

You Can Catch More Flies with Honey: Debunking the Theory in the Context of International Tax Enforcement

By
Hale E. Sheppard

Hale E. Sheppard examines the accomplishments and pitfalls of international tax enforcement.

I. Introduction

Conventional wisdom dictates that you can catch more flies with honey than with vinegar. This may be true as a general notion, but its validity in the context of international tax enforcement is suspect. Based largely on information gathered from former promoters of offshore tax shelters, reports by assorted governmental agencies and recent congressional hearings, the IRS has become acutely aware of various offshore tax avoidance strategies and structures. In an effort to thwart these tax abuses, the IRS, adhering to conventional wisdom, initially offered honey as an inducement to noncompliant taxpayers to disclose their prior behavior and then start anew. This honey primarily came in the form of the Offshore Voluntary Compliance Initiative, under which the IRS agreed to waive or significantly reduce penalties for acquiescent taxpayers. Despite the IRS's optimism, relatively few

noncompliant taxpayers elected to take part in the initiative—so much for the honey.

Armed with a significant amount of information concerning offshore tax-avoidance schemes and the U.S. taxpayers involved in them, the IRS recently decided to resort to the vinegar. Not surprisingly, this vinegar consists of civil and criminal penalties, many of which are quite severe. Lest there be any doubt about the IRS's willingness to use vinegar, it signed, and then greatly expanded, a tax information-sharing alliance with state tax authorities. There is no ambiguity regarding the message that the federal and state governments intend to send to noncompliant taxpayers with this new partnership. In the words of the IRS commissioner, "We're closing in on you from all sides."¹

Hale E. Sheppard, J.D., LL.M., is an attorney specializing in international taxation and tax controversies.

Given the present circumstances, it appears that noncompliant taxpayers have three main options at this time:

1. Do nothing and hope that the IRS fails to discover them
2. Wait for the IRS to send a letter under the so-called Last Chance Compliance Initiative and comply with the terms of the letter
3. Immediately come clean with the IRS pursuant to the standard voluntary disclosure program

Each of these options has its disadvantages; nevertheless, it is extremely important that noncompliant taxpayers consult a qualified and trusted tax advisor, review the pros and cons of each option and make a decision before being subjected to that IRS vinegar.

II. The New Breed of Offshore Investors

The manner in which certain U.S. taxpayers conduct offshore financial activities seems to be an open secret these days. According to articles by tax practitioners, IRS reports and congressional hearings, abusive offshore arrangements commonly develop in the following manner.² A self-proclaimed offshore expert (*i.e.*, a promoter) approaches a U.S. taxpayer offering an assortment of offshore possibilities with supposed tax benefits. Once hired, the offshore promoter's first step is to help the U.S. taxpayer organize a corporation in a country with two main characteristics: little or no income tax and strict financial secrecy. This foreign corporation does not appear to be owned by the U.S. taxpayer since various nominees (who are usually employees of a local law

firm or financial management company) officially control the entity. These nominees typically execute an agreement clarifying that they hold the shares of the foreign corporation on behalf of the U.S. taxpayer, who is referred to as the "beneficial owner." In this manner, the U.S. taxpayer's ownership of the foreign corporation is not mentioned in any of the official corporate documents or government filings. Next, the offshore promoter aids the taxpayer and/or the foreign corporation in establishing local financial accounts, such as interest-bearing savings accounts, certificate of deposits, and security accounts through which the taxpayer can trade stocks, bonds, *etc.*³

After the foreign corporation and foreign financial accounts are established, the offshore promoter then works with the U.S. taxpayer in identifying surreptitious methods to transfer money or other assets to the new corporation and accounts.⁴ Once this is accomplished, the promoter designs techniques through which the taxpayer can access the funds and accounts without alerting the IRS. One of the most common tactics for doing so involves the use of an offshore credit and/or debit card (such a MasterCard, Visa or American Express) issued by the foreign financial institution at which the taxpayer maintains an account. As with domestic credit/debit cards, whenever the U.S. taxpayer wants to access the funds in the foreign accounts, he/she simply makes cash withdrawals or purchases an item on credit. To further insulate the taxpayer from IRS scrutiny of the offshore activity, the foreign financial institution that issued the credit/credit card, the law firm that established the foreign corporation, the lo-

cal management company that handles all of the investment activities, and the promoter agree to institute discreet billing methods. Such cautious billing practices ordinarily include not sending any documentation to the taxpayer in the United States.⁵

In the past, it was widely believed that tax avoidance schemes, especially those involving foreign entities and financial accounts, were used primarily by the ultra-rich and the ultra-sneaky. Now, however, it is clear that this *modus operandi* has been adopted by the masses. As one commentator artfully explains:

Policymakers who wonder how far down-market the tax shelter phenomenon has gone need only consult the IRS's latest list of summonses, which reads like a chronicle of an everyday shopper's preferred vendors. Leona Helmsley's admonition that "only little people pay taxes" is being turned inside out as a substantial number of little people appear to have offshore accounts they access with credits cards. The people suspected of cheating the tax system use their offshore credit cards to buy things off of eBay, services from Yahoo!, and books, music, and movies from Amazon.com ... They use the credit cards to pay their BellSouth and AT&T phone bills. They charge their plane tickets from Delta and American Airlines on these credit cards, along with the Hammacher Schlemmer catalog products they buy in-flight and the Hertz and Avis Rent A Car charges they ring up after they land. These offshore bank customers stay

at Hyatts and Ramada Inns and Omni Hotels. They read Time Life publications. They shop at Nordstrom and Old Navy. They charge Microsoft computers, Earthlink memberships, and AT&T wireless telephones on these credit cards. ... The times have clearly changed from when primarily “rich guys” would, for example, use the cards to hide assets from their ex-wives. While the rich guys stashed their money away and forgot about it, the new offshore card customer clearly uses his or her account for current, everyday consumption and living expenses.⁶

