By Amy Walsh

Do Your Clients Still Have Hidden Foreign Accounts?

They missed the government's big forgiveness program, but can still come clean to win some leniency. And that may be a good idea—given the criminal and financial liabilities these accounts create for them, their heirs and their estates' executors

The events of the past year make it clear that the U.S. government has launched an unprecedented assault on taxpayers who hide their assets in offshore bank accounts. In addition to bringing numerous criminal cases, the government has accepted thousands of taxpayers' voluntary disclosures of their hidden foreign bank accounts in exchange for the promise not to prosecute and leniency on penalties.[1]

The government's formal voluntary disclosure program for foreign bank accounts ended on Oct. 15, 2009. In spite of this deadline passing, it's not too late for clients who still have secret foreign bank accounts to come clean. Clients who don't come forward risk not only jail time and draconian fines for themselves, but also financial hardship and headaches for their heirs and executors.

Major Offensive

So far, the Justice Department has brought eight criminal cases against taxpayers and professionals who assisted taxpayers, for their violation of U.S. law through the use of secret foreign bank accounts.[2] This wave of prosecutions emanated from two primary sources: the cooperation of former UBS banker Bradley Birkenfeld, and a list of about 250 UBS account holders that UBS turned over to the Justice Department pursuant to the bank's deferred prosecution agreement with the Justice Department. In that agreement, UBS admitted that it had assisted U.S. taxpayers in evading income tax with regard to their foreign accounts.[3]

More recently, pursuant to UBS' Aug. 19, 2009 settlement of the Justice Department's summons enforcement action, the bank agreed to provide account information for about 4,450 of its account holders to the Swiss Federal Tax Administration (SFTA), which will review the information and decide which of those accounts should be disclosed to the U.S. government. UBS already has notified about 500 of the 4,450 account holders that their accounts have been forwarded to the SFTA for this review. Meanwhile, the U.S. Department of Justice has made clear that "American taxpayers who sought to avoid taxes by hiding their assets in Swiss accounts are on notice that this investigation continues."[4]

Parallel to launching its criminal line of attack, the government also has used the specter of prosecution to persuade taxpayers to voluntarily disclose their foreign accounts to the Internal Revenue Service, with the goal of generating millions of dollars in tax revenue. To that end, on March 23, 2009, the IRS established a formal voluntary disclosure program specifically tailored to taxpayers with undisclosed foreign bank accounts.

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This program ended on Oct. 15, 2009, after having been extended 22 days past the IRS' initial deadline because of an unmanageable flood of taxpayers who wanted to participate. The program, based on the long-standing practice of the IRS to accept voluntary disclosure of all varieties of tax liabilities, succeeded in motivating thousands of taxpayers to come clean with the IRS and agree to pay substantial sums of tax, interest and penalties.

The voluntary disclosure program provided three benefits to the taxpayers who qualified for the program:

(1) The IRS agreed not to refer the taxpayer to the Department of Justice for criminal prosecution (which in all practicality means that the taxpayer will not be prosecuted).

(2) The IRS agreed to limit its examination of the foreign accounts to tax years 2003 through 2008.

(3) The IRS agreed to cap the penalties associated with the accounts to an accuracy-related penalty of 20 percent of the tax due on the undisclosed accounts, and a penalty of 20 percent of the highest balance in the account between 2003 and 2008 for the failure to file a Report of Foreign Bank and Financial Accounts (FBAR).[5]

A taxpayer wishing to qualify for the voluntary disclosure program must meet four requirements:

(1) The voluntary disclosure had to be "timely" (in other words, the taxpayer had to submit his or her name to the IRS before the IRS opened an investigation or audit of the taxpayer).

(2) The money in the foreign account had to be from a legal source.

(3) The voluntary disclosure had to be accurate, truthful and complete (meaning that the taxpayer had to answer whatever questions the IRS had about the account, the bankers that the taxpayers met with, or other aspects of the taxpayer's returns).

(4) Plus, the taxpayer had to pay the tax, interest and penalties assessed.

The IRS' voluntary disclosure initiative appears to have achieved its goal—it has brought thousands of taxpayers into compliance and will generate millions of dollars in future tax revenue.

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Still Out in the Cold?

