NAVIGATING THE IRS'S CRACKDOWN ON OFFSHORE TAX EVASION *

The Department of Justice Tax Division and the Internal Revenue Service have been ramping up an intense crackdown on offshore tax evasion, and the IRS's reduced resources due to new budget cuts are having no effect on IRS enforcement initiatives in this area. Fortunately, there are several alternatives available to navigate these situations.

The Government's reach has extended far beyond Switzerland (where it is pursuing criminal investigations of a dozen Swiss banks and another 100 banks are seeking to avoid criminal investigations and prosecutions) to jurisdictions including Israel (Bank Leumi recently entered into a Deferred Prosecution Agreement with the Department of Justice, paid a penalty of $270,000,000 and agreed to identify numerous additional Bank Leumi account holders in the U.S. to the IRS), India, Liechtenstein, Luxemburg, Barbados, Hong Kong, Singapore - and is pursuing numerous investigations in other areas not yet made public.

Fourteen active federal grand jury investigations involving foreign banking institutions, as well as the recently enacted FATCA legislation (which mandates that a foreign financial institution identify and reveal American depositors – individual and entity – to the IRS or suffer a 30 percent withholding on withholdable payments and pass-through payments), along with the Department of Justice amnesty program for Swiss banks (BSI SA became first Swiss bank in this disclosure program to agree to pay a $211 million penalty and turn over U.S. account holders' identity to escape criminal charges) to disclose how they aided tax evasion. Taken together, all of the foregoing will result in the eventual disclosure of several thousands of taxpayers' identities to the IRS.

To date, taxpayers have made more than 52,000 disclosures since the first IRS Offshore Voluntary Disclosure Program opened in 2009 and tax authorities have collected more than $7 billion from these initiatives alone.

For individuals and business entities with undisclosed foreign accounts and unreported income from international sources, time is of the essence to review the options available. These are dangerous times. Nothing is more destructive than a criminal tax investigation with the real probability of prison time and draconian fraud and Foreign Bank Account Report ("FBAR") penalties.

Fortunately, options exist. First, the IRS Offshore Voluntary Disclosure Program ("OVDP") provides taxpayers a way to resolve their non-compliance with these rules. Taxpayers who are not under criminal investigation or audit, and whose names have not been disclosed to the IRS by foreign banks, are eligible and can escape criminal prosecution and more severe civil penalties.

* Robert J. Alter is a partner at McElroy, Deutsch, Mulvaney & Carpenter in Morristown, N.J., and past chairman of the Section of Taxation of the N.J. State Bar Association. He specializes in representing business and individual clients in civil and criminal tax disputes with state and federal authorities.

They can stop looking over their shoulders, repatriate the funds, file truthful and accurate tax returns in the future, and not leave headaches for their heirs.

In addition to providing a means to avoid criminal prosecution, the program provides those who participate certainty as to their maximum civil penalty exposure, instead of a potential laundry list of confiscatory civil tax and FBAR penalties.

The overall penalty structure of the offshore voluntary disclosure program includes a 27.5% penalty (50% if the taxpayer has accounts at a dozen or so already identified "bad banks" including UBS and Credit Suisse) of the highest balance in the account over the past eight years as a substitute for the potential willful FBAR penalty of the higher of $100,000 or 50% of the highest balance in the account. With respect to the calculation of the substitute penalty under the program, it is important to note that the IRS includes the fair market value of any assets acquired with "tainted" funds in calculating the 27.5%. There are certain penalty mitigation situations recognized, as well as the opportunity to opt out of the program in the less egregious, "non-willful" tax cases. Participants in the program must file all original or amended tax returns and delinquent FBARs for the past eight years, and include a payment for back taxes, interest and an accuracy penalty.

The Opt-out procedure entails an irrevocable election by a taxpayer to have his or her case handled under the standard audit process. Once the election is filed, together with the taxpayer's alternative penalty calculation recommendation, the case is removed from the civil settlement structure set up in the offshore voluntary disclosure program and an examination is initiated. An opt-out will result in an examination of the taxpayer for all open years under the offshore voluntary disclosure program. The scope of the examination is determined by the IRS, and all civil penalties are on the table including FBAR penalties, civil fraud penalty, and penalties for failing to file information returns, if applicable. Taxpayers who opt out of the program must continue to cooperate with the IRS, provide information requested and subject themselves to an interview. In determining whether to opt out or not, advisers have to consider the nature and size of the errors and what caused them, and generally the most important factor is to assess the taxpayer's exposure under the willful FBAR penalty (potentially the greater of $100,000 or 50% of the highest account balance for each open year).

Next, taxpayers who balk at incurring the financial costs and penalties associated with participating in the offshore voluntary disclosure program may have other attractive alternatives.

Last year, IRS expanded its Streamlined Procedures and added a Delinquent International Information Returns procedure and a delinquent FBAR procedure which should be considered.

