Voluntary Disclosures and Proof of Source of Funds

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One of the key questions in the IRS Offshore Voluntary Disclosure letter is "source of funds". For many taxpayers with funds offshore who did not file Foreign Bank Account Reports (FBAR's) this question presents multiple problems. The problems are discussed below.

First, taxpayers who used an Informal Value Transfer System (sometimes referred to as a Hawala network) cannot easily provide proof of the source of funds other than where the funds currently are deposited. Often these funds have their origination in the taxpayer's or the taxpayer's family's country of origin and were sent to an foreign financial institution through the informal network in order to avoid currency control or disguise the transfer of funds for other reasons. Reasons for not filing FBAR's for these accounts often vary, but range from simple claims of ignorance of the law to other more complex reasons. But, the failure to file FBAR's is where the U.S. compliance problem begins for not filing FBAR's may result in both serious civil and criminal penalties. Civil and criminal tax penalties may also apply if ownership of the foreign accounts was not disclosed on the taxpayer's income tax returns and if earnings on the accounts were not reported.

The second issue to be faced is that foreign financial institutions are now preparing to comply with the Foreign Account Tax Compliance Act (FATCA) which will require reporting to the IRS of account information by U.S. account holders. The term U.S. account holders is very inclusive and includes direct and indirect account owners account balances and activity. Many foreign financial institutions have now started asking U.S. account holders to close their accounts. This is where the source of funds becomes an issue again.

The the problem is when a person who used an Informal Value Transfer System to originate the establishment of a foreign account attempts to open a U.S. account or transfer funds to an existing account. The due diligence process of U.S. banks and financial firms as required under the Bank Secrecy Act of the USA Patriot Act require proof of the source of funds. Many U.S. financial are

refusing to open accounts where proof of source cannot be adequately established. Similarly, fund transfers from a foreign financial account to a into an existing domestic account may trigger a Suspicious Activity Report (SAR). This process could be much simpler if FBAR's had been filed and income from the foreign financial account reported for income tax purposes.

So the issue that taxpayers who have problems with proving source of funds is whether to leave funds offshore in what may be a never ending search for a foreign financial institution that will accept U.S. account holders, or come into compliance by (for example) filing a voluntary disclosure. Any filing now will be after the deadline of the Offshore Voluntary Disclosure Initiative (OVDI) which ended October 9, 2011. The risks of not moving forward with a voluntary disclosure will become greater as foreign financial institutions subject accounts to greater scrutiny and as disclosure of foreign held assets for U.S. income tax purposes is required for tax returns due for 2011 (HIRE Act Sec. 6048 and 6038D). As time moves on the taxpayer's options are getting fewer and fewer.

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