Undeclared Foreign Accounts—Voluntary Disclosures and FBARs After the IRS Settlement Initiative

By Scott D. Michel

Scott D. Michel discusses how taxpayers with undeclared offshore accounts can avoid criminal liability by making a "voluntary disclosure."

Background

For the past two years, the worldwide business press has been full of stories about potentially thousands of U.S. taxpayers who may have undeclared accounts in Switzerland, Liechtenstein and other foreign countries. Secret foreign bank accounts are no longer the stuff of Hollywood, and the law practice of criminal tax has moved from the legal trades to the front pages of major newspapers. Developments have been fast and furious.

In late 2007 and early 2008, details began to emerge about the guilty plea of a wealthy Los Angeles–area real estate developer, who in turn cooperated against his Swiss UBS private banker. The banker was later arrested, and he cooperated with authorities by providing his client list as well as documents reflecting a decade long set of marketing practices by UBS aimed at encouraging U.S. account holders to commit tax fraud.[1]

Meanwhile, in February 2008, it was disclosed that a former employee of LGT Truehand, a trust company affiliated with LGT Bank in Liechtenstein, had stolen customer data and provided it to tax authorities throughout the EU, and to the IRS as well under a newly enacted "whistleblower" provision.[2]

In July 2008, a U.S. Federal District Court authorized the IRS to serve a "John Doe" administrative summons on UBS seeking the production of the records of all accounts that it maintained during the period 2002–2007 for U.S. customers who instructed the bank not to disclose their identities to the IRS. Around the same time, the IRS served a request for assistance under the Swiss-U.S. Treaty on Double Taxation for records of accounts in which a "blocking entity" had been inserted between the account's beneficial owner and the account assets; such a practice was designed to evade rules on withholding where U.S. securities were held in the account.[3]

The U.S. Senate Permanent Subcommittee on Investigations held hearings in the summer of 2008 relating to LGT and UBS, exposing the uses of foreign accounts to hide assets from the IRS. Representatives from UBS testified before the Subcommittee about their willingness to cooperate with the American investigations and about changes in their banking practices.[4]

After the hearings, UBS began to notify its American clients with undeclared accounts that their private banking arrangement would be terminated unless the clients agreed to convert their accounts to "declared" status.[5]

In late September 2008, the IRS posted on its Web site a new version of Treasury Form 90-22.1 (Foreign Bank Account Report), known as the "FBAR," with more detailed and explicit instructions, expanding the reporting requirements in a number of material ways. Much of the attention in this area is prompted by the extraordinarily tough civil penalties imposed for the willful failure to file this form.

In October 2008, the IRS proposed tougher rules for the Qualified Intermediary (QI) program, includ-

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ing requirements that QI financial institutions must provide early notification of material failure of internal controls, must improve evaluation of risk of circumvention of U.S. taxation by U.S. persons and must agree to audit oversight by a U.S. auditor.

Other matters relating to the UBS investigation followed quickly:

- In early November, a senior UBS bank official was indicted on one count of criminal conspiracy. This appears to be a direct result of the cooperation of the UBS private banker who pled guilty and cooperated. In January 2009, a U.S. District Judge declared that the bank official was officially a fugitive from justice.[6]
- The IRS and the Justice Department, along with the Manhattan District Attorney's Office, apparently obtained information on approximately 70 U.S. account holders who engaged in wire transfers between their U.S.-based UBS accounts and Swiss based accounts at that same institution.[7]
- In February 2009, the U.S. Department of Justice and UBS entered into a Deferred Prosecution Agreement, whereby UBS agreed to pay the United States $780 million to resolve all criminal, and most civil, issues arising from the bank's role in facilitating U.S. tax evasion. Other terms of the UBS deferred prosecution agreement included the extraordinary disclosure of the identities of approximately 250 to 300 account holders to the Justice Department, as well as production of voluminous records of their accounts.[8]
- As of this writing, the Justice Department had obtained guilty pleas from seven UBS account holders whose names were apparently provided either by the cooperating private banker or by the Swiss Federal Tax Authority pursuant to the Deferred Prosecution Agreement. The Justice Department has also said that perhaps as many as 150 other account holders are under criminal investigation.[9]
- The IRS settled the John Doe summons case with UBS in August 2009, agreeing to a timetable whereby UBS would respond, through the Swiss government, to a new treaty request identifying certain types of accounts that would be disclosed. Notices from UBS have gone out to thousands of American account holders informing them that their account information may be disclosed.[10]
- The Justice Department has charged additional Swiss bankers, financial advisors and lawyers alleging, among other things, a conspiracy to help Americans commit tax fraud, bribery of Swiss government officials, and other offenses.[11]

Further, the press has reported, and the government has confirmed, that other persons affiliated with banks in "secrecy" jurisdictions throughout the world have stolen customer data and may be approaching the IRS and other law enforcement agencies seeking whistleblower rewards. Indeed, in December 2009, it was reported that data had been stolen from HSBC's private banking group in Geneva and provided to certain tax authorities.[12]

International pressure is growing for greater transparency as to financial accounts in various countries. The United States and Liechtenstein entered into an Information Exchange Agreement, applicable for years 2009 and beyond. The Swiss and U.S. governments signed a new Treaty protocol in September 2009. The OECD and the EU have been pressuring countries like Switzerland to be more transparent, and Switzerland was recently removed from the "gray list" of potential tax havens as a result of concrete steps taken by the Swiss to become more open. Similar pressure is being exerted on bank-secrecy jurisdictions in Asia deemed by some to be tax havens.

