IRS Targets Offshore Bank Accounts: Taxpayers Need Professional Guidance on Quick, Complete Disclosure

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The author believes that disclosure of offshore accounts can be handled with discretion and to the satisfaction of both the taxpayer and the IRS. But, he adds, full disclosure is mandatory, professional assistance and advice is essential, and the time is now.

With the steps I'm announcing today, we are beginning to crack down on Americans who are bending or breaking the rules, and we're helping to ensure that all Americans are contributing their fair share. In other words, we're beginning to restore fairness and balance to our tax code."

— President Obama
May 4, 2009

To many, tax management is an imperative. But one approach — offshore banking — has recently caught the attention of policymakers. The misuse of offshore bank accounts now, more than ever, has the potential to land tens of thousands of Americans in some very hot water.

To be sure, tax haven abuse — by individuals and corporations — has been known about for years. And it has been decried by politicians even as they turned a blind eye to it. There had been little political will to tighten rules, or create new ones, while the economy was doing well and America was prospering. Even with respect to enforcement of existing rules, there was a hesitancy to pursue the issue either for the purpose or tax revenue enhancement, or as a criminal matter.

Now, however, it seems that the necessary prerequisites are in place to prompt decisive action from the Administration and federal agencies:

- Government spending is accelerating and tax receipts are declining due to the recession.
- A litany of financial frauds, involving billions of dollars, have been making headlines for the past year — e.g., Madoff and others.
- Voter backlash from the recent bank bailouts is pressuring the Administration to take action on abuses within the financial services industry.
- The new president campaigned vigorously on tax fairness and ending what many see as favoritism of the rich in public policy.

The president has been very vocal about his be-

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liefs in "fairness." He is rolling out some very stringent policies to curb abuse — for financial institutions, individuals and corporations.

On May 4, 2009, the president released the following proposed guidelines as part of his plan to close existing loopholes and increase enforcement against financial institutions and high net worth individuals. The following five bullet points are taken from the press release that was issued by the White House on May 4, 2009:

- *Eliminating Loopholes for "Disappearing" Offshore Subsidiaries:* Traditionally, U.S. companies have been required to report certain income shifted from one foreign subsidiary to another as passive income subject to U.S. tax. But over the past decade, so-called "check-the-box" rules have allowed companies to make their foreign subsidiaries "disappear" for tax purposes — permitting them to legally shift income to tax havens and make the taxes they owe the United States disappear as well. The Obama administration proposes to reform these rules to require certain foreign subsidiaries to be considered as separate corporations for U.S. tax purposes.
- *Cracking Down on the Abuse of Tax Havens by Individuals:* Currently, wealthy Americans can evade paying taxes by hiding their money in offshore accounts with little fear that either the financial institution or the country that houses their money will report them to the IRS. In addition to initiatives taken within the G-20 to impose sanctions on countries judged by their peers not to be adequately implementing information exchange standards, the Obama Administration proposes a comprehensive package of disclosure and enforcement measures to make it more difficult for financial institutions and wealthy individuals to evade taxes.
- *Withholding Taxes From Accounts at Institutions That Don't Share Information With The United States:* This proposal requires foreign financial institutions that have dealings with the United States to sign an agreement with the IRS to become a "Qualified Intermediary" ("QI") and share as much information about their U.S. customers as U.S. financial institutions do, or else face the presumption that they may be facilitating tax evasion and have taxes withheld on payments to their customers. In addition, it would shut down loopholes that allow QIs to claim they are complying with the law even as they help wealthy U.S. citizens avoid paying their fair share of taxes.
- *Shifting the Burden of Proof and Increasing Penalties for Well-Off Individuals Who Seek to Abuse Tax Havens:* In addition, the Obama administration proposes tightening the reporting standards for overseas investments, increasing penalties and imposing negative presumptions on individuals who fail to report foreign accounts, and extending the statute of limitations for enforcement.
- *Devoting New Resources for IRS Enforcement to Help Close the International Tax Gap:* As part of the Obama Administration's budget, the IRS will hire nearly 800 new employees devoted to international enforcement, increasing its ability to crack down on offshore tax avoidance.

