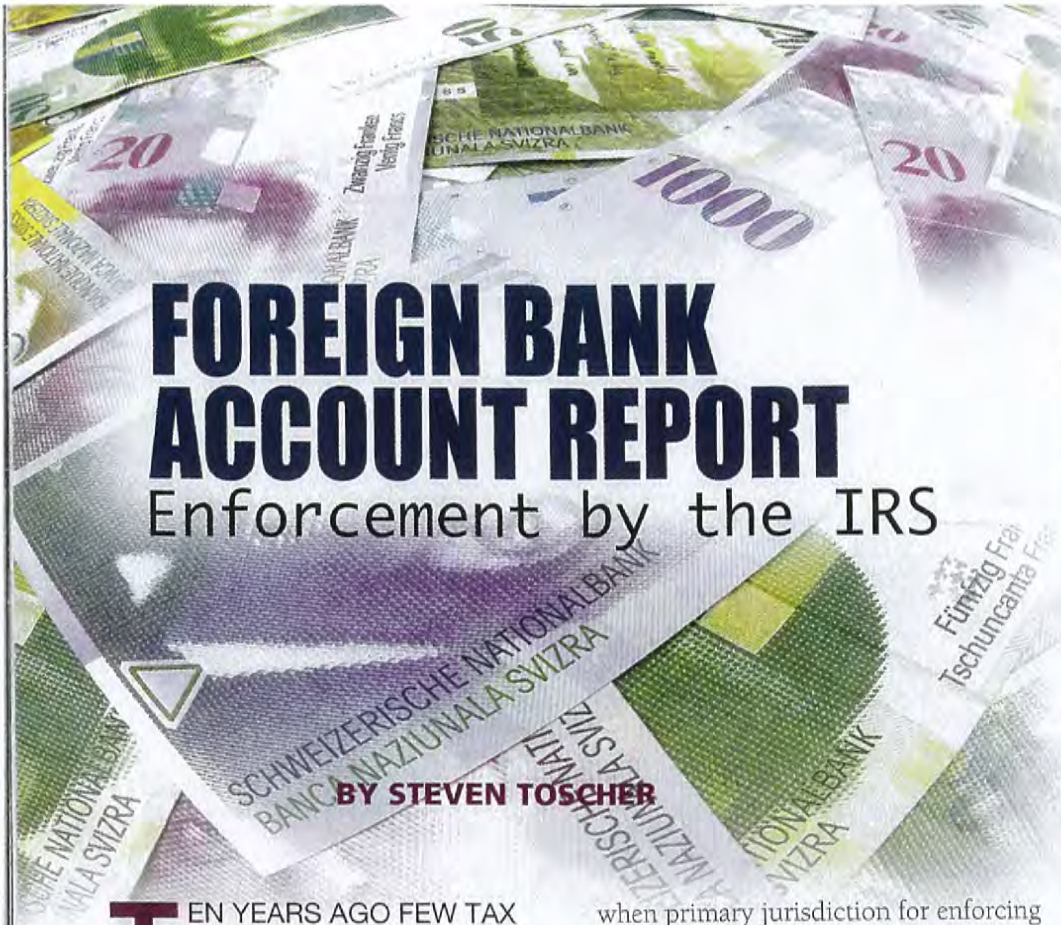

FOREIGN BANK ACCOUNT REPORT

Enforcement by the IRS

BY STEVEN TOSCHER

TEN YEARS AGO FEW TAX practitioners knew what a Foreign Bank Account Report ("FBAR") form[1] looked like and even fewer taxpayers new of their obligation to file the form. That is no longer the case. The Internal Revenue Service ("IRS") recently completed two Offshore Voluntary Disclosure Initiatives ("OVDI" or "Initiatives") in which approximately 30,000 United States taxpayers came forward and voluntarily disclosed their foreign bank accounts and past non-compliance to the IRS.[2]

These taxpayers were able to avoid potential criminal prosecution under the IRS long-standing voluntary disclosure practice and resolve their civil liability for additional taxes, interest and penalties. The most recent Initiative ended on September 9, 2011. The IRS announced that it collected $2.2 billion from taxpayers in the 2009 Initiative and an additional $500 million as down payments from taxpayers on the 2011 Initiative.[3]

Now that these two Initiatives have ended, what can now be expected from the IRS in terms of criminal investigations and prosecutions; civil examinations? And how will the IRS deal with taxpayers who come forward now and make a voluntary disclosure after the close of these formal Initiatives?

