FRAUD & NEGLIGENCE

Experiences With the 'New' Voluntary Disclosure Program—Some Good, Some Bad

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Centralization of the process eliminates the inconsistency that had previous existed among various IRS offices, which had led some taxpayers to engage in a type of "forum shopping" about where to make their disclosures. But the Service's new approach has eliminated discretion and calls for much higher penalties than taxpayers would have expected under past practice, making it less likely that some of them will risk coming forward voluntarily.
[pg. 46]

In the last two years, a relatively obscure program from the Department of Justice and the IRS—the voluntary disclosure practice—became extremely popular, with more than 17,000 participants in 2009. We will examine this program in theory, its evolution over the years, and lessons learned as result of the program's being used heavily in the last 18 months.

IRS VOLUNTARY DISCLOSURE PRACTICE

The Service's voluntary disclosure practice is set forth in the Internal Revenue Manual.[1] The Department of Justice has a similar policy.[2] Generally, a "voluntary disclosure" is the process of voluntarily reporting previously undisclosed income (or false deductions) through an amended return or the filing of a delinquent return (the "informal approach"), or by direct contact with the IRS Criminal Investigation Division (CID) (the "formal approach").

A taxpayer's timely, voluntary disclosure of a significant unreported tax liability is an important factor to the IRS in considering whether the matter should be referred to the Department of Justice for criminal prosecution.[3] The Department of Justice also considers a voluntary disclosure as an important factor in deciding whether to prosecute a taxpayer.[4]

The voluntary disclosure process described in the IRM does not create any substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice that is provided solely for internal guidance to IRS personnel.[5] Voluntary disclosure does not apply to taxpayers with illegal-source income, for example, those who failed to report income from embezzlement, Medicare fraud, or other white collar crimes.[6] A timely voluntary disclosure will not automatically guarantee immunity from criminal prosecution, but following a true voluntary disclosure the IRS normally will not recommend a criminal prosecution to the Department of Justice.[7] In seeking to avoid prosecution, a taxpayer cannot rely on the fact that the IRS may not have recommended other, similarly situated taxpayers for criminal prosecution.[8]

[pg. 47]

A voluntary disclosure must be truthful, timely, and complete. The taxpayer also must show a willingness to cooperate (and must in fact cooperate) with the Service in determining the correct tax liability. In addition, the taxpayer must make good faith arrangements with the IRS to pay, in full, the tax and interest determined by the IRS to be applicable.[9]

To be timely, the disclosure must be received before:

- (1) The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.
- (2) The Service has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance.
- (3) The IRS has initiated a civil examination or criminal investigation directly related to the specific liability of the taxpayer.
- (4) The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).[10]

HOW TO MAKE A VOLUNTARY DISCLOSURE

A voluntary disclosure does not occur until the IRS has actually been contacted.[11] As noted above, a voluntary disclosure may be made through an "informal approach" or a "formal approach." Although the Service does not regard the informal approach as a "true" voluntary disclosure, it is a very common method of correcting errors or omissions.

The Informal Approach—Delinquent or Amended Returns

One approach to correcting past tax compliance issues is for a taxpayer to do so informally by merely submitting new or amended tax returns (typically for a period of six years[12]), together with payment of the taxpayer's tax liability, including interest and penalties, directly to the IRS service center assigned to the taxpayer's area of residence. Such an approach (a "quiet disclosure") does not involve initiating contact with IRS personnel beyond filing the returns.

This approach typically will cause the Service to issue letters relating to penalties (e.g., failure-to-file penalties), and may cause the IRS to begin an audit. If there is no such contact, however, the taxpayer will not receive any formal acknowledgment of having complied.

Returns filed pursuant to a timely voluntary disclosure have significant audit potential. Due to various federal-state information-sharing agreements, any applicable state returns should be filed or amended contemporaneously with the federal returns. Returns for related entities also should be contemporaneously filed or amended.

Historically, most practitioners advocated this approach. The IRS has now publicly stated that it believes the informal approach is not a valid voluntary disclosure.

The Formal Approach—Direct Communication With CID

Another approach to making a voluntary disclosure (a so-called "noisy disclosure") is for a taxpayer to directly contact CID and arrange a meeting to discuss whether the taxpayer's facts and circumstances satisfy the terms of the Service's voluntary disclosure practice, and whether the IRS has begun an investigation that the taxpayer is not aware of.[13] A taxpayer should consult with counsel and carefully evaluate eligibility under the voluntary disclosure policy before making contact with CID.

