The Trouble with Foreign Financial Accounts

Your Client Tells You About an Offshore Account, but the IRS Voluntary Disclosure Window Has Closed

By Marla Carew and Eric Nemeth

Introduction

By the time this issue of the *Michigan Bar Journal* is published, summer vacations and back-to-school season will be distant memories. Some practitioners will realize too late—or only realize as they read this article—that one or more of their clients missed the September 23, 2009 closing date for the IRS's foreign financial account Voluntary Disclosure Initiative. Now what? Does this really matter for Michigan taxpayers?

Disclosure of foreign bank accounts matters for all taxpayers. In April 2009, the IRS filed criminal charges against a UBS client, who subsequently pled guilty, for attempting to evade taxation by failing to disclose more than $3 million in assets held in a Swiss bank account. While this might seem to affect only wealthy taxpayers, increased IRS enforcement of foreign account disclosure is and will continue to be widespread. While UBS client Steven Rubenstein, a Florida yacht broker, had the wherewithal to attempt to shield approximately $3 million in assets, he was charged with the familiar offense of filing a false tax return after IRS examination of his 2007 Form 1040 revealed that he had neglected to disclose his interest in, or signature authority over, an account in Switzerland.[1] In addition to the ongoing investigation of UBS clients, the government has signaled that it intends widespread enforcement of foreign account disclosure rules.[2] "Some United States taxpayers are evading billions of dollars per year in United States taxes through the use of offshore accounts," stated John DiCicco, acting attorney general for the Department of Justice Tax Division.[3] "The IRS will not hesitate to use all the tools available to combat offshore tax evasion by individuals and businesses," added IRS Deputy Commissioner for Services and Enforcement Linda Stiff.[4]

Fast Facts:

- Federal law requires all U.S. taxpayers with "financial interests" or signature or other authority in foreign financial accounts with an aggregate value *exceeding $10,000* at any time during the calendar year to disclose the same to the IRS.
- The stated objective of the Voluntary Disclosure Initiative was to "bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws."
- Attorneys must tread carefully if approached by a potential client or contacted by an accountant with an "offshore problem."

Guidance Following the Voluntary Disclosure Deadline

How might a Michigan practitioner encounter foreign bank account disclosure issues, and what must he or she do in the wake of the closed Voluntary Disclosure Initiative? The answer will depend on the facts of each situation. An individual who did not know and had no reason to know of a foreign financial account over which he or she had signatory authority will deal with a much different response from the government than someone who had either legal or illegal sourced income and controlled and operated a significant foreign account.

A likely scenario is an individual with family from the "old country" that established a foreign bank account for a variety of reasons (e.g., ease of travel, sentimental reasons, or legitimate business reasons). Long ago, a relative might have put your client on the account (think probate avoidance), but did not tell the client. The income, if any, was not earned by the client. One day, your client learns of the account because of a family death or similar situation.

The polar opposite is the person who knowingly and intentionally maintains one or more foreign bank accounts and not only did not disclose the accounts, but also did not report the income. This client looks for advice either because the foreign financial institution now is turning over the information to the U.S. Treasury Department or, worse yet, the client has been contacted by the IRS.

The Procedure for Foreign Account Disclosure and Current Compliance

Federal law requires all U.S. taxpayers with "financial interests" or signature or other authority in foreign financial accounts with an aggregate value *exceeding $10,000* at any time during the calendar year to disclose the same on form TD 90.221, the Report of Foreign Bank and Financial Accounts or "FBAR." In such cases, the FBAR must be filed annually by June 30 with the United States Treasury IRS Computing Center in Detroit.[5] Extension of the time to file an annual tax return *does not* extend the FBAR deadline.[6]

This disclosure is not limited to individuals. Partnerships, corporations, consolidated groups, and fiduciary or other taxpayers must disclose foreign accounts when the aggregate value of such accounts exceeds the disclosure threshold. The process of disclosure is twofold: the taxpayer (1) checks the box for interest in a foreign account in its annual tax return and (2) completes the FBAR and files it with the Detroit Computing Center. Failure to file the FBAR when required subjects taxpayers to a range of penalties that may, in the case of willful violations, be as high as the greater of $100,000 or 50 percent of the balance in the account at the time of the violation.[7]

The terms "financial account," "financial interest," and "signature or other authority" that trigger the disclosure rules and the filing of annual FBARs are broad and will affect many more taxpayers than a cursory review of the terms would suggest. According to the instructions for Form TD 90-22.1, "financial accounts" are a broad category including bank, securities, derivatives, and other financial instrument accounts; accounts in which investments are held in a commingled fund; and savings, demand, checking, time deposit, or other accounts with financial institutions.

