

# **DEALING WITH THE IRS COLLECTION DIVISION**

## **VOLUNTARY DISCLOSURE OF OFFSHORE ACCOUNTS<sup>8</sup>**

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Things are getting ever more uncomfortable for U.S. taxpayers holding undisclosed offshore bank and investment accounts. And in the wake of the very public fight between the Internal Revenue Service and Union Bank of Switzerland (UBS), it is quite possible that one of your clients will reveal to you that he has an offshore account he "forgot" to mention.

Your advice to such a client will need to be informed by an understanding of detailed new policy pronouncements by the IRS that seek to apply a standardized penalty framework to voluntary disclosure of previously undisclosed offshore accounts and entities. Specifically, the IRS is temporarily offering some leniency on penalties if the taxpayer makes a qualifying voluntary disclosure of offshore accounts and offshore income. Please note that this new IRS program will run only until September 23, 2009. A description of the new policy can be found in a Memorandum from the Deputy Commissioner for Services and Enforcement dated March 23, 2009, and in an extensive set of explanatory questions and answers issued by the IRS on May 6, 2009.<sup>2</sup>

The context of this, of course, is that U.S. citizens and resident aliens are taxable on their worldwide income, including income earned on foreign accounts and investments. Foreign source income is reported as part of the usual Form 1040 individual income tax return. But in addition, U.S. citizens and resident aliens are required to report their interest in or signature authority over an account with a financial institution in a foreign country if at any time during the year the aggregate

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<sup>2</sup> See the relevant IRS announcements at [www.irs.gov/newsroom/-article/0,,id=206012,00.html?portlet=7](http://www.irs.gov/newsroom/-article/0,,id=206012,00.html?portlet=7). These include (1) two Memoranda from Faris R. Fink, Deputy Commissioner, SBSE, Barry B. Schott, Deputy Commissioner, LMSB International, and Victor Song, Deputy Chief, Criminal Investigation Division; (2) a Memorandum from Linda E. Stiff, Deputy Commissioner for Services and Enforcement; and (3) the explanatory Frequently Asked Questions (FAQ) issued by the IRS on May 6, 2009.

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value of all such accounts exceeds \$10,000. This is done by filing Form TD 90-22.1 Report of Foreign Bank and Financial Accounts (known as an FBAR). This is separate from the Form 1040 income tax return, and is filed not with the IRS but with the Treasury Department in Detroit, with a due date of June 30th.<sup>3</sup>

Penalties for willful failure to file the FBAR as and when required can reach the greater of 50% of the total balance of the foreign account, or \$100,000.<sup>4</sup> And there is always the possibility of criminal prosecution in appropriate cases.<sup>5</sup> The statute of limitations on the assertion of FBAR penalties is six years from the date of the violation (i.e. the due date of the FBAR). The statute of limitations for criminal prosecution specifically related to FBARs is five years. The statute of limitations on prosecution for failure to file an income tax return, or for tax evasion with respect to the unreported income from an offshore account (or from any other source) is six years from the due date of the tax return or, if later, the "last affirmative act of evasion."<sup>6</sup>

In addition to reporting the income on the Form 1040 and filing the FBAR, several other sets of rules with their own required annual reports may be relevant if a client has a foreign account. The most common is the Form 3520 Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. This must disclose various transactions including the creation of a foreign trust, a transfer of property to a foreign trust, and the receipt of distributions from a foreign trust or other entity.<sup>7</sup> The penalty for failure to file the form, or for filing an incomplete form, is 35% of the gross reportable amount.

Related to this, a Form 3520-A Annual Information Return of Foreign Trust with a U.S. Owner is required to report an ownership interest in or certain other powers over a foreign trust, even if during the year there are no transactions with the trust requiring the filing of a Form 3520.

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<sup>3</sup> 31 U.S.C. 5314, part of the Bank Secrecy Act.

<sup>4</sup> 31 U.S.C. 5321(a)(5). Nonwillful violations are subject to a civil penalty of not more than \$10,000.

<sup>5</sup> 26 U.S.C. 7203 makes it a misdemeanor to willfully fail to pay any tax or to make a return. Tax evasion is prosecuted under 26 U.S.C. 7201, and is a felony.

<sup>6</sup> IRC ' 6531. The due date includes filing extensions.

<sup>7</sup> 26 U.S.C. 6048 and 6039F.

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The penalty for failing to file this information return is 5% of the value of the trust assets determined to be owned or controlled by the U.S. person.

The IRS, of course, has had a longstanding voluntary disclosure policy.<sup>8</sup> The issuance of the new guidance related to offshore accounts is consistent with this policy, but gives practitioners a much clearer set of rules with which to advise clients and to assist them in getting back into full compliance. The Service's stated objective in centralizing the processing of such disclosures and issuing this new guidance is to "offer a uniform penalty structure for taxpayers who voluntarily come forward," and to make sure taxpayers "are treated consistently and predictably." The consistency element won't matter much to your clients, but they will find the predictability element extremely important. The IRS understands this, noting that a disclosure enables taxpayers to "become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution," while providing an opportunity "to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues."