In March 2009, the IRS announced a "settlement initiative" aimed at encouraging Americans to come forward with voluntary disclosures about previously undeclared accounts. Any qualified U.S. taxpayer participating in this initiative would avoid criminal prosecution and pay civil penalties that, while substantial, would be well below what the U.S. tax authorities could otherwise seek to collect. The initiative expired on October 15, 2009, with 14,700 American taxpayers taking advantage of the special program.

In April 2009, the IRS served a "John Doe" summons on First Data Corporation, a processor of credit and debit card transactions, seeking information on U.S. merchants who have directed the deposit of business receipts to foreign accounts, and during the summer, settled this matter with First Data, presumably resulting in the production of additional account information.[13]

In the IRS settlement initiative, the IRS has obtained information on a number of additional foreign financial institutions, as well as specific bankers, financial advisors and other persons. This information will be used to formulate additional treaty requests and perhaps summonses to be served on other foreign governments and banks. Press reports over the past year have suggested that this process may already be underway.

In this swirling enforcement environment, tax practitioners continue to be approached by clients seeking advice on how to clean up their affairs before the government comes knocking at their door. The cases range across a broad factual spectrum.

In many cases involving undeclared foreign accounts, the account was opened with legal funds, sometimes even "tax paid" funds, with the account holder seeking the protection of a bank secrecy jurisdiction because of World War II, the Holocaust or other personal or family-related developments.

In some of these cases, a second or third generation of taxpayers became aware of accounts established by their parents or grandparents, and they want to clean the matter up; in other instances, elderly taxpayers wish to make voluntary disclosures so as not to burden their heirs with the problem of having a previously undeclared foreign account.

And of course in other cases, the taxpayers involved are persons who affirmatively sought to hide money from the IRS, concealed the transfer of untaxed funds into their foreign accounts, and hid their methods of withdrawal from such accounts. Irrespective of the "rawness" of the fact pattern, however, any such case is eligible for noncriminal resolution under the IRS's voluntary disclosure policy.

Regardless of the underlying reasons for the establishment of the account, most of these cases share a number of common characteristics:

- A failure to report income earned on the accounts
- A failure to disclose the existence of the account on the individual's U.S. tax return (There is a place to check a box answering the question whether the taxpayer has signature authority or a financial interest in a foreign account, and if so, to list the names of the countries where the account is held.)
- A failure to file annual FBAR forms disclosing the existence of the account
- Potentially, a failure to file additional IRS forms regarding a taxpayer's relationship to a foreign trust or foreign corporation, or the taxpayer's receipt of funds from foreign sources, including gifts and bequests

Each of these failures, if willful, could be the basis for tax felony prosecutions in the U.S. which, under U.S. criminal sentencing guidelines, would likely result in incarceration. Similarly, and irrespective of the criminal consequences, each of these could also result in the assessment of significant, and potentially confiscatory, civil money penalties.

Tax practitioners are also being consulted by foreign financial institutions and financial intermediaries that have advised or assisted U.S taxpayers in establishing and maintaining undeclared foreign accounts. Some of these institutions are QIs that failed to exercise due-diligence under applicable know-your-customer rules and may be exposed to revocation of their QI status and civil penalties. Other foreign financial institutions and financial advisors that knowingly facilitated tax evasion by U.S. persons could be exposed to criminal investigation and prosecution.

The risk that these institutions' prior misconduct will become known to the IRS is increasing by the day in light of the expanding Department of Justice investigations of foreign banks, the growing number of U.S. taxpayers who are cooperating with IRS and Department of Justice investigators in hopes of avoiding mitigating civil and criminal penalties, and the disclosures that the IRS is receiving from whistleblowers.

Both individual U.S. taxpayers and foreign financial institutions that have engaged in these types of misconduct in connection with undeclared offshore accounts may be able to avoid criminal liability by making a "voluntary disclosure" before the IRS or any other U.S. government agency has begun an investigation that would lead to discovery of the criminal misconduct. The manner and means of such a disclosure, and the reporting positions undertaken, must be determined with great care based on a careful analysis of all relevant facts of the particular case.

The Voluntary Disclosure Policy

Because the IRS has limited investigative resources and cannot hope to detect and pursue more than a small percentage of nonfilers or tax evaders, it is obviously in the government's interest to encourage taxpayers who have violated U.S. tax laws to file amended and delinquent returns.

Recognizing that fact, and the fact that a true voluntary disclosure makes conviction unlikely, the IRS for many years has followed a policy under which a voluntary disclosure is, technically, deemed a factor to be considered in the decision whether to initiate a criminal investigation or recommend prosecution. The IRS takes great pains to state that the policy does not provide an "amnesty." However, as a practical matter and in our many years of experience in dealing with cases involving undeclared accounts, it is inconceivable that the IRS would recommend criminal prosecution of a person who made a voluntary disclosure that meets all elements of the policy.

