

NAVIGATING VOLUNTARY DISCLOSURE IN THE WAKE OF THE GOVERNMENT'S
ASSAULT ON UNDISCLOSED FOREIGN ACCOUNTS

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Introduction

A rash of recent events makes clear that the DOJ and IRS are targeting, like never before, business and individuals engaged in sheltering assets and income in undisclosed foreign bank accounts. In the past year, the DOJ has brought criminal charges against individuals who allegedly recruited and facilitated the establishment of undisclosed foreign bank accounts for the purpose of evading U.S. tax obligations, and it has also recently sought to expand the scope of the money laundering statute to encompass tax evasion and thus significantly increase the tools and leverage at its disposal in pursuing offshore tax evaders.

Most notably, on February 19, the day after announcing a deferred prosecution agreement with UBS that included a \$780 million payment by UBS to settle the investigation into its role in facilitating offshore evasion, the DOJ filed a summons enforcement action in federal district court in Miami seeking the disclosure of the identities of the owners of 52,000 Swiss-based UBS account accounts holding an estimated \$15 billion in cash and securities. The DOJ has threatened to bring criminal charges against individual account holders who are uncovered during these summons enforcement proceedings, and it is only a matter of time before the government pursues similar strategies against other tax havens in the Caribbean and elsewhere, as the IRS Commissioner, Doug Shulman, has promised to make offshore tax evasion a centerpiece of the IRS's enforcement efforts.

These recent developments make clear that the thousands of U.S. citizens holding foreign accounts are at risk of significant civil and criminal liability. John DiCicco, Acting Assistant Attorney General for the DOJ Tax Division, recently warned that it is "time for those who are trying to hide from the IRS to rethink their actions," and IRS Commissioner Shulman urged taxpayers to "talk to a tax professional and come forward under our voluntary disclosure process [because] [h]aving the IRS find you could mean a much heavier price than coming forward on your own."¹

The government's high-powered assault on the holders of Swiss bank accounts raises a host of interesting and complex legal questions regarding the interplay of U.S. and Swiss law and treaties. Swiss banks maintain that compliance with the IRS requests for lists of account holders would improperly force employees to violate Swiss law, which criminalizes the disclosure of account-holder information unless there is evidence of tax fraud (as opposed to

¹ February 19, 2009 Department of Justice Press Release, <http://www.usdoj.gov/opa/pr/2009/February/09-tax-139.html>.

merely tax evasion). It is likely that the interplay and inconsistency between U.S. and Swiss criminal laws will have to be resolved by federal courts, and potentially the U.S. Supreme Court.

But for now, the most pressing and nettlesome question confronting practitioners is how to advise clients wishing to become tax compliant and considering coming forward under the IRS's voluntary disclosure program, which allows individuals to lessen the odds of criminal prosecution for past non-reporting, provided they meet certain criteria. Should these individuals seek to participate in the IRS's voluntarily disclosure program, and, if so, what is the most effective means of making such disclosures? Not surprisingly, the answers to these thorny but important questions depend greatly on the factual circumstances present in each case.

Potential Criminal and Civil Penalties

Before considering these questions, it is important to understand the types of criminal and civil liability such account holders could be facing for having failed to report foreign financial accounts and the income derived from them.

On the criminal side, there are the usual penalties for tax evasion and for the willful filing of a false income-tax return, which can range up to five years imprisonment and \$500,000 per fraudulent return. For willful failures to file a foreign-financial account report -- a Form TD F 90-22.1, commonly known as an "FBAR" -- or to correctly report information on that report, or to keep required records, the maximum criminal penalty is a fine of \$500,000 or ten years in prison, or both. The limitations period upon criminal charges is five years from the date of the violation. An FBAR filing violation occurs on June 30th of the year following the calendar year to be reported.

