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Offshore Voluntary Disclosures: To Certify or Not to Certify

By Michelle E. Espey

Taxpayers with undisclosed foreign assets face an even greater risk of detection than ever before.

Both the Internal Revenue Service and Department of Justice have ramped up their efforts to detect and bring to justice those who unlawfully hide assets overseas to avoid paying tax. In addition, the Foreign Account Tax Compliance Act, which became law in March 2010, serves to target noncompliance by requiring foreign financial institutions to report information to the IRS about certain financial accounts held by U.S. taxpayers or by foreign entities.

MICHELLE E. ESPEY

Every day the IRS receives more and more information, but many taxpayers hesitate to disclose due to fear, lack of information or guidance as well as concern over the related risks and costs. The good news for taxpayers with still undisclosed assets is that, in June of this year, the IRS made a number of substantial changes to its offshore voluntary compliance programs. Taxpayers now have another opportunity to voluntarily come forward and correct prior non-reporting issues, whether inadvertent or intentional.

The IRS' current offshore program, known as the 2014 Offshore Voluntary Disclosure Program will be available for an indefinite period until otherwise announced (meaning that the IRS can change the terms of this program at any time (e.g., increase penalties, limit eligibility or terminate the program entirely). The 2014 OVDP is designed for taxpayers whose failure to report income, pay tax, and submit required information returns was due to willful conduct and who seek assurances that they will not be subject to criminal liability and/or substantial monetary penalties.

It is a continuation of the IRS' 2012 program with a few substantial changes. First, a 50 percent miscellaneous offshore penalty will now apply, instead of the 27.5 percent penalty, if either a foreign financial institution at which the taxpayer has or had an account or a facilitator who helped the taxpayer establish or maintain an offshore arrangement has been publicly identified as being under investigation or as cooperating with a government investigation.

The IRS' current foreign financial institution or facility list includes, but is not limited to, UBS AG, Credit Suisse AG, Credit Suisse Fides, Wegelin & Co., Stanford International Bank, Ltd., The Hong Kong and Shanghai Banking Corporation Limited in India (HSBC India) and The Bank of N.T. Butterfield & Son Limited (also known as Butterfield Bank and Bank of Butterfield), its predecessors and subsidiaries.

Second, the reduced penalty structures available under prior programs have been eliminated due to the expansion of the Streamlined Filing Compliance Procedures. Like the 2014 OVDP, the new SFCP will be also available for an indefinite period. The SFCP are available to taxpayers who are prepared to certify that their failures to report and pay tax due did not result from willful conduct. The SFCP afford only individual taxpayers (including the estates of individual taxpayers) a streamlined method for filing amended or delinquent returns and provide more forgiving terms for resolving outstanding tax and penalty obligations (e.g., a waiver of all penalties for eligible U.S. taxpayers residing outside the United States or a miscellaneous 5 percent offshore penalty for those eligible U.S. taxpayers who reside in the United States).

Returns submitted under the SFCP will not be subject to IRS audit automatically, but they may be selected for audit under the existing audit selection processes applicable to any U.S. tax return and may also be subject to verification procedures (meaning the accuracy and completeness of submissions may be checked against information received from banks, financial advisors and other sources).

As a result, returns submitted under the SFCP may be subject to IRS examination, additional civil penalties, and even criminal liability, if appropriate. Due to the fact that individual taxpayers who submit under the SFCP may not participate in the 2014 OVDP, those contemplating disclosure must carefully review and analyze their reasons for failing to report income, pay tax and submit required information returns, including Reports of Foreign Bank and Financial Accounts, also known as FBARs.

All facts and circumstances must be considered before any representations are made to the IRS by means of a non-willful certification, which must be signed under penalties of perjury. In general terms, non-willful conduct is conduct that is due to mere negligence, inadvertence, mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.

The vast majority of taxpayers with previously undisclosed interests in a foreign financial account or asset believe that they are more "non-willful" than not, but will the IRS agree? Although the IRS has articulated a standard of willfulness that seems to be in line with the one generally applied by the courts, it is unclear whether the IRS will remain faithful to that standard.

Willful conduct is conduct that is due to a voluntary, conscious and intentional violation of a known duty. The following factors will be considered: (i) source of funds (i.e., unreported income or inheritance), (ii) the extent of account activity (i.e., deposits and withdrawals from one institution to another can reveal intentions to manage and conceal funds), (iii) the taxpayer's degree of financial and business sophistication and education, (iv) whether the account was previously disclosed to the return preparer or others, (v) whether a non-U.S. passport was used to open the account, (vi) whether the taxpayer made a conscious effort to avoid reporting requirements (i.e. willful blindness), (vii) whether the taxpayer made in-person visits and/or communicated in code, and (viii) whether the taxpayer instructed the financial institution to not send account statements.

The IRS will review each certification of non-willful status and may even seek to interview a taxpayer. There is no "perfect" fact pattern and absolutely no guarantee that a certification will be accepted.

Taxpayers who are not completely confident about their ability to prove that their non-compliance was non-willful may be taking a substantial risk when submitting a certification under the SFCP. If the Internal Revenue Service has already independently received or discovers any new evidence of willfulness, fraud or criminal conduct, the certification will be rejected and an examination or investigation likely commenced. Because there are no appeal rights in the 2014 OVDP, once the IRS makes a determination regarding the willfulness or non-willfulness of a filer's past non-compliance, that determination is fixed. The taxpayer will then not only have disclosed his offshore assets and past non-compliance, but he will have also exposed himself to the maximum potential penalties, with no criminal protection.

For the above reasons, taxpayers with any doubts, confusion or uncertainty about the facts relating to their disclosure case should consult with their trusted adviser to evaluate and commence the process.

Michelle E. Espey is an attorney with Moritt Hock & Hamroff, where she is involved in many aspects of tax law, business tax planning, state and local taxation, and tax controversy matters. She represents many individuals and businesses in audits and collection matters before the Internal Revenue Service and New York State Department of Taxation and Finance.