tax notes international
Volume 54, Number 1 ■ April 6, 2009

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by William M. Sharp Sr. and Larry R. Kemm

Reprinted from *Tax Notes Int'l*, April 6, 2009, p. 7

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HIGHLIGHTS

News Analysis: IRS Reduces Penalties on Offshore Voluntary Disclosures

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The IRS has issued new penalty guidance in an effort to lure American taxpayers with unreported offshore financial accounts back into the U.S. tax system. Despite earlier claims that it would not initiate a national settlement program, the Service on March 26 released memoranda detailing a coordinated attack on offshore account noncompliance and a new penalty framework to apply to voluntary disclosure requests involving offshore accounts.

Although not cast as a formal compliance initiative, the guidance provides foreign account holders with some certainty in resolving noncompliance issues involving unreported offshore accounts. One significant caveat is that the new guidelines apply only to those who come forward on or before September 23, 2009.

In a two-pronged approach, IRS Commissioner Douglas Shulman announced efforts to (1) combat offshore account noncompliance, and (2) encourage voluntary compliance by providing new penalty guidance for voluntary disclosures involving offshore accounts.

The new penalty guidance is contained in a March 23 memorandum issued by Linda E. Stiff, deputy commissioner for services and enforcement. The memorandum sets forth a civil penalty framework to be applied to voluntary disclosure[1] requests related to unreported offshore accounts and offshore entities.[2] As described below, this framework limits the exposure to the civil foreign bank account reporting (FBAR) penalty,[3] as well as other potential penalties related to past offshore noncompliance.

A separate memorandum issued by Faris R. Fink, deputy commissioner with the IRS Small-Business/Self-Employed Division (SB/SE), and Barry Schott, deputy commissioner (international) with the IRS Large and Midsize Business Division, also dated March 23, emphasizes that offshore cases sent to the field for examination are work of the highest priority. The memorandum instructs examiners to use the full range of information gathering tools in properly developing offshore issues, and it also revokes the Last Chance Compliance Initiative (LCCI). In doing so, it notes that taxpayers will no longer be able to minimize their exposure to penalties through the terms of LCCI. An attachment to the memo sets forth the panoply of penalties that may apply in an offshore account situation.[4]

The message conveyed with the released memoranda is clear: Taxpayers with unreported foreign accounts should come forward now through the voluntary disclosure program. ''For taxpayers who continue to hide their head in the sand, the situation will only become more dire,''[5] Shulman said. He noted that those who don't come in of their own accord will face the full range of civil and criminal penalties. As such, he encouraged noncompliant U.S. taxpayers to come forward now under the voluntary disclosure program and ''get right'' with the government.[6]

With promises of significantly reduced penalties and avoiding criminal prosecution, the Service is encouraging American taxpayers with undisclosed offshore bank

[1]For a detailed description of the previous requirements for an IRS voluntary disclosure, as well as considerations related to the manner in which UBS clients should become compliant with U.S. tax law, see William M. Sharp Sr. and Larry R. Kemm, ''The UBS Summons and IRS Voluntary Disclosure,'' *Tax Notes Int'l*, Sept. 22, 2008, p. 1043, *Doc 2008-19459*, or *2008 WTD 186-12* [Article 1]; and ''Voluntary Disclosure Update for U.S. UBS Clients,'' *Tax Notes Int'l*, Nov. 10, 2008, p. 487, *Doc 2008-23454*, or *2009 WTD 219-8*.

[2]''Memorandum for Commissioner, Large and Mid-Size Business Division, Commissioner, Small Business/Self-Employed Division,'' *Doc 2009-6775* or *2009 WTD 57-32*.

[3]FBAR refers to the foreign bank account reporting obligation to file Form TD F 90-22.1. For a detailed discussion of the FBAR rules, see Steven Toscher and Michel R. Stein, ''FBAR Enforcement Five Years Later,'' *Journal of Tax Practice and Procedure*, June-July 2008, p. 37.

