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Journal of Taxation (WG&L)

Journal of Taxation

2018

Volume 128, Number 01, January 2018

Articles

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PROCEDURE

IRS New Compliance Campaigns and International Audits of Individuals

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The IRS is attempting to efficiently use its limited resources by moving towards issue-based examinations.

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On 11/3/17, the IRS announced the roll out of 11 Large Business and International (LB&I) Compliance Campaigns.¹ LB&I previously announced the roll out of its first 13 campaigns on 1/31/17.² In an effort to make the best use of its limited resources, the IRS is moving toward “issue-based examinations” in which a civil tax audit is focused on a particular issue that LB&I has deemed to be a compliance risk.³ LB&I's goal is to improve return selection, identify issues representing a risk of noncompliance, and make the greatest use of limited resources, according to the IRS. The IRS' website describes in detail each one of the IRS campaigns, and the information is well worth reviewing because it provides insight into the areas that the government is pressing. Knowledge of the compliance campaigns is particularly useful when representing a taxpayer before the IRS. This article briefly discusses two of the IRS compliance campaigns dealing with individual international issues and provides guidance regarding what to expect if a taxpayer becomes the subject of an issue-based examination dealing with offshore accounts.

SWISS BANK PROGRAM CAMPAIGN

One of the campaigns, the “Swiss Bank Program Campaign,” targets individuals with undisclosed bank accounts and those who have not come forward and handled their offshore accounts.⁴ To briefly provide some background, the Department of Justice ran the Swiss Bank Program beginning in 2013 as a path for Swiss financial institutions to resolve potential criminal liabilities, and banks that have participated in this program have provided information on U.S. persons with beneficial ownership of

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foreign financial accounts. Many individuals with accounts at Swiss banks participated in the IRS Offshore Voluntary Disclosure Program (OVDP) to handle their offshore compliance issues; but those who did not, perhaps because they closed their Swiss account and moved the funds to another account, are now at risk of being contacted by the IRS.

OVDP DECLINES-WITHDRAWALS CAMPAIGN

Another campaign, the “OVDP Declines-Withdrawals Campaign,” addresses individuals who applied for pre-clearance into the IRS OVDP but were either denied access to OVDP or withdrew from the program on their own accord.⁵ The IRS has a procedure in place where an individual can request preclearance to the IRS OVDP before providing a detailed disclosure through an Offshore Voluntary Disclosure Letter.⁶ This procedure typically is used by an individual who is unsure whether he or she is eligible to participate in the OVDP and does not want to provide a full disclosure to the IRS without knowing his or her eligibility upfront. For those individuals who were denied entry into the OVDP, the IRS plans to address these individuals noncompliance through a variety of treatment streams including examination.⁷ This means one should expect the IRS to follow up and contact individuals who either were declined entry into the OVDP or withdrew their application. Stay tuned.

SOFT LETTERS

Notably, the IRS may use soft letters or notices encouraging voluntary self-correction and follow-up with issue based examinations when warranted.⁸ According to the IRS, a soft letter is an outreach letter to a taxpayer seeking information about a compliance issue but is not a formal examination of the taxpayer's return.⁹ For example, the IRS may have received information about an individual's foreign financial account(s) or an interest in a foreign entity but has no record of the individual filing a Report of Foreign Bank and Financial Accounts (FBAR) or a Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations; given the agency's limited recourses, the IRS may issue a letter or notice to the individual seeking voluntary compliance instead of

selecting the person's tax return for audit. A soft letter is a way for the IRS to improve noncompliance with LB&I's limited resources.¹⁰

OBSERVATIONS

A few general observations can be made from the IRS LB&I Compliance Campaigns:

- (1) There will likely be an increase in the number of individuals who either become the subject of a civil examination or are otherwise contacted by the IRS through a soft letter.
- (2) Anticipate an examination (tax audit) that is more focused on a particular compliance issue such as one of the 11 campaigns selected for rollout on 11/3/17, as opposed to a more-ended examination; identifying the compliance issue early in the audit and working efficiently to resolve that particular issue with the agent (as opposed to other issues in the case) can significantly aid in an early case resolution.
- (3) If a taxpayer has been contacted by the IRS, determine if he or she attempted to participate in the OVDP and/or had an account at one of the Swiss banks; if so, the taxpayer's offshore activities may be the focus of the audit.
- (4) For a taxpayer with undisclosed foreign financial accounts or assets, a prudent course of action still is to participate in one of the IRS offshore compliance options such as the Streamlined Filing Compliance procedures; the cost or expense of participating in a program, even the 2012 OVDP, is far less than the potential risk of becoming the subject of a civil examination or criminal investigation; do not expect the IRS to continue to run the programs indefinitely, as the number of individuals who participate in the programs will decline.¹¹

WHAT TO EXPECT IF A TAXPAYER BECOMES THE SUBJECT OF A CIVIL EXAMINATION

What happens if a taxpayer becomes the subject of a civil examination and has undisclosed foreign financial accounts or assets? Unlike a normal income tax audit that focuses solely on adjustments to an individual's income tax return (e.g., disallowed deduction or unreported income), the IRS revenue agent will examine three distinct cases or potential compliance issues:

- Title 26 Unreported income case.
- Title 26 Offshore information return case.
- Title 31 FBAR case.

