[Alerts and Updates]

IRS Voluntary Disclosure Practice Update

August 28, 2009

U.S. Accounts to Be Disclosed Under U.S.-Swiss Settlement Agreement: "Amnesty" for Undisclosed Offshore Accounts Expires September 23, 2009

On August 19, 2009, the Internal Revenue Service (IRS) and the U.S. Department of Justice announced a settlement agreement with UBS regarding certain accounts held at the bank by U.S. persons. The offshore voluntary disclosure program announced in March 2009 is scheduled to expire on September 23, 2009. IRS Commissioner Doug Shulman has stated there is no "present intent" to extend this deadline. This deadline and the widely reported negotiations on account-holder name disclosure between the IRS and Swiss banking and governmental authorities indicate that U.S. persons may want to promptly examine any interests they may have in undisclosed foreign accounts and, where appropriate, take steps to comply with the emerging IRS protocols relating to these accounts.

Current expectations are that the settlement may lead to the disclosure of approximately 4,450 accounts within the next year, although the stated goal of the IRS is to obtain information on up to 10,000 such accounts. It is important to note that the IRS has stated that the anticipated disclosure "will not by itself preclude the account holder from coming into the IRS under the Voluntary Disclosure Program." With the September 23, 2009, deadline approaching for the voluntary disclosure program, U.S. foreign account holders may want to quickly consider whether participation in the voluntary program presents an opportunity to remedy early what might otherwise be a protracted and costly process with the IRS after account information is released.

The Swiss–U.S. Settlement Agreement

The United States will submit to the Swiss government a Treaty Request describing certain accounts for which it seeks information. The criteria used to identify the account holders that are subject to the Treaty Request have not been disclosed, but by agreement, may be disclosed by the Swiss or the U.S. governments in mid-November 2009. Account information will be submitted to the Swiss Federal Tax Administration (SFTA). The SFTA will render final decisions regarding disclosure of account information on 500 accounts within 90 days of receiving the Treaty Request, and will render the balance of its decisions regarding all the requested accounts within one year of receiving the Treaty Request. U.S. account holders whose accounts are subject to the Treaty Request will soon receive notices that their account information has been requested. Account holders will be requested to designate an agent in Switzerland for purposes of receiving information relative to the SFTA proceedings. U.S. persons who desire to appeal SFTA decisions relative to their accounts may file an appeal with the Swiss Federal Administrative Court. Such an appeal may require the U.S. person to notify the U.S. Attorney General. Failure to provide notice may result in criminal prosecution. Account holders will also be encouraged to participate in the IRS voluntary disclosure program, which is scheduled to expire on September 23, 2009.

The Offshore Voluntary Disclosure Program

As noted above, on March 26, 2009, the Internal Revenue Service ("IRS") made public a program allowing U.S. persons with foreign financial accounts to greatly reduce their exposure to significant civil tax penalties and, in many cases, to eliminate the prospects of criminal prosecution. At the time, it was believed that many U.S. persons with undisclosed offshore financial arrangements had been hesitant to disclose them to the government for fear of the multiple steep penalties that could apply to

such offshore financial accounts and arrangements. In many instances, particularly where trusts or foreign corporations are involved, the panoply of penalties may exceed the highest balance in the offshore account.

The new Penalty Framework for Voluntary Disclosure Requests applies to all voluntary disclosure requests containing offshore issues. It will apply to all pending voluntary disclosure requests and will remain in effect until September 23, 2009.

Starting the Voluntary Disclosure Process: The Letter to the Criminal Investigation Voluntary Disclosure Coordinator

The first step in the voluntary disclosure process is a communication with the taxpayer's local IRS Criminal Investigation (CI) office, stating that the taxpayer wishes to make a voluntary disclosure. That communication can be made either thorough a meeting with an IRS Criminal Investigation special agent or through the submission of a letter to the taxpayer's local IRS Criminal Investigation voluntary disclosure coordinator. The letter-a form of which is available on the IRS website-must contain the following:

- The taxpayer's name, address, date of birth, Social Security number, passport number, the highest balances in the account and the amount of unreported income for each of the years 2003 through 2008;
- A through explanation of the reason for setting up the account;
- The source of funds deposited into the account;
- The names of persons with access to the account;
- The identity of the taxpayer's contact at the financial institution; and
- The identity of an persons who advised the taxpayer with regard to the establishment of the account, including the name of any trusts or corporations involved in the foreign financial structure.

