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Is Making A "Quiet Disclosure" In Today's Environment A Smart Choice For A Taxpayer with An Undisclosed Foreign Account?

The environment that taxpayers with unreported offshore bank accounts find themselves in today is downright frightening. The vision that many people have – and that politicians are only too happy to promote – is that of wealthy expats who throw Great Gatsby-esque parties, during which the attendees burn their delinquent tax notices with fondue candles as they cackle over bad jokes and gossip about people who aren't in the room.

This vision has been the driving force behind the U.S. government's aggressive pursuit of U.S. taxpayers with undisclosed offshore accounts. Some believe that the current economic and political climate facing foreign account holders is so hostile that it bears an uncanny resemblance to "McCarthyism," the term that has its origins in the period of U.S. history known as the "Second Red Scare." Beginning in 1950 and lasting until 1956, "McCarthyism" was symbolic of heightened political repression against communists, as well as a campaign spreading fear of their influence on American institutions and of espionage by Soviet agents.

Originally coined to criticize the anti-communist pursuits of Republican U.S. Senator Joseph McCarthy (Wisconsin), "McCarthyism" soon took on a broader meaning. The term is now used more liberally to describe reckless, unsubstantiated accusations, as well as demonized attacks on the patriotism of political adversaries.

Has "McCarthyism" been reincarnated today, with the targets being U.S. persons who own unreported foreign accounts? A compelling argument can be made that the heightened scrutiny that such taxpayers receive can mean but one thing: that the government has resorted to branding every taxpayer with an unreported offshore account with the dreadful letter "C" for "Criminal."

While there have been many voices crying out for change, no one stands out more than that of Nina Olson's, the National Taxpayer Advocate. In her annual report to Congress, Ms. Olson made it clear that this is 2015, not 1931, and that not every taxpayer with an unreported offshore account is the modern-day equivalent of "Al Capone," the American gangster whose seven-year reign as Chicago crime boss came to an abrupt end in 1931 when he was convicted of tax evasion and sentenced to eleven years in prison.

Caught between FATCA and the draconian penalties looming over their heads like the "Sword of Damocles," those who have been branded with the "Scarlett Letter" find themselves in the unenviable position of having to choose between a limited number of choices, none of which is popular. Not surprisingly, fear of making the "wrong choice" is so palpable that the thought of disclosing foreign accounts by any means other than the IRS's compliance-driven initiatives or the

offshore voluntary disclosure program (OVDP) doesn't even cross the mind of the prudent person in this dilemma.

Even those who want to be fully informed of their options so that they can make a well-informed decision usually couch the question in a way that pre-supposes an unfavorable answer: "Is making a 'quiet disclosure' a wise choice in such a hostile environment?" By "quiet disclosure," I am specifically referring to filing delinquent FBARs.

My answer to this question is that "one size does not fit all." Indeed, certain cases are ripe for quiet disclosure, while others aren't. While the necessary ingredients needed to make a quiet disclosure are not always present in the typical undisclosed foreign bank account case, just because the moon and stars do not align does not mean that it should be abandoned altogether.

Before throwing out the idea of making a "quiet disclosure" with the bathwater, consider this. A quiet disclosure furthers the IRS's mission of encouraging voluntary compliance and self-policing by allowing taxpayers to self-correct. Thus, by overlooking the delinquent FBAR submission procedures, you might be making a huge mistake.

Cases that are ripe for "quiet disclosure" can be broken down into two main categories. For each category, assume that the taxpayer is a U.S. person with an offshore bank account that meets the definition of "foreign financial account" for purposes of triggering an FBAR-reporting requirement. Assume also that the failure to report the account was accidental and inadvertent:

(1) Failure to file FBAR, but foreign accounts were fully disclosed on U.S. income tax return and all taxable income was properly reported (along with payment of U.S. taxes resulting therefrom): The taxpayer properly reported his foreign financial accounts on his U.S. income tax return and paid all tax on the interest generated by those accounts. However, he neglected to file FBARs.

(2) Failure to file U.S. tax return and failure to file FBAR – but corresponding U.S. tax liability is negligible: The taxpayer is a non-resident who has failed to file U.S. tax returns and FBARs to report her financial interest in a personal foreign checking account at ABC Bank in Country B. However, she complied with Country B's tax laws and properly reported all of her income on Country B's tax returns. After taking into consideration the foreign tax credit for taxes paid to Country B, not to mention the light interest income generated by the account, even if she had properly disclosed these accounts, her corresponding U.S. tax liability would have been negligible.

a. **Hypotheticals Based on Recently Issued IRS Bulletin**

Below are two common fact patterns that are custom-tailored for each category. They are based on two specific scenarios that were published in an IRS bulletin entitled, "Options Available to Help Taxpayers With Offshore Interests" back on January 13, 2015. The bulletin consists of a chart whereby a situation is presented in the left-hand column and the corresponding recommended compliance option is listed adjacent to the situation in the right-hand column (see Part "C" below).

