To Our Clients and Friends **July 22, 2009**

Taxpayers Still Have Time to Resolve Offshore Tax Issues Through the Voluntary Disclosure Program

By: Michael J. Miller, Richard A. Levine, Howard J. Levine and Mark David Rozen

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The IRS has recently gone to great lengths to step up enforcement efforts against taxpayers that hide bank accounts or other assets outside the United States. This includes hiring additional enforcement agents, pursuing criminal prosecutions, and—as widely reported in the press—serving "John Doe Summonses" on UBS demanding that it disclose the identities of its U.S. account holders. IRS Commissioner Doug Shulman has publicly stated that "offshore accounts harbor billions of dollars, and people should take notice that the secrecy surrounding these deals is rapidly fading." Accordingly, taxpayers who have not complied with their U.S. tax obligations may now face unprecedented risks of detection and exposure to severe civil penalties or even criminal prosecution.

The IRS prefers that taxpayers come into compliance voluntarily, and is willing to offer some leniency to those who come forward. On March 23, 2009, the IRS announced the creation of a new voluntary disclosure program (the "Program") for taxpayers with undeclared foreign accounts and other "offshore" tax issues. The Program, which is available only through September 22, 2009, generally allows taxpayers to avoid criminal prosecution; to avoid the civil fraud penalty; and to pay a reduced amount in lieu of all other penalties.

Qualification for the Program

Most taxpayers qualify for the program, but there are important exceptions. First, any taxpayer who is already under examination is not eligible, even if the examination has nothing to do with undisclosed foreign accounts or entities. Second, any taxpayer with income from illegal sources is also ineligible. Other taxpayers should qualify, provided that they cooperate fully with the IRS and make full payment of the amounts due.

Terms of the Program

A taxpayer who makes a voluntary disclosure under the Program must amend (or file) six years of tax returns starting with 2003, and pay all taxes and interest due. In addition, the taxpayer will be subject to two penalties. The first penalty is an accuracy penalty equal to 20% of the underpayment of tax for each year (or, for any year in which no return was filed, a delinquency penalty of up to 25% of the tax for such year). The second penalty is a one-time payment equal to 20% of the highest aggregate value of the taxpayer's unreported offshore

accounts or entities during the six-year period. In the case of an account or entity that was not opened or formed by the taxpayer (e.g., an inherited account), the latter penalty is reduced from 20% to 5% in certain circumstances. Under the Program, a taxpayer is not required to pay tax on unreported income earned prior to 2003.

The above penalties are imposed in lieu of all other penalties that may potentially apply. Thus, for example, a taxpayer in the Program would not be subject to additional penalties for civil fraud; failure to disclose foreign financial accounts on Treasury Department Form 90-22.1 (commonly referred to as a "foreign bank account report" or "FBAR"); failure to report foreign gifts on IRS Form 3520; and failure to file certain information returns relating to foreign corporations on IRS Forms 926 and 5471.

The penalties payable under the Program may represent only a small fraction of the penalties that might potentially be imposed on a taxpayer who willfully fails to report income and disclose foreign financial accounts or entities. For example, under current law, the penalty for willful failure to disclose a foreign account is the greater of $100,000 or 50% of the balance of the account for each year in which such failure occurs. Supplemental guidance issued by the IRS on May 6, 2009, provides an illustration in which the total tax and penalties imposed under the Program on a taxpayer with an unreported offshore account is $386,000, plus interest. In contrast, the total tax and penalties imposed on the same taxpayer if he were not in the Program would be at least $2,306,000, plus interest (as well as the risk of criminal prosecution).

What About "Quiet" Disclosure?

Some taxpayers have made so-called "quiet" disclosures by filing amended returns that include all of their previously unreported income. Taxpayers in such circumstances may take advantage of the favorable penalty framework described above only if they come forward, by September 22, 2009, to make a "noisy" disclosure under the terms of the Program. The IRS has emphasized that any taxpayer who sought to avoid penalties by quietly submitting amended returns is at risk, because it "will be closely reviewing these returns to determine whether enforcement action is appropriate." If the IRS audits the amended returns of a taxpayer who made a quiet disclosure, the favorable penalty framework described above would not apply, and criminal prosecution may also be a possibility.

Significance of the September 22, 2009 Deadline

As indicated above, the Program is available only through September 22, 2009. Accordingly, taxpayers with undisclosed foreign accounts or other offshore tax issues need to evaluate the advantages and disadvantages of the Program and consider taking action as soon as possible. It's not yet too late, but time is running out.