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Why Holders of Foreign Bank Accounts Need to Worry About IRS's Voluntary Disclosure Data-Mining Program

By JAY NANAVATI

Have you ever been surprised by Facebook or LinkedIn's ability to suggest people to whom you may be connected, when even you had forgotten how you were connected to those people?

Perhaps the social networks' technology crunched data that you provided on your home town, Boy Scout troop, high school, first job at McDonald's, or fly-fishing hobby, to find latent connections between you and a long-lost acquaintance.

U.S. taxpayers who are still considering whether to disclose their accounts need to understand that IRS's data-mining software increases their risk of being detected.

Use of such data-mining technology is widespread, and the Internal Revenue Service has adopted it to find taxpayers with undisclosed offshore bank accounts.

U.S. taxpayers who are still considering whether to disclose their accounts need to understand that IRS's data-mining software increases their risk of being detected. They should act accordingly and seek legal advice immediately.

E-Trak

According to a Sept. 21, 2011, report by the Treasury Inspector General for Tax Administration (TIGTA), IRS's data-mining software is called the E-Trak Offshore Voluntary Disclosure system.

Jay Nanavati is counsel at Baker Hostetler. He practices criminal tax defense, white collar criminal defense, and civil tax controversy. Most recently, he was assistant chief of the Western Criminal Enforcement Section of the Justice Department Tax Division. He can be reached at jnanavati@bakerlaw.com or (202) 861-1747.

E-Trak does not lack for data inputs. Since 2009, more than 33,000 taxpayers have contributed detailed information to E-Trak by participating in IRS's Offshore Voluntary Disclosure Program (OVDP).

The OVDP provides for reduced civil penalties, generally 27.5 percent of the highest aggregate account balance, and protection from criminal prosecution. On the other hand, detection by IRS can lead to a number of painful consequences, including civil penalties that can be larger than the balance in the accounts and criminal prosecution.

Taxpayers with undisclosed accounts need to act before E-Trak and IRS find them. This is because taxpayers whose accounts IRS has discovered are ineligible to participate in the OVDP.

Unfortunately, even if you have not heard from IRS, it may already be too late to come forward and participate in the OVDP. This is because eligibility depends on when IRS discovers your accounts, not on when IRS informs you of its discovery. This makes it imperative that taxpayers with offshore accounts discuss their options with an attorney immediately.

Taxpayers with undisclosed accounts have options. First, they can enter the OVDP and pay a penalty. Depending on the taxpayer's circumstances, including the reason for the creation of the account, an attorney may be able to negotiate a greatly reduced penalty with IRS.

Second, they can enter the OVDP and choose to "opt out." This allows the taxpayer to use the OVDP's protection from criminal prosecution while choosing to go through a full IRS audit instead of paying the prescribed OVDP penalties. A taxpayer for whom a 27.5 percent penalty is inappropriate might choose this option.

Finally, the taxpayer can make a so-called quiet disclosure. This means filing amended tax returns and Reports of Foreign Bank and Financial Accounts (FBARs) for the years for which the statute of limitations is still open. While a quiet disclosure does not provide the protections of the OVDP, certain taxpayers with small account balances and other favorable characteristics may find this route attractive.

Whichever option the taxpayer chooses, full disclosure is essential. There is no such thing as a partial disclosure. Coming into the OVDP means inviting IRS's thorough scrutiny of your financial affairs.

The only thing worse than failing to disclose your offshore accounts is presenting an incomplete, and there-

fore false, disclosure to IRS. This means disclosing all of your accounts, not just the ones that are at banks whose names have been in the news as targets of IRS's enforcement efforts.

This also means disclosing the identities of all of the people at the banks with whom you have met or even communicated regarding your offshore accounts. You can bet that when IRS approaches them, the bank employees will disclose the customers whom they have assisted. Once they give IRS your name, you are no longer eligible for the OVDP and are likely to face the full wrath of the U.S. government.

Unfortunately, there are many people who do not realize that they are U.S. taxpayers. People who are not U.S. citizens and who have not lived in the United States for many years may still be U.S. taxpayers.

U.S. citizens are not the only people who are U.S. taxpayers. Anyone who is a lawful permanent resident of the United States, often called a green card holder, or who meets a "substantial presence" test must disclose their offshore bank accounts. This includes green card holders who have permanently left the United States but have not formally relinquished their green cards.

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In part to address this issue, IRS has made a significant public information effort regarding who must disclose their offshore accounts. The longer people in this situation wait to disclose their offshore accounts, the less convincing will be their assertion that they were unaware of their U.S. tax obligations.

