OFFSHORE TAX NON-COMPLIANCE

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A federal and state tax enforcement area that continues to be very active is offshore tax non-compliance. It remains one of IRS' top enforcement priorities.

The IRS and Department of Justice are continuing their enforcement drive to track down unreported foreign bank accounts. Swiss bank secrecy no longer exists. Outside of Swiss banks, banks in the United Kingdom, Canada, France, Israel, Germany, China, Hong Kong, Taiwan and India are also facing government scrutiny. The IRS is expanding its efforts from Europe to the Middle East, Far East and Caribbean banking institutions and getting more information on offshore tax non-compliance then it ever did before.

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 report on its U.S. accounts – individual and entity – to the IRS or suffer a 30 percent withholding on withholdable payments and pass thru payments) and the Department of Justice amnesty program for Swiss banks (106 banks producing information) to disclose how they aided tax evasion will result in the eventual disclosure of several thousands of taxpayers' identities to the IRS.

For individuals and business entities with undisclosed foreign accounts and unreported income from international sources, these are dangerous times…nothing is more destructive than a criminal tax investigation with the real probability of prison time and draconian fraud and FBAR – foreign bank account report – penalties.

Fortunately, an option exists – the IRS Offshore Voluntary Disclosure Program. 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. They can stop looking behind their shoulders, repatriate the funds, file truthful and accurate tax returns in the future, and not leave their heirs headaches. Over $5.5 billion has been collected to date, with 39,000 taxpayers coming forward in 2009.

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 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 an opt out of the program opportunity in the least 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 being made 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).

Taxpayers who balk at incurring the financial costs and penalties associated with participating in the offshore voluntary disclosure program, do not have any other attractive alternatives. One option that has been utilized 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 didn't engage in willful concealment type 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 – is the last, best option to escape criminal prosecution and avoid much larger civil tax penalties 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 to participate in the program 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.

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