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Foreign Bank Account Reporting (FBAR) - IRS Amnesty Program

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Was it a bad idea for some taxpayers to process their past years returns through the IRS voluntary disclosure program?

On October 15 of last year, the six month IRS "amnesty program" expired. In our comments below, we attempt to help our readers, or at least those still having concerns about the IRS program, evaluate the various options available.

Ever since the Service initially announced the special voluntary disclosure program in March 2009, there has been a lot of confusion about how the program would be administered. Advisors were instructing their clients up to the October 15 deadline, to sign up or face dire consequences. We've seen copies of various letters to the IRS with little more than the taxpayers name and social security number forwarded to the Service before the deadline expired. Our own view about the benefit of the program for many taxpayers was less than enthusiastic in part because there was a lot of uncertainty about IRS policy when it came to resolving penalties.

- If a taxpayer wished to participate in the program last year, the process initially started with the Criminal Investigations unit at the local level. If the case was determined not to fall into the criminal arena, it would be forwarded to Philadelphia for review where the tax, interest and penalties could be assessed. Tax criminals (those who knowingly hid income offshore to evade income tax) might have found this program to be a good deal from the financial side:
- If the unreported income was not from illegal activities (e.g. theft, money laundering or drugs) and as long as an investigation was not already underway, the taxpayer would not be prosecuted criminally. This was the general policy (in past years) before the 2009 program, and is still the policy today.

In lieu of fraud penalties of 75% of the tax due, and up to 50% of the balance in any foreign bank account that went unreported, the amnesty program replaced these penalties with a maximum 20% FBAR penalty. This often resulted in a huge savings.

Today, the 20% limitation no longer exists, so the criminal tax evader can now lose up to 50% of the balance in his or her foreign account in addition to other penalties. For the noncriminal types of taxpayers, which cover the vast majority of offenders, the benefit of processing through the program was much less clear. Take for example, an individual that had unreported income of a nominal amount. Assume a U.S. person with \$1,000,000 in their foreign account had interest income that was offset by a net loss on stock transactions in a brokerage account, so the net underreporting of income on their past returns was minor. While the actual income tax and related penalties would be zero, the taxpayer would now face a potential \$200,000 penalty (20% of the highest value in their account) for the FBAR penalty.

We saw situations where inherited funds were in foreign accounts because they were still being managed by the family's advisors in their home country. Even though taxes were paid in the foreign country, U.S. reporting of worldwide income was still mandatory. In several situations

we calculated that U.S. taxes due were minor, especially after factoring in the foreign tax credit that would offset the U.S. tax liability. However, the 20% FBAR penalty results in a huge penalty when compared to how the Service administered the voluntary disclosure program in the past. In past years, the FBAR penalties would generally be limited to \$10,000 per account per year.

There are two reasons that noncriminal taxpayers might have considered processing through the program:

1. Penalties. While not explicitly stated by the IRS, as a general policy, the Service could impose the maximum FBAR nonreporting penalty of 50% across the board on those offending taxpayers not in the program.
2. Fear. Unfortunately, many advisors became too enthusiastic that their client's name was going to appear on "the list", referring to the list of U.S. persons with accounts in Swiss Banks. It almost felt like McCarthy era references to Americans on a list.

We heard comments from advisors such as:

- "The IRS has a list of every U.S. person with a Swiss Account."
- "If you're on the list, you're toast if you don't sign up for the amnesty program."
- "If you don't agree to allow the Swiss Bank to turn over your tax information to the IRS, for sure, you'll be charged with criminal tax evasion."

Taxpayers intimidated by such comments like the above were eager to throw themselves under the bus. After all the hoopla, the Swiss banks, the Swiss Government and the IRS are still waging war in the courts over providing the list of U.S. persons with Swiss accounts.

For taxpayers that signed up for the voluntary disclosure process, they're fully committed, and in a queue of sorts like waiting at the DMV for their number to come up. We've had discussions with the IRS about the timeline to process these cases. Not many have been processed to date, so we can't offer any real certainty on this point.

For taxpayers that did not sign up for the program last year, they still face the question of how best to proceed. The following comments address this issue. There is a difference in whether the unreported income is in a Swiss Bank or not.

If you have unreported income in a non-Swiss institution and have not filed the necessary information on Treasury Form TD 90-22.1, the following considerations need to be reviewed with your advisor:

- Income tax considerations: If you amend your return to report such income, you will owe the additional tax. Interest and penalties will be assessed.
- Statute of limitations: In general, there is a three year statute from the time of the initial return filing in which the IRS can initiate an audit. If more than 25% of gross income is unreported in your return, the statute is extended for an additional three years.

