

## [ By-Lined Article ]

# IRS Offshore VDP -- Last Opportunity for Taxpayers to Avoid Criminal Prosecution and Penalties?

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As a result of the current state of the economy and recent calls for more regulation on international finance, it should come as no surprise that the federal government is seeking ways to close tax havens and increase collections from taxpayers. Taxpayers who have offshore accounts (e.g., foreign trusts, corporations, bank, mutual funds, hedge funds, life insurance policies, annuities and debit and prepaid credit card accounts) are required to disclose annually such assets and accounts via Form TD F 90-22.1 Report of Foreign Bank and Financial Accounts, or FBAR, and to report annually income earned from those accounts on their U.S. income tax return.

The U.S. Tax Code makes no distinction between interest earned from U.S.-based accounts and interest earned abroad. Although many offshore banks, tax havens and clearing houses may decide not to report income to U.S. tax authorities, and may have no legal obligation to do so, businesses, individuals, estates or trusts that are subject to U.S. income tax are required to report, under the penalties of perjury, earnings from these accounts.

The penalties for failure to file FBARs or supply information, including filing a false or fraudulent report, can be up to \$500,000 and imprisonment of up to five years. The penalties for failure to report earnings include charges of criminal tax evasion, as well as fraud and filing penalties up to 75 percent of the unpaid tax.

## The Program

The Treasury Department has implemented a Voluntary Disclosure Program, or VDP, for taxpayers with offshore assets. On March 23, the Internal Revenue Service issued a series of internal memorandums from the Criminal Investigation Division, or CID, services and enforcement unit, the small business/self-employed division and large and midsize business divisions regarding the high priority treatment of offshore account earnings and related reporting. The memoranda stress the IRS's commitment to develop and utilize a full range of information gathering tools for properly identifying offshore-based income. These memoranda further address the high-priority objective of the Treasury Department to process any voluntary disclosure requests and the ridged penalty framework associated with the program.

On March 26, IRS Commissioner Doug Shulman, following his March 17 testimony to the Senate Finance Committee whereby he committed to aggressively pursue individuals and institutions that facilitate unlawful tax avoidance, formally announced the new voluntary disclosure program in connection with unreported foreign income and accounts. The program, unofficially known as the IRS Voluntary Disclosure Program for Offshore Accounts, is available until Sept. 23, although legislation granting extensions may occur. Additionally, in May, the IRS issued a series of frequently asked questions and answers in an effort to give taxpayers some guidance regarding program compliance, which may help to limit taxpayers' exposure to additional and increased penalties.

The practice of voluntary disclosure is not a new concept, but one where increasing attention is being focused. Taxpayers have the opportunity to become compliant, resolve their tax liabilities and reduce their chance of criminal prosecution. The IRS will not

recommend criminal prosecution under the current VDP for offshore account disclosure as long as the taxpayer complies with all provisions of the VDP.

## Qualification

To qualify for the program, taxpayers have until Sept. 23 to disclose unreported income and undisclosed foreign accounts. Prior to this deadline, taxpayers must make full disclosure to their nearest special agent in charge of the IRS Criminal Investigation Division Office. It is strongly advised that taxpayers do not make any disclosure before securing qualified tax representation.

The program is open to individuals, partnerships, corporations and trusts that are not currently under criminal investigation. Taxpayers under criminal investigation will be immediately disqualified from participation in the program. The IRS has established a six-year look-back period to compile all records and statements from foreign banks and entities and assess the income, assets and associated tax. Taxpayers must show a willingness to cooperate and in fact cooperate fully with the IRS in determining their correct tax liability, as well as make good faith arrangements with the IRS to pay in full, the tax, interest and any applicable penalties.

The disclosure must occur prior to the IRS initiating a civil examination or criminal investigation, or receiving information from third parties (media, informant or other government agency) or acquiring information through other methods, such as subpoena or search warrant actions.

The taxpayer must file amended income tax returns (or if no returns were filed, delinquent returns) for the look-back period of six years or less, if the activity was established within the last six years. Note that if the activity started more than six years ago, the IRS may also have the right to extend their examination. Taxpayers must file delinquent or amended FBARs for foreign bank accounts, and, on a going forward basis, annually report (via FBAR) their direct or indirect interest in, or signature authority over, a financial account maintained with a financial institution in a foreign country if the account exceeds the aggregate value of \$10,000 at any time during any calendar year.

Provided the taxpayer files timely, accurately and fully complies with the VDP requirements, pays the statutory tax and interest associated with the unreported or underreported foreign income, the IRS will reduce applicable penalties and the exposure period as noted below.

## The Process

The process associated with making a voluntary disclosure of offshore accounts and the associated income involves the collection of information, coordinated through the CID as well as paying tax and related penalties. This process, however, pales in comparison to the alternative (non-disclosure, involuntary discovery or disclosure by a foreign bank to the U.S. government) that can involve criminal prosecution, the potential for even greater penalties and possibly prison time.