This means that a practitioner should be informed and knowledgeable with respect to the procedures for handling these different cases. The Internal Revenue Manual (IRM) contains procedures for each type of case and is worth reviewing. For example, Part 4, Chapter 26, section 17 deals with FBAR procedures during the examination process.

Briefly, a Title 26 income tax case probes for unreported income, and this generally is accomplished by an IRS agent issuing a summons for the taxpayer's foreign and domestic bank records and performing a detailed bank deposit analysis. A Title 26 offshore information return case probes for unfiled information returns, such as Forms 5471 or Forms 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, and seeks to impose civil penalties, unless an individual can establish reasonable cause for failing to file the form(s). Lastly, a Title 31 FBAR case probes for unfiled Fincen Forms 114, Report of Foreign Bank and Financial Account, and seeks to impose civil penalties unless reasonable cause exists for the unfiled FBARs.

The IRS agent is trained to examine all three compliance issues simultaneously. The case is not linear in the sense that the agent issues a summons, waits to get the records, and then issues a second summons. The examination team, which generally consists of the agent, his or her manager, and additional reviewers or team members located in other geographical areas, move forward on multiple fronts looking for unreported income, unfiled information returns, and unfiled FBARs. In short, these are multi-faceted exams that require a taxpayer to develop a defensible strategy early for each aspect of the case.

Common Information Returns

Some of the more common information returns that IRS agents typically look for during the examination process include the following:

- FinCEN Report 114, Foreign Bank and Financial Accounts (FBAR).
- Form 8938, Statement of Specified Foreign Financial Assets.
- Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.
- Form 3520A, Annual Information Return of Foreign Trust with a U.S. Owner.
- Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations.

At the commencement of the case, it is helpful to interview the taxpayer, and determine a taxpayer's offshore accounts and beneficial interests in foreign entities such as corporations and trusts. This typically requires getting into the weeds with an individual and fully understanding the taxpayer's offshore activities. Also, it is important to know what forms should have been filed and for what years. This information provides a case roadmap for the civil penalties at issue, the amount of the penalties, and whether reasonable cause exists to avoid the penalties. An important tactical strategy is to stay one step ahead of the agent and begin formulating a reasonable cause explanation for any unfiled information return(s), as opposed to being caught off guard when the issue is raised for the first time by the agent.

Special Enforcement Program

If the agent assigned to the case is from the IRS Special Enforcement Program (SEP), it is a telltale sign that the case likely will involve an in-depth examination. Be proactive and ask the agent upfront if he or she works for SEP (the agent's business card normally will not reveal this information and only states that the agent is a revenue agent working for Small Business and Self Employed (SB/SE)). IRM, Part 4, Chapter 16, section 1, which provides internal guidelines for the agents, deals with SEP responsibilities and case development, and is worth reviewing to gain an understanding of how SEP operates and develops a case.¹² A SEP agent is very different than a normal revenue agent.

In some instances, there may be reasonable indications that unreported income exists prior to the start of the actual examination, which may come from informants/whistleblowers, IRS Criminal Investigation, federal, state, or local law enforcement, or the IRS Information Reporting Program. Inquire with the agent as to what prompted the civil audit and/or what the agent is looking for (e.g., unreported income) because the agent's response, even if not fully complete, can be a clue as to the compliance issue(s) involved in the case.

The Examination Steps

There are three key information gathering tools that the IRS agent will use during the examination phase of the case:

- Summons.
- Interviews.
- Treaty requests through Exchange of Information.

An IRS agent generally will request information informally by issuing an Information Document Request (IDR). If a taxpayer refuses to cooperate and produce the information, the agent will issue a summons for the taxpayer's records.¹³ As indicated above, anticipate that the IRS agent will request the taxpayer's foreign and domestic bank records and perform a detailed bank deposit analysis (BDA) that searches for unreported income. SEP agents typically are experienced agents who have been with the IRS for years and are quite skilled at performing a BDA.¹⁴ Stay ahead of the agent and perform an internal BDA and ask the agent for a copy of his or her BDA for comparison purposes. Experienced agents know that a practitioner can obtain the agent's BDA through a Freedom of Information Act (FOIA) Request and usually will turn over a copy without having to file a FOIA request.