For taxpayers who have unreported income from foreign accounts, and who have not been contacted by the IRS about the offshore account or are otherwise under criminal investigation or civil examination, the IRS's new guidance suggests submitting a letter to the Special Agent in Charge of the local IRS Criminal Investigation Division (CID) Office. The letter should provide the taxpayer's name and identifying information, and a brief explanation of the problems with the previously filed returns (or the fact that returns are unfiled). If they are ready, the amended or delinquent returns can be submitted with this letter, but this is not necessary. The issue here is that the voluntary disclosure is timely only if it predates IRS action. Waiting until the amended or delinquent returns are ready involves the risk that IRS action might be taken while you're working on the returns, thereby denying the client the benefits and protections of a voluntary disclosure. Upon receipt of the letter, CID will determine the "timeliness, completeness, and truthfulness" of the voluntary disclosure. Again, if the taxpayer is already under CID investigation, or even under audit by the Examination Division, it is too late.

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<sup>8</sup> For more on the IRS voluntary disclosure policy, see Mr. Haynes' article on "Representing Nonfilers" previously published in [The Freestate Accountant](#) and available on his website at [www.bjhaynes.com/articles](http://www.bjhaynes.com/articles). The IRS's "voluntary disclosure practice" is also described in the Internal Revenue Manual at IRM 9.5.11.9 (9-9-2004), which includes guidance on making a valid and timely disclosure, as well as examples of what does or does not constitute a qualifying voluntary disclosure.

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The above-described approach, amounting to loudly walking into the lion's den, is to be distinguished from the common practice of making a "quiet disclosure." This is usually accomplished simply by filing amended returns, or the previously delinquent returns, with the appropriate IRS Service Center, and hoping for the best. However, where the case involves offshore accounts, the IRS's new guidance urges taxpayers to bring themselves within the specific protections of the new uniform penalty structure, which can only be accomplished through the prescribed method of submitting a voluntary disclosure letter to CID. Even where a "quiet disclosure" has already been made, the Service suggests sending the previously submitted documents, including copies of any amended returns, to the local CID office.

The civil penalty benefit offered by the new IRS initiative is avoiding the possible repetitious and overlapping penalties, and to instead boil them down to only two penalties:

an accuracy-related penalty of 20% of the tax<sup>9</sup>, and

an additional penalty of 20% of the largest balance in the foreign account(s) during the prior six years.<sup>10</sup>

These penalties would be "in lieu of the FBAR and other potential penalties" that might otherwise apply. The May 6th FAQ presents an example involving \$1,000,000 deposited into an offshore account in 2003. It computes the penalties under the uniform penalty framework at \$281,000, but asserts that the penalties that might otherwise apply would amount to more than \$2,000,000, or more than twice the amount deposited into the offshore account in the first place! These could include the above-described FBAR penalties equal to the greater of \$100,000 or 50% of the amount in the account each year, a 75% civil fraud penalty on the unreported tax<sup>11</sup>, and additional penalties for failing to file the various information returns such as the Forms 3520 and 3520-A.

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<sup>9</sup> 26 U.S.C. 6662.

<sup>10</sup> The conversion to U.S. dollars is to be done at the exchange rate applicable on the last day of each year.

<sup>11</sup> 26 U.S.C. 6651(f) or 6663. If the fraud penalty is not imposed, other penalties may apply. The late filing penalty is 5% per month to a maximum of 25% (6651(a)(1)). It is computed on the net amount due on the return after allowing any timely payments or credits. If the failure to file is due to fraud, the penalty is tripled to 15% per month to a maximum of 75%. The late payment penalty is 0.5% per month, again to a maximum of 25% (6651(a)(2)). If the IRS issues a notice of intent to levy, the penalty increases to 1% per month (6651(d)), and if the taxpayer and the IRS have entered

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If the taxpayer has previously reported all of the income from the foreign account and the only problem is the failure to file the required FBARs, the IRS instructions are to simply file the FBARs with the Treasury Department's office in Detroit in the normal manner, and to include a statement explaining why the reports were not previously filed.<sup>12</sup> In the absence of unreported income and a tax understatement, however, the IRS advises that invoking the new voluntary disclosure procedures is unnecessary merely to file previously unfiled FBARs.