The taxpayer is to sign the letter under penalties of perjury, agreeing to cooperate with the IRS and to pay any liability that is due.

Typically this communication is forwarded by the taxpayer's U.S. tax counsel after counsel has provided the client with a detailed debriefing regarding the account. Taxpayers who are already under investigation or examination by the IRS or have illegal sources of income will not qualify for voluntary disclosure.

Assuming that the CI special agent assigned to review the taxpayer's submission is convinced that the taxpayer has made a complete and truthful disclosure regarding the foreign account, and has agreed to file amended and delinquent returns and pay the delinquent taxes and applicable penalties, the taxpayer will be preliminarily eligible for voluntary disclosure. At that point, the taxpayer's voluntary disclosure requests will be sent to the IRS Philadelphia Offshore Identification Unit ("POIU") for civil processing.

Determination of Tax Liability and Penalties

The POIU is authorized to enter into closing agreements relative to offshore issues in the following manner:

- Assess all tax and interest going back six years (2003 through 2008), unless the account/entity was formed or acquired within the six-year period, in which case the look-back period will start with the earliest year in which the account/entity was formed/acquired;
- File or amend all returns, including an FBAR;

- Assess an accuracy-related penalty or delinquency penalty on all years (the reasonable-cause exception will not apply);
- In lieu of all other penalties that may apply, including FBAR and information-return penalties, assess a penalty equal to 20 percent of the amount in the foreign bank accounts/entities in the year with the highest aggregate account/asset value; and
- A 5-percent penalty is substituted for the foregoing 20-percent penalty where: (a) the taxpayer did not open or cause to be opened any accounts or formed any entities, (2) there has been no activity (deposits, withdrawals) in the account or entity during the period the taxpayer controlled the account/entity, and (3) all applicable U.S. taxes have been paid on the funds in the account/entity and only account/entity earnings have escaped U.S. taxation.

The FAQs

On May 6, 2009, and again on June 24, 2009, July 31, 2009, and August 25, 2009, in response to numerous requests from practitioners regarding guidance on how the new program would impact their clients, the IRS issued a combined 52 Frequently Asked Questions ("FAQs").

The IRS stated that if a civil examination of the taxpayer has been commenced, regardless of whether it relates to offshore accounts, the taxpayer would not qualify for the program. Where taxpayers paid tax on the foreign account's earnings but failed to file FBARs, the taxpayer is directed to file the delinquent FBARs and no penalties will be asserted.

The days of making quiet or "stealth" voluntary disclosure regarding foreign accounts by simply filing amended or delinquent returns disclosing the previously undisclosed account and reporting the previously undisclosed income are now in the past. The FAQs clarify that in instances where the taxpayer made a "stealth" voluntary disclosure, the taxpayer still may face criminal prosecution and the imposition of significant penalties. A taxpayer in such a situation may take advantage of the new penalty framework by sending the previously filed returns to the taxpayer's local IRS CI office.

The following example of how the penalty framework applies demonstrates the significant difference between a taxpayer who takes advantage of the program and one who does not and is audited. For an account with an average balance during the period 2003 through 2008 of $1,175,000 and annual earnings of $50,000, the total tax, accuracy-related penalty and substitute FBAR penalty is $386,000. A taxpayer who does not come forward under the voluntary disclosure program and is discovered by the IRS faces a civil liability of $2,301,000. In addition, that same taxpayer faces the prospect of criminal prosecution, a 75-percent civil fraud penalty and potential penalties for failure to file information returns relative to foreign trusts and corporations if such entities are in the foreign financial structure. It is important to note that unreported taxable transactions occurring before 2003 do not have to be reported in order to qualify for the program.

