Top Tax Practice Tips and Representation Strategies:

Offshore Accounts—Quick Tips

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Offshore Accounts—Quick Tips

The IRS investigation into taxpayers with unreported foreign bank accounts continues unabated. The IRS has stated that more than 30,000 disclosures of offshore accounts have been made. UBS turned over the names of around 4,500 account holders pursuant to a John Doe summons. Names of some HSBC India clients have been made available to the IRS. Credit Suisse has already begun turning over the names of some of its clients. Press reports indicate that the IRS is in negotiations with the Swiss government and at least 11 Swiss banks. If the negotiations are successful these banks would turn over the names of their U.S. account holders, and avoid criminal prosecution. It appears that banks in other countries including Israel are also under investigation.

The IRS recently concluded the second and perhaps the last, limited amnesty program for taxpayers who made disclosures by September 9, 2011. As part of the disclosure process the IRS has been requesting and receiving information about those financial institutions which were heavily involved with U.S. clients. As a result the IRS has a treasure trove of information regarding other financial institutions that were complicit in what it sees as a rampant tax evasion scheme. The IRS has promised to follow up on this information by continuing its push to obtain information from offshore banks outside of Switzerland.

In addition starting this year taxpayers will be required to file Form 8938. A copy is attached, along with a copy of the instructions. Form 8938 implements IRC Section 6038D which requires the reporting of "specified foreign financial assets." The Form 8938 is in addition to, and not a substitute for the filing of the Report of Foreign Bank and Financial Accounts, TDF 90-22.1 (FBAR) form. Form 8938 requires information regarding each foreign account, and also requires that the taxpayer check a box if the account was either opened, or closed during the tax year. This gives the IRS yet one more way of determining if a taxpayer has been in compliance for prior years since in all likelihood someone who fails to check the box indicating all accounts were opened during the year had a prior reporting obligation. Of course there are of exceptions, but it is one more tool for the IRS.

On another front, FATCA reporting is due to begin in 2013, and in the future it looks like the vast majority of foreign financial institutions will be reporting massive amounts of financial information to the IRS regarding their U.S. clients.

In this environment what is the tax professional to do? The stakes are huge since the penalty for willfully failure to file an FBAR is the greater of $100,000 or 50% of the balance in the account. The penalty for failure to file the Form 8938 is a "mere" $10,000. In cases where the failure to file continues after notification by the IRS the penalty can reach $50,000. IRC Section 6038D(f).

First, protect yourself and your firm. Tax preparers should obtain written affirmative representations from their clients about the non-existence of foreign assets before failing to file

Form 8938, or checking the "no" box on Schedule B stating the taxpayer has no financial interest in, or signatory authority over a foreign financial account. Failure to conduct appropriate due diligence can result in preparer penalties, and sanctions all the way up to and including disbarment from practice before the IRS pursuant to Circular 230. If you determine that your client has a previously undisclosed foreign financial account there are three basic possible courses of action. One option is to simply ensure that the taxpayer is in compliance with regard to all future filings. This is the minimum standard. Clearly a tax professional can't be a party to filing a false tax return, nor should the client aggravate an already bad situation by continuing to file false tax returns.

It may be advisable, however, to go further by making a voluntary disclosure of the past non-compliance. In the vernacular of criminal tax attorneys, a disclosure can be either "quiet," or "noisy." The noisy disclosure involves contacting IRS Criminal Investigation (CI) either in person, telephone, or more commonly by letter to notify the IRS of the taxpayer's prior non-compliance. In order to qualify as a true voluntary disclosure the communication to the IRS must be truthful, timely and complete. In addition, the taxpayer must show a willingness to cooperate with the IRS, and must in fact cooperate with the IRS in determining his or her correct tax liability. The taxpayer must also pay the liability in full, or make good faith arrangements with the IRS to make full payment of tax, interest, and penalties. See Internal Revenue Manual (IRM) 9.5.11.9.

One problem which taxpayers often face is whether a disclosure has been "timely." According to the IRM a disclosure is timely only if it is received by the IRS before the IRS has:

a) started an investigation or has notified the taxpayer that it intends to start an exam;

b) received information from a third party alerting it to the specific taxpayer's non-compliance

c) initiated an exam directly related to the specific liability of the taxpayer; or

d) acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action such as a grand jury subpoena.

In the context of offshore accounts the IRS' current position is that if the voluntary disclosure is received before the IRS actually receives information from a foreign bank then even though a John Doe summons proceedings was already underway the disclosure will not be disqualified as untimely.

As an alternative to the noisy disclosure a taxpayer can make a quiet disclosure. It differs from the noisy disclosure in that no direct contact with CI is made. Instead amended tax returns are filed, and possibly late FBARs. In some situations the taxpayer goes back three years; in many six years is recommended. For a long time a quiet disclosure was the most common method of repairing past tax mistakes including non-reporting of offshore accounts. Beginning in 2009, high ranking officials in the IRS began making public statements that quiet disclosures were not “true voluntary disclosures,” and hinting that it was actively searching for, and auditing clients who simply filed amended tax returns. As a result the quiet disclosure has lost some of its luster.

Nevertheless, the IRM remains unchanged in appearing to endorse a quiet disclosure. It is worth noting that the Voluntary Disclosure Practice is not legally binding on the IRS. As a result the IRS is free to interpret it as it pleases. The only constraint is whatever the current Commissioner of Internal Revenue decides is good tax policy. Another point to ponder is that a careful parsing of the Internal Revenue Manual Voluntary Disclosure Practice suggests that the amended returns must be accompanied by a letter. If a letter is necessary then the main advantage of the quiet disclosure, i.e. anonymity, is undercut.

In deciding between a noisy and voluntary disclosure the most important factor may be the assessment of the degree of risk of criminal prosecution. After all the only assurance that one gets from a voluntary disclosure is almost certain protection from going to jail. If there is no risk then why bother doing a noisy disclosure? Unfortunately, the only people who have no risk are the deceased. For everyone else it’s a matter of degree. Remembering of course that sometimes clients’ recollections of the facts turn out to be less than accurate, a non-exhaustive list of factors to be considered arranged in no particular order include:

1. Client’s age
2. Source of the funds in the account
3. Client’s education, and profession
4. Whether the original principal balance in the account was required to be reported on tax returns
5. Whether income from the offshore account was reported on tax returns
6. Size of the tax deficiency if any
7. Number of years the account was open
8. Client’s command of written, and spoken English
9. Client’s discussions, if any, with his tax preparer regarding the accounts
10. Client’s reasons for opening the offshore account
11. Whether the client took any affirmative steps to hide the account, e.g. numbered accounts, offshore nominee entities, mail hold agreements
12. The client’s reasons for recent non-reporting of the accounts in light of stepped up IRS publicity.

Only after considering these and other factors can the tax professional begin to assess how to proceed in addressing a client’s past non-compliance.