According to published reports by the Internal Revenue Service ("IRS"), abusive offshore transactions generally involve foreign jurisdictions that offer financial secrecy laws in an effort to attract investment from outside their borders. These jurisdictions are commonly referred to as "tax havens" because, in addition to the financial secrecy they provide, they impose little or no tax on income from sources outside their jurisdiction. It has been estimated that some $5 trillion in assets worldwide are held "offshore" in tax havens. Presumably, transfers from the U.S. represent a large share of this wealth. One authority has estimated the annual revenue loss to the U.S. at a minimum of $70 billion.

But the immediate concern for many U.S. taxpayers is what's happening on the enforcement front. The IRS is retroactively investigating offshore tax haven abuse back to 2003. The targets are tens of thousands of U.S. individuals and corporations that hold accounts at overseas institutions in places like Switzerland, the Bahamas and the Cayman Islands to name a few. At least 40 countries aggressively market themselves as tax havens. Some have gone so far as to offer asylum or immunity to criminals who invest sufficient funds. They permit the formation of companies without any proof of identity of the owners, per-

haps even by remote computer connection. Generally, though, such extremes are found in emerging nations where the stability and security of the financial, legal and political systems is questionable. Because of secrecy laws in these countries, they are a favored place to funnel assets in an attempt to avoid reporting and taxation.

The emblematic case, currently making its way through the courts, is the one against Union Bank of Switzerland ("UBS"), in which the U.S. government is seeking access to upwards of 50,000 accounts in Switzerland held by American taxpayers. Even while providing approximately 250 customer names to the IRS, UBS has not provided the remaining names. UBS's position is that they would be violating Swiss Law if they complied with the U.S. government's request.

At the same time, the IRS has instituted a voluntary disclosure program, in an effort to coax taxpayers into self-disclosure. But the program has a strict time limit. And even if the taxpayer wants to disclose, if the IRS unearths evidence of wrongdoing before the taxpayer has a chance to make a voluntary disclosure, the opportunity vanishes. The taxpayer is cut off from the benefits of voluntary disclosure and will likely face the full weight of financial and criminal penalties.

This situation calls for immediate communications efforts by attorneys and accountants with their clients, and here I believe it's in the client's best

The details of the voluntary disclosure program are as follows:

- Available until September 23, 2009
- Eligible taxpayers include individuals, corporations, partnerships and trusts
- Qualifying taxpayers may avoid criminal prosecution and civil fraud penalties by full and immediate disclosure — incomplete disclosure, if subsequently discovered, will likely void any agreement under the program
- Taxpayers will have to file up to six years of tax returns (2003 — 2008), either amended or delinquent, and pay all taxes and interest due (tax years ending prior to January 1, 2003, will not be subject to any income adjustments or interest and penalties)
- They will also have to file any un-filed FBAR forms -- Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR) — together with an explanation for the late filing (if all taxes had been paid there is no penalty for late filing of an FBAR form)
- Unreported income will be taxed and interest will be due on the computed amount20% accuracy related penalty or 25% delinquency. Delinquency penalty is for failure to file and accuracy related is for substantial understatement of income tax for any taxable year if the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or $5,000.
- A one time penalty of up to 20% of the highest aggregate balance held in the bank account and all assets (or at least the taxpayer's share) held by foreign entities (e.g., trusts and corporations) for which the taxpayer was required to file information returns, as well as all foreign assets (e.g., financial accounts, tangible assets such as real estate or art, and intangible assets such as patents or stock or other interests in a U.S. business) held or controlled by the taxpayer. (The IRS will reduce the latter 20% penalty to 5% in cases only where [1] the taxpayer did not open or cause any accounts to be opened or entities, [2] there has been no activity during the period when the account or entity was controlled by the taxpayer, and [3] all U.S. taxes have been paid on the funds in the account or entity.

interest that attorneys and accountants work together. But all types of advisors/counselors need to get educated on the issues surrounding the use and abuse of tax havens; generally, in order to help clients resolve any existing issues and avoid any future liability.