The disclosure examiners at the POIU do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 5-percent/20-percent offshore penalty to the total penalties that would otherwise apply. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes.

If a taxpayer disagrees with the penalty suggested by the POIU, the taxpayer may request that the case be referred for a standard exam. If, after the exam, the taxpayer continues to disagree with the suggested penalty, the matter may be referred to the IRS Appeals office for review.

Where a taxpayer has transferred funds from one unreported foreign account to another, any duplication will be eliminated in computing the 20-percent penalty. Similarly, only one 20-percent offshore penalty will be applied to a voluntary disclosure relating to the same account. For instance, if parents gave signatory authority to their children, there would be a single 20-percent offshore penalty imposed. The children with no ownership interest would file penalty-free delinquent FBARs. Also, where a taxpayer has multiple accounts, the values of the accounts are aggregated for each year, and the penalty is calculated at 20 percent of the highest year's aggregate value.

If the taxpayer is a decedent's estate or an individual who participated in the failure to report the foreign account or foreign entity in a required gift or estate tax return—either as an executor or "advisor"—complete and accurate estate or gift tax returns necessary to correct the error must be filed.

Where trusts, corporations or other entities are involved in the foreign financial structure, the appropriate returns (Forms 3520, 3520-A, 5471, 5472, 926, 8858 and 8865) must be filed.

Where the taxpayer has failed to file information returns, such as Form 5471 or Form 3520, but has reported and paid all the related tax obligations arising from the foreign corporation or trust, the taxpayer may file the delinquent returns with an explanation why the returns are late. No penalty will be imposed.

Where delinquent FBARs are filed, the current version of the FBAR (revised in October 2008) is to be filed. However, the taxpayer may rely on the instructions from the prior version of the form (revised in July 2000) for purposes of determining who must file to report the foreign accounts maintained in 2008 and prior years. Taxpayers who reported and paid tax on all of their 2008 taxable income, but only recently learned of their FBAR filing obligations and did not have sufficient time to gather the necessary information to complete the 2008 FBAR by June 30, 2009, have until September 23, 2009, to file the delinquent return. No penalty will be imposed for these late filers.

On August 25, 2009, the IRS issued FAQ #52, addressing the concern raised for any U.S. account holder who receives notice that an account is included in the Treaty Request. FAQ #52 recognizes that receipt of this notification will not by itself disqualify the account holder from making a voluntary disclosure under the offshore Voluntary Disclosure Practice (VDP) by the September 23 deadline. Although many of these notices will not be sent to account holders until after September 23, the offshore VDP deadline applies to all offshore account holders, even if they have not received a notice by that date.

The IRS anticipates that the new penalty framework will result in significant participation by U.S. persons with undisclosed foreign accounts. Several advantages of participation in voluntary disclosure exist. U.S. persons taking advantage of voluntary disclosure are likely to be in a position to repatriate their funds to the U.S. without concern. In many cases, the new penalty structure is far less steep than the penalties that could otherwise be imposed. For most U.S. persons, participation in voluntary disclosure is likely to eliminate the prospect of criminal prosecution.

The new penalty structure is open to U.S. persons until September 23, 2009, at which time its benefits will expire and the IRS will re-evaluate the penalty framework. It remains to be seen whether an extension of the program occurs or whether a new program is initiated with more severe penalties. What is known is that if a U.S. person with an undisclosed foreign account is discovered by the IRS, that person is likely to face stiff penalties and the prospect of criminal prosecution.

For Further Information

If you would like more information about this new IRS initiative, please contact Thomas Ostrander, the author of this Alert, Hope Krebs or Stan Barg in Philadelphia, Jon Grouf in New York, any member of the International Practice Group, Michael A. Gillen of the Tax Accounting Group or the attorney in the firm with whom you are regularly in contact.