On the civil side, there are myriad penalties. For a violation of the income-tax reporting requirements, there is a fraud penalty of 75 percent of the tax that was evaded. A penalty of 20 percent of the amount of the underpayment is applicable for income-tax reporting failures that are negligent but not fraudulent. For failures to file a Form TD F 90-22.1 or to keep related records that are willful and that occurred after October 22, 2004, penalties can reach the greater of \$100,000 or 50 percent of the balance in the account at the time of the violation for willful violations. These Penalties apply for each year of each violation, and the 75-percent tax penalty for fraud has no limitations period.

The IRS's Voluntary Disclosure Practice

As noted, IRS Commissioner Shulman has invited persons with unreported foreign accounts to come forward quickly and avail themselves of the IRS's Voluntary Disclosure Practice. That practice is described in the Internal Revenue Manual. The Practice has a bearing upon whether the IRS will conduct a criminal investigation and recommend that the Department of Justice

should commence a criminal prosecution. The Practice is not designed to address the IRS's discretion whether to impose civil tax or FBAR penalties.

The Internal Revenue Manual states that a voluntary disclosure made by a taxpayer will be considered by the IRS along with all other factors in the investigation in determining whether a criminal prosecution will be recommended to the Department of Justice. The Internal Revenue Manual is quick to add that the Practice creates no substantive or procedural rights as it is simply a matter of internal IRS practice, provided solely for the guidance of IRS personnel.

Voluntary Disclosure does not apply to taxpayers with illegal source income. A Voluntary Disclosure occurs when the taxpayer's disclosure of the unreported liability is truthful, timely, complete, and when (a) the taxpayer has shown a willingness to cooperate (and does cooperate) with the IRS in determining her correct tax liability and (b) the taxpayer makes good faith arrangements to pay in full to the IRS the tax, interest, and any penalties determined to be applicable.

Importantly, a disclosure is considered to be timely if it is received at a time when the IRS has not yet received information from a third party alerting the IRS to the specific taxpayer's noncompliance or has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer. Possible ambiguity over whether these elements were present and thus preclusive with regard to the owners of the 52,000 UBS accounts was apparently clarified by Commissioner Shulman's statement on February 19, 2009, that the Voluntary Disclosure Practice would be available if the account holders voluntarily come forward.

Navigating the Voluntary Disclosure Practice

Given the aggressiveness of the IRS's enforcement efforts and the severity of the potential criminal and civil penalties involved, participation in the IRS's Voluntary Disclosure Practice should be carefully considered by any non-compliant taxpayer. Before advising such a client regarding this program, any practitioner would be well-served to take the following steps:

- Conduct Thorough Due Diligence: The potential stakes and the fact-sensitive nature of the inquiry dictate that the practitioner obtain a complete and accurate understanding of the facts. First, it is important to determine the scope of the problem – the number of years involved, the size of assets, the number of taxable events and whether acts of concealment, falsification of documents, or other potential badges of fraud are involved. All of these issues are critical to assessing potential criminal and civil exposure. Second, it is critical to pressure-test the client's story. Participation in the Voluntary Disclosure Practice will most likely require responding to IDRs, producing documents, and submitting to interviews. Not only can such subsequent fact-finding interfere with your goals when making the Voluntary Disclosure, but misstatements during this phase can, and often are, the grounds for subsequent criminal prosecution. You cannot take your client's word; you need to obtain records from the bank, examine passports, and talk to the tax preparer. If, for example,

your client has made frequent and regular trips to Switzerland and Lichtenstein, the IRS may be less likely to accept his or her story of careless neglect. Third, you need to keep abreast of the quickly evolving legal landscape involving the interplay between the privacy laws of other jurisdictions and U.S. laws. A significant IRS victory on any of these issues will make the IRS less likely to agree that your client satisfied the “timely” element of the voluntary disclosure program. No one has a crystal ball, but if your client is inclined to participate, delay could have serious costs. On the other hand, if the IRS is on the ropes in these enforcement proceedings, will it be more likely to issue another Last Chance Compliance Initiative or a global settlement offer? If so, you need to determine whether your client would be likely to qualify for these programs.