A "financial interest" occurs when:

- A United States person (itself a broad term, not limited to individual taxpayers) is the owner of record or has legal title over an account, whether the account is maintained for the person's benefit or not;
- A United States person's agent, nominee, or attorney, or corporation in which the person owns directly or indirectly more than 50 percent of the total votes or value of stock, or a partnership in which the person owns an interest in more than 50 percent of profits or capital, or a trust in which the person has a direct or indirect present beneficial interest in more than 50 percent of the assets or from which the person receives more than 50 percent of the current income, is the owner of record or holder of legal title; or
- A United States person or another person acting on his or her behalf established a trust for which a trust protector has been appointed and the trust is the owner of record or holder of legal title to the account.[8]

A person has "signature authority" over an account if he or she may control the disposition of money or other property in it by delivery of a signed document. "Other authority" exists when a person can exercise power comparable to signature authority over an account by communicating with the bank or account holder directly, indirectly, orally, or by other means.[9]

History of the FBAR, Current Compliance, and the 2009 Voluntary Disclosure Rules

The Bank Secrecy Act of 1970 (BSA) gave the Department of Treasury authority to issue regulations requiring filings and recordkeeping by financial institutions and other persons if useful for tax, criminal, and other matters or to implement programs and procedures to combat money-laundering.[10] Section 5314 of the BSA authorizes the secretary of the Treasury to require citizens and residents of the United States to keep records or file reports or both regarding transactions with foreign financial agencies. Under this authority, the secretary promulgated a regulation at 31 CFR 103.24, which states:

> (a) Each person subject to the jurisdiction of the United States (except a foreign subsidiary of a U.S. person) having a financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country shall report such relationship to the Commissioner of the Internal Revenue for each year in which such relationship exists, and shall provide such information as shall be specified…by the Secretary….

The FBAR is the form proscribed by 31 CFR 103.24. Once filed with the IRS's Detroit Computing Center, it is input into the BSA financial database and becomes available to the IRS and Department of Treasury Financial Crimes Enforcement Network (FinCEN) for analysis and use in tracking flows of money.[11] The secretary of the Treasury delegated to the IRS the authority to investigate violations of 31 CFR 103.24;[12] the IRS Criminal Investigation Division analyzes failures to file for possible criminal investigation, while traditionally, FinCEN retained the right to pursue civil enforcement of non-criminal failures to file.[13]

While filing of an FBAR for taxpayers meeting the test of a "financial interest" in a foreign bank account exceeding the threshold amount has been required since 1991, compliance has not always been widespread. In calendar year 1991, 116,600 FBAR forms were filed with the Detroit Computing Center,[14] while in calendar year 2008, approximately six years after the Department of Treasury instituted a post-9/11 Patriot Act initiative to increase reporting of foreign financial accounts, 344,967 FBAR forms were filed.[15] Although Treasury was motivated immediately after 2001 to increase FBAR reporting enforcement in an attempt to identify foreign financing of terrorist activities,[16] more recently the UBS tax shelter prosecutions have increased Treasury awareness of the "tax gap" attributable to use by tax evaders of sophisticated means, including shelters and offshore accounts, to attempt to hide previously untaxed income from the IRS.[17]

The IRS terminated its "Last Chance Compliance Initiative" for voluntary disclosure of undisclosed foreign financial accounts on March 23, 2009,[18] and issued a list of 30 frequently asked questions (FAQs) on its website dealing with the close of the disclosure window and drop-dead date of September 23, 2009 for taxpayers who had previously failed to file FBARs or made "quiet disclosures" via amended returns.[19] On March 26, 2009, the IRS released comments from Commissioner Doug Shulman on offshore accounts, announcing voluntary disclosure of undisclosed interests and authority of foreign financial accounts. Shulman stated:

