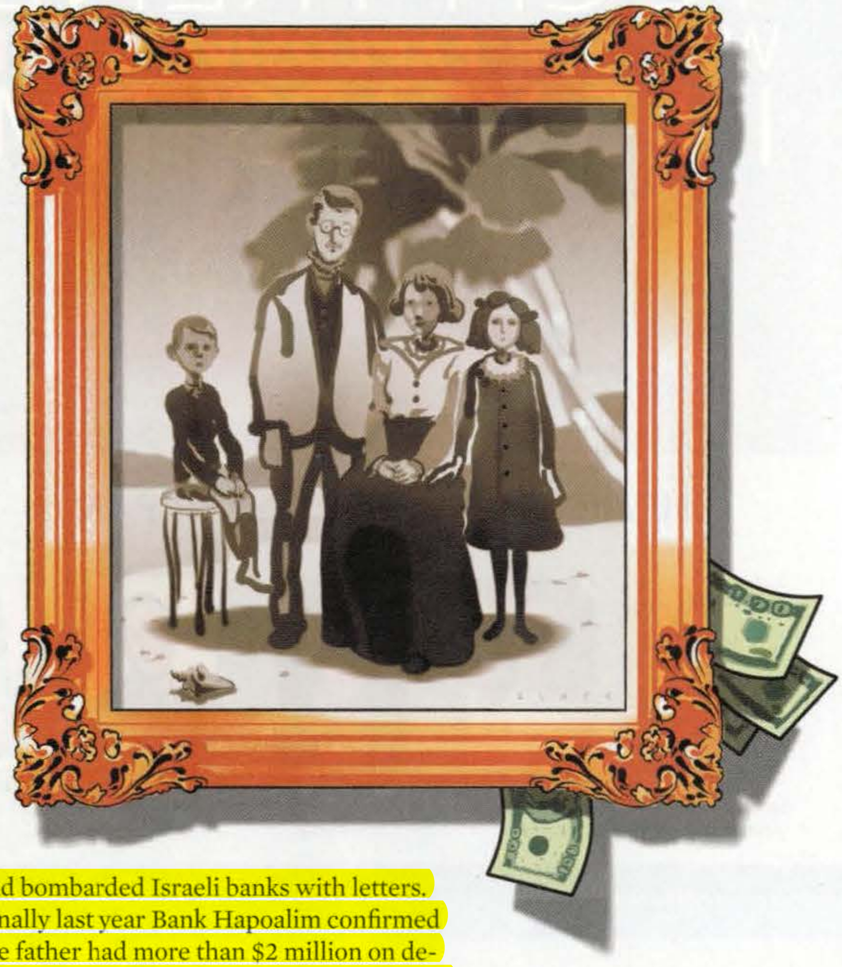

Family Secrets

As the government closes in, the owners of offshore accounts, and their heirs, face legal perils and tricky choices.

BY DEBORAH L. JACOBS AND JANET NOVACK

The jig is up for secret offshore accounts. In May Credit Suisse pleaded guilty to conspiring to aid U.S. tax evaders. More than 100 other Swiss banks are handing over leads that should eventually out more U.S. tax dodgers. Israeli, Asian and Caribbean banks are all under investigation. Plus, the Foreign Account Tax Compliance Act (FATCA), which took effect July 1, requires foreign financial institutions to report accounts held by U.S. persons to the Internal Revenue Service.

But the best way to get right with Uncle Sam isn't always clear—especially if, like lots of account holders, you're not a flagrant tax cheat. Consider this immigrant family's tale: Before fleeing to the U.S. during the fall of the Shah, an Iranian Jew moved part of his fortune to an Israeli bank. He died in California in 2009 without ever reporting his stash to the U.S. Treasury—not on his income tax return and not on the Foreign Bank Accounts Report (FBAR) that U.S. citizens or residents must file each year if they own or control foreign accounts worth $10,000 or more. (It's possible he never knew he had to file FBARs.)

The man also never shared info about the account with heirs, but his son had a hunch and bombarded Israeli banks with letters. Finally last year Bank Hapoalim confirmed the father had more than $2 million on deposit, says Los Angeles tax attorney Pedram Ben-Cohen, the son's lawyer. What next? Ben-Cohen advised the son to skip the IRS' burdensome and much ballyhooed Offshore Voluntary Disclosure Program (OVDP), which requires participants to pay eight years of back income taxes, interest and penalties, plus a separate FBAR penalty usually equal to 27.5% of the highest balance of their offshore accounts during the past eight years. Since the Israeli account hadn't earned anything for the past five years, no income taxes were due. And the son, who had done nothing wrong, didn't need the protection from criminal prosecution OVDP participants get. Instead, Ben-Cohen filed five years of back FBARs. "We disclosed all the details, and we're just sitting tight," he says, noting that less than a quarter of 1% of all FBARs were audited in 2012.

