Conflicting Advice in Foreign Tax Matters

By Eric L. Morgenthal

I remember a time when I was at a tax seminar; I had watched an attendee raise her hand to ask a question of a speaker. She had inquired about Foreign Bank Account Reporting (FBAR) and the procedure for correcting her client's filing deficiencies. In response, the answer provided was, "you are going to have to file several back year tax forms and your client will HAVE TO pay a large penalty." Other advice followed. The kind I typically see in many "one size fits all" columns online. But of the words I heard that day, the ones "HAVE TO" resonated in my mind the most. Those words stayed with me because they carried so many presumptions, particularly in connection with the statute of limitations, nature of the error/omission and the taxpayer's intent. Due to the commonality of these misconceptions, I'd like to take this opportunity to clarify the measures associated with addressing and correcting a client's foreign tax reporting deficiencies. Many clients have been receiving conflicting advice and it's easy to see how they can become confused.

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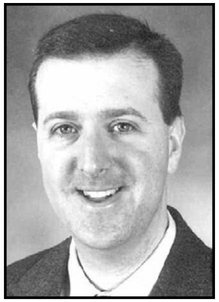
In 2009, the IRS had introduced an Offshore Voluntary Disclosure Initiative/Program (OVDI/OVDP). In the years that followed, the program was reintroduced and revised. Soon enough, thousands of practitioners started jumping on the foreign tax repair bandwagon. Many often with no foreign tax experience or holding limited knowledge of the foreign tax reporting and compliance requirements. They merely heard there was some form of amnesty being provided and instantly touted services to assist clients in rendering their submission. But there was a problem. Oftentimes, they themselves didn't understand the full implications or content of what they were submitting.



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Beware the silent disclosure endorsed by the preparer

A common fact pattern starts when the client visits their accountant. The client indicates that they've heard of a foreign tax crackdown from family or a friend and are wondering if it applies to them. Befuddled, the accountant recognizes that there were several years of unreported foreign income and filings. Either the accountant was not aware of the offshore activity's disclosure requirements or that the client had engaged in that activity. But a kneejerk reaction among some accountants was to advise the client to keep it nondescript – perhaps out of self-interest, because after all, they had signed the returns containing the deficiencies. They advised the client to consider preparation and "quiet" submission of corrected back-year or deficient tax returns to the IRS Processing center – not the Criminal Investigation Division. In effect, they were hoping the submission would sneak into and be buried in a pile of paper at the IRS offices, never to be seen again. But because proceeding quietly was not viewed by the IRS as a formal "Disclosure," there were no protections from prosecution.

Technically, IRS Circular 230 mandates that the accountant not formally endorse anything other than a "Loud" Disclosure anyway. But despite that instruction, more than 10,000 taxpayers arranged for the preparation of "quiet disclosures" of foreign bank accounts under the 2009 OVDI Program. And as a result, on April 26, 2013, the U.S. Government Accountability Office (GAO)[1] recommended that the IRS more effectively detect and pursue "quiet disclosures" and "first-time" filers. Since that time, the IRS has been using data mining techniques to trail them. Based upon this development, taxpayers must carefully weigh their criminal exposure before contemplating this path.

A common attorney recommended path

Afterward, the client commonly turns to their attorney. Besides, a Voluntary Disclosure submission, if made, is directed to the IRS Criminal Investigation Division. Civil liberties could potentially be at stake and the client is seeking the safest path to reindoctrinate back into the tax system. Along those lines, the Voluntary Disclosure becomes recommended and a large penalty is assessed to close the matter. The attorney considers advising the client to "opt-out" of the disclosure program framework but pauses after receiving a warning letter from the IRS. The letter describes that if an opt-out is undertaken; exposure to all penalties "in full" would be back on the table (even the willful one for one-half of the balance per year). The attorney gets scared and instead directs the client to accept the high flat rate penalty imposed on the value of the assets under the disclosure program. Often, it ends there. The attorney then touts himself as a hero who saved the client from jail in exchange for voluntarily surrendering a large sum of money. But what is unfortunate is that the large penalty payment may not even have been necessary or in the best interests of the client to make.

The client's dilemma

And therein lies the problem for the client: caught between the tax preparer who may have caused the problem and the attorney without the necessary background in International Tax to resolve it correctly. And between those two points of

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direction lies the opt-out that the client was brought closer to but ultimately scared away from, even though they may have been better served by giving stronger consideration to that option.

Opting out

If your client did not carry the indicia of willful intent, then the decision to opt-out of the Voluntary Disclosure program should be given strong attention. It offers the comfort that a loud disclosure, in good faith was made while maintaining the appeals rights afforded under the traditional audit process. After all, not every offshore account was secretly established in Switzerland.

Many practitioners were afraid that opting-out would re-invite criminal exposure or retribution. But based upon the National Taxpayer Advocate's report to Congress, the IRS had not initiated any criminal proceedings against those who had opted-out of the 2009 program at all. And the average penalty asserted on 2009 OVDI opt-outs was a mere $15,737, far less than the hundreds of thousands that were often imposed and consented to under advice of counsel in the OVDI. (Something I'm sure many practitioners would not want their clients to be made of aware of now.)

When a taxpayer opts-out, the IRS agent assigned will typically conduct a multi-hour interview with the client. And true, there are always risks. But unlike the OVDI, which imposes rigidity on its examiners, opt-out auditors are given more leeway. In fact, they are *expected* to take facts and circumstances into account. Not something mentioned when the client gets the threatening letter saying that opting out puts all available penalties (including willful) back on the table. In fact, Penalty "Mitigation" Guidelines[2] were even provided to minimize the consequences on smaller violations. If convinced, the IRS is even authorized to issue a Letter 3800 warning letter that abates the penalties for one or many of the tax years entirely. And to clarify the process, the IRS has updated its Appeals procedures for the resolution of contested FBAR assessments outside the OVDI.[3] Again, something many advisors may not have been aware of or were scared away from pursuing.

Although the "loud" voluntary disclosure option is the only path that Circular 230 allows tax advisors to affirmatively endorse, it does not mean that the client should be railroaded into surrendering a draconian penalty for unwillful and unintentional omissions, particularly if it's being done solely because of the advisors trepidation with the path not taken. Granted, many clients are willing to pay a premium for closure. However, the unfitting threat of "all penalties back on the table" should not supersede the independent judgment that their Attorney's are being paid to provide. When deciding to opt-out, the difference in tax dollars owed can be significant. In the tax controversy arena, attorney familiarity with foreign tax audits and appeals is critical. This is not the time to dabble.

Note: Eric L. Morgenthal, Esq., CPA, M.S. (Taxation) maintains his Tax Law practice in Melville, NY specializing in International, Federal and New York State Tax Controversy matters.

[1] (*GAO-13-318*)

[2] To obtain Penalty Mitigation, IRS requires that: no Tax or BSA convictions for prior 10 years, No foreign money was from illegal sources, person cooperated with the examination, and the underpayment did not trigger a fraud penalty for the income tax violations.

[3] Revised IRM 8.11.6