Now that Oct. 15, 2009 has come and gone and the IRS' initiative is no longer available, many taxpayers who decided not to participate are weighing their options regarding their undisclosed foreign accounts. To meaningfully evaluate the options, taxpayers first need to analyze what their potential liability is for maintaining an unreported foreign account and what the potential benefits are of voluntarily disclosing their tax liability after the IRS has ended its formal initiative.

The first and most significant risk of not disclosing a foreign bank account is the risk of criminal prosecution. Failure to report a foreign bank account can result in criminal charges of tax evasion, in violation of 26 U.S.C. Section 7201; filing a false return, in violation of 26 U.S.C. Section 7206(1); and the failure to file or filing a false FBAR, in violation of 31 U.S.C. Section 5322. A conviction for violating each of these statutes relating to just one tax year can result in 18 years imprisonment and the imposition of fines up to $1 million, as well as a restitution in the form of the tax and interest due to the IRS.[6]

The second, and not insignificant risk, is that the government will discover the undisclosed account through the many sources of information at its disposal: cooperating witnesses, documents turned over by UBS or other foreign banks, or a random audit. The IRS has made clear that it will pursue the maximum

available penalties against taxpayers who have continued to maintain undisclosed foreign accounts. These civil penalties, in addition to the criminal penalties listed above, include a fraud penalty consisting of 75 percent of the underpayment of tax (or in the alternative, a 20 percent accuracy-related penalty), as well as FBAR penalties of up to 50 percent of the amount in each foreign account for each year of non-reporting. The imposition of these penalties would likely wipe out the assets in the foreign account, and in some cases, would result in the taxpayer owing the IRS more money than was in the account.

Taxpayers who keep hiding foreign accounts from the IRS are committing a crime every year they file a tax return and fail to file an FBAR.

Taxpayers also have to consider seriously that if they continue to hide their interests in foreign bank accounts, they are committing a crime every year they file a tax return and fail to fail an FBAR. As described above, the potential punishment if they're discovered and convicted is a decade or more in jail and financial devastation.

The potentially adverse consequences of continuing to hide an offshore account affect not only the taxpayer, but also his heirs and executors of his estate. A taxpayer's ownership of an undisclosed foreign account presents all kinds of issues when the taxpayer dies. The executor is legally obligated to report the account on the estate tax return; the income from the account on the decedent's final income tax return; and information about the account on an FBAR. In addition, the executor may be responsible for filing amended personal income tax returns on behalf of the decedent to pay the tax on the undisclosed income earned in prior years. Beyond all these obligations, the executor may be personally liable for the unpaid tax if he is on notice that there is an unpaid tax obligation and nevertheless distributes the proceeds of the estate.[7]

As for the heirs that inherit the account, they must report their interest in the account on their personal tax returns going forward. Given the heightened scrutiny regarding foreign bank accounts, a new disclosure of a foreign bank account may trigger an audit of the heirs' prior returns. If the heirs who inherited the account were previously signatories on the undisclosed account, they likely didn't disclose their interest in the account on Schedule B of their Form 1040. An audit of the heirs' prior returns may reveal this inaccuracy and could result in the assessment penalties.

Given the seriousness of these consequences, taxpayers must ask themselves: Is this hornet's nest the legacy they really want to leave?

Disclosing Now

Even though the Oct. 15, 2009, deadline has passed, taxpayers still may be able to voluntarily disclose secret foreign accounts and receive some leniency from the IRS. For decades, taxpayers have been striking these deals pursuant to Internal Revenue Manual 9.5.11.9, and the IRS has not announced any prohibition against doing a post-Oct. 15, 2009, voluntary disclosure.

Taxpayers will have to meet the same requirements that applied to those participating in the recent IRS disclosure initiative to qualify for post-Oct. 15, 2009, voluntary disclosures:

(1) The voluntary disclosure must be "timely" (in other words, the taxpayer had to submit his name to the IRS before the IRS opens an investigation or audit on the taxpayer).

(2) The money in the foreign account has to be income from a legal source.

(3) The voluntary disclosure must be accurate, truthful and complete.

(4) And the taxpayer must pay the tax, interest and penalties assessed.

