

# OFFSHORE MISDOINGS, REPENTANCE, AND THE US INTERNAL REVENUE SERVICE

*The IRS treats those who come forward to acknowledge their offshore misdoings much more leniently than those who wait and are caught. Taxpayers considering coming forward should, however, first consult tax advisors familiar with the process*

*By Kent D Lawson*

*“We acknowledge and bewail our manifold sins and wickedness, which we, from time to time, most grievously have committed by thought, word, and deed, against thy divine Majesty, provoking most justly thy wrath and indignation against us. We do earnestly repent, and be heartily sorry for these our misdoings”*

– recited from The Book of Common Prayer by Prince Charles and Camilla Parker Bowles at their wedding

**I**t is good that Prince Charles is not American. His confession would be inadequate to deal with his inclination not to pay certain taxes. The US Internal Revenue Service (IRS) encourages hearty confessions, but requires a bit more detail. Generally, or rather very generally, the IRS forgives taxpayers who come forward before they are caught rather than imposing severe civil and criminal penalties.

## Offshore misdoings

It would be prudent for those who have not been caught yet to consider coming forward to acknowledge their misdoings. US citizens and tax residents report their income on a worldwide basis. They must also report their interests in:

- foreign bank accounts,
- trusts,
- corporations,
- partnerships, and
- other entities.

Reporting is often required regardless of whether or not the foreign entities have taxable income. The wilful failure to file required returns is a crime.

The reporting requirements for foreign entities are esoteric enough that many accountants are unaware of them and most do not have the expertise to prepare them. It is good that the unintentional failure to file is not a crime and

that civil penalties for the unintentional failure to file can be abated for reliance on an uninformed lawyer or accountant.

## Increasing IRS focus

For the past few years, the IRS has been increasing its focus on the improper use of offshore tax havens. Even some of the most obstinate tax havens have entered into Tax Information Exchange Agreements (TIEAs) with the US.

With the passing of the USA PATRIOT Act, the US has been expanding the capabilities of the Financial Crimes Enforcement Network (FinCEN). FinCEN uses its network of supercomputers to track electronic banking transactions. See [www.fincen.gov](http://www.fincen.gov).

The IRS issued summonses to credit card companies to obtain the names of people using offshore credit cards. VISA, MasterCard, and American Express have all provided the names of their clients. The IRS has used its computers to match the names against taxpayer information.

## At the crossroads

Taxpayers who have not filed the proper returns find themselves at a crossroads. The IRS will view them as less culpable if they come forward before the IRS catches them. However, some think that if they do not come forward that the IRS may never catch them.

Coming forward may give the IRS the information it needs to convict them of a crime or impose civil penalties. At a minimum, coming forward means being willing to pay back taxes and interest. More taxpayers would come forward if the IRS sent clearer and more consistent messages about the consequences. In this regard, the IRS is currently doing a much better job regarding criminal than civil penalties.

## Criminal consequences

Taxpayers considering coming forward may be interested in the data shown in



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Criminal investigation	Total
Investigations initiated	4269
Prosecution recommendations	2859
Information/indictments	2406
Total convictions	2151
Total sentenced*	2095
Percentage to prison	83
Average months to serve	42

\*Sentence includes confinement to federal prison, halfway house, home detention, or some combination thereof.

**Table 1: Current fiscal year 2005 (1 October 2004 to 30 September 2005) criminal investigations.** Data Source: Criminal Investigation Management Information System.

Table 1, which relate to all federal tax crimes, not just those involving tax havens. The obvious conclusion is that it is better to avoid a criminal investigation.

In 2002, the IRS published criteria regarding when it will consider coming forward as a mitigating factor in deciding whether it will refer a case to the Department of Justice for criminal prosecution. If a taxpayer makes a "voluntary disclosure" the IRS is unlikely to recommend prosecution.

To avoid prosecution through a voluntary disclosure, a taxpayer must:

- have no illegal source income;
- make a truthful disclosure;
- make a disclosure prior to an IRS lead or investigation;
- make a complete disclosure;
- cooperate in determining his or her tax liability;
- make arrangements to pay tax interest and penalties in full.

These published criteria for this practice can be seen online at:

- IRS News Release 2002-135  
<http://www.irs.gov/newsroom/article/0,,id=104359,00.html>
- Internal Revenue Manual 9.5.3.3.1.2.1  
<http://www.irs.gov/newsroom/article/0,,id=104361,00.html>

Voluntary disclosure usually consists

of filing back returns for six years if the misdoings go back that far. The statute of limitations for tax crimes is generally six years. A voluntary disclosure can be made simply by mailing the returns with payment to an IRS service centre.

