DeBlis & DeBlis

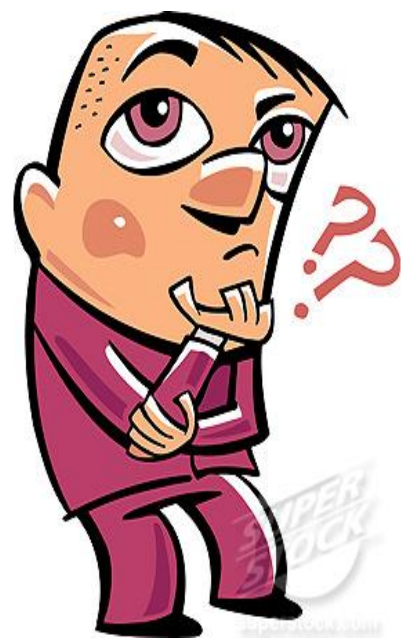
HIGH-STAKES TAX DEFENSE & COMPLEX CRIMINAL DEFENSE

1012 Broad Street, 2nd Fl
Bloomfield, NJ 07003
Tel (973) 783-7000
Fax (973) 338-3955
www.DeBlisLaw.com

Can the Streamlined Compliance Procedures Be Used to Correct Defective Returns That Go Back Beyond the Most Recent Three Tax Years?

The issue that this article seeks to address is whether a non-willful taxpayer with an undisclosed offshore account can use the streamlined compliance procedures to correct defective tax returns that go back beyond the most recent three tax years? In other words, are the streamlined procedures limited to the most recent three years of troublesome tax returns or could they go back as far as six? Assume for purposes of this blog that the most recent three tax years are 2013, 2012, and 2011.

The issue comes up in the following circumstances. I would like to acknowledge **Virginia La Torre Jeker, Esq.** as being the inspiration behind this blog as well as being the "think tank" behind the hypotheticals contained below and for her input into this article regarding the operation of the statute of limitations with respect to foreign assets.



Scenario # 1: An Incorrectly Filed Tax Return in Tax Years Four Through Six

John is a U.S. citizen with an undisclosed offshore account. He moved to France in 2008 after taking a job with a French advertising agency (very chique!). That same year, John inherited an offshore bank account from his father for which he is the beneficial owner. It is maintained at Banque de France.

John's tax woes began in 2008, the year that he fired his accountant and began preparing his own tax returns. Although John has timely filed his income tax returns since 2008, he filed them incorrectly. Specifically, he omitted significant offshore income. What type of offshore income? Believing that only his U.S.-source income was taxable, John omitted his overseas salary as well as the interest generated from his offshore account. And although his offshore account generated negligible interest income, when combined with his overseas salary, the amount of foreign-source income omitted from his U.S. tax returns was not insignificant. It exceeded 25%.

To make matters worse, John checked the box "no" on Schedule B of his U.S. tax return, which asks taxpayers if they have an ownership interest in a foreign financial asset. Not surprisingly, he has never filed an FBAR.

Michael J. DeBlis Jr., Esq. | *Partner*
MJDeBlisJr@DeBlisLaw.com

Michael J. DeBlis III, Esq. | *Partner*
MJDeBlis@DeBlisLaw.com

John wishes to use the Streamlined Foreign Offshore Procedures to come into compliance. Assume that John satisfies most of the eligibility requirements, with the remaining issue being whether his conduct was "non-willful." As John is preparing his certification, he discovers that his 2008, 2009, and 2010 tax returns have the same problem as his 2011, 2012, and 2013 tax returns: He grossly underreported his gross income.

Ever so savvy, John knows that the IRS only has *three years* from the date the return was filed (or the date when the return was due to be filed) to assess tax, interest, and penalties and that the statute of limitations has run on all three tax years (i.e., 2008 through 2010). As John is doing the math, he sees that the statute of limitations on the *latest* U.S. tax return from that period – 2010, which was filed on April 15, 2011 – would have expired on April 15, 2014.