As for the benefits of using this offshore arrangement, the U.S. taxpayer earns income such as interest, dividends and capital gains without paying any taxes whatsoever. The taxpayer also enjoys a certain degree of asset protection by placing his/her funds beyond the reach (and the knowledge) of the U.S. court system. Simply stated, creditors have a difficult time accessing the taxpayer’s offshore funds when they do not even know they exist. While the U.S. taxpayer participating in the offshore arrangement obviously derives economic benefits, this is not the proverbial victimless crime. Indeed, such offshore arrangements are detrimental to (1) the IRS, which suffers an incalculable amount in lost revenues and expends tremendous resources in its attempts to stop these offshore activities; (2) law-abiding U.S. taxpayers, who are forced to pay additional taxes to cover the shortfall occasioned by the offshore schemes; and (3) the U.S. tax system as a whole, which suffers a loss of integrity. In the

words of Senator Max Baucus during a recent congressional hearing, if tax evasion through offshore tax shelters persists, “the average taxpayer who is playing by the rules and paying his or her share will feel like a chump [and] support for our system based on a largely voluntary system of reporting will deteriorate if not collapse.”⁷

III. Locating the Flies

In attempt to prevent further injury to the IRS, law-abiding taxpayers and the federal tax system as a whole, the U.S. government has taken several steps. In 1996, John Matthewson, the former president of Cayman-based Guardian Bank and Trust, was convicted of bank fraud, tax evasion and money laundering.⁸ In exchange for leniency with respect to his punishment, Mr. Matthewson purportedly provided the IRS with encrypted computer files containing the identities (or at least detailed account information) of over 1,000 U.S. taxpayers involved in offshore arrangements.⁹ The data provided by Mr. Matthewson have been described as a “goldmine” of information that will keep the IRS busy for years¹⁰ and “a bonanza for federal prosecutors.”¹¹ As for Mr. Matthewson personally, he has been called the “the most valuable source of information U.S. enforcement agencies have ever had” regarding the manner in which offshore financial institutions facilitate tax evasion.¹²

Based on the leads obtained from Mr. Matthewson and other sources, the IRS launched the Offshore

Credit Card Program (OCCP).¹³ As part of the OCCP, the U.S. government obtained a federal court order in October 2000 to serve so-called John Doe summonses on American Express and MasterCard, two of the companies that had presumably issued offshore credit/debit cards to numerous U.S. taxpayers. A “John Doe summons” is essentially an order to a third party to relinquish information concerning U.S. taxpayers whose precise identity is unknown to the IRS.¹⁴ These initial summonses were designed to acquire information regarding the

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identities and financial activities of U.S. taxpayers holding credit/debit cards issued by banks in Antigua, Barbuda, the Bahamas and the Cayman Islands.¹⁵ Later, in March 2002, the IRS obtained another federal court order to serve a John Doe summons on Visa International. After a certain degree of haggling, the credit card companies complied with the summonses.¹⁶

As a further component of the OCCP, the IRS next turned its attention to the businesses at which the U.S. taxpayers used their offshore credit/debit cards. In August 2002, the IRS persuaded seven federal courts to allow it to serve John Does summonses on more than 40 businesses, including airlines, hotels, car rental companies and Internet retailers.¹⁷ In October 2002, the IRS again convinced 11 federal courts to authorize the issuance of John Doe summonses to over 70 additional businesses.¹⁸

The IRS publicly labeled the OCCP a successful program, one yielding “promising” results. In support of this favorable characterization, the IRS stated that as of July 2003 approximately 2,900 tax returns had been audited, more than \$3 million worth of past-due taxes were collected, and dozens of cases were referred for criminal prosecution.¹⁹

In the context of international tax enforcement, it is clear that conventional wisdom does not apply: You cannot catch more flies with honey than with vinegar.

IV. Show Me the Honey

Establishing foreign corporations, foreign financial accounts and offshore debit/credit cards is not illegal for U.S. taxpayers.²⁰ However, failing to report these offshore activities by submitting to the IRS the required information returns and failing to pay the requisite income taxes does violate the law. The U.S. government taxes the worldwide income of all “U.S. persons.”²¹ This ordinarily means that *all* income earned by U.S. persons, whether in the United States or abroad, must be reported to the IRS and subjected to U.S. income tax during the year in which it is earned.²²

A U.S. taxpayer who engages in the typical abusive offshore arrangement could incur various penalties; that is, the IRS has at its disposal plenty of vinegar. With regard to civil sanctions, if a taxpayer engages in fraud, then the IRS may impose a penalty equal to 75 percent of the amount of the

underpayment.²³ Furthermore, in cases where the taxpayer underpays the amount of taxes owed because of negligence or intentional disregard of U.S. tax law, the IRS may impose an accuracy-related penalty equal to 20 percent of the underpayment.²⁴ The IRS may also impose a five-percent-per-month penalty to the amount of taxes owed in situations where

the taxpayer fails to file certain returns before the deadline.²⁵

With respect to foreign financial accounts, a taxpayer must disclose certain accounts annually on Schedule