If the CID official confirms that a valid voluntary disclosure can be made, the taxpayer can prepare and file amended or delinquent tax returns and can pay the appropriate tax. The taxpayer generally will not receive formal acknowledgment of compliance. The taxpayer, however, may send the Service a letter reciting the voluntary disclosure and the fact that the disclosure was timely.

When it is unclear whether a CID official will accept a disclosure as a voluntary disclosure, the taxpayer may provide a description of the circumstances and inquire whether a disclosure in the described circumstances would be considered voluntary. If the answer is in the affirmative, the returns or amended returns may be filed.

OVCI, LCCI, AND THE 2009 PENALTY FRAMEWORK

The IRS has had three separate programs addressing undeclared offshore funds.

The Offshore Voluntary Compliance Initiative

On 1/14/03, the Service announced an initiative, designated the Offshore Voluntary Compliance Initiative (OVCI), to encourage the voluntary disclosure of unreported income by persons having offshore payment cards or other financial arrangements to avoid paying taxes.[14] OVCI was a by-product of several "John Doe" cases against various parties, including VISA, MasterCard, American Express, and PayPal.[15]

Taxpayers were told that individuals who came forward would not face criminal prosecution, the civil fraud penalty, and certain information return penalties, but these taxpayers would still have to pay back taxes, interest, and certain penalties for six years.[16] The deadline to participate in the initiative expired on 4/15/03, clearing the way for a vigorous enforcement effort by the IRS.

The IRS treated the program as a success and issued a statement that, as of 7/30/03, 1,299 taxpayers had participated. The result was the collection of $75 million in taxes and the identification of more than 400 promoters, of which 214 were previously unknown to the Service.[17] In

[pg. 48]

the authors' experience, however, the number of individuals who participated in the OVCI was relatively low and most taxpayers used the process to correct past mistakes in information reporting filings. Given the results, it is likely that privately the IRS discussed whether the energy and effort used to raise $75 million of revenue had been worth the effort.

The Last Chance Compliance Initiative

Given the limited participation in OVCI, the Service began issuing letters under what was eventually known as the Last Chance Compliance Initiative (LCCI)[18] for those who had been identified by the IRS as a holder of offshore payment cards or a participant in offshore financial arrangements. The program was never formally announced but offered taxpayers a final opportunity to minimize their exposure to penalties by providing the IRS complete information to determine the proper tax treatment of unreported offshore activity.

As would be expected, the relief offered under LCCI was more limited than that offered by OVCI, and minimized, but did not eliminate, penalty exposure for qualifying individuals.[19] For example, the "last chance" letter stated that for qualifying individuals, should the facts of the case demonstrate that a civil fraud penalty was warranted, the civil fraud penalty would be imposed only for the major year, with the accuracy related penalty to be applied to the other years depending on the facts in each case.[20] The "last chance" letter also stated that for FBAR violations, civil penalties "will be imposed for only one year, and [the IRS] may resolve the FBAR penalty for less than the statutory amount based upon the facts and circumstances of your case."[21] This was a penalty of $10,000.[22]

LCCI applied to tax years subsequent to 1998, but the IRS reserved the right to examine prior years if the information exposed substantial noncompliance. Individuals were instructed to notify the IRS of their intent to participate within 30 days and provide all of the requested information within 150 days from the date of the letter.[23]

The 2009 Penalty Framework

On 3/26/09, the Service released three memoranda concerning the voluntary disclosure process for cases involving offshore issues. Since that time, there has been much confusion regarding those memoranda. In addition, in light of the significant changes to the voluntary disclosure process made by these memoranda for cases involving offshore issues, there has been heightened interest in alternatives for resolving compliance issues if it is not possible to do so through voluntary disclosure or other administrative means. The release of these memoranda represent the first time that the IRS has tried to impose information reporting penalties in a significant way.

The three memoranda dated 3/23/09 that the IRS released on 3/26/09 address:

- (1) Emphasis on and proper development of offshore examination cases, managerial review, and revocation of LCCI.
- (2) Routing of voluntary disclosure cases.
- (3) Authorization to apply penalty framework to voluntary disclosure requests regarding unreported offshore accounts and entities.