The current version of the IRS policy is found in the Tax Crimes section of the INTERNAL REVENUE MANUAL. The IRS MANUAL makes it clear that the voluntary disclosure "policy" provides no legal or formal guarantee. It states:

> It is currently the practice that a voluntary disclosure will be considered with all the other factors in the investigation in determining whether criminal prosecution will be recommended. This voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice. ... A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended.[14]

Voluntary Disclosure Requirements

As a threshold matter, the voluntary disclosure policy has always been available only to taxpayers who have legal source income. Thus, any undeclared accounts that hold the proceeds of criminal conduct (other than tax fraud), such as bribery or corruption, narcotics, money laundering, *etc.*, will not be the basis for an acceptable voluntary disclosure.

Timeliness

The IRS MANUAL describes the specific criteria for determination of timeliness.[15] A disclosure is timely if it occurs before any of the following:

- The IRS has initiated a civil examination or criminal investigation of the taxpayer or has notified the taxpayer that it intends to commence such an examination or investigation.
- The IRS has received information from a third party (*e.g.,* informant, other governmental agency or the media) alerting the IRS to the specific taxpayer's noncompliance.
- The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.
- The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (*e.g.*, search warrant, grand jury subpoena).

Note, importantly, that the taxpayer may be unaware that the IRS has initiated a civil examination or a criminal investigation, or that the IRS has otherwise received specific information about his or her previous noncompliance. The IRS policy contains the following example of a situation that is NOT a voluntary disclosure:

> A disclosure made by a taxpayer after an employee has contacted the IRS regarding the taxpayer's double set of books. This is not a voluntary disclosure even if no examination or investigation has yet commenced because the IRS has already been informed by the third party of the specific taxpayer's noncompliance. The conclusion would be the same whether or not the taxpayer knew of the informant's contact with the IRS.[16]

Thus, the fact that the taxpayer is not aware that an inquiry has commenced, while relevant, does not provide complete comfort.

Under the current IRS policy, unlike previous iterations, eligibility does not depend on whether a "prompting event," such as a divorce or business dispute, caused the taxpayer to come forward. The policy no longer looks to the subjective motivation underlying the taxpayer's disclosure.

While the Justice Department voluntary disclosure policy on timeliness had differed from the IRS's, in a recent revision to the CRIMINAL TAX MANUAL, the DOJ adopted the IRS policy as its own, emphasizing that a voluntary disclosure is only one factor the Department would consider in deciding whether to authorize prosecution.

The timeliness test presents a serious problem for taxpayers and their advisors in the current climate. For many potential voluntary disclosure candidates, whether their name has been provided to the IRS or the Justice Department as having a potentially unreported foreign account is uncertain. For example, in some cases, such as those taxpayers whose names were provided by the LGT whistleblower, it is almost inconceivable that the IRS would deem their coming forward as satisfying the timeliness requirement. Other individuals may have dealt with the cooperating UBS private banker, who has identified the names of his clients to the U.S. authorities and provided information to the best of his recollection about their accounts. And as noted above, other whistleblowers are said to be coming forward.

With the uncertainties over exactly what information has been provided concerning undeclared accounts at other banks, it is difficult for a practitioner to make a judgment as to whether a given client meets the timeliness requirement. This may inform the practitioner's judgment as to which "method" of making a voluntary disclosure the practitioner recommends to the client after a full examination of the relevant facts.

During the IRS settlement initiative, the IRS changed the agency's practice regarding so-called pre-clearances. In a pre-clearance, the IRS would agree to check its databases and the taxpayer's file to determine whether any event had occurred that would render the taxpayer ineligible for a voluntary disclosure. Such events would include an audit flag going up on a taxpayer's account, or their name having been provided to the IRS by UBS.

Until mid–July 2009, except in anecdotal cases in the New York metropolitan area, the IRS had refused to engage in pre-clearances. In the midst of the settlement initiative, it changed its policy mid-course during the settlement program and began to pre-clear taxpayers who wanted to know whether they could make a timely voluntary disclosure. It was apparent, however, that different IRS offices were using different pre-clearance methods—some were consulting only a database of UBS cases, while others made a broader search. It is unclear, now that the settlement initiative has expired, whether the IRS will officially continue these pre-clearances in voluntary disclosure cases.

Truthfulness

A voluntary disclosure obviously must be truthful in all respects. This requirement presents some problems in the area of undeclared accounts because foreign bank information may be unobtainable or incomplete. Even where bank information going back for a period of years is satisfactory, certain data, such as purchase prices needed to ascertain a taxpayer's basis in a long held but eventually sold asset, may still be unavailable.

Presumably, a taxpayer's best estimate made in good faith and based on all available information would satisfy this requirement if precision is not possible, but a taxpayer whose return contains such estimates should plainly disclose on the face of the amended return the methods used to calculate the line items.

In a voluntary disclosure involving previously undeclared accounts, the taxpayer must, of course, report all income earned on the account and must acknowledge his or her signature authority and/or financial interest in the account at Part III of Schedule B of the Form 1040.