Often, there are behind the scenes activities that are on-going, and that the IRS agent will not disclose to the taxpayer. The case may involve a confidential informant who has disclosed the taxpayer's offshore bank accounts,

or the IRS may have a confidential document linking the taxpayer to a foreign bank account or foreign entity. Today, the IRS has a treasure trove of information from the issuance of John Doe summons, IRS OVDP, the Department of Justice's Swiss Bank Program, the Foreign Account Tax Compliance Act, and other sources. Do not expect the IRS to reveal this information during the audit, even if pressed, as the agent may be precluded from disclosing any information based on the advice of IRS Counsel. Considering this, the best course of action is to assume that the government knows about the taxpayer's offshore accounts and/or entities and proceed accordingly. It can be risky to claim that the alleged foreign financial account or offshore entity does not exist (and/or that the government somehow has got it wrong) and then wait for the government to produce evidence of the account through, for example, a treaty request.

IRS INTERVIEWS

Expect the agent to ask for a taxpayer interview. If the taxpayer refuses, anticipate a summons compelling the testimony.¹⁵ Interviews are routine in complex cases and difficult, but not impossible, to avoid. The IRS also may interview the tax return preparer, spouse, business partners, and other individuals involved in the taxpayer's business. The IRS agent will prepare a written memorandum of the interview with the taxpayer, and if there are misstatements, the agent documents the information without telling the taxpayer. The taxpayer will have to deal with that later during the audit. This can be a trap for the unwary because false or inconsistent statements make it more difficult for a taxpayer to avoid civil penalties, which the IRS determines later in the case. This underscores the importance of properly preparing a taxpayer for an IRS interview; and a practitioner who is retained after a taxpayer has made false or inconsistent statements may find it difficult to unwind those statements and turn a case around.

An important source of information for the government is the return preparer or accountant who prepared the tax return. Expect the IRS to ask for the accountant's file, the documents relied on to prepare the return, and a copy of the tax organizer.¹⁶ The agent is investigating whether the taxpayer concealed information from the accountant in preparing the tax return, and if so, the agent may use this information to build a fraud case. Contact the accountant ahead of the IRS and:

- Interview the accountant about the preparation of the tax return and any information returns.
- Know what the taxpayer said, and did not say, to the accountant about any foreign source income, offshore accounts, or assets.
- Obtain and review a copy of the accountant's file used to prepare the tax return and any email correspondence between the taxpayer and the accountant.

Finally, tax counsel should prepare a memorandum detailing any information learned from the accountant. Significantly, there is no attorney-client privilege communication with the accountant,

and so a taxpayer, and a representative, should be careful about what he or she says to an accountant. A *Kovel* engagement letter with the accountant will not prevent the IRS from interviewing the accountant about the facts and information that the accountant relied on in preparing the tax return. A true *Kovel* accountant is not the same person who prepared and filed the client's tax return, but rather a behind the scenes person who works in conjunction with tax counsel.¹⁷ Additionally, transferring the accountant's file to the lawyer's office and then claiming the Fifth Amendment likely will not work.¹⁸

TREATY REQUESTS

The IRS can obtain information, such as information about a foreign bank account, through tax treaties and Tax Information Exchange Agreements (TIEAs).¹⁹ The agent may resort to obtaining information through these means, if a taxpayer fails to produce certain documents or information requested in a summons. However, treaty requests take time and can slow a case down as the agent waits to receive the information. A better course of action may be for a taxpayer to be proactive and produce a set of documentation with an affidavit signed under penalty of perjury in an effort to resolve the issue early at the Examination level.

Tell A Consistent Story

Another important strategy is to tell a consistent factual story throughout the examination. IRS agents do not like false statements or inconstant explanations as to why income was not reported on a tax return or an information return was not filed. Taxpayers who attempt to outwit or outsmart the agent by making false statements or changing their story as the case progresses typically do not win in the end. It is better to hold back with an explanation than make one up on the fly and attempt to fix it later when additional information is learned about the case. Even good faith and honest, but incorrect, statements can be troublesome. Responses such as “let me look into that, and I'll get back to you” can buy time to better understand the facts of the case, while at the same time being upfront with the agent.

Fifth Amendment

Claiming Fifth Amendment privilege may be a knee jerk reaction in response to an agent's

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question, but a more prudent course of action is to try to understand the case from the taxpayer's point of view and see if there is a pathway to resolve the case civilly. Cases can be factually complex and take time to work through. In short, a practitioner should get into the weeds, fully understand the facts of the case, and see if there is a reasonable explanation for a seemingly flagrant compliance issue. Additionally, some taxpayers are not always upfront with the facts and

tend to hold back and reveal additional information over time as they internally evaluate how the case is progressing. This can be problematic when defending a taxpayer in a tax audit.

