The IRS's Hard Line on Offshore Compliance

Recent Developments Encourage Voluntary Disclosure

By Michael Sardar

For decades, the IRS has pursued U.S. taxpayers who maintain hidden offshore income and assets. Until recently, most tax professionals would have agreed that the IRS's success in the area of offshore tax evasion was limited at best. The IRS has greatly ramped up its offshore compliance efforts over the past eight years. For the most part, these efforts have been met with success. Yet some taxpayers continue to maintain unreported foreign assets hoping to get away with noncompliance, or hoping that they will face no repercussions when they get caught. In reality, the IRS is becoming more skilled at discovering offshore noncompliance, and it has made it clear that the price of noncompliance will go up.

Background

Prior to the IRS's latest offshore compliance efforts, most foreign asset reporting requirements for individual taxpayers were scarcely enforced, and penalties were rarely imposed. For example, in 2001, compliance with the Report of Foreign Bank and Financial Accounts (FBAR) reporting obligations stood at only 20%; between 1993 and 2002, the FBAR penalty was imposed in only a handful of cases. Criminal indictments for FBAR violations were similarly low. (See the U.S. Department of the Treasury's *Report to Congress in Accordance with Section 361(b) of the USA Patriot Act*, April 26, 2002, http://www.fincen.gov/news_room/rp/files/ReportToCongress361.PDF.) Since the start of the latest offshore enforcement push in 2008, FBAR penalties have been at the center of the IRS's efforts and are among its most powerful weapons when dealing with noncompliant taxpayers.

Since 2008, the IRS and the Department of Justice (DOJ) have been increasingly successful in identifying offshore tax offenders. In 2009, UBS, Switzerland's largest bank, entered into a non-prosecution agreement with the DOJ and agreed to cease offering services to U.S. taxpayers. UBS also provided the account information for thousands of U.S. taxpayers. Soon after, Wegelin, one of Switzerland's oldest banks, entered a guilty plea in federal district court in connection with its role in assisting tax evading US taxpayers and ultimately went out of business. More recently, Credit Suisse, another large Swiss bank, pleaded guilty to assisting U.S. taxpayers with evading taxes, and agreed to pay record-breaking fines as well as provide information to U.S. authorities about its U.S. account holders. Finally, the IRS and the DOJ are currently administering a program whereby Swiss banks can come forward with information about their U.S. account holders in an effort to avoid criminal prosecution by the DOJ. More than 100 Swiss banks are participating in the program, which will require the banks to pay large fines and hand over U.S. client data. In addition to these successes—and in great part *because* of them—the IRS has spurred over 50,000 taxpayers to come forward and disclose their noncompliant offshore assets under the IRS's Offshore Voluntary Disclosure Program (OVDP).

Despite its greatly improved track record, some insist that the IRS's success in combating offshore evasion remains lacking, and unreported foreign assets may in fact be safe from IRS capture. Such critics argue that the IRS has yet to find the right mechanism to obtain the names of U.S. taxpayers with foreign accounts on a wide-scale basis. In addition, despite small increases in the penalty rate under the OVDP over several years, those making voluntary disclosure today are not paying a significantly higher price than those who made a voluntary disclosure in 2009. Finally, some note that the DOJ Program for Swiss Banks has yet to yield actual taxpayer names since its announcement in August 2013. Recent and upcoming developments make it clear that taxpayers who continue to hide assets offshore should not take any solace in such criticism.

Recent Developments

Increased penalties within the OVDP. In the summer of 2014, the IRS announced an increase of the OVDP's miscellaneous offshore penalty from 27.5% to 50% for voluntary disclosure participants who held accounts at any foreign financial institution that has been publicly identified by the IRS or DOJ as 1) cooperating with the IRS or DOJ regarding the disclosure of U.S. account holders, 2) being under investigation by the IRS of DOJ, or 3) being the subject of a court approved summons seeking information concerning U.S. account holders. At the time, the IRS released a list of 10 financial institutions that meet these public disclosure criteria. More recently, after the IRS announced a settlement with Bank Leumi of Israel in connection with Leumi's role in assisting U.S. taxpayers to avoid U.S. tax and reporting obligations, the IRS further expanded the list to include Leumi and its affiliates.