Issues are sometimes presented where there taxpayer has been taking funds out of the foreign account during the period that will be covered in the amended filings. Generally, practitioners advise that the taxpayer need report as income on the amended filings only the dividends, interest and capital gains (or losses) earned in the account. But where an account was established with funds on which taxes have never been paid, the situation gets more complex, and in some cases, especially those involving nongrantor trusts, the client may have to report amounts withdrawn from the account as income.

Many foreign accounts entail investments in multiple currencies. Practitioners need to be mindful of special, technical rules under Code Sec. 988 that require separate reporting for currency transactions, even those involving simple exchanges from, say, a dollar-based account to purchase a Euro-based instrument.

Completeness

The disclosure must be complete, but that term is not defined in the MANUAL. The Justice Department's CRIMINAL TAX MANUAL, at §4.02(2), specifies that the taxpayer must make a full disclosure of the facts.

A major element of the advice to the client will relate to the number of years for which to consider amended returns. Many practitioners default to six years' worth of amended returns since that is the length of the statute of limitations on prosecution of tax offenses in the United States. The IRS settlement initiative required six years of amended and/or delinquent filings. However, in some cases, the risk of a criminal prosecution may be quite low—the "inherited account" situations are frequently in this category—so a practitioner may decide to recommend fewer than six years of amended filings. The number of years to go back depends on the facts and circumstances of each case.

The completeness requirement also raises an issue for a taxpayer whose prior inaccurate return may raise issues other than those that prompted the taxpayer to want to come forward. For example, a taxpayer may wish to make a voluntary disclosure to report a previously undisclosed foreign bank account, but his original return may have other lurking issues, such as unsubstantiated business expenses. Most practitioners advise clients who file amended returns that they should correct all material errors on any prior return, not just those that may have motivated the taxpayer in the first instance toward a voluntary disclosure.

Foreign Trusts and Corporations

The U.S. tax code requires taxpayers generally to disclose in filings with their tax return their control over any foreign corporations or their receipt of funds from a foreign trust, or by gift or inheritance from a foreign source. If the account was omitted from an estate tax return, for example, then the estate return may require amendment.

Many undeclared accounts are nominally held in the name of corporations, foundations, trusts or other legal entities. The practitioner must evaluate whether to make separate, additional filings that describe the taxpayer's relationship with any entities in which the undeclared assets are held. If the account was held in a trust, it may be necessary to file a Form 3520 reflecting a distribution from a foreign trust or a gift or bequest from a foreign source. If the account is held by a corporation, a Form 5471 may be required.

Such decisions about appropriate return positions can raise a difficult set of issues in which the entity (or entities) in which the account was held might be deemed an alter ego, nominee or sham by the IRS. The rules on such filings can be quite technical, and practitioners should strive to avoid errors that could put a client's voluntary disclosure in less of a positive light or, at worst, deprive the client of voluntary disclosure treatment and the reasonably safe assurance that he or she will not be prosecuted.

In foreign account situations, a complete voluntary disclosure will also include the filing of appropriate delinquent or amended FBARs. This information return, filed with the Detroit IRS Computing Center, solicits detailed information about a filer's foreign account(s), including the name in which an account is held, the bank's location, the account number, the balance in the account and other data. It applies to both individuals and business entities. As noted in the introduction, the IRS recently issued a new FBAR form, revised as of October 2008 and now mandatory for any filing.

The new FBAR form made some important changes and offered some significant clarifications:

- It clarifies that "debit card and pre-paid credit card accounts" are now reportable foreign financial accounts.
- It provides that a U.S. person has a financial interest in any foreign account "for which the owner of record or holder of legal title is a trust, or a person acting on behalf of such a trust, that was established" by that person "and for which a trust protector has been appointed." This does not apply to heirs, but the instructions retained the rule whereby any U.S. person who is more than a 50-percent beneficiary in a foreign trust must file the FBAR reporting the trust's foreign account.
- It expands the filing requirement beyond U.S. citizenship or residency to now include anyone "in and doing business in the United States." It then requires a foreign identification number, such as a foreign passport number. This means that foreign nonresident alien individuals or entities that are "in" the United States and have business interests here are required to file and provide their identifying information. IRS guidance suggests that sporadic business pursuits, such as those engaged in by athletes or entertainers, or by occasional management of U.S. investments, would not trigger an FBAR filing requirement. However, the IRS has suspended the effect of this expansion in the filing requirement until it issues further guidance.[17]
- It requires identifying information about any non-U.S. beneficial owner of any account over which the filer may have a power of attorney or other similar authority.
- Specifically as regards voluntary disclosures, the new form and the instructions provide for a specially designated amended filing, by including a box on the form noting that it is an amendment to a previously filed FBAR. The instructions request that the filer "attach a statement explaining the changes." Similarly, the instructions note that for delinquent filings, the filer should "attach a statement explaining the reason for the late filing." This statement will be important in the IRS's consideration of potential civil penalties.

The new instructions make it clear that one cannot avoid the filing requirement by giving an intermediary signatory authority over the account. A person who can instruct the intermediary to act is deemed to control the account.

Because of substantial confusion in the practitioner and filing community, the IRS has extended the deadline on 2008 FBAR filings until June 30, 2010, for two sets of filers, those with signing authority but no financial interest in an account (including corporate signers) and those invested in foreign "commingled funds" such as hedge funds. The IRS is reviewing the instructions and filing requirements for these categories and may propose changes prior to the new deadline. The IRS is likely to make material changes in the FBAR filing requirements for such filers.