[4]In another memorandum issued by Fink, Shott, and Victor Song, deputy chief, Criminal Investigation, dated March 23, 2009, it was disclosed that voluntary disclosure requests with offshore issues will be routed through the Philadelphia Offshore Identification Unit for civil processing.

[5]''Statement from IRS Commissioner Doug Shulman on Offshore Income,'' *Doc 2009-6833* or *2009 WTD 57-33*.

[6]*Id*.

accounts to become U.S.-tax-compliant through its voluntary disclosure program. Whereas past settlement initiatives have been criticized for not attracting enough noncompliant taxpayers, this initiative may draw in more taxpayers, given the Service's continuing legal pressure on UBS AG to disclose the names of 52,000 of its American clients.[7]

The penalty framework guidance is a welcome development that will provide both account holders and tax counsel more certainty and consistency regarding the potential implications of coming forward through the voluntary disclosure process.

A Cautionary Note

This new penalty framework applies to ''voluntary disclosure *requests* containing offshore issues.'' (Emphasis added.) The memorandum issued by Stiff adds state that the ''outlined framework will be applied to all such requests that have been submitted to the IRS.'' The likely, if not inescapable, interpretation of that language, together with the memorandum's reference to the closing agreement process, is that the new penalty guidelines will apply only to ''walk-through'' (aka ''noisy'') voluntary disclosures and not to so-called service center filings (aka ''quiet''). Assuming this is the case, tax counsel should caution clients who decide to go the ''quiet'' route. Assuming the submission is examined (which seems more likely these days),[8] the exposure is substantial should the Service impose maximum penalties a far cry from the comfort of the memorandum's 20 percent penalty safe haven.

Separate from the penalty framework outlined in the memorandum, the Service has adopted additional administrative changes to the procedural manner in which voluntary disclosure submissions are to be handled, at least in the context of offshore financial accounts. The changes include an advance disclosure of taxpayer names and identifying information, the requirement that voluntary disclosures be submitted to the judicial district of the Service where the taxpayer resides, and that in appropriate cases, the taxpayers make themselves available to be interviewed as part of the requirement for cooperation in the voluntary disclosure process. Although these procedural changes will undoubtedly cause anxiety for many taxpayers who wish to come forward, in practical terms they should have no adverse implications for taxpayers who otherwise qualify for voluntary disclosure.[9]

Details of the Penalty Framework

The memorandum deals with the civil income tax aspects of resolving a voluntary disclosure for an undisclosed account. The memorandum states that after the Criminal Investigation division makes the preliminary determination that a taxpayer is eligible to make a voluntary disclosure, the voluntary disclosure request will be forwarded for processing to the Philadelphia Offshore Identification Unit and then redistributed to civil examiners who specialize in offshore examinations. The memorandum says the matter will be concluded through a duly executed closing agreement.

As set forth in the memorandum, three principal areas of civil resolution apply:

- First, all applicable taxes and interest will be imposed during the six-year period preceding the voluntary disclosure submission, and the taxpayer must file all required amended or dilatory income tax returns, information returns, and Forms TD F 90-22.1 (FBAR).
- Second, either an accuracy or delinquency penalty will be assessed for all years during the six-year period, and the taxpayer may not rely on a reasonable cause exception to avoid those penalties.
- Third, in lieu of all other penalties that may otherwise apply, including the FBAR penalty, a penalty equal to 20 percent of the amount in the offshore account or foreign entity will be imposed for the year with the highest aggregate account value during the six-year period. Although this 20 percent penalty would be in lieu of several potential penalty provisions, its importance is related to the FBAR penalty and will be discussed in that context below.

In an important exception to the general rule for the FBAR penalty guidelines, a reduced penalty of 5 percent of the account balance may apply if all of the

[7]*See* ''Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities Before the Senate Committee of Finance'' (prepared by the Joint Committee on Taxation), July 23, 2008 (reporting that the IRS had received Offshore Voluntary Compliance Initiative applications from only 1,299 taxpayers); *see also* Martin Sullivan, ''Keeping Score on Offshore U.K. 60,000, U.S. 1,300,'' *Tax Notes Int'l*, July 9, 2007, p. 146, *Doc 2007-15466*, or *2007 WTD 129-7*.

