ALERTS AND UPDATES

IRS Announces New Voluntary Disclosure Program

February 9, 2011

On February 8, 2011, the U.S. Internal Revenue Service announced a special voluntary disclosure initiative designed to bring offshore funds back into the United States tax system. The deadline for participation in the program is August 31, 2011. Internal Revenue Commissioner Douglas Shulman calls this new initiative "the last, best chance for people to get back into the system."

The new program comes on the heels of the first initiative (the 2009 Offshore Voluntary Disclosure Program or "2009 OVDP"), announced in March 2009, which resulted in more than 15,000 voluntary disclosures before ending in October 2009. Since that date, more than 3,000 additional taxpayers have come forward making disclosures to the Internal Revenue Service with respect to their offshore foreign arrangements.

The Internal Revenue Service's new program, formally titled the "2011 Offshore Voluntary Disclosure Initiative" (2011 OVDI), includes a penalty structure that is higher than the earlier program, covers more years (2003–2010) and has a deadline (August 31, 2011) that some taxpayers may simply not be able to meet for reasons beyond their control.

The Internal Revenue Service has posted online [frequently asked questions and answers] about the 2011 OVDI.

The 2011 OVDI has the following general components:

- A penalty equal to 25 percent of the amount held in foreign accounts/entities or value of foreign assets in the year with the highest aggregate asset value covering the periods 2003 through 2010.
  - A reduced penalty of 12.5 percent for those situations where the taxpayer's foreign assets did not exceed $75,000 in any calendar year covered by the program.
  - A 5-percent penalty for taxpayers who did not open the foreign account and for foreign residents who were unaware they were U.S. citizens.
- The filing of original and amended tax returns and the payment of taxes, interest and an accuracy-related penalty no later than August 31, 2011.

Why a Second Offshore Initiative, and Why Should a Taxpayer Participate?

According to the Internal Revenue Service, the 2009 OVDP demonstrated the value of a uniform penalty structure for taxpayers who came forward voluntarily and reported their previously undisclosed foreign accounts and assets. The program offered a consistency and predictability to taxpayers in determining the amount of tax and penalties they faced and also enabled the Internal Revenue Service to centralize the civil processing of offshore voluntary disclosures. The 2009 OVDP ended October 15, 2009, with some 15,000 taxpayers participating in the program. The Internal Revenue Service has recently determined that a similar initiative should be available to the large number of taxpayers with offshore accounts and assets who applied after the October 15, 2009, deadline. The 2011 OVDI is available to taxpayers who come forward and complete all requirements on or before August 31, 2011.

The 2011 OVDI is consistent with the Internal Revenue Service's long-standing voluntary disclosure practice. When a taxpayer makes a truthful, timely and complete disclosure of the taxpayer's noncompliance, the Internal Revenue Service will not recommend criminal prosecution to the U.S. Department of Justice. Taxpayers who do not submit a voluntary disclosure run the risk of detection by the Internal Revenue Service and the imposition of substantial penalties including the civil fraud penalty and various foreign information return penalties. All of these penalties are in addition to the risk of criminal prosecution.

There is now a significant risk of the Internal Revenue Service discovering taxpayers' compliance shortcomings relative to their offshore financial arrangements. The Internal Revenue Service has increased its investigation of the foreign financial activities of U.S. taxpayers. Information regarding U.S. taxpayers' foreign activities becoming more readily available to the Internal Revenue Service through tax treaties, whistleblowers and the recently-enacted Foreign Account Tax Compliance Act (FATCA) and the reporting requirements for foreign financial assets under the new Internal Revenue Code section 6038D. In addition, the Internal Revenue Service has confirmed it has expanded its investigation of foreign banks far beyond UBS, to other banks (large and small) in Europe, the Middle East and Asia.

Who Is Eligible for the 2011 OVDI?

The new initiative applies to both individuals and entities who make a "timely," complete and accurate disclosure.