At the same time, John has been "burning the midnight oil" on the IRS website and has discovered two well-known exceptions to the traditional three-year statute of limitations: the first extends the statute of limitations from three years to six years when the understatement is due to a foreign financial asset and the second eliminates the statute of limitations impediment altogether. With respect to the former, an expanded statute of limitations was enacted in 2010 that extends the statute of limitations from three years to six years when income omitted from a taxpayer's U.S. tax return exceeds $ 5,000 and the omission is attributable to one or more foreign financial assets.[i] This amendment is effective for income tax returns due after the date of enactment or for tax returns filed on or before that date if the statute of limitations is still open.

The full impact of the expanded statute of limitations hits John like a ton of bricks. He realizes that his earlier years' returns are not time-barred by the statute of limitations. To the extent that they relate to foreign financial assets, which they clearly do, the statute of limitations would be open even on his earliest return.[ii] In other words, the IRS can now go all the way back to 2008 to assess tax, penalties, and interest.

Moreover, John knows that in the event that the IRS establishes fraud, there is no statute of limitations impediment to the assessment of civil liabilities. In other words, the IRS can go back to time immemorial when they suspect that fraud is in play.

To the extent that the IRS uncovers fraud, John could be subject to the 800-pound gorilla of all civil penalties – the civil fraud penalty. The reason why the civil fraud penalty has a reputation as being the "800-pound gorilla" is because it is the largest civil penalty in dollar magnitude. Indeed, it is equal to 75% of the portion of the underpayment which is attributable to fraud.

Ever the worrier, John fears that he might win the audit lottery and that his omitted offshore income and undisclosed offshore account will be the "one-two punch" that inspires the revenue agent to expand her examination to include earlier tax years: specifically, 2008 through 2010. If so, John could be subject to the following parade of horribles: (1) assertion of the draconian civil fraud penalty, not to mention the willful FBAR penalty (recall that John inherited the offshore account in 2008) and/or (2) a possible referral of his case to CI for investigation.

The pressure is too much for John to bear. He hasn't had a good night's sleep in over a week. John wants to know whether he can use the streamlined foreign offshore procedures to correct six years of tax returns or whether it is limited to the most recent three years. Under the streamlined foreign offshore procedures, taxpayers must submit delinquent or amended U.S. tax returns for the most recent three tax years. Delinquent FBARs must be submitted for the most recent six years.

Although this has not been memorialized in any IRS publications, it appears that the IRS's official position is consistent with a strict constructionist view. According to the OVDP hotline, taxpayers cannot use the streamlined compliance procedures to correct defective tax returns that go back beyond the most recent *three tax years*. Therefore, John cannot use the streamlined domestic offshore procedures to correct his 2008, 2009, and 2010 tax returns.

What other options, if any, does John have? He has three. First, he can scrap the idea of using the streamlined procedures altogether and instead make a "quiet disclosure." In making a "quiet disclosure," John could file six years of amended U.S. tax returns and six years of delinquent FBARs. The downside to this option is that there is no guarantee that the IRS won't assess onerous penalties, such as the willful FBAR penalty and the civil fraud penalty.

Compounding matters is the fact that the willful FBAR penalty could possibly be asserted for each year that John failed to disclose the account – up to a maximum of six years. Because John inherited the account back in 2008 and because the statute of limitations for asserting an FBAR penalty is six years from the date of the violation (with the violation date occurring on June 30 of the year *following* the calendar year for which the account is being reported), the IRS could theoretically go back as far as 2008 to assert FBAR penalties.

Moreover, while the risk of prosecution is ever so slight, the fact remains that John is not guaranteed immunity from prosecution. Therefore, taxpayers who find themselves in unwieldy situations like John should only make a quiet disclosure when they have a legitimate explanation for the discrepancy – i.e., "an innocent mistake" – and when the mistake has little, if any, impact on the bottom line: the true tax liability. If, after peeling back the layers, there are badges of fraud, then this option should be thrown out with the bathwater.

Second, John could combine streamlined reporting with filing amended tax returns, in what John might call a "mélange a fruit." For example, he could use the streamlined foreign offshore procedures to correct his troubled tax returns relating to the most recent three tax years (i.e., 2011 through 2013) while filing amended tax returns to correct his troubled tax returns relating to tax years four through six (i.e., 2008 through 2010).

