Practice

Epilog: The IRS Penalty Memos and the Voluntary Disclosure of Offshore Accounts

By Charles P. Rettig and Kathryn Keneally

IRS Commissioner Doug Shulman has continually attempted to encourage taxpayers, particularly those with undisclosed interests in foreign financial accounts, to get back into compliance. On or about July 21, 2008, the IRS served a John Doe Summons on a noted Swiss bank ("the Swiss Bank")[1] for information regarding accounts of certain U.S. persons that became the subject of a matter pending in the U.S. District Court for the Southern District of Florida ("the John Doe Action").[2]

On August 19, 2009, the United States and the Swiss Confederation entered into an agreement providing for an information exchange mechanism intended to achieve the U.S. tax compliance goals of the John Doe Action while also respecting Swiss sovereignty ("the US-Switzerland Agreement"). Specifically, under the US-Switzerland Agreement, the IRS received authority to deliver to the Swiss Federal Tax Administration (SFTA) a request for administrative assistance, pursuant to Article 26 of the 1996 Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income ("the 1996 Convention"), seeking information with regard to accounts of certain U.S. persons maintained at the Swiss Bank in Switzerland ("the Treaty Request").

Also on August 19, 2009, the United States, the IRS and the Swiss Bank entered into a Settlement Agreement ("the Settlement") providing that the Swiss Bank would provide account information, on a rolling basis, to the SFTA on the following schedule:

- Within 60 days after it receives notice from the SFTA that the Treaty Request has been received by the SFTA, the Swiss Bank is required to submit and has submitted to the SFTA the first 500 cases described in paragraphs 2.A.b and 2.B.b of the

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Annex to the US-Switzerland Agreement (the Disclosure Criteria).

- Within 180 days after it receives notice from the SFTA that the Treaty Request has been received by the SFTA, the Swiss Bank is required to submit to the SFTA the remaining cases described in the Disclosure Criteria.
- Within 270 days after it receives notice from the SFTA that the Treaty Request has been received by the SFTA, the Swiss Bank is required to submit to the SFTA all the remaining cases subject to the Treaty Request.

As a result, the Swiss Bank is to complete the production to the SFTA of all cases potentially responsive to the Treaty Request no later than 270 days after it receives notice that the Treaty Request has been received by the SFTA. Based on an analysis conducted by the Swiss Bank, it has been estimated that information concerning approximately 4,450 accounts will be provided to the SFTA in response to the Treaty Request.

IRS Penalty Memos and the Voluntary Disclosure of Offshore Accounts

In several recent columns, we have discussed the IRS Penalty Memos of March 23, 2009, setting forth "a penalty framework" initially in effect until September 23, 2009—but later extended to October 15, 2009—for taxpayers to make a voluntary disclosure of "offshore issues" to the IRS. In the most significant of the March 23, 2009, Penalty Memos, the IRS announced their "penalty framework" for those taxpayers who decided to come forward as part of a voluntary disclosure to address offshore issues. For the taxpayers who have made a timely voluntary disclosure before October 15, 2009, including those who began the voluntary disclosure process before the issuance of the Penalty Memorandum, the IRS agreed to enter into agreements to resolve tax liabilities relating to offshore issues on the following terms:

- The taxpayer is required to file or amend income tax returns for tax years 2003–2008 including information returns and Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts (commonly known as an "FBAR"), and tax and interest will be assessed for these six years. In cases where the offshore account was opened or the offshore entity was formed between 2003 and 2008, the IRS requires the filing and payment from the earliest year in issue.
- The IRS will assess either a 20-percent accuracy-related or a 25-percent delinquency penalty on the income tax for each year. These penalties are based on the amount of tax determined to be due for each year with respect to the amended income tax returns. This is a lower penalty than the potentially applicable 75-percent civil fraud penalty.
- In lieu of all other potential penalties, including the FBAR penalty and other information return penalties, the IRS will assess an additional "Misc." penalty equal to 20 percent of the amount in the offshore account or foreign entity on any day during the year with the highest aggregate account and asset value. This 20-percent penalty may be reduced to five percent under the following limited circumstances:
  - The taxpayer did not open or cause any foreign accounts to be opened or foreign entities formed.
  - There has been no activity in any offshore account or entity (no deposits, withdrawals, *etc.*) during the period the account/entity was controlled by the taxpayer.
  - All applicable U.S. taxes have been paid on the funds deposited in the foreign accounts/entities (where only account/entity earnings have escaped U.S. taxation). (Many have referred to the potential five-percent taxpayer as the "mythical five-percent taxpayer" since few, if any, taxpayers will actually be able to demonstrate entitlement to the reduced FBAR penalty.)

