VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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OFFSHORE ACCOUNTS

Have they lost their appeal?

Under the Bank Secrecy Act of 1970, U.S. taxpayers are required to report not only cash transactions of $10,000 or more, but also foreign accounts with combined balances of $10,000 or more on an annual basis. But who really reports these accounts? It always appeared to be a great way to not pay taxes on investment income. Well, not any more.

Earlier this week (2/8/2011), the IRS introduced its 2nd voluntary compliance program for U.S. owners of undisclosed offshore assets. The 1st voluntary disclosure program in 2009 allowed taxpayers to avoid criminal prosecution if they revealed all their previously undisclosed foreign assets, submitted amended returns, and paid all taxes due plus a fixed penalty that was significantly less than the maximum possible. IRS is basing the new program on lessons it learned in the earlier effort, including the benefit of centralized processing. Among the 15,000 taxpayers who came in under the 2009 initiative, the average unpaid tax was about $200,000, with many having much higher amounts. The penalties are stiff, so you may want to take notice this time around.

So what's the rule? You must report accounts you hold in foreign banks and other financial institutions if your total balance is $10,000 or greater. The $10,000 threshold is for your aggregate account balances. In other words, your total of all your foreign accounts combined.

If you earn dividends or interest in these accounts, that income is reported on Form 1040 Schedule B, and you would check the box in Part III Line 7a and indicate the country or countries where you have accounts. Additionally, any foreign taxes paid on your interest and dividends may qualify for the Foreign Tax Credit on Form 1116.

Example: John and Lisa Smith are US citizens living and working in Switzerland. They have checking, savings, and retirement accounts in Switzerland. Their highest balances for the year were $1,000 in checking, $2,500 in savings, and $8,500 in an annuity retirement fund. Since the total of all their accounts exceeds $10,000, they are required to file TD F 90-22.1 to report the accounts they own.

What to do? Report each foreign financial account you hold on Treasury Department Form 90-22.1 and provide information on all your financial accounts held in foreign countries, including:

- Bank accounts (checking and savings)
- Investment accounts
- Mutual funds
- Retirement accounts

- Securities and other brokerage accounts
- Debit card and prepaid credit card accounts

Whether (and how) to come forward is the most pressing question in many foreign bank account disclosure situations. It may be tempting to think you are better off waiting to see if you are caught. Surely, you might reason, some kind of deal would be available at that time? Unfortunately, this is quite dangerous. While it seems risky to make any kind of disclosure that appears self-incriminating without a definite deal on the table, the risks on the opposite side of the equation (i.e., doing nothing) are vastly greater. Later, you will see what happened to the Doctor and his Swiss bank account.

Although it is understandable that many taxpayers would rather stick their heads in the sand, don't do it. Yes, there are risks in stepping forward and saying that you failed to report overseas income and a foreign account. Although the risk of criminal prosecution in such a disclosure is pretty remote, the risk of significant financial penalties is certainly present.

So exactly what are the penalties involved in this disclosure? Here's an example. Let's assume the taxpayer has the following amounts in a foreign account over a period of six years. We will also assume for purposes of the example that the amount on deposit is not unreported income in 2005.

Year	Amount on Deposit	Interest Income	Account Balance `
2005	$1,000,000	$50,000	$ 1,050,000
2006		$50,000	$ 1,100,000
2007		$50,000	$ 1,150,000
2008		$50,000	$ 1,200,000
2009		$50,000	$ 1,250,000
2010		$50,000	$ 1,300,000

If the taxpayer comes forward and has their voluntary disclosure accepted by the IRS, they face this potential scenario: They would pay **$386,000 plus interest**. This includes:

- Tax of $105,000 (six years at $17,500) plus interest,
- An accuracy-related penalty of $21,000 (i.e., $105,000 x 20%), and
- An additional penalty, in lieu of the FBAR and other potential penalties that may apply, of $260,000 (i.e., $1,300,000 x 20%).