[8]Given the increased focus on offshore account noncompliance, it would not be surprising if the Service increased its service center examination resources to include a concerted focus on Form 1040X, Schedule B, zeroing in on the names of new foreign banks added thereto as well as amendments to Part III (that is, checking the FBAR indicator box ''yes'').

[9]Even with the recent administrative changes, it is still possible to complete a valid voluntary disclosure through one of two avenues, a negotiated walk-through submission or a service center filing. A service center filing would keep the taxpayer from having to appear before the IRS during the voluntary disclosure process, but it raises additional risks in connection with the filing of amended returns, as discussed in this article. For a detailed discussion of both voluntary disclosure alternatives before the issuance of the guidance discussed in this article, see Sharp and Kemm, *supra* note 1.

following conditions are met during the period in which the taxpayer ''controlled'' the account or foreign entity:

- First, the taxpayer did not open, or cause to be opened, any foreign account or cause any entity to be formed.
- Second, there have been no deposits or withdrawals from the account.
- Third, all applicable U.S. taxes were paid on the funds in the offshore account or foreign entity (that is, where only account/entity earnings have escaped U.S. taxation).

This is a conjunctive test, so all three conditions must be satisfied to be eligible for the reduced 5 percent penalty.

The memorandum authorizes LMSB and SB/SE to resolve voluntary disclosures on the basis of the described penalty framework for taxpayers who have already commenced a voluntary disclosure or who come forward within six months from the date of the March 23 memorandum (that is, on or before September 23, 2009).[10]

Finally, the memorandum notes that the terms outlined in the penalty framework will apply only to taxpayers who make a voluntary disclosure request and fully cooperate with the Service as part of the voluntary disclosure process. Thus, the requirements for an eligible voluntary disclosure under Information Release 2002-135 must be satisfied.[11] And, as discussed below, we understand that the expected cooperation may include that the taxpayer be personally interviewed and willing to provide information regarding bankers or others involved with establishing the foreign bank account or foreign entities used in the account ownership structure.

Highlights

Not Limited to UBS Accounts

The memorandum states that the framework is to be applied to voluntary disclosure requests ''containing offshore issues.'' These offshore issues refer to unreported offshore accounts and offshore entities. There is no express or implied suggestion that the framework will be limited to cases involving unreported offshore financial accounts held with UBS AG, or through foreign corporations, foundations, or other entities used to hold an offshore account with UBS AG in Switzerland.

The memorandum was undoubtedly prompted by pressure from the large volume of voluntary disclosures arising from the UBS AG and U.S. government situation. U.S. citizens and residents who have maintained unreported offshore accounts have become increasingly nervous as the U.S. government has chipped away at Swiss bank secrecy.[12] Many account holders have come forward through the voluntary disclosure process to avoid criminal prosecution and become compliant with their U.S. reporting and tax payment obligations. And because of the publicity surrounding the UBS AG matter, individuals holding unreported accounts at other financial institutions are starting to come forward through the voluntary disclosure process.

Because the memorandum does not limit its scope to offshore accounts involving UBS AG, it appears the Service may apply the new penalty framework broadly to all accounts held through other foreign banks in Switzerland or elsewhere. On balance, that may not be a bad result for account holders of other financial institutions that want to come forward. However, the level set forth in the memorandum for resolving the FBAR penalty substantially exceeds the level that was imposed under prior voluntary compliance initiatives.[13] Thus, it is uncertain whether the new penalty framework will provide any incentive to account holders at other foreign financial institutions to voluntarily come forward.

[10]The memorandum does not address the issue of the taxpayer whose voluntary disclosure submission was made before the memorandum's issue date (March 26, 2009), other than stating that those taxpayers qualify for relief under the memorandum. Arguably, those taxpayers should be given appropriate preferential treatment given that they relied on the IRS's many public statements that taxpayers should act now and not later.