The Government's significant enforcement efforts in the foreign bank account area commenced in 2003 when primary jurisdiction for enforcing foreign bank account reporting was turned over to the IRS.[4] The watershed event occurred in February of 2009, when the giant Swiss bank, UBS, under threat of criminal prosecution from the U.S. Department of Justice ("DOJ"), turned over "secret" bank account information on approximately 280 of their U.S. clients and subsequently agreed to turn over information on many thousands more. The veil of Swiss secrecy was breached—forever.[5]

With the end of the two OVDIs, one could reasonably ask: Is this the beginning of the end of the IRS' enforcement effort? More likely, this is the end of the beginning. If the government can be taken at its word, the multi-front enforcement effort of the IRS and the DOJ will continue. As noted recently by IRS Commissioner Doug Shulman: "By any measure, we are in the middle of an unprecedented period for our global international tax enforcement efforts. We have pierced international bank secrecy laws, and we are making a serious dent in offshore tax evasion."[6]

The enforcement effort includes criminal investigations and prosecutions, IRS civil examinations and efforts by Congress to strengthen foreign bank obligations to report information on U.S account holders, as reflected in the recently enacted FATCA legislation.[7] Enacted in 2010, and now scheduled to be effective in 2014, FATCA will require foreign financial institutions to report to the IRS information on accounts held by U.S. taxpayers (or their entities). Failure to make the required reports subjects the banks to substantial and punitive withholding taxes.

Criminal Investigations and Prosecutions

As of the present date, there have been over 60 publicly announced criminal prosecutions arising out of the UBS foreign bank account investigation. The charges have included the filing of false income tax returns, tax evasion, conspiracy and the failure to file the FBAR form, all federal felonies. There have been 32 plea dispositions, three guilty verdicts and no acquittals—yet. Additionally, it is estimated there are an additional 100 pending criminal investigations for which charges have not yet been brought. These criminal investigations and prosecutions include U.S. taxpayers, attorneys, foreign bankers and foreign banks.

The sentences handed down for foreign account bank violations under the advisory Federal Sentencing Guidelines have ranged from probation to multiple years in jail. Very recently, on November 10, 2011, a former client of UBS was sentenced to one year and a day for conspiring to defraud the IRS.

Press reports suggest there are approximately eleven Swiss banks under active criminal grand jury investigation for illegally assisting U.S taxpayers in evading taxes. Investigating and prosecuting the banks is a core strategy of the DOJ and the IRS. Without the assistance of the banks and bankers, U.S. taxpayers would find it difficult if not impossible to avoid U.S. taxation through the foreign banking system. The strategy has paid big dividends for the Government. The UBS investigation and its fallout helped persuade approximately 30,000 U.S. taxpayers to enter into the OVDIs.

Credit Suisse Account Holders

There is now a repeat of that strategy relating to another Swiss banking giant—Credit Suisse. Taxpayers have started receiving the letters similar to those which UBS clients received, indicating that a request for information on U.S. account holders has been received and that Credit Suisse has been ordered to turn over the information to the Swiss Federal Tax Administration (the Swiss IRS) and then to the IRS

unless the U.S taxpayer can demonstrate the turnover of the information would violate Swiss law, including the U.S.-Swiss Tax Treaty. Taxpayers who banked with UBS did not fair well in preventing the turn over of account information to the IRS and it is unlikely that Credit Suisse account holders will do any better.

Civil Enforcement Efforts

The criminal investigations and prosecutions are but one prong of the Government's multi-faceted enforcement effort. There are not enough resources to prosecute every person who might be guilty of a tax crime, including one related to a foreign bank account. Accordingly, a robust effort should be expected by the civil examination function of the IRS to examine those taxpayers who are believed to have foreign bank accounts and who have not come forward on their own through the voluntary disclosure process.

While a letter from an IRS Revenue Agent investigating a civil tax matter is a far happier greeting than a grand jury subpoena served by the Criminal Investigation Special Agent, these civil examinations contain their own set of challenges.