In cases where it is uncertain whether or not a taxpayer meets these criteria, the Criminal Investigation Division can be contacted on an anonymous basis. If the Criminal Investigation Division agrees that the criteria are met, it will enter into an agreement not to refer the case for prosecution.

### Civil consequences

As of October 2005, the IRS has no published rules regarding how to exercise its discretion in imposing civil penalties. The IRS temporarily had rules that were part of an amnesty programme known as the Offshore Voluntary Compliance Initiative (OVCI). The OVCI gave taxpayers a short window from 14 January to 15 April 2003 to come forward. Revenue Procedure 2003-11 describes the initiative: <http://www.irs.gov/pub/irs-drop/rp-03-11.pdf>

There was not enough time for everyone to come forward and the IRS had to come up with a secretive Last Chance Voluntary Compliance Initiative. The initiative was not publicised. Rather letters were mailed to people whose names were discovered as a result of the offshore credit card programme. Some lawyers slipped clients into the programme who did not have offshore credit cards to receive the same deal regarding penalties. The Last Chance Voluntary Compliance Initiative is now over.

What now? In practical experience, the OVCI guidelines are a good, but not a foolproof predictor of what a taxpayer should expect when coming forward to file back returns. The most severe penalties are usually not imposed. These include the civil fraud penalties, which are 75% of the unpaid tax. Failure to file penalties for interests in foreign bank accounts, trusts, corporations, partnerships, and other entities are also usually not imposed. These penalties are poten-



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tially significant even if there is no underpayment of tax. For example the penalty for:

- wilful failure to report a foreign bank account is 50% of the account balance;
- failure to report the transfer of assets to a foreign trust is 30% of the assets transferred;
- failure to report an interest in a foreign corporation is \$10,000 per year.

If back taxes are owed, taxpayers should expect to pay them along with interest, and late filing penalties.

The late filing penalty is capped at 25% of the underpayment and can be abated if the failure to file is due to reasonable cause and not wilful neglect.

Taxpayers may also be subject to a 20% accuracy-related penalty if there was a substantial understatement of tax.

The imposition of penalties is inconsistent. In some cases, the IRS imposes more penalties than OVCI guidelines call for. In other cases, it imposes fewer penalties. It does so with no apparent reason. Although the civil voluntary compliance system is inconsistent, it still gives taxpayers a strong incentive to come forward before they are caught.

**Reform needed**

The problem of noncompliance is ongoing. The reporting rules for offshore entities are esoteric enough that there will always be taxpayers that run foul of them and later learn that they are in noncompliance.

Filing deadlines are often missed because some of them are not synchronised with regular deadlines for individual tax returns. The problem is exacerbated because unscrupulous promoters continue to sell fraudulent offshore tax scams.

The criminal voluntary disclosure rules work well. They provide a clear standard and can be read in an official pronouncement.

The civil voluntary disclosure rules are nonexistent. Some IRS officials are trying to fill the vacuum by saying that

they are continuing to follow the spirit of OVCI. Taxpayers should be able to rely on something more tangible than spirit. The IRS should have clear rules in official pronouncements that apply fairly in the same way to everyone.

*“Clear civil voluntary  
disclosure rules that apply  
fairly in the same way  
to everyone are needed ”*

Lawyers on both coasts are touting special connections inside the IRS that give them the inside track on minimising civil penalties. It is happening so frequently that their sales pitches are starting to sound the same. The problem stems in part from the fact that a taxpayer can choose to approach IRS officials at various offices scattered across the country to file back tax returns. The way the rules are applied should not depend upon the connections of a taxpayer's lawyer inside the IRS.

Management in the IRS often seems fixed on increasing statistics. The short window of opportunity for the OVCI seems intended to create a sudden burst of activity so the programme could be declared a success.

The IRS needs to give greater thought to doing justice more permanently. It would be simple to make the standards set by the OVCI permanent.

There is no reason not to have permanent standards for civil penalties just as there are permanent standards regarding voluntary disclosure and criminal prosecutions.

Although reforms are needed, taxpayers should not wait to come forward. If they wait it may be too late. The IRS treats those who come forward to acknowledge their offshore misdoings much more leniently than those who wait and are caught. Taxpayers considering coming forward should first consult tax advisors familiar with the process. ♦



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