

# New York Law Journal



WWW.NYLJ.COM

VOLUME 241—NO. 92

©2009 INCISIVE MEDIA US PROPERTIES, LLC

An incisivemedia publication

THURSDAY, MAY 14, 2009

TAX LITIGATION ISSUES

Expert Analysis

## One Last Chance For Offshore Account Holders

*Jack Tigie was a leader of the criminal tax bar for almost 30 years. For the past 16 years, he was the principal author of this column, providing timely insights for practitioners. Jack passed away earlier this month. He will be sorely missed by his colleagues at Morvillo Abramowitz, by his many friends in the New York legal community, and by the tax bar around the country.*

By  
**Jeremy H.  
Temkin**



Last year, this column addressed the Internal Revenue Service's pursuit of information from the Swiss bank UBS as part of its continued focus on abusive tax schemes and overseas tax shelters.<sup>1</sup> The IRS's investigation became public when a UBS employee, Bradley Birkenfeld, pled guilty to helping an American billionaire evade \$7.2 million in federal income taxes. At that time, the IRS sought to use its authority under §7609(f) of the Internal Revenue Code to serve a "John Doe summons" on UBS seeking to identify the holders of offshore accounts.

Disclosure of the IRS's investigation and the John Doe summons set off shockwaves as the holders of offshore accounts sought to mitigate their civil and criminal exposure. On March 23, 2009, the IRS came out with guidance regarding civil penalties it will impose on taxpayers who make "voluntary disclosure" of their offshore accounts. This guidance should help attorneys and accountants advising such taxpayers of their options going forward.

### Voluntary Disclosure Practice

On Feb. 18, 2009, UBS reached a deferred prosecution agreement with the Justice Department in which it admitted that certain of its private bankers and managers had helped individuals evade their U.S. tax obligation, and agreed to pay \$780 million to avoid criminal prosecution.<sup>2</sup> As part of the deferred prosecution agreement, UBS agreed to send all of its cross-border U.S. clients a letter directing the clients to provide instructions as to how to close their accounts, and informing the clients that, if no such instructions are received, UBS will "initiate... steps deemed appropriate for the closure of and remittance of funds in [the] account. Such steps may include the liquidation of [the] assets." The letter will also inform clients that "the IRS has a voluntary disclosure practice to encourage U.S. taxpayers to bring themselves voluntarily into full

compliance with the U.S. tax laws, and, in exchange, the IRS may provide for substantial relief from otherwise applicable penalties and fines."<sup>3</sup>

In various incarnations, the voluntary disclosure practice referenced in the UBS letter has existed since at least 1961.<sup>4</sup> The practice, memorialized in the Internal Revenue Manual (the "Manual"), does not confer any rights upon taxpayers. Rather, the voluntary disclosure practice is an internal means by which the IRS encourages taxpayers to disclose outstanding tax issues. Such disclosure, along with other factors, is considered by the IRS in determining whether to recommend criminal prosecution.<sup>5</sup>

On March 23, 2009, the IRS came out with guidance regarding civil penalties it will impose on taxpayers who make 'voluntary disclosure' of their offshore accounts.

As set forth in the Manual, a voluntary disclosure occurs when a taxpayer makes a truthful, timely and complete communication to the IRS and when: (i) a taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and (ii) the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.<sup>6</sup>

Perhaps the key issue in determining whether a voluntary disclosure has occurred is the timeliness of the disclosure. A disclosure is deemed timely if it is received before the IRS has: (i) initiated a civil examination or criminal investigation of the taxpayer or his or her specific liability, or has notified the taxpayer that it intends to commence such an examination or investigation; (ii) received information from a third party alerting it to the taxpayer's noncompliance; and (iii) acquired

information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., a search warrant, a grand jury subpoena).<sup>7</sup>

Because the voluntary disclosure practice requires taxpayers to expose their tax liability without knowing if they will be subject to criminal prosecution, practitioners have debated the relative benefits of either participating in the voluntary disclosure program or having the client quietly file appropriate returns (including amended returns) and pay the delinquent taxes and interest.

After disclosure of the UBS investigation, some taxpayers had been making voluntary disclosures while others were making so-called "quiet" disclosures. To encourage self-reporting by U.S. taxpayers holding offshore accounts, on March 23, 2009, the IRS provided guidance regarding the extent of penalties it will impose on holders of offshore bank accounts who pursue the IRS's voluntary disclosure practice.<sup>8</sup> In announcing the guidance, IRS Commissioner Doug Shulman made clear that the IRS's goal is "to get those taxpayers hiding assets offshore back into the system" and expressed his view that "the guidance represents a firm but fair resolution of these cases and will provide consistent treatment for taxpayers. The goal is to have a predictable set of outcomes to encourage people to come forward and take advantage of our voluntary disclosure practice while they still can."<sup>9</sup>

In order to take advantage of the voluntary disclosure practice, a taxpayer approaches the IRS's Criminal Investigation (CI) section, which screens applications to determine if the taxpayer is eligible for the program. In making this determination, the IRS will consider, at a minimum, 1) whether the taxpayer is currently the subject of a criminal investigation or civil examination; 2) whether the taxpayer is the subject of an investigation by any federal or state agency; 3) whether the taxpayer has reason to believe the government has obtained information about his or her liability; 4) whether any of the money in the account represents the proceeds of unlawful activity; and 5) whether a bank or foreign government has notified the taxpayer that the IRS has requested information about the taxpayer.