Nevertheless, claiming the Fifth Amendment can trigger the IRS Revenue Agent to refer the case to Criminal Investigation, which can make a bad case worse. It is better to pay money to the IRS than face a criminal investigation.

Statute of Limitations

A potential trap for the unwary is that the civil statute of limitations may remain open if the case involves unfiled information returns. Typically, the IRS has three years after a tax return is filed (regardless of whether such return was filed on or after the prescribed due date) to assess additional tax (e.g., audit the return).²⁰ However, if an individual fails to file an information return, such as a Form 5471, the time for assessment of any tax with respect to the individual income tax return does not expire before the date that is three years after the date on which the individual furnishes the late-filed information return.²¹

Suppose an individual has unfiled Forms 5471 for a foreign company located in Taiwan for years 2010-2014. Even though the taxpayer always timely filed his or her individual income tax return, the normal three-year statute of limitations does not apply, and the limitation period remains open for the individual income tax returns for 2010-2014. This means that the individual is at risk not only for civil penalties for any unfiled Forms 5471 for 2010-2014, but potentially at risk for a Title 26 income tax examination for those years as well. Experienced IRS revenue agents working international cases are aware of this rule, and this can be a trap for unsuspecting taxpayers, who become the subject of an audit.

Moreover, the assessment procedures for civil penalties for many unfiled information returns are not subject to deficiency procedures, which means that an individual does not have a right to petition the U.S. Tax Court to contest the penalty.²² Continuing the example, if an individual has delinquent Forms 5471, the IRS can assess civil penalties for failing to file the forms, and the taxpayer's procedural options are limited to resolving the civil penalty case at the examination level or attempting to settle the case at IRS Office of Appeals. This underscores the importance of having a good working relationship with the agent and a reasonable explanation for why the forms were not filed. False statements or inconsistent explanations as to why the form was not filed can make it problematic to obtain penalty abatement or relief.

CONCLUSION

LB&I is moving toward compliance-based examinations. Practitioners should take the time to read and review the IRS website describing LB&I's Compliance Campaigns to be informed and knowledgeable about the areas that the government is pressing. Understanding the compliance issues can greatly assist a practitioner in representing a taxpayer before the IRS or even preparing

a return. Additionally, considering the IRS' recent announcements in 2017, expect the IRS to contact taxpayers in the coming months either through soft letters seeking voluntary compliance or civil examinations. Taxpayers, who may be the subject of the IRS' new campaigns, would be wise to seek the advice of competent tax counsel, who can evaluate the case, explain the options, and develop a defensible strategy.

¹ “Large Business and International Launches Compliance Campaigns,” www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns.

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*; Internal Revenue Manual (IRM) 9.5.11.9 (an individual can be denied preclearance if, for example, the IRS received information from a third party or initiated a civil examination or criminal investigation).

⁶ IRS FAQ No. 23, Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014.

⁷ *Id.*

⁸ “Large Business and International Launches Compliance Campaigns,” Note 1, *supra*.

⁹ *Id.*

¹⁰ *Id.*

¹¹ The IRS currently is offering four offshore compliance options: (1) Streamlined Filing Compliance Procedures; (2) Delinquent FBAR Submission Procedures; (3) Delinquent International Information Return Submission Procedures; and (4) 2012 OVDP. See, “Streamlined Filing Compliance Procedures,” www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures.

¹² IRM 4.16.1, SEP Responsibilities and Case Development.

¹³ Section 7602; IRM 25.5.5, Summons for Taxpayer Records and Testimony.

¹⁴ IRM 4.16.1.3, SEP Agent Duties and Responsibilities.

¹⁵ Section 7602.

- 16** *Williams*, 110 AFTR2d 2012-5298 , 659 (CA-4, 2012) (false answers on tax organizer and federal tax return evidenced conduct that was meant to conceal or mislead sources of income).
- 17** *Kuehne*, 98 AFTR2d 2006-7402 (DC Ore., 2006); *Kovel*, 296 F.2d 918 9 AFTR2d 366 (CA-2, 1961) (presence of accountant while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege; accountant is necessary, or at least highly useful, for the effective consultation between the client and the lawyer that the privilege is designed to permit).
- 18** *Sideman Bancroft, LLP*, 111 AFTR2d 2013-460 (CA-9, 2013) (court enforced IRS summons seeking documents that taxpayer transferred to attorney; foregone conclusion exception to Fifth Amendment applied).
- 19** IRM 4.60.1.1, Exchange of Information—Overview.
- 20** Section 6501(a).
- 21** Section 6501(c)(8).
- 22** IRM 20.1.9.2, Assessment Procedures for Penalties Not Subject to Deficiency Procedures; IRM 20.1.9.1.1 (“Appeals currently provides a prepayment, post assessment appeal process for all international penalties.”).

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