OFFSHORE COMPLIANCE

STRATEGIES FOR CURRENT FILINGS OF NONCOMPLIANT TAXPAYERS AS FBAR DEADLINE APPROACHES

The IRS is stepping up its offshore enforcement, so tax practitioners must be alert to their clients' foreign assets and potential reporting requirements.

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As tax season progresses, efforts by the IRS and the Justice Department (DOJ) to detect, audit, investigate, and even prosecute taxpayers who have not properly reported non-U.S. assets continue. There have been major new developments on the enforcement front in the U.S. and globally, and initiatives begun in 2008 show no sign of slowing down. The reporting of offshore accounts and other foreign assets remains a challenge for practitioners, and there are still legions of U.S. taxpayers who are not fully compliant and who, absent voluntary disclosure, remain at risk. Just over five years after the DOJ and the Swiss banking giant UBS inked a Deferred Prosecution Agreement, starting the cascade that has all but ended banking secrecy worldwide, it is a good time to take stock of where things stand and the implications for practitioners whose return preparation and other tax clients suddenly disclose an issue with foreign assets.

Reporting requirements

Most tax practitioners have become well aware of the myriad of forms and deadlines applying to U.S. taxpayers with foreign financial accounts, other foreign assets, or relationships to foreign business enterprises and foreign trusts. Detailed instructions and commentary on all such filings can be found on the IRS website. In a nutshell, the major requirements are these:

- On income tax filings, U.S. taxpayers must report their worldwide income, including all income earned on foreign accounts and from foreign assets. Schedule B of Form 1040 must note whether the taxpayer has a foreign account and if so, its location and whether the taxpayer has an obligation to file the Report of Foreign Bank and Financial Accounts (FBAR) form. If the taxpayer holds foreign funds, the return must reflect proper reporting of passive foreign investment companies (PFICs).
- Subject to certain income thresholds, income tax returns must also contain the new (as of 2011) Form 8938 reporting "specified foreign financial assets" (SFFA) if the taxpayer has such assets in excess of $50,000. SFFAs are defined broadly and can include interests in non-U.S. corporations and partnerships, certain relationships to foreign trusts, and real estate (income producing or not) if held in a structure of any kind.
- FBARs are due June 30. The FBAR requirement applies to any U.S. citizen, green card holder, or statutory resident with a reportable financial interest in or signatory authority over a foreign financial account. Such interests can be indirect, *e.g.,* through ownership in a corporation or partnership that itself holds a foreign account, or in certain circumstances as the owner or beneficiary of a foreign trust. The Form is now FinCEN Form 114, which replaced Form TD F 90-22.1, and filings are done only electronically on the FinCEN website.
- International tax practitioners are generally aware of other forms, *e.g.*, Forms 3520 and 3520A (for certain affiliations with foreign trusts, or the receipt of gifts or bequests from a non-U.S. person), Forms 5471 and 5472 (interest in controlled foreign corporations and certain transactions with foreign corporations), Form 926 (reporting transfers of property to a foreign corporation), and Form 8865 (reporting certain interests in foreign partnerships).
- Many of these filing obligations extend beyond individual taxpayers to corporations, partnerships, trusts and estates, and even tax-exempt organizations.

Consequences of noncompliance

Sanctions for failing to comply with these reporting requirements can be severe. At worst, the willful failure to report foreign accounts or foreign assets is a felony, punishable by substantial fines and possible incarceration. 1 It can also subject the noncompliant taxpayer to severe and potentially catastrophic civil penalties, including the draconian FBAR penalty of 50% of a foreign account's value for *each year* of willful noncompliance, for as much as six years under the applicable statute of limitations. 2 There can be severe penalties for failure to file the Forms 8938, 3520, and 3520A without reasonable cause, 3 and perhaps more important, the failure to file any of these information returns affiliated with foreign assets can keep the assessment period of limitations open for the entire tax return indefinitely, or until the form is later filed. 4

This article will address the latest developments relating to audits, investigations, penalty assessments and criminal prosecutions arising from undeclared foreign assets, and then discuss options for tax practitioners whose clients now, for whatever reason, suddenly disclose a reportable foreign asset that affects not only their 2013 filing, but prior years as well.

The DOJ's Swiss bank program

For any U.S. taxpayer with an unreported relationship of any kind with almost any bank in Switzerland since 2008, 8/29/13, was significant. The DOJ on that day announced a special program for Swiss banks to obtain "non-prosecution agreements" or "non-target letters" in exchange for the transmission of voluminous data about accounts maintained at their institutions by U.S. persons. Banks also face significant penalties on such accounts unless they can demonstrate that clients have been tax compliant or have entered, or will now enter, the IRS's Offshore Voluntary Disclosure Program (OVDP). 106 Swiss banks have agreed to provide such information to the DOJ, and as of the writing of this article, these banks are furiously attempting to meet a mid-year deadline both to provide such data and to drive any noncompliant account holders into voluntary disclosure.