Cooperation

In order to take advantage of the voluntary disclosure policy, the taxpayer must cooperate with the IRS in the determination and payment of his tax liability. No consideration will be given to a partial voluntary disclosure that is followed by a claim of the Fifth

Amendment, a refusal to cooperate in an audit or a refusal to give financial information relevant to a claim of inability to pay. This guideline provides leverage to the IRS should it audit the taxpayer's delinquent or amended return.

This element of the policy may create issues for a taxpayer reporting an undeclared account. Often, other family members or business associates may have been involved at some point, for example, by having control over undeclared foreign assets. Clients should be advised that if they make a voluntary disclosure and the IRS seeks additional information about their accounts, they will be unable to refuse to provide requested information. Such a refusal would jeopardize the voluntary disclosure.

Similarly, during the IRS settlement initiative, the IRS required participating taxpayers to disclose the identities of their bankers, financial advisors, attorneys and other persons who were involved in any respect in their establishment or usage of undeclared foreign accounts. Taxpayers should be advised that if they pursue voluntary disclosures in the post-settlement initiative environment, it is almost certain that such information will continue to be requested.

It remains somewhat unclear how the IRS will process taxpayers who participated in the voluntary disclosure initiative in the examination phase. Practitioners around the country were reporting that the IRS was issuing IDRs that required extensive document submissions, and that in some cases the IRS was insisting on taxpayer interviews. Some practitioners have already seen closing agreements resolving offshore account voluntary disclosure cases.

Payment

The voluntary disclosure policy requires the taxpayer to pay the tax. It also will require payment of interest, which is statutorily required. In any voluntary disclosure situation, it is clearly best if the taxpayer is able to pay the tax and interest with the filing of any amended returns. If the taxpayer is unable to make payment, the policy requires that he or she make "good-faith arrangements" to pay the tax. In a situation involving undeclared accounts, funds in the account may be used to pay the tax obligation.

Procedures and Tactics

Timeliness Issues

Before recommending a voluntary disclosure, counsel should inquire carefully into circumstances bringing the taxpayer to the process, and compare them to the timeliness criteria of the policy. If the IRS continues to pre-clear taxpayers, then a practitioner can discover if the disclosure would be timely be providing the IRS with the taxpayer's name, address, social security number and date of birth. If the pre-clearance policy is changed yet again, then the practitioner will need to consider factors such as whether the taxpayer had an account at UBS that might have been disclosed. The practitioner should also evaluate whether the client believes that he or she is at risk of being the subject of an informant's disclosure. Uncertainties over the "timeliness" issue traditionally prompted differing views among practitioners who specialize in criminal tax matters about the best way to make a voluntary disclosure:

- **Quiet Disclosures.** The traditional procedure for making a voluntary disclosure is to mail the amended or delinquent return, with payment for tax and interest, if possible, to the IRS Service Center. Most practitioners do not advise their clients to self-assess civil penalties. Such returns are rarely selected for audit, and civil penalties may be avoided altogether.
- **Noisy Disclosures.** A second method is to contact the Criminal Investigation Division in the appropriate district. In the experience of many practitioners, various districts handle the process differently. In some districts, the CID agent will accept the name of the taxpayer and confirm the taxpayer's eligibility for a voluntary disclosure without seeking much more additional information. In other districts, CID agents insist on a more complete disclosure of the facts and circumstances of the taxpayer's disclosure, including estimates of tax liability, *etc.* In many situations involving "noisy disclosures," however, a Revenue Agent is eventually assigned to examine the returns, and there is a heightened risk of civil penalties.

During the settlement initiative, the usual tactical analysis that leads a U.S. practitioner to recommend a "noisy" or a "quiet" disclosure was largely rendered moot by the recently expired IRS settlement initiative. The IRS required noisy disclosures to take advantage of the discounted penalty formulas offered in the settlement initiative, and midway through the program, even issued an "optional intake letter" with a series of general questions that the taxpayer was required to answer.

Note that IRS has sent conflicting signals on this tactical question. For many years, IRS representatives have said in various public appearances that either the "quiet" or the "noisy" disclosure methods could, if all other elements were met, constitute a valid voluntary disclosure. This longstanding position, understood by practitioners for many years, was put into question by remarks from IRS officials in the spring of 2009 when they indicated in public statements associated with the IRS settlement initiative that the IRS might not recognize "quiet disclosures" as valid.

It remains unclear whether the IRS will revert to its old voluntary disclosure practice prior to the implementation of the settlement initiative. Practitioners may revert to quiet disclosures, which may be preferable especially in cases where there is little criminal exposure, such as a case involving a widow who inherited a foreign account established by her husband (or perhaps his ancestors), and who was unaware of the account until just prior to her husband's death. However, such a quiet disclosure may run an enhanced risk of civil penalties if the IRS discovers the amended filings and undertakes an audit.

