

BNA TAX MANAGEMENT ADVISORY BOARD MEETING

**UNDECLARED FOREIGN ACCOUNTS, TAX FRAUD
AND THE UBS INVESTIGATIONS: IS A VOLUNTARY DISCLOSURE
TO THE IRS THE RIGHT APPROACH?**

By

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BIOGRAPHICAL NOTE

LAWRENCE S. FELD

Lawrence S. Feld is an attorney in New York City whose practice includes the defense of criminal tax cases and other white collar criminal charges. He is a graduate of Columbia Law School where he was Articles Editor of the Columbia Journal of Law and Social Problems. He was formerly Assistant Chief Appellate Attorney (Criminal Division) in the United States Attorney's Office for the Southern District of New York. Mr. Feld is the co-author of a two volume treatise, *Tax Fraud and Evasion* (Thomson Reuters, 2007). He has also published articles on tax litigation, criminal tax cases, the federal sentencing guidelines and white collar criminal subjects in the *Department of Justice Manual* (Prentice-Hall Law & Business, 1990), *Practice Under the New Federal Sentencing Guidelines* (Prentice-Hall Law & Business, 1989), *Journal of Taxation, Taxes, Business Crimes Bulletin, Corporate Counselor, Criminal Liability Reporter*, and the *New York Law Journal*. Mr. Feld has appeared as a lecturer, panel member, and panel chair on numerous continuing legal and accounting education programs relating to criminal tax litigation and white collar criminal defense issues. He is a former Chair of the Committee on Civil and Criminal Tax Penalties, Section of Taxation, American Bar Association, and a former Chair of the Committee on Criminal Advocacy of the New York City Bar Association. He is a member of the Continuing Legal Education Committee of the City Bar. Mr. Feld is an adjunct professor of law at the New York Law School, Graduate Tax Program.

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The United States, each year, loses an estimated \$100 billion in tax revenues as a result of offshore tax abuses. Offshore tax havens are believed to hold billions of dollars in assets owned by citizens of other nations, including the United States.¹ These undeclared accounts represent funds hidden from tax authorities by taxpayers from the United States and other countries outside of the tax havens. Within the past year, there have been a number of developments revealing that financial institutions in these tax havens have been facilitating international tax evasion on a spectacular scale.

United States taxpayers who own or control undeclared foreign accounts face a broad array of significant criminal and civil penalties if their accounts are discovered by the Internal Revenue Service (“IRS”) or the Department of Justice. There is a substantial risk of prosecution, conviction and incarceration for tax and related offenses and possible civil tax and other penalties that may result in the loss of the undeclared assets. These taxpayers need to consider whether they may qualify for participation in the IRS voluntary disclosure program and the benefits and burdens of a voluntary disclosure. This paper explores (1) the background of the current investigations and prosecutions (particularly the UBS cases); (2) analyzes foreign financial account re-

* The author gratefully acknowledges the invaluable assistance of Barbara L. Bailin, Senior Legal Assistant.

¹ See U.S. Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, “Tax Haven Banks and U.S. Tax Compliance,” Staff Report (July 17, 2008) at 1, citing different studies by a variety of tax experts as the basis for the \$100 billion estimate (hereinafter “Staff Report”).

porting obligations; (3) examines the applicable criminal and civil penalties; and (4) reviews the IRS voluntary disclosure practice.

The LGT Bank Investigation

In February 2008, it was disclosed that Heinrich Kieber, a former employee of a Liechtenstein trust company, provided tax authorities around the world with misappropriated information regarding approximately 1,400 persons who had accounts at that company, the LGT Bank in Liechtenstein. The German tax authorities executed multiple search warrants and arrested a prominent businessman for allegedly using Liechtenstein bank accounts to evade approximately \$1.45 million in taxes. About a week later, the IRS announced that it had initiated enforcement action involving more than 100 U.S. taxpayers to insure proper income reporting and tax payments in connection with accounts in Liechtenstein. Other countries followed suit. ²

The UBS Investigations

In May 2008, a second international tax scandal erupted when the United States arrested Bradley Birkenfeld (“Birkenfeld”), an American citizen and a private banker formerly employed by UBS AG, one of the largest banks in the world, on a charge of conspiracy with a wealthy real estate developer named Igor Olenicoff to defraud the IRS of \$7.2 million in taxes owed by Olenicoff on \$200 million of assets hidden in offshore accounts in Switzerland and Liechtenstein. ³

² Staff Report at 2.

³ *United States v. Birkenfeld*, Dkt. No. 08-CR-60099 (Zloch) (S.D. Fla., April 10, 2008). The indictment charged that Birkenfeld and his co-conspirators, as part of the conspiracy, “would and did defraud the United States for the purpose of impeding, impairing, obstructing and defeating the lawful government functions of the IRS in the ascertainment, computation, assessment and collection of United States income taxes.” (Indictment ¶9). This is commonly known as a *Klein* conspiracy. *United States v. Klein*, 247 F.2d 908, 915(2nd Cir. 1957), *cert.*

Birkenfeld decided to plead guilty and cooperate with the government. During his guilty plea, Birkenfeld admitted that between 2001 and 2006, while he was employed as a director in the private banking division of UBS, he routinely traveled to and had contacts within the United States to help wealthy American citizens conceal their ownership of assets held in offshore and evade the payment of taxes on the income generated from those assets. According to statements and documents filed with the court, Birkenfeld's services to American clients violated a 2001 agreement that the Swiss bank entered into with the United States. Under the terms of the agreement, the bank would identify and document any customers who received reportable U.S. source income. This agreement was a major departure from historical Swiss bank secrecy laws under which Swiss banks concealed bank information for U.S. clients from the IRS.⁴

denied, 355U.S. 924 (1958). For a full explication and analysis of tax fraud conspiracies, see 1 I. Comisky, L. Feld and S. Harris, *Tax Fraud and Evasion*, ¶3.05[6] (2007) ("Comisky, Feld and Harris, *Tax Fraud and Evasion*").

⁴ The indictment (¶¶5 and 6) described the tax fraud scheme as follows:

In 2001[UBS] voluntarily entered into a Qualified Intermediary Agreement with the Internal Revenue Service pursuant to which [UBS] agreed to identify and document any customers who received reportable United States source income. In accordance with IRS requirements, UBS agreed to have its customers fill out IRS Forms W-8BEN, which require foreign beneficial owners of bank accounts to be identified, and IRS Forms W-9 which require United States beneficial owners of bank accounts to be identified. This Qualified Intermediary Agreement was a major departure from historical Swiss bank secrecy laws under which Swiss banks concealed bank information for United States clients from the IRS. [UBS] further agreed to issue IRS Forms 1099 to United States customers for United States source payments of dividends, interest, rents, royalties and other fixed or determinable income paid into the United States customers' off-shore bank accounts and file the Form 1099 information with the IRS. As a result of this Agreement, [UBS] was able to hold itself out as a Qualified Intermediary and claim benefits as a Qualified Intermediary. At all relevant times, to this Indictment, [UBS] represented to the IRS that it had continued to honor this Qualified Intermediary Agreement.

