Amnesty or Not?

The April 15th deadline to participate in the IRS's Voluntary Compliance Initiative has come and gone. Now what?

By Lewis J. Saret

At the beginning of this year, the IRS initiated a program, effective January 14, 2003 and ending three months later, on April 15, 2003, permitting US taxpayers, who have used offshore accounts and other financial arrangements to avoid reporting or to underreport taxable income, to come forward, report the income and avoid many of the otherwise applicable civil and criminal penalties and related costs.

According to published reports, Pamela Olson, Treasury Assistant Secretary for Tax Policy, has stated that the voluntary compliance initiative will constitute an important source of information for the Treasury Department, which is continuing its efforts to improve and expand the US's broad network of bilateral tax treaties and tax information exchange agreements. Also, according to Ms. Olson, better tax information exchange relationships will permit the IRS to obtain the information it needs from other countries so it can pursue taxpayers attempting to hide income offshore to avoid their tax obligations.

The US recently expanded its network of tax information exchange agreement with offshore financial jurisdictions and now has agreements with Antigua, Bahamas, BVI, Cayman Islands, Guernsey, Jersey, Isle of Man and the Netherlands Antilles. It can be assumed that the IRS will exchange information with these countries, as well as others within its extensive network of tax treaties, including the United Kingdom, France and Germany.

Acting IRS Commissioner, Robert Wenzel, in testimony before a Senate appropriations subcommittee, has indicated that the IRS has received a good response to the initiative, and has received several promising leads on promoters of offshore arrangements.

The Voluntary Compliance Initiative

The program was aimed at taxable years 1999 to 2002. Years prior to 1999, in certain circumstances, may not be subject to scrutiny, but taxpayers nonetheless will have to provide information about their involvement in offshore financial arrangements during these years.

The interest and penalties imposed depended on the amount of the unpaid tax liability, the years involved, whether a return was inaccurate or if a return should have been filed and was not.

By way of example, a taxpayer who understated his income to avoid $100,000 in taxes in 1999 would wind up paying $149,319. This includes the tax liability plus $29,319 in interest and an additional accuracy-related penalty of $20,000.

If a taxpayer did not step forward, his tax liability generally would include the civil fraud penalty of $75,000, and therefore higher interest of $42,758. The total amount due would be $217,758, without considering probable additional civil penalties for failure to file certain information returns. Also, without coming forward, the taxpayer must worry about possible criminal penalties.

Not an amnesty: Although loosely referred to as an offer of tax amnesty, this was a misnomer, as taxes were not wholly or partially forgiven. Instead, if the taxpayer met the requirements of the program, the IRS agreed not to impose a number of civil and criminal penalties. The taxpayer will have to pay the tax and, in appropriate circumstances, certain delinquency and accuracy-related penalties. If the Foreign Bank and Financial Accounts Report (Treasury Form 90-22.1) also was not filed, the civil and criminal penalties associated with this failure would also be dropped.

Those who participated in the program were required to give complete information about how they were introduced to the account or arrangement, information about any promoter or other person involved, etc.

There are really two groups of persons affected by the Offshore Voluntary Compliance Initiative (the “Initiative”), the term the IRS uses for this program: One, US taxpayers that have used offshore arrangements and, therefore, have some exposure. Two, non-US persons-advisors, banks, trust companies, investment management firms, and other persons that might be characterized by the IRS as "promoters."

Individual taxpayers: In regard to individuals, they were required to assess the "opportunity" rapidly. Were they eligible? What was the possibility of being drawn into the program but learning later that there are hidden detriments? What happens if the individual is not able to make full payment of taxes and penalties due?

The taxpayer must fully pay the tax liabilities and interest or make "other financial arrangements" that are acceptable to the IRS. What these arrangements are and the negotiation of the details will now be very important. If some type of workout is called for, it will be necessary to carefully prepare the necessary financial statements. In this regard, the IRS has stated that, although the Initiative requires taxpayers to fully pay their tax liabilities, including applicable penalties and interest for all years involved, as well all other unpaid, previously assessed liabilities, it is possible to request other payment arrangements acceptable to the IRS. However, the IRS also indicates that the burden will be on the taxpayer to establish inability to pay, based on full disclosure of all assets and income sources, domestic and offshore under the taxpayer's control.