Where CI preliminarily determines that the taxpayer is eligible, the voluntary disclosure requests are forwarded to the Philadelphia Offshore Identification Unit (POIU) for civil processing. In addition, outstanding voluntary disclosure cases with offshore issues are to be forwarded to the POIU in order to centralize the processing of all such cases

JEREMY H. TEMKIN is a principal in Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer. GRETCHAN R. OHLIG, an attorney, assisted in the preparation of this article.

within the IRS.<sup>10</sup>

### Penalty Adjustments

The IRS's guidance offers taxpayers who disclose their offshore accounts before Sept. 23, 2009, the opportunity to come into compliance by making a voluntary disclosure, while paying reduced (but still substantial) penalties and minimizing the risk of criminal charges. Such taxpayers will be required to file or amend returns for the past six years (2003-2008), including Reports of Foreign Bank and Financial Accounts (FBARs) and other information returns, and will be assessed all taxes and interest for that period. This means the taxpayer is liable for taxes and interest on any unreported income used to fund the offshore account as well as any unreported income generated by the account.

Second, the taxpayer will be assessed either an accuracy-related penalty of 20 percent of the underreported tax or a delinquency penalty of 25 percent of the unreported tax. Third, "[i]n lieu of all other penalties that may apply, including FBAR and information return penalties, [the IRS will] assess a penalty equal to 20 percent of the amount in foreign bank accounts/entities in the year with the highest aggregate account/asset value."

This last penalty will be reduced to 5 percent in the limited circumstances where: (i) the taxpayer did not open or cause any accounts to be opened or entities formed; (ii) there has been no activity in any account or entity during the period it was controlled by the taxpayer; and (iii) all applicable U.S. taxes have been paid on the funds in the accounts (where only account/entity earnings have escaped U.S. taxation).<sup>11</sup>

While these "reduced" penalties may seem harsh, they pale in comparison to those that could otherwise be imposed. Thus, absent the IRS's guidance, taxpayers seeking to come into compliance could be subject to: (a) taxes and interest on all previously unreported income; (b) accuracy-related penalties; (c) FBAR penalties of up to 50 percent of the value of the account in each year it was open; (d) a possible fraud penalty of up to 75 percent of the unpaid taxes; and (e) penalties relating to additional information returns that may have been required. The penalty adjustments set forth in the IRS's guidance are available only to those taxpayers making a voluntary disclosure request containing offshore issues before Sept. 23, 2009 (i.e., six months after the policy was announced) including requests that were previously submitted and have not yet been resolved.<sup>12</sup>

Of course, the major benefit of making a voluntary disclosure remains the expectation that, if the voluntary disclosure is accepted, the IRS will not recommend criminal prosecution of the newly compliant taxpayer. While taxpayers that used offshore accounts to hide the proceeds of illegal activity will not qualify for the leniency afforded by the guidance, the IRS appears to be focused on bringing offshore account holders into compliance with their tax obligations. By contrast, the program is apparently aimed at "developing intelligence" on bankers, lawyers, accountants and others who help the rich hide assets from tax authorities." Thus, taxpayers participating in the voluntary disclosure program must cooperate with the IRS in both a civil and criminal context.

### Increased Enforcement

While the IRS is hopeful that its adjusted penalty provisions will maximize participation in the program, it has made clear that regardless of such voluntary disclosures, it is committed to seeking out those who utilize offshore tax shelters. Thus, the IRS's Strategic Plan for 2009-2013 specifically promotes its emphasis on offshore tax shelters by highlighting its commitment to international tax administration.

In addition, in a March 23, 2009, memorandum to employees in the IRS's Small Business/Self-Employed Division (SBSE) and Large and Mid-Size Business Division (LMSB), the deputy commissioners of those divisions wrote that offshore cases are "work of the highest priority."<sup>13</sup> The memorandum notes that examiners should interview taxpayers, make third-party contacts, and utilize its summons power to develop such cases. Indeed, recent press reports suggest the IRS is in the process of serving John Doe summonses on other offshore banks. Moreover, the memorandum directs examiners to "request

In announcing the guidance, IRS Commissioner Doug Shulman made clear that the IRS's goal is 'to get those taxpayers hiding assets offshore back into the system' and expressed his view that 'the guidance represents a firm but fair resolution of these cases and will provide consistent treatment for taxpayers.'

foreign-based information through exchange of information under applicable treaties and tax information exchange agreements in any cases where the taxpayers have accounts or transactions in countries with such agreements."