> [W]e draw a clear line between those individual taxpayers with offshore accounts who voluntarily come forward to get right with the government and those who continue to fail to meet their tax obligations….[W]e have also provided guidance to our agents who have cases of unreported offshore income…we are instructing our agents to fully develop these cases, pursuing both civil and criminal avenues….For taxpayers who continue to hide their head in the sand, the situation will only become more dire.[20]

The voluntary disclosure allowed taxpayers to pay back taxes and interest for six years with reduced penalties (accuracy or delinquency on each year plus 20 percent of the amount in the account for the year with the highest aggregate account or asset value). The 30 FBAR FAQs discuss the criminal and civil penalties that await taxpayers who failed to come forward before September 23, 2009, documents needed for full disclosure and recordkeeping, and more immediate matters such as contact information for the March 23–September 23, 2009 "last chance" period.

Undisclosed Foreign Financial Accounts after the 2009 Voluntary Disclosure Initiative

By the time Michigan practitioners read this article, it will be too late to qualify for voluntary disclosure and the reduced penalty regime for undisclosed foreign financial accounts. However, in addition to getting and keeping clients compliant with the FBAR filing rules, the May 2009 FAQs offer practitioners some guidance for how to proceed in 2010 and beyond with undisclosed or "quietly disclosed" offshore accounts.

The individual foreign account is the mythical Hydra that the tax controversy practitioner must attempt to slay. The potential pitfalls of such accounts are enormous. There is tax due and owing on unreported income. The IRS will likely assert the 75 percent civil fraud penalty, plus interest on the tax and penalty. The penalties for failure to file the FBAR will be asserted for each year in which the FBAR was not filed. The combination of those two items is likely to be a multiple of the income evaded in the first place. Each head on this mythic beast is more frightening to clients than the one already seen (or slain).

Beyond the financial pain for an undisclosed foreign bank account, significant criminal penalties are likely. Each tax return on which the individual did not "check the box" on Schedule B, Part

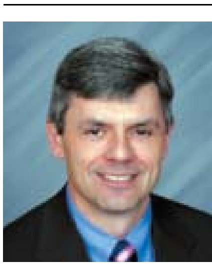
III to disclose a foreign bank account may be grounds for a false return charge—a three-year felony—pursuant to 26 USC 7206(1). If the proper criteria are present, the charge could be elevated to tax evasion—a five-year felony—pursuant to 26 USC 7201. The worst-case scenario could include significant prison time *plus* tax, penalty, interest, and fines.

The length and frequency of prison terms for financial crimes continue to increase. The government has established an impressive string of high-profile convictions (including guilty pleas) of tax shelter promoters and other sophisticated white-collar defendants, including former partners at major accounting and law firms. Furthermore, because of the presence of offshore money, courts have historically denied bail to such offenders because of the "perceived flight risk."

Attorneys must tread carefully if approached by a potential client or contacted by an accountant with an "offshore problem." While the recent special disclosure program featuring reduced penalties has ended, long-standing strategies (including traditional voluntary disclosure) and opportunities to mitigate or address taxpayer problems continue to be useful. An enduring practitioner goal remains to "keep a civil case civil." Individuals who can establish they did not know or have reason to know of an undisclosed foreign account will still have opportunities for a reasonable resolution with the IRS. The stated objective of the Voluntary Disclosure Initiative was to "bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws."[21] That language suggests that proper factual development could provide a viable defense to the onerous civil and criminal sanctions for those who continue to utilize undisclosed and untaxed foreign accounts.

The world is getting smaller and faster. Electronic transactions leave trails. Informants and other compliance checks make hiding money harder and much more risky. The IRS has its mandate from Congress and the executive branch to get the money. Clients and practitioners alike should take them seriously. ■

Marla Carew focuses her practice at Varnum Riddering in federal, state, and local tax law, including tax controversy and tax planning, and has experience in corporate, mergers and acquisitions, securities, and general business law. She is also a frequent speaker on both federal and state tax issues. She is a graduate of the University of Michigan Law School and holds an LL.M. in taxation from Wayne State University Law School.