The first memorandum. The purpose of the first memorandum "is to ensure examinations with offshore transactions and/or entities continue to be emphasized and receive priority treatment during the examination process."[24] It directs examiners to "utilize the full range of information gathering tools in properly developing offshore issues, with special emphasis on detecting unreported income," such as interviewing taxpayers, making third party contacts, issuing summonses to taxpayers and third parties, and requesting foreign-based information through exchange of information under applicable treaties and tax information exchange agreements (TIEAs) in any cases where the taxpayers have accounts or transactions in countries with such agreements.[25]

The memorandum further urges examiners to "be alert for badges of fraud and consult with Fraud Technical Advisors in developing cases for criminal referrals or the assertion of the civil fraud penalty."[26]

The second memorandum. The second memorandum directs that, effective as of 3/23/09, voluntary disclosure requests containing offshore issues where CID has preliminarily determined taxpayer eligibility will be forwarded by CID to the Philadelphia Offshore Identification Unit (POIU) for civil processing.[27]

In addition, the memorandum states that any voluntary disclosures with offshore issues that were in Area/Industry case inventories as of the date of the memorandum are to be forwarded to the POIU (regardless of whether there has been prior taxpayer contact by the Service). Nevertheless, all incoming voluntary disclosure requests will continue to be screened initially by CID to determine if the taxpayer is eligible to make a voluntary disclosure. For voluntary disclosure requests containing only domestic issues, where CID has preliminarily determined taxpayer eligibility, CID will continue to forward those requests to the appropriate Area/Industry office for civil processing.[28]

The third memorandum. Under the new penalty framework applicable in voluntary disclosure cases, as described in the third memorandum,[29] the IRS is authorized to

[pg. 49]

execute agreements to resolve tax liabilities related to offshore issues of taxpayers who make voluntary disclosure requests, according to the following terms:

- (1) All taxes and interest due for the prior six tax years will be assessed. Where an account or entity was formed or acquired within the six-year look-back period, taxes and interest will be assessed starting with the earliest year in which an account was opened or acquired or an entity was formed.

- (2) The taxpayer must file or amend all returns for all tax years at issue, including information returns and FBARs.
- (3) Either an accuracy or delinquency penalty will be assessed for all years (and no reasonable cause exception may be applied).
- (4) In lieu of all other penalties that may apply, including information return and FBAR penalties, a penalty equal to 20% of the amount in foreign bank accounts and/or entities in the year with the highest aggregate account and/or asset value will be assessed.
- (5) If (a) the taxpayer did not open or cause any accounts to be opened or entities formed, (b) there has been no activity in any account or entity (no deposits, withdrawals, etc.) during the period the account or entity was controlled by the taxpayer, and (c) all applicable U.S. taxes have been paid on the funds in the accounts and/or entities (where only account and/or entity earnings have escaped U.S. taxation), then the penalty in lieu of all other penalties that might apply is reduced to 5%.[30]

The terms authorized under the third memorandum were available to all voluntary requests containing offshore issues that had been submitted to the IRS, but were not yet resolved, and any such requests that were submitted within six months of the date of the memorandum.[31] The new penalty framework offered the potential for significant relief for taxpayers who made voluntary disclosures within the terms authorized.

Experience With the 2009 Penalty Framework

The form of the 2009 penalty framework is a bit misleading in that it makes certain statements about how it operates in theory, but how it works in practice is quite different.

The 5% penalty is illusory. The 5% penalty is illusory and illustrates the fact that the IRS did not understand the conflict between the way it designed its penalty framework and the operation of anti-money-laundering rules in most secrecy jurisdictions. Under those rules, an account of a deceased person cannot remain in the name of the deceased account holder. It must, at a minimum, be transferred over to the current heir. Thus, unless there was a trust or some other form of structure in place that allowed the account ownership structure to continue beyond the death of the account holder, it would not be possible for an account to remain in the name of the deceased individual and certainly not for more than a year.

Example: Mr. O inherited a Swiss bank account from his mother in 2006. Mr. O took no money from the account, and also added no money. He visited the bank only once after his mother passed away, and the banker required for Swiss anti-money-laundering purposes that at least a signatory card be signed. Mr. O is, in theory, someone who should be eligible to take advantage of the 5% penalty framework, but in practice he is not eligible to do so.