During the period from at least in or about 2001 through the date of this Indictment,

When UBS notified its U.S. clients of the requirements of this agreement, many of the bank's wealthy U.S. clients refused to be identified, to have taxes withheld from the income earned on their offshore assets or to sell their U.S. investments. These accounts were known at UBS as the United States undeclared business. UBS has estimated that it has approximately 20,000 accounts in Switzerland for U.S. clients, of which roughly 1,000 are declared accounts and 19,000 undeclared accounts that have not been disclosed to the IRS.⁵

According to evidence provided by Birkenfeld to the court, managers and bankers at the firm, including Birkenfeld, assisted the U.S. clients in concealing their ownership of the assets held offshore by helping these wealthy customers create nominee and sham entities. This was done to prevent the risk of losing the approximately \$20 billion of assets under management in the United States undeclared business, which earned the bank approximately \$200 million per year in revenues.

To further assist U.S. clients of the bank in concealing their offshore accounts, Birkenfeld admitted that he, Mario Staggli, additional private bankers and managers at UBS and others advised U.S. clients to place cash and valuables in Swiss safety deposit boxes, and purchase jewels, artwork and luxury items using the funds in their Swiss bank account while overseas. Additionally, they advised the clients to misrepresent the receipt of funds from the Swiss bank account in the United States as loans from the bank; destroy all off-shore banking records existing in the

defendants BRADLEY BIRKENFELD and MARIO STAGGL, and others known and unknown to the Grand Jury, participated in a scheme to defraud the IRS by falsifying Swiss bank documents, by falsifying IRS Forms W-8BEN, by failing to prepare Forms W-9, by setting up nominee entities, by failing to issue IRS Forms 1099, and by failing to comply with the terms of the Qualified Intermediary Agreement with the IRS in order to conceal from the IRS United States source income paid into Swiss bank accounts beneficially owned by United States taxpayers.

⁵ Staff Report at 84.

United States; utilize Swiss bank credit cards that they claimed could not be discovered by U.S. authorities; and file false U.S. individual income tax returns that omitted income earned by the clients and fraudulently misrepresented that the clients did not have an interest in and signature authority over accounts held offshore.

Birkenfeld admitted that from at least 2001 through the date of the indictment, he conspired with Staggl, Olenicoff, the American real estate developer, additional private bankers and managers employed by the Swiss bank, and others to defraud the United States of approximately \$7.2 million in tax revenue by assisting Olenicoff in evading income tax on the income earned on \$200 million of assets hidden offshore in Switzerland and Liechtenstein.

To circumvent the requirements of the agreement between the bank and the IRS, Birkenfeld and others conspired to conceal Olenicoff's ownership and control of the \$200 million of assets hidden offshore by creating and utilizing nominee and sham entities, including Bahamian corporations, Liechtenstein trusts and Danish corporations.⁶

Birkenfeld's alleged co-conspirator, Mario Staggl, part owner of a trust company, remains at large in Liechtenstein where he resides.

The prosecution of Birkenfeld was aided by information obtained from (at least) two individuals. First, the United States detained as a material witness in that prosecution Martin Liechti, a senior UBS private banking official from Switzerland who had been traveling on business in Florida and allegedly seized his personal computer and other evidence. The second individual is Igor Olenicoff, the real estate developer whose taxes Birkenfeld helped to evade.

⁶ "Banker Pleads Guilty to Helping American Real Estate Developer Evade Income Tax on \$200 Million" in Department of Justice Press Release, dated June 19, 2008 which may be found at <http://www.usdoj.gov/tax/txdv08550.htm>.

Olenicoff had pled guilty in 2007 to one count of filing a false tax return and had agreed to pay six years of back taxes, interest and penalties totaling \$52 million owed on assets and income hidden in foreign accounts.⁷ Olenicoff was sentenced to a two year term of probation and 120 hours of community service.

In November 2008, a grand jury in the Southern District of Florida returned an indictment against Raoul Weil who was the chairman and CEO of UBS' Global Wealth Management & Business Banking Division which includes UBS' Private Banking Division.⁸ The Private Banking Division has hundreds of private bankers dedicated to providing financial services to wealthy individuals and their families around the world. Like Birkenfeld, Weil was charged with a *Klein* conspiracy. The indictment charged Weil with conspiring to defraud the IRS by "providing unlicensed and unregistered banking services and investment advice in the United States and other activities intended to conceal from the IRS the identities of [UBS'] United States clients, who wilfully evaded their income tax obligations by, among other things, filing false income tax returns and failing to disclose the existence of their [UBS] account to the IRS."

It is clear that Olenicoff cooperated with the federal authorities and his information led to Birkenfeld's investigation, prosecution and conviction. Birkenfeld, in turn, entered into a cooperation agreement with the government which led to, among other things, the indictment of Raoul Weil.

Birkenfeld's information also enabled the Department of Justice to obtain, pursuant to IRC §7609(f), an order from the United States District Court for the Southern District of Florida

⁷ *United States v. Olenicoff*, Dkt. No. SA CR No. 07-227 (CJC) (S.D. Cal.).

⁸ *United States v. Raoul Weil*, Dkt. No. 08 CR 60322 (Cohn) (S.D. Fla., November 6, 2008). Weil failed to appear in court to respond to the indictment, and the District Court has declared him to be a fugitive. NY Times, January 14, 2009, at B3, col. 1.

to serve a John Doe summons on UBS AG for information regarding US taxpayers who may be using UBS to evade federal income taxes.⁹ It appears that this may be the first time that a John Does summons has been issued to a non-U.S. bank. It is unclear at the present time whether UBS has complied with the IRS summons. On October 1, 2008 an article in The New York Times reported that UBS delivered information requested by the John Doe summons to the Swiss taxing authorities, but it is unclear whether any part of this information has been delivered to the United States government.¹⁰

As part of his cooperation, Birkenfeld appears to have provided the government with extensive information about his U.S. clients whom he had helped create undeclared accounts at UBS. It is believed that this information has become part of an IRS database identifying persons whom the IRS believes may have ownership or control over undeclared accounts.

Reports of Foreign Financial Accounts

The Bank Secrecy Act (“BSA”)¹¹ gave the Department of the Treasury authority to establish recordkeeping and filing requirements for U.S. persons with financial interests in or signature authority, or other authority over financial accounts maintained at financial institutions in foreign countries. Title 31, U.S.C. §5314, provides that “the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports or keep records and file reports, when the resident, citizen or

⁹ *In the Matter of the Tax Liabilities of John Does, et al.*, Dkt. No. 08-21864-MC (Lenard/Garber) (S.D. Fla., July 1, 2008).

¹⁰ NY Times, October 1, 2008, at C3, col. 5.

¹¹ The BSA was recodified in 1982 as 31 U.S.C. §§5311-5322.

person makes a transaction or maintains a relation for any person with a foreign financial agency.”¹² A willful failure to file is a felony.¹³

The Secretary of Treasury has promulgated regulations requiring a report to be filed by each person subject to U.S. jurisdiction with a “financial interest in, or signature or other authority over, a bank, securities or other financial account in a foreign country.”¹⁴ Thus, every U.S. person having a financial interest in, or signature or other authority over, any foreign financial account with an aggregate value exceeding \$10,000 at any time during the calendar year must report that relationship by filing Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (“FBAR”), in addition to disclosing the existence of such an account on Part III of Schedule B of Form 1040 and including the income from such account on the U.S. person’s federal income tax return. The FBAR is required for each calendar year that a U.S. person maintains such an interest, signature or other authority over a foreign financial account. The FBAR must be filed on or before June 30 following the calendar year in which the relationship existed.¹⁵ It is important to remember that an extension of time for filing a U.S. income tax return does not extend the deadline for filing an FBAR. In other words, there is no extension of time available for the late filing of an FBAR.¹⁶

¹² 31 U.S.C. §5314.