UNDERSTANDING THE VOLUNTARY DISCLOSURE PROGRAM

The IRS offshore tax program (the "Program") was announced prior to the April 15th due date of individual tax returns for calendar year 2008. Any 2008 unfiled returns, or returns on extension through October 15, 2009, should report any foreign source income earned during calendar year 2008. Additionally, June 30, 2009, is the due date for filing a report of Financial Bank and Foreign Accounts ("FBAR") form for any qualifying account held during calendar year 2008 with a balance of more than $10,000 anytime during the year. Both of these filing requirements should be considered when making application for the Program.

Successful voluntary disclosure — within the short time frame stipulated by the IRS under the Program — can potentially fully resolve any criminal exposure and minimize the possible impact of civil penalties. Moving quickly may also ease the repatriation of funds into U.S. banking institutions. However, it is important to proceed with caution and the right guidance and support.

The IRS is aware that some taxpayers have attempted so-called "quiet" disclosures by filing amended returns and paying any related tax and interest for previously unreported offshore income without otherwise notifying the IRS. 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.

Those taxpayers must send previously submitted documents, including copies of amended returns, to their local IRS Criminal Investigation office by September 23, 2009. Taxpayers who made "quiet" disclosures but do not plan to provide copies of the amended returns should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years.

It is important to note that the IRS has stepped up its enforcement efforts, including the use of John Doe summonses, to identify taxpayers using offshore accounts and entities to avoid tax. In addition, the IRS continues to receive information from whistleblowers and other taxpayers making voluntary disclosures.

If the IRS receives specific information about a taxpayer's noncompliance before the taxpayer attempts to make a voluntary disclosure, *the disclosure will not be considered timely and the taxpayer will not be eligible for the criminal and civil penalty relief available under the voluntary disclosure practice*. Therefore, taxpayers should not wait until the end of the six-month period to make their voluntary disclosures, as there is no guarantee that he or she will still be eligible or that the current penalty terms will be available after six months.

"One of these measures would let the IRS know how much income Americans are generating in overseas accounts by requiring overseas banks to provide 1099s for their American clients, just like Americans have to do for their bank accounts here in this country. If financial institutions won't cooperate with us, we will assume that they are sheltering money in tax havens, and act accordingly. And to ensure that the IRS has the tools it needs to enforce our laws, we're seeking to hire nearly 800 more IRS agents to detect and pursue American tax evaders abroad."

— President Obama
May 4, 2009

THE IRS IS TAKING A HARD LINE POSTURE

Given the clear and forceful statements from the president and various government agencies, no one should think that this is a short-term issue that will disappear as soon as the heat of the moment subsides. This is a long-term, comprehensive enforcement ef-

fort that will persist for some time.

The Administration has sent a forceful message that the IRS will take a hard line with those whom it suspects of crossing the line form tax management into tax fraud. The authorities are using all means at their disposal to uncover, pursue and prosecute tax evasion using offshore accounts. Not only are they seeking more cooperation from tax haven countries, but they also have a number of legal tools at their disposal including, The Patriot Act. If the U.S. can prove funds are related to illegal conduct under any number of scenarios, then other governments are more likely to provide financial disclosure. And the IRS is adding hundreds of new agents to its enforcement division.

In addition, the IRS will be looking to accomplish the greatest deterrent effect for the least expense — i.e., the agency will likely go after a big names and high-dollar cases so that the deterrent effect will trickle down to everyone else. Such an approach also reinforces the Administration's message of tax fairness — i.e., that high-net-worth clients need to pay their fair share because they're doing so much better than everyone else. The basic message that the Feds are sending out is: if we think you are a U.S. taxpayer who's avoiding taxes with offshore shelters*, we're going to do everything in our power to find out*.