Under the revised OVDP rules, if the 50% miscellaneous offshore penalty applies to *one* of a taxpayer's noncompliant accounts or assets, the same penalty will apply to *all* of the taxpayer's OVDP assets. Thus, a taxpayer with one small account at one of the identified banks, and several larger accounts at other banks, will be subject to the 50% penalty with respect to the balances in *all* accounts. The IRS will continue to expand the list as more foreign banks are publicly identified as IRS or DOJ targets. It is expected that all of the Swiss banks participating in the DOJ Program for Swiss Banks will be added to the list once they finalize their nonprosecution agreements with the DOJ.

Increased penalties outside of the OVDP. A likely intended collateral consequence of increased OVDP penalties will be increased penalties for taxpayers caught with unreported foreign accounts outside of the OVDP. Tax advisors should note that while the FBAR statute authorizes the IRS to impose a penalty equal to the greater of $100,000 or 50% of the value of the account for each year of a willful FBAR violation, the IRS has generally imposed only a one-time 50% penalty, even in multiyear FBAR cases. As the miscellaneous offshore penalty within the OVDP reaches the 50% mark for more taxpayers, the penalties outside of the OVDP will have to increase in order to preserve an incentive for taxpayers to enter the OVDP. One recent example of the IRS's willingness to impose multiple FBAR penalties can be found in the court case *United States v. Zwerner* [Case 1:13-cv-22082-CMA (S.D. Fla. 2013)]. In *Zwerner*, the IRS successfully sought three 50% FBAR penalties in connection with an unreported foreign bank account.

DOJ Program for Swiss Banks working as intended. In early 2015, banks participating in the DOJ Program for Swiss Banks have begun to receive individualized treaty requests seeking the names of U.S. taxpayers holding unreported Swiss bank accounts. Treaty requests are formal requests authorized under the United States–Switzerland tax treaty that seek the waiver of Swiss bank secrecy protection on an otherwise secret Swiss bank account. A treaty request that is approved by the Swiss authorities requires the relevant Swiss bank to provide the United States with the name of the account holder. Under the tax treaty, Switzerland is required to honor such requests where the account at issue was used in connection with tax fraud.

The IRS and the DOJ have made treaty requests to Swiss authorities with mixed success. On many occasions, the United States lacked adequate information to establish tax fraud to the satisfaction of the Swiss authorities. This is likely to change with this new round of treaty requests. As part of their participation in the DOJ Program for Swiss Banks, banks have already provided the IRS and DOJ with all of the details on offending accounts except for the name of the account holder. This information is in turn used to draft detailed treaty requests that are much more likely to establish tax fraud to the satisfaction of the Swiss authorities and, therefore, ultimately lead to the turnover of U.S. account holder names. Thus, despite taking some time to reach this phase, the program will likely achieve its intended result.

FATCA. The Foreign Account Tax Compliance Act (FATCA) was passed by Congress in 2010 with the stated goal of curbing offshore tax evasion. Under FATCA, participating foreign financial institutions are required to report foreign accounts held by their U.S. customers to the IRS. FATCA requires foreign financial institutions to review their records to determine which accounts have U.S. indicia, such as a U.S. passport, a U.S. address, or a U.S. telephone number. When FATCA was first announced, skeptics insisted that foreign banks would not cooperate and that certain unfriendly jurisdictions would continue to be a haven for tax cheats; however, banks all over the world, including those in China, Russia, and the Cayman Islands, have signed up for FATCA. Despite some early delays, FATCA is on track to achieve its stated goal, with the first round of reporting by foreign banks due on March 31, 2015.

In addition to reporting by foreign banks, FATCA introduced Form 8938, which must now be filed by U.S. taxpayers holding certain foreign financial assets. Soon, the IRS will be able to use matching programs to compare the information reported by foreign banks under FATCA with the information provided by U.S. taxpayers on Form 8938. Taxpayers generating a mismatch will be more likely to be audited by the IRS. A failure to file Form 8938 will subject taxpayers to financial penalties of up to $60,000 and an indefinite tolling of the ordinary statute of limitations on the taxpayer's entire tax return for that year. Thus, while time is generally on a taxpayer's side, FATCA turns the tables on such thinking by allowing the IRS a potentially endless amount of time to find taxpayers that fail to report their foreign accounts.

Consider Compliance

Taxpayers with unreported foreign assets will find it harder to keep their noncompliance unknown to the IRS. Tax professionals should advise such taxpayers to come into compliance before it is too late. At present, the IRS's OVDP continues to be available and should be utilized by taxpayers who need its protections. Taxpayers whose noncompliance was inadvertent and not willful should consider utilizing the IRS's newly announced streamlined compliance programs, which provide a path to compliance for taxpayers whose behavior was not willful and minimize or even eliminate penalties (http://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures). ❑

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