non-bank/securities account assets (e.g. stock interest in a foreign business) over the period 2003 through 2010. The penalty amount is 25 percent (formerly 20 percent).

What is the "offshore penalty"?

It is an administratively created substitute for the much higher potential penalties that could be imposed under the various statutes penalizing the non-filing of FBARs and other information reporting forms on foreign assets or transactions.

For example, for a "willful" violation of the FBAR filing requirements, the maximum statutory penalty is 50 percent of the total value of any undisclosed foreign account. Each year is a separate violation. Thus, a six-year case involving the willful non-filing of FBARs results in a maximum statutory FBAR penalty of 300 percent (50 percent per year x six years) of the account value.

Are there any exceptions to the 25 percent "offshore" penalty?

The penalty is reduced to 5 percent for inherited accounts/assets if certain criteria are met.

There is also a 12.5 percent (not 25 percent) penalty structure for small ($75,000 or under) undisclosed foreign accounts.

Finally, as in the 2009 program, no penalty will apply where there was no U.S. tax due on the non-reporting of the foreign account or asset.

Can I negotiate on the penalties?

The FAQs that IRS issued provide a one-word answer: "No."

II. Is The 2011 OVDI A Further Step Forward Or A Step Backwards By IRS?

This is clearly not an "open arms" amnesty offer. There are a number of requirements, all of which may be strictly enforced, including the August 31, 2011 deadline to complete the entire process (including obtaining the required records, analyzing all of the issues and filing eight years worth of amended returns, FBARs and other required filings).

Finally, the cost is not cheap. With professional fees, back taxes plus all penalties and interest the actual cost of participation in the 2011 OVDI may exceed 40 percent of the value of the previously undisclosed offshore accounts/assets.

III. What Are The Alternatives?

Few taxpayers who contemplate making a formal voluntary disclosure do so for noble reasons. They do so because they fear the consequences of being caught and because some event (the audit of a vendor or customer, an investigation of an industry, etc.) has made that fear more real.

Non-compliant taxpayers have always had three basic options:

1) Make a formal voluntary disclosure; get an IRS commitment not to criminally prosecute, pay the civil tax, penalties (which the 2011 program provides a "cap" on) and interest and move forward without having to worry about the past;

2) Make a "quiet" disclosure by filing a number (usually either three or six) of years' amended returns with an IRS Service Center and delinquent FBARs in Detroit, and hope the filings will simply be processed without being scrutinized; or

3) Do nothing – hope for the best (and pray).

IV. Conclusion

The *Dahake* indictment suggests that the "International Bank" is under IRS scrutiny and, like UBS, may soon agree to cooperate with IRS and give over the names of its U.S. customers with accounts in other countries. If that happens, holders of such accounts cannot participate in the 2011 OVDI and face criminal prosecution or, at best, harsh civil penalties.

Even if one is not Indian-American and does not have an NRI account at the "international bank" mentioned in the *Dahake* Indictment, IRS's success in negotiating tax treaties and/or mutual legal assistance treaties ("MLATs") with an increasing number of former tax havens, the coordinated attack on tax havens by all major developed countries as well as new legislation (such as the recently enacted provisions of Foreign Account Tax Compliance Act, or FATCA) will make it increasingly difficult for any non-compliant U.S. taxpayer to maintain secret accounts/assets in "safe" jurisdictions and "safe" institutions anywhere.

In short, "doing nothing" increasingly is not a viable option for anyone who wants to be able to use and/or enjoy their undisclosed foreign accounts/assets.

Moreover, there are practical problems with completing a "quiet" disclosure for the prior six years (to cover the entire typical criminal prosecution period) in an offshore account/asset case. FBAR filings are much fewer in number than tax return filings, and all FBARs go to one place. Filing six delinquent FBARs disclosing foreign accounts with large balances is likely to raise eyebrows, especially now that IRS is actively looking to identify those trying "quiet" disclosures.

One doing a "quiet" disclosure who is discovered should expect to incur the wrath of IRS for trying to do what IRS has expressly said it frowns on. Even if criminal prosecution is unlikely, a vigorous civil attack (and maximum penalties) can be expected. For example, if the IRS can prove the taxpayer acted with the intent to evade U.S. tax, a 75 percent per year "civil fraud penalty" will apply to any resulting tax deficiencies, and there is no civil statute of limitations on how far IRS can look back. Moreover, such a taxpayer will also face FBAR penalties, which could be 50 percent of the account balance each year as well as other penalties for not filing other required "information" returns (Forms 5471, 926 or 3520).

These options will increasingly appeal only to the real risk taker, and it can be expected that more and more non-compliant taxpayers are likely to decide that, even at a 40 percent or more cost, solving the problem now is better than facing criminal prosecution and a federal prison sentence as well as truly draconian civil penalties if they are discovered later.