The difference between option two and option one is stark. Assuming that John's streamlined submission is successful, under option two he would not be liable for any penalties whatsoever. That's right. No failure-to-file and failure-to-pay penalties. No accuracy-related penalty. No information return penalty. And no FBAR penalty. Therefore, at first blush, going streamlined makes all the sense in the world.

However, this option has a major shortcoming. Because the streamlined procedures only cover the most recent three tax years when it comes to U.S. tax returns and not any earlier years, there is the uncertainty of what could happen in tax years 2008, 2009, and 2010. Might the IRS assert onerous civil penalties? Might the IRS refer John's case to CI for investigation or, worse yet, to the Department of Justice with a recommendation for prosecution?

If this keeps John lying awake at night, enough that he seeks reassurances that he will not be prosecuted and/or saddled with onerous penalties that leave him with nothing more than the shirt on his back, then he should consider option number three: the offshore voluntary disclosure program.

The 2014 OVDP covers the most recent eight years and thus covers all of John's "troubled" years. And while John's pride might be hurt by having to enter a program that now has the official designation of catering to the Al Capone's of the offshore banking world – i.e., "willful" non-disclosers – he can take solace in two things. First, and most important, the peace of mind of knowing that he will not be prosecuted. And second, avoidance of the dreadful willful FBAR penalty.

<u>Scenario Number 2</u>: Failure to File A Tax Return in Tax Years Four Through Six

Adam is a U.S. citizen with an undisclosed offshore account. He moved to Switzerland in 2008 after taking a job with a Swiss consulting company and has lived there ever since. That same year Adam opened up a checking account at Grosser Schweizer Bank, a Swiss Bank.

Adam's tax woes go back to 2008, when he relocated to Switzerland. He did not file any U.S. tax returns in 2008, 2009, and 2010. However, he has been fully compliant, at least as far as filing U.S. income tax returns go, since 2011. He has never filed an FBAR.

Although Adam checked the box "no" on Schedule B of his U.S. tax return, which asks taxpayers if they have an ownership interest in a foreign financial asset, and although his Swiss account generated a substantial amount of interest income, the fact remains that after applying the foreign tax credit for taxes paid to Switzerland, Adam had no tax deficiency with respect to the unreported income.

Adam wishes to use the Streamlined Foreign Offshore Procedures to come into compliance. Assume that Adam satisfies most of the eligibility requirements, with the remaining issue being whether his conduct was "non-willful."

. Adam knows that the statute of limitations for the IRS to assess and collect any outstanding balances does not begin until a return has been filed. Because Adam did not file any U.S. tax returns for 2008, 2009, and 2010, he knows that the statute of limitations for assessing tax and penalties for each of these years has been suspended. As a result, he fears that the IRS will go back and assert civil penalties for this three-year period. In that case, he could face a whole host of civil penalties: from failure to file and failure to pay to the civil fraud penalty. Also looming in the back of Adam's mind is whether his case would be ripe for a referral to CI.

The pressure is too much for Adam to bear. He hasn't had a good night's sleep in over a week. Adam wants to know whether he can use the Streamlined Foreign Offshore Procedures not only to file *amended* tax returns for the most recent three tax years but also to file *delinquent* returns for the three earliest tax years – namely, 2008, 2009, and 2010. Under the streamlined foreign offshore procedures, taxpayers must submit delinquent or amended U.S. tax returns for the most recent three tax years. Delinquent FBARs must be submitted for the most recent six years.

Although this has not been memorialized in any IRS publications, it appears that the IRS's official position is consistent with a strict constructionist view. According to the OVDP hotline, taxpayers cannot use the streamlined compliance procedures to file delinquent tax returns that go back beyond the most recent three tax years. Therefore, Adam cannot use the streamlined foreign offshore procedures to file delinquent tax returns for 2008, 2009, and 2010.

