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THE NEW IRS VOLUNTARY DISCLOSURE POLICY:

A CRITICAL VIEW

In the 1989 movie classic, *Field of Dreams,* Kevin Costner hears a voice in his head, "Build it and they will come." On March 26, 2009, the Internal Revenue Service announced a new voluntary disclosure policy regarding overseas bank accounts and structures. Whether or not taxpayers after learning of the new policy will "come" remains to be seen. There are serious questions as to whether the new policy will provide the necessary "stick" to induce taxpayers who have such accounts to come forward or whether it will drive them further away. The initial experience is that the latter may be the rule and not the exception.

An Overview of the History of the Voluntary Disclosure Process

Until 1952, the IRS had a "formal" voluntary disclosure policy. The premise of this policy was that a taxpayer who was non-compliant could come forward and inform the IRS of his transgressions and avoid criminal prosecution. The key of a successful voluntary disclosure was (and still is) that the taxpayer "get to the IRS before the IRS gets to you." While the stated policy of the voluntary disclosure process is to permit a taxpayer to avoid criminal prosecution for tax offenses, the abatement of civil monetary penalties is an equal diving force behind most voluntary disclosures. This has become especially true since 1996 when the Internal Revenue Code was amended to provide enormous civil penalties for a taxpayer's failure to report certain overseas structures and a renewed effort in recent years by the IRS to insure compliance with foreign bank account reporting by taxpayers. The 1996 amendments to the Code and the IRS attention to foreign bank account reporting, coupled with the LGT (Liechtenstein Global Trust)

and UBS (Switzerland) cases of the last year provided a "perfect storm" that led to the promulgation of the new voluntary disclosure policy on March 26.

Prior to February 2008, when the LGT case was announced, the voluntary disclosure process was largely unregulated by the IRS National Office. Each local office had significant leeway in accepting and processing voluntary disclosure cases. Essentially, a taxpayer coming forward would have to represent that the unreported income and/or assets were from "legal" sources (not drugs, illegal gambling, etc.) and that the IRS had not contacted the taxpayer or that the taxpayer was not under civil audit or criminal investigation. It was generally understood by practitioners in this field that a taxpayer who made a voluntary disclosure would have *all civil and criminal* penalties waived and would only be required to pay six years worth of taxes and interest.

The LGT and UBS Cases

The knowledge that U.S. taxpayers were hiding money and other assets overseas was not new at the end of 2007.

On February 14, 2008, news was released that security had been severely breached at Lichtenstein Global Trust ("LGT"), a company owned by the ruling Prince of Liechtenstein. Heinrich Kieber, a person with a checkered past, was hired by LGT in April 2001 to scan documents of client files so that such files could be easily retrieved through a computer. Before leaving LGT in November 2002, Kieber decided to copy about 1,400 files for himself. In 2006 he reportedly sold these files to the German government for between 4-5 million Euros. Since only about 600 files pertained to Germany, the Germans gave (sold) the files pertaining to other countries to those countries.The U.S. received about 100 of the cases.

In December 2007, Igor Olenicoff, a naturalized U.S. citizen, who ranked as 215 on Forbes list of the 400 richest Americans, pled guilty to filing one count of a false 2002 tax return. Olenicoff, who had significant real estate holdings and was reportedly worth $1.6 billion, reportedly hid $200 million overseas with the assistance of UBS. In April 2008, it was reported that Olenicoff would not receive any jail time for his guilty plea. He paid $52 million to the U.S. Treasury, paid a fine of $3,500 and a $100 special assessment. More importantly, he fingered UBS as the protagonist of the plan for him to

hide assets and specifically identified a UBS employee, Bradley Birkenfeld, and a Lichtenstein resident, Mario Staggl, as the perpetrators behind the strategy. Both Birkenfeld and Staggl were indicted in May 2008 and Birkenfeld pled guilty in June 2008 and Staggl remains a fugitive. UBS has been accused of overseeing banking services that concealed approximately $20 billion from the IRS, a scam that apparently generated about $200 million per year for the bank. The crux of most tax evasion strategies using offshore accounts and structures were certain loopholes in the Qualified Intermediary program initiated by the IRS in the late 1990's that conferred withholding agent status on banks like UBS. In short, UBS used its position as a QI to fabricate strategies to avoid the QI rules.