- Carefully Analyze Potential Criminal and Civil Liability: In many scenarios, particularly those involving inherited accounts, the potential tax liability and civil penalties is a far more realistic and onerous threat than criminal prosecution. As noted above, however, a taxpayer has to agree to pay all tax, interest, and penalties to take advantage of the Voluntary Disclosure Practice. The potential civil penalties could be draconian and could, in fact, far exceed the total value of the assets held in the undisclosed account. That is particularly true if your client failed to file the required FBAR for a number of years, or is potentially subject to civil fraud penalties, which are not bound by any statutes of limitation. There is no point in rushing in to negotiate a tax liability and penalty package that your client cannot or will not pay, particularly when the risk of criminal prosecution is low. The IRS believes there are hundreds of thousands of taxpayers who have failed to disclose foreign accounts, many thousands of whom did so willfully. The IRS does not have the resources to prosecute every willful evader, and the risks of prosecution, even in cases of willfulness, will vary depending on such factors as the scope and duration of criminal conduct, the amount of the delinquent taxes, the deterrent value, and the prosecuting district.
- Evaluate Disclosure Options: There are two ways to disclose the existence of foreign accounts and income: “quiet disclosure” or “noisy disclosure.” Quiet disclosure involves simply filing amended returns with the appropriate IRS service center and filing in Detroit the necessary FBAR forms that disclose the account and state the reason for the prior non-disclosure. An amended return will typically be examined by CID for potential prosecution and/or participation in the Voluntary Disclosure Practice. If CID is not interested in pursuing a criminal investigation, the matter will be referred to IRS Exam for a civil audit. On the other hand, a “noisy disclosure” involves contacting someone responsible for making a decision on prosecution – i.e., a senior representative of CID or a responsible person in the local U.S. Attorney’s office -- to explore, on an anonymous basis, the potential applicability of the Voluntary Disclosure Practice. This noisy approach should be through an attorney who will gauge the chances that the client will be allowed to participate in the disclosure program before any identifying information is provided. If accepted for Voluntary Disclosure, the taxpayer will cooperate with Exam representatives to determine all liabilities for taxes, interest, and civil penalties, which liability will then be memorialized in an issue-specific IRS closing agreement.

- Balance Delayed Closure Against Intangibles Such as Peace of Mind: Perhaps the most prominent advantage of noisy disclosure is that it has the potential to bring closure. Although neither the DOJ or IRS will grant amnesty or immunity as part of this program, taxpayers can be assured that issues covered in the closing agreement with the IRS will not be subject to criminal prosecution. The quiet disclosure route, however, provides less immediate feedback and less certainty. It is possible a case will get hung up in CID, and the taxpayer will hear nothing. Or the return could have fallen through the cracks, or on a back burner. However, the risks of any disclosure are not insignificant, and are accelerated and magnified with noisy disclosure. You are putting your client squarely in the IRS's sights, and any inconsistencies or false statements can be fatal to an effort to avoid prosecution. What is worse, they can provide an independent ground for criminal prosecution. In addition, disclosure provides no protection of on-going or unrelated tax issues that could arise during the subsequent examination. On the other hand, doing a correct current filing (which a non-filer is obliged to do if the non-filer's accounts had an aggregate maximum balance of more than 10,000 dollars in 2008) may raise a red flag if corrective back filings are not also done -- perhaps prompting the IRS to view all past non-filings as willful for FBAR penalty purposes.
- Minimize Risk: To the extent possible, an attorney needs to carefully control the disclosure process and his or her client to minimize these risks. Disclosure statements should be kept as brief as possible, and the attorney needs to be diligent to ensure that every statement is accurate and supported by documents, if possible. The attorney-client privilege should also be carefully protected. If an accountant is to be involved in the process, that process needs to be cloaked with protections designed to comply with the *Kovel* case, which allows for the protection of accountant work product designed to assist an attorney.

Finally, we must emphasize that the IRS will presumably “pull the plug” on the availability of the Voluntary Disclosure Practice if it secures a victory in the summons-enforcement case in either the district court or the Eleventh Circuit. According to the current schedule, it is likely that the district court will issue a decision this summer. Thus, decisions regarding participation in the Voluntary Disclosure program – as difficult and unattractive as they may be – need to be made quickly.

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