Another example of the illusory nature of the 5% penalty is that the IRS views the taking of funds from the account in a year in which the client was fully compliant vitiates the ability to use the 5% option.

Example: Mr. G, along with his brother and sister, inherited a Swiss bank account from their father in 2006. Since they did not know what to do with the account, they "ignored" the account until Old Swiss Bank insisted the account be closed in 2008. The clients in 2008 properly filed all relevant forms and reported all income. The Service's position is that the closing of the account in 2008 vitiates their ability to avail themselves of the 5% penalty under the penalty framework, notwithstanding their proper compliance in 2008.

The penalty framework is not fairly implemented. The IRS memorandum explaining the penalty framework states with regard to the 20% penalty that, "in lieu of all of the penalties that may apply" a flat 20% will be applied.[32] Nevertheless, even clients who properly filed for tax years 2007 and 2008 are having a 20% penalty applied against those years if they were the years with the highest account balances. This seems highly unfair to those clients who were already in compliance.

Example: Mr. N, a resident of New York, went to see a tax attorney in 2006. Mr. N fully complied with his tax obligations for 2005, 2006, 2007 and 2008, yet when he read the Q&A discussing the fact that informal disclosures are not viewed as a voluntary disclosure, he participated in the voluntary disclosure program. The IRS imposed a penalty equal to 20% of the highest account balance, which was 2008.

It seems completely inappropriate for the Service to now impose a 20% penalty when the taxpayer has been compliant for half of the years. In all of the years in which compliance was not timely the IRS did not have a 50% FBAR penalty but only a $100,000 FBAR penalty. Yet, this is the position the IRS is taking.

[pg. 50]

Thus, we are seeing situations where the 20% penalty is being imposed even though this penalty is actually larger than what the IRS can technically impose under the law. Why the Service believes it has been given the authority to impose a penalty greater than what is permitted under statute is unknown. If one chooses to "opt out" of the penalty framework, the Service's attitude is that it is entitled to do a full audit on all items of income for all years. The IRS further reserves the right to go back to prior years and impose other penalties at higher levels. This is to ensure that participants do not opt out. Furthermore, two separate revenue agents in two separate districts have now asserted that an "opt out" would mean that the taxpayer had not cooperated and that the case would be returned to CID for further consideration of whether a criminal prosecution would be recommended.

The IRS has publicly stated the following on its website:

"Q34. If, after making a voluntary disclosure, a taxpayer disagrees with the 20 percent offshore penalty, what can the taxpayer do?

"A34. If any part of the penalty structure is unacceptable to a taxpayer, that case will follow the standard audit process. All relevant years and issues will be subject to a complete examination. At the conclusion of the examination, all applicable penalties (including information return and

FBAR penalties) will be imposed. Those penalties could be substantially greater than the 20 percent penalty. If the case is unagreed, the taxpayer will have recourse to Appeals."

This attitude on the part of the Service is outrageous.

You're in! You're out! Another issue involves taxpayers who have been preliminarily accepted into the program, who have submitted a response to the first information document request (IDR), who have had no changes or additional facts that had not been previously disclosed to the IRS, and yet who are kicked out of the program by IRS because of what is perceived to be a change in circumstances. We have now experienced a number of taxpayers who were accepted into the program, were told to make further disclosures as part of the program, and then were told that they were never eligible to participate in the program. This is highly unfair.

Example: Mrs. M submitted a voluntary disclosure to the IRS prior to 10/15/09. As part of that, she disclosed that she was working with certain promoters and further disclosed that she had accounts with a number of banks. Mrs. M was then told that she had been accepted. The client then filed a long letter providing additional account information and received a preliminary acceptance into the voluntary disclosure program. After that period, while in audit, she was told that she no longer qualified. This change was not based on any additional information that changed the Service's view of the original information provided.

THE EVOLUTION OF THE PROGRAM AND LESSONS LEARNED

The principal lesson learned from our experiences in the area of voluntary disclosure during the last ten years is that it is highly beneficial to change from a decentralized process to a much more centralized procedure.

In the past, the voluntary disclosure process was highly decentralized, inherently local, and purely discretionary. Taxpayers who wished to become compliant needed to go to their local criminal investigation coordinator and, based on personal relationships with that coordinator, could experience the process in a manner that varied greatly from district to district.