Civil and Criminal Penalties for Nondisclosure

Taxpayers who do not disclose their foreign accounts are subject to massive civil penalties. These include the so-called FBAR penalty, which is 50 percent of the highest annual account balance per year. Added together, these annual FBAR penalties can far exceed the balance of the accounts.

In addition, taxpayers face a penalty of up to \$50,000 per return for failing to file Form 8938, Statement of Foreign Financial Assets, reporting certain foreign financial assets, a 75 percent fraud penalty, a penalty of up to 25 percent for failing to file a tax return, a penalty of up to 25 percent for failing to pay a tax, and a penalty of up to 40 percent for filing an inaccurate return, among other penalties.

Most worrisome are the criminal penalties that the government may pursue. These include five years in prison for each count of tax evasion, three years in prison for filing a false tax return, one year in prison for failing to file a tax return, and 10 years in prison for failing to file an FBAR.

If IRS's revenue agents determine during an audit that the failure to disclose a foreign bank account is potentially criminal, they can refer the case to the special

agents at IRS Criminal Investigation (CI). Once CI investigates and refers the case to the Department of Justice's Tax Division, an indictment may be imminent.

Although the risk of detection by IRS may seem low, IRS's use of E-Trak in the last few years has greatly improved its ability to find taxpayers, bankers, and other professionals who are involved in the world of offshore bank accounts.

Data-mining with E-Trak is simply a way to exploit large quantities of data to find connections among people that might not otherwise have been apparent. In a sense it is a cousin of the well-known social networks that have arisen on the internet. It is often said that we are all no more than six degrees of separation from any other person. It seems reasonable to assume that far fewer degrees separate each of the U.S. taxpayers who maintain undeclared offshore accounts at a relative handful of foreign banks in Switzerland, Israel, India, China, Hong Kong, Liechtenstein, the United Arab Emirates, and other jurisdictions.

E-Trak's advantage over commercial social networks is the quality of the data that it processes. IRS requires taxpayers who voluntarily disclose their accounts to provide information that will be fed to E-Trak, including:

- the names of any and all foreign financial institutions where they maintained accounts;
- the dates on which they opened or closed the accounts;
- their points of contact at each financial institution;
- the circumstances of all face-to-face meetings with their points of contact;
- all of their communications with the financial institutions; and
- all face-to-face meetings or communications regarding their accounts with independent, non-bank advisers.

In addition to filling out detailed disclosure forms, many of the 33,000 taxpayers who have disclosed offshore accounts have undergone face-to-face interviews with IRS and the Department of Justice. According to published reports, these interviews have focused on the taxpayers' interactions with others regarding their foreign accounts. E-Trak digests the interviews and written information and suggests possible connections among taxpayers and the bankers, lawyers, and financial advisers who may have assisted them in setting up and maintaining their offshore financial accounts.

This sort of data-mining-as-social-networking is a force multiplier for IRS. Instead of having information on only 33,000 self-reporting U.S. taxpayers, IRS can use data-mining to uncover similarly situated taxpayers who have not disclosed their accounts. The same is true of E-Trak's ability to identify the professionals who may have assisted U.S. taxpayers in setting up and maintaining undisclosed accounts.

IRS has made no secret of its data mining efforts. In a Nov. 16, 2010, speech, IRS Commissioner Doug Shulman said, "We have been scouring the vast quantity of data we received from the [OVDP] applicants and from various other sources. Although more data mining is still to be done, this information has already proved invaluable in supplementing and corroborating prior

leads, as well as developing new leads, involving numerous banks, advisors and promoters around the world.”

FATCA

The phasing in over the coming year of the Foreign Account Tax Compliance Act of 2010 (FATCA) will only increase the breadth and depth of the data available to IRS and E-Trak.

Non-U.S. financial institutions will face significant new due diligence and reporting requirements on pain of punitive 30 percent withholdings.

On its website, IRS touts the role of FATCA reporting in improving its ability to find taxpayers with undisclosed foreign accounts: “The IRS remains actively engaged in ferreting out the identities of those with undis-

closed foreign accounts. Moreover, increasingly this information is available to the IRS under tax treaties, through submissions by whistleblowers, and will become more available under the Foreign Account Tax Compliance Act (FATCA)”

FATCA is yet another reason for taxpayers and especially financial institutions to seek competent legal counsel.

With large budget deficits for the foreseeable future, the U.S. government is likely to step up its efforts to find undeclared foreign accounts and income. Refusal to deal with this reality is no longer an option. The only way to deal effectively with the internalization of tax enforcement is to get out ahead of IRS and talk about your options with an attorney.

After all, once IRS and E-Trak find you, your options dwindle tremendously.