[11]*See* IR 2002-135 (modifying IRM 9.5.3.3.1.2.1 and setting forth the requirements for a timely voluntary disclosure); *see also* Sharp and Kemm, Article 1, *supra* note 1, at pp. 1044-1047 (describing the requirements for an eligible voluntary disclosure).

[12]The initial event inciting publicity of the unreported offshore accounts at UBS was the July 1, 2008, issuance of the John Doe summons order by the federal district court in Miami. The anxiety of UBS account holders was further heightened when UBS entered into a deferred prosecution agreement with the U.S. Justice Department on February 18, 2009, and further accelerated with the handover of U.S. account holder names at UBS (roughly 250 to 300 names) on February 18, 2009. *See* Lynnley Browning, ''The Swiss Bank Is Set to Open Its Secret Files,'' *The New York Times*, (Feb. 18, 2009), *available at* http://www.nytimes.com/2009/02/19/business/worldbusiness/19ubs.html; Jeremiah Coder, ''UBS Settles With Justice Department for $780 Million,'' *Tax Notes Int'l*, Feb. 23, 2009, p. 659, *Doc 2009-3640,* or *2009 WTD 31-1*; and Arden Dale, ''Getting Personal: As UBS Tax Case Widens, Time to Come Clean,'' *The Wall Street Journal*, Feb. 20, 2009, *available at* http://sec.online.wsj.com/article/BT-CO-20090220-712997.html?mod=crnews.

[13]For example, under the Offshore Voluntary Compliance Initiative, the Service waived any FBAR penalty; *see* Rev. Proc. 2003-11, 2003-1 C.B. 311. However, when the noncompliant taxpayer was ''caught'' under LCCI (see IRM 4.26.17.4(2)), the Service imposed a harsher, one-year assessment of the FBAR penalty.

Harsh Results

As noted above, the penalty to be applied in lieu of all other potential penalties under the new penalty framework is equal to 20 percent of the value of the account for the tax year with the highest aggregate account value during the preceding six-year period. Because the Treasury Department can impose a penalty equal to 50 percent of the maximum account balance for any year in which there is a violation (that is, failure to file the FBAR form), the 20 percent penalty on its face might appear eminently reasonable.

Because of the crash in the markets, however, many account holders have already lost 30 percent or more of the value of their accounts. Thus, by imposing the FBAR penalty under the memorandum by reference to the year with the highest account value during the six-year disclosure period, there is a turbocharge effect to the stated 20 percent penalty.[14]

The FBAR penalty under the new penalty framework comes at a time when the Service has been complacent in its enforcement of the FBAR penalty. The Service has not been overly aggressive in either the pursuit or application of the FBAR penalty in the past.[15] Thus, it is surprising that the Service has adopted a particularly harsh approach to enforcing the FBAR penalty for past infractions in this economic environment.

And it is ironic that under this new framework, the FBAR penalty could exceed the amount that otherwise could be statutorily applied for a specific year. For example, assume that the year in which an account had the largest aggregate value was 2003.[16] Before changes made in 2004,[17] the maximum penalty that could be applied for an FBAR violation for 2003 was $100,000.[18] Under the penalty framework in the memorandum, however, the penalty imposed regarding the 2003 account value could far exceed $100,000.

Because of the potentially harsh economic implications of the new FBAR penalty, account holders who otherwise want to become U.S.-tax-compliant may be dissuaded from coming forward via a walk-through or noisy submission now. That may be particularly true for account holders at financial institutions other than UBS AG, who believe there is little chance of the IRS discovering their account information. However, playing the audit lottery is ill-advised given the significant legal downside of getting caught.

Penalty Exception

As described above, the memorandum provides for a reduced 5 percent FBAR penalty under an exception to the general 20 percent penalty framework. Because of conditions imposed for this exception, however, the reduced 5 percent penalty will be unattainable in all but the rarest of circumstances.

To be eligible for the reduced penalty exception, three separate conditions must be satisfied, as described above. Based on these conditions, the exception is, for all practical purposes, limited to the unique situation in which an individual inherits an account and never deposits or withdraws any funds into or from it. This is because the taxpayer may neither have opened or caused to be opened any foreign account (or formed any foreign entity) during the period in which the taxpayer controlled the foreign account or foreign entity.

