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FRAUD & NEGLIGENCE

## IRS Renews Its Focus on Unreported Foreign Accounts and Assets: The 2011 Disclosure Program

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*There are some significant flaws in the Service's latest attempt to encourage taxpayers to voluntarily report offshore income and assets, and to pay the related income taxes and penalties. Nevertheless, there are many very good reasons for taxpayers who are not in compliance to take advantage of the newest IRS offer. There might not be a third opportunity.*

In early February, Commissioner Shulman announced the creation of a second voluntary disclosure program for taxpayers with unreported foreign income, which will continue until 8/31/11. <sup>1</sup> The announcement was timed to fall in the middle of a new round of enforcement, coming subsequent to the indictments of two taxpayers and a UBS banker, and before the indictments of three more taxpayers, another UBS banker, and four foreign banks.

While this new voluntary disclosure program ("2011 VDP")—officially the 2011 Offshore Voluntary Disclosure Initiative—has many similarities to the 2009 Offshore Voluntary Disclosure Program ("2009 VDP"), it also introduces some significant differences. With ever-increasing IRS enforcement coming on the heels of its receiving unprecedented amounts of information provided through whistleblowers, treaty partners, UBS under the deferred prosecution agreement, or participants in the 2009 VDP, time is running out for taxpayers with unreported foreign source income to come forward. It should be understood, however, that the 2011 VDP is not the only method by which taxpayers can resolve their noncompliance, which begs the question: will taxpayers make use of the 2011 VDP?

The official announcement was short on details as to what was included or required in the 2011 VDP. The parameters of the 2011 VDP are gleaned from a series of frequently asked questions and answers (FAQs), 53 in all, that the Service posted on its website the day of the announcement. <sup>2</sup> The IRS also created a new portal for the 2011 VDP. <sup>3</sup>

### WHO SHOULD CONSIDER THE 2011 VDP?

In FAQ4, the IRS discusses the reasons why taxpayers should participate making a voluntary disclosure in accordance with the terms of the 2011 VDP:

"Taxpayers with undisclosed foreign accounts or entities should make a voluntary disclosure because it enables them to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution. Making a voluntary disclosure also provides the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues. Taxpayers who do not submit a voluntary disclosure run the risk of detection by the IRS and the imposition of substantial penalties, including the fraud penalty and foreign information return penalties, and an increased risk of criminal prosecution. The IRS remains actively engaged in ferreting out the identities of those with undisclosed foreign accounts. Moreover, increasingly this information is available to the IRS under tax treaties, through submissions by whistleblowers, and will become more available as the Foreign Account Tax Compliance Act (FATCA) and Foreign Financial Asset Reporting (new [IRC §6038D](#)) become effective." <sup>4</sup>

The Service's answer in FAQ4 is incomplete—the 2011 VDP is not required for taxpayers who have undisclosed foreign accounts or entities but who do *not* have any unreported foreign income:

- FAQ17 indicates that taxpayers may file delinquent Forms TD F 90-22.1 ("Report of Foreign Bank and Financial Accounts" (FBAR)) and avoid penalties, provided there is no unreported taxable income associated with the

account. The delinquent FBARs must be filed by 8/31/11, however, the closing date for the 2011 VDP.

- FAQ18 provides similar benefits to taxpayers who failed to file information returns (Forms 5471 or 3520) reporting their connection to a controlled foreign corporation or foreign trust. <sup>5</sup> Such taxpayers must file the delinquent information returns with the appropriate service center by 8/31/11.
- FAQ38 indicates taxpayers may file delinquent FBARs and avoid penalties if the purpose of that FBAR is to report signature authority over an account in which the taxpayer has no beneficial interest. These delinquent FBARs also must be filed by 8/31/11.

Taxpayers filing the delinquent information returns in accordance with FAQ17, FAQ18, or FAQ38 also must submit a letter along with the delinquent return explaining the reason behind the noncompliance. Such taxpayers would be wise to refer to the particular FAQ under which the delinquent return is being filed.

Similarly, the 2011 VDP is not appropriate for taxpayers with domestic-based noncompliance. The IRS has taken a hard line with regard to the concept of *no unreported taxable income*. Consequently, even if no tax is due as a result of a foreign tax credit, the Service has denied the above relief to taxpayers.

Quiet disclosure. In FAQ15, the IRS encourages taxpayers who made "quiet disclosures" to use the 2011 VDP. The Service considers taxpayers as having made a quiet disclosure if, without otherwise notifying the IRS, they filed amended returns and paid the related tax and interest associated with previously unreported offshore income. "Quiet disclosure" also should include taxpayers who never previously filed tax returns.

Taxpayers who made quiet disclosures and elect not to participate in the 2011 VDP are at risk of being criminally prosecuted and examined, according to FAQ16. (The Service had provided taxpayers with a similar warning in 2009 FAQ10.) The answer goes on to state that "[t]he IRS has identified, and will continue to identify, amended tax returns reporting increases in income. The IRS will be closely reviewing these returns to determine whether enforcement action is appropriate."

