



IRS to Step Up Enforcement of Foreign Account Reporting

By Barbara J. Langkau, CPA

In March 2009, IRS Commissioner Doug Shulman issued a statement that began “My goal has always been clear — to get those taxpayers hiding assets offshore back into the system.”

A review of the Department of the Treasury’s May 2009 “*General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals*” (aka - the “Green Book”) supports the current administration’s Treasury Department plans to actively seek out US taxpayers who are not reporting income on, or the existence of, offshore accounts. Twenty-nine of the one hundred twenty-four page proposal directly relate to reporting foreign income and accounts as well as a new penalty structure for those who are not complying with the filing requirements.

Voluntary Disclosure Program

On March 23, 2009, the Treasury Department announced the Voluntary Disclosure Program which will allow taxpayers to come forward and disclose previously unreported foreign income or accounts under a penalty framework more favorable than if the unreported income and accounts are discovered upon audit. The Voluntary Disclosure Program is currently set to expire on September 23, 2009, six months after the announcement of the program. The IRS believes that six months is a reasonable period of time for taxpayers to make voluntary disclosures and to assess the results from agent examinations. Highlights include:

- For taxpayers that truthfully, timely, and completely comply with all provisions of the Voluntary Disclosure Program, the IRS will not recommend that criminal prosecution by the Department of Justice be pursued.
- Under this program, taxpayers will be required to file amended or delinquent returns declaring the unreported income and/or undeclared foreign accounts for all applicable years for 2003 through 2008.
- Taxpayers that are under audit during the six month Voluntary Disclosure Program will not be permitted to participate in the Program and will be subject to the higher penalty structure for unreported income and/or accounts.

Even though the IRS has had a voluntary disclosure practice for years, by establishing the Voluntary Disclosure Program, where exposure to penalties are more predictable and cases are resolved in an organized and coordinated manner, taxpayers will come forward and declare the foreign income and/or accounts. But reports have shown that taxpayers are “reluctant to come forward because of uncertainty about the amount of their liability for potentially onerous civil penalties.” The IRS is hoping the program will provide sufficient data to further its understanding of how foreign accounts and entities are being marketed to US taxpayers as ways to evade or avoid income tax.

How likely is it that taxpayers, who are intentionally neglecting to report foreign income and accounts, will step forward through this Program? Personally, I believe it is very unlikely. In order for the IRS to find useful data on this process, it will need to rely on their audit process, not the Voluntary Disclosure Program.

The data collected from the Voluntary Disclosure Program will likely be provided by taxpayers who are looking to correct an oversight. A major concern is that rules and procedures that are implemented to identify and capture taxpayers engaged in intentional criminal activity undoubtedly trap law abiding taxpayers

who are guilty of nothing more than an innocent oversight or misinterpretation of ambiguous directions provided by federal agencies.

Also announced in March, enforcement from the IRS will come through the combination of a Voluntary Disclosure Program and IRS directives to agents to “fully develop” cases involving undeclared foreign income and/or unreported foreign accounts and to pursue all available penalties, including the maximum penalty for willful failure to file the Report Foreign Bank & Financial Accounts (FBAR) and the fraud penalty along with criminal prosecution.

On March 23, 2009, a memo referencing the IRS Strategic Plan for 2009–2013, issued to the IRS Examination and Industry directors stated “offshore cases sent to the field are work of the highest priority. Examiners should utilize the full range of information gathering tools in properly developing offshore issues, with special emphasis on detecting unreported income.”

Six year look back period

Normally, there is a three-year statute of limitations for making adjustments to a previously filed tax return. So, how can the IRS have a six-year look back period for filing under the Voluntary Disclosure Program?

The six-year look back period is a resolution by the IRS for encouraging voluntary disclosure of offshore income. If a taxpayer participates in the Program they must report for this six year period and agree to the assessment of the related tax and interest to obtain the benefit of the reduced penalty structure.

If the taxpayer does not agree to the tax, interest and penalties under the six-year look back period, the case will be referred to the field for a full audit. Under audit, the three-year statute of limitations will apply; however, the lower penalty structure will not be available. If, as a result of the audit, the IRS can prove that there was a substantial omission of income this would open up the full six year period for assessment. Certain forms must be filed with the IRS in order to start the statute of limitations. If a required form, such as FBAR, was not filed it remains open to audit until filed and the appropriate statute expires.

Taxpayers with unreported foreign income who do not participate in the Program may face possible criminal charges including tax evasion (up to five years in prison plus a fine of up to \$250,000), filing a false return (three years, \$250,000 fine), and failure to file an income tax return (one year, \$100,000 fine). Failure to file a FBAR or filing a false FBAR are both violations subject to criminal penalties that could result in up to ten years in prison and a criminal penalty of up to \$500,000.

For taxpayers who have a significant amount of unreported foreign income, it would be more beneficial to participate in the program and access the lower penalty structure and limit the number of years that can be assessed.

Penalties for unreported foreign accounts

Taxpayers who fail to file the annual FBAR can be subject to the following:

- Civil penalties for a non-willful violation of up to \$10,000 per violation
- Civil penalties for a willful violation up to the greater of \$100,000, or 50 percent of the amount in the account at the time of the violation
- Criminal penalties for violating the FBAR requirements while also violating certain other laws of up to a \$500,000 fine or 10 years imprisonment or both

Civil and criminal penalties may be imposed together.

