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IN PRACTICE

TAXATION

Tax Amnesty Is Still an Option

IRS offers second chance to taxpayers with undeclared foreign holdings

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The IRS has "moved East" in its attack on foreign banks and their U.S. customers with undisclosed offshore accounts. On Jan. 26, 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 that 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, are now "where the money is," and that the number of foreign accountholders in these places dwarfs even the 52,000 who reportedly had accounts with Swiss bank UBS at the time of its tax-evasion controversy in 2008. The IRS is also said to be sifting through the information provided by taxpayers who already made voluntary disclosures to identify other banks to which some UBS accounts were transferred. These institutions are apparently also under scrutiny.

On Feb. 8, shortly after Dahake's indictment, IRS Commissioner Douglas Shulman announced the 2011 Offshore Voluntary Disclosure Initiative (OVDI), a second voluntary disclosure program for those U.S. taxpayers who still have undisclosed foreign holdings. Like the program that ended on Oct. 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 OVDI as good a deal as the 2009 version? No, it is not. And the 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 Aug. 31. It has also indicated that the offshore penalty would be applied even to foreign assets not subject to the Report of Foreign Bank and Financial Accounts (FBAR) or other reporting requirements, if acquired with funds the taxpayer cannot prove were previously reported. However, half a loaf is better than none. 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.

Key Aspects of the New Program.

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

How to 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.
2. The 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 and activities to the IRS Offshore Voluntary Disclosure Coordinator in Philadelphia. This document has significant potential for self-incrimination, so anyone considering participating in the 2011 program needs competent legal advice before applying for preclearance and certainly before submitting the OVDL.

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

*What happens after preliminary acceptance? T*he client has to file eight years of amended returns as well as FBARs and any other required-information return regarding foreign assets or transactions, such as Form 5471 and Form 3520, by Aug. 31.

What if I miss the deadline? If the client has received a preliminary acceptance letter from IRS-CI, he has protection against criminal prosecution but, according to the IRS, he will not qualify for the civil penalty protections available under the 2011 OVDI.

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. 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 nonbank/securities account assets (e.g., stock interest in a foreign business, etc.) over the period from 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 nonfiling 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 nonfiling of FBARs results in a maximum statutory FBAR penalty of 300 percent of the account value (50 percent per year, multiplied by six years).

Are there any exceptions to the 25 percent offshore penalty? The penalty is reduced to 5 percent for inherited accounts and 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 unreported foreign account or asset.

Can I negotiate on the penalties? The FAQs that the IRS issued provide a one word answer: "No."

Is This a Step Forward or Backward for 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 Aug. 31 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 and assets.

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, the investigation of an industry, etc.) has made that fear more real.

Noncompliant 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 several (usually either three or six) years' worth of amended returns with an IRS Service Center, and delinquent FBARs in Detroit, and hope the filings will simply be processed without being scrutinized.
3. Do nothing — hope for the best (and pray).

The Dahake indictment suggests that "the international bank" in question is under IRS scrutiny and, like UBS did, may soon agree to cooperate with the 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 will face criminal prosecution or, at best, harsh civil penalties.

Even if one is not Indian-American and does not have an Non-Resident Indian account at the bank mentioned in the Dahake indictment, the success of the IRS in negotiating tax treaties or mutual legal assistance treaties 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), will make it increasingly difficult for any noncompliant U.S. taxpayer to maintain secret accounts or assets in "safe" jurisdictions and "safe" institutions anywhere.

In short, doing nothing is increasingly not a viable option for anyone who wants to be able to use and enjoy their undisclosed foreign accounts or 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 cases involving offshore accounts or assets. 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 the IRS is actively looking to identify those attempting to make quiet disclosures.

One who is discovered making a quiet disclosure should expect to incur the wrath of the IRS for trying to do what the IRS has expressly said it frowns on. Even if criminal prosecution is unlikely, a vigorous civil attack (and maximum penalties) can be expected.

These options will increasingly appeal only to the real risk-taker. It can be expected that more and more noncompliant taxpayers are likely to decide that, even at a cost of 40 percent or more, solving the problem now is better than facing criminal prosecution and truly draconian civil penalties if discovered later.■