It would seem logical to conclude that taxpayers who elected to file quiet disclosures decided to call the Service's bluff by virtue of having made the quiet disclosure. Until the IRS does prosecute a taxpayer who made a quiet disclosure, it would appear that taxpayers will continue to use this approach as a means through which to come into compliance.

Other taxpayers. The more than 3,000 taxpayers who made traditional voluntary disclosures in accordance with the *Internal Revenue Manual* after the 2009 VDP are eligible to participate in the 2011 VDP. And it appears the IRS is rewarding those taxpayers for coming forward without knowing the terms of the penalties to which they would be subjected. Such taxpayers are receiving letters from the Austin IRS office overseeing the 2011 VDP, informing them that their cases have been referred to the Austin Campus to resolve the civil tax liabilities, interest, and penalties. The letter further advises taxpayers that they must follow the terms of the 2011 VDP. Notwithstanding, the IRS is excluding 2009 and 2010 for purposes of computing the offshore penalty.

Taxpayers who are under audit are not eligible for the 2011 VDP. <sup>6</sup> This is no different than the 2009 VDP or the traditional voluntary disclosure program authorized by the IRM.

## APPLYING FOR THE 2011 VDP

FAQ23 explains that there is a pre-clearance procedure by which taxpayers or their advisors can determine if the taxpayer is qualified to make a voluntary disclosure. This step will basically confirm that the taxpayer is not already under examination, investigation, or that the taxpayer's name is included in the information received from a third party.

Procedurally, the pre-clearance is requested by faxing the IRS Criminal Investigation Lead Development Center at (215) 861-3050. The fax should include the taxpayer's name, date of birth, Social Security number, and address, as well as a copy of the tax advisor's power of attorney. The IRS will fax a reply, but pre-clearance does not equate to acceptance into the 2011 VDP.

Once the taxpayer qualifies to make a voluntary disclosure in accordance with the 2011 VDP, a copy of the offshore voluntary disclosure letter must be submitted to the Offshore Voluntary Disclosure Coordinator, 600 Arch Street, Room 6404, Philadelphia, Pennsylvania 19106. The intent is for Criminal Investigation (CI) to make a decision within 30 days of receipt of the letter. <sup>7</sup>

What if a taxpayer or tax advisor is not certain about proceeding with a voluntary disclosure? The 2011 VDP permits such persons to discuss hypothetical fact patterns on an anonymous basis by calling the 2011 VDP hotline at (267) 941-0020 or their local CI office with questions. It is important to understand that "[i]f the IRS receives information relating specifically to the taxpayer's undisclosed foreign accounts or undisclosed foreign entities while the

hypothetical question is pending, the taxpayer may become ineligible to make a voluntary disclosure." [8](#)

## 2011 VDP TERMS

Taxpayers participating in the 2011 VDP are required to file and pay the following items and amounts:

(1) *Returns*. Taxpayers are required to file, by 8/31/11, correct tax returns (and information returns) for the eight-year period 2003-2010. If the taxpayer previously filed tax returns, then the returns must be amended pursuant to the 2011 VDP, and if no such returns were ever filed, then initial returns will be filed. Of course, if a taxpayer's noncompliance involves fewer than eight years, only those years with noncompliance must be cured.

(2) *Deficiency payments/late payments*. Taxpayers will pay the total tax deficiency that arises by virtue of filing proper tax returns. In the event a taxpayer is amending tax returns in the 2011 VDP, the total tax deficiency will be subject to a 20% accuracy-related penalty. If a taxpayer is filing initial returns, as opposed to amended returns, then in lieu of the accuracy-related penalty on the deficiency, the taxpayer will be subject to the delinquency penalties (i.e., late-filing and late-payment).

(3) *Offshore penalties*. Taxpayers will also be subjected to one of three offshore penalties that are incorporated into the 2011 VDP:

- () 25%. The offshore penalty under the 2011 VDP is 25% of "the highest aggregate balance" held within the foreign accounts during the eight-year period. The highest aggregate balance on which the penalty is based also includes (a) the value of any assets procured with unreported income, whether the assets are held in or outside of an entity, and (b) the value of any income-producing assets if the income is unreported, even if the asset was procured with reported income.
- () 12.5%. Taxpayers can qualify for a penalty of 12.5%, instead of 25%, provided that during the years covered by the 2011 VDP (a) the highest aggregate account balance, (b) the FMV of assets generating income, which were not reported in the U.S., and (c) the FMV of assets in undisclosed foreign entities, if procured with untaxed funds, at no point exceeded \$75,000. [2](#)
- () 5%. The 2011 VDP permits certain individuals who inherited accounts, and certain individuals who did not know that they were U.S. citizens, to qualify for a reduced penalty of 5% in lieu of the 25% penalty. [10](#)