On May 6, 2009, the IRS issued Frequently Asked Questions (FAQs) intended to clarify various provisions within the foregoing Penalty Memos regarding the voluntary disclosure of offshore accounts. There were initially 30 Q&As, which were updated on June 24, 2009, to modify A26 and to add Q&A 31–51; on July 31, 2009, to modify A6, A21 and A22; and finally on August 25, 2009, to add Q&A 52. The FAQs remain available at *www.irs.gov/newsroom/article/0,,id=210027,00.html*. The guidance set forth within the FAQs remains instructional for those who entered the program on or before October 15, 2009, regarding penalty application and the processing of their voluntary disclosures.

Together with the efforts to obtain information from the Swiss regarding U.S. account holders, the Penalty Memos formed the backbone of the government's search for U.S. account holders of previously undis-

closed interests in foreign accounts throughout the world. The uncertainty surrounding the Disclosure Criteria set forth in the attachment to the Settlement caused many foreign account holders to enter the voluntary disclosure program described in the Penalty Memos. Generally, the Penalty Memos were mostly viewed as an opportunity to come into compliance with a high degree of certainty in the ultimate resolution.

The Penalty Memos provided a degree of certainty regarding the civil penalties to be applied to the specified tax years. IRS field personnel are authorized to enter into closing agreements within the guidelines of the Penalty Memos and can be expected to interpret the Penalty Memos as their "marching orders." Those who failed, for whatever reason, to participate in the voluntary disclosure process afforded by the Penalty Memos but who later decide to make a voluntary disclosure retain the ability to argue against penalties based on reasonable cause, nonwillfulness, *etc*. To protect the integrity of the penalty initiative, it will likely be difficult for the IRS to agree, administratively, to penalties that are less than those set forth within the Penalty Memos. However, a lower FBAR penalty could statutorily apply where there was no willfulness and/or where there was reasonable cause and the other information penalties could be excused where there was reasonable cause. On October 26, 2009, IRS Commissioner Doug Shulman made the following remarks at an AICPA conference in Washington, D.C.:

> Now, for individuals with overseas income and assets, it's straightforward. If you are a U.S. individual holding overseas assets, you must report and pay your taxes or we will be increasingly focused on finding you.
>
> A key aspect of our future international offshore work will be mining the voluntary disclosure information from people who have come forward. We will be scouring this information to identify financial institutions, advisors, and others who promoted or otherwise helped U.S. taxpayers hide assets and income offshore and skirt their tax responsibilities at home.
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> In addition, we're increasing our scrutiny of annual FBARs or foreign bank and financial account reports. Current law requires that U.S. taxpayers file an FBAR if their foreign financial accounts total more than $10,000. But current rules make it difficult to catch all of those who do not. Tough, anti-international tax abuse legislation proposed by the President would tighten these rules and impose tougher penalties on undisclosed foreign accounts.
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> Aside from the legislation, there is an active project working to update definitions and instructions under the current FBAR rules. We're also working with Treasury and Congress in following up on other related Administration Green Book proposals.
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> Our future offshore efforts will also be focused on multiple points around the globe, including funds flowing out from Europe to Asia, Central America and the Caribbean. To this end, the IRS is opening international Criminal Investigation offices in several new locations around the world—in Beijing, Panama City and Sydney, in addition to existing offices, such as Hong Kong and Barbados. The new locations will put the IRS closer to key locations around the globe for international tax administration purposes.

On November 17, 2009, the IRS and the Department of Justice ("the Department") jointly announced that more than 14,700 taxpayers disclosed foreign bank accounts *via* the foregoing voluntary disclosure program. Many others are believed to have opted for a "quiet" disclosure by simply filing amended income tax returns and FBARs. It has been rumored that the IRS has created various filters—including reviewing delinquent FBAR filings—specifically designed to locate those who attempted "quiet" disclosures. The examination outcome for those who pursued a quiet voluntary disclosure remains uncertain.

The overall compliance impact of the Penalty Memos and the Settlement is uncertain but, under any standard, there has been a significant step forward and a substantial "crack" in bank secrecy within Switzerland. Other perceived "tax havens" are sure to take notice and may well attempt to negotiate a similar soft landing for their financial institutions. Lastly, financial mercenaries (a.k.a., whistleblowers) within Switzerland are likely rejoicing that the Settlement left a few scraps of client information to possibly be disclosed under Code Sec. 7623 for a hefty 30-percent reward.