The difference post-Oct. 15, 2009, is that the benefits the taxpayer should expect to receive from the IRS will be drastically reduced. It will no longer be a forgone conclusion that the government will forbear criminal prosecution.

Instead, the IRS is likely to evaluate quite closely the merits of each taxpayer's circumstances before making a decision about possible criminal charges. Also, even if the IRS accepts the voluntary disclosure and recommends the taxpayer not be prosecuted, civil penalties will not be capped at a 20 percent tax penalty and a 20 percent FBAR penalty, and the tax years will not necessarily be limited to 2003 through 2008.

Here's the one bright spot: Based on the unique circumstances of each taxpayer's case and with the assistance of an experienced tax practitioner, a taxpayer should be able to negotiate penalties that are less than the maximum amounts available to the IRS under the law.

Based on factors that the IRS has traditionally considered in deciding whether to accept a voluntary disclosure, certain facts may be relevant to the IRS' decision regarding post-Oct. 15, 2009, voluntary disclosures of offshore accounts:

- What was the original reason for opening the foreign account?
- Did the taxpayer open the account, or was the account opened by someone other than the taxpayer?
- Was the account in the name of a trust or corporation?
- How frequently did the taxpayer use the account, and for what purpose?
- What is the size of the account?
- How much tax is owed on the income earned from the account?
- Why didn't the taxpayer make a voluntary disclosure before Oct. 15, 2009?

Taxpayers still have the opportunity to come clean with the IRS and voluntarily disclose a foreign bank account. From a practical standpoint, the IRS is motivated to play ball: The Service has limited resources to initiate criminal cases or to conduct full audits. The voluntary disclosure process saves the IRS considerable time and resources because it requires the full cooperation of the taxpayer and usually results in the taxpayer paying tax, interest and penalties without further litigation.

The question going forward will be: exactly how open will the IRS be with regard to such post-Oct. 15, 2009 voluntary disclosures—and how expensive will they be for taxpayers?

Endnotes

1. According to the Internal Revenue Service, "more than 7,500 U.S. taxpayers with undeclared offshore accounts had stepped forward under its limited amnesty program." Laura Sanders, "IRS Touts Its Amnesty, Trains Sights on Evaders," *The Wall Street Journal*, Oct. 15, 2009.
2. *See United States v. Birkenfeld*, 08-6009 (S.D. Fla. 2008) (former UBS banker); *United States v. Weil*, 08-60322 (S.D. Fla. 2008) (UBS banker); *United States v. Moran*, 09-60089 (S.D. Fla. 2009) (taxpayer); *United States v. Rubenstein*, 09-60166 (S.D. Fla. 2009) (taxpayer); *United States v. Chernick*, 09-60182 (S.D. Fla. 2009) (taxpayer); *United States v. McCarthy*, 09-00784 (C.D. Cal. 2009) (taxpayer); *United States v. Schumacher and Rickenbach*, 09-60210 (S.D. Fla. 2009) (Swiss banker and Swiss lawyer); *United States v. Homann*, 09-0724 (D.N.J. 2009) (taxpayer).
3. Deferred Prosecution Agreement and Information, *United States v. UBS AG*, 09-60033 (S.D. Fla. Feb. 18, 2009).
4. Comment by Jeffrey H. Sloman, Acting U.S. Attorney for the Southern District of Florida, Press Release, Department of Justice (Aug. 20, 2009), available at *www.usdoj.gov/opa/pr/2009/August/09-tax-825.html*.
5. *See* Voluntary Disclosure: Frequently Asked Questions, available at *www.irs.gov/newsroom/article/0,,id=210027,00.html*.
6. The statutory maximum punishment for a violation of each statute is as follows: Five years imprisonment and a $250,000 fine for violating 26 U.S.C. Section 7201 (tax evasion); three years imprisonment and a $250,000 fine for violating 26 U.S.C. Section 7206(1) (filing a false return); and 10 years imprisonment and a $500,000 fine for violating 31 U.S.C. Section 5322 (willfully failing to file an FBAR or filing a false FBAR while committing other crimes (for example, tax evasion or filing a false tax return)).
7. *See* A. Kapiloff and M. Brackney, "Stuck with the Bill? An Executor's Personal Liability for Unreported Foreign Accounts," *Journal of Taxation*, September 2009.