As in Scenario # 1, Adam has three options. First, he can scrap the idea of using the streamlined procedures altogether and instead make a "quiet disclosure." In making a "quiet disclosure," Adam could file three years of *delinquent* tax returns for the three earliest years (i.e., 2008 through 2010), three years of *amended* tax returns for the three latest years (i.e., 2011 through 2013), and six years of delinquent FBARs (i.e., 2008 through 2013). The downside to this option is that there is no guarantee that the IRS won't assess onerous civil penalties, such as information-reporting penalties, the willful FBAR penalty, and the civil fraud penalty.

Compounding matters is the fact that the willful FBAR penalty could possibly be asserted for each year that Adam failed to disclose the account – up to a maximum of six years. Because Adam opened the account back in 2008 and because the statute of limitations for asserting an FBAR penalty is six years from the date of the violation (with the violation date occurring on June 30 of the year *following* the calendar year for which the account is being reported), the IRS could theoretically go back as far as 2008 to assert FBAR penalties.

Moreover, while the risk of prosecution is ever so slight, the fact remains that Adam is not guaranteed immunity from prosecution. Therefore, taxpayers who find themselves in unwieldy situations like Adam should only make a quiet disclosure when there is an innocent explanation for not filing. To the extent that there was a sinister motive underlying Adam's decision not to file – for example, that he did not want to pay any taxes – then this option should be thrown own with the bathwater.

Do not forget to check for badges of fraud! For example, to the extent that Adam's unreported income in the years that he did not file was substantial (say, $ 500,000 or more), then no matter how much Adam might blame his failure to file on a mere oversight, the combination of a large tax deficiency with a three-year pattern of noncompliance is the equivalent of being on the receiving end of a "knockout punch" in a heavyweight boxing match. Indeed, due to the strong evidence that it has to prove willfulness, not to mention the case's jury appeal, this is just the type of case that the government looks for when it is evaluating which cases to authorize for prosecution under the policies of the Federal Tax Enforcement Program.

Second, Adam could combine streamlined reporting with filing delinquent tax returns. For example, he could use the streamlined foreign offshore procedures to correct his troubled tax returns relating to the most recent three tax years (i.e., 2011, 2012, and 2013) while filing delinquent tax returns for tax years four through six (i.e., 2008, 2009, and 2010).

The difference between option two and option one is stark. Assuming that Adam's streamlined submission is successful, under option two he would not be liable for any penalties whatsoever. That's right. No failure-to-file and failure-to-pay penalties. No accuracy-related penalty. No information return penalty. And no FBAR penalty. Therefore, at first blush, going streamlined makes all the sense in the world.

However, this option has a major shortcoming. Because the streamlined procedures only cover the most recent three tax years when it comes to U.S. tax returns and not any earlier years, there is still the uncertainty of what could happen in tax years 2008, 2009, and 2010. Might the IRS assert onerous civil penalties? Might the IRS refer Adam's case to CI for investigation or, worse yet, to the Department of Justice with a recommendation for prosecution?

If this keeps Adam lying awake at night, enough that he seeks reassurances that he will not be prosecuted and/or saddled with onerous penalties that leave him with nothing more than the shirt on his back, then he should consider option number three: the offshore voluntary disclosure program.

The 2014 OVDP covers the most recent eight years and thus covers all of Adam's "troubled" years. And while John's pride might be hurt by having to enter a program that now has the official designation of catering to the Al Capone's of the offshore banking world – i.e., "willful" non-disclosers – he can take solace in two things. First, and most important, the peace of mind of knowing that he will not be prosecuted. And second, avoidance of the dreadful willful FBAR penalty.

As draconian as the offshore penalty might be, it is only a one-time penalty. By comparison, the willful FBAR penalty can be piled up like a stack of bricks, one on top of the other, as far as the eye can see. Therefore, if you're having trouble reconciling the offshore penalty, do not forget how staggering multiple years' worth of willful FBAR penalties can be and how the IRS can go back as far as six years in time to assert them.

Conclusion

If there is a lesson to be learned here, it's this. Be sure to consult an experienced tax attorney before deciding which option to choose. An experienced tax attorney will help you navigate the choppy waters of international tax compliance and help you decide which option is best for you.

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[i] See Section 6501(e).

[ii] Indeed, the statute of limitations on John's 2008 tax return, which was filed on April 15, 2009, does not expire until April 15, 2015.