"VOLUNTARY DISCLOSURE" MEANS EXACTLY THAT

Under the rules of the Program, there is no substitute for full and voluntary disclosure. But first, taxpayers need to provide a full explanation — with documentation — to their accounting and legal advisors, to get an appraisal of their potential exposure. These advisors also need to complete sufficient due diligence to verify their client's story so that they can verify it to the authorities; the authorities will do their own investigation as well. Of important note is that disclosure requires providing a *reason* why the taxpayer used offshore accounts, as well as proof that the sheltered income was not earned illegally.

Again, time is of the essence. The IRS is serving banks with subpoenas right now. If a bank makes a disclosure about the taxpayer's account before the taxpayer does, then he or she won't qualify for the program. As a result, the monetary penalties will be raised to 75%, and there will be a serious threat of civil fraud penalties (not to mention significant potential reputational damage) and possible criminal penalties. And, finally, the complete truth is absolutely essential: any later disclosure (voluntary or involuntary) will likely nullify any previous relief from prosecution.

Now, some people might be in a gray area and not know whether what they have done is illegal or not. Generally, if certain accounts were set up to avoid reporting income or identifying income/accounts to the government (and paying taxes on the funds), then chances are that activity is illegal, and it's necessary to move forward to rectify the situation.

THE ROLE OF PROFESSIONAL ADVISORS

Lawyers and accountants are not just the professionals who taxpayers turn to in times of trouble; they are champions of their clients' best interest, working to ensure that clients' needs are met to the furthest extent possible including helping clients stay out of trouble.

That commitment is also met by strong responsibility. We advise that now would be a good time to reassert a basic fundamental of practice management: Know your client and what he or she is trying to accomplish. Remember that there are many legitimate reasons to hold offshore accounts — e.g., investments in local currencies; payroll accounts for local employees; trust accounts intended to protect inheritance. But these are all fairly transparent and don't involve *hiding* anything. Red flags are easy to spot: Evasion and concealment are the marks of bad motive or purpose and likely indicate questionable legality from a tax-reporting standpoint.

Remember that executing strategies for your clients that turn out to be illegal places you right in the middle of a conspiracy — having committed an overt act and likely to be indicted with the client. The issue here is one of educating clients about the rules and paying strict attention to clients' needs and requests. It's crucial that attorneys, accountants and financial advisors convey to clients the difference between legitimate strategies for tax minimization versus tax fraud — and, specifically in this case, the legitimate versus suspect uses of offshore accounts.

A UNIQUE SKILL SET IS REQUIRED TO RESOLVE THESE ISSUES

In the current context of fiscal pressure, the government is pushing forward quickly on efforts to crack down on potentially illegal tax havens. Compliance with these disclosure requirements is a complex process — both taxpayers and their legal counsel will want to make sure that efforts are moving forward correctly.

The requirements can range from preparing amended returns, to arranging for installment agreements and representing taxpayers before the IRS and other tax authorities, to providing due diligence, forensic accounting and other fraud investigation services. We recommend that any tax advisor handling these issues should be…

- Well-versed in international tax codes and familiar with foreign bank accounts, such as properly recording associated income and calculating exposure and penalties.
- Experienced with high-net-worth clients and have insight into their unique financial, business and reputational sensitivities.
- Forensic experts, which can make all the difference in developing a tailored disclosure strategy for individual taxpayers.
- Able to provide litigation support, to work with legal counsel on complex matters that require discretion and appropriately handle the attorney-client work product.
- Knowledgeable about government agencies, such as the Criminal Investigation Division of the IRS and SEC, as well as other agencies.

With the right professional support, and a well-intentioned effort to provide full disclosure, I believe that the current issue of disclosure of offshore accounts can be handled with discretion and to the satisfaction of both the taxpayer and the IRS. But full disclosure is mandatory, professional assistance and advice is essential, and the time is now.