If the taxpayer does not come forward and the IRS discovers their offshore activities, they face up to **$3,651,000 in tax, accuracy-related penalty, and FBAR penalty**. The taxpayer would also be liable for interest and possibly additional penalties, and an examination could lead to criminal prosecution. The civil liabilities potentially include:

- The tax and accuracy-related penalty, plus interest, as described above,
- FBAR penalties totaling up to $3,525,000 for willful failures to file complete and correct FBARs (2005- $525,000, 2006 - $550,000, 2007 - $575,000, 2008 - $600,000, 2009 - $625,000 and 2010 - $650,000),
- The potential of having the fraud penalty (75 percent) apply, and
- The potential of substantial additional information return penalties if the foreign account or assets is held through a foreign entity such as a trust or corporation and required information returns were not filed.
- If the foreign activity started more than six years ago, the Service may also have the right to examine additional years.

- And, the taxpayer could potentially be up against criminal charges for tax evasion, which is not only more fines but also prison.

So, this taxpayer with the $1 million account in the Cayman Islands has a choice of (a) disclosing and paying $386,000 plus interest, or (b) wait to get caught and eventually pay $3.65million plus penalties, interest, and potential criminal fines and prison term…ouch!

You should also be aware that this offshore reporting is not just for bank accounts. The offshore penalty is intended to apply to all of the taxpayer's offshore holdings that are related in any way to tax non-compliance, regardless of the form of the taxpayer's ownership or the character of the asset. The penalty applies to all assets directly owned by the taxpayer, including financial accounts holding cash, securities or other custodial assets; tangible assets such as real estate or art; and intangible assets such as patents or stock or other interests in a U.S. or foreign business. If such assets are indirectly held or controlled by the taxpayer through an entity, the penalty may be applied to the taxpayer's interest in the entity or, if the Service determines that the entity is an alter ego or nominee of the taxpayer, to the taxpayer's interest in the underlying assets.

Doctor Pleads Guilty to Charges Related to Failure to Comply with Reporting Requirements for Overseas Accounts

Case summary: In 2010, a United States Attorney announced that a doctor pled guilty to conspiracy to impede the United States and to making a false statement. He was facing a maximum sentence of ten years in prison and a maximum fine of $500,000.

Case details: According to court documents, in 1997, the doctor inherited an undeclared bank account at a Switzerland branch of one of the world's largest international banks. The account was held in the name of a phony Liechtenstein trust. In 1999, the doctor met with an attorney who managed the account in Switzerland. The foreign attorney instructed the doctor to keep the account "hush," to avoid keeping any records relating to the account, and to send coded letters if he wished to meet with the attorney. Further, the attorney advised the doctor that if he transported or mailed less than $10,000 in U.S. currency back to the United States, he would not have to declare the funds to the U.S. government upon re-entry to the United States.

Prosecutors alleged that in 2009, the doctor was informed that the international bank was closing his undeclared Swiss account and that he had until the end of the year to travel to Switzerland to withdraw all funds. He made multiple trips to Zurich in 2009 and met with his attorney at his office and a Swiss banker at the private wealth office of the international bank. The attorney and the Swiss banker refused to wire the money to the United States, as it would leave a trail for U.S. law enforcement. Instead, they provided him with approximately $240,000 in U.S. currency. The doctor received most of the currency in individually wrapped bundles of sequentially numbered, new $100 bills.

According to court documents, with the assistance of the attorney, the doctor mailed multiple packages containing over $200,000 in U.S. currency from Switzerland to the United States to himself and another person.

In his plea, the doctor admitted that, upon his return to the United States, he falsely informed a U.S. Customs Inspector that he had traveled to Switzerland to purchase diamonds. Further, he falsely stated to a U.S. Customs Inspector that he had not recently mailed any U.S. currency from Switzerland into the United States. However, the plea agreement also noted that Customs and Border Protection officers seized a package containing approximately $9,000 addressed to the defendant's residence.

Prosecutors alleged that, for the years 1997 through 2008, the doctor made and subscribed false U.S. Individual Income Tax Returns, Forms 1040, that failed to report on the Schedules B attached to the returns that he had an interest in a financial account in a foreign country. Additionally, the doctor failed to report the income he earned on his undeclared Swiss account on his tax returns.

From 1997 through 2008, the doctor failed to file with FinCEN a required Report of Foreign Bank and Financial Accounts on Form TD F 90-22.1 (FBAR) reporting his interest in his undeclared Swiss account. As part of his plea agreement, the doctor agreed to forfeit to the government over $200,000 in U.S. currency that law enforcement officials seized from packages that the doctor mailed from Switzerland to his residence in the United States.

I hope this helps you understand a little better how the foreign account reporting works and what your options may be regarding compliance with the disclosure rules. If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.