Inherited accounts. Taxpayers must satisfy all four of the following requirements in order to qualify for the reduced penalty:

- The taxpayer did not open the account or cause the account to be opened. A taxpayer still may qualify for the reduced penalty if the bank required a new account to be opened following the death of the initial account owner.
- The taxpayer must have had infrequent contact with the bank and exercised minimal control over the account. A taxpayer who provided the bank with a "hold mail" document or exercised any investment discretion over the account will not qualify for the reduced penalty. "Infrequent contact" includes communication with the bank to provide new contact information or to request the account balance.
- During the years covered by the 2011 VDP, the taxpayer could not have taken out more than \$1,000 in any calendar year, unless the account was closed and the funds were transferred to the U.S.
- If the funds were deposited into the account prior to 1991, the IRS will presume that all applicable U.S. taxes were paid. If, however, there are any deposits after 1990, the taxpayer will have to identify the source of the deposit and, if that source was taxable in the U.S., prove that tax was paid on it.

The 2011 VDP actually expands the possibility for taxpayers to qualify for the 5% penalty when they inherited an account. Experience indicates that it was quite difficult to qualify for the 5% inherited account penalty offered in the 2009 VDP. In the prior program, taxpayers were only entitled to the reduced penalty if they (1) did not open or create the foreign account, (2) had never withdrawn money from the foreign account or contributed money to the foreign account, and (3) all U.S. taxes were paid on the funds that were deposited into the account. Furthermore, taxpayers who could satisfy these three requirements could not qualify for the reduced penalty if they exercised any investment discretion over the funds in the account.

Foreign-domiciled U. S. citizens. The procedural requirements for "accidental" U.S. citizens to qualify for the 5% penalty are surprising. If a taxpayer was born in the U.S. to foreign parents, and is consequently a U.S. citizen, but grew up in a foreign jurisdiction, the taxpayer is entitled to the 5% penalty provided she did not know she was a U.S. citizen.

An example in FAQ52(2) fleshes out these requirements. The example states that the taxpayer "became aware she was a U.S. citizen when she had to get a birth certificate in order to obtain a passport from the foreign jurisdiction where she resides." Because this is the only instance in which the taxpayer realized she was a U.S. citizen, the example declares she is entitled to the reduced 5% offshore penalty.

A variation on this example has the opposite result: the taxpayer was born in the U.S. to foreign parents, grew up in the foreign jurisdiction, but always knew that she was a U.S. citizen; her penalty will be 25% and not 5%.

Treating similarly situated citizens differently is ill conceived. It is not clear how many people worldwide are uncertain as to the place of their birth. Consequently, it is quite probable that few persons will qualify for the reduced penalty based on the requisite lack of knowledge as to having been born in the U.S. It is unclear how the IRS is going to determine whether taxpayers previously knew that they were or were not U.S. citizens.

Inclusion of 2009 VDP participants. Taxpayers who participated in the 2009 VDP are permitted to benefit from the reduced penalties (12.5% and 5%) available in the 2011 VDP. Revenue agents should apply the new penalty regime for those taxpayers who can satisfy the requisite criteria for the reduced penalties.

For taxpayers in the 2009 VDP whose cases have since been closed, procedures are provided by which they can request the benefits of the 2011 VDP penalties. Such taxpayers are instructed to mail a package to Internal Revenue Service, 3651 South IH-35 Stop 4301 AUSC, Austin, Texas 78741, Attn: 2009 OVDP Determination. The package should include the following:

- A letter explaining the taxpayer's belief that she qualifies for reduced penalties.
- The name of the revenue agent assigned to the case.
- A copy of the Form 906 closing agreement.
- The taxpayer's contact information (name, address, Social Security number, home and cell phone numbers).

## 2011 VDP SUBMISSIONS

As stated above, taxpayers must file correct tax returns for the eight-year period 2003-2010. Additional documents are also required, however, and all such documents must be filed by 8/31/11. This is a significant departure from the 2009 VDP, under which taxpayers only had to identify their desire to participate in the program by its deadline (10/15/09).

Once a taxpayer has been admitted into the 2011 VDP, she must submit a package to the IRS including all of the following documents, as set forth in FAQ25, no later than 8/31/11:

- Copies of all previously filed tax and information returns for the years 2003-2010.
- Complete and accurate amended tax returns for the years 2003-2010. If the taxpayer is the executor of a decedent's estate and a gift tax or estate tax return was required to report the existence of a foreign account, asset, or entity, the taxpayer must include either original gift and estate tax returns or amended returns.
- Complete and accurate delinquent information returns, as required, for the years 2003-2010. If the taxpayer is requesting that the IRS waive the requirement to file the information returns (exclusive of the FBAR), the taxpayer should submit a completed and signed Statement on Dissolved Entities.
- A copy of the completed and signed Offshore Voluntary Disclosure Letter, which was required in order to be admitted into the 2011 VDP.
- A completed Foreign Account or Asset Statement for each previously undisclosed foreign account or asset held during the years 2003-2010. This is a new form created for participants in the 2011 VDP.
- If the taxpayer held any shares in a passive foreign investment company (PFIC) during the years 2003-2010, the taxpayer must advise whether it is choosing to use the alternative to the statutory PFIC computation that resolves PFIC issues on a basis that is consistent with the mark-to-market methodology authorized in [Section 1296](#) but does not require complete reconstruction of historical data. [11](#)
- A completed Foreign Financial Institution Statement for each foreign financial institution with which the taxpayer had undisclosed accounts or transactions during the years 2003-2010, if the highest aggregate balance on the undisclosed accounts exceeded \$1 million in any one of the years 2003-2010. This is a new form created for participants in the 2011 VDP.
- A completed Taxpayer Account Summary With Penalty Calculation signed by the taxpayer under penalties of perjury. While this is a new form created for participants in the 2011 VDP, it is similar to a form revenue agents prepared for participants in the 2009 VDP, and which accompanied the Form 906 Closing Agreement. The document summarizes the taxpayer's foreign accounts, the aggregate highest account balances, the FMV of foreign assets, and the penalty computation. In addition to the taxpayer, the tax advisor named on the power of attorney also must sign it.
- A statement identifying all offshore entities held by the taxpayer during the years 2003-2010, whether the entity is held directly or indirectly, and the taxpayer's ownership or control of such entities.
- A completed Form 872 signed by the taxpayer extending the statute of limitations on tax years 2003-2008, by virtue of which the IRS can assess additional income tax. In the 2009 VDP, revenue agents with varying degrees of success asked taxpayers or their representatives to sign Forms 872 for 2006 and then, months later, for 2007.
- A completed Consent signed by the taxpayer extending the time in which civil penalties may be assessed for

FBAR violations. This is a new form created for participants in the 2011 VDP.

- Copies of bank statements for all undeclared accounts during the years 2003-2010 if the highest aggregate balance during the years exceeds \$500,000. Those taxpayers whose account balances do not exceed \$500,000 should be prepared to provide such statements to the revenue agent upon request. This is a change from the 2009 VDP, under which taxpayers were required to provide copies of all bank statements regardless of the value of the unreported accounts.
- A check made payable to the Department of Treasury satisfying in full all tax, interest, and penalties associated with the taxpayer's voluntary disclosure. If payment in full cannot be made, IRS requires the taxpayer to submit proposed payment arrangements along with a completed Form 433-A ("Collection Information Statement for Wage Earners and Self-employed Individuals") or Form 433-B ("Collection Information Statement for Businesses").

The package should be delivered to Internal Revenue Service, Attention 2011 Offshore Voluntary Disclosure Initiative, 3651 South IH-35 Stop 4301 AUSC, Austin, Texas 78741. On receipt of the package, the Service will assign a revenue agent to the file. The agent will be charged with two distinct tasks: (1) confirming that the taxpayer's voluntary disclosure is correct, accurate, and complete, and (2) determining the proper tax, interest, and penalties that are owed.

## PROBLEMS WITH THE 2011 VDP

Although there are a number of problems with the 2011 VDP, such as the requirement to submit all of the required documents by 8/31/11, the following are of the greatest concern:

- (1) The penalty computation.
- (2) Retroactive application.
- (3) Punishing dual citizens.
- (4) Inclusion of permanent residents.

### Penalty Computation

FAQ50 states "[u]nder no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes." Revenue agents will be charged with making the determination as to whether penalties would be lower outside of the program. When making this determination, however, revenue agents will be required to assume in all open years that the maximum penalties could be assessed by the IRS. (As noted above, taxpayers already will have provided the Service with a Form 872 extending the statutes for the 2003-2008 tax years.)

Unless the taxpayer was actively involved in evading tax, it is possible that reasonable cause or other mitigating factors would help reduce the size of any assessed penalty. Nevertheless, FAQ50 indicates that the penalties are determined "without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability." Consequently, it is not clear as to when a 50% FBAR penalty, which is the maximum that could be imposed, would ever be less than the penalties provided under the 2011 VDP.

### Retroactive Application

In the 2009 VDP, FAQ35 provided "under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes." In substance, this is identical to FAQ50 under the 2011 VDP.

In the 2009 VDP, however, the answer makes no reference to the penalty under the VDP being compared to the maximum civil penalties that otherwise would be applicable. In practice, revenue agents often requested representatives to provide them with their analysis as to why the 20% penalty should not apply. After the 2011 VDP, this is no longer possible. Until a participant in the 2009 VDP challenges the IRS in court as to the propriety of changing rules retroactively, it appears as though FAQ35 is no longer helpful to taxpayers in the 2009 VDP.

### Punishing Dual Citizens

The 2011 VDP subjects accidental Americans to penalty. These can be persons born in the U.S. to foreign parents, but who otherwise grew up outside the U.S. Under certain circumstances, it also can include persons born outside of the U.S. if one of the parents is a U.S. citizen and files the necessary paperwork with the local U.S. Embassy.