Most practitioners are aware of the OVDP, which began in 2009, and more than 43,000 taxpayers have participated in the program. Perhaps not surprisingly, however, a substantial number of Americans still have unreported assets abroad. Many live outside the U.S., and others just stubbornly refused to "come clean," hoping that moving from one bank to another, from one country to another, or from a bank to a non-bank asset, would protect them from detection and investigative follow up.

The DOJ's Swiss bank program is aimed precisely at this group of noncompliant taxpayers. The key data that banks will have to provide concern "leavers," i.e., account holders who, sometime after the UBS investigation became public in 2008, transferred funds out of one Swiss bank to another, or from Switzerland to another perceived secrecy jurisdiction, such as Singapore or Israel, or into a non-bank asset, such as bullion, real estate, or collectibles. While Swiss law still prohibits the banks from voluntarily turning over client names absent an appropriate waiver, the DOJ program compels the production of other substantial information, which might allow the IRS to use other means to identify the U.S. account holders. Moreover, the DOJ is readying a number of "treaty requests" under the U.S.-Swiss Double

Taxation Treaty to obtain the identities of "leaver" bank clients. Anyone with an account at these 106 institutions has probably heard from their bank, pressuring them to provide evidence of prior compliance or to consult a tax advisor about making a voluntary disclosure.

The Foreign Account Tax Compliance Act

Most information reporting provisions of the Foreign Account Tax Compliance Act (FATCA) take effect in 2014. In addition to implementing in 2011 the new requirement to report SFFAs on Form 8938, FATCA is now ushering in a global automatic information disclosure regime, whereby financial institutions anywhere in the world must determine who among their account holders has U.S. tax status and then disclose information concerning such accounts to the IRS. Otherwise, a covered bank or other entity could face 30% withholding on their entire U.S. investment portfolio.

One key recent development regarding FATCA is the number of countries whose governments have signed bilateral "Intergovernmental Agreements" (IGAs) with the Treasury Department. Six years ago it would have been unheard of to imagine that jurisdictions such as Switzerland, Liechtenstein, the Cayman Islands, the Isle of Man, the Bahamas, Bermuda, and other countries previously considered tax havens would agree to such a massive information reporting regime vis-à-vis the U.S., but they have. Most other developed countries have signed IGAs or are progressing toward one, and major financial centers such as Singapore and Hong Kong are considering signing a FATCA protocol as well.

Unlike the DOJ's Swiss bank program, which is moving quickly, FATCA over the next two years will continue to drive banks and other entities to contact clients in order to let them know that their account information will soon be provided to the IRS. And FATCA has a broad reach - it can apply not just to banks, but to trusts, trust companies, other fiduciaries, foreign corporations, insurance companies, and the like.

Criminal prosecutions

The IRS and DOJ continue to pursue a variety of targets in the offshore account area; in general, IRS criminal investigations are increasing, and the pursuit of offshore targets is one reason. [5] New indictments have been returned recently against account holders connected to banks in Israel and India, and it is widely expected that criminal charges will soon extend to Americans with accounts in Asia. Enforcement against so-called "enablers" continues apace as well-these are the bankers, lawyers, fiduciaries, and investment advisors alleged to have assisted U.S. taxpayers in hiding money and other assets overseas. One prominent Swiss banker was arrested on holiday in Italy, and other bankers and advisors believed to have engaged in willful criminal conduct have been detained at the U.S. border. Tax practitioners in the U.S. who have assisted clients in hiding foreign accounts are also under scrutiny. [6]

Meanwhile, the DOJ still has more than a dozen Swiss banks under criminal investigation, and these cases will resolve themselves in indictments, or deferred or non-prosecution agreements, with a condition of such agreements likely being detailed disclosures from these banks about their U.S. customers, paving the way for more treaty requests to expose the identity of account holders.

IRS examinations

Notwithstanding budget pressures, the IRS continues to open and pursue civil audits of individuals with unreported offshore assets. These examinations have increased in severity. Agents have been instructed to look for cases in which the willful FBAR penalty can be assessed. FBAR penalties, however, are not self-enforcing; the DOJ must sue to collect. Last year, in a rare event, the DOJ filed a lawsuit in federal court in Florida to collect a 200% FBAR penalty (50% times four years of violations). 7 The case is pending, and more such cases are likely.

Because of a requirement that the DOJ file a collection lawsuit in the FBAR context, agents are on the look-out for civil penalties under the Code that require fewer administrative resources. Practitioners handling offshore exams have seen increased attention to penalties for failing to report foreign trusts and foreign corporations, as well as the use of special assessment procedures whereby penalties can increase absent filing after notification.