Disclosure Criteria Revealed

On November 17, 2009, the Department and the IRS revealed the Disclosure Criteria set forth in the attachment to the Settlement, which governed the selection

of approximately 4,450 U.S. account holders at the Swiss Bank to be identified. The Disclosure Criteria included accounts at the Swiss Bank between 2001 and 2008 with a balance of more than one million Swiss francs together with various types, including bank-only accounts, custody accounts in which securities or other investment assets were held and offshore company nominee accounts through which an individual indirectly held beneficial ownership.

The Disclosure Criteria also included (i) accounts where there is evidence of "fraudulent conduct," such as false documents or use of calling cards to disguise the source of trading, the threshold for disclosure is 250,000 francs, and (ii) accounts that generated revenues of an average of more than 100,000 francs a year for at least three years including any year between 2001 and 2008. For purposes of the foregoing, "revenues" are defined to include gross income (interest and dividends) and capital gains (which are calculated as 50 percent of the gross sales proceeds generated by the accounts during the relevant period).

Under the Disclosure Criteria, "fraudulent conduct" is deemed to exist for "offshore company accounts" where the foreign account records reflect that beneficial owners continued to direct and control, in full or in part, the management and disposition of the assets held in the offshore company account or otherwise disregarded the formalities or substance of the purported corporate ownership (*i.e.*, the offshore corporation functioned as nominee, sham entity or alter ego of the U.S. beneficial owner) by (i) making investment decisions contrary to the representations made in the account documentation or in respect to the tax forms submitted to the IRS and the Swiss Bank; (ii) using calling cards / special mobile phones to disguise the source of trading; (iii) using debit or credit cards to enable them to deceptively repatriate or otherwise transfer funds for the payment of personal expenses or for making routine payments of credit card invoices for personal expenses using assets in the offshore company account; (iv) conducting wire transfer activity or other payments from the offshore company's account to accounts in the United States or elsewhere that were held or controlled by the U.S. beneficial owner or a related party with a view to disguising the true source of the person originating such wire transfer payments; (v) using related entities or persons as conduits or nominees to repatriate or otherwise transfer funds in the offshore company's account; or (vi) obtaining "loans" to the U.S. beneficial owner or a related party directly from, secured by, or paid by assets in the offshore company's account.

Overview of Historical IRS and Department Voluntary Disclosure Policies

The IRS policy concerning voluntary disclosure set forth in Internal Revenue Manual (IRM) 9.5.11.9 (June 26, 2009) provides that a taxpayer's voluntary disclosure is a factor that "may result in prosecution not being recommended." To obtain this qualified benefit, the disclosure must be "truthful, timely, complete"; must demonstrate a willingness by the taxpayer to cooperate, and actual cooperation, in determining the tax liability; and must include "good faith arrangements" by the taxpayer to pay the tax, interest and any penalties in full. For a disclosure to be "timely," it must be received by the IRS before any of the following has occurred:

- 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.
- 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.
- The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.
- 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).

In a related policy statement, the Department has stated that it will "give consideration to a 'voluntary disclosure' on a case-by-case basis in determining whether to prosecute but such disclosure is not conclusive of the issue." The Department states that "there are two elements to voluntary disclosure (1) it must be made timely and (2) the taxpayer must thereafter fully cooperate with the government." The Department requires the timeliness element satisfy an "all events' test" such that disclosure will not be viewed as timely if (1) the IRS "has already initiated an inquiry that is likely to lead to the taxpayer and the taxpayer is reasonably thought to be aware of that activity"; or (2) "[s]ome event occurred before the disclosure which the taxpayer probably knew about and which event is

likely to cause an audit into the taxpayer's liabilities." Regarding the cooperation element, "[i]f taxes are not paid because of a claim of inability to pay, then full and accurate disclosure must be made by the taxpayer of his financial position."

In past experience, a voluntary disclosure may be done by directly contacting the IRS. Depending on the circumstances, a taxpayer's representative may make a proffer of the facts, without disclosing the identity of the taxpayer. The IRS will then inform the representative as to whether, assuming that the proffered facts bear out and that the taxpayer is not already the subject of a disqualifying inquiry, the taxpayer will be accepted into the voluntary disclosure program. The representative then may disclose the taxpayer's identity (a "noisy" disclosure), and the IRS will make its final determination.

In some circumstances, IRS agents have agreed that the taxpayer's representative may first disclose the taxpayer's identity to determine whether there is a disqualifying inquiry under way. As a third option, under appropriate circumstances, the IRS may consider the late filing of a tax return (a "quiet" disclosure) to meet its voluntary disclosure standards, and may exercise its discretion not to proceed with criminal charges.