These are taxpayers who should be encouraged to come into compliance. If a taxpayer is otherwise off the U.S. radar, imposing unjustified penalties for coming forward is likely to further encourage these individuals to remain

"underground." If these dual-citizen taxpayers do not consider themselves U.S. citizens, or in certain instances do not even realize they have such status, there simply appears no justification for punishing them, much less drawing a distinction in the penalty amount. The 2011 VDP appears to be designed to punish these persons who receive none of the benefits of U.S. citizenship. The penalty seems clearly disproportionate.

The typical U.S. citizen who fails to report foreign assets under the 2011 VDP will pay a 25% penalty on the value of these foreign holdings. This contrasts with dual-citizen taxpayers, who never hid money or assets, but rather who hold such assets in their home country. Further compounding the problem is this penalty imposed on the assets held by dual-citizen taxpayers on their entire net worth, provided such taxpayers have no U.S. holdings. The net result is that a dual-citizen taxpayer is punished more severely under the 2011 VDP than a domestic-based U.S.-citizen taxpayer.

In related circumstances, Congress and the IRS have recognized the tenuous relationship that certain citizens may have with the U.S. For this reason, there are exceptions to the exit tax imposed under the expatriation law enacted by the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245, 6/17/08; the "HEART legislation"). [Section 877\(c\)\(2\)\(A\)](#) applies to individuals who became dual citizens at birth. In order to qualify for exemption from the exit tax:

- (1) The individual must have obtained U.S. citizenship solely by reason of birth, as well as citizenship of another country,
- (2) At the time of the expatriation the individual must remain both a citizen and income tax resident of the other country, and
- (3) The individual was not a U.S. resident under the substantial-presence test for more than ten years out of the 15-year period ending with expatriation.

The 2011 VDP is not a statutory creation but rather simply a program announced by the IRS. It would seem appropriate for the Service to follow the logic of the HEART legislation, and permit such dual-citizen taxpayers to come into compliance without imposing any penalties.

## Permanent Residents

An often overlooked exception to the 20% penalty imposed in the 2009 VDP is the extension of the 5% penalty to accounts held by permanent residents prior to their attaining such immigration status. Specifically, FAQ46 stated that "the penalty may be limited to five percent if the taxpayer did not avoid U.S. tax with respect to the deposits and if the account was passively held during the year the taxpayer was in the U.S." The 2011 VDP does not provide any similar benefit to permanent residents.

## WHY PARTICIPATE IN THE 2011 VDP?

Taxpayers with unreported foreign income should consider participating in the 2011 VDP to avoid the potential of criminal prosecution <sup>12</sup> and exposure to much greater civil penalties. Of course, the extent to which the taxpayer or taxpayer's counsel is certain that criminal penalties would not be applicable to the taxpayer's facts, the attractiveness of the program is minimized. In such circumstances, a traditional voluntary disclosure may be appropriate.

Whether taxpayers make a traditional voluntary disclosure or participate in the 2011 VDP, the issue is coming forward, and quickly. Unless a taxpayer has been in a coma or stuck on the island with Tom Hanks in *Castaway*, it would be next to impossible not to know by now that foreign accounts have to be reported in the U.S. This is serious business for the IRS and Department of Justice. During the announcement introducing the 2011 VDP, Commissioner Shulman stated: "As we continue to amass more information and pursue more people internationally, the risk to individuals hiding assets offshore is increasing.... This new effort gives those hiding money in foreign accounts a tough, fair way to resolve their tax problems once and for all. And it gives people a chance to come in before we find them." <sup>13</sup>

He continued to urge those taxpayers with noncompliance to use the 2011 VDP when he stated: "Combating international tax evasion is a top priority for the IRS. We have additional cases and banks under review. The situation will just get worse in the months ahead for those hiding assets and income offshore. This new disclosure initiative is the last, best chance for people to get back into the system." <sup>14</sup>

In addition, John DiCicco, Acting Assistant Attorney General of the DOJ's Tax Division, stated on 2/25/11 to attendees at the Federal Bar Association's Section on Taxation conference that taxpayers were "playing with fire," if they did not report their undeclared foreign accounts. He went on to say that "the world is shrinking and it's getting harder and harder for would-be tax cheats to hide their income and assets in a foreign bank." <sup>15</sup>

Subsequent to the announcement introducing the 2011 VDP, the government indicted two taxpayers for failing to report the existence of their foreign accounts, [16](#) indicted a former UBS banker now with Credit Suisse, [17](#) and in a separate proceeding indicted four other Credit Suisse bankers. [18](#) To the extent to which the IRS receives information on U.S. taxpayers from any of these or other sources, taxpayers will no longer be eligible for a voluntary disclosure.