In another audit-related development, the IRS has become better able to detect so-called "quiet disclosures." When the IRS announced the OVDP in 2009, it made clear that it expected taxpayers with unreported offshore assets to use the OVDP "front door," rather than quietly file amended tax returns and/or FBARs (which had been the prevailing practice for decades). More than a few taxpayers elected simply to make their filings outside of the OVDP, hoping that the amended or delinquent forms would slip through unnoticed. The Service has begun to find these taxpayers. There may have been good and valid reasons for a taxpayer not entering the OVDP, but these audits can be intense, with agents at least starting the exam believing that the taxpayer acted improperly by electing not to do so.

The OVDP

The offshore disclosure program continues. The formula for such disclosures has become well known-a request for preclearance to ensure that the disclosure will be timely, the submission to the IRS Criminal Investigation Division of information about the pertinent accounts and other assets, and then an eight-year filing package with the payment of tax, interest, and penalties, including the omnibus 27.5% penalty for unreported foreign assets. There are limited other routes into formal disclosure, such as FAQ 17 and 18, for filing FBARs or other information returns when no income went unreported, or the "streamlined" procedure for a narrow class of non-filers residing abroad.

There have been rumors of changes to the OVDP. The IRS reserves the right to terminate it at any time, or to make certain classes of taxpayers ineligible, e.g., account holders at certain banks that may be the subject of DOJ enforcement action. Another issue drawing attention is IRS intransigence in the OVDP with regard to certain refunds in years that might close under ordinary limitations periods; many practitioners are beginning to file protective refund claims in many of their OVDP cases, and one can only imagine how the IRS will deal with the processing issues associated with such claims in connection with the already overburdened OVDP machinery.

On the other hand, practitioners have urged the IRS to simplify the program in order to save IRS resources, and to expand the "streamlined" procedure so that more non-resident Americans can easily come into tax compliance. Until the IRS announces any such new reforms, if it does so, noncompliant taxpayers have limited options, and OVDP participants are looking at about a year or more from initiation to closing agreement, with varying degrees of inspection and review of a disclosure package, sometime depending on which office-or which agent-is assigned to it.

2014 will also see increased attention to "opt outs." These are cases in which OVDP participants have decided to argue that their conduct was not willful, hoping to avoid the 27.5% offshore penalty. Such an election prompts a more intensive review of a client's disclosure. Anecdotal evidence is that the IRS is processing many of the opt-out cases so far on a fair and reasonable basis, but as more taxpayers choose this route, it will remain to be seen whether this remains the prevailing view.

Implications for 2014 filings

All of this suggests that taxpayers who have failed to report foreign accounts or other offshore assets or transactions remain at serious risk of enforcement activity. Tax practitioners who prepare returns have due diligence obligations to learn whether clients have to report such assets. Practitioners should be on the lookout for any signal from a client that there may be a foreign account, or that some other reporting may be required.

Beyond that, however, clients could be more likely to disclose previously unreported assets this year. They might have received contact from a Swiss bank participating in the DOJ Program as to an account they closed after 2008. A bank implementing FATCA may have reached out to them. A family member overseas may have made a disclosure in a country with a robust information exchange regime with the U.S. Or, the more traditional motives for making a disclosure of a previously unreported foreign asset may kick in-awareness from press reports, fear, guilt, or, among the elderly, a desire not to saddle their family with a mess upon their death.

If a client has a current filing obligation for any foreign account or asset, obviously, that obligation must be satisfied for 2013 filings. Continuation of noncompliance could be a new felony for all involved. What should a practitioner do, however, if a client has held back for many years in describing a foreign asset, but now suddenly wants to come to terms with it on the 2013 returns coming due? The following tips are suggested:

(1) Be mindful of privilege. There is generally no privilege for communications in connection with a

current filing. A client who describes a foreign bank account or asset for the first time to a return preparer in connection with a filing due for 2013, and who has not engaged in retrospective compliance efforts such as OVDP, instantly makes the return preparer a witness in any audit or investigation that might arise from prior non-reporting.

- () Moreover, except for **Section 7525** , **8** accountant-client communications are generally not protected as to prior year issues, and **Section 7525** does not apply in criminal cases. As most know, however, engagement by counsel under the "*Kovel* doctrine" can bring a tax preparer under the attorney-client privilege. **9**
- () Thus, accountants who are confronted during filing season with a first-time FBAR or other required disclosure for a current filing should instruct a client that if the account or asset has gone unreported in prior years, the client should seek tax counsel. A lawyer can advise under privilege whether some kind of retrospective compliance measure should be taken. Counsel can also work with the return preparer on current filings to minimize privilege waivers and seek to protect the client, if possible, from sanctions for prior noncompliance that may become visible given the required disclosures for 2013. This is especially the case if information about the client is likely to reach the IRS through some independent means, e.g., a Swiss bank participating in the DOJ Program.