Often, however, even when an individual is named as heir or successor to an existing unreported offshore account, the bank may close the existing account and transfer the funds into a new account established solely in the name of the heir or under a new account number. It would appear in that situation that the account holder could not satisfy the requirement that no account be formed during the period in which the taxpayer controlled the foreign account. This scenario is particularly relevant in a fact pattern involving the death of a U.S. taxpayer and the transfer of his or her account to new offshore accounts established in the names of the decedent's many U.S. successors.

Further, there is no time limit associated with the requirement that a taxpayer not form an account during the period that he or she controls the foreign account. Thus, even if an individual established an account decades ago (possibly even before he or she was a U.S. citizen or resident), the individual presumably would not qualify for the reduced penalty exception even if no additional deposits were made and no withdrawals occurred since the time the account was formed.

Another less apparent but equally important obstacle to qualifying for the 5 percent FBAR penalty is the condition that all applicable U.S. taxes were paid on the funds in the offshore account or foreign entity and that only account or entity earnings have escaped U.S. taxation. Assume in the fact pattern above that on the death of a U.S. taxpayer, his or her account was not

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[14]Also, because UBS is requiring all U.S. account holders to close their accounts with it, the account holders will be required to realize the built-in losses associated with the holdings in their UBS account.

[15]The Service was delegated authority to enforce the FBAR penalty in April 2003 and, until recently, appeared more focused on the enforcement of income tax and information reporting aspects of the offshore account activity in the context of a voluntary disclosure.

[16]In most situations this would be unlikely, but still may be possible because of withdrawals or specific investment decisions.

[17]*See* the American Jobs Creation Act of 2004 and 31 U.S.C. section 5321(a)(5)(C)(i), (D)(i) (increasing the maximum possible FBAR penalty for willful violations to 50 percent of the account balance per violation).

[18]31 U.S.C. section 5321(a)(5)(B)(i) (regarding willful violations under the law in effect until October 22, 2004).

transferred to new offshore accounts established in the names of the decedent's many U.S. successors, but that the decedent's account remained opened and the U.S. successors simply became the account owners on that same account at the time of the patriarch's death. However, assuming that the appropriate U.S. estate tax was not paid on the offshore account, then the ''all applicable U.S. taxes were paid on the funds'' condition would not be deemed satisfied.[19]

Because of the conditions attached to the reduced penalty exception, few account holders will be able to realize the benefit of a lower penalty percentage.

Only a Framework

Finally, the guidance in the memorandum provides only a penalty framework for resolving the civil tax aspects of offshore account situations in the voluntary disclosure context. In other words, the framework itself lacks the force of binding law. In some situations, it may be appropriate to deviate from the penalty framework set forth in the memorandum.

The memorandum itself does not grant agents within LMSB or SB/SE the discretion to depart from the penalty framework (nor, for that matter, does it preclude a departure). It is unclear whether this means an agent would be precluded from entering into a closing agreement if the framework appeared to produce clearly excessive penalties in a situation. Even then, however, the resolution of the matter potentially could be elevated to a higher authority within the Service for approval on terms outside the memorandum's penalty framework.

In administering the memorandum's penalty guidelines, the Service should exhibit reasonable flexibility to settle all voluntary disclosure cases based on a common-sense facts and circumstances analysis. Every voluntary disclosure request necessitates a close review of the material fact pattern, keeping in mind that the Service's voluntary disclosure program requires the factual submission to be truthful, accurate, and complete.

When the facts and circumstances indicate a lesser level of willfulness or similar egregious conduct, and assuming the case does not otherwise qualify for the reduced 5 percent penalty, but has mitigating factors, the Service should grant penalty relief at some reduced penalty below 20 percent. Overall the reduced 5 percent penalty and the prescribed 20 percent penalty should be administered in such a manner to consider all mitigating factors and resolve cases between 5 percent and 20 percent.

[19]Apart from this condition not being satisfied, the U.S. successors still would be personally liable for the patriarch estate's U.S. estate tax. Section 6324(a)(2).