UBS has notified a number of account holders that their information may be disclosed pursuant to the settlement of the John Doe summons litigation. This notice is required under Swiss law. The IRS has made clear that U.S. account holders who receive such notice may nonetheless commence the voluntary disclosure process and that such notice will not, by itself, render a disclosure untimely unless UBS has already provided the account holder's name to the U.S. government.

Determination of Tax Liability

Tax return preparation is not subject to any privilege. Thus, it is often advisable to have the amended or delinquent return prepared by an accountant working for counsel, rather than by the taxpayer's return preparer, so the analysis will remain privileged if a decision is later made not to disclose. Once amended returns are filed, that waives the "Kovel"[18] privilege as to the information on the returns.

Practitioners generally avoid, where possible, converting the taxpayer's regular return preparer into a Kovel accountant. Where the same person serves in both capacities, in the event of any kind of IRS examination, it will be difficult for that person to maintain a clear distinction between what he learned in a privileged capacity and what he learned purely in the capacity of a return preparer.

Having said this, in many cases where clients are set on going forward with a voluntary disclosure, there is reduced risk. Indeed, in many ongoing voluntary disclosure under the settlement initiative, practitioners became comfortable relying on the taxpayer's original accountants once the IRS accepted the taxpayer into the program.

Current Year Returns

There is no legal obligation for a taxpayer with undeclared accounts to file amended returns. However, as each year passes, a new return comes due, which must be filed in a timely, accurate and complete manner. Similarly, the FBAR deadline of June 30 rolls around every year. A practitioner should always advise a client seeking advice about a potential voluntary disclosure that the client must comply with the next set of filing requirements. Any suggestion to the contrary by the practitioner could subject him or her to potential criminal liability, *i.e.,* aiding or assisting in the failure to file a return or the filing of a false return.

This precept becomes important because many clients express a fear that a current filing may trigger scrutiny of their prior conduct, and some change their minds about making a voluntary disclosure prior to actually filing. Thus, the practitioner should always advise the client of the legal requirements for the current filing season and memorialize in the file that such advice was given.

This issue also can present problems simply by virtue of the calendar. A taxpayer whose return is on extension to October 15 of a given year may be undertaking to make a voluntary disclosure during the summer and fall of the same year. If the amended returns are not ready to be filed, the taxpayer should nonetheless report the foreign account on the current year return. The same analysis holds for FBAR filings—they should be made on a timely basis regardless of the progress of the amended returns for a voluntary disclosure filing.

The Issue of the FBAR Penalty

The willful failure to file an FBAR is a felony according to 31 USC §5322(a). The IRS has acknowledged, at least informally, that its voluntary disclosure policy applies to FBAR related offenses. Thus, a taxpayer can utilize the voluntary disclosure process to avoid criminal sanctions for the nonfiling of the FBAR, as well as for the failure to report the existence of, and income earned on, a foreign account on the income or estate tax returns. The failure to file the FBAR can also trigger substantial civil penalties:

- For FBARs due on or before June 30, 2004, there was no civil penalty for the non-willful failure to file an FBAR. A willful failure to file the FBAR could lead to a civil penalty from $25,000 up to the balance in a foreign account, with a cap of $100,000.[19]

- For FBARs due on June 30, 2005, and beyond, Congress dramatically upped the ante. A nonwillful failure to file an FBAR can be penalized up to $10,000, but a willful failure to file can result in a civil penalty of as much as 50 percent of the value of the foreign account, with no cap.[20] Thus, a taxpayer with a substantial undeclared foreign account may face the prospect of a civil penalty for a multi-year, willful failure to file the FBAR that would not just exhaust the balance of the entire account but result in the taxpayer having to pay additional funds.

Clients must be aware that a set of delinquent FBARs arriving at the Detroit Computer Center might provoke a penalty examination with the attendant risks. Under the instructions issued October 1, 2008, amended or delinquent FBARs are required to include a statement explaining why the forms are amended or why they were filed late. There are rumors that the IRS has in place at the Detroit Center a mechanism to capture any "old year" FBARs that may be filed.

The IRS has the burden of proving willfulness, and must engage in special judicial proceedings to collect the penalty if imposed, so a practitioner may be able to negotiate it downward, or away altogether, especially in the case of inherited accounts or where there are other factors indicating that the taxpayer was unaware of the FBAR filing requirement or otherwise acted with reasonable cause.

In recent years, practitioners could advise their clients that the IRS usually does not become aggressive on civil penalty issues in voluntary disclosure matters because it wants to encourage taxpayers to come forward and practitioners to advise them to do so. However, the increased attention to undeclared accounts, and the implementation of a fairly tough settlement initiative, suggests that the IRS will be much more aggressive in these cases now and in the future.

FBAR filings can themselves create voluntary disclosure issues for others involved with the foreign financial accounts that are being disclosed. For example, a person filing an FBAR generally must identify a joint account holder, who would have an independent obligation to file an FBAR. Similarly, executors or other fiduciaries with signature authority over foreign accounts by virtue of their position have independent FBAR filing requirements.

During the IRS settlement initiative, persons with signing authority over foreign accounts but no unreported income could rectify their FBAR noncompliance without fear of civil penalties by following what was known as the "FAQ9" procedure, whereby they would file the delinquent FBARs with an explanatory letter in Detroit, and send a copy of their filing plus copies of their tax returns for the years involved to the IRS in Philadelphia. The IRS explicitly promised that in such circumstances, no penalties would be imposed.