(2) If a client (or any related entity) is already under audit and the issue of an undisclosed foreign account or asset arises, the client should be sent immediately to a lawyer, although it is not necessarily the case that the lawyer should assume control of the examination. This event raises the "eggshell audit" scenario, in which the tax practitioner might hope to resolve the examination without the foreign issue arising. Filing current year returns and other forms in these circumstances is fraught with peril-one cannot simply avoid filing, and yet an admission on a current return can implicate prior year noncompliance. In some circumstances, it might even be advisable for the client to assert the Fifth Amendment privilege on a tax return or other filing, to the extent lawfully allowed. **10**

(3) Non-filers present a special set of issues. There are large numbers of Americans living overseas who have not filed tax returns, thinking that their compliance in their home country (often with higher tax rates than the U.S.) should excuse them from reporting. This is of course not so-such persons-even "accidental Americans"-are obligated to file tax returns, FBARs, and other required information returns. Many such persons have been contacted by a Swiss bank, have received a FATCA letter from their financial institution, or are just waking up to the history of noncompliance. Practitioners obviously may not advise the client to persist in failing to file for 2013. While many of these cases entail little tax, the IRS is increasingly aggressive about imposing penalties, and the potential limitations period and penalty issues are magnified by the non-filings. Such clients should consult under privilege with tax practitioners to coordinate the prior year strategies with current deadlines.

(4) Family situations can create difficulties. Foreign parents often add their U.S. children to a bank account. A U.S. sibling may hold a power of attorney over a bank account held by a non-U.S. sibling, who has not reported that account to the country of his or her residence. A U.S. taxpayer may hold

stock in a foreign family business, or a holding company for real estate. A non-U.S. relative might die, leaving U.S. heirs standing to inherit funds not declared in a foreign country. Provisions of a non-U.S. trust might kick in, leaving a U.S. relation the beneficiary of a heretofore unknown sum. There are multiple ways in which families with a minimal U.S. footprint can find themselves in a mess. Practitioners should be on the lookout for these circumstances as well-each triggers both a potential current filing issue and the need to confront possible prior compliance failures.

(5) As an ethical matter, CPAs and lawyers are under a slightly different regime. Both types of professionals must advise a non-complying taxpayer as to the options for coming back into compliance and the consequences of not doing so. When a client is recalcitrant, CPAs must consider withdrawal rather than continue to prepare filings; lawyers may continue to represent the client, but many do not. **11** This problem, obviously, becomes magnified when the tax practitioner must at the same time confront a current year filing deadline. In these circumstances, practitioners might consult their own counsel or a colleague who has previously handled such an issue.

Conclusion

The U.S. government continues to pursue tax noncompliance relating to offshore assets. It is obtaining increased cooperation and access to information around the world. Many noncompliant taxpayers have cleaned up their situations over the past five years, but many others engaged in self-help or denial, hoping to escape having to pay tax, penalties, and interest. The walls continue to close in on such persons, and having to confront filings for 2013 could raise significant issues.

Tax practitioners should ensure that ethical and due diligence obligations are met in helping clients understand if they must report foreign accounts, assets, or transactions. When a client who has not complied in the past realizes that a looming deadline or possible disclosure from outside sources could result in the issue arising, the client will need sound advice from the tax practitioner on the current filing. Accountants and lawyers who prepare tax returns confronted with a disclosure from a client should instantly be on guard for privilege and other issues, and ensure that current filing deadlines are met consistent with the client seeking to resolve prior year compliance issues in an appropriate manner.

1

See, e.g., **Sections 7201** , 7206(1); 18 U.S.C. section 371.

2

See 31 U.S.C. section 5321(a)(5).

3

See **Sections 6038** , 6046, 6677(b), 6662(b)(7), 6662(j).

4

See **Section 6501(c)(8)** .

5

IRS Criminal Investigation Annual Business Report-2013 (2/24/14).

6

For an excellent summary of the offshore account cases brought to date, see: www.bloomberg.com/news/2013-11-01/offshore-tax-scorecard-ubs-credit-suisse-hsbc-baer.html.

7

Zwerner, No. 1:13-cv-22082-CMA (S.D. Fla. complaint filed 6/11/13).

8

The section creates the "federally authorized tax practitioner privilege," which extends the equivalent of the attorney-client privilege to non-attorney tax practitioners in some circumstances.

9

Kovel, **9 AFTR 2d 366** , 296 F2d 918, 62-1 USTC ¶9111 (CA-2, 1961).

10

See Michel, "Criminal Tax Investigations and Current Year Returns: New Thoughts on a Perennial Issue," 19 White-Collar Crime Reporter 1 (December 2004).

11

See Treasury Department Circular No. 230, 31 C.F.R. section 10.21 (2011); AICPA Statement on Standards for Tax Services, No. 7, Form and Content of Advice to Taxpayers, p. 27 (2009).