In some districts, a taxpayer was required to participate in a process that was conducted very openly from beginning to end and required immediate identification. In other districts, a taxpayer could start the process anonymously and was required to give more formal disclosure only at a later point. In some districts, once the taxpayer received criminal clearance the taxpayer was able to simply file the applicable amended tax returns and would never hear anything from the IRS again. In still other districts, the taxpayer was required to submit to a formal audit. Additionally, in some districts there were penalties while in other districts there were none.

The following examples highlight these discrepancies. In Florida, a taxpayer could typically complete an entire disclosure from start to finish on an anonymous basis, with the taxpayer's name being disclosed only at the very end of the process. In that district, a taxpayer typically was required to file amended tax returns for the last six years, was charged interest on any unpaid tax, and was given a negligence penalty for the prior six years. Further, there would be one FBAR penalty of approximately $10,000.

In contrast, in New York as late as 2008, it was possible to complete a disclosure paying only unpaid taxes and interest with no additional penalty. Additionally, in districts that were further away from the major cities, where the issue of undeclared funds was far less common, the penalties were often more draconian. Thus, taxpayers would attempt to choose their district such that they were able to get the result that was desirable.

As a result of the centralization of the disclosure process, such disparate treatment should no longer occur.

From No Serious Penalties to Penalties Galore

Historically, when taxpayers went through a formal voluntary disclosure process, there were rarely any significant information reporting penalties imposed on the taxpayer. At most, one or two negligence penalties for failure to file an FBAR (in the range of $10,000) were the only penalties levied.

Except for specific special cases in which there was a risk of later disclosure to the U.S. or significant

[pg. 51]

information reporting penalties that would immediately be triggered on a filing, there was historically very little motivation for noncompliant taxpayers to participate in a formal voluntary disclosure process. As a result, most practitioners generally recommended to their clients the use of "informal disclosure." In theory, the taxpayer ran the risk of being "caught." In practice, however, the taxpayer never heard anything back from the IRS or Department of Justice.

Our experience had been that if a taxpayer did participate in the formal voluntary disclosure process, generally most, if not all, penalties were abated. Based on many years of actual experience, participating in a formal voluntary disclosure would cost the average client only 12% to 15% of the account in question. This low cost meant that clients who felt that they should formally disclose were much more willing to do so, in light of the fact that the likely penalties were not so significant.

Moreover, historically the relevant IRS coordinators had much more discretion and tended to be relatively sympathetic in considering the relevant issues and were willing to work to resolve the issues amicably. Of course, state taxes were an additional issue and virtually everyone just filed amended returns.

Prior to 2009, the only noticeable difference in the process and in the cost occurred during the OVCI and the LCCI. As a result of OVCI, our experience was that the average taxpayer lost 15%-20% of the relevant account; as a result of LCCI the average taxpayer lost 20%-25% of the relevant account. The problem with OVCI and LCCI was that taxpayers, assuming they had not been identified by the IRS in an LCCI letter, typically did better outside of the scope of these programs than they did within the context of the programs. While the formal penalty frameworks had the benefit of giving a degree of certainty to taxpayers with regard to an economic result, that certainty traditionally meant a much higher cost for the result in question. In contrast, in our experience, taxpayers who came in after OVCI, but who were not specifically targeted by LCCI, typically got as good or better results than they would have gotten under OVCI.

The 2009 penalty framework and the subsequent modifications changed the entire process. First, there is now a centralization of process and method. Instead of every district having its own process, there is a nationwide procedure that is followed, beginning with interviews and the "optional long formal letter." Further, the penalties associated with the compliance process have been regulated.

The benefits of this approach are that it has resulted in a national centralized administration of voluntary disclosures and an amount of certainty as to the process for taxpayers. The drawback of this approach is that the process has been moved away from agents who truly knew what they were doing in this area, a very limited number of practitioners, and instead moved towards service centers in which the people involved initially had limited experience—or no experience—with the issue of voluntary disclosure, offshore assets, dealing with undeclared funds, and the nature of relevant investments.

The consequences for taxpayers is that the actual cost of participating in the voluntary disclosure process went from an average of approximately $40,000 per taxpayer to in excess of $100,000 per taxpayer. Thus, for taxpayers, the current processes has more than doubled the cost of complying.

