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TEN TREMONT STREET, SUITE 600 – BOSTON, MASSACHUSETTS 02108
Telephone: 617.720.6040 – Facsimile: 617.720.1919
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Published April 4, 2011
Massachusetts Lawyers Weekly

Foreign Bank Accounts – An IRS Offer You Can't Refuse

Alexander A. Bove Jr., Esq. & Melissa Langa, Esq.*

A 6,000 year old Sumerian tablet discovered in Africa was inscribed: "You can have a Lord, you can have a King, but the man to fear is the tax collector." Times haven't changed much. But today the end of that inscription might read: "the man to fear is the tax collector if he finds out you haven't been paying your taxes." Thousands, maybe hundreds of thousands, of United States taxpayers have not been paying their U.S. income tax on foreign bank accounts and other foreign investments, and now, unless they take advantage of an Internal Revenue Service program offered to help taxpayers come clean, they will have something to fear.

Federal law requires every U.S. person with one or more foreign financial accounts that exceed $10,000 in total for the year to report the accounts (on a Foreign Bank Account Report-FBAR) and pay a tax (with their form 1040) on all taxable income related to such accounts, whether or not they actually receive it. The penalties for not filing the FBAR and paying the tax

* The authors gratefully acknowledge the able assistance of their associate, Jaclyn O'Leary, in the preparation of this article.

are severe and could include criminal prosecution and jail. Because in the past foreign banks and other foreign financial institutions would not report either the existence of the account or its income to the U.S. government, many taxpayers/account holders conveniently believed that they, too, could report nothing. As a result, billions of dollars of taxable income went unreported, and the government lost corresponding billions in taxes. And as a result of that, the IRS stepped up its investigations into the problem spurred and highlighted by the huge UBS bank scandal.

In effort to get taxpayers with unreported accounts and income to come forth on their own and save the IRS time and expense in discovery and audit, the IRS proposed a special 2009 "Voluntary Disclosure Program" (VDP), offering a taxpayer who came clean on or before October 15, 2009, a one-time 20 percent penalty on the highest balance of his foreign accounts during the previous six years, so long as he paid all back taxes for those years, plus related penalties and interest. Although 20 percent may sound high to some, it is a true bargain when compared to the regular penalty of the greater of 50 percent or $100,000 per year, which, in the course of six years, could amount to a total penalty of up to triple the balance in the foreign account. Another VDP bargain was the fact that the program did not involve an audit. The IRS' sole concern was unreported income related to foreign financial accounts. Therefore, a taxpayer who had a concern, say, over a deduction in one of the years involved in the program, had no worry about the issue being addressed. For all these reasons, the 2009 VDP program was considered a huge success, attracting more than 15,000 taxpayers.

Obviously, that number did not include every U.S. taxpayer who had a foreign financial account. For one reason or another, many missed the deadline. Some never knew about the program or learned about it too late. Others chose a "quiet disclosure"; and still others decided to do nothing. A quiet disclosure is one where the taxpayer prepares all the overdue FBAR's, as

well as amended income tax returns, and quietly files those along with the tax due on the income, hoping it will somehow slip under the IRS radar screen or blend in among the millions of other documents the IRS receives. Little did they anticipate that the IRS would reportedly target late-filed FBARs and amended returns containing foreign income, to be scrutinized at a later date. Nevertheless, the "quiet disclosure" taxpayers still have a chance. They may now enter a new program and avoid the exposure to later discovery and the more severe penalties.

In the wake of the success of the VDP program, the IRS recently announced a follow-up program, the 2011 offshore Voluntary Disclosure Initiative (VDI), which will be available until this August 31st to taxpayers who missed the first program, including those who placed themselves in direct line of sight by making quiet disclosures. Like the VDP, the VDI is not a taxpayer audit and is focused on offshore accounts only. Also like the VDP, the VDI is not concerned with a taxpayer who had a foreign financial account and failed to file the FBAR reports but nevertheless reported and paid tax on the foreign income from those accounts. In that case there will be no penalties but the taxpayer should file all overdue FBAR's from 2003-2010, along with a statement explaining the situation. They do not need to enter the VDI program.

The first significant difference between the VDP and the VDI is the penalty structure. The onetime 20 percent penalty has been increased to 25 percent, while a new "de minimus rule" reduces the penalty to only 12 ½ percent if the total account balance never exceeded $75,000 during the applicable year period. Like the VDP program, however, some taxpayers may qualify for a 5 percent penalty if the account was inherited, had little or no activity, and it can be shown taxes were paid on the original deposits.