## TRADITIONAL VOLUNTARY DISCLOSURE

For taxpayers whose noncompliance is not cured by the FAQs, the 2011 VDP is not the only option. The 2011 VDP website makes clear that taxpayers still may make a voluntary disclosure in accordance with IRM section 9.5.11.9.4. Taxpayers can proceed with such a voluntary disclosure by contacting their local CI office to speak with a special agent.

The *Internal Revenue Manual* defines a voluntary disclosure as having taken place when the taxpayer's communication is truthful, timely, and complete. [19](#) These terms require that the taxpayer show a willingness to cooperate (and does in fact cooperate) with the Service in determining the correct tax liability. The taxpayer also has to make good faith arrangements with the IRS to pay in full the tax, interest, and any penalties the Service determines are applicable. [20](#)

When successful, taxpayers can use the voluntary disclosure program to come into compliance and avoid criminal prosecution. Taxpayers need to be aware that not all voluntary disclosure submissions are accepted, and thus criminal prosecution is a potential outcome from a disclosure which is found not to qualify. [21](#) Cases involving illegal source income will not qualify. [22](#)

Disclosures are timely if they are received before the occurrence of any of the following:

- (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. [23](#)
- (3) The IRS has initiated a civil examination or criminal investigation that is 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). [24](#)

There are risks associated with making a voluntary disclosure after 8/31/11. FAQ11 indicates that civil penalties may apply for tax years prior to 2003 for any such taxpayers who make a voluntary disclosure once the 2011 VDP terminates. It is not clear, however, if the IRS intends to pursue civil penalties prior to 2003 for taxpayers who submit a voluntary disclosure in accordance with the IRM before 8/31/11.

Taxpayers should be aware that the statute of limitations associated with information returns is tolled until the required information return is filed. The penalties on these forms are often much higher than the underlying tax liability. The Service of course is limited by the statute of limitations when it comes to assessing income tax. Generally, the IRS has three years from the filing of a return in which to audit a taxpayer and assess additional tax ([Section 6501\(a\)](#)). The period is increased to six years if a taxpayer omits 25% or more of gross income ([Section 6501\(e\)](#)).

The statute of limitations also applies to information required to be reported on certain foreign transfers. FATCA section 513 amended section 6501(e) to also extend the statute of limitations to six years where a taxpayer omits more than \$5,000 of income attributable to one or more assets required to be reported under [Section 6038D](#). Thus, even if the taxpayer does not have a substantial understatement, the IRS will have six years in which to investigate and audit the taxpayer. In addition, the three-year and six-year statutes of limitations will be suspended until the information required to be reported under [Section 1295\(b\)](#), [1298\(f\)](#), [6038](#), [6038A](#), [6038B](#), [6038D](#), [6046](#), [6046A](#), or [6048](#) is provided to the IRS. [25](#)

## RISKS OF NONDISCLOSURE

If a taxpayer is not in compliance, depending on the extent of the noncompliance, the statute of limitations may remain open for both the underlying tax and penalties associated with not filing information returns. Of course, if the IRS does not learn about the existence of the taxpayer's noncompliance, then not making a voluntary disclosure would appear to be a valid gamble. If, however, a taxpayer is found, the following are some of the potential penalties that could be assessed were the IRS to audit a taxpayer who did not participate in the 2011 VDP or make a traditional voluntary disclosure:

- Criminal prosecution.
- The civil fraud penalties under [Sections 6651\(f\)](#) and [6663](#), which can amount to penalties of 75% of the unpaid tax.
- A 20% or 40% accuracy-related penalty (of course, the 20% penalty is imposed within the 2011 VDP).
- Failure-to-pay penalties under [Sections 6651\(a\)\(2\)](#) and [\(a\)\(3\)](#) (these penalties also are imposed within the 2011 VDP).
- Failure-to-file penalties under [Section 6651](#) (again, these penalties also are imposed within the 2011 VDP).
- Penalties for failure to file foreign corporation information returns (Form 5471 and Form 5472), which begin at \$10,000 and can run as high as \$50,000 per return.
- Penalties for failure to report transfers of property to a foreign corporation (Form 926), which begin at 10% of the value of the property transferred to the corporation and which can reach a maximum of \$100,000 per return.
- Penalties for failure to file a Form 3520 reporting the transfer of funds to a foreign trust or receipt of a distribution from a foreign trust, which begin at 35% of the amount transferred to or received from the foreign trust.
- Penalties for failure to file a Form 3520 to report the receipt of a gift or inheritance from a foreign person or estate, or a gift received from a foreign corporation or partnership, which begin at 5% of the value of the gift and can reach as high as 25% of the value.
- Penalties for failure to file Form 3520-A, reflecting ownership of a foreign trust under the grantor trust rules, which consists of a penalty of 5% of trust assets.
- Penalties for failure to file foreign partnership information returns (Form 8865), which start at \$10,000 and can reach a maximum of \$50,000 per return, plus up to \$100,000 of the value of property transferred to the foreign partnership.
- Penalties for failure to file FBARs, which can reach as high as 50% of the account balance, and in certain situations jail.