B of Form 1040 (*U.S. Individual Income Tax Return*) and on Form TD F 90-22.1 (*Report of Foreign Bank and Financial Accounts*), which is commonly known as a “Foreign Bank Account Report” or “FBAR.”²⁶ If a taxpayer violates the FBAR filing requirement, the annual penalty is \$10,000, regardless of whether the violation was willful.²⁷ This penalty is increased to the greater of \$100,000 or 50 percent of the balance of the foreign financial account in cases where the taxpayer “willfully” fails to file an FBAR.²⁸ Every U.S. person who controls a foreign corporation must also file an annual Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*).²⁹ For each year that he/she fails to do so, the IRS may assert a penalty of \$10,000.³⁰

In addition to the various civil penalties described above, the U.S. government may potentially bring a slew of *criminal* charges against a taxpayer engaged in the typical offshore arrangement, including

tax evasion³¹ and signing false documents under penalties of perjury.³² Many of these criminal penalties involve significant fines, lengthy prison sentences or both.

A. The Offshore Voluntary Compliance Initiative

Despite the availability and scope of these penalties, the IRS decided to first test the theory that flies are more easily lured by honey. The IRS introduced in January 2003 a partial tax amnesty program known as the Offshore Voluntary Compliance Initiative (OVCI).³³ The IRS was eager to recapture lost revenue, but it limited the scope of the OVCI to U.S. taxpayers who (1) submitted their applications before the IRS (either independently or through leads from informants or other governmental agencies) identified them as potential tax cheats; (2) did not promote, solicit or in any way facilitate tax evasion by using offshore payment cards or offshore financial arrangements; (3) did not obtain the offshore income illegally; and (4) did not use the offshore credit/debit cards or offshore financial arrangements to support or in any way facilitate any illicit activity.³⁴

In addition to satisfying these eligibility requirements, the taxpayer was obligated to supply the IRS with many items related to the relevant tax years, including copies of the taxpayer’s previously filed federal income tax returns; copies of any relevant powers of attorney; descriptions of offshore credit/debit cards, foreign accounts and foreign assets in which the taxpayer has or had any ownership or beneficial interest; descriptions of any entities and nominees through which the taxpayer exercised control over

foreign funds, assets or investments; descriptions of the source of any foreign funds, assets or investments owned or controlled by the taxpayer; copies of all promotional materials, transactional materials and other related documentation regarding offshore credit/debit cards or offshore financial arrangements; accurate-amended or delinquent-original federal income tax returns; complete and accurate Forms 5471; and complete and accurate FBARs.³⁵

Provided that the IRS was satisfied with these items, it agreed with respect to the relevant tax years not to impose the civil penalties for fraud,³⁶ failure to file Forms 5471³⁷ or failure to file FBARs.³⁸ The IRS further agreed to impose the failure-to-file penalty, the failure-to-pay penalty and/or the accuracy-related penalty only “in appropriate circumstances.”³⁹ Importantly, the IRS also decided to treat participation in the OVCI as a “voluntary disclosure,” thereby lessening the possibility of criminal prosecution.⁴⁰

According to the IRS, the OVCI honey generated a “strong response” since over 1,200 taxpayers submitted applications, the IRS collected more than \$75 million in back taxes, and more than 400 promoters of offshore arrangements were identified.⁴¹

B. The Last Chance Compliance Initiative

The deadline for taking part in the OVCI expired on April 15, 2003.⁴² Based on the information that it acquired through the OVCI and the OCCP, one must assume that the IRS could have immediately pursued individual taxpayers and promoters. Before expending all of these efforts and resources, however, the IRS decided to offer noncompliant taxpayers another bit

of honey through a program unofficially known as the Last Chance Compliance Initiative (LCCI).⁴³

The IRS did not introduce the LCCI amid great fanfare. Instead, the LCCI came into existence subtly as many U.S. taxpayers whose identities the IRS had obtained thanks in large part to the OVCI and the OCCP received a relatively innocuous-looking letter from the IRS. The letter begins by stating that the IRS will give the taxpayer “one final opportunity” to minimize his/her penalty exposure by providing the IRS complete information regarding any unreported offshore activity. If the taxpayer fails to respond affirmatively to this letter within 30 days, then the IRS will automatically subject the taxpayer to an examination and impose appropriate penalties.

If, however, the taxpayer decides to accept the offer and provides the IRS with all of the necessary financial and tax information within the allotted time, then certain penalties could be mitigated. In particular, the LCCI letter indicates that the IRS will impose the civil fraud penalty for only one year, and only when “warranted.” The IRS also agrees to penalize the taxpayer’s failure to file FBARs with respect to only one year. The IRS further limits itself to imposing the failure-to-file penalty, the failure-to-file penalty and the accuracy-related penalty only “in appropriate circumstances.” It is important to note, though, that the LCCI letter does not prohibit the IRS from potentially pursuing criminal penalties against the taxpayer in connection with the offshore activities.