Another difference is the number of tax years scrutinized and the reporting required to

enter the program. The VDI disclosure period encompasses seven years (2003-2010) instead of the VDP's six. Further, unlike the VDP, for the VDI all amended returns and supporting information, copies of original returns, and miscellaneous specified additional IRS forms must be completed and sent along with payment for all overdue taxes, interest, and penalties, together with the request to be admitted into the program, on or before the August 31st deadline. In addition, the taxpayer, when cleared for the program as explained just below, must submit a signed agreement to extend the period of limitations on collection of tax. Previously, a simple request to be admitted to the program was sufficient if sent prior to the deadline, and the IRS would follow up with a request for information. A taxpayer may be "pre-cleared" for admission to the program by faxing personal information (e.g. name, social security number, date of birth, and address) to the IRS Criminal Investigation Lead Development Center, which will then advise whether the taxpayer is cleared to enter the program. Taxpayers who are already being audited for any reason and for any years will be denied clearance.

One very important point that has surprised many advisors is the scope of "accounts" that are considered under the program. Common understanding, as well as the actual law and the instructions accompanying the FBAR form, define "financial accounts" quite specifically. Briefly, it includes bank and brokerage accounts, hedge funds, and a number of other financial arrangements. The definition does NOT include real estate, jewelry, or works of art. Nevertheless, the VDI does include such assets if it cannot be established that they were acquired with after-tax funds, or if they produced any unreported income during the years involved. Say we have a taxpayer with a summer home in Italy valued at $ 1 million which is rented part of the year, with the rent deposited in a U.S. account but not declared as income. The taxpayer never had a foreign "financial" account, so never filed an FBAR. According to the IRS "Q&A", the

taxpayer would be exposed to a penalty on the value of the home, plus tax and penalties on the unreported taxable income. This will undoubtedly come as quite a shock to many. (Note that if there was no income and if the property was acquired with after- tax funds, there will be no reporting and no penalties.)

It is interesting to consider the number of U.S. taxpayers who have or have had foreign accounts but who are still failing to report such accounts. The fact that a person may have closed her account and withdrawn the funds a year or two (or more) ago does not put that person in the clear. If the IRS discovers the existence of the accounts before the taxpayer comes forth, the penalties could and likely will be severe, as noted above. For instance, the IRS materials explaining the VDI program contain an example where a taxpayer had a foreign account with an initial balance of $ 1 million, and growing by $ 50,000 each year from 2003 through 2010, with an ending account balance of $1,900,000. If that taxpayer failed to enter the VDI program and was discovered by the IRS, he would pay penalties, including taxes and interest of about $4.5 million (on the $1.4 million account)! And that assumes the IRS would not impose the 75 percent fraud penalty, and does not address exposure to criminal prosecution. And further bad news to quiet filers: limiting the period to 2003-2010 is a concession offered by the VDI program. Taxpayers who have not entered the program and who were later discovered will not benefit by that limitation, so if the accounts go back further and there are delinquencies, the IRS could (and has suggested it would) go back further.

Attorneys and other advisors who know that a client has a foreign account have a duty as a tax return preparer under IRS Circular 230 to notify the client of his noncompliance and the consequences of such action, and to refrain from preparing the income tax return of that client (or any substantial portion thereof) if the taxpayer decides against disclosure. To prepare or

advise on such a return would be a violation of Circular 230 and would expose the advisor to suspension or disbarment from practicing before the IRS. And if the IRS notifies the Board of Bar Overseers of such violations, further disciplinary action may well result. It is clearly not worth the risk.

After going through the 2011 program, what if the taxpayer is unhappy with the outcome? Is there an appeals process? Simple answer: No. The IRS considers the VDI as a special package offer, and nothing about it is negotiable. The agents handling each case "have no discretion to settle cases for amounts less than what is properly due and owing." If the taxpayer disagrees with the outcome and wants to "fight it", she must give the IRS written notice of the decision to withdraw from the program, and that decision is irrevocable. The case will then be referred for "examination" (audit) for civil or criminal review or both. And as noted above, the years will not be restricted to 2003-2010. All in all, it seems that for taxpayers with unreported foreign accounts or income, it's an offer they can't refuse.

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