A similar procedure had existed in a prior set of FAQs regarding FBARs, and one would presume that the IRS would continue to take this approach as to persons with signature authority but no ownership rights (and thus no unreported income) in a foreign account.

Corporate FBARs

The FBAR filing requirements apply to corporations and other business entities. There are provisions for streamlined and consolidated filings by companies with control of over 25 foreign accounts. There are independent FBAR filing requirements for employees who have signature authority over corporate foreign accounts, even though they may have no financial interest in such accounts. The FBAR instructions provide an exception for employees with signature authority over, but no financial interest in, an account of a publicly traded company or certain large companies, if the company's CFO notified the employees in writing that the company filed and, specifically, that each account at issue was included in the company's FBAR. The new instructions now extend this exception to the employees of a subsidiary of such a company that made a consolidated FBAR filing and whose CFO issued the required notice.

Employees of banks have no FBAR filing requirement for their corporate accounts so long as they have no financial interest in the account. No "CFO certification" is required.

A company that has failed to file FBARs in prior years for itself or its employees may face a situation requiring a corporate voluntary disclosure. Such a disclosure may also entail additional filings by employees with signatory authority over company accounts.

Other Penalties

As noted earlier, many undeclared accounts were set up through nominee type entities, such as trusts or foundations (in Liechtenstein, *stiftungs*), or companies in which the account holder or a nominee held the shares. A taxpayer's relationship with such entities is generally required to be reported on U.S. tax filings. Distributions from and relationships with foreign trusts are reportable on Forms 3520, and one's ownership of a foreign company is generally reportable on a Form 5471.

Forms 3520 and 3520-A

If a U.S. transferor of property to a foreign trust, or a U.S. recipient of a distribution from such a trust, fails timely file a Form 3520 to report these transactions, the IRS may impose a penalty equal to 35 percent of the gross value of the property transferred to or received from the trust. If a U.S. donee fails to timely file a Form 3520 to report the receipt of a large foreign gifts, or files the form incorrectly or incompletely, such donee may be subject to a penalty equal to five percent, not to exceed 25 percent, of the value of the gift or bequest received in the relevant year. If a foreign grantor trust fails to timely file a Form 3520-A, or fails to furnish all of the required information, the U.S. owner may be subject to a penalty equal to five percent of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of the tax year.

The failure to timely file a complete and correct Form 3520 or Form 3520-A may result in an additional penalty of $10,000 per 30-day period for failing to comply within 90 days of notification by the IRS that the information return has not been filed. The total penalty for failure to report a trust transfer, however, cannot exceed the amount of the property transferred.

Form 5471

Depending on the type of foreign corporation involved, and the company's relationship to the U.S. shareholder, there are varying penalties that may be imposed on the failure to file a Form 5471. Generally, the penalty is $10,000 per failure to file, but additional penalties can be imposed if the form is not filed after notice by the IRS.

These penalties generally have a "reasonable cause" exception, meaning that if the taxpayer can demonstrate that his or her failure to file the form was due to reasonable cause, the penalty can be abated in its entirety. Reasonable cause can include, for example, advice from a practitioner on which the taxpayer had relied, or a simple lack of knowledge on the taxpayer's part of the filing requirement.

Institutional Voluntary Disclosures

The IRS and Department of Justice voluntary disclosure policies are not limited to individual taxpayers. In the current environment, foreign financial institutions that have advised or assisted U.S. taxpayers in establishing and maintaining undeclared foreign accounts should consider making voluntary disclosures. In the UBS case, the U.S. Department of Justice took the position that the bank's maintenance of undeclared accounts for U.S. customers and acceptance of Forms W-8BEN from nominee corporations constituted a crime under U.S. law. If UBS had not entered into the February 2009 deferred prosecution agreement, it likely would have been indicted and prosecuted for conspiracy to defraud the United States.

The Department of Justice and the IRS are actively investigating whether other foreign banks, financial institutions or financial intermediaries have provided similar services to U.S. persons. U.S. taxpayers who wish to participate in the voluntary disclosure program are routinely asked, as an element of their mandatory cooperation, to identify all financial advisors and bank personnel who advised or assisted them in establishing their undeclared accounts. Other U.S. taxpayers who are not eligible to make voluntary disclosures may choose to cooperate with the U.S. government's investigations of foreign banks and advisors in order to avoid or mitigate criminal penalties.

A QI or other foreign financial institution that has engaged in conduct analogous to that of UBS and LGT may be able to avoid U.S. criminal exposure by making a voluntary disclosure before the IRS or Department of Justice identifies it as a target of a criminal tax investigation.

Conclusion

The IRS voluntary disclosure policy has been in effect for nearly 60 years in one form or another, and it has enabled thousands of taxpayers to clean up their tax affairs and avoid criminal prosecution, often at a more than reasonable cost, in terms of tax, interest and penalties.

The events of the past year have tested the voluntary disclosure policy in a number of respects. There have been conflicting signals from the IRS about the method of disclosure. Many practitioners commenced or even made full voluntary disclosures for clients only to be told that they were "too late" because the IRS already had their client's name; it is not clear whether the IRS or Justice Department will prosecute such persons. As of this writing, it was also not clear how the IRS would process voluntary disclosures regarding offshore accounts beyond the expiration of the IRS settlement initiative.

