# AN AMERICAN SOLUTION TO OFFSHORE TAX EVASION

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## BACKGROUND

The United States Department of Justice Tax Division and the I.R.S. have been ramping up an intense crackdown on offshore tax evasion, and while new budget cuts have vastly reduced I.R.S. resources, the cutbacks are having no effect on I.R.S. enforcement initiatives in this area.

At present, the U.S. government's reach has extended far beyond Switzerland, where the Department of Justice is pursuing criminal investigations against a dozen Swiss banks and is engaged in a settlement program with an additional 100 banks that will enable the banks to avoid criminal prosecution. Jurisdictions of note include India, Liechtenstein, Luxemburg, Barbados, Hong Kong, Singapore, and Israel (where Bank Leumi recently entered into a Deferred Prosecution Agreement with the Department of Justice, paid a penalty of $270 billion, and agreed to identify numerous U.S. account holders to the I.R.S.). In addition, the U.S. government is pursuing investigations in various jurisdictions that have not yet been made public.

As alluded to above, there are fourteen active federal grand jury investigations involving foreign banking institutions, and the Department of Justice has begun an amnesty program through which Swiss banks may disclose their roles in aiding tax evasion. BSI SA became the first participant in this program, agreeing to pay a $211 million penalty and turn over U.S. account holders' identities in order to escape criminal charges. Further, F.A.T.C.A. legislation now operational mandates that a foreign financial institution identify and reveal American depositors – both individuals and entities – to the I.R.S. or suffer a 30% withholding on U.S. source withholdable and pass-through payments, including gain proceeds, in the event of non-participation. Taken together, the foregoing will result in the eventual disclosure of several thousand taxpayer identities to the I.R.S.

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

## PATHS TO COMPLIANCE

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 and come into compliance. These are dangerous times, and nothing is more destructive than a criminal tax investigation, which brings with it the real possibility of prison time, draconian fraud penalties, and penalties for willful failure to file Foreign Bank and Financial Account Reports ("F.B.A.R.'s").

## Offshore Voluntary Disclosure Program

Fortunately, options do exist to address the exposure areas. First, the I.R.S. Offshore Voluntary Disclosure Program ("the Program") provides a way for certain taxpayers to resolve their non-compliance within set rules. Taxpayers, who are not under criminal investigation or civil audit, whether or not related to the undisclosed accounts, are eligible to participate in the Program and escape criminal prosecution and more severe civil penalties provided that their names have not been disclosed to the I.R.S. by foreign banks. This approach allows noncompliant taxpayers to stop looking over their shoulders, repatriate funds held offshore, and file truthful and accurate tax returns, thereby avoiding numerous headaches for themselves and, in many cases, their heirs.

***"In addition to providing a means to avoid criminal prosecution, the Program provides participants with certainty as to their maximum civil penalty exposure."***

*Structure of Penalties*

In addition to providing a means to avoid criminal prosecution, the Program provides participants with certainty as to their maximum civil penalty exposure, instead of a laundry list of confiscatory civil tax and F.B.A.R. potential penalties.

The overall penalty structure of the Program includes a 27.5% penalty (or 50% in the case of accounts held at any of the dozen or so already-identified "bad banks," such as UBS and Credit Suisse) levied on the highest balance in the account over the past eight years. The potential willful F.B.A.R. penalty, which it supplants, is the higher of $100,000 or 50% of the highest balance in the account for each year not closed by the running of the statute of limitations. With respect to the calculation of the substitute penalty under the Program, it is important to note that the I.R.S. includes the fair market value of any assets acquired with tainted funds in calculating the 27.5%. Foreign real estate, artwork, and jewelry are treated as financial assets for purposes of computing the penalty base.

There are certain recognized situations that may mitigate this penalty, as well as an opportunity to opt out of the Program in the least egregious, non-willful cases. Participants in the Program must file all original or amended tax returns and delinquent F.B.A.R.'s for the past eight years, and include payment for back taxes, interest, and the accurate penalty.

*Opting Out*

The opt-out procedure entails an irrevocable election made by the taxpayer to have the case handled under the standard audit process. Once this election is filed, together with the taxpayer's recommendation for alternative penalty calculation, the case is removed from the civil settlement structure set up in the Program and an examination is initiated. Opting out will result in an examination of the taxpayer for all open years. The scope of the examination is determined by the I.R.S., and all civil penalties may be imposed, including F.B.A.R. penalties, civil fraud penalties, and penalties for failing to file information returns, if applicable. Taxpayers who opt out of the Program must continue to cooperate with the I.R.S., provide any information requested, and subject themselves to an interview. In determining whether to opt out or not, advisers should consider the nature, size, and cause of the errors. Generally, the most important factor to assess is the taxpayer's exposure under the willful F.B.A.R. penalty.

## Alternative Programs

Taxpayers who balk at incurring the financial costs associated with participating in the Program may find other compliance options more attractive. Last year, the I.R.S. expanded its Streamlined Filing Compliance Procedures ("Streamlined Procedures") and added procedures for filing delinquent international information returns and delinquent F.B.A.R.'s, all of which should be considered.

*Streamlined Procedures*

The expanded Streamlined Procedures are available to a wide 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. and present inside the U.S. for not more than 34 or 35 days in any of the three years covered. For the Streamlined Domestic Offshore Procedure, a tax return must have been filed for the covered years.