If your return is not selected for audit, then the whole matter would seem to disappear. Are you required by law to amend your return? There is no statute on point so taxpayers are not continuing to violate the law if they choose not to amend their past years' returns. The basic reason for amending a return is to stop the running of additional interest in the event one's return is audited and additional tax is assessed. If the taxpayer mistakenly omitted foreign income from his or her returns, but didn't knowingly file a false return, and the amounts of omitted income are not significant, then it's highly unlikely that there are criminal risks to be concerned about. It's more about the risk of doing nothing and letting the statute run, or

deciding to file amended returns. Since there are no penalties for filing late FBARs, it's strongly recommended that delinquent FBARs are filed even if amended tax returns are not filed.

From our recent discussions with the IRS, we understand that the Service will flag amended returns for further review if they report income from offshore accounts. This is where the current IRS policy gets muddy. If a "quiet filing" as they are referred to, is selected for audit and it's determined that the FBAR was not timely filed, the Service may impose the full 50% FBAR penalty. In our discussions, we pointed out that their FAQ 15 that was released last year specifically states that the limit on the FBAR penalty for "nonwillful" situations will be limited to \$10,000. However, the Service appears to be taking a narrow view that except in the most extreme situations, nonfiling of FBAR is by default, willful, so the 50% penalty should apply.

Why, we asked, would anyone file an amended return if the IRS is going to view all nonfilings of FBARs as willful? This is inconsistent with IRS policy in the past, and at best, it's misleading when the FAQ above gives the impression that the \$10,000 limit would apply. There appears to be no brightline test dealing with this matter, so until the IRS clarifies how the FBAR penalty will be determined, the risk of a 50% FBAR penalty is a significant problem. This policy seems to be at odds with encouraging taxpayers to bring their returns into compliance. As a practical matter, since taxpayers in the 2009 program will be subject to a 20% penalty, the likely approach of the Service would be to impose the same standard on taxpayers that amend their returns today who are not in the 2009 program. However, in our view, taxpayers with FBAR issues would be ill advised in noncriminal situations to amend their returns until this matter is clarified.

We also understand that whenever FBAR violations exist, the local district audit procedures require review at higher levels to insure that penalties for FBAR violations are assessed on a consistent basis.

For taxpayers with funds in Swiss banks, the issue is more complex. Filing amended returns may result in having the returns flagged for review. Doing nothing means a "wait and see" regarding the continuing battle being waged by the Service against the Swiss government. Will the consequences be worse by doing nothing? We can't say for sure.

Today, some taxpayers are regretting their decision to go into the voluntary disclosure program. One can withdraw from the program by formal request. If a taxpayer withdraws from the program, their case will be sent to the local district and will be subject to a full audit. Why would one consider withdrawing from the program? Assuming there are no criminal concerns, if the taxes due are not significant, and the balance in the foreign account is also minor in amount, there doesn't seem to be any reason to remain in the program unless there are other risk issues in the returns.

We inquired about procedures for withdrawing from the program. The Philadelphia office which oversees the civil side of this program is considering issuing comments on this subject.

Summary

The voluntary disclosure program has been around for many years, and is still in existence today. It's still a viable option in situations where there is potential criminal exposure.

The amnesty program that expired in October provided certain guarantees regarding lower penalties for nonfiling of FBARs, but guidelines were lacking in detail regarding activities of the taxpayer and when the higher or lower penalties would apply. Many taxpayers had relatively little activity in their foreign accounts, and very little taxes to pay. Rather than process their delinquent taxes through the normal filing of returns, they had to engage criminal counsel to process through the Service's amnesty program.

So while the Service encouraged taxpayers to "come in from the cold", they placed significant cost burdens on taxpayers that wished to participate in the program.

The IRS crafted the 2009 amnesty program in such a way that accountants could no longer represent or assist taxpayers whenever foreign accounts were in question because the amnesty program required all persons to first be cleared through the criminal investigation group within the IRS, even for relatively small amounts of tax. Forcing all taxpayers to hire criminal counsel as the only way to initiate contact with the IRS was an absurd requirement for many taxpayers. The uncertainty about the magnitude of penalties that would be assessed also discouraged many taxpayers from participating in the program. The result was that only a fraction of the taxpayers eligible to participate chose to go this route. For some, this was a wise choice.

High risk tax offenders with the potential of criminal prosecution and dire consequences might take note of WC Fields who once commented "On the whole, I'd rather be in Philadelphia".

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