These challenges include the potential of a referral to the Criminal Investigation if "firm indications of fraud" are discovered during the audit and the large, some would say draconian, civil penalty liabilities for failure to appropriately report the existence of a foreign bank account. While the more serious penalties relate to willful failures to report the income or the existence of the foreign account, such as the 50 percent willful FBAR penalty[8] or the 75 percent civil fraud penalty[9], there are also substantial penalties where the taxpayer will have to show reasonable cause in order to avoid those penalties, a standard more difficult for a taxpayer to meet.[10]

The draconian nature of the penalties is made clear from the IRS' own announcements.[11] In their example of a penalty calculation, assuming there was $1 million in an account beginning in 2003 and it earned a modest $50,000 of interest income each year, the potential civil liabilities, tax, accuracy related penalty, accrued interest and the 50 percent willful FBAR penalty, totals $4,375,000. As one can see, the civil exposure—even if a taxpayer is lucky enough to avoid a criminal investigation

and prosecution—is very substantial, indeed life threatening from an economic point of view.

Many practitioners ask whether the IRS will really assert these draconian penalties. While the IRS may have a considerable burden of proof in sustaining willful penalties and asserting these very large penalties implicates constitutional limitations[12]—the answer is yes. The leadership of the IRS appears committed to vigorously enforcing the laws relating to these foreign information reporting penalties.

There is no question that the multi-faceted enforcement effort will continue, including criminal investigations and prosecutions, civil examinations and the assertion of large civil penalties. As a practical matter, just like every taxpayer who commits a criminal violation will not be caught and punished, not every foreign account holder will fall within the net of IRS civil enforcement efforts. But if the enforcement effort continues as anticipated and the FATCA legislation is implemented, the risks of being caught will increase dramatically. Criminal investigations and prosecutions take a severe toll on any taxpayer—even those who are not convicted. Civil tax enforcement efforts—when large draconian penalties are at stake—pose a similar hazard. Both can be "life" threatening.

A Voluntary Disclosure is Still Possible

Thus far, 30,000 taxpayers have entered into the formal OVDIs. Some believe many more taxpayers have quietly amended their tax returns or are starting to comply with their foreign reporting obligations prospectively. The question is how many more taxpayers are still out in the cold, waiting for the next foreign bank to come under scrutiny? No one knows for sure. Estimates range from hundreds of thousands to millions of U.S. taxpayers.

Based upon the recent activity concerning Credit Suisse, there appears to be many U.S. taxpayers who have not come forward. What should those taxpayers do at this time? While the formal OVDIs have now terminated, the IRS and DOJ's long-standing voluntary disclosure practice and policies are still in effect[13] and there is still time to come forward with a voluntary disclosure if the taxpayer's name has not already been turned over to the Government.

The current IRS policy on voluntary disclosure generally provides that a voluntary disclosure occurs when the communication to the IRS is truthful, timely, complete, and when (a) the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and (b) the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.

A disclosure is timely if it is received before:

a. the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;
b. the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance;
c. the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or
d. the IRS has acquired information directly related to the specific

liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).[14]

Even if the taxpayer has received a letter from Credit Suisse (or another foreign bank) stating that information has been requested by the IRS, the taxpayer may still be eligible if the Government has not received the information on the specific taxpayer. However, if a foreign banker or adviser has already provided the name of the taxpayer to the IRS (e.g., they are cooperating with the IRS or DOJ), it is likely too late.

When a taxpayer does come forward and qualifies for a voluntary disclosure, the IRS will not recommend, and the taxpayer will be able to avoid, a criminal investigation and prosecution. However, the termination of the formal OVDIs leaves taxpayers guessing as to what the civil examination and penalty regime will be.

Under the recently concluded OVDI, taxpayers were expected to file amended returns for the years 2003 through 2010, pay all tax and interest, a 20 percent accuracy related penalty and a 25 percent foreign information reporting penalty on the highest value of their foreign bank accounts and other foreign financial assets during that period of time.