¹³ 31 U.S.C. §5322.

¹⁴ 31 C.F.R. §103.24.

¹⁵ TD F 90-22.1, General Instructions, “Who Must File this Report.” The FBAR should not be filed with the accountholder’s federal income tax return, but should be mailed to the Department of the Treasury, PO Box 32621, Detroit MI 44832-0621. *Id.*, Filing Information, “When and Where to File”. “The FBAR is considered filed when it is received in Detroit, not when it is postmarked.” IRM 4.26.16.3.7 (July 1, 2008).

¹⁶ IRM 4.26.16.3.7.1 (July 1, 2008).

On April 10, 2003, the Financial Crimes and Enforcement Network (“FinCEN”) delegated enforcement authority to the IRS for this statutory framework. The IRS is responsible for investigating possible civil violations, assessing and collecting civil penalties and issuing administrative rulings. The IRS describes the purpose of the FBAR rules as follows:

The FBAR rules were established because of the utility of the information required in criminal, tax, and other regulatory matters and in the conduct of intelligence or counterintelligence activities including analysis to protect against international terrorism. The reports filed as a result of this regulation provide leads to investigators that facilitate the identification and tracking of illicit funds or unreported income, as well as providing additional prosecutorial tools to combat money laundering and other crimes.¹⁷

Form TD F 90-22.1 was substantially changed in October 2008 and the amended form must be used after December 31, 2008.¹⁸ For FBAR purposes, the term “United States person” means a citizen or resident of the United States or “a person in or doing business in the United States” and the amended FBAR form refers to 31 CFR §103.11(z) which, in turn, includes an individual, corporation, partnership, trust or estate, Indian tribe, and “all entities cognizable as legal personalities.”¹⁹ The October 2008 amended FBAR form added language that requires the filing of a report by a “person in and doing business in the United States.” The instructions require that a non-U.S. person meeting the “person in and doing business” requirement provide identification by way of a foreign passport number and the country of issuance.²⁰

¹⁷ Workbook on the Report of Foreign Bank and Financial Accounts (“FBAR”), <http://www.IRS.gov/businesses/small/article/0,,id=159757,00.html>. See also, 31 U.S.C. §5311.

¹⁸ For the newly revised TD F 90-22.1 and Instructions, see www.IRS.gov/pub/IRS-pdf/f90221.pdf.

¹⁹ 31 CFR §103.11(z); IRM 4.26.16.3.1.1 (July 1, 2008).

²⁰ TD F. 90-22.1, Instructions for Specific Items, Item 4.

The term “financial account” has a broad definition that includes any bank, securities, securities derivatives or other financial instrument accounts, including any accounts in which the assets are held in a commingled fund and the account owner holds an equity interest in the fund. The term also includes any savings, demand, checking, deposit, time deposit, or any other account (including debit card and pre-paid credit accounts) maintained by a financial institution or other person engaged in the business of a financial institution. The instructions to the October 2008 amended FBAR note that a “financial account” does not include individual bonds, notes or stock certificates held by the filer, or an unsecured loan to a foreign trade or business that is not a financial institution.²¹

The term “financial interest” is defined by the instructions to the FBAR as follows:

Financial Interest. A financial interest in a bank, securities, or other financial account in a foreign country means an interest described in one of the following three paragraphs:

1. A United States person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others including non–United States persons.

2. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power for all shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income, taking into account any special allocation agreement) or more than 50 percent of the

²¹ TD F. 90-22.11, Instructions, General Definitions, Financial Account; IRM 4.26.16.3.2 (July 1, 2008).

capital of the partnership; or (d) a trust in which the United States person either has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.

3. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed. A trust protector is a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee.

Correspondent or “nostro” accounts (international interbank transfer accounts) maintained by banks that are used solely for the purpose of bank-to-bank settlement need not be reported on this form, but are subject to other Bank Secrecy Act filing requirements. This exception is intended to encompass those accounts utilized for bank-to-bank settlement purposes only.²²

The terms “signature or other authority” over an account are defined by the instructions to the FBAR as follows:

Signature or Other Authority Over an Account. A person has signature authority over an account if such person can control the disposition of money or other property in it by delivery of a document containing his or her signature (or his or her signature and that of one or more other persons) to the bank or other person with whom the account is maintained. Other authority exists in a person who can exercise comparable power over an account by communication with the bank or other person with whom the account is maintained, either directly or through an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person, either orally or by some other means.²³

If two persons maintain an account or if several persons each own a partial interest in an account, then each U.S. person has a financial interest in that account and each person must file

²² TD F. 90-22, General Definitions, Financial Interest; IRM 4.26.16.3.4 (July 1, 2008).

²³ TD F. 90-22, General Instructions, General Definitions, Signature or Other Authority Over an Account; IRM 4.26.16.3.5 (July 1, 2008).

an FBAR. The IRS explains the rules governing the reporting of spousal joint accounts as follows:

A spouse having a joint interest in an account with the filing spouse could be included as a joint accountowner in Part III of the FBAR. The filer should write (spouse) on line 26 after the last name of the joint spousal owner. If the only reportable accounts of the filer's spouse are those reported as joint owners, the filer's spouse need not file a separate report. But if the accounts are owned jointly by both spouses, the filer's spouse should also sign the report. It should be noted that if the filer's spouse has a financial interest in other accounts that are not jointly owned with the filer or have signature or other authority over other accounts, the filer's spouse must file a separate report for all accounts including those owned jointly with the other spouse.²⁴

The recordkeeping requirements for foreign accountholders are as follows:

Record Keeping Requirements. If this Report is required, certain records must be retained. Such records must contain the name in which each such account is maintained, the number or other designation of such account, the name and address of the foreign bank or other person with whom such account is maintained, the type of such account, and the maximum value of each account during the reporting period. Retaining filed copies of this report will help to meet these requirements. The records must be retained for a period of five years and must kept at all times available for inspection as provided by law.²⁵

There are several exceptions to the FBAR filing requirement.²⁶ In addition, the reporting obligation does not apply if the account is in an institution known as a "United States military banking facility."²⁷ There are special rules where a person has signature or other authority but

²⁴ Workbook on the Report of Foreign Bank and Financial Accounts ("FBAR"), <http://www.IRS.gov/businesses/small/article/0,,id=159757,00.html>.

²⁵ TD F. 90-22.11, General Instructions, Filing Information, Recordkeeping Requirements; IRM 4.26.16.3.8 (July 1, 2008).

²⁶ TD F. 90-22, General Instructions, Exceptions; IRM 4.26.16.3.5.3 (July 1, 2008).

