

## Undisclosed Foreign Accounts: Time to Come Clean? IRS Partial Amnesty Deadline Looming

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The IRS has announced a partial amnesty program for taxpayers with undisclosed foreign accounts. This may present an opportunity for those who have not been reporting their foreign income, but it also raises some serious questions and presents challenges for taxpayers and their advisers.

U.S. citizens and residents are subject to U.S. tax on their world-wide income. There are very strict rules requiring reporting of foreign accounts, and there are draconian penalties for failure to comply with annual information reporting requirements on foreign accounts. The new IRS Voluntary Disclosure Program substantially eases the penalties for past failures to report foreign accounts, but in order to qualify corrected returns and information must be filed with the IRS by September 22, 2009.

### NO SECRETS TO CONCEAL

Recent IRS litigation against UBS discovered that there are over 52,000 U.S. persons with \$2.4 billion in "secret" Swiss accounts held by UBS. There are tens of thousands of U.S. persons holding foreign accounts with other financial institutions and in other tax haven jurisdictions. Many of these are "legacy accounts" established by prior generations, including deceased parents or grandparents, that have been held quietly accumulating income for decades. But changes in international banking laws now make it more difficult for banks to assure secrecy.

Harsh penalties for failure to file, plus taxes and interest, could wipe out an entire account within a few years of non-filing. This situation has resulted in a disincentive for taxpayers who might otherwise want to comply with the law after years of non-disclosure. People holding such accounts who wanted to report the income in recent years had to wrestle with the quandary of full disclosure and possibly risking the loss of the entire account, and more, to taxes, interest and penalties. Many have lived in fear of the IRS somehow discovering the accounts, or feeling guilty about their failure to report the foreign income, while at the same time recognizing the financially severe potential consequences of coming clean.

The new IRS partial amnesty program is intended to provide a viable solution for such people, to report the accounts with limited penalties that will generally leave some of the funds for the taxpayer, and allow them to repatriate the accounts and report future income without fear of the past. The new program may also be the result of the fact that the IRS does not have the resources to deal with the numbers and circumstances of foreign accounts, even as international bank secrecy laws have eroded in recent years.

### THE IRS VOLUNTARY DISCLOSURE PROGRAM

Under the new IRS Voluntary Disclosure Program (affectionately dubbed by some practitioners as "VD"), taxpayers must file amended returns and foreign account information returns just for the past six years. It doesn't matter if the account had been held for much longer than that, the program requires filing and paying just for the past six years. All applicable taxes and interest on the unreported income must be paid for that period. The IRS will also assess an annual accuracy penalty of 20% or a delinquency penalty of 25% of the tax due, with no reasonable cause exception allowed. But in

lieu of other penalties, including the virtually confiscatory penalties for failing to file the Annual Report of Foreign Bank and Financial Accounts (FBAR), a single penalty will be assessed equal to 20% of the highest balance of the undisclosed account during the six year period.

As an example of the application of these partial amnesty rules, if somebody had a one million dollar foreign account for the past six years, that generated \$50,000 per year of interest income, participation in the Voluntary Disclosure Program would result in \$386,000 owed to the IRS for taxes and the limited penalties. The taxes would be \$105,000, plus interest would be calculated on that until paid. The accuracy penalty would be \$21,000, and the additional penalty (in lieu of the FBAR and other potential penalties) would be \$260,000.

If the taxpayer in the above example did not voluntarily come forward in the VD Program and the IRS discovered the undisclosed account, the IRS could impose a total assessment of up to \$2,306,000 in taxes, accuracy related penalties and the FBAR penalties, plus interest. There could also be liability for substantial additional penalties, including a 75% fraud penalty, and possible criminal prosecution. Further onerous information return penalties could apply if the foreign accounts or assets were held through a foreign entity, such as a trust or corporation, which did not file required returns.

### GOOD DEAL OR BUM DEAL?

Based on the example, it would seem that all taxpayers with undisclosed foreign accounts should be rushing to file through the Voluntary Disclosure Program. The prospects for drastically reducing penalties, having a substantial portion of the funds left after settling the past taxes, being able to freely

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wire funds into U.S. accounts, not having to worry when going through customs upon returning from international trips, not to mention actually obeying the law, all have a tremendous appeal. But this program may not have such an appeal for everybody.

In the prior example, if that account had been invested in a portfolio of international stocks that had been actively traded over the past six years, the actual tax and interest due on the trading may be far in excess of the amount calculated in the above example. Also, as the markets approximately doubled from 2003 through late 2007, the special 20% penalty alone could be in excess of \$500,000 since it is calculated on the highest balance in the account. But with the crash of the markets through 2008 and into early 2009, there may be less value left in the account than the taxes, interest and penalties under the VD Program. If a significant portion of the account had been invested in Madoff "feeder funds," then the picture would be more bleak, making voluntary disclosure seem even less attractive.

Nevertheless, the IRS has given no indication that they will grant special consideration to unfortunate investment circumstances. The best such taxpayers may hope for would be the tax benefit of net operating loss carrybacks. The only special circumstances the IRS may consider involves inactive inherited accounts where prior taxes have been paid. The 20% penalty may be reduced to 5% if the taxpayer did not open the account, there has been no activity in the account, and all taxes have been paid on amounts deposited into the account. Most taxpayers with undisclosed foreign accounts will not qualify for this reduced penalty.

## HOW DO I SIGN UP?

In order to participate in the Voluntary Disclosure Program the taxpayer or the taxpayer's representative must contact an IRS Special Agent in the local Criminal Investigation Division, indicating intent to make a voluntary disclosure, with the taxpayer's identification information. Follow up communications should include the facts and circumstances and an explanation of the unreported income. Amended returns must be filed for the six years, plus FBAR information returns. Although the actual tax, interest and penalties need not be paid immediately, arrangements will have to be made for payment within a reasonable time.

The deadline for participation in the IRS Voluntary Disclosure Program is September 22, 2009. Therefore, taxpayers will have to act quickly to review their situation, consult with their tax advisers, and file with the IRS. (It should also be noted that there is no similar state tax amnesty program, although filing with the state will be necessary.) If you are already under IRS audit or criminal investigation, or if the IRS or Department of Justice already has information on the foreign account, it may be too late to participate.

In the event the foreign institution has not provided all information necessary for filing complete amended returns, the taxpayer should submit all available information to the IRS and supplement it as further information becomes available. This may often be the case, as banks such as UBS with time-honored traditions of secrecy (including concealing Nazi looted assets and hiding accounts from families of Holocaust victims), have been less than forthcoming with complete information. As some of these

institutions rush to jettison their U.S. customers' accounts in an effort to avoid IRS prosecution and changing international treaties, taxpayers may have to make due with the best information available in good faith efforts to report as accurately as possible.

## CONCLUSION

If you have an undisclosed foreign account, you should immediately consult with your tax adviser about participating in the Voluntary Disclosure Program. For many people this may be a good opportunity to come clean at a relatively low cost; however, it requires quick action before the partial amnesty window closes.

Applicable Treasury Regulations require that you be informed that any U.S. tax advice contained in this communication and any attached documents is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding U.S. tax penalties.

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