Penalties for unreported foreign income

Taxpayers participating in the Program will be assessed the following:

- Tax on the unreported income
- An accuracy related penalty of 20% of the tax on the unreported income
- An additional penalty, in lieu of the FBAR and other potential penalties, or 20% of the highest balance in the unreported account generating the income in the six-year look back period

How to participate in the Voluntary Disclosure Program

To participate in the Voluntary Disclosure Program, taxpayers must send a letter to the nearest Special Agent in Charge, IRS Criminal Investigation Ybutmstating that they wish to make a voluntary disclosure. The letter should contain:

- Taxpayer's name, address and social security number or other taxpayer identification number
- Passport number and date of birth
- An explanation of any previously unreported or underreported income or incorrectly claimed deductions or credits to undisclosed foreign accounts or undisclosed foreign entities
- The reason(s) for the error or omission

Tax practitioners assisting taxpayers with the disclosure should include Form 2848 (Power of Attorney) which will permit the IRS to work directly with the practitioner. If the taxpayer has already prepared the amended or delinquent returns they may submit them with the letter.

“Quiet” disclosure

Some taxpayers are attempting to bypass the Voluntary Disclosure Program and its related penalties through a “quiet” disclosure – simply amending prior returns that did not appropriately report foreign account income and hope they don't get “caught” and assessed penalties. The IRS has stated that it is identifying amended returns which are reporting increased income, and will closely review these returns to determine whether to pursue additional action including a full examination and/or criminal prosecution related to all applicable years.

Those who have already filed amended returns may come forward under the program by filing copies of the previously submitted amended returns along with their letter to the criminal investigation unit requesting to be brought into the Voluntary Disclosure Program.

Guidance for reporting offshore hedge fund investments

Whether investors in offshore hedge funds are required to file FBAR has been a common question. Do offshore hedge fund investors meet the definition of holding a foreign account and/or having signature or other authority over the account?

Many tax practitioners have interpreted the FBAR instructions to indicate that these investments would not meet the reporting requirements. The investor has simply entered into a subscription agreement with a fund that may, or may not have an account offshore of which the investor may not be aware. The investor also does not have the ability to direct the distribution of money or other property from the fund's accounts other than to file a redemption request. Unless the investor owned more than 50% of the fund, it is believed that a FBAR report would not be required. This IRS appears to agree with this interpretation in a series of frequently asked questions related to FBAR on the IRS website (last updated 6/29/09).

Q. If a United States person holds a partnership interest in a hedge fund that is located in the United States but that owns foreign financial accounts, must the United States person report his interest in a hedge fund on an FBAR, assuming the United States person does not hold more than a 50% partnership interest in the hedge fund?
A. Generally, no. If the hedge fund is located in the United States, a financial interest in the hedge fund is not an interest in a foreign financial account for FBAR reporting purposes, even though the hedge fund may have foreign operations. If the domestic partnership has a financial interest in a foreign financial account, then it may have to file a FBAR. If a United States person who is an officer, employee, or partner of the partnership has a financial interest in, or signature or other authority over a foreign financial account, then that person may also have to file a FBAR. If a partner owns an interest in more than 50 percent of the profits of the partnership (distributive share of income, taking into account any special allocation agreement) or more than 50 percent of the capital of the partnership, then that partner has a financial interest, for FBAR reporting purposes, in the foreign financial accounts of the partnership and may have to file a FBAR.

Due to the uncertainty of the current IRS position related to offshore hedge funds, a number of these funds sent notices to investors during the last week of June advising that a FBAR report be filed by the June 30th due date to avoid significant penalties for failure to file. This left many tax preparers in a quandary – should a FBAR be prepared due to the verbal commentary of IRS staff in the June 12th teleconference? Or should they rely on the guidance provided in writing in the FAQ section of the IRS website? As a tax practitioner, in the absence of anything binding with regard to the IRS staff's verbal comments made on June 12th, I would

follow the written guidance provided by the IRS through their FAQ section and interpretation of the form instructions until other definitive, written guidance is provided by the IRS. Hopefully, the IRS will clarify its position before the 2009 reports must be prepared.

What if a taxpayer's only violation is failure to file a FBAR report?

The Voluntary Disclosure Program is intended to provide a way for taxpayers who did not report income to come forward and declare the income now.

Taxpayers who did report all income, but failed to file a FBAR when required, should not use the Voluntary Disclosure Program. The IRS is instructing these taxpayers to:

- File the delinquent FBAR report according to the form's instructions (use the instructions for the appropriate year)
- Attach an explanation for why the reports are being filed late
- Send copies of the delinquent FBAR, along with copies of the tax return, for all relevant years to the address below by September 23, 2009:

Internal Revenue Service
11501 Roosevelt Blvd
South Bldg., Room 2002
Philadelphia PA 19154
Attn: Charlie Judge, Offshore Unit, DP S-611

The IRS is indicating that they will not impose a penalty for failure to file the FBAR.

Action to take now

As taxpayers or tax practitioners, working with investments that may hold foreign accounts, it is critical that we understand the changes being made to and/or clarifications provided with respect to the required reporting of foreign income and accounts to ensure that the tax returns and other reports we sign are complete, accurate and timely filed. Review all investment relationships to determine if foreign account reporting is required and has not been inadvertently overlooked.

Evaluate all relationships in which you may have sufficient authority over the foreign account to require reporting – even if the actual account is not your own. If you should have filed FBAR reports for any year between 2003 and 2008 but didn't, have it prepared now and file it according to the IRS instructions. If you have unreported income, participate in the Voluntary Disclosure Program. It's time to come forward and declare this income.

Disclosure: To ensure compliance with Treasury Circular 230, we are required to inform you that any advice concerning U.S. federal tax issues contained in this article is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.