## 2011 FBARS

Whether or not a voluntary disclosure is made, taxpayers must recognize that the filing requirements for the 2011 FBAR reporting the existence of accounts held in 2010 have changed. On 2/23/11, the Financial Crimes Enforcement Network (FinCEN) announced the introduction of final Regulations amending the rules under the Bank Secrecy Act provisions that apply to the FBAR. The changes are effective as of 3/28/11. The final Regulations did not make substantial changes to the Proposed Regulations, which were introduced on 2/26/10. <sup>26</sup> Notwithstanding, taxpayers and tax preparers should be aware of a few noteworthy changes that were introduced in either the proposed or final Regulations.

1. U.S. persons are required to file an FBAR if they have a financial interest, signature authority, or other authority over foreign financial accounts if in the aggregate the accounts equal or exceed \$10,000 at any point within the year. The final Regulations expand the definition of a U.S. person, and as a result the number of persons who may have an FBAR filing obligation. A U.S. person includes the following:

- A U.S. citizen.
- A permanent resident (i.e., green card holder).
- A resident alien in accordance with the rules of [Section 7701\(b\)](#).
- A domestic trust or estate.
- A domestic business entity (corporation, partnership, LLC).

As a result, resident aliens under the substantial presence test and LLCs are now required to file an FBAR if they otherwise meet the requisite filing obligations.

The final Regulations eliminated all references to nonresident aliens having to file an FBAR if they were "in and doing business in the U.S." They similarly explain that even if a permanent resident classifies as a nonresident under a treaty tie-breaker, the FBAR filing obligation will remain. No such rule applies to resident aliens who satisfy [Section 7701\(b\)](#) but who can either establish a closer connection to another country or qualify for a treaty tie-breaker. If a nonresident alien elects to be a U.S. person under [Section 6013\(g\)](#) or [\(h\)](#), such person will not have an FBAR filing obligation.

Finally, the Regulations explain in great detail that the test as to whether a business entity or trust is domestic is simply whether the entity was formed in the U.S. If it is a foreign entity that makes a tax election to be a U.S. person, it will not have an FBAR filing obligation.

2. An account is foreign if it is located outside of the U.S., its territories, possessions, and Indian lands. As a result, if there is a foreign account with U.S. investments, the account must be reported on an FBAR. This contrasts with a domestic account that owns foreign investments.



The final Regulations continue to reserve for a future date guidance on hedge funds, private equity funds, and similar investments. Those assets will, however, have to be reported under FATCA and [Section 6038D](#). A foreign mutual fund, which is a reportable investment, is defined to include pooled investments open to the public, where shares have a net asset value and regular redemptions.

3. Signature and other authority is defined to include persons who have authority "(alone or in conjunction with another), to control the disposition of money, funds, or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained." The obligation to file an FBAR will exist only for persons who have the authority to directly deliver instructions to the financial institution, and have the institution act on such directions.

## CONCLUSION

The IRS and Department of Justice are committed to ending tax evasion involving foreign assets and entities. If, along the way, the government catches a taxpayer who did not have the intent to evade tax but who is not in compliance, it is unclear how such taxpayer will be treated. It would appear better for such taxpayers to be proactive, as opposed to reactive.

While the 2011 VDP is far from perfect, it does offer taxpayers one more chance to resolve their foreign sourced noncompliance. In the event taxpayers cannot overlook the imperfections of the 2011 VDP and believe that they would be better off dealing with a revenue agent who has discretion when considering the assessment of penalties, such taxpayers should consider making a voluntary disclosure in accordance with the IRM.

Regardless of which route is selected, time is of the essence. When announcing the 2011 VDP, Commissioner Shulman closed his remarks this way: "We are not letting up on international tax issues, and more is in the works. For those hiding cash or assets offshore, the time to come in is now. The risk of being caught will only increase." [27](#) The VDP 2011 announcement came prior to the indictment of the Credit Suisse bankers, and subsequent to the indictment of a taxpayer with an HSBC account. Both institutions were quick to point out that they were not under investigation and were cooperating with the IRS. It appears that these and any other financial institutions will do their best to avoid being prosecuted.

To add a final push to encourage taxpayers to come forward, CI Division Deputy Chief Rick Raven, speaking during a BNA Tax & Accounting webinar on 2/18/11, said that whistleblowers are providing a huge amount of information to the IRS. He stated: "You can't discount the amount of information that comes from" whistleblowers, which is becoming "a cottage industry." [28](#)

## Practice Notes

Taxpayers who are not in compliance with the requirements to report foreign assets or income must quickly consider whether to take advantage of the new 2011 VDP or instead to make a voluntary disclosure under the guidelines in the *Internal Revenue Manual*. While the latter allows for some discretion on the part of the revenue agent in determining applicable penalties, it also would seem to lack the certainty of the Service's newest attempt to bring noncompliant taxpayers in from the cold.

