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US Foreign Tax Compliance – IRS "Carrot & Stick Approach"

The US Internal Revenue Service (IRS) is aggressively expanding its enforcement of US income tax laws against US taxpayers who have avoided their US income tax compliance obligations with respect to their offshore income or activities. As one example, on April 1, a US criminal complaint was issued and an arrest was made of a South Florida accountant who, through a British Virgin Islands nominee company, had control over and access to a previously undisclosed account with UBS in Switzerland. Apparently, this is the first criminal action following the recent disclosure by UBS of the names of a limited number of US persons with UBS accounts. The US government continues to aggressively pursue the names and accounts of another 52,000 US customers of UBS.

In addition to these efforts, President Obama's 2010 fiscal year budget proposal calls for the hiring of additional IRS personnel to vigorously and fully enforce the US tax laws against US persons with offshore activities. In fact, this area is viewed as a source of increased government revenue. As summarized below, if US persons fail to take advantage of the "carrot" recently announced by the IRS, the "stick" of aggressive IRS and US Treasury criminal enforcement and the assertion and collection of civil and criminal penalties will follow.

The IRS "carrot" was announced in three internal IRS memoranda publicly released on March 23, 2009. The essence of the "carrot" offered by the IRS is that US taxpayers must come forward prior to September 22, 2009; report their failure to comply fully with their US reporting and compliance requirements with respect to certain offshore income or interests; and pay the income taxes, interest and certain penalties that are due. Specifically, this new voluntary disclosure program has three key elements:

1. The taxpayer must file six years of amended or delinquent US income tax returns and reports,

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and pay the additional income taxes and accrued interest thereon. The delinquent reports could include, depending on the source of the unreported income, the Report of Foreign Bank and Financial Accounts (FBAR), which is used to report signature authority over or ownership of foreign bank or investment accounts; Form 5471, Information Return of US Persons With Respect to Certain Foreign Corporations, which is used to report income allocated from Controlled Foreign Corporations; Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, which is used to report distributions by foreign trusts to US persons; or Form 8621, Return by a Shareholder of a Passive Investment Company or Qualified Electing Fund, which is used to report income allocated from a Passive Foreign Investment Company.

2. The taxpayer must pay a 20-percent accuracy-related penalty for income previously omitted from a return or a 25-percent delinquency penalty for failure to file the return in question in a timely manner. One of these penalties must be applied to each of the six years in question, and "reasonable cause" may not be used as a defense against the imposition of the penalty.

3. The taxpayer must pay a one-time 20-percent penalty for the amount in either the foreign bank account or the undisclosed foreign entity based on the year with the highest potential penalty exposure.

There are two exceptions to these three elements. First, if the period of noncompliance is less than six years, the relevant period is limited to the period of noncompliance. Second, the 20-percent "special" penalty, described in (3), can be reduced to 5 percent if the taxpayer did not establish the foreign account or entity in question; the taxpayer has never withdrawn or received money from the foreign account or entity; and all US taxes have been paid on the funds in the account or foreign entity.

These requirements, especially the payment of two categories of penalties, may seem quite onerous to the taxpayer. However, a taxpayer who takes advantage of this voluntary disclosure program will avoid criminal penalties and civil fines, as well as additional penalties for not filing a supplemental or information return. For example, since October 22, 2004, the monetary penalty for the willful failure to file the FBAR is the *greater* of (i) US$100,000 or (ii) 50 percent of the balance in the account at the time of the violation. The penalty for a nonwillful violation is now US$10,000.

Existing voluntary disclosure programs, which permit taxpayers to make a preliminary, confidential no-name submission using their representative, are terminated with respect to such offshore activity. The new voluntary disclosure program is now the only one

available for foreign activities or interests of US taxpayers. Moreover, the IRS commissioner in his announcement of this new voluntary disclosure program made clear that IRS personnel are to use all of their available resources and enforcement authority to examine the foreign activities of US taxpayers and, if noncompliance is found, to assert all possible fines, interest and penalties, including criminal penalties where appropriate. Consequently, if a US taxpayer does not disclose past or current noncompliance prior to September 22, 2009, he or she may not be given any further opportunity to negotiate a settlement of these penalties.

Taxpayers who are considering use of this new voluntary compliance program need to consider several other important points. The program is not available to certain US taxpayers. Specifically, a taxpayer will not qualify for the program if the IRS has (i) already initiated a civil or criminal investigation of the taxpayer or one that will directly or indirectly involve the taxpayer; (ii) notified the taxpayer that it intends to commence such an examination; or (iii) received information from a third party regarding the taxpayer's noncompliance. Also, the program does not apply to any income related to criminal activities of the taxpayer. All applications under this program will be first submitted to the Criminal Investigation unit of the IRS to determine the taxpayer's eligibility. If the taxpayer is eligible, the matter will be referred to the Philadelphia Offshore Identification Unit for civil processing.

The program requires that the taxpayer make a full and complete voluntary disclosure. The taxpayer must assist the IRS in its investigation of offshore activities of other taxpayers and, more importantly, must disclose the persons who guided or assisted the taxpayer in his or her noncompliance activities. If a taxpayer refuses to cooperate with the IRS, he or she risks losing the benefits of the voluntary disclosure program after the taxpayer's own information has been disclosed.

Taxpayers who could possibly take advantage of the voluntary disclosure program include persons with dual citizenship who have not reported their worldwide income for US purposes; US taxpayers, especially resident aliens, who have not reported foreign-source income or interests in or over foreign bank accounts; and US taxpayers with indirect interests in foreign entities that could subject the US taxpayer to a US reporting obligation. Each taxpayer's situation is unique. We encourage taxpayers who believe that they could have potential liability to the IRS with respect to their offshore interests and who might benefit from the new voluntary disclosure program to seek professional US tax advice as soon as possible. Such persons should act promptly because disclosure must be made before the IRS identifies the taxpayer's noncompliance and in any event prior to September 22, 2009. There is no assurance from the IRS that this program will continue after that date.