V. Resorting to the Vinegar

As mentioned above, the IRS proclaimed both the OCCP and

the OVCI successes based on the fact that these initiatives yielded millions in back taxes, led to approximately 1,200 taxpayers “coming clean,” and identified hundreds of previously undiscovered offshore promoters.⁴⁴ These results are certainly laudable; however, it is apparent the IRS failed to tempt the majority of non-compliant taxpayers with honey. This conclusion is derived from a recent report by the Treasury, which states that “[e]xtrapolating from the limited information available concerning the number of foreign bank and credit card accounts held by United States citizens, the IRS estimates that there may be as many as 1 million U.S. taxpayers who have signature authority or control over a foreign bank account.”⁴⁵ This conclusion gathers further support from a recent study by the U.S. Government Accounting Office, which found that “[o]f the more than 1 million taxpayers that the IRS estimated might be involved in offshore schemes when it initiated the OVCI program, 861 taxpayers came forward.”⁴⁶ Faced with the magnitude of offshore activity and the relatively meager participation in the OVCI, the IRS seems to have dropped the honey in favor of vinegar.

A. The Abusive Tax Avoidance Transaction Partnership

Cooperation between taxing authorities at the federal and state level is nothing new. For example, the IRS, the Financial Management Service Department of the U.S. Treasury, and state child support agencies have collaborated since 1981 in maintaining the Federal Tax Refund Offset Program. Under this program, federal tax refunds owed to noncustodial parents are intercepted and sent

to the proper state child support agency to pay the noncustodial parent's delinquent child support debt. As of 2002, the program had collected more than \$15 billion in past-due child support payments.⁴⁷ The federal and state governments have worked together in other ways, too. Although state tax authorities audit taxpayers, they rely to a certain extent on federal tax audits for enforcement. Since *state* tax liability is often calculated based on *federal* tax liability, "states rely extensively on federal examination activities for verification of the tax base and the appropriate treatment of various transactions."⁴⁸ This relationship is not one sided. Indeed, the IRS has historically used lists of registered state taxpayers to identify potential federal nonfilers and to cross-check reported income and activities. State driver's license files also constitute a good source for the IRS of current taxpayer addresses and potential assets to seize in cases of tax deficiencies.⁴⁹

This traditional federal-state teamwork was dramatically strengthened in September 2003 when the IRS and most states signed a Memorandum of Understanding aimed at detecting and penalizing U.S. taxpayers involved in abusive tax avoidance transactions ("the ATAT Partnership").⁵⁰ Under the ATAT Partnership, the IRS and state tax authorities agreed to periodically exchange lists of participants in ATATs, share audit results from ATAT cases, inform one another regarding newly discovered ATATs, jointly participate in ongoing ATAT training and other educational activities, appoint members to the cross-functional ATAT council, and initiate communications on an as-needed basis in order to facilitate the purposes of the ATAT Partnership.⁵¹

The ATAT Partnership was welcomed by federal and state tax officials. IRS Commissioner Mark W. Everson, for instance, labeled the agreement "a milestone in state and federal cooperation" designed to enable various levels of government to jointly and aggressively pursue tax evaders.⁵² Other IRS officials also praised the Memorandum of Understanding, calling it a "testament to the positive impact that partnering between the IRS and the State tax organizations can have on good tax administration"⁵³ and "an important new partnership" in the fight against abusive tax scams.⁵⁴ State revenue agencies also expressed their support of the new relationship with the IRS. Case in point: the California State Controller recently categorized the situation as a "win-win" for state governments and the federal government, and a "lose-lose" for tax cheats.⁵⁵ Similarly, Stephen M. Cordi, deputy comptroller for the state of Maryland and president of the Federation of Tax Administrators, welcomed the ATAT Partnership given the dire state of fiscal affairs. According to Mr. Cordi, "Abusive tax avoidance transactions have become a threat to the fiscal health of our states. It's hard to overstate the size of the problem, or the difficulty of dealing with it in an efficient and systematic way."⁵⁶

Approximately four months after the ATAT Partnership was introduced, the IRS announced that it had begun sharing leads on over 20,000 taxpayers.⁵⁷ Five months after that, it was announced that under the ATAT Partnership the IRS and the states had identified certain tax-avoidance schemes that cost the government "tens of millions of dollars" in tax revenues and had shared leads

on more than 28,000 taxpayers.⁵⁸ Based on these "promising early results," the IRS and the states revealed their intention of further expanding the ATAT Partnership by introducing three joint enforcement initiatives: (1) State Income Tax Reverse Filing Match, under which the IRS will compare the information provided by taxpayers on state income tax returns with federal data to identify nonfilers and those taxpayers underreporting the amount of their income; (2) the Federal-State Offshore Payment Card Matching Initiative, which contemplates increased use of state databases by the IRS to help identify taxpayers who have participated in offshore credit/debit card abuses; and (3) the Title 31 Money Servicing Businesses Memorandum of Understanding that establishes a framework for the federal-state information exchange to increase compliance by particular businesses in the financial services industry.⁵⁹

B. Recent Civil and Criminal Enforcement

The U.S. Department of Justice (DOJ), working in conjunction with the IRS, has demonstrated its willingness to fully use the information that it receives from the ATAT Partnership and related sources. In the words of Eileen J. O'Connor, Assistant Attorney General for the Tax Division, "People who engage in, facilitate or promote tax fraud are increasingly likely to be on the receiving end not only of civil enforcement actions, but also of criminal prosecution."⁶⁰