[1](#)

IR-2011-14, 2/8/11.

[2](#)

[www.irs.gov/businesses/international/article/0,,id=235699,00.html](http://www.irs.gov/businesses/international/article/0,,id=235699,00.html).

[3](#)

[www.irs.gov/newsroom/article/0,,id=234900,00.html](http://www.irs.gov/newsroom/article/0,,id=234900,00.html).

[4](#)

See Packman and Rivero, "Increased Disclosure, Penalties, and Audit Periods Courtesy of the Foreign Account Tax Compliance Act," [112 JTAX 266 \(May 2010\)](#), for more information on FATCA in general and [Section 6038D](#) in particular.

[5](#)

Even though FAQ18 specifies Forms 3520 and 5471, it would appear that taxpayers could benefit from the abatement of penalties and file delinquent Forms 3520-A, 8865, and 926, provided there is no unreported income connected with the entity that is being reported on the corresponding form.

[6](#)

FAQ14.

[7](#)

FAQ24.

[8](#)

FAQ22.

[9](#)

FAQ53.

[10](#)

FAQ52.

[11](#)

Additional information regarding these issues is available at FAQ10.

[12](#)

Even if a taxpayer participates in the VDP or uses the advantages provided in FAQ17 or FAQ18, the Department of Justice still may seek to penalize the taxpayer. For an example, see Sheppard, "IRS Giveth and DOJ Taketh Away: Recent Opinion Jeopardizes Retroactive FBAR Relief," [114 JTAX 18 \(January 2011\)](#).

[13](#)

See note 1, *supra*.

[14](#)

*Id.*

[15](#)

See "DiCicco Says DOJ Tax Division's Emphasis on Offshore Tax Evasion Remains Priority," BNA Daily Tax Report, 2/28/11, page G-7.

[16](#)

On 2/17/11, Utah businessman Jon Robertson was indicted; see [www.justice.gov/opa/pr/2011/February/11-tax-204.html](http://www.justice.gov/opa/pr/2011/February/11-tax-204.html). On 2/18/11, Edward Gurary, an Ohio man residing in Switzerland, was indicted; see [www.justice.gov/usao/ohn/news/2011/18Feb2011.html](http://www.justice.gov/usao/ohn/news/2011/18Feb2011.html). In addition, on 3/4/11, Arthur Joel Eisenberg, a Washington man, was sentenced following his guilty plea in December 2010 for not reporting his UBS account; see [www.justice.gov/opa/pr/2011/March/11-tax-279.html](http://www.justice.gov/opa/pr/2011/March/11-tax-279.html).

[17](#)

On 3/1/11, Christos Bagios, the head of Credit Suisse's Relationship Management West Coast Group, was indicted. Prior to joining Credit Suisse, Bagios worked for UBS for 15 years and was the private banking representative for parts of California. See [www.nytimes.com/2011/03/02/business/global/02tax.html?src=busln](http://www.nytimes.com/2011/03/02/business/global/02tax.html?src=busln).

[18](#)

On 2/23/11, Credit Suisse bankers Marco Parenti Adami, Emanuel Agustoni, Michele Bergantino, and Roger Schaerer were indicted for their role in advising taxpayers in evading U.S. income tax. See [www.justice.gov/tax/txdv11225.htm](http://www.justice.gov/tax/txdv11225.htm). The indictment refers to banks in Hong Kong and Switzerland to which the Credit Suisse advisors encouraged taxpayers to transfer their assets. These banks have since been named as Bank Leumi, Bank Frey, and Maerki Baumann. See [www.nytimes.com/2011/02/24/business/global/24tax.html](http://www.nytimes.com/2011/02/24/business/global/24tax.html).

[19](#)

IRM 9.5.11.9.3.

[20](#)

IRM 9.5.11.9.3.A and B.

[21](#)

IRM 9.5.11.9.2.

[22](#)

*Id.*  
[23](#)

This includes whistleblowers, and trust officers are a key source of information for the IRS. Whistleblowers have come from Bank Julius Baer, HSBC Holdings plc, LGT Bank of Liechtenstein, Dutch Bank, Rabobank, and UBS, to name but a few.

[24](#)

IRM 9.5.11.9.4. See also notes 16-18, *supra*, on recent indictments.

[25](#)

For a summary of the many information returns and an analysis as to when they must be filed, see Packman, "Noncompliance After the IRS Offshore Income Reporting Initiative—What Options Remain?," [111 JTAX 281 \(November 2009\)](#).

[26](#)

For a complete analysis of the Proposed Regulations, see Packman, "Reporting Foreign Accounts: Treasury Applies the Carrot and the Stick," [112 JTAX 334 \(June 2010\)](#).

[27](#)

See note 1, *supra*.

[28](#)

See "Past Lessons Guiding New IRS Offshore Disclosure Initiative," Tax Notes International, 2/28/11.

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