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April 23, 2009

IRS Offers Settlement for Secret Offshore Accounts

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Recently there has been a great deal of activity in the United States and the European Union ("EU") concerning possible tax evasion or avoidance through secret offshore accounts. This has included litigation by the U.S. government in Florida concerning Americans with secret bank accounts at UBS in Switzerland. There are a reported 52,000 Americans with such UBS accounts. The issue is by no means restricted to UBS or Switzerland. Congress and the Obama administration have also shown a great deal of interest in ending noncompliance by Americans with offshore accounts and ending other perceived international tax abuses.

The Swiss government has objected to a UBS agreement with the U.S. government to turn over the identities of its American secret account holders to the IRS. These objections are based on domestic Swiss bank secrecy laws and upon limitations in the current tax treaty between the United States and Switzerland regarding information sharing. However, Switzerland and other tax haven countries are under pressure by the United States and the EU to change their bank secrecy laws. Switzerland has also agreed to renegotiate its tax treaty with the United States. The IRS clearly believes that it eventually will learn the identities of all 52,000 Americans with secret UBS accounts. Americans with secret offshore accounts at UBS or elsewhere should assume that the IRS will be successful eventually.

Americans with secret offshore bank accounts fall into various categories. At one extreme are drug dealers, money launderers, terrorists and other criminals of various stripes. The IRS and other U.S. law enforcement agencies are not likely

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to treat people in this category gently. Other Americans may have established these accounts as creditor protections, though in a misguided way. Some may have established the secret accounts simply with a tax avoidance motivation, but are not otherwise engaged in illegal activity. They have not reported the income from those accounts, however. Some people may not have established the secret accounts themselves, but have inherited them.

Americans with offshore bank accounts have multiple reporting obligations. One obligation is to disclose the existence of the account annually by filing with the Treasury Department a foreign bank account report ("FBAR"). The FBAR is not filed with the taxpayer's annual income tax return. It is due by June 30 each year. The IRS now has the task of administering the FBAR program. Failure to comply with the FBAR filing requirement may result in criminal sanctions and severe civil penalties. The civil sanctions alone could exceed by several multiples the total amount in the foreign bank account.

Another obligation is disclosure on the account holder's annual income tax return. IRS Form 1040 asks the taxpayer whether or not the taxpayer has or had control over a foreign bank account during the year. Failure to disclose could result in criminal sanctions apart from criminal sanctions under the FBAR rules. Likewise, the taxpayer is required to report and pay taxes on the income from the account. Failure to do so could result in liability for taxes, civil penalties and interest, as well as criminal sanctions.

Accordingly, Americans with undisclosed offshore accounts that have not been reporting and paying U.S. taxes on the earnings from those accounts are not in an enviable position. At the same time, the IRS is able to differentiate those account holders who are engaged in money laundering, drug dealing, etc., from less culpable holders of secret accounts. The government is unwilling to make concessions to the former group, but the IRS has announced a voluntary disclosure program for the latter group. Participation in the voluntary disclosure program may result in waiver of potential criminal sanctions under both the FBAR rules and the tax rules and reduced (though still potentially significant) civil penalties. Taxes and interest would have to be paid.

The IRS has an interest in collecting proper taxes for prior years and going forward. The IRS also has an interest in getting noncompliant taxpayers back into compliance in order

to improve the atmosphere of tax compliance and as a matter of fairness to taxpayers who have been compliant. As a practical matter, the IRS has limited resources. It has an incentive to encourage voluntary compliance so that it does not have to pursue 52,000 or more taxpayers who have secret offshore accounts. However, relief is not automatic for taxpayers who step forward with voluntary disclosures. Each such taxpayer will be evaluated by the IRS on a case-by-case basis to determine if the taxpayer is eligible for relief under the program. The taxpayer also must comply with requirements established under the program. Therefore, the voluntary disclosure program presents noncompliant taxpayers with a risk-balancing situation. The taxpayer could choose to remain noncompliant. In that case, the risk is that the taxpayer will be caught and subjected to severe criminal and civil sanctions. The alternative risk is that the taxpayer will participate in the program by making a voluntary disclosure to the IRS, but then be determined by the IRS to be ineligible for relief. Tax advisors are likely to advise taxpayers to participate in the voluntary disclosure program, but all the facts and circumstances must be evaluated by taxpayers in making a choice.

The IRS announced the voluntary disclosure program on March 26, 2009. It will last for six months. At that point, the IRS will reevaluate the program and decide what further actions would be appropriate. The program utilizes the IRS voluntary disclosure practice that is already set forth in the Internal Revenue Manual. Taxpayers who follow the procedures in the manual, and who are determined to be eligible for relief, will have criminal prosecution waived under both the FBAR and tax code rules. In lieu of the potential FBAR civil penalties and certain tax code civil penalties (e.g., the fraud penalty), a penalty will be imposed equal to 20 percent of the amount in the foreign bank account or certain other entities in the year with the highest aggregate account/asset value. An accuracy or delinquency penalty also will be assessed, as appropriate. The IRS will be looking back six years for this value determination, as well as six years of unreported tax liabilities and interest. There are certain other refinements under the program, but the foregoing description summarizes generally the consequences of participation by an eligible taxpayer.

The disclosure must be voluntary and timely. A disclosure is voluntary when the taxpayer’s (or the taxpayer’s representative’s) communication to the IRS is truthful and complete. The taxpayer must show a willingness to cooperate

(and in fact does cooperate) with the IRS in determining his or her correct tax liability. The taxpayer also must make good faith arrangements with the IRS to pay in full the tax, interest and penalties determined by the IRS to be applicable. It is important to note that participation in the program can be initiated before the taxpayer has sufficient information to make a calculation of the income from the account. In many cases, the periodic reports to the customer from the foreign bank showed asset allocations and market values, but not gains, losses, or income. A taxpayer can initiate participation in the voluntary disclosure program and obtain this information later.

A disclosure is timely if the IRS receives it before 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, before 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, before the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer, and before the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., a search warrant or grand jury subpoena). The foregoing are the standards in the Internal Revenue Manual. However, senior IRS officials have recently been reported to state that even if the IRS already has a taxpayer's name on a list from an outside source, the taxpayer can still make a voluntary disclosure as long as the IRS has not opened an examination or investigation on that taxpayer. That is merely a press report, however.

The IRS settlement offer is favorable to taxpayers that potentially can benefit from it. Time is of the essence, however. Taxpayers that can participate in the voluntary disclosure program should discuss it with their tax advisors as soon as possible. Recent statements by the IRS claim that participation is increasing rapidly.

It is unclear what the various state tax agencies will do regarding state taxes with respect to these secret accounts. The IRS has information-sharing agreements with these state tax agencies. A taxpayer that participates in the federal program should assume that information will be provided by the IRS to the appropriate state tax agency. This is a matter to be discussed by the taxpayer with his or her tax advisor.

Manatt, Phelps & Phillips, LLP, has experience working in this area of tax compliance. If a client or potential client of the firm needs or wants to discuss these issues, that person can contact any person within the law firm. The firm's tax attorneys with the most experience in this area are:

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Donald J. Fitzgerald Mr. Fitzgerald's practice focuses on federal and state income taxation including transactional matters, controversies, administration and regulations, ruling requests and other tax matters. Transactional matters include planning and advising regarding international tax matters as well as U.S. domestic matters. He performs these services for corporations, partnerships and individuals.