With regard to criminal issues, the DOJ announced that in 2003 it referred approximately 1,130 taxpayers to the U.S. Attorney's Office for prosecution of assorted tax violations.⁶¹ In making these referrals the DOJ focused on

various tax-avoidance schemes involving, among other things, shifting assets and income to hidden offshore accounts, failing to file returns and not fully reporting income.⁶² Along with making general announcements regarding the recent increase in criminal tax enforcement, the DOJ also provided details of particular cases. For instance, the DOJ announced in April 2004 that two taxpayers pled guilty to filing fraudulent tax returns, a crime that carries with it a fine of up to \$250,000, three years of imprisonment, or both.⁶³ According to the DOJ announcement, the taxpayers made payments to certain domestic shell corporations (*i.e.*, ones without any employees or business activity), fraudulently deducted these payments as professional fees, ultimately deposited these payments in offshore bank accounts that they controlled, and accessed these untaxed funds by using offshore credit/debit cards.⁶⁴ In a similar announcement the DOJ explained that several more taxpayers pled guilty to tax fraud in April 2004.⁶⁵ Like the previous case, the taxpayers here admitted to using shell corporations, unreported foreign financial accounts and offshore credit/debit cards to circumvent U.S. tax laws.⁶⁶

The DOJ has also proclaimed its readiness to use information partially obtained through the ATAT Partnership in the civil context. In a recent release, the DOJ stated that it filed lawsuits in 2003 to halt the activities of 35 promoters of abusive tax schemes, and managed to enjoin 28 of these promoters.⁶⁷ As was the case in the criminal arena, the DOJ did not limit itself to generalizations concerning civil tax enforcement. Instead, the DOJ issued a release in March 2004 explaining that

it had successfully enjoined a promoter who was commingling the funds of over 250 customers in various bank accounts held in the promoter's name in order to make it difficult for the IRS and the DOJ to trace the income, assets, expenditures and identities of the customers. This scheme allowed the customers to avoid paying approximately \$24 million in federal taxes.⁶⁸

C. Complement to the ATAT Partnership

Identifying noncompliant taxpayers will also be facilitated by a new state initiative designed to complement the ATAT Partnership. In February 2004, the California Franchise Tax Board, the Federation of Tax Administrators, the Multistate Tax Commission, and representatives of 11 state taxing authorities met to develop strategies regarding how the states could better cooperate to combat abusive tax shelters.⁶⁹ Shortly thereafter, the Federation of Tax Administrators announced the signing of the Memorandum Agreement Pertaining to Abusive Tax Avoidance Transactions, which is intended to supplement the ATAT Partnership. Whereas the ATAT Partnership centers on information sharing between the IRS and the states, the new Memorandum focuses on information sharing between and among the states regarding ATATs.⁷⁰

VI. Assessing Taxpayer Options

As a result of the information acquired by the IRS under the OCCP, the OVCI, the growing ATAT Partnership and the burgeoning state complement thereto, the probability of a U.S. taxpayer involved in

offshore activities being detected by the IRS has increased dramatically. Noncompliant taxpayers, therefore, have three main options at this juncture: Do nothing and hope that the IRS fails to discover them; Wait for the IRS to send an LCCI letter and comply with this initiative; or Immediately come clean with the IRS pursuant to the standard voluntary disclosure program. The pros and cons of each of these three options are examined below.

A. Option 1—Do Nothing

Although tax practitioners may be ethically restrained from suggesting such a strategy, taxpayers could opt for complete inaction and simply hope that the IRS fails to discover them.⁷¹ Those considering this option may take comfort in a recent study by the U.S. Government Accounting Office (GAO) regarding the challenges facing the IRS in combating ATATs. According to the study, the IRS has encountered various staffing and resource problems in its attempt to implement a new enforcement strategy. The study states, in particular, that the:

IRS has begun shifting, although more slowly than expected, and plans to continue shifting, significant resources into addressing schemes, but the potential volume of additional work that may be identified and inexperience with the rate at which staff can close cases makes it unclear whether the additional resources and the caseloads will match each other.⁷²

With respect to offshore credit/debit card abuses, the GAO study reveals that as of July 2003 the IRS had managed to close only 18 percent of these cases that it had anticipated closing by that date.⁷³

What's more, this situation may worsen in the future. The GAO study indicates that thanks to the OVCI and the OCCP the IRS was able to identify hundreds of offshore promoters and noncompliant taxpayers.⁷⁴ While this is positive news in theory, it could lead to difficulties and uncertainty in terms of enforcement. As the GAO study explains, "There is the potential that the volume of cases could grow significantly, but it is not clear how much the caseload will grow or how quickly."⁷⁵ The IRS's enforcement-capability troubles have also been highlighted by high-ranking government officials. For instance, on his way out of office, former IRS Commissioner Charles O. Rossotti revealed that 60 percent of the tax debts identified by the IRS are never pursued, 75 percent of taxpayers who fail to file tax returns do not face any enforcement action, and 79 percent of taxpayers participating in abusive schemes are never subjected to penalties.⁷⁶