²⁷ TD F. 90-22, General Instructions, General Definitions, Military Banking Facility; IRM 4.26.16.3.2. (July 1, 2008).

no financial interest in a foreign financial account and where a corporation should file a consolidated report on behalf of a corporate parent and its subsidiary.²⁸

The willful failure to file an FBAR or to retain records of a foreign financial account is punishable by a term of imprisonment of up to five years, a criminal fine of up to \$250,000 or both.²⁹ The criminal penalties are enhanced if the violation occurs while violating another law of the United States or if the violation was part of a pattern of any illegal activity involving more than \$100,000 in a twelve month period. The enhanced criminal penalties are a term of imprisonment of up to ten years, a maximum criminal fine of \$500,000, or both.³⁰ A person who willfully submits a false FBAR can be charged under the false statement statute, 18 U.S.C. §1001 which carries a maximum term of imprisonment of five years, a maximum fine of \$250,000 (\$500,000 for a corporation), or both.³¹

There are few reported decisions interpreting the FBAR reporting obligation or the sanctions for its violation.³² Each FBAR not filed or falsely filed constitutes a separate criminal violation. The criminal statute of limitations is five years under 18 U.S.C. §3282.

²⁸ TD F. 90-22, General Instructions, Explanations For Specific Items, Parts IV and V.

²⁹ 31 U.S.C. §5322(a). Venue for a prosecution under 31 U.S.C. §5322 would be in Michigan where the FBAR should have been filed. Of course, a willful failure to file an FBAR could be part of the evidence supporting a charge under IRC §§7201 and 7212(a) and 18 U.S.C. §371.

³⁰ 31 U.S.C. §5322(b).

³¹ 18 U.S.C. §1001; 18 U.S.C. §3571(b).

³² *United States v. Sturman*, 951 F.2d 1466, 1475-1476 (6th Cir. 1991), *cert. denied*, 504 U.S. 985 (1992); *United States v. Clines*, 958 F.2d 578 (4th Cir.), *cert. denied*, 505 U.S. 1205 (1992).

The applicable civil penalties for FBAR violations are substantial and complex. The civil penalty for a violation of the FBAR statute was increased by the American Jobs Creation Act of 2004.³³

The civil penalty provisions are as follows:

(5) Foreign financial agency transaction violation.—

(A) Penalty authorized. The Secretary of the Treasury may impose a civil money penalty on any person who violates, or causes any violation of, any provision of section 5314.

(B) Amount of penalty.—

(i) In general. Except as provided in subparagraph (C), the amount of any civil penalty imposed under subparagraph (A) shall not exceed \$10,000.

(ii) Reasonable cause exception. No penalty shall be imposed under subparagraph

(A) with respect to any violation if—

- (I)** such violation was due to reasonable cause, and
- (II)** the amount of the transaction or the balance in the account at the time of the transaction was properly reported.

(C) Willful violations. In the case of any person willfully violating, or willfully causing any violation of, any provision of section 5314—

(i) the maximum penalty under subparagraph (B)(i) shall be increased to the greater of—

(I) \$100,000, or

(II) 50 percent of the amount determined under subparagraph (D), and

(ii) subparagraph (B)(ii) shall not apply.

(D) Amount. The amount determined under this subparagraph is—

(i) in the case of a violation involving a transaction, the amount of the transaction, or

(ii) in the case of a violation involving a failure to report the existence of an account or any identifying information required to be provided with respect to an account, the balance in the account at the time of the violation.³⁴

³³ The American Jobs Creation Act of 2004, Pub. L. No. 108-357, tit. VII, §821, 118 Stat. 1418 (Oct. 22, 2004).

³⁴ 31 U.S.C. §5321(5).

There are civil penalties for negligence, pattern of negligence, non-willful and willful violations. The statutory change with respect to willful violations dramatically increased the potential liability. The statute permits a maximum civil penalty for a willful failure to file an FBAR equal to \$100,000 or 50% of the balance in the account at the time of the violation, whichever is greater. Thus, if that civil penalty is applied for two or more years, the total amount of the penalty assessed could equal the value of the account.

This statute is replete with issues of interpretation and application. First, what does “willfulness” mean in this provision? Initially, it may be observed that the same definition of willfulness should apply to both 31 U.S.C. §5321 (civil penalty) and 31 U.S.C. §5322 (criminal penalty). It is believed that willfulness in these statutes means the intentional violation of a known legal duty, which is the same standard that governs willfulness for offenses defined in the Internal Revenue Code.³⁵

Under this definition, there is no willful violation unless the person having an interest in or signature or other authority over the foreign account knew that he or she had a duty to file an FBAR. If such person had no knowledge of a duty to file an FBAR, there cannot be willful violation of the reporting obligation. Of course, knowledge of the duty to file an FBAR may be established by circumstantial evidence. The IRM provision describing the FBAR willfulness penalty states, in relevant part, as follows:

1. The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty.
2. A finding of willfulness under the BSA must be supported by evidence of willfulness.

³⁵ IRM 4.26.16.4.5.3 (July 1, 2008) (“The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty.”); *Cheek v. United States*, 498 U.S. 192 (1991).

3. The burden of establishing willfulness is on the Service.
4. If it is determined that the violation was due to reasonable cause, the willfulness penalty should not be asserted.
5. Willfulness is shown by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements. In the FBAR situation, the only thing that a person need know is that he has a reporting requirement. If a person has that knowledge, the only intent needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR.
6. Under the concept of "willful blindness", willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements. An example that might involve willful blindness would be a person who admits knowledge of and fails to answer a question concerning signature authority at foreign banks on Schedule B of his income tax return. This section of the return refers taxpayers to the instructions for Schedule B that provide further guidance on their responsibilities for reporting foreign bank accounts and discusses the duty to file Form 90-22.1. These resources indicate that the person could have learned of the filing and recordkeeping requirements quite easily. It is reasonable to assume that a person who has foreign bank accounts should read the information specified by the government in tax forms. The failure to follow-up on this knowledge and learn of the further reporting requirement as suggested on Schedule B may provide some evidence of willful blindness on the part of the person. For example, the failure to learn of the filing requirements coupled with other factors, such as the efforts taken to conceal the existence of the accounts and the amounts involved may lead to a conclusion that the violation was due to willful blindness. The mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness.
7. Willfulness can rarely be proven by direct evidence, since it is a state of mind. It is usually established by drawing a reasonable inference from the available facts. The government may base a determination of willfulness in the failure to file the FBAR on inference from conduct meant to conceal sources of income or other financial information. For FBAR purposes, this could include concealing signature authority, interests in various transactions, and interests in entities transferring cash to foreign banks.³⁶

³⁶ IRM 4.26.16.4.3 (July 1, 2008).

The IRS has the burden of proof in establishing that a violation of the FBAR reporting obligation is willful.³⁷ Although it does not appear that there are any judicial decisions on burden of proof in the FBAR civil penalty context, it is believed that the IRS will have to satisfy its burden of proof by “clear and convincing evidence”, the same standard that exists in civil tax fraud cases where the Service must produce such evidence to establish the taxpayer’s intent at the time of the violation.³⁸

There are other open questions. For example, if the proposed civil penalty is 50% of “the balance of the account at the time of the violation” what is the “time” of the violation in the context of a failure to file an FBAR? In this regard, it should be remembered that the FBAR must be filed on or before June 30 of the year following the calendar year for which the FBAR is filed.³⁹ Which date(s) during this six month period is the date for determining “the balance in the account” when the “willful” violation occurred? The IRM fixes the date of a filing violation as June 30 of the year following the calendar year for which the account is reported:

The date of a filing violation is June 30th of the year following the calendar year for which the accounts are being reported. This date is the last possible day for filing the FBAR so that the close of the day with no filed FBAR represents the first time that a violation has occurred. The amount [balance] in the account at the close of June 30th is the amount to use in calculating the filing violation.⁴⁰

³⁷ Since the FBAR penalty is not a tax or a tax penalty, it would seem that the presumption of correctness that courts traditionally apply to tax assessments would not apply to an FBAR penalty assessment; as stated above, the burden of establishing willfulness is on the Service. IRM 4.26.16.4.5.3 (July 1, 2008).

