



Getting Foreign Accounts Right With the Government

The IRS announces a reduced penalty program with respect to previously unreported foreign bank accounts.

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Originally published in the *AICPA Tax Insider Newsletter*

April 9, 2009

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The IRS has declared war against and is aggressively pursuing those individuals with undeclared offshore bank accounts and institutions that facilitate unlawful tax avoidance. As testified to by Commissioner of Internal Revenue Douglas Shulman, "[m]y advice to US taxpayers who have undeclared offshore accounts and income is simple. The IRS has been steadily increasing the pressure on offshore financial institutions that facilitate concealment of taxable income by US citizens. That pressure will only increase under my watch. Those who are unlawfully hiding assets should come and get right with their government through our voluntary disclosure process."

It is axiomatic that U.S. taxpayers are taxable on their world wide income, including any earnings on offshore bank accounts. Although there is nothing illegal in owning or controlling an offshore bank account, the earnings on such accounts are taxable and must be included in the U.S. taxpayer's tax return. Furthermore, there are certain reporting requirements that must be met. In general, U.S. taxpayers must disclose offshore accounts by answering a question regarding foreign accounts contained in Schedule B of their Form 1040. That question for 2008 is: "At any time during 2008, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account or other financial account?" The taxpayer need not answer yes if the combined value of the foreign accounts was \$10,000 or less during the year, otherwise the taxpayer must answer the question yes. A taxpayer who answers "yes" to this question must then file with the Treasury Department a Report of Foreign Bank and Financial Accounts ("FBAR"). This form must be filed for each year, where the \$10,000 threshold is met, by June 30 of the following year.

The failure to truthfully answer the question regarding foreign accounts or to file the FBAR may constitute a criminal offense and may be subject to civil and criminal penalties. The filing of a Form 1040 without truthfully answering the foreign account question may be subject to a fraud penalty of 75 percent of the tax ultimately due. The willful failure to file the FBAR may be subject to a penalty of the greater of \$100,000 or 50 percent of the account value for each year that the FBAR was not filed. As a result, the FBAR penalty for

not filing may exceed the value of the account and result in personal liability for the penalty by the U.S. taxpayer.

Announcement of Program

To incentivize taxpayers to disclose previously undeclared foreign bank accounts and to pay the taxes on the earnings of those accounts, the IRS on March 26, 2009 announced a new penalty structure to be applied to voluntary disclosures of undeclared foreign accounts. The new initiative took effect on March 23, 2009 and continues for six months. Those taxpayers taking advantage of this voluntary disclosure program can avoid criminal prosecution and certain penalties that otherwise might apply, including the 75 percent civil fraud penalty.

Voluntary Disclosure Practice

In order to be eligible for this initiative, the taxpayer must make a voluntary disclosure of the delinquent returns, including the filing of the FBARs, for the previous six years that meets the "voluntary disclosure" requirements in the Internal Revenue Manual. To constitute a "voluntary disclosure", the disclosure must be truthful, timely, and complete, and the taxpayer must cooperate with the IRS in determining the taxpayer's correct tax liability. In addition, the taxpayer must make a good faith effort to pay in full the tax, interest and any penalties, or make an arrangement with the IRS to pay such tax, interest and penalties. The voluntary disclosure practice is not available to taxpayers with respect to illegal source income. A disclosure is timely if made before the taxpayer has been singled out for a civil investigation or criminal investigation or been notified by the IRS that it intends to make such examination or investigation. Under the reduced penalty voluntary disclosure, a taxpayer will be able to take advantage of the program even though the IRS already has taxpayer's name on a list from third party sources, as long as the IRS has not opened up an examination or investigation of that taxpayer. This amounts to the relaxation of the rules that would otherwise apply to a voluntary disclosure.

Specifics of the Reduced Penalty Program

Under this initiative, the taxpayer will have to file corrected returns for the prior six years, including all information returns and FBARs and pay the delinquent taxes, interest and penalties as a result of including the previously unreported income from the foreign account. In addition, the taxpayer will have to pay an accuracy penalty of 20 percent of the delinquent taxes or a delinquency penalty of 25 percent of such taxes for each of the six years and the reasonable cause exception will not apply. Further, instead of all other penalties, including the penalty for the failure to file an FBAR, the taxpayer will have to pay a penalty equal to 20 percent of the highest value of the account at any time during the six year period. This 20 percent penalty is reduced to 5 percent if the taxpayer did not open the account, there was no activity in the account during the period that the taxpayer controlled the account and all U.S. taxes have been paid on the funds in the account, except for the earnings in the account which have escaped U.S. taxation. It still needs to be determined whether the taxes referenced with respect to the funds in the account are to income taxes or includes transfer taxes. It is cautioned in the IRS pronouncement that it will only apply if the taxpayer makes a voluntary disclosure and fully cooperates with the IRS both civilly and criminally.

What Should Taxpayers With Undeclared Foreign Accounts Do?

Since a voluntary disclosure is only available to a taxpayer who is not already the subject of an examination or investigation, taxpayers with foreign accounts should act quickly to take advantage of the reduced penalty initiative. But first, inquiry should be made to the Criminal Investigation to determine if the taxpayer is already a target of an examination or investigation. If the taxpayer is eligible to make a voluntary disclosure, the taxpayer should have prepared amended or corrected returns for the last six years showing the earnings from the offshore account and the resultant tax due. The amended returns and payment of the taxes and interest should be delivered to the IRS, together with delinquent FBARs and the 20 percent or five percent penalty as the case may be. The IRS, based upon the corrected returns and the facts and circumstances will assess the penalties and interest owing.

As testified to by Commissioner Schulman in front of Congress, those taxpayers who truly make a voluntary disclosure can avoid criminal prosecution. However, "[f]or those taxpayers who continue to hide their head in the sand, the situation will only become more dire." Commissioner Shulman's advice is that taxpayers who have an undeclared account "should come forward now under out voluntary disclosure practice and get right with the government.

About the Author

Thomas R. Wechter concentrates his practice in tax planning for individuals, corporations and venture capital and private equity firms. He focuses on complex transactions involving acquisitions, dispositions, spin-offs, and new venture investments.

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