Assuming that the IRS is unable to identify them, the pros for taxpayers of doing nothing may include the avoidance of taxes, interest and penalties. However, the cons associated with this inaction option outweigh the pros since, despite the staffing and resource problems that it is currently experiencing, the IRS will ultimately identify most noncompliant taxpayers. This eventuality is supported by the fact that the IRS has already identified many promoters and obtained offshore account information under the OCCP, the OVCI and the ATAT Partnership. Perhaps more importantly, the IRS now has essentially all the time in the world to pursue certain taxpayers. The IRS

generally has three years from the date a return is filed during which to assess tax.⁷⁷ However, the IRS is not restricted by any such time limit in cases where a taxpayer fails to file a return, files a false return or engages in tax evasion.⁷⁸ Also, if a taxpayer files a return, but there is a "substantial omission" from gross income (*i.e.*, more than 25 percent of the proper amount) shown on the return, then the statute of limitations is extended to six years from the date the return was filed.⁷⁹ The statute of limitations is similarly extended from three year to six years in the case of many criminal offenses.⁸⁰ Assuming the IRS manages to identify the noncompliant taxpayer, he/she could conceivably face many of the penalties described earlier, including those for civil fraud, failure to file timely returns, failure to file FBARs, failure to file Forms 5471, perjury and tax evasion.

B. Option 2—Participate in the LCCI

As explained above, the IRS is offering certain taxpayers "one final opportunity" to minimize their penalty exposure by providing the IRS with complete information regarding any unreported offshore activity within a designated time period.

In terms of pros, participation in the LCCI means reduced civil penalties for the taxpayer, as well as preservation of taxpayer confidentiality. Resolving an issue under the LCCI allows a taxpayer do so privately, without having his/her identity, tax violations, financial information and the like exposed as part of a court proceeding. On the downside, disclosing under the LCCI does not preclude the IRS

from pursuing criminal charges against the taxpayer.⁸¹

C. Option 3—Make an Immediate Voluntary Disclosure

If participating in the LCCI is unappealing or impossible, taxpayers have one remaining option: making an immediate voluntary disclosure.⁸² According to the IRS's standard voluntary disclosure program revised in December 2002, a submission to the IRS will qualify as a "voluntary disclosure" when (1) it is truthful, timely and complete; (2) the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability; and (3) the taxpayer makes good faith arrangements with the IRS to pay in full the applicable tax, interest, and penalties.⁸³

On the bright side, selecting this option may save the taxpayer from criminal prosecution. The INTERNAL REVENUE MANUAL provides that although making an acceptable voluntary disclosure does not automatically guarantee that a taxpayer will avoid criminal prosecution, the IRS will consider this, along with all other relevant factors, when determining whether a particular case should be recommended for criminal prosecution.⁸⁴ Also, as was the case with participation in the LCCI, making a standard voluntary disclosure preserves the confidentiality of the taxpayer's identity and other personal information. On the other hand, making a standard voluntary disclosure does not relieve the taxpayer from his/her obligation to fully pay all back taxes, interest and "any penalties

determined by the IRS to be applicable.”⁸⁵

VII. Conclusion

In the context of international tax enforcement, it appears that conventional wisdom does not apply:

You cannot catch more flies with honey than with vinegar. It is also clear that the IRS is now knowledgeable about offshore tax avoidance strategies, highly motivated to stop them and willing to use vinegar to do so. Under these circumstances, it seems that three main options

remain for noncompliant U.S. taxpayers. Although each has its downsides, it is essential that noncompliant taxpayers consult a qualified and reliable tax advisor, review the pros and cons of each option and make a decision before experiencing that IRS vinegar.

ENDNOTES

¹ Mark W. Everson, *Everson Comments on Antishelter Agreement Between IRS, State Agencies*, 2003 TNT 180-12 (Sept. 17, 2003).

² Thomas W. Ostrander, *The Offshore Credit Card and Financial Arrangement Probe: Fraught with Danger for Taxpayers*, 99(2) J. TAX’N 114 (2003); U.S. Internal Revenue Service, *Full Text: Publication 1150, Tax Havens and Their Use by United States Taxpayers—An Overview*, 93 TNT 119-22 (June 6, 1993); Dale Hart, *IRS Small Business Testimony at Finance Committee Hearing on Tax Scams*, 2003 TNT 63-24 (Apr. 2, 2003); U.S. Senate, Committee on Finance, *Taxpayer Beware: Schemes, Scams and Cons*, Hrg. 107-77 (Apr. 5, 2001).

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ Amy Hamilton, *Profile of Offshore Bank Customers Emerges in Latest IRS Filings*, 2002 TNT 169-1 (Aug. 30, 2002).

⁷ U.S. Senate, Committee on Finance, *supra* note 2, at 3.

⁸ Michael Allen, *Murky World of Offshore Banking Emerges in U.S. Tax-Fraud Probe*, WALL ST. J., Aug. 3, 1999, at A18.

⁹ *Senate Panel Presses Large U.S. Banks on Abuses, Airs New Findings*, 12(6) MONEY LAUNDERING ALERT 1 (April 2001).

¹⁰ *Id.*

¹¹ Beth Piskora and Jesse Angelo, *Pay No Attention to the Man in the Booth*, N.Y. POST, Aug. 8, 1999, at 59.

¹² *Supra* note 9.

¹³ U.S. Internal Revenue Service, *Offshore Credit Card Program (OCCP)*, available at www.irs.gov/newsroom.

¹⁴ Any summons that does not identify the person with respect to whose liability the summons is issued may be served only after a court proceeding in which the IRS establishes that (1) the summons relates to the investigation of a particular person or ascertainable group or class of persons, (2) there is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of U.S. tax law, and (3) the information sought and the identity of the person(s) is not readily available from other sources. Code Sec. 7609(f).