All voluntary disclosures, whether under traditional voluntary disclosure principles or the 2011 OVDI, must be "timely"—*i.e.*, the disclosure must be made before the Internal Revenue Service becomes aware of the taxpayer's noncompliance. Taxpayers who are currently under civil examination, regardless of whether it relates to undisclosed foreign accounts or foreign entities, are not eligible for the 2011 OVDI. Similarly, taxpayers under criminal investigation by the Internal Revenue Service's Criminal Investigation division are also ineligible. The mere fact that the Internal Revenue Service has issued a John Doe summons seeking information that may identify a taxpayer as holding an undisclosed foreign account does not disqualify the taxpayer from this initiative. However, once the Internal Revenue Service obtains information under the John Doe summons that provides evidence of a specific taxpayer's noncompliance, that particular taxpayer may become ineligible for participation in the program.

Pre-clearance and Preliminary Acceptance

Taxpayers who desire to be advised whether their disclosure would be "timely" should make a request for "preclearance" before submitting their offshore voluntary disclosure. Preclearance is secured by faxing to the Criminal Investigation Lead Development Center in Philadelphia, Pennsylvania, identifying information (name, date of birth, social security number and address), executed power of attorney (if represented) and a request for preclearance before making a disclosure. Criminal Investigation personnel will then notify the taxpayers or their representatives via fax whether or not they are cleared to make a voluntary disclosure. Taxpayers who are cleared should, within 30 days of receipt of the fax notification, make their voluntary disclosure by submitting their offshore voluntary disclosure letter to the Internal Revenue Service, Offshore Voluntary Disclosure Coordinator, in Philadelphia, Pennsylvania. Criminal Investigation personnel will review the offshore voluntary disclosure letter and notify taxpayers or their representatives by mail whether their offshore voluntary disclosures have been preliminarily accepted or declined.

What Documents Must the Taxpayer Submit to Qualify for the 2011 OVDI?

Taxpayers who are preliminarily accepted will be required to submit to the Internal Revenue Service a significant amount of information and documentation, including:

- Original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure.
- Complete and accurate amended federal income tax returns for all years covered by the disclosure with all applicable schedules.

- A complete Foreign Account or Asset Statement for each previously undisclosed foreign account or asset during the voluntary disclosure period.

- For applicants disclosing offshore financial accounts with an aggregate highest account balance in any year of $1 million or more, a completed Foreign Financial Institution Statement for each foreign financial institution with which the taxpayer had undisclosed accounts or transactions during the voluntary disclosure period.

- A properly completed and signed Taxpayer Account Summary with penalty calculation.

- A check payable to the U.S. Department of the Treasury in the total amount of tax, interest, accuracy-related penalty and, if applicable, the failure-to-file and failure-to-pay penalties for the voluntary disclosure period. For those taxpayers who cannot pay the total amount of the tax, interest and penalties, a complete Collection Information Statement Form 433-A (for individuals) or Form 433-B (for entities).

- For applicants disclosing offshore financial accounts with an aggregate highest account balance in any year of $500,000 or more, copies of offshore financial account statements reflecting all account activity for each of the tax years covered by the disclosure. For applicants disclosing offshore financial accounts with an aggregate highest account balance of less than $500,000, copies of offshore financial account statements reflecting all account activity for each of the tax years covered by the voluntary disclosure must be readily available upon request.

- Properly completed and signed agreements to extend the period of time to assess tax and to assess FBAR penalties.

How Will the Internal Revenue Service Process the Material Provided by the Taxpayer?

The materials submitted will be reviewed by an examiner who may ask for additional specific information. The examiner will certify that the voluntary disclosure is correct, accurate and complete by reviewing the taxpayer's records, along with the amended or delinquent returns. The examiner also verifies the amount of tax interest and civil penalties.

An actual examination of returns submitted under this program will not be conducted, although the Internal Revenue Service reserves the right to do so. The process under this initiative is to assign the voluntary disclosure to an examiner to certify the accuracy and completeness of the disclosure. This process is less formal than an examination and does not carry with it all the rights and legal consequences of an examination. Most importantly, the taxpayer will not have appeal rights with respect to the Internal Revenue Service's determination. Although the program does not define the certification process as an "examination," the examiner will have the right to ask any relevant question, request any relevant documents and even make third-party contact if necessary to certify the accuracy of the amended returns without converting the certification into an examination.