It is fair to conclude that unless there are mitigating circumstances, at a minimum, in any voluntary disclosure made now, the IRS will be looking for a civil resolution framework similar to the last OVDI, although the penalty structure will likely be higher. The 2009 OVDI foreign information-reporting penalty of 20 percent was increased to 25 percent in the 2011 program.

While the uncertainty of the civil penalty structure does create a more complex judgment for both the tax practitioner and the taxpayer—what is important is that the practice regarding voluntary disclosures which allow taxpayers to avoid criminal prosecution is alive and well and taxpayers wanting to avoid potential criminal prosecution should act promptly. Moreover, the IRS Commissioner has made clear that in considering penalties, the IRS should continue to "draw a clear line between those individual taxpayers with offshore accounts who voluntarily come forward to get right with the government and those who continue to fail to meet their obligations."[15] The line referred to by the Commissioner is a bright, rigid and unforgiving line.

A taxpayer who has committed a very serious and provable criminal tax violation can receive the benefits of the voluntary disclosure practice and avoid prosecution. The sins of the past are basically forgiven, at least for criminal purposes. But in order to qualify, the taxpayer must get to the IRS before the IRS gets to the taxpayer.

A taxpayer whose case is much less egregious—but on the wrong side of this line—may find himself the subject of criminal investigation, potential prosecution and incarceration. Timing is everything in the voluntary disclosure world and the clock is ticking for U.S holders of foreign bank accounts who are not yet in compliance.

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[1] The Foreign Bank Account Report form is a TD F 90.22.1 and is authorized under the Bank Secrecy Act (Title 31 U.S.C Sections 5311-5330). For more in depth analysis of the substantive requirements and history of FBAR enforcement, see Toscher and Stein, *"FBAR Enforcement is Coming!*, CCH Journal of Tax Practice & Procedure (December-January 2004); Toscher and Stein, *"FBAR Enforcement–an Update*, CCH Journal of Tax Practice & Procedure (April-May 2006); Toscher and Stein, *"FBAR Enforcement–Five years Later*, CCH Journal of Tax Practice & Procedure (June July 2008).

[2] See IRS News Release, IR-2011-94, September 15, 2011.

[3] Id.

[4] See IRS News Release, IR-2003-48, April 10, 2003.

[5] For a more complete discussion of the UBS matter, see Toscher, *"Civil and Criminal Tax Enforcement Implications of the UBS Enforcement Initiative and the Future of Voluntary Disclosure,"* 52 Tax Management Memo No. 3, 43 (January 31, 2011).

[6] See IRS News Release, IR-2011-94, September 15, 2011.

[7] FATCA was added as part of the Hiring Incentives to Restore Employment Act of 2010 and is codified in Sections 1471-1474 of the Internal Revenue Code.

[8] See Title 31 U.S.C. Section 5321(a)(5). The IRS must prove willfulness by "clear and convincing" evidence and a general presumption of correctness afforded to tax assessments does not apply. See CCA 200603026 (September 1, 2005). See also *Williams v Untied States*, CA No. 1:09-cv-437 (E.D. Va. Sept. 1, 2010). See recently, *Browning v Commissioner*, T.C. Memo 2011-261 (11/3/11) (holding taxpayer liable for fraud penalty in part because of undisclosed foreign bank account).

[9] See Title 26 U.S.C. 6663.

[10] See for example, Title 26 U.S.C. Section 6677, relating to certain failures to report transactions with a foreign trust.

[11] See IRS OVDI FAQ No. 12.

[12] See Toscher & Lubin, *"When Penalties are Excessive – The Excessive Fines Clause as a Limitation on the Imposition of the Willful FBAR Penalty,"* CCH Journal of Tax Practice & Procedure, December 2009-January 2010.

[13] The current IRS policy is contained in Internal Revenue Manual (IRM) 9.5.11.9 (October 6, 2011) and the DOJ Policy is contained in the Tax Divisions Criminal Tax Manual (2008 Ed.), Sec. 4.01 and Sec. 3 (Tax Division Policy Directives and Memoranda), pp. 3-12 and 3-13.

[14] IRM 9.5.11.9 (October 6, 2011).

[15] See Statement by Commissioner Shulman on Offshore Income, March 26, 2009, Doc. 2009-6833, 2009 TNT 57-11.