¹⁵ U.S. Internal Revenue Service, *IRS Issues Chronology on Credit Card Tax-Avoidance Schemes, John Doe Summonses*, 2003 TNT 10-12 (Jan. 15, 2003); See also U.S. General Accounting Office, *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Schemes*, GAO-04-50 (Nov. 2003), at 10-12.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ U.S. Internal Revenue Service, *Offshore Compliance Program Shows Strong Results*, IR-2003-95 (July 30, 2003); Amy Hamilton, *IRS Collects \$75 Million in Taxes Through Offshore Amnesty*, 2003 TNT 147-2 (July 31, 2003).

²⁰ Dale Hart, *IRS Small Business Testimony at Finance Committee Hearing on Tax Scams*, 2003 TNT 63-24 (Apr. 2, 2003). According to this IRS official, “[w]hile it is not illegal to have a credit card issued by an offshore bank, there is ample basis for believing that many people are using offshore credit cards to repatriate funds hidden offshore to evade paying U.S. taxes. Use of an offshore credit card, trust, or other arrangement to hide or underreport income or to claim false deductions on a federal tax return is illegal.”

²¹ Reg. §1.1-1(b); Code Sec. 7701(a)(30).

²² There are certain limited exceptions to these rules. See, e.g., Code Sec. 911.

²³ Code Sec. 6663.

²⁴ Code Sec. 6662(b).

²⁵ Code Sec. 6651(a)(1). This penalty increases to 15 percent of such tax per month, not exceeding a maximum of 75 percent, if the failure to timely file a return is due to fraud. Code Sec. 6651(f).

²⁶ Under the Bank Secrecy Act, a U.S. person with a financial account in a foreign country with a value exceeding \$10,000 at any time during the year must file an FBAR. Previously, the authority to enforce the FBAR penalties resided with the U.S. Treasury Department’s Financial Crimes Enforcement Network. This power, however, was recently delegated to the IRS. See *IRS and FinCEN Announce Latest Efforts to Crack Down on Tax Avoidance Through Offshore Accounts*, IR-2003-48 (Apr. 10, 2003).

²⁷ 31 USC §5321(a)(5), as amended by Act

Sec. 821 of the American Jobs Creation Act of 2004 (P.L. 108-357).

²⁸ *Id.*

²⁹ Code Sec. 6038(a).

³⁰ Code Sec. 6038(b).

³¹ Code Sec. 7201.

³² Code Sec. 7206.

³³ Rev. Proc. 2003-11, 2003-1 CB 311 (Jan. 27, 2003).

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Internal Revenue Service, *Offshore Compliance Program Shows Strong Results*, IR-2003-95 (July 30, 2003).

⁴² Rev. Proc. 2003-11, 2003-1 CB 311 (Jan. 27, 2003).

⁴³ See Testimony of Nina E. Olson, National Taxpayer Advocate, before the Senate Committee on Finance on the Tax Gap and Tax Shelters, 2004 TNT 141-44 (July 21, 2004) (attaching the *Abusive Schemes Tipping Point Study*, which examines the OCCP, OVCI, LCCI, and ATAT Partnership); Minutes from the South Texas IRS/Tax Practitioners Council Meeting, Oct. 30, 2003 (stating that Susan Graham, SBSE Compliance Chief, announced the launch of the “Last Chance Compliance Initiative”), available at www.texastaxsection.org; Caplin & Drysdale, *Foreign Bank Accounts—Last Chance for Taxpayers* TAX ALERT, July 2004, at 2 (explaining the OVCI and the LCCI), available at www.caplindrysdale.com; Thomas W. Ostrander, *The Offshore Credit Card and Financial Arrangement Probe: Fraught with Danger for Taxpayers*, 99(2) J. TAX’N 114 (2003) (explaining and distinguishing the OVCI and LCCI); Steven Toscher and Michael R. Stein, *FBAR Enforcement Is Coming!* available at www.taxlitigator.com/articles/fbar.htm (describing the LCCI and the potential hazards for taxpayers participating in it); INTERNAL REVENUE MANUAL §5.3.1.2.4, Code Cases with Case Codes and Subcodes (Nov. 1, 2004) (explicitly referring to the program as the “Last Chance Compliance Initiative” and the “LCCI”).

