

IRS Focus on Offshore Account Holders

What's Next?

by Wendy Abkin

FOR SEVERAL YEARS, IRS officials have been focused on educating lawyers and accountants about reporting obligations related to offshore financial arrangements, most notably the “Report of Foreign Bank and Financial Accounts,” or “FBAR” form. These complex filing rules have been poorly understood by both taxpayers and practitioners, and the potentially stiff penalties were rarely enforced by the IRS. However, with the help of attacks on foreign bank secrecy laws (and, specifically, banking giant UBS), strengthened information exchange agreements with treaty partners, and a former-banker-turned-informant, it is safe to say that 2009 was the year the IRS delivered its message loud and clear.

In March of 2009, the IRS announced a limited time “special offer” aimed primarily at holders of overseas bank accounts who had not met their tax reporting obligations. Built on a longstanding policy of the IRS, the “Offshore Voluntary Disclosure Program” provided that eligible taxpayers who voluntarily came forward to report their offshore financial arrangements would get a significant break on potential civil penalties (which can be as high as 50% of the value of the account each year) and, most importantly, would be immunized from criminal prosecution for their prior failures. After the October 15, 2009 deadline passed, the IRS announced that at least 14,700 taxpayers had voluntarily come forward — an overwhelming response.

So, what happens next? What factors should be considered by those who — intentionally or not — missed that deadline? Should they — and can they — still come forward? The IRS has made it clear that the longstanding voluntary disclosure policy remains in effect and taxpayers can still come forward to remedy their past

reporting failures and mitigate the risk of criminal prosecution, despite missing the October 15, 2009 deadline. What is not clear, however, is how the IRS will apply the potentially ruinous penalties under those circumstances. To qualify as a “voluntary disclosure,” the taxpayer must make a timely, truthful and complete communication to the IRS regarding the taxpayer’s past compliance failures. In addition, the taxpayer must cooperate with the IRS to determine the correct tax liability and make good-faith arrangements to pay the tax, interest and penalties. Finally, to be a voluntary and timely disclosure, the taxpayer must reach out to the IRS before it becomes aware of the taxpayer’s non-compliance or initiates action with respect to that taxpayer. Since the IRS can learn about a particular taxpayer from third parties or other investigations or examinations that lead to the taxpayer, a taxpayer does not necessarily know whether the IRS has already become aware of the past compliance failures. Thus, the opportunity for a timely, voluntary disclosure may be lost if the taxpayer waits too long.

Many offshore account holders may have declined to participate in the IRS Offshore Voluntary Disclosure Program for reasons based on erroneous assumptions, such as: 1. The account was not at UBS or was not at a Swiss bank (the reporting rules apply to financial accounts in any other country); 2. The account had been closed recently or was to be closed in the near future (if the account was open at any time in a prior year, the necessary form must be filed by June 30 of the following year); 3. The funds in the account weren’t from illegal activities (the source of the funds in the account is irrelevant for reporting purposes); 4. Tax was already paid on the money in the account (also irrelevant; the form to be filed is for

informational purposes only, and no additional tax is due simply for having a foreign account); 5. The money in the account was inherited (also irrelevant, but the account holder may have had other filing obligations in prior years depending on his or her relationship to the original depositor); and 6. The account balance is too low to interest the IRS (if the aggregate value of all offshore accounts is over \$10,000, the report of foreign bank accounts must be filed; no one wants to be the guinea pig to find out “how low will they go?”).

In addition, taxpayers may conclude there is little risk of being penalized because they believe the IRS will never find them. They may be right; the IRS acknowledges that it won’t find everyone. But taxpayers should be aware that the world has changed. In recent years, the IRS has devoted significant funding and resources to increasing international tax compliance, both at the individual and corporate levels. Legislation is now pending to give the IRS more enforcement tools. And the IRS is not the only tax agency pursuing this course; tax administrators from many other countries have agreed to cooperate in a global effort to combat tax evasion, focusing on banking, wealthy individuals and offshore activities. On a practical level, the 14,700 taxpayers who came forward under the Offshore Voluntary Disclosure Program represent potentially 14,700 more leads for the IRS. Additional revenue agents have been hired and trained in these specific issues. After those agents have honed their skills reviewing the information provided by the 14,700 who participated in the disclosure program, they’ll turn their attention (and their new skills) to those who didn’t. The IRS Criminal Investigation Division has, in fact, already begun investigations focused on offshore accounts.

Taxpayers who held a foreign account or accounts with a total value of more than \$10,000 during 2009 can't simply ignore the problem or make it go away by closing the account. The FBAR is due June 30, 2010. During this filing season, return preparers are likely to exercise much more due diligence about offshore account issues. Clients may be surprised to find their return preparer asking pointed questions about foreign accounts and unreported income during this filing season. Preparers are themselves facing additional scrutiny for failing to flag the issue previously. Furthermore, if the foreign account is held through other entities, such as foreign corporation or foreign trust, there are additional reporting obligations. The "unwinding" of these arrangements may be fraught with additional tax consequences and reporting obligations.

Finally, California taxpayers must also consider the impact of their decisions for state tax purposes. Although there is no FBAR required for California tax purposes, if a taxpayer amends a federal tax return, there is an obligation to file an amended California tax return if additional state tax is due. However, the Franchise Tax Board ("FTB") is not bound by the IRS agreement not to criminally prosecute individuals who voluntarily disclose. The federal disclosure process may include a taxpayer's damaging admissions about unreported income or other compliance failures. FTB officials have not indicated how they will approach such issues.

Advisors to taxpayers with offshore financial arrangements must consider many factors in evaluating how to deal with past compliance failures, as well as future reporting obligations. Many uncertainties remain, but one thing is clear: neither the problem *nor* the IRS will go away on its own. ♦



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