Under the new initiative, the IRS is requiring the correction of erroneous tax returns, or the filing of missing tax returns and/or FBARs, for a period of six years (although it explicitly reserves the right to examine additional tax years if the foreign activity started more than six years ago). This is entirely consistent with prior IRS practice regarding the number of years of "retroactive compliance" that will ordinarily be required when a noncompliant taxpayer is trying to get back into compliance.<sup>13</sup>

After the six month period covered by the current settlement initiative, the IRS vows to "re-evaluate the framework . . . and decide whether or how to continue the practice going forward." Thus, taxpayers are urged not to miss this six month window of opportunity because "there is no guarantee that the taxpayer will still be eligible or that the current penalty terms will be available." The question of eligibility is a reference to the requirement that a voluntary disclosure must predate an IRS investigation or audit. And as to this, the IRS pronouncement includes the following ominous warning:

The IRS has stepped up its enforcement efforts, including the use of John Doe summonses, to identify taxpayers using offshore accounts and entities to avoid tax. In addition, the IRS continues to receive information from whistleblowers and other

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into an installment agreement it can be reduced to 0.25% per month (6651(h)). The late filing and late payment penalties are coordinated so that the combination of the two is limited to 5% per month for any month for which both penalties would apply.

<sup>12</sup> The FBAR Form TD 90-22.1 was revised in October 2008. In submitting FBARs, taxpayers should use the current version of the form, but should apply the tests for whether an account required disclosure applicable in the tax year in question.

<sup>13</sup> IRM 4.12.1.3 (05-03-1999) has long provided that in determining whether to deviate from the normal six year enforcement period the following factors should be considered: the taxpayer's prior history of noncompliance, the existence of income from illegal sources, the effect on voluntary compliance, the anticipated revenue in relation to the time and effort required to determine the tax due, and any special circumstances of a particular taxpayer, class of taxpayer, or industry.

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taxpayers making voluntary disclosures. If the IRS receives specific information about a taxpayer's noncompliance before the taxpayer attempts to make a voluntary disclosure, the disclosure will not be timely and the taxpayer will not be eligible for the criminal and civil penalty relief available under the voluntary disclosure practice. Finally, taxpayers run a substantial risk that the uniform penalty structure described in the internal guidance will not be available past the 6-month deadline or that the terms will be less beneficial to taxpayers.

So as bad as it may seem, the message to taxpayers is that from this point it can only get worse.

Obviously there is a very short deadline on this. If the tax returns are not ready, the taxpayer can still make the disclosure and submit the amended or delinquent returns as soon as they can be prepared. Similarly, if the records from the foreign account are not immediately available, the disclosure can still be made, to include a statement describing what you're doing to get the records with which to prepare the revised returns. The Service explains that "difficulty in completing a voluntary disclosure started during [the six-month timeframe] will not disqualify a cooperative taxpayer from the penalty relief."

The IRS guidance contemplates full payment of the relevant taxes, penalties and interest, and all other unpaid previously assessed liabilities. However, if a taxpayer cannot make full payment, the IRS FAQs state that the Service will consider other arrangements, so that inability to pay immediately should not disqualify a taxpayer from getting into compliance and securing the benefit of the offered penalty relief. In these circumstances, however, "the burden will be on the taxpayer to establish inability to pay, to the satisfaction of the IRS, based on full disclosure of all assets and income sources, domestic and offshore, under the taxpayer's control." The taxpayer can then negotiate "other financial arrangements, acceptable to the IRS, to resolve all outstanding liabilities" in order to be eligible for relief.<sup>14</sup>

The Service has established a Voluntary Disclosure Hotline to deal with questions about this new foreign account disclosure and penalty resolution effort, as well as other offshore disclosure issues. The phone number is 215-516-4777, which goes to the IRS's Philadelphia Offshore Identification Unit (POIU).

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<sup>14</sup> For more on "collection alternatives" such as installment agreements or offers in compromise, see Mr. Haynes' articles on these subjects previously published in [The Freestate Accountant](#) and available on his website at [www.bjhaynes.com/articles](http://www.bjhaynes.com/articles).

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## Conclusion.

The open warfare between the IRS and Union Bank of Switzerland is just the tip of the iceberg. The IRS and the Department of Justice have for some time been engaged in a broad offensive against the holders of offshore accounts and trusts, and this effort will only increase. The best time to have fixed this problem was during the Offshore Voluntary Compliance Initiative (OVCI), but that program ended on April 15, 2003, more than six years ago. The new standardized penalty framework announced on March 23rd, and explained in more detail on May 6th, is a similar initiative that should be utilized if at all possible.

Taxpayers with offshore accounts can count on ever increasing IRS scrutiny using ever more sophisticated ways to identify the holders of such accounts, and an ever growing list of promoters, banks and financial institutions that have buckled under IRS pressure to disclose lists of account holders. It is time for such taxpayers to get into compliance, to pay what has to be paid (so as to avoid paying far more in the future), and in the process to keep themselves out of federal prison. By studying the terms of the new IRS initiative described herein, along with the referenced IRS pronouncements and Internal Revenue Manual provisions, you will be in a better position to help your clients do this. By bringing themselves into compliance they may be a little poorer, but they will sleep much better.