This requirement may be problematic for a taxpayer such as a dual citizen, who is a foreign resident but is present in the U.S. for somewhat more than 34 or 35 days in each of the three years covered by the Streamlined Procedure. Such individuals do not clearly fit the requirements to participate in the Streamlined Domestic Offshore Procedure. Nonetheless, at conferences, I.R.S. officials have unofficially suggested that a taxpayer faced with this situation should file under the Streamlined Domestic Offshore Procedure, as in non-egregious cases discretionary relief may be allowed.

Under these procedures, there is a three-year look back period for filing amended income tax returns and a six-year look back period for filing delinquent F.B.A.R.'s, versus an eight-year look back period for both under the Program. For eligible taxpayers residing in the U.S., the only penalty that will be assessed is a miscellaneous offshore penalty equal to 5% of the foreign financial assets that triggered the tax compliance issue. It is calculated on the highest year-end balance and asset values during the six-year look back period applicable to F.B.A.R.'s. For eligible taxpayers residing outside the U.S., no penalty will be assessed.

Both the domestic and foreign Streamlined Procedures require taxpayers to certify under penalties of perjury that previous failures to comply were due to non-willful conduct and to submit a detailed narrative statement explaining the facts that resulted in their failure to disclose offshore accounts or assets. For this purpose, non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.

A decision to enter into the Streamlined Procedures can be risky, particularly under certain factual circumstances, and should not be undertaken lightly in the event the I.R.S. rejects the application. It should be noted that there is no guarantee against criminal tax investigation or prosecution under the Streamlined Procedures and an application for such relief disqualifies a taxpayer from subsequently seeking entry into the Program. In fact, Streamlined Procedures should only be utilized as an alternative in cases of truly non-willful conduct. 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 of non-willfulness can also result in civil or criminal liabilities.

*Transitional Treatment*

For those taxpayers who entered into the Program prior to July 1, 2014, another option has been offered by the I.R.S. Pursuant to the Transition Rules: Frequently Asked Questions (FAQs) No. 6, these taxpayers may request the application of the lower-penalty terms available under the Streamlined Procedures in cases that are deemed to be non-willful. In such situations, all required terms of the Program must be satisfied and taxpayers must submit a certification setting forth their non-willful conduct and formally request that transitional treatment be applied to their O.V.D.P. applications. In practice, the I.R.S. will suggest transitional treatment on its own initiative.

*Delinquent International Information Return Submission Procedures*

For taxpayers who do not need to use the Program or Streamlined Procedures to file delinquent or amended tax returns to report and pay additional tax, the I.R.S. Delinquent International Information Return Submission Procedures may be utilized in certain circumstances. These submission procedures are available to taxpayers who have not filed one or more required international information returns (*e.g.*, Forms 3520 and 3520-A) if they (i) have reasonable cause for not timely filing the information returns; (ii) are not under a civil examination or a criminal investigation by the I.R.S.; and (iii) have not already been contacted by the I.R.S. about the delinquent information returns. 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.

***"Taxpayers who entered into the Program prior to July 1, 2014...may request the application of the lower-penalty terms available under the Streamlined Procedures in cases that are deemed to be non-willful."***

*Delinquent F.B.A.R. Submission Procedures*

In addition, Delinquent F.B.A.R. Submission Procedures also exist for taxpayers who do not need to use either the Program or the Streamlined Procedures to file delinquent or amended tax returns in order to report and pay additional tax, but who (i) have not filed a revised F.B.A.R.; (ii) are not under civil examination or criminal investigation by the I.R.S.; and (iii) have not already been contacted by the I.R.S. about the delinquent F.B.A.R.'s. These taxpayers should file the delinquent F.B.A.R.'s and include a statement explaining the cause for late filing.

The I.R.S. has represented that under certain circumstances it will not impose a penalty for failure to file delinquent F.B.A.R.'s. Income from a foreign financial account reported on the delinquent F.B.A.R.'s must have been properly reported on the taxpayer's U.S. tax returns, all tax on the income must have been paid, and the taxpayer may not have been previously contacted regarding an income tax examination or a request for delinquent tax returns for the years for which the delinquent F.B.A.R.'s are submitted.

## Quiet Disclosure

A final option that has been utilized in the past is known as making a "quiet disclosure." Such a disclosure, which is not limited to reporting foreign accounts or income, involves filing original or amended tax returns and delinquent F.B.A.R.'s with the appropriate I.R.S. Service Center to correct deficiencies in original returns, in the hope that such filings will not be selected for audit and/or referred to the I.R.S. Criminal Investigation Division.

If the quiet disclosure is successful, it has the benefit of avoiding all penalties with respect to undisclosed foreign accounts. In addition, it may shorten the look back period. However, there are considerable risks associated with such a strategy, since the I.R.S. strongly disfavors this approach and takes the position that any taxpayer who chooses to forgo recognized procedures is attempting to "game the system."

For taxpayers who have little criminal tax exposure because they did not engage in any conduct qualifying as willful concealment, a quiet disclosure may be attractive. Nevertheless, if tax return filings are audited, the chance of leniency on penalties may be significantly compromised. Any quiet disclosure must be truthful and accurate as to every material matter.

## CONCLUSIONS

For many individuals and entities with undisclosed foreign accounts or assets and unreported income from international sources, the Program and the related offshore initiatives detailed above, with their known civil penalty outcomes, currently are the last, best options to come into compliance with offshore reporting. We have entered into an environment where the I.R.S. is constantly acquiring information under new disclosure initiatives and following more leads from ongoing foreign bank investigations. It is critical that noncompliant taxpayers recognize that time is of the essence; it will be too late to take advantage of these programs once a foreign bank discloses the taxpayer's name to the I.R.S. More and more, doing nothing is not a viable option for anyone who wants to use and enjoy undisclosed foreign accounts or assets.