Despite IRS Public Statements, Informal Disclosures Seem to Work

It is our firm's position to discourage clients from informal disclosures because of the FAQs issued in 2009 that have taken the position that such a "quiet disclosure" does not constitute a valid "voluntary disclosure" and does not preclude the Service from considering prosecution of the taxpayer. Nevertheless, we know of many taxpayers—either with other law firms or who worked with accountants directly—who did, in fact, engage in informal disclosures.

To date, and following our discussions with numerous practitioners, it does not appear a single taxpayer who just filed tax returns has had any follow-up from the IRS. Given the harsh and often irrational approach the Service is taking towards formal disclosures, one needs to ask: "Was making a formal voluntary disclosure a mistake?"

Most Clients Were Not ‘Bad People’

There has been much press about the specific individuals who have been subjected to criminal indictments and who have entered guilty pleas, giving the perception that most of the noncompliant taxpayers were people actively facilitating the movement of funds from the U.S. to suspect offshore structures and then creating ways for the money to get back into the U.S. This definitely is the exception, not the rule. In our experience, given the entire range of cases we are handling and have handled globally, these types of taxpayers constitute less than 10% of the total population of those taxpayers participating in the voluntary disclosure process. This fact can be attributed to two things:

[pg. 52]

- (1) The U.S. has a culture of compliance and very few people actually try from within the U.S. to hide money outside the U.S. Although it is possible to read stories in the various criminal complaints about people who created actual schemes to move money into and out of the U.S.,[33] one very rarely sees this type of behavior in practice. Further, it is actually quite hard to secretly move money in large amounts outside the U.S. Doing so requires a very large and complicated scheme. This is not like Europe, where historically the movement of cash across the border from Italy to Switzerland or from Germany to Luxembourg or from France to Monaco was common.
- (2) The worst tax evaders still remain tax evaders. For all the hype about voluntary compliance and the number of participants, a significant number of people still have not entered into voluntary disclosure, as discussed above.

Thus, while the issue of undeclared money is significant, most of the offenders are not "bad people" but rather are people who, either themselves or via their parents, experienced some form of event which gave that person reason to mistrust government and a subsequent need to keep a certain amount of money as a safety net. Ultimately, while many of these noncompliant taxpayers knew that they were breaking the law, most of these people were not doing it for the purposes of saving money or to put one over on the government. Rather, they were doing it as part of having an exit strategy from the U.S. While most Americans typically do not think this way, people who have suffered various forms of persecution do. Thus, many of these people are arguably inappropriately hurt by a structure that does not allow any mitigation of penalties based on circumstances.

THE HIRE ACT

The Hiring Incentives to Restore Employment (HIRE) Act of 2010 (P.L. 111-147, 3/18/10) is primarily aimed at providing businesses with tax incentives to help finance the hiring and retention of new employees. To offset the projected revenue loss from these incentives, the Foreign Account Tax Compliance Act (FATCA) was added to the bill.[34]

The purpose of FATCA was to "detect, deter, and discourage offshore tax evasion" by Americans through the use of financial institutions outside of the U.S., as well as to close certain information reporting loopholes that allowed U.S. persons to avoid disclosure of offshore assets and income.[35] In addition, FATCA attempts to regulate certain perceived abuses concerning the use for the benefit of U.S. persons of property held in trust, that were identified by the Senate Subcommittee on Investigations in its 2006 report on tax haven abuses.[36]

In the context of voluntary disclosure, a new accuracy-related penalty of 40% on any understatement of tax liability attributable to an undisclosed foreign financial asset has been added, in Section 6662(j).[37] This new penalty is double the penalty for underpayment on U.S. assets.

Further, FATCA amends Section 6501(e) to provide a new six-year limitations period for assessment of tax on understatements of $5,000 of income attributable to assets required to be reported. The modified limitations period for assessment is also tolled if a taxpayer fails to provide timely information returns required with respect to passive foreign investment corporations.

The new offshore compliance provisions of the HIRE Act will increase both the cost and the stakes of correcting past nondisclosure. On paper, these provisions seem like an effective way to encourage compliance by imposing a 40% negligence penalty. Practically speaking, however, the steep penalties may do little to encourage compliance and may discourage those taxpayers who have not yet made voluntary disclosure from doing so. While the IRS has greatly publicized the fact that it had 17,000 formal voluntary disclosures by 10/15/09,[38] as a practical matter that is a "mere drop in the bucket" compared to the amount of money still undeclared.