³⁸ See Tax Court Rule 142(b): “In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue is on the respondent, and that burden of proof is to be carried by clear and convincing evidence.” See generally, Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶9.05 at 9-47.

³⁹ TD F. 90-22, General Instructions, Filing Information.

⁴⁰ IRM 4.26.16.4.5.5 (July 1, 2008).

According to the IRM, the date for determining the calculation of an FBAR penalty for violation of the recordkeeping requirement is the date that the examiner first requests records:

The date that the examiner first requests records is the date of the violation for failure to keep records. The date of the violation should be tied to the date of the request, and not a later date to avoid the taxpayer manipulating the amount in the account after receiving a request for records. The balance in the account at the close of the day on which the records are first requested is the amount to use in calculating the recordkeeping penalty violation.⁴¹

A civil penalty for an FBAR violation may be assessed “at any time before the end of the six-year period beginning on the date of the transaction with respect to which the penalty is assessed.”⁴² An action to recover an assessed penalty may be commenced up to two years after the date the penalty was assessed or two years after the date a judgment becomes final in a criminal action dealing with the same transaction.⁴³ The civil penalty statute provides that a civil penalty may be imposed “notwithstanding the fact that a criminal penalty is imposed with respect to the same transaction.”⁴⁴

The statutory penalty computation provides a ceiling on the FBAR penalty. The actual amount of the penalty is left to the discretion of the examiner. The Service has adopted guidelines to promote consistency by Service employees in exercising this discretion for similarly situated persons. There are highly detailed standards governing issues relating to mitigation of

⁴¹ IRM 4.26.16.4.5.5 (July 1, 2008).

⁴² 31 U.S.C. §5321(b)(1).

⁴³ 31 U.S.C. §5321(b)(2).

⁴⁴ 31 U.S.C. §5321(d). For discussion of whether the double jeopardy clause may preclude criminal and civil FBAR penalties from being imposed consecutively or *seriatim*, see 2 Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶¶11.02[5][e]; 11.05[2][e].

FBAR penalties.⁴⁵ The examiner possesses the discretion to determine that the facts of a particular case do not justify asserting a penalty.⁴⁶

Criminal Tax Sanctions

Congress created a comprehensive statutory system of criminal and civil sanctions to prohibit and punish tax fraud. The general aim of this system of penalties is to deter non-compliance with the filing and payment provisions of the Internal Revenue Code (“the Code”), thereby protecting the proper administration of the tax system and the revenue that the system is intended to produce. The most serious offense defined by the Code is tax evasion (IRC §7201) which the United States Supreme Court described as:

the capstone of a system of sanctions which singly or in combination were calculated induce prompt and forthright fulfillment of every duty under the income tax law and to provide a penalty suitable to every degree of delinquency.⁴⁷

An individual convicted of violating IRC §7201 faces potentially devastating consequences. For each count of conviction evasion, there is a possible five year term of imprisonment and a criminal fine of up to \$250,000.⁴⁸ The elements of the offense of tax evasion are “willful-

⁴⁵ IRM 4.26.16.4.6 (July 1, 2008).

⁴⁶ IRM 4.26.16.4.7 (July 1, 2008).

⁴⁷ *Spies v. United States*, 317 U.S. 492, 497 (1943).

⁴⁸ IRC §7201 provides that a maximum fine of \$100,000 may be imposed per count of conviction in the case of an individual and a maximum fine of \$500,000 per count of conviction in the case of corporations. However, 18 U.S.C. §3571 authorizes criminal fines that are larger than those specified in IRC §7201: a maximum fine of \$250,000 per felony offense in the case of an individual and \$500,000 for a felony offense in the case of an organization. The defendant is also liable for the costs of prosecution.

ness, existence of a tax deficiency . . . and an affirmative act constituting an evasion or attempted evasion of the tax”⁴⁹

Tax fraud is frequently prosecuted under IRC §7206(1), the false statement statute which is also sometimes referred to as the “tax perjury statute.” A violation of IRC §7206(1) is punishable by up to three years’ imprisonment, a fine of up to \$250,000 (\$500,000 for a corporation), or both, plus the costs of prosecution. The essential elements of the offense defined by IRC §7206(1) are as follows:

- (1) the defendant made and signed a return, statement or other document that contained a written declaration that it was being signed subject to the penalties of perjury;
- (2) the return, statement or other document contained false information with respect to a material matter;
- (3) the defendant did not believe that the material matter was true and correct; and
- (4) the defendant acted willfully.⁵⁰

A taxpayer who willfully fails to disclose income earned from a foreign account that must be reported on Form 1040 and/or who falsely answers “no” to the question on Part III (Foreign Accounts and Trusts) whether at any time during the preceding year he had an interest in, or a signature or other authority over a financial account in a foreign country containing more than

⁴⁹ *Sansone v. United States*, 380 U.S. 343, 351 (1965). For a comprehensive discussion of IRC §7201, see Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶2.03.

⁵⁰ See *United States v. Bishop*, 412 U.S. 346, 350 (1973). See generally, Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶2.04.

\$10,000 violates IRC §7206(1).⁵¹ The government possesses significant advantages when it prosecutes under IRC §7206(1) because no tax deficiency or actual tax consequences need to be proved in order to secure a conviction. The falsehood is the gist of the offense.

As previously noted, the government has employed a *Klein* conspiracy charge against the UBS bankers. That offense may also be charged against taxpayers who participate in such a scheme.

Recent developments indicate that there is a risk of money laundering charges for tax fraud schemes related to undeclared foreign accounts.⁵² Charging a tax offense as a violation of the money laundering statutes substantially increases the severity of criminal penalties and also enables the government to seek a forfeiture of assets that are proceeds of a money laundering offense.⁵³

Money laundering is commonly associated with “dirty money,” that is, concealing “proceeds” from a variety of crimes, such as narcotics, organized crime, bribery, kickback schemes, espionage, etc.⁵⁴ Tax offenses are usually thought to be crimes that do not create “proceeds” of the offense. This view was recently adopted by the Eleventh Circuit in *United States v. Khanani*,

⁵¹ *United States v. Mueller*, 74 F.3d 1152, 1156 (11th Cir. 1996); *United States v. Franks*, 723 F.2d 1482 (10th Cir. 1983), *cert. denied*, 469 U.S. 817 (1984).

⁵² Comisky and Lee, “Increased IRS Scrutiny of Offshore Activity: Raising the Stakes For U.S. Citizens With Bank Accounts Abroad,” *Journal of International Taxation* (January 2009).

⁵³ The principal money laundering statute, 18 U.S.C. §1956, provides for a maximum term of imprisonment of twenty years, a maximum fine of \$500,000 or twice the value of the property involved in the transaction, whichever is greater. The civil and criminal forfeiture statutes are applicable to property involved in, or traceable to, proceeds of the offense. 18 U.S.C. §§ 981 and 982.