It is very much in the IRS' interest to encourage taxpayers to come forward and bring funds held in undeclared accounts "back into the system," for future taxation on income and gains earned by such funds and, eventually, perhaps, through imposition of the estate tax. The voluntary disclosure policy is an important component of the IRS's overall compliance mission.

In light of the many developments occurring in the past six months in the area of undeclared accounts, and the increasing ability of the U. S. government to penetrate bank secrecy, it would still behoove financial and legal advisors worldwide to consider advising individual U.S. clients who may have undeclared accounts and institutional clients who may have assisted U.S. taxpayers to establish such accounts to take advantage of the voluntary disclosure policy before the window for any such disclosure may close. Although the civil liabilities may be severe, the ability to avoid criminal prosecution in the enhanced enforcement environment is a substantial benefit to be considered.

ENDNOTES

[1] IRS Press Release, Dec. 12, 2007, *Real Estate Developer Igor Olenicoff Pleads Guilty to Filing a False Tax Return and Fails to Disclose Foreign Bank Accounts to IRS, available at www.irs.gov/newsroom/article/0,,id=212163,00.html* (last visited Dec. 22, 2009); Carlyn Kolker and David Voreacos, *Billionaire Linked to UBS Tax Probe Hid Moneyin Offshore Banks, Bloomberg.com,* May 31, 2008, *available at www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aLVvrzlgKByA* (last visited Dec. 22, 2009).

[2] Carter Dougherty, *U.S. Among Countries Investigating Tax Evasion,* N.Y. TIMES, Feb. 27, 2008, *available at www.nytimes.com/2008/02/27/business/worldbusiness/27tax.html?sq=hans%20kieber&st=nyt&scp=3&pagewanted=print* (last visited Dec. 22, 2009).

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[4] Evan Perez, *Offshore Tax Evasion Costs U.S. $100 Billion, Senate Probe of UBS, LGT Indicates, WSJ.com,* July 17, 2008, *available at online.wsj.com/article/SB121624391105859731.html#printMode* (last visited Dec. 24, 2009).

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[6] Lynnley Browning, *UBS Executive Indicted in U.S. Inquiry,* N.Y. TIMES, Nov. 12, 2008, at B9, *available at www.nytimes.com/2008/11/13/business/worldbusiness/13ubs.html* (last visited Dec. 24, 2009); Carlyn Kolker, *Ex-UBS Executive Raoul Weil Declared a Fugitive by U.S. Judge, Bloomberg.com,* Jan. 14, 2009, *available at www.bloomberg.com/apps/news?pid=20601087&sid=aSEvhPR7Ok6A&refer=home* (last visited Dec. 24, 2009).

[7] Lynnley Browning, *Indictments expected in UBS inquiry,* N.Y. TIMES, Nov. 11, 2008, *available at www.nytimes.com/2008/11/11/business/worldbusiness/11iht-11ubs.17706564.html* (last visited Dec. 24, 2009).

[8] U.S. Department of Justice Press Release, Feb. 18, 2009, *UBS Enters into Deferred Prosecution Agreement—Bank Admits to Helping U.S. Taxpayers Hide Accounts from IRS; Agrees to Identify Customers & Pay $780 Million, available at www.justice.gov/opa/pr/2009/February/09-tax-136.html;* the Agreement is available at *www.justice.gov/tax/UBS_Signed_Deferred_Prosecution_Agreement.pdf* (last visited Dec. 24, 2009).

[9] Lynnley Browning, *U.S. Builds Crime Cases on Clients of UBS,* N.Y. TIMES, Aug. 13, 2009, *available at www.nytimes.com/2009/08/14/business/14ubs.html* (last visited Dec. 24, 2009).

[10] *Supra* note 3.

[11] Lynnley Browning, *U.S. Indicts Two in Switzerland on Tax Charges,* N.Y. TIMES, Aug. 13, 2009, *available at www.nytimes.com/2009/08/21/business/global/21tax.html* (last visited Dec. 24, 2009).

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[13] D. Col. Pacer docket sheet entry, *U.S. v. First Data Corp, re: settlement of involving John Doe summons.* 1:09-cv-00861-REB *USA v. John Does,* Robert E. Blackburn, presiding, date filed: Apr. 13, 2009, date terminated: Apr. 15, 2009, date of last filing: Sept. 14, 2009, Doc. No. 9, filed & entered Sept. 14, 2009, Order Docket Text: STIPULATION AND ORDER. By Judge Robert E. Blackburn on Sept. 14, 2009.

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[15] *Id.,* at ¶4.

[16] *Id.,* at ¶7E.

[17] Announcement 2009-51, IRB 2009-25, 1105 (June 22, 2009).

[18] *United States v. Kovel,* 296 F2d 918 (2d Cir. 1961).

[19] 31 USC §5321(a)(5)(A) (2003), amended by Act Sec. 821(a) of P.L. 108-357, Title VIII (Oct. 22, 2004, 118 Stat. 1586).

[20] 31 USC §5321(a)(5).