More than 45,000 taxpayers have entered the OVDP since 2009, coughing up $6.5 billion in back taxes, interest and penalties. But that's a small fraction of the people who have started answering "Yes" to the question on Schedule B of the 1040: "Did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account or brokerage account) located in a foreign county?"

Only 281,349 taxpayers answered "Yes" on their 2007 tax returns—even though billionaire real estate developer Igor Olenicoff had just pleaded guilty to a felony for answering "No" when he had more than $200 million offshore. Then, in 2009 Switzerland's largest bank, UBS AG, handed over U.S. customers' names and the game began to change. On their 2011 tax returns (the latest year available) 587,438 taxpayers answered "Yes" to the offshore question. But that's only "the tip of the iceberg," says veteran Houston tax lawyer John A. "Jack" Townsend.

Options? Some taxpayers decide to comply only going forward, gambling that an understaffed IRS won't audit their old 1040s within the usual three-year statute of limitations. Others have done "quiet disclosure"—sending the IRS amended back tax returns and a check.

Still others are just learning they've got a problem. A new client came to Ben-Cohen recently after a Swiss bank sent him a letter warning it would be giving the Department of Justice information about an account his late father set up for his benefit and then closed in 2009. He told Ben-Cohen he hadn't known the account existed and doesn't know where the money is.

Heirs who don't know all the facts and account holders whose behavior falls in gray areas have some tricky decisions to make, especially since the IRS in June made a "streamlined filing compliance" option widely available. Under it a taxpayer (or his estate) has to pay only three years of back taxes, plus an FBAR penalty equal to 5% of the account's highest end-of-the-year value during the last six years. (Expats can escape the 5% penalty altogether.)

The catch? To qualify you must certify that previous lapses resulted from "non-willful" conduct, which the IRS vaguely defines as "negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law."

"All of our clients are going to think their actions are not willful. But the government might not agree," laments Fort Lauderdale tax lawyer Jeffrey A. Neiman, a former offshore prosecutor. If your CPA asked whether you had an offshore account, and you lied, the IRS might consider that willful, Ben-Cohen warns.

Moreover, the streamlined program provides no protection from criminal charges. Indeed, tax lawyers predict the government will prosecute a few account holders it believes have wrongly certified their failures weren't willful.

So if there's an unreported offshore account in your family, hire a lawyer with offshore chops. This isn't a do-it-yourself project, what with the potential for criminal charges and/or confiscatory civil penalties—up to 50% of an account's balance for each year of willful non-FBAR filing.

If you're a cheat (say, you hid untaxed money skimmed from a U.S. business offshore), the lawyer will urge you to enter the OVDP. Warning: If you're already under audit or the government knows about your account, you aren't eligible for the OVDP—that's why Beanie Babies billionaire H. Ty Warner was rejected by the OVDP and had to plead guilty to tax evasion last year.

What if a deceased spouse or parent might have willfully broken the law and you now inherit the account? "The government has been really aggressive, but the one thing it hasn't done is indict a dead person," deadpans Neiman.

Still, families seeking finality may want to go through the OVDP, says Chicago tax lawyer Robert E. McKenzie. Otherwise, years later the IRS could demand more back taxes and penalties with heirs on the hook for up to the amount they inherited. For the very rich the OVDP may be cheap insurance against being targeted by headline-hunting prosecutors. One client, McKenzie notes, opted to pay the OVDP penalty on his late dad's secret $5 million account because it was "a drop in the bucket" for an estate worth hundreds of millions. *

GREEN, YELLOW, RED

Bill Miller famously beat the S&P 500 index 15 years in a row before the credit crunch. His $2 billion Legg Mason Opportunity Trust midcap fund was up 68% last year, more than double the broader market. What does he like in the second half?

"AAA"
That's Amazon, Apple and... airlines. Consolidation and restructuring now mean lots of upside in the skies; Delta, American and United Continental make up nearly 10% of Miller's portfolio.

BITCOIN
Warren Buffett called it a "mirage," but Miller isn't junking the crypto-currency. He's picked some up for his own account—while acknowledging that what he dubs a "venture investment" could end up a total bust.

UTILITIES
They were the best-performing sector in the S&P 500 in the first half, but Miller is far from electrified—they're vastly overpriced, he says.

FINAL THOUGHT

"Income tax returns are the most imaginative fiction being written today."

—HERMAN WOUK