⁵⁴ The list of predicate activities for a money laundering charge contained in 18 U.S.C. §1956(c)(7) does not include tax offenses.

502 F.3d 1281, 1295-1296 (11th Cir. 2007). There, the defendants were convicted of employing illegal aliens and paying them with funds that were skimmed from retail stores. The money laundering charge rested on the theory that the defendants had paid the illegal aliens with income skimmed from the business, had not reported that income to the IRS and had failed to remit federal or state employment taxes on the wages of the workers. The District Court granted a motion for judgment of acquittal on this charge and the Eleventh Circuit affirmed. The Court of Appeals, quoting the District Court opinion, concluded that “proceeds” are “something which is obtained in exchange for the sale of something else as in, most typically, when one sells a good in exchange for money.” The Eleventh Circuit agreed with the District Court that the term proceeds “does not contemplate profits or revenue indirectly derived from labor or from the failure to remit taxes.”⁵⁵

There is, however, a contrary line of authority. The analysis begins with the Supreme Court’s decision in *Pasquantino v. United States*, 544 U.S. 349 (2005) which held that a scheme to smuggle liquor from the United States into Canada to evade Canadian excise taxes could be prosecuted as a violation of the wire fraud statute, 18 U.S.C. §1343, if there was proof that the defendants employed U.S. wire facilities (*e.g.*, telephone, fax, internet, etc.) to effectuate the scheme. Wire fraud and its sister statute, mail fraud, 18 U.S.C. §1341, are predicate offenses under the money laundering statute. *Pasquantino* authorizes a prosecution of a scheme to evade foreign taxes if the U.S. mails or wire facilities are employed. The decision did not address whether a mail fraud or wire fraud prosecution could be applied to a scheme to evade domestic U.S. income taxes which, in turn, could become the basis for a money laundering charge.

⁵⁵ *United States v Khanani*, 502 F.3d at 1295-96, quoting *United States v. Maali*, 358 F. Supp. 2d 1154, 1158, 1160 (Md. Fla. 2005).

It is well established that the mailing of a false state income tax or sales tax return may be charged as a mail fraud violation and therefore form the basis for a money laundering charge.⁵⁶ The Tax Division of the Department of Justice, for many years, had a policy of limiting the use of the mailing of tax returns to establish a mail fraud charge.⁵⁷ The Tax Division recently altered this policy to allow a purely domestic tax offense to be charged as mail or wire fraud which, in turn, could be a predicate for a RICO or money laundering violation. The Directive states:

Tax Division authorization is required before charging mail fraud, wire fraud or bank fraud alone or as the predicate to a RICO or money laundering charge for any conduct arising under the internal revenue laws, including any charge based on the submission of a document or information to the IRS. Tax Division approval also is required for any charge based on a state tax violation if the case involves parallel federal tax violations.

Tax Division Directive No. 128 now permits Tax Division approval of mail fraud, wire fraud or bank fraud charges in tax related schemes to defraud the government or other persons “if there was a large fraud loss or a substantial pattern of conduct and there is a significant benefit to bringing the charges instead of, or in addition to, Title 26 violations.” The Directive provides that “absent unusual circumstances,” the “Tax Division will not approve mail or wire fraud charges in cases involving only one person’s tax liability or when all submissions to the IRS were truthful.” The Directive also states that fraud charges should be considered if there is a significant benefit at the charging stage (*e.g.*, supporting forfeiture of the proceeds of a fraud scheme; allowing the government to describe the entire scheme in the indictment) or at trial to insure that all relevant evidence will be admitted or at sentencing to insure that full restitution will be ordered.

⁵⁶ *United States v. Helmsley*, 941 F.2d 71 (2d Cir.), *cert. denied*, 502 U.S. 1091 (1991).

⁵⁷ U.S. Department of Justice, Tax Division Directive, 99 (March 30, 1993).

With respect to money laundering charges, Tax Division Directive No. 128 provides that the Tax Division will not authorize the use of mail fraud, wire fraud, or bank fraud charges to convert “routine tax prosecutions” into RICO or money laundering offenses, but it will do so where “unusual circumstances warrant it.” It is readily apparent that the amended Directive enhances the government’s discretion to employ money laundering charges in criminal tax cases.

A recent Third Circuit decision suggests that the risk of a mail fraud or wire fraud prosecution and a money laundering charge for a federal income tax offense has become more acute.⁵⁸ In that case, the Court of Appeals held that the mailing of tax returns as part of a scheme to defraud the Virgin Islands government of its 4% gross receipts tax could be charged as a mail fraud and, in turn, could form the predicate for an international money laundering charge. The Third Circuit noted the Eleventh Circuit’s decision in *Khanani* and then ignored it. The Third Circuit explained its holding as follows:

[W]e hold that unpaid taxes, which are unlawfully disguised and retained by means of the filing of false tax returns through the U.S. mail, constitute ‘proceeds’ of mail fraud for purposes of supporting a charge of federal money laundering. Here, 4% of the unreported gross receipts that should have been paid as tax to the Virgin Islands but were instead included in the lump sums of money which the defendants sent to Amman, Jordan, were clearly ‘proceeds’ of the fraudulent scheme perpetrated by the defendants. Specifically, the defendants’ fraudulent scheme was that of concealing certain gross receipts from the Virgin Islands government through the mailing of fraudulent tax returns in order to defraud, cheat and deprive the government of the 4% gross receipts taxes it was owed, thus enabling the defendants to unlawfully retain such Government property and profit from their scheme. *See Pasquantino v. United States*, 544 U.S. 349, 355-56 (2005) (holding that Canada’s right to uncollected excise taxes on imported liquor is ‘property’ in its hands, depriving Canada of that money inflicts ‘an economic injury no less than had they embezzled the funds from the Canadian treasury.) Here, the mailings were both for the purpose of executing the scheme and were material to the consummation of the scheme. . . . The use of the mail to file fraudulent tax returns and fail to pay all taxes owed was not

⁵⁸ *United States v. Yusuf*, 536 F.3d 178, 186-190 (3rd Cir. 2008).

incident to an essential part of the scheme, but also was clearly an essential part of the scheme because such mailings were the defendants' way of concealing the scheme itself by making the fraudulently reported gross receipts seem legitimate. . . .

Furthermore, the mailings of the fraudulent tax returns resulted in 'proceeds' of mail fraud based on the nature of the entire *ongoing fraudulent scheme* because the unpaid taxes unlawfully retained by defendants represented the 'proceeds' of a fraud that was also furthered by previous mailings. (Emphasis in original).⁵⁹

The Court of Appeals did not address the fact that 18 U.S.C. §1956(c)(7) does not define tax crimes as "specified unlawful activity," *i.e.*, the statutorily required predicate for money laundering. If *Yusuf* represents a valid statement of the law in this area, it is a small step for a prosecutor to charge that evaded federal income taxes, which are part of a scheme to defraud the IRS effectuated through the mailing or electronic filing of a false income tax return, can be charged as mail or wire fraud, which, in turn, can be the basis of a money laundering charge.

Civil Tax Penalties

The Internal Revenue Code contains approximately 130 penalty provisions. There are several that are potentially applicable in the context of undeclared foreign accounts. The civil fraud penalty is one of the most potent sanctions. IRC §6663 provides, in relevant part, as follows:

If any part of the underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75% of the portion of the underpayment attributable to fraud.

