



IRS OFFERS “PEACE OF MIND” TO OWNERS OF OFFSHORE ACCOUNTS OR OFFSHORE ENTITIES

The United States Internal Revenue Service (“IRS”) has finally issued guidelines to deal with Voluntary Disclosure Requests by United States (“US”) citizens and US residents (collectively, “US Persons”), including Puerto Rico residents, that have unreported offshore accounts and entities (the “**IRS Offshore Accounts Guidelines**”). Such a request is the first step for entering into a settlement agreement with the IRS concerning US income tax obligations arising from such offshore accounts or foreign entities.

US Persons may hold offshore accounts directly, or indirectly through controlled foreign entities such as corporations and trusts organized in offshore jurisdictions. These offshore jurisdictions include such well known tax-haven jurisdictions as Panama, Cayman Islands, Luxembourg and Liechtenstein, as well as financial centers such as Great Britain, Switzerland, Netherlands, Spain and Canada, among others.

In past years, the IRS and tax collectors from major European Union (“EU”) countries have been increasingly active in identifying and pursuing taxpayers with unreported income derived from offshore accounts or controlled offshore entities. This mounting legal pressure has also weakened the traditional

offshore bank secrecy that has allowed taxpayers to avoid paying taxes on their offshore holdings, as offshore jurisdictions have been increasingly willing to share such information with the US and major EU countries.

According to the New York Times, the US Justice Department has recently: (i) obtained from a foreign bank information on 285 US Persons; (ii) filed legal action to compel a foreign bank to disclose information to the IRS on 52,000 US taxpayers that prosecutors suspect have undeclared offshore accounts; and (iii) about 100 criminal investigations into wealthy US Persons have already been opened. Just last week, countries that are members of the Group of 20 (“G-20”) made a commitment to develop means to control the use of illegal tax havens, in part by increasing disclosure requirements for taxpayers.

Residents of Puerto Rico (“PR”), including those that are not US citizens (i.e., US resident aliens that are residents of PR), are subject to US income taxation on their US and foreign/offshore source income. Pursuant to Section 933 of US Internal Revenue Code (“US-IRC”), bona fide PR residents generally can only exclude from US income taxation the in-

US Persons, including PR residents, who have a financial interest in or signature or other authority over any “foreign financial accounts”, if the aggregate value of such foreign financial accounts exceeds \$10,000 at any time during the calendar year, must fully disclose details of such relationships each calendar year by filing the report of Foreign Bank and Financial Accounts (commonly known as “FBAR”- US Treasury form TD F 90-22.1) with the US Department of the Treasury on or before June 30, of the succeeding year. Foreign financial accounts include bank, securities, or other types of financial accounts, in a foreign country. A US Person can have a financial interest in or signature or other authority over accounts that are not in the US Person’s name, such as those owned by trusts, corporations or other entities controlled by or set-up for the benefit of such US Persons.

Civil and criminal penalties, including in certain circumstances a fine of not more than \$500,000 and imprisonment of not more than five years, are provided for failure to file the FBAR report, supply information, and for filing a false or fraudulent report.

In addition, a US Person that fails to disclose to the IRS income from offshore accounts and the holdings of such accounts, risks payment of back-taxes, no statute of limitation when fraud is involved, interest charges, and an array of highly punitive penalties that combined could exceed the principal amounts held in the offshore accounts. These taxpayers also face the threat of federal criminal prosecution for US tax evasion, or for failure to annually file the FBAR report. PR residents are also exposed to the risk of PR income taxation, interest and penalties, and PR criminal prosecution, as the PR Treasury has requested the US Treas-

ury Department to share with it any information that it obtains regarding offshore accounts or foreign entities.

Pursuant to the IRS Offshore Accounts Guidelines, taxpayers will only have a six (6) month period (i.e., until September 22, 2009) to file a Voluntary Disclosure Request with the IRS.

A Voluntary Disclosure Request, and entering into an agreement with the IRS under the IRS Offshore Accounts Guidelines, avoids criminal prosecution, but entails the following taxation and penalties regime:

- (1) filing US income tax returns, or amended returns, for the last six (6) years;
- (2) filing all required information reports, such as Forms 3520-A and 3520 for foreign trusts for those years;
- (3) payment of any US taxes and interest thereon due for those six (6) years, plus the accuracy related penalty of 20% when US income tax returns were filed for those years, or the 25% penalty for late filing of a return if a US income tax return was not filed for any of such years;
- (4) filing the FBAR report (TD F 90-22.1) for the six (6) years;
- (5) in lieu of all other penalties that may apply (i.e., the 5% to 35% penalties for failure to report or timely report the principal amount transferred to foreign trusts, and FBAR’s prescribed maximum willful violation penalty of 50% of the highest annual balance of each account for the last three (3) years, etc.)

the IRS will agree to a “reduced” penalty of either: 20% of such highest aggregate account/asset value; or 5% of such value, if the taxpayer (i) did not open or cause any of the offshore accounts to be opened, (ii) there has been no activity in the account or entity (no deposits, withdrawals, etc.) during the period the taxpayer controlled the account / entity, and (iii) all applicable US taxes have been paid on the funds in the accounts/entities (where only account/entity earnings have escaped US taxation) ; and

(6) the taxpayer will have to fully cooperate with the IRS, both civilly and criminally.

It should be noted that the penalties described in paragraph (3) above are based on the amount of US income taxes due. Meanwhile, those described in paragraph (5) are assessed on the highest value of the unreported offshore assets. It should also be noted that offshore capital gains income of PR residents is considered PR source income, and as such will not be subject to US income taxation.

To the extent that PR taxation has also been avoided through the unreported offshore account/entities, PR residents should also request and obtain a closing agreement with the Puerto Rico Treasury Department.

The US Congress is currently considering legisla

tion to provide even harsher penalties for taxpayers with unreported offshore accounts or entities. As can be appreciated, under the current US-IRC provisions the arsenal of tax penalties that can be assessed by the IRS against taxpayers with unreported offshore accounts or entities can approximate and even exceed the principal amounts held in such accounts.

Clearly, the IRS Offshore Accounts Guidelines are not lenient, and they have not been described as a tax amnesty; however, based on the expected continuing trend of IRS enforcement against taxpayers with unreported offshore accounts or entities, those that fail to timely file a Voluntary Disclosure Request risk not only taxes, interest and very severe tax penalties, but also US and/or PR criminal prosecution.

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