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Audit Might Be Best Choice for U.S. Taxpayers in Voluntary Disclosure Program

by Randall Jackson

U.S. taxpayers who enrolled in the IRS's voluntary disclosure program may find it in their best interests to challenge the IRS penalty through an audit, David Gannaway, director in the Litigation and Corporate Financial Advisory Services Group at Marks Paneth & Shron LLP in New York, told Tax Analysts on April 7.

Applications for the program were due October 15, 2009, and the final deadline for taxpayers to comply with an information document request was January 15. Affected taxpayers now are awaiting confirmation of their submissions and the penalty they will be required to pay to complete the process. (For prior coverage of the voluntary disclosure program, see *Doc 2009-7193* or *2009 WTD 64-6*.)

However, Gannaway said taxpayers' immediate concern should be whether they will accept the penalty or challenge it through an audit.

The IRS is wading through more than 15,000 submissions it received in response to the voluntary disclosure program, a number that, while far short of the total number of people who could have joined the program, may have surprised the IRS and left it ill-equipped to complete the evaluations in the time frame originally planned, Gannaway said.


David Gannaway

Gannaway told Tax Analysts that taxpayers should now be deciding whether the possible upside of challenging the IRS's findings may be worth the stress and the risk of alternate penalties and litigation costs.

''What they need to be concerned about is the decision they'll have to make once the IRS does call — should they accept the standardized penalty, or contest it by asking for an audit. An audit can be difficult and time consuming, but it could drastically lower the 20 percent 'offshore' penalty amount that taxpayers will have to pay,'' Gannaway said in an April 5 client alert.

Taxpayers taking part in the voluntary disclosure program will be required to pay all back taxes and interest accrued in the six years preceding the disclosure; an accuracy or delinquency penalty for all years involved; and a 20 percent penalty, assessed for the year in which the highest aggregate amount was held in the taxpayer's account, in lieu of all other penalties, most notably the foreign bank account reporting penalty.

A 5 percent penalty could replace the 20 percent penalty if, throughout the period in which the taxpayer controlled the account:

- the taxpayer did not open (or cause to be opened) any foreign account, or cause any entity to be formed;
- there were no deposits or withdrawals from the account; and
- all applicable U.S. taxes were paid on the funds in the offshore account or foreign entity (so that only the earnings escaped U.S. taxation).

However, those conditions are difficult to meet and will essentially apply only to inherited accounts that have never been accessed.

Gannaway said that in his experience, a high percentage of taxpayers joining the voluntary disclosure program either inherited offshore accounts or placed savings that had already been taxed in the U.S. into an offshore account, believing the assets would be more secure there. Often they never receive any earnings from the offshore accounts, he said, adding that only a small number systematically go offshore to avoid paying their taxes.

By instituting a set penalty, the IRS has eliminated the thought process for field agents. ''But this creates a situation in which everyone is in the same pool —

those who have spent years dodging taxes and those who inherited money that was in an offshore account,'' Gannaway told Tax Analysts. The IRS ''is not evaluating each individual case on its merits. This program forces the assigned revenue agents to rubber-stamp each case and apply the 20 percent penalty without fully exploring the relevant facts,'' he said.

Because the penalty is always 20 percent (with the one exception mentioned above), the variation in the amount of the penalty arises solely from the amount held in each account. Therefore, rather than penalizing conduct, the IRS is penalizing based on account size, by implication assuming that all taxpayers acted willfully, Gannaway said.

In an audit, the key issue for a taxpayer is the need to force the IRS to prove that the taxpayer's actions were willful, Gannaway said. If the government is unable to do so, the taxpayer could face a much lower penalty of $10,000 per year for each year an FBAR was not filed. But if a taxpayer is found to have acted willfully and has opted out of the voluntary disclosure program, the 20 percent penalty cap will no longer apply and the taxpayer could face penalties of up to 50 percent.

That brings the taxpayer's decision down to a cost benefit analysis. Variables to be considered include the amount held in the account (or the magnitude of the possible penalties involved), the cost of litigation, and the stress of undergoing an audit. Gannaway said he has clients who would much prefer completing the process and putting it behind them rather than litigating against the IRS, regardless of the variables.

The difference in penalties can be extreme. For example, Gannaway said, for an individual with a $500,000 account facing a $100,000 penalty under the voluntary disclosure program, successfully challenging the IRS could lower that cost to $50,000. However, the cost of litigation and the stress involved could make that option unappealing to the taxpayer. But for a taxpayer with a $5 million account, the 20 percent penalty is $1 million. In that case, the audit option could be appealing.

To prove that a taxpayer acted willfully, the IRS must show that the taxpayer acted to evade taxes. Ordinary bank records may not indicate that, Gannaway said, but e-mails and faxes, including communications between the taxpayer and an overseas institution such as Swiss bank UBS, can be telling.

For that reason, the change in bank secrecy rules — particularly involving Switzerland — could have a major impact on taxpayers. IRS investigators conducting interviews with taxpayers and the related accountants and brokers offshore now can compare those findings with records that were previously unavailable. Through those investigations, the IRS will try to establish that a taxpayer had knowledge of what was going on, and willfulness may then be established.

Gannaway said he believes many taxpayers are uninformed about the audit option and so are unaware of the possibility of significantly reducing their penalties.

He added that because the FBAR was promulgated following the Bank Secrecy Act under Title 31, and not Title 26, of the U.S. Code (with enforcement authority delegated to the IRS), litigation would take place in a federal district court rather than a tax court, which could work in the taxpayer's favor in some cases.

Gannaway said the voluntary disclosure program may not be a good deal for most taxpayers now awaiting a response from the IRS and that those taxpayers should consult with their tax advisers about challenging the outcome through an audit.

♦ *Randall Jackson is a legal reporter with Tax Notes International. E-mail: rjackson@tax.org*