As noted above, the IRS has the burden of proving fraud by clear and convincing evidence. It should be noted that the fraud penalty does not apply to any portion of an underpayment that the taxpayer proves by a preponderance of the evidence was not due to fraud.⁶⁰

⁵⁹ 536 F.3d at 189-190.

⁶⁰ IRC §6663(b). For a comprehensive discussion of the civil fraud penalty, *see*

An underpayment of tax resulting from taxpayer misconduct where the proof falls short of fraud, will usually result in the application of the accuracy penalty under IRC §6662. To the extent a portion of an underpayment of tax is not due to fraud but rather to negligence or disregard of rules and regulations, a 20% addition will apply to that portion of the underpayment. “Negligence” includes “any failure to make a reasonable attempt to comply with the provisions of [the Code], and the term ‘disregard’ includes any careless or reckless or intentional disregard.”⁶¹ The meaning of these terms has been explained as follows:

Under IRS regulations, carelessness occurs when a taxpayer does not exercise reasonable diligence to determine the correctness of a return position. Recklessness occurs when a taxpayer makes little or no effort to determine whether a rule or regulation exists under circumstances that suggest a deviation from the standard of conduct that a reasonable person would observe. Intentional disregard occurs when a taxpayer knows the applicable rule or regulation that is disregarded. It would appear knowingly understating income or claiming merely unallowable deductions would always be at least reckless under the regulations.⁶²

To establish fraud, the evidence must demonstrate the existence of a specific wrongful intent to evade tax. Carelessness and negligence are not fraud.⁶³ The intentional disregard of rules and regulations, even flagrant disobedience, without evidence of a specific intent to defraud is also not fraud.⁶⁴

The accuracy related penalty also applies to substantial valuation misstatements or substantial tax understatements, without reference to the intent of the taxpayer. IRC §6662(d) pro-

Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶¶8.01-8.05.

⁶¹ IRC §6662(c).

⁶² Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶8.02[7][a] at 8-67, citing Reg. §1.6662-3(a)(2).

⁶³ *Id.*, note 408 citing cases.

⁶⁴ *Id.*, note 409 citing cases.

vides that there is a substantial understatement of income tax if the correct income tax is understated by more than the greater of 10% or \$5,000. In the case of corporations, the floor is \$10,000.⁶⁵ There are exceptions where the taxpayer had substantial authority for the return position or where the questioned item was properly disclosed.⁶⁶ These exceptions are unlikely to be applicable to taxpayers with undeclared accounts. The substantial understatement penalty would undoubtedly be asserted as an alternative to the civil fraud penalty in situations where the Service is concerned about meeting its burden of proof to establish fraud.

Information returns are required under IRC §6035, §6038, §6038A, §6038B, §6038C, §6039F, §6046, §6046A and §6048 (see Forms 5471, 5472, 926, 3520, 3520-A, 8865). Civil delinquency penalties for failure to file the required information returns can be large. IRC §6667, for example, imposes substantial civil penalties for failure to file Forms 3520 and 3520-A (or filing such forms incorrectly or incompletely) with respect to certain foreign trusts. IRC §6669 imposes substantial civil penalties for failure to file Form 5471 (or an incomplete or incorrect form) with respect to certain foreign corporations and partnerships. The interpretation and application of these penalties provisions are beyond the scope of this paper.

Voluntary Disclosure

A voluntary disclosure refers to the situation where a person comes forward to the IRS before being contacted and corrects past mistakes in an honest manner. The principal benefit sought by such action is that such a person will not become the subject of a criminal recommendation by IRS, Criminal Investigation (“CI”). In 2002, CI formally adopted and publically an-

⁶⁵ See IRC §6662(d)(1)(B).

⁶⁶ See IRC §6662(d)(2)(B).

nounced a “voluntary disclosure practice.”⁶⁷ This “voluntary disclosure practice” is contained in an IRM provision⁶⁸ which states as follows:

Voluntary Disclosure Practice

(1) It is currently the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended. This voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel. Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution.

(2) A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. This practice does not apply to taxpayers with illegal source income.

(3) A voluntary disclosure occurs when the communication is truthful, timely, complete, and when:

a. the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and

b. the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.

(4) A disclosure is timely if it is received before:

a. the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;

b. the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer’s noncompliance;

⁶⁷ IR-2002-135 (Dec. 11, 2002).

⁶⁸ IRM CI [9.5]9.5.3.3.1.2.1 (Dec. 11, 2002).

c. the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or

d. the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

(5) Any taxpayer who contacts the IRS in person or through a representative regarding voluntary disclosure will be directed to Criminal Investigation for evaluation of the disclosure. Special agents are encouraged to consult Area Counsel, Criminal Tax on voluntary disclosure issues.

(6) Examples of voluntary disclosures include:

a. a letter from an attorney which encloses amended returns from a client which are complete and accurate (reporting legal source income omitted from the original returns), which offers to pay the tax, interest, and any penalties determined by the IRS to be applicable in full and which meets the timeliness standard set forth above. This is a voluntary disclosure because all elements of (3), above are met.

b. a disclosure made by a taxpayer of omitted income facilitated through a barter exchange after the IRS has announced that it has begun a civil compliance project targeting barter exchanges; however the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intention to do so. In addition, the taxpayer files complete and accurate amended returns and makes arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable. This is a voluntary disclosure because the civil compliance project involving barter exchanges does not yet directly relate to the specific liability of the taxpayer and because all other elements of (3), above are met

c. a disclosure made by a taxpayer of omitted income facilitated through a widely promoted scheme regarding which the IRS has begun a civil compliance project and already obtained information which might lead to an examination of the taxpayer; however, the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so. In addition, the taxpayer files complete and accurate returns and makes arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable. This is a volun-

tary disclosure because the civil compliance project involving the scheme does not yet directly relate to the specific liability of the taxpayer and because all other elements of (3), above are met.

d. A disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year. The individual files complete and accurate returns and makes arrangements with the IRS to pay the tax, interest, and any penalties determined by the IRS to be applicable in full. This is a voluntary disclosure because the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so and because all other elements of (3), above, are met.

(7) Examples of what are not voluntary disclosures include:

a. a letter from an attorney stating his or her client, who wishes to remain anonymous, wants to resolve his or her tax liability. This is not a voluntary disclosure until the identity of the taxpayer is disclosed and all other elements of (3) above have been met.

b. a disclosure made by a taxpayer who is under grand jury investigation. This is not a voluntary disclosure because the taxpayer is already under criminal investigation. The conclusion would be the same whether or not the taxpayer knew of the grand jury investigation.

c. a disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted gross receipts from a partnership, but whose partner is already under investigation for omitted income skimmed from the partnership. This is not a voluntary disclosure because the IRS has already initiated an investigation which is directly related to the specific liability of this taxpayer. The conclusion would be the same whether or not the taxpayer knew of the ongoing investigation.

d. a disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted constructive dividends received from a corporation which is currently under examination. This is not a voluntary disclosure because the IRS has already initiated an examination which is directly related to the specific liability of this taxpayer. The conclusion would be the same whether or not the taxpayer knew of the ongoing examination.

e. a disclosure made by a taxpayer after an employee has contacted the IRS regarding the taxpayer's double set of books. This is not a voluntary disclosure even if no examination or investigation has yet commenced because the IRS has already been informed by the third party of the specific taxpayer's noncompliance. The conclusion would be the same whether or not the taxpayer knew of the informant's contact with the IRS.