As many of you are aware, my motto is "learning by doing." Merely reading about what steps to take to solve a tax problem is like reading about how to ride a bicycle. Unless you get on the bicycle and fall off a few times, all the reading in the world isn't going to teach you how to ride it. Similarly, the only way to become proficient at solving tax problems is by schlepping your way through challenging hypotheticals that stretch your knowledge and understanding of the arcane and nebulous rules that have come to be known as the U.S. international tax regime.

Let's begin with a fact pattern that is custom-tailored to fit the first category. Joan is a U.S. citizen who lived abroad for three years from 2011 to 2013. While living abroad, Joan opened a personal checking account with a bank located in Country X in 2011. Assume that the highest balance in that account during the three years (2011, 2012, and 2013) was $ 150,000 (US).

Joan never filed an FBAR. However, she filed U.S. income tax returns for all three years. In doing so, she disclosed her foreign account on Schedule B and properly reported all of the interest income generated by that account. Thus, Joan reported and paid tax on all taxable income resulting from her unreported foreign account.

Joan just recently learned that she should have been filing FBARs in prior years after hiring an accountant to prepare her 2014 return. She wants to come into compliance. What should she do? According to the IRS's recent bulletin entitled, "Options Available to Help Taxpayers With Offshore Interests," Joan should file delinquent FBARs for the last three years and attach a statement explaining why they were filed late. Specifically, she should state that she was previously unaware of her obligation to report this account, but that as soon as she became aware she acted swiftly to fix the problem.

Will the IRS impose a penalty for Joan's failure to file these FBARs? So long as there is no tax liability and Joan has not previously been contacted by the IRS – i.e., no audit has commenced and/or no request was made by an IRS agent for delinquent FBARs – the answer is, "no." Because neither of these conditions exists, no FBAR penalty will be asserted.

A variation of this theme also applies to situations where the taxpayer failed to file other international information forms besides the FBAR, but no tax was due.

Consider the following example. Tommy Taxpayer is a U.S. citizen who owns a Controlled Foreign Corporation and a foreign trust. He has been living overseas since 2011. Tommy failed to file the necessary international information forms, specifically Form 5471 (for Controlled Foreign Corporations) and Form 3520 (for Foreign Trusts). However, Tommy did file U.S. tax returns where he reported and paid U.S. tax on all income resulting from these transactions.

Just as in the case of Joan's failure to file FBARs, the bulletin recommends that Tommy file delinquent forms – here, Forms 5471 and 3520 – according to their respective instructions. In addition, Tommy should attach a statement explaining why they were filed late.

Cutting to the chase, will the IRS impose penalties for Tommy's failure to file Forms 5471 and 3520? So long as there is no tax liability and Tommy has not previously been contacted by the IRS – i.e., no audit has commenced and/or no request was made by the IRS agent for delinquent Forms 5471 or 3520 – the answer is, "no." Because neither of these conditions exists, no penalties for failing to file Forms 5471 or 3520 will be asserted.

The following is a fact pattern that is custom-tailored to fit the second category. Trevor is a U.S. citizen who works and lives in Country A. He has a brokerage account in Country A that he opened in 2008. The account had a high balance of $ 150,000 (US) and generated interest income of $ 2,000 (US) each year. Trevor complied with Country A's tax laws and properly reported all of his income on his Country A tax returns.

Unfortunately, Trevor did not do the same when it came to his U.S. tax obligations. Not only did Trevor fail to file U.S. income tax returns, but he failed to file FBARs disclosing his financial interest in this account. This was due to the fact that he mistakenly assumed that he only had to report the account on his Country A tax return.

After reading recent press releases and learning about his U.S. income tax return and FBAR-reporting obligations, Trevor hired a tax preparer to assist him in coming into compliance with his U.S. tax obligations.

After applying the foreign tax credit for taxes paid to Country A, Trevor's U.S. tax liability – resulting from the interest generated by his unreported County A account – amounted to less than $ 1,500 (US) per year for each of the last six years.

What should Trevor do? According to the IRS's recent bulletin entitled, "Options Available to Help Taxpayers With Offshore Interests," Trevor must do the following:

(1) File delinquent U.S. income tax returns for the past three years (i.e., 2011 thru 2013);

(2) File delinquent FBARs disclosing his foreign account for the past six years (i.e., 2008 thru 2013);

(3) Attach a statement to the FBAR explaining why the FBARs were filed late. For example, Trevor might state that he was previously unaware of his obligation to report this account, but that as soon as he became aware he acted swiftly to fix the problem.

(4) Payment of all tax and interest due must accompany the submission.

b. The Risks Associated With Making A Quiet Disclosure

What happens if the IRS disagrees with Joan, Tommy, or Trevor's explanation for filing late FBARs? In other words, what if the IRS believes that their failure to file FBARs was not inadvertent or accidental, but instead willful?

This could result in any one of a number of "parade of horribles," the most serious of which is a referral to Criminal Investigation. While this is generally the exception and not the rule, taxpayers should be mindful of the fact that, unlike OVDP, a "quiet disclosure" does not guarantee immunity from prosecution.

At the same time, if you thought that you could "change horses in midstream" and seek shelter in the OVDP bunker the moment the IRS questions your explanation, you are sadly mistaken. Unfortunately, it is too late. At the risk of sounding crass, the message that the IRS is sending is this: "You've made your bed so sleep in it!"