To properly comply with the VDP by Sept. 23, taxpayers will need to:

- Make initial contact with the CID before the due date to request inclusion in the program.
- Make a proper assessment of all tax and interest associated with the tax periods within the voluntary disclosure period (six-year look-back period or the earliest year if the activity started within that period).
- Provide to the nearest CID office all copies of original and amended tax returns for the voluntary disclosure period.

- Amend federal tax returns for previously filed returns or originals, if not filed by the taxpayer, for all years covered under the VDP.
- Provide to the CID office a detailed explanation of prior unreported or previous underreported income, including the reasons for the error or omission.
- Complete an accurate FBAR for foreign accounts maintained during the calendar years covered by the voluntary disclosure period.
- File delinquent FBAR's with copies of tax returns for all related years to the Offshore Identification Unit in Philadelphia by the VDP due date without the risk of FBAR penalties, if taxpayer has reported and paid tax on foreign income.
- Send to the local CID office by the VDP due date all information previously submitted to the IRS to be part of the program, if taxpayer has previously filed amended tax returns and paid the interest and penalty associated with previously unreported offshore income in an attempt to "quietly" make disclosure to the IRS; all taxpayers who have attempted to make a "quiet" disclosure and who are not compliant with the voluntary disclosure run the risk of further examination by the IRS and possible criminal prosecution.
- Contact the IRS or the assigned agent for assistance with the voluntary disclosure by the VDP due date, if taxpayer is experiencing difficulty in obtaining information from foreign banks.

It is highly recommended that taxpayers seeking to enter the program seek qualified tax and legal advice and representation in connection with considering and making a voluntary disclosure.

## The Cost and Benefit

The program requires that taxpayers:

- File amended income tax returns for the prior six years (e.g., tax years 2003 through 2008) reflecting unreported foreign source income.
- File FBARs for the prior six years reflecting required foreign account information.
- Pay interest on unpaid tax at the statutory rates.
- Pay a 20 percent accuracy-related penalty or a 25 percent delinquency penalty.
- Pay a 20 percent penalty based upon the highest balance of the foreign account during the past six years. This penalty may be reduced to 5 percent if the taxpayer did not open or create the foreign account, there has been no activity in the account (deposits or withdrawals) and all U.S. taxes have been paid on the funds deposited to the account.

In return, the IRS will agree not to pursue:

- Criminal tax evasion charges.
- Imprisonment.
- Other fraud (e.g., 75 percent of the unpaid tax) and filing penalties (the greater of \$100,000 or 50 percent of the foreign account balance).

## Risks of Non-compliance

In the event that the taxpayer does not come forward through the VDP and the IRS becomes aware of the taxpayer's offshore activities (through foreign bank disclosure or other reported transactions) the taxpayer could face stiffer penalties and fines or

imprisonment and would be disqualified from participation in the VDP. The IRS believes that the taxpayers who come forward voluntarily will get a fair settlement based on their prescribed penalty framework. The IRS believes that they are being firm but fair by allowing taxpayers to voluntarily come forward, pay taxes and penalties associated with underreporting and avoid criminal prosecution. However, the IRS will assess stiffer penalties and have instructed their agents to fully develop cases of unreported offshore income and to pursue both civil and criminal remedies, consider all available penalties including fraud and willful failure to file FBAR reports and to use all means at their disposal and in the Internal Revenue Code to develop these cases.

The IRS has at their disposal a myriad of civil and criminal remedies and penalties. Delaying disclosure of offshore account income could create significant financial and psychological burdens, depending on the taxpayer's facts and circumstances. The civil penalties relating to fraud could be as high as 75 percent of tax due.

Criminal charges relating to fraud or tax evasion, failure to file a tax return or filing a false tax return can be substantial. A taxpayer ultimately convicted of tax evasion can be subject to a prison term of up to five years and a fine of up to \$250,000. A person who fails to file a return is subject to a prison term of up to one year and fine of up to \$100,000. A person who files a false return is subject to a prison term of up to three years and a fine of up to \$250,000. A taxpayer who willfully fails to file a FBAR can be subject to a prison term of up to 10 years and penalties of up to \$500,000. The potential for penalties and fines to exceed the value of the accounts is high for non-compliant taxpayers.

The VDP is not something that taxpayers should ignore. This framework is monitored through the criminal investigation division of the IRS. Taxpayers ignoring the VDP are putting themselves at great risk. Voluntary disclosure, albeit painful, will be lenient when compared to the non-disclosure and subsequent IRS discovery of offshore assets.

It is not yet clear what will happen after Sept. 23, regarding extension of the current program. Taxpayers run the risk of stiffer penalties by not participating now. What is clear is that the IRS intends to focus on offshore activity with a great sense of urgency. The IRS continues to step up its enforcement efforts by pressuring foreign governments and foreign financial institution to cooperate with disclosures of foreign-based accounts. Taxpayers' individual facts and circumstances should be thoroughly addressed with qualified tax and legal professionals when making a voluntary disclosure, while considering the potential risks associated with not cooperating in the current framework of the VDP.

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