Procedural Changes

Beyond the guidance in the memorandum, the Service has also made three significant policy changes to the voluntary disclosure process.

First, the taxpayer's name and identifying information must be provided to the IRS upon initiation of the voluntary disclosure process.[20] Generally, that means taxpayer names and Social Security numbers must be provided when scheduling a meeting with the CI division to present the voluntary disclosure submission (although the authors understand that whether and to what extent this will be followed will be determined on a case-by-case basis). This represents a departure from past practices in which the CI division would permit tax counsel to present a client's factual scenario without disclosing the identities of the taxpayers involved.[21]

This change will undoubtedly cause many taxpayers concern, because the taxpayer effectively has no bargaining chips once his identity is known (that is, the account cannot be concealed any longer if the U.S. government has a criminal interest in the case or if for other reasons the taxpayer decides not to continue the case). Nevertheless, assuming that the taxpayer's facts have been fully developed by counsel to establish satisfaction of the voluntary disclosure requirements (that is, legal-source income, timely submission, and so forth), there effectively should be no enhanced risk that the past conduct will be criminalized, other than the ''unknown'' factor associated with the timeliness condition if the taxpayer has been previously turned in.[22]

Second, we understand that all voluntary disclosure submissions must now be made within the judicial district where the taxpayer resides. In the past, tax counsel could generally present a voluntary disclosure to any CI field office in any judicial district. Because voluntary disclosure is a federal matter, presenting the voluntary disclosure in a state other than the state where the taxpayer resided was not an obstacle to moving the voluntary disclosure forward.

From a practical perspective, the change in policy represents a sensible approach to distributing the workload from voluntary disclosure cases to the jurisdictions

[20]This requirement would apply only to a negotiated walk-through voluntary disclosure. In contrast, the service center filing involves filing amended returns along with penalty abatement and reasonable cause statements; see *supra* note 11.

[21]For a detailed discussion of past voluntary disclosure practices, see Sharp and Kemm, Article 1, *supra* note 1.

[22]A voluntary disclosure will not be timely if the Service has initiated an examination of the taxpayer or has received information from a third party alerting it to the taxpayer's noncompliance. *See supra* note 11. In the context of UBS, an account holder's identity could be known to the Service as a result of being included on one of the lists obtained by the Service, or as a result of a whistle-blower claim, or through a random audit.

where the taxpayers reside. It also makes sense since the local field office may be best positioned to conduct background checks on the taxpayers.

The third procedural change is the IRS's announced intention to personally interview the taxpayer as part of the taxpayer's requirement to cooperate in the voluntary disclosure process. Taxpayers may be required to make themselves available to be personally interviewed by the Service. This represents a departure from past practices whereby the Service would process and resolve voluntary disclosures without ever meeting with the taxpayers.

The IRS's desire to interview taxpayers as part of the voluntary disclosure process is understandable when relevant information may be gleaned from an interview. However, counsel may be wary of allowing a client to openly talk about a matter involving potential criminal implications before the government has provided any indication or assurances that it does not intend to pursue criminal prosecution. And apart from the legal concerns, the psychological and emotional impact on the account holders (many of whom are elderly) who must submit to an interview by the Service may be significant.

The Service is to be commended for taking steps to streamline the processing of voluntary disclosures related to offshore accounts. Given the developments with UBS AG, the volume of those disclosures will surely continue to surge in the coming months. The penalty framework outlined in the memorandum is welcome in the sense that it provides certainty to taxpayers who come forward voluntarily.

However, the monetary cost of coming forward may be high, depending on the circumstances. For that reason, the guidance may not have the effect of encouraging taxpayers to come forward. It is hoped the Service will be reasonable in applying the framework, and possibly in resolving cases outside the context of the framework in appropriate situations. ◆

♦ *William M. Sharp Sr. and Larry R. Kemm are partners with Sharp & Associates, P.A., in Tampa, Fla.* *The authors gratefully acknowledge the contributions of Neil Rumbak, also with Sharp & Associates, P.A.*