Finally, the IRS continues to gather information from UBS. While UBS is contesting the original John Doe summons, it reportedly turned over information regarding approximately 250 accounts that were not protected under Swiss law in connection with the deferred prosecution agreement. And in connection with litigation regarding the John Doe summons, UBS recently disclosed that it had identified and disclosed to the IRS 463 U.S.-based accounts that received wires from Swiss accounts with the same account holder.<sup>14</sup>

### Legislative Efforts

The IRS is not alone in its pursuit of offshore tax abuses. A report prepared by the Joint Committee on Taxation notes that "[t]he IRS faces significant enforcement challenges...in confirming the status of an offshore payee as a bona fide non-U.S. investor. [Thus], if a U.S. person can arrange to receive investment income through means that permit the U.S. person to appear to be a foreign person, the U.S. investor may be able to evade U.S. income tax entirely."<sup>15</sup>

In the face of this report, and encouraged by the promise of Switzerland and other countries to increase information-sharing with the IRS and the U.S. government, the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means is currently holding public hearings on issues of banking secrecy practices and the effectiveness of

current tax treaties and tax information exchange programs between the United States and foreign governments. Undoubtedly, these hearings will lead to even more calls to limit the availability of undisclosed offshore accounts and may produce additional investigative tools for the IRS.

### Conclusion

Participation in the IRS's voluntary disclosure practice will come at a substantial cost to clients who have grown accustomed to their "tax-free" offshore accounts. However, the IRS's guidance serves as a carrot to non-compliant taxpayers to resolve their tax liabilities. For clients eligible to participate, the program represents a one-time opportunity to limit their financial exposure while maximizing the likelihood of avoiding criminal charges. Thus, while making a voluntary disclosure will undoubtedly result in substantial penalties, clients will risk even greater penalties if they (and their offshore accounts) are discovered in the future. While many clients may be loath to pay the steep price of participation now, they will undoubtedly regret their decision should their account otherwise come to the IRS's attention in the future.

1. John J. Tigue, Jr. and Jeremy H. Temkin, "The Internal Revenue Service's Offshore Tax Initiative," *New York Law Journal* (July 17, 2008).

2. Evan Perez and Tom Herman, "IRS Cuts Penalties to Lure Tax Evaders," *The Wall Street Journal* (March 27, 2009).

3. Peter D. Hardy and Thomas E. Zehnle, "Deferred Prosecution Agreement Struck With Swiss Bank UBS as Government Tightens Enforcement Net Around Foreign Accounts," *ABA CJS White Collar Crime Committee Newsletter* (March 2009).

4. See John J. Tigue, Jr. and Jeremy H. Temkin, "The 'New' IRS Voluntary Disclosure Policy."

5. IRM 9.5.11.9(1) (Sept. 9, 2004).

6. Id. §(3).

7. Id. §(4).

8. On May 6, 2009, the IRS issued answers to 30 "Frequently Asked Questions" regarding the application of the voluntary disclosure practice to offshore accounts. See [www.irs.gov/pub/irs-news/faqs.pdf](http://www.irs.gov/pub/irs-news/faqs.pdf).

9. Statement from IRS Commissioner Doug Shulman on Offshore Income (Mar. 26, 2009) (available at <http://www.irs.gov/newsroom/article/0,,id=206014,00.html>).

10. Department of the Treasury, IRS Memorandum for SBSE Examination Area Directors, LMSB Industry Directors and CI Directors of Field Operations from Faris R. Fink, Deputy Commissioner, SBSE, Barry B. Shott, Deputy Commissioner, LMSB International, and Victor Song, Deputy Chief, Criminal Investigations (March 23, 2009) (available at <http://www.irs.gov/newsroom/article/0,,id=206012,00.html>).

11. Id.

12. Memorandum for Commissioner, Large and Mid-Size Business Division, Commissioner, Small Business/Self-Employed Division from Linda E. Stiff, Deputy Commissioner for Services and Enforcement, Re: Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Unreported Offshore Accounts and Entities (March 23, 2009) (available at <http://www.irs.gov/newsroom/article/0,,id=206014,00.html>).

13. Memorandum for SBSE Examination Area Directors and LMSB Industry Directors from Faris R. Fink, Deputy Commissioner, SBSE, and Barry B. Shott, Deputy Commissioner, LMSB International, Re: Emphasis on Proper Development of Offshore Examination Cases, Managerial Review, and Revocation of Last Chance Compliance Initiative (March 23, 2009) (available at <http://www.irs.gov/newsroom/article/0,,id=206012,00.html>).

14. See Brief of UBS AG in Opposition to the Petition to Enforce the John Doe Summons, filed in *United States v. UBS AG*, 09-CV-20423 (S.D. Fla.) on April 30, 2009.

15. Joint Committee on Taxation, "Tax Compliance and Enforcement Issues with Respect to Offshore Accounts and Entities," Prepared for the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (March 30, 2009) (available at <http://www.house.gov/jct/x-23-09.pdf>).