Given that the U.S. voluntary disclosure program penalty framework has expired and taxpayers are no longer guaranteed a certain result, many people who otherwise may have considered voluntary disclosure may now avoid compliance altogether, rather than run the risk of being subject to higher penalties.

CONCLUSION

The issue of undeclared money held offshore by U.S. persons is serious and needs to be addressed. While the goal of preventing offshore tax evasion is an admirable one, the unintended consequences of overzealous penalties will not achieve this goal. Unless and until the IRS and the Department of Justice adopt a voluntary disclosure penalty framework that allows a certain amount of discretion with regard to extenuating circumstances and credit for partial compliance, it is unlikely that individuals who feel that they are not at risk of being otherwise revealed to the IRS will come forward under the current voluntary disclosure process. As it currently stands, the financial cost of coming forward is incredibly high and, except in the case of a few very specific taxpayers, the risk of being caught and prosecuted is very low.

Practice Notes

There is now a centralization of process and method. Instead of every district having its own process, there is a nationwide procedure that is followed, beginning with interviews and the "optional long formal letter." Further, the penalties associated with the compliance process have been regulated. The benefits of this approach are that it has resulted in a national centralized administration of voluntary disclosures and a degree of certainty as to the process for taxpayers.

[1] IRM 9.5.11.9 (9/9/04). Prior to 2004, the voluntary disclosure policy looked at the subjective intent of the taxpayer, examining factors such as whether the taxpayer thought she was under audit and whether she thought she was caught. This approach was administratively unworkable.

[2] See Department of Justice, Criminal Tax Manual, §4.00.

[3] IRM 9.5.11.9.

[4] See note 2, supra.

[5] IRM 9.5.11.9(1). Cf. Tenzer, 80 AFTR 2d 97-6676 127 F3d 222 (CA-2, 1997), cert. den.

[6] IRM 9.5.11.9(2).

[7] IRM 9.5.11.9(1).

[8] Id., but see note 5, supra.

[9] IRM 9.5.11.9(3).

[10] IRM 9.5.11.9(4).

[11] IRM 9.5.11.9(3).

[12] Under Section 6501(e) and Reg. 301.6501(e)-1, the statute of limitations for the IRS to assess unpaid taxes is six years if the taxpayer files a return but omits gross income in excess of 25% of the amount of gross income stated in the filed tax return. Further, the criminal statute of limitations is six years.

[13] IRM 9.5.11.9.

[14] Rev. Proc. 2003-11, 2003-1 CB 311.

[15] See, e.g., IR-2003-5, 1/14/03.

[16] See note 14, supra.

[17] IR-2003-95, 7/30/03.

[18] See, e.g., IRM 4.26.16.4.6.4 (7/1/08). The letters were issued as IRS Letter 3649 (DO) (Rev. 6-2003).

[19] See Letter 3649, supra note 18.

[20] Id.

[21] Id.

[22] Id.

[23] Id.

[24] IRS Memo., "Emphasis on and Proper Development of Offshore Examination Cases, Managerial Review, and Revocation of Last Chance Compliance Initiative" (3/23/09).

[25] Id.

[26] Id.

[27] IRS Memo., "Routing of Voluntary Disclosure Cases" (3/23/09).

[28] Id.

[29] IRS Memo., "Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Unreported Offshore Accounts and Entities" (3/23/09).

[30] Id.

[31] Id.

[32] Id.

[33] We have heard of cases involving such things as moving cash overseas by yacht and cash transactions in stocks.

[34] HIRE Act, section 501. See Packman and Rivero, "Increased Disclosure, Penalties, and Audit Periods Courtesy of the Foreign Account Tax Compliance Act," 112 JTAX 266 (May 2010).

[35] Cong. Rec. S10785 (daily ed., 10/27/09) (statement of Sen. Baucus (D-Mont.), Chair, Committee on Finance).

[36] Staff of the Senate Permanent Subcommittee on Investigations, 109th Cong., Tax Haven

Abuses: The Enablers, the Tools and Secrecy (8/1/06).

[37] "Undisclosed foreign financial asset" includes all assets subject to certain information reporting requirements for which the required information was not provided by the taxpayer as required under the applicable reporting provisions. An understatement is attributable to an undisclosed foreign financial asset if it is attributable to any transaction involving the asset.

[38] See generally Packman, "Noncompliance After the IRS Offshore Income Reporting Initiative—What Options Remain?," 111 JTAX 281 (November 2009).