For those who made the initial filing, called a written request to participate, they have approximately five months (150 calendar days) within which to submit a number of items including:

- Copies of previously filed original and amended federal income tax returns for tax periods ending after December 31, 1998;
- Copies of any powers of attorney granted by the taxpayer with respect to the subject tax years;
- Descriptions of offshore payment cards and foreign and domestic accounts of any kind (including the name and address of the bank or financial institution, the account number, and the date the account was opened), and descriptions of foreign assets in which the taxpayer has or had any ownership or beneficial interest or that are or were controlled by the taxpayer (*i.e.,* the taxpayer has or had the practical ability to direct or influence the financial transactions or affairs of an account or entity, or the use or disposition of an asset, whether this ability was exercised directly or indirectly through a nominee, agent, power of attorney, letter of directions, letter of wishes, or any other device whatsoever) at any time after December 31, 1998;
- Descriptions of entities of any kind (including corporations, partnerships, trusts, and estates) and any nominees through which the taxpayer exercised control over foreign funds, assets, or investments at any time after December 31, 1998;
- Descriptions of the source of any foreign funds, assets, or investments owned or controlled by the taxpayer at any time after December 31, 1998;
- All related promotional materials, transactional materials, and other related correspondence and documentation received subsequent to the date the taxpayer submits the request to participate in the Program (such materials received prior to submitting a request will have been supplied with the request);
- Complete and accurate amended or delinquent original federal income tax returns of the taxpayer for all tax years ending after December 31, 1998, which are supported by an explanation of previously unreported income or incorrectly claimed deductions or credits (whether or not related to offshore payment cards or offshore financial arrangements);
- Complete and accurate amended or delinquent original information returns required by sections 6035, 6038, 6038A, 6038B, 6038C, 6039F, 6046, 6046A, and 6048 for which the taxpayer requests relief from penalties; and
- Complete and accurate Foreign Bank Account Reports for tax years ending after December 31, 1998.

Taxpayers and their advisors will be hard pressed to pull together these materials in this short period. It remains be seen whether requests for extensions of time will be granted.

Also, as with all exercises involving the filing of late returns, there will be a large number of "judgment calls" including how to handle the section 911 earned income exclusion and foreign tax credit issues.

There will be issues as to what to do with respect to non-US tax authorities, and State tax authorities, which may be owed returns and taxes as well. Obviously, information

provided to the US can be exchanged by the US with State and other countries' tax authorities. In the case of States, the IRS has announced that 10 states have indicated they will grant special consideration to individuals who apply to the Initiative. According to the IRS, if individuals amend their state returns and pay all tax, penalties, and interest by October 15, they can avoid prosecution by these states. The states participating are California, Idaho, Louisiana, Maryland, Nebraska, New Jersey, New York, North Carolina, Utah and Vermont. The IRS has indicated that additional states are expected to announce they will offer similar treatment to applicants of the Initiative.

An additional issue is whether, where taxpayers are denied eligibility for participation in the Initiative, the IRS will admissions made in requests to participate in the program to prosecute them. Here, the IRS has stated that information about a taxpayer requesting participation in the Initiative is legally admissible in subsequent criminal proceedings.

At the end of the process, the taxpayer and the IRS will enter into a closing agreement, which like all such agreements entails a number of legal issues. The exact wording of that agreement should be constructed with great care. There will be issues that arise in connection with joint returns, especially where one spouse was not aware of the activities of the other spouse. There will be special issues where the taxpayer is a trust or an estate.

Unusual issues can arise where the foreign trustee bears obligations to other beneficiaries. For example, to what degree should a trustee cooperate where one US beneficiary wishes to participate but this has implications for other US and non-US beneficiaries? Also, the trust, acting through the trustee, may be required to join in the filings. What indemnifications should the trustee obtain?

Offshore promoters: While at first blush it seems this program was aimed at taxpayers who used offshore accounts, credit cards paid against those accounts, foreign corporations, foreign trusts, and the like, to avoid US taxes, in no small measure the program is designed to enable the IRS to proceed "with a vengeance" against promoters and facilitators of these schemes. The wording of various announcements and explanations makes clear that the IRS intends to use every means available to it to attack these persons.

For the advisors, banks, trust companies, investment management firms, and the like who may be thrown into the category -- rightly or wrongly -- of "promoters," they will want to anticipate the IRS's next steps. They probably should not wait until they receive, for example, a request for information or writ issued by their "home country" tax authority at the behest of the IRS pursuant to an applicable tax information exchange agreement.

Filing Amended Returns Versus Filing Under The Initiative.

The IRS has clearly tried to steer taxpayers to use the Initiative, rather than quietly file amended tax returns, reflecting offshore accounts and other arrangements. In this regard, the IRS is currently screening all amended returns against newly developed criteria to

identify taxpayers who tried to circumvent the Initiative, and it has stated that it will audit amended returns identified during this screening process.

What's Next?

What is the IRS's next step? We believe that the next step will be for the IRS to pursue US taxpayers who had these arrangements and did not come forward, as well as promoters, wherever they are located. We think that the IRS will be looking to make examples of some people. Concerning non-US firms, such firms run the risk of aiding and abetting a tax fraud, among other possible things.

Lewis J. Saret is a lawyer and member of the Washington and London law firm Moore & Bruce, LLP (www.mooreandbruce.com). He may be reached by e-mail at: lsaret@mooreandbruce.com