There are several important aspects of the voluntary disclosure policy that need to be emphasized. First, as the IRM provision specifically states, these are internal policy guidelines and do not establish enforceable substantive or procedural rights for taxpayers.⁶⁹ Second, a voluntary disclosure does not automatically guarantee immunity from prosecution, but it may result in prosecution not being recommended. Third, the policy specifically excludes taxpayers with illegal source income. Fourth, a taxpayer who comes forward and who qualifies under a publicly announced initiative promising no CI recommendation for prosecution may still be investigated.⁷⁰ Fifth, in order to be eligible for the promise of no prosecution, all of the qualifying factors must be present.⁷¹

The Tax Division of the Department of Justice has its own voluntary disclosure policy. The Tax Division credits a taxpayer's voluntary disclosure only as a factor to be considered in evaluating the potential for conviction. In reviewing cases where a claim of voluntary disclosure

⁶⁹ See *United States v. Hebel*, 668 F.2d 995 (8th Cir.), *cert. denied*, 456 U.S. 946 (1982); *United States v. Choate*, 619 F.2d 21 (9th Cir. 1980).

⁷⁰ See *Crystal v. United States*, 172 F.3d 1141 (9th Cir. 1999).

⁷¹ See *United States v. Tenzer*, 127 F.3d 222 (2nd Cir. 1997), where the court held that a defendant who claimed to have made a voluntary disclosure could nevertheless be prosecuted because the court determined that he had failed to comply with the requirements of the IRS' voluntary disclosure policy, since he failed to pay or make a bona fide arrangement to pay his outstanding taxes. In another case, the Seventh Circuit held that the defendant's desire to participate in the IRS nonfiler program was defective because he already had personal contact with the Special Agent who was investigating him. *United States v. Knotterus*, 139 F.3d 558 (7th Cir. 1998) (defendant observed agent taking photographs of his residence and fled to avoid conversation).

has been advanced, Tax Division personnel focus on the taxpayer's cooperation and timeliness of disclosure.⁷²

A taxpayer who files amended income tax returns and delinquent FBARs to disclose an ownership interest in or signature or other authority over a foreign account and who reports income omitted from original tax returns would ordinarily come within the IRS voluntary disclosure policy. It is believed that an otherwise qualified UBS accountholder (not currently under examination or investigation) can make a qualifying voluntary disclosure, despite the publicity surrounding the UBS investigations and prosecutions and the government's attempt to obtain the identities of the accountholders.

In this regard, it should be noted that the voluntary disclosure practice states in relevant part:

(4) A disclosure is timely if it is received before:

- a. the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;
- b. the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance;

To illustrate the application of this guideline, the voluntary disclosure practice provision gives as an example of a voluntary disclosure the following:

(6) Examples of voluntary disclosures include:

- c. a disclosure made by a taxpayer of omitted income facilitated through a widely promoted scheme regarding which the IRS has begun a civil compliance project and already obtained information which might lead to an examination of the taxpayer; however, the

⁷² DOJ-CTM §4.01[2]. *See generally*, Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶4.07[2][a] at 4-77.

IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so. In addition, the taxpayer files complete and accurate returns and makes arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable. This is a voluntary disclosure because the civil compliance project involving the scheme does not yet directly relate to the specific liability of the taxpayer and because all other elements of (3), above are met.

However, absent some specific IRS pronouncement, it remains uncertain exactly when the opportunity to make a voluntary disclosure is terminated because of progress in enforcement and other proceedings involving UBS.⁷³

Practitioners frequently debate the manner of making a voluntary disclosure. One method is simply filing the requisite forms and tax returns with payment using routine methods. The other is to request advance “clearance” from local CI management and then file returns and make the payment to a revenue agent upon audit. Whether to make a “quiet” disclosure or a “noisy” disclosure is a delicate decision that is dependent upon the existence of, and weight to be given, to various considerations:

Factors to consider in the decision include the amounts involved, existence of nontax criminal conduct, egregiousness of any affirmative acts of evasion or obstruction, and possible loss of attorney-client privilege, including on account of the crime fraud exception. The taxpayer’s need for prompt application of the voluntary disclosure practice, other assurance, or an inkling of the parameters of possible criminal or civil tax controversy may affect the decision how to proceed.⁷⁴

With respect to undeclared UBS accountholders, discussion among knowledgeable practitioners indicates that many have opted for a pre-clearance approach.

⁷³ Comisky, Feld and Harris, *Tax Fraud and Evasion*, ¶10.07[7] at S10-11.

⁷⁴ *Id.*

It is important to observe that there appears to be no formal voluntary disclosure policy regarding foreign financial account disclosure, information forms relating to foreign trusts and gifts (Form 3520 series) or interests in foreign corporations (Form 5471 and related schedules). As previously discussed, there are substantial criminal and civil penalties for non-compliance with the obligation to file FBARs and substantial civil penalties for failure to file these other forms. UBS accountholders (and other U.S. persons having undeclared foreign accounts) contemplating an income tax voluntary disclosure also need to consider the filing of delinquent FBARs and other information forms if the latter are applicable to their particular fact situations.

For many taxpayers with undisclosed foreign accounts, a voluntary disclosure to the IRS is the best way to maximize their chances of avoiding criminal prosecution and minimizing the risk of draconian civil penalties for their tax and FBAR delinquencies. The IRS voluntary disclosure practice, despite its uncertainty, would be the best way to proceed for many taxpayers who wish to regularize their situation. But it is not suitable for all. It should be emphasized that half-hearted participation in this program is an enormous mistake. Amended tax returns must not only correct errors relating to offshore accounts, but all other errors and omissions. Filing false amended tax returns will disqualify the taxpayer from participating in the program and can be the basis for additional criminal and civil penalties. Furthermore, participation in the program will require accurate and complete disclosure of all assets and property if the taxpayer seeks an offer in compromise or an installment payment agreement. If the taxpayer intentionally fails to provide truthful and complete disclosure during the voluntary disclosure process, any closing agreement obtained can be set aside and the tax years reopened.⁷⁵

⁷⁵ IRC §7121(b) provides that a closing agreement “shall be final and conclusive” “except upon the showing of fraud for malfeasance, or misrepresentation of a material fact” *See also* Rev. Proc. 68-16, 1968-1 C.B.770; Rev. Proc. 94-68, 1994-2 C.B. 803.

In addition, if counsel for a taxpayer knowingly or unknowingly misstates material facts to the IRS during the voluntary disclosure process or presents false documents, there is a risk of additional criminal charges.⁷⁶ There is also a risk that the attorney-client privilege will be lost under the “crime fraud” exception to the privilege if such conduct occurs.⁷⁷

Taxpayers with illegal source income, as previously noted, do not qualify for participation in the voluntary disclosure program. They face a host of other difficult issues that are beyond the scope of this paper.

Is a voluntary disclosure to the IRS the right approach for a taxpayer with an undeclared foreign financial account? Guidance is available to assist that worried client chart a safe course through these perilous waters.

⁷⁶ IRC §7212(a); 18 U.S.C. §§1001, 1505, 1519.

⁷⁷ Comisky, Feld & Harris, *Tax Fraud & Evasion*, ¶506[2][c].