The LGT and the UBS cases brought the use of offshore accounts and structures to evade U.S. reporting to center stage, and U.S. Senate hearings were held in July 2008. At those hearings UBS apologized for its role in assisting U.S. clients to evade the payment of U.S. taxes and several clients of LGT were called to testify. Since the Senate hearings, a top level UBS banker was indicted, UBS entered into a deferred prosecution agreement with the IRS on February 18, 2009, in which it agreed to pay $780 million for defrauding the IRS and agreed to release the names of nearly 300 U.S. taxpayers of the reportedly 17,000 clients/52,000 accounts that U.S. persons hold at UBS. For months Douglas Shulman and other top IRS officials have been warning U.S. taxpayers who are not tax compliant to voluntarily disclose to the IRS. It is because of the IRS response to the LGT and UBS cases that U.S. taxpayers with unreported accounts and income been making voluntary disclosures in unprecedented numbers. Further, there has been a general expectation that the lenient IRS voluntary disclosure policy that existed prior to February 2008 would still be applied.

The New IRS Voluntary Disclosure Policy

The new IRS voluntary disclosure policy announced on March 26 is as stunning for its lack of clarity as it is for its change in policy. The official IRS announcement stated:

> The purpose of this memorandum is to set forth a penalty framework to be applied to voluntary disclosure requests containing offshore issues. *The outlined*

> *framework will be applied to all such requests that have been submitted to the IRS and are not yet resolved, and will remain in effect for six months from the date of this memorandum...*Effective as of the date of this memorandum, you are authorized to execute agreements to resolve the tax liabilities related to offshore issues of taxpayers who make voluntary disclosure requests in the following manner:
>
> > (1) Access all taxes and interest due going back six years…
> >
> > (2) Access either an accuracy or delinquency penalty on all years (no reasonable cause exception may be applied), and
> >
> > (3) *In lieu of all other penalties that may apply, including FBAR and information return penalties, assess a penalty equal to 20% of the amount in foreign bank accounts/entities in the year with the highest aggregate account/asset value.*
> >
> > If, (a) the taxpayer did not open or cause any accounts to be opened or entities formed (b) there has been no activity in any account or entity (no deposits, withdrawals, etc.) during the period the account/entity was controlled by the taxpayer, and (c) all applicable U.S. taxes have been paid on the funds in the accounts/entities (where only account/entity earnings have escaped U.S. taxation), then the penalty in (3) is reduced to 5%.

Clearly the new policy imposes penalties that were not present under the old policy. Particularly vexing is the lack of guidance on (3), above. Is the 20% penalty imposed on highest amount in all accounts and structures although some accounts or structures may have been reported? What happens if a taxpayer has already submitted a request but the request has not been fully processed by the March 26 release? Is there any possibility of abatement of some of the penalty for unusual circumstances? It appears that this "one size fits all" policy may have a detrimental effect on taxpayers who would otherwise come forward.

Will Taxpayers Come Forward

The initial reaction of clients and their advisors to the new IRS policy is not positive based on the authors' experience. Of the potential nine new cases that the authors have dealt with since the March 26 announcement, only two taxpayers have decided to disclose. The other seven taxpayers decided to not come forward at this time specifically because of the 20% penalty in (3), above. What the IRS may have overlooked is that most taxpayers have modest accounts ($10 million or less). In almost all circumstances, taxpayers have lost significant value in the last two years because of the market decline. Thus a 20% penalty on the highest six year balance is in most cases a 40% penalty on the present value of those accounts. Compared with the previous policy waiving all penalties, the new policy appears severe. The comparison of the new policy on "small" versus "large" accounts is significant. Taxpayers considering a voluntary disclosure want to know "what will be left for me." For example, if a taxpayer had a "high" balance of $100 million which is now worth $50 million. The taxpayer under the new policy would pay $20 million in penalties to the IRS (assuming no income for the six year period) and keep $30 million. These taxpayers can live with that result. However, a taxpayer with a high of $2 million with a current value of $1 million pays $400,000 in penalties to the IRS and keeps $600,000. While the percentages and proportions are the same, the actual dollars left to the taxpayer after payment of the penalty to the IRS makes the smaller taxpayer more insecure. The concern is that the uniform policy announced on March 26 may drive taxpayers away despite "dire" warnings by Commissioner Shulman to those who continue to hide assets and income. The new voluntary disclosure policy should be reconsidered. When taxpayers come forward the federal government receives future income and estate taxes that it might not otherwise receive, states receive similar revenue and the IRS does not have to waste time and resources identifying and prosecuting non-compliant taxpayers. Further, persons who would not otherwise be criminals may become criminals because they fear that the economic cost of disclosure is too high.