With respect to the expanded Streamlined Procedures, procedures are now available to a wider range of taxpayers living both inside and outside the U.S. Specifically, there is now both a Streamlined Domestic Offshore Procedure (for taxpayers residing in the U.S.) and a Streamlined Foreign Offshore Procedure (for taxpayers residing outside the U.S.). Under both of those procedures, there is a three-year (vs. eight years under the 2014 OVDP) lookback period for filing amended income tax

returns and a six-year look-back period for filing delinquent FBARSs. For eligible taxpayers residing in the U.S., the only penalty that will be assessed is a miscellaneous offshore penalty equal to 5% (vs. 27.5 or 50% under the 2014 OVDP) of the foreign financial assets that triggered the tax compliance issue – calculated on the highest year–end balance and asset values over the past six FBAR years. For eligible taxpayers residing outside the U.S., no penalty will be assessed.

Both Streamlined Procedures require that taxpayers certify under penalty of perjury that previous failures to comply were due to non-willful conduct; in that regard the taxpayer is required to submit a detailed narrative statement of the facts explaining his or her failure to disclose offshore accounts/assets.

In view of the fact that there is no criminal tax investigation/prosecution guarantee under the Streamlined Procedures, and an application for Streamlined relief disqualifies a taxpayer from subsequently seeking entry into the 2014 OVDP in the event IRS rejects the Streamlined application, a decision to opt for that alternative can be risky in certain factual circumstances. In fact, instead of choosing the 2014 OVDP option, opting for Streamlined Procedures should only be utilized in truly non-willful conduct situations. Caution is advised in evaluating willful and non-willful conduct in this context, and any possible so-called badges of fraud must be identified. A false Certification can also result in civil or criminal liabilities.

Furthermore, for those taxpayers who were already in the IRS Offshore Voluntary Disclosure Program by May, 2014, another option has been recognized by the IRS. Specifically, pursuant to Transition Rules: Frequently Asked Questions No. 6, these taxpayers can request transitional treatment under the applicable lower penalty terms available under the Streamlined Procedure. In those situations, all required terms of the OVDP Program must still be satisfied. In addition, taxpayers have to submit a Certification setting forth their non-willful conduct and request that the lower penalty terms in the Streamlined Procedures be applied to their OVDP applications.

Another alternative is the IRS Delinquent International Information Return Submission Procedures, this option can be utilized for taxpayers who do not need to use the OVDP or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who have not filed one or more required international information returns (e.g., Forms 3520, 3520-A); have reasonable cause for not timely filing the information returns; are not under a civil examination or a criminal investigation by the IRS, and have not already been contacted by the IRS about the delinquent information returns. Those eligible taxpayers can utilize this procedure by filing the delinquent information returns with a statement of the facts establishing reasonable cause for the failure to file.

In addition, there is also an IRS Delinquent FBAR Submission Procedure, for taxpayers who do not need to use either the OVDP or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who have not filed an FBAR, are not under a civil examination or a criminal investigation by the IRS and have not already been contacted by the IRS about the delinquent FBARs. These taxpayers should file the delinquent FBARs

and include a statement explaining why they are filing the FBARs late.

The IRS has represented that it will not impose a penalty for the failure to file the delinquent FBARs by the taxpayers who properly reported the existence of the accounts on their tax returns, have paid all tax on the income from a foreign financial account reported on the delinquent FBARs, and have not previously been contacted regarding an income tax examination or a request for delinquent tax returns for the years for which the delinquent FBARs are submitted.

A final option is known as making a "quiet disclosure". Such a disclosure, not limited to reporting foreign accounts or income, involves filing original/amended tax returns (and delinquent FBARs) with the appropriate IRS Service Center that correct deficiencies in original returns in the hope that such amended return filings will not be selected for audit and/or referred to the IRS Criminal Investigation Division.

If the quiet disclosure is successful, it has the benefit of avoiding some of the more harsh penalties with respect to undisclosed foreign accounts and shortens the look back time period. However, there are considerable risks associated with such a strategy, since the IRS strongly disfavors this approach and takes the position that the taxpayer is "gaming the system."

For those taxpayers who have little criminal tax exposure since they haven't engaged in willful concealment conduct, a quiet disclosure is more attractive. Nevertheless, if their tax return filings are audited, the chance of leniency on penalties will be significantly compromised. Finally, it should go without saying that any quiet disclosure must be truthful and accurate as to every material matter.

For many individuals and entities with undisclosed foreign accounts, assets and unreported income from international sources, the offshore voluntary disclosure program with its known civil penalties outcome and related offshore initiatives detailed above are the last best options in an environment where the IRS is getting more information under new disclosure requirements and following more leads from ongoing foreign bank investigations. It is critical that these taxpayers and their advisers recognize that time is of the essence here, since it will be too late if a foreign bank discloses the taxpayer's name to the IRS first.

Doing nothing is increasingly not a viable option for anyone who wants to be able to use and enjoy the undisclosed foreign account or assets.

For more information about obligations and alternatives regarding offshore assets, or to schedule an appointment, contact Bob Alter (ralter@mdmc-law.com; 973-425-8715) or Michael Scullin (mscullin@mdmc-law.com; 215-557-2975).

This article is informational in nature. It is not being provided in the context of any attorney-client relationship and is not intended to constitute legal advice.