Eric Nemeth is a partner at Varnum concentrating on tax and financial controversy (IRS and various states) from examinations, appellate conferences, criminal investigations, witness representation, and civil and criminal tax litigation. He works with government regulatory and general tax matters. He has served as senior trial attorney for the District Counsel of the Internal Revenue Service and as special assistant U.S. attorney for the U.S. Department of Justice.

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FOOTNOTES

1. Department of Justice Press Release 09-296, *UBS Client Charged with Filing False Tax Return* (April 2, 2009), available at <http://www.justice.gov/opa/pr/2009/April/09-tax-296.html>; Department of Justice Press Release 09-344, *UBS Client Pleads Guilty to Filing False Tax Return Hid Assets Worth $3 Million in Secret Swiss Bank Account* (April 14, 2009), available at <http://www.justice.gov/opa/pr/2009/April/09-tax-344.html>. All websites cited in this article were accessed November 11, 2009.
2. Department of Justice Press Release 09-349, *Department of Justice Asks Court to Serve Summons for Offshore Records* (April 15, 2009), available at <http://www.justice.gov/opa/pr/2009/April/09-tax-349.html>.
3. *Id.*
4. *Id.*
5. Internal Revenue Service, Instructions to Form TD F 90-22.1 (Rev. October 2008), available at <http://www.irs.gov/pub/irs-pdf/f90221.pdf>.
6. *Id.*
7. Internal Revenue Service, Internal Revenue Manual 4.26.16.4, *FBAR Penalties* (July 1, 2008), available at <http://www.irs.gov/irm/part4/irm_04-026-016.html#d0e529>.
8. *Id.*
9. *Id.*
10. Titles I and II of PL 91-508, 84 Stat 1114, as amended, codified at 12 USC 1829b, 12 USC 1951 through 1959 and 31 USC 5311 through 5330. The regulations implementing Title II of the Bank Secrecy Act appear at 31 CFR Part 103.
11. United States Treasury, *A Report to Congress in Accordance with § 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)* (April 26, 2002), available at <http://www.ustreas.gov/press/releases/reports/fbar.pdf>.
12. United States Treasury, Treasury Directive 15-41, *Bank Secrecy Act—Internal Revenue Service* (December 1, 1992), available at <http://www.ustreas.gov/regs/td15-41.htm>.
13. United States Treasury, *A Report to Congress*, n 11 *supra* at 4–5.
14. *Id.* at 6.
15. United States Treasury, *Financial Crimes Enforcement Network Annual Report: Fiscal Year 2008*, p 6, available at <http://www.fincen.gov/news_room/rp/files/YEreport/FY2008/>.
16. United States Treasury, *A Report to Congress*, n 11 *supra* at 11.
17. Department of Justice Press Release 09-344, n 1 *supra*.
18. Internal Revenue Service, Memorandum on SB/SE and LMSB Offshore Examination Cases (March 23, 2009), available at <http://www.irs.gov/pub/newsroom/memorandum_on_sbse_lmsb_offshore_examination_cases.pdf >; Memorandum on Routing of Voluntary Disclosure Requests (March 23, 2009), available at <http://www.irs.gov/pub/newsroom/memorandum_on_routing_of_voluntary_disclosure_cases.pdf> and Memorandum Authorizing Application of Penalty Framework (March 23, 2009), available at <http://www.irs.gov/pub/newsroom/memorandum_authorizing_penalty_framework.pdf>.
19. Internal Revenue Service, *Frequently Asked Questions* (May 6, 2009), available at <http://www.irs.gov/pub/irs-news/faqs.pdf>.
20. Internal Revenue Service, *Statement from IRS Commissioner Doug Shulman on Offshore Income* (March 26, 2009), available at <http://www.irs.gov/newsroom/article/0,,id=206014,00.html>.
21. Internal Revenue Service, *Frequently Asked Questions*, n 19 *supra* at 1, question #2.