Please note that the IRS has not of-

ENDNOTES

- ficially labeled this new program as the “Last Chance Compliance Initiative,” and that this program is referred to as the LCCI in this article solely for the sake of simplicity.
- ⁴⁴ U.S. Internal Revenue Service, *Offshore Compliance Program Shows Strong Results*, IR-2003-95 (July 30, 2003).
- ⁴⁵ U.S. Treasury Department, *A Report to Congress in Accordance with § 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act)*, Apr. 26, 2002, at 6.
- ⁴⁶ U.S. Government Accounting Office, *Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions*, GAO-04-972T (July 21, 2004), at 31.
- ⁴⁷ Frank Shafroth, *The Tax Doctor: Reason to Love Refunds*, 2004 State Tax Today 70-4 (Apr. 12, 2004).
- ⁴⁸ *Id.*
- ⁴⁹ *Id.*
- ⁵⁰ U.S. Internal Revenue Service, Small Business/Self-Employed Division, *IRS SB/SE Releases Memo of Understanding on Abusive Transactions*, 2003 TNT 180-27 (Sept. 17, 2003). See also *Federal and State Tax Authorities Initiate Partnership to Combat Tax Shelters; Pledge More Information Sharing*, Vol. 90(43) STANDARD FEDERAL TAX REPORTS 1-2 (Sept. 25, 2003).
- ⁵¹ *Id.*
- ⁵² U.S. Internal Revenue Service, *IRS and States Announce Partnership to Target Abusive Tax Avoidance Transactions*, IR-2003-11 (Sept. 16, 2003); See also U.S. Internal Revenue Service, *IRS and States Announce Partnership to Targeting Abusive Tax Avoidance Transactions*, 2003 TNT 180-10 (Sept. 17, 2003).
- ⁵³ Dale R. Hart, *SB/SE Commissioner Highlights Provisions of Agreement to Fight Tax*, 2003 TNT 180-11 (Sept. 17, 2003).
- ⁵⁴ Pamela F. Olson, *New Partnership Will Restore Faith in Tax System*, Olson Says, 2003 TAX NOTES INT’L 180-13 (Sept. 17, 2003).
- ⁵⁵ *States, D.C. Comment on Agreement to Fight Abusive Tax Transactions*, 2003 TNT 180-32 (Sept. 17, 2003).
- ⁵⁶ Shafroth, *supra* note 56.
- ⁵⁷ U.S. Internal Revenue Service, *IRS, States Move Forward in Fight Against Abusive Tax Avoidance*, IR-2004-19 (Feb. 10, 2004); Allen Kenney, *IRS, States Share Leads on Tax Avoidance Schemes*, 2004 STATE TAX TODAY 28-2 (Feb. 11, 2004).
- ⁵⁸ U.S. Internal Revenue Service, *IRS and State Partnership Moves Forward to Improve Compliance and Service*, IR-2004-77 (June 7, 2004); Internal Revenue Service, *IRS Announces Partnership with States Producing Early Results*, 2004 TNT 110-23 (June 8, 2004); Allen Kenney, *IRS Commissioner: Service to Increase Information Sharing with States*, 2004 STATE TAX TODAY 111-3 (June 9, 2004).
- ⁵⁹ *Id.*
- ⁶⁰ U.S. Department of Justice, News Release—*Justice Department Notes Increase in Tax Enforcement: Civil and Criminal Enforcement Against Tax Cheats on the Rise* (Apr. 6, 2004).
- ⁶¹ *Id.*
- ⁶² *Id.*
- ⁶³ U.S. Department of Justice, News Release—*Two Businessmen Plead Guilty to Tax Fraud in Offshore Credit Card Scheme: Credit Cards Were Used to Spend Untaxed Income Stashed in Foreign Accounts* (Apr. 13, 2004).
- ⁶⁴ *Id.*
- ⁶⁵ U.S. Department of Justice, News Release—*Third Promoter of Offshore Tax Fraud Scheme Pleads Guilty in Oregon: Prosecutions Also Snares Clients Who Used Scheme to Cheat* (Apr. 2004).
- ⁶⁶ *Id.*
- ⁶⁷ U.S. Department of Justice, News Release, *supra* note 69.
- ⁶⁸ U.S. Department of Justice, News Release—*Justice Department Sues to Shut Down Alleged “Warehouse Banking” Scam: Complaint Alleges Los Angeles-Area Man Helps Customers Hide Income and Assets from IRS* (Mar. 2004).
- ⁶⁹ Franchise Tax Board, *California FTB Meets with States to Discuss Combating Abusive Tax Shelters*, 2004 STATE TAX TODAY 22-4 (Feb. 3, 2004).
- ⁷⁰ Hawaii Department of Taxation, *State Signs Agreement to Share Abusive Tax Shelter Information*, 2004 STATE TAX TODAY 53-14 (Mar. 18, 2004).
- ⁷¹ JEROME BORISON, EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE “NEW” IRS (2001–2002), at 2-20 and 2-21 (discussing rules contained in Circular 230, American Bar Association Formal Opinion 314, and various statements of the American Institute of Certified Public Accountants regarding appropriate behavior in cases of taxpayer noncompliance error or omission).
- ⁷² U.S. General Accounting Office, *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Schemes*, GAO-04-50 (Nov. 2003), at 15.
- ⁷³ *Id.*, at 20.
- ⁷⁴ *Id.*, at 22.
- ⁷⁵ *Id.*
- ⁷⁶ Jonathan Weisman, *GAO Finds Increase in Tax Evasion; report Says IRS Needs More Resources*, WASH. POST, Dec. 19, 2003, at E1.
- ⁷⁷ Code Sec. 6501(a).
- ⁷⁸ Code Sec. 6501(c)(1), (2) and (3). Each of these provisions states that “the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.” (Emphasis added.)
- ⁷⁹ Code Sec. 6501(e).
- ⁸⁰ Code Sec. 6531.
- ⁸¹ Thomas W. Ostrander, *The Offshore Credit Card and Financial Arrangement Probe: Fraught with Danger for Taxpayers*, 99(2) J. TAX’N 114 (2003).
- ⁸² Internal Revenue Service, *IRS Revises Voluntary Disclosure Practice*, IR-2002-135 (Dec. 11, 2002).
- ⁸³ INTERNAL REVENUE MANUAL, at §9.5.3.3.1.2.1, Voluntary Disclosure Practice (Dec. 2002).
- ⁸⁴ *Id.*
- ⁸⁵ *Id.*

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