Voluntary Disclosures Around the World

In the United Kingdom, under the "New Disclosure Opportunity," which began in September 2009 and will continue until March 2010, participants are required to pay their taxes associated with previously undisclosed foreign accounts together with a 10-percent penalty (the penalty increases to 20 percent if the account holder was previously contacted by the U.K. tax authorities during a previous 2007 amnesty). French tax authorities opened a dedicated office for the voluntary disclosure of previously undeclared foreign accounts providing reduced penalties and a degree of anonymity.

The Italian tax amnesty (September 15, 2009, to December 15, 2009), expected to cause the repatriation of 100 billion Euros, offered anonymity, payment of five percent of the total funds disclosed and no requirement to disclose how the funds were earned. Canada did not create a special amnesty program because Canadians have 10 years to report undeclared income and pay the taxes, plus interest, to avoid prosecution. However, according to Revenue Canada, more than 50 Canadian clients of the Swiss Bank have reportedly come forward to disclose unpaid taxes and investigations have so far found $6.4 million in unreported income.

Prosecution of Attempted Voluntary Disclosures?

On or about February 18, 2009, the U.S. government received information regarding approximately 250 U.S. account holders having interests in a single foreign financial institution. Without knowledge of the foregoing, many of these account holders contacted the IRS—encouraged by the ongoing remarks of IRS Commissioner Doug Shulman to "get right" with the government—and attempted a voluntary disclosure in accordance with the voluntary disclosure framework set forth within the Penalty Memos. These taxpayers have generally been advised that their attempted voluntary disclosure is "untimely and incomplete."

Does the prosecution of an account holder who attempted a historical voluntary disclosure before any government contact somehow promote future voluntary compliance? Should the government continue to prosecute the volunteers knowing that the vast majority of the matters involving the 4,450 account holders will be resolved civilly? Why freeze the efforts of others who may desire to come into compliance but are concerned about the potential criminal investigation/prosecution? Practitioners are presently unable to provide any degree of certainty to their clients who have yet to step forward. Does the government already have information regarding the foreign account? Knowing that some have been prosecuted and others are being subjected to intensive criminal investigations by the IRS, who would possibly step forward now? Will the desire to increase prosecution numbers overcome any sense of historical restraint on what is, at most, a slightly deficient voluntary disclosure? Feel lucky?

Account holders were ineligible to participate in the voluntary disclosure framework set forth within the Penalty Memos if they or a related entity were under IRS examination at any time on or after March 23, 2009. Although some of these account holders attempted to come into the program, many others stayed away and their audits were concluded without discovery of the undisclosed interest in the foreign account. If the audit was generated for a reason other than unreported income, does the exclusion of these account holders promote future voluntary compliance?

The government will not be able to criminally prosecute thousands of individuals with previously undisclosed foreign financial accounts. The highest value in any criminal prosecution is deterrence of other similarly situated taxpayers. The threat of potential prosecutions for those who are technically deficient and somewhat confused will have a significant negative effect on the future of our voluntary compliance system for years into the future.

The Road Ahead

The IRS has long encouraged participation in the voluntary disclosure process for all taxpayers, whether having interests in offshore accounts or otherwise. The Department has a somewhat similar policy regarding the nonprosecution of taxpayers who have made a timely voluntary disclosure. It is a valuable tool for enhancing compliance in our system of taxation while preserving the limited enforcement resources of the IRS.

Those with interests in foreign accounts that have not previously been disclosed should immediately consult competent counsel. They likely remain eligible for the benefits of the long-standing IRS voluntary disclosure program mitigating the possibility of a future criminal prosecution. The IRS is expected to at least temporarily continue its current procedures for a criminal pre-clearance and for disclosures made according to the "three-page letter" (available at *www.irs.gov*). However, it is difficult to determine the potential administrative resolution of civil penalties for those who did not participate in the framework set forth in the Penalty Memos.

This is a target-rich environment for the government. The IRS is committed to enforcement concerning offshore accounts and can be expected to continue to enhance these efforts. Recent enforcement efforts and the changing environment concerning bank secrecy may lead the government to many taxpayers with undisclosed interests in foreign financial accounts. However, the IRS simply will not be able to locate the vast majority of foreign account holders through enforcement efforts alone. The government should reconsider and broaden the eligibility guidelines for future voluntary disclosures. Enhancing overall future compliance is an extremely worthwhile endeavor, even if a few volunteers are allowed to survive in the process.

Endnotes

[1] UBS, AG is the Swiss Bank. However, we specifically decline to refer to UBS, AG in order to highlight the fact that the scenario referred to in our column can be expected to be repeated with respect to foreign financial institutions throughout the world.

[2] *United States of America v. UBS AG*, Case No. 09-20423-Civ-Gold/MCALILEY (SD-FLA, Miami Division).