Taxpayers looking for guidance need look no further than the eminent archaeologist, Indiana Jones. In the same way that "Indie" had to choose between the "real" Holy Grail and the "fake" Holy Grail with the latter resulting in a gruesome death (i.e., decaying into dust) and the former resulting in eternal life, you must choose "wisely."

Outside of criminal prosecution, what other risks could a taxpayer face? None other than FBAR penalties, the 800-pound gorilla of civil tax penalties. To the extent that a penalty is warranted, there are two types: non-willful and willful.

Both types have varying upper limits, but no floor. For example, the maximum nonwillful FBAR penalty is $ 10,000. And the maximum willful FBAR penalty is the greater of (a) $ 100,000 or (b) 50% of the closing balance in the account as of the last day for filing the FBAR.

Two critical points should be kept in mind when it comes to FBAR penalties. First, FBAR penalties are determined per account, not per unfiled FBAR. And second, penalties apply for each year of each violation. Taken together, this means that FBAR penalties can be aggregated, one on top of the other, catapulting one's liability into the penalty stratosphere.

Those who think that the likelihood of the IRS asserting multiple FBAR penalties, let alone multiple *willful* FBAR penalties, is remote are probably not a frequent visitor to the Department of Justice's press release website. If recent cases are any indication, not only has the IRS shown a willingness to assert multiple willful FBAR penalties that are enough to make Warren Buffet cry "uncle," but it has done so with impunity.

For as malicious and mean-spirited as it might seem, the IRS has support for its position. Indeed, it has wrapped itself in the "invisibility cloak" (the magical garment from the world of "Harry Potter" which makes anyone who wears it invisible) of recent circuit court decisions that have diluted the quantum of proof needed to establish "willfulness." Therefore, it should come as no surprise that the IRS has been asserting willful FBAR penalties more aggressively now than ever before.

While the IRS could theoretically assert a willful FBAR penalty for any reason whatsoever – including for something as arbitrary and capricious as a dislike for the color of your shoes – keep in mind that just because the IRS thought that it was appropriate does not make it "official." You can challenge the assertion. In doing so, you'd be putting the IRS's feet to the fire, by holding them up to their burden of proving "willfulness" in court.

As demonstrated in the *Zwerner* case, the IRS must prove willfulness to the satisfaction of a jury. And while willfulness need only be proven by clear and convincing evidence in the civil context, the fact remains that proving the existence of a mental state is easier said than done.

Even if the IRS can make out a colorable claim of willfulness, the taxpayer can mount a defense. Such defenses are grounded in "reasonable cause."

The authority for the "reasonable cause" exception is found in the IRS Manual. The IRM approves of the "reasonable cause" guidance provided under 26 C.F.R. §1.6664, Reasonable Cause and Good Faith Exception to the § 6662 penalties.

Whether a taxpayer's FBAR noncompliance was due to "reasonable cause" is based on a consideration of all the facts and circumstances. Factors that weigh in favor of a determination that an FBAR violation was due to reasonable cause include the following:

- The sophistication and education of the taxpayer;

- Whether there were recent changes to the tax forms or to the law that the taxpayer could not reasonably be expected to know;

- The level of complexity of the tax or compliance issue;

- Reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account;

- Evidence that the unreported foreign account was established for a legitimate purpose and that no effort was made to intentionally conceal the reporting of income or assets; and

- That there was no tax deficiency related to the unreported foreign account (or, if there was a tax deficiency, it was de minimis).

Other factors, in addition to those listed here, might weigh in favor of a determination that the failure to file an FBAR was due to reasonable cause. No single factor is determinative. It is a "facts and circumstances" test.

Factors that weigh against a determination that an FBAR violation was due to reasonable cause include the following:

- Whether the taxpayer's background and education indicate that he should have known of the FBAR reporting requirements;

- The taxpayer's compliance history (i.e., whether the taxpayer had been penalized before);

- Evidence that the unreported foreign account was established for an illegitimate purpose (i.e., sheltering money from the U.S. government);

- That the taxpayer failed to disclose the existence of the account to his tax preparer; and

- That there was a tax deficiency related to the unreported foreign account.

As with factors that weigh in favor of a determination that an FBAR violation was due to reasonable cause, there may be other factors that weigh against a determination that a violation was due to reasonable cause.

The meaning of "reasonable cause" is not as clear and precise a term as a modern household appliance. Reasonable cause is a broad term that has spawned a substantial amount of case law. It is for this reason that taxpayers should always consult with a tax professional before relying upon reasonable cause as a defense to a civil penalty.

The takeaway is this: Taxpayers should carefully weigh their options before deciding to enter one of the IRS's compliance-driven initiatives or the offshore voluntary disclosure program. The stakes could not be higher. Therefore, this should never be done alone, but instead by consulting with an experienced tax professional.

Those who are feeling overwhelmed and perhaps even discouraged by this process can seek comfort in the words of the famous poet, Dylan Thomas. They offer inspiration to those who have raised their masts and begun their Maiden voyage into the "choppy seas" of foreign asset reporting:

> Do not go gentle into that good night.
>
> Rage, rage against the dying of the light.