What Taxpayers Are Subject to Penalties and What Penalties Will Be Applied?

The Stated Standard for the Amount of Penalties to Be Imposed

The voluntary disclosure examiners will not have any discretion to settle cases for amounts less than what is "properly due and owing." However, because the 25-percent offshore penalty is a proxy for the FBAR penalty, other penalties imposed under the Internal Revenue Code and potential liabilities for years prior to 2003, there may be cases where a taxpayer making a voluntary disclosure would owe less, if the special offshore initiative did not exist. *Under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes. The examiners will compare the amount due under the offshore initiative to the tax interest and applicable penalties (at their maximum levels and without regard to issues relating to reasonable cause, willfullness, mitigation factors or other circumstances that may reduce liability) for all open years that a taxpayer would owe in the absence of the 2011 OVDI penalty regime. The taxpayer will pay the lesser amount.*

Penalty-Free Circumstances

Taxpayers who have reported all their income but have merely failed to file FBARs should not use the voluntary disclosure process to remedy their compliance issues. Those taxpayers who reported and paid tax on all of their taxable income but did not file FBARs should file the delinquent FBARs with the Department of the Treasury and attach a statement explaining why the reports are filed late. No penalty will be incurred for failure to file the delinquent FBARs if there are no unreported tax liabilities and the FBARs are filed by August 31, 2011.

FBARs for 2010 are due on June 30, 2011, and must be filed by that date.

Similarly, taxpayers who have not filed Form 5471 for controlled foreign corporations or Form 3520 for foreign trusts may file those returns penalty-free in the instances where they have reported all the taxable income with respect to all transactions related to the controlled foreign corporation or the foreign trust.

Sham Entities

In many instances, offshore assets have been held in the name of a foreign entity that the taxpayer controlled, and the sole purpose of the entity was to conceal ownership of the assets. Taxpayers who decide to participate in the 2011 OVDI may intend to dissolve the entity, but the question arises as to whether those taxpayers are required to file delinquent information returns for the entity. Generally speaking, a taxpayer who holds assets through a foreign entity he or she controls, such as a corporation or a trust, is required to file information returns for the entity (Form 5471 for a foreign corporation and Forms 3520 and 3520-A for a foreign trust). However, in cases where the taxpayer certifies under penalties of perjury that the entity had no purpose other than to conceal the taxpayer's ownership of assets and where the taxpayer dissolves the entity, the Internal Revenue Service may agree to waive the requirement that delinquent information returns be filed, if it concludes that it is in the Internal Revenue Service's interest to do so. Taxpayers desiring to exercise this option should submit a Statement on Dissolved Entities with their submission.

Business Accounts and Foreign Entities

Where a taxpayer's failure to report foreign financial transactions includes foreign personal and foreign business accounts, a 25-percent offshore penalty applies to both, assuming there is unreported income with respect to those accounts. No distinction is drawn on whether it is a business account or a savings or investment account. If the business to which the foreign account relates is a foreign business, the value of the entire business would be included in the penalty base to the extent of the taxpayer's interest. There is no definition of "value of the entire business."

No De Minimis Unreported Income Exception

The Internal Revenue Service takes a hard line and states that there is no amount of unreported income that is considered de minimis for purposes of determining whether there has been tax noncompliance with respect to an account or asset, and whether the account or asset should be included in the base for the 25-percent penalty.

Pre-2003 Transactions Excluded

Gain realized on a foreign transaction occurring before 2003 does not need to be included as part of the voluntary disclosure. If the proceeds of the transaction were repatriated and were not offshore after December 31, 2002, they are not included in the base of the 25-percent offshore penalty. However, if the proceeds remained offshore after December 31, 2002, they are included in the base of the penalty.

Penalty Applies to All Foreign Assets Related to Tax Noncompliance

The 20-percent penalty is intended to apply to all the taxpayer's offshore holdings that are related in any way to tax noncompliance regardless of the form of the taxpayer's ownership or the character of the assets. The penalty applies to all assets directly owned by the taxpayer, including financial accounts held in cash, securities or other custodial accounts; tangible assets such as real estate or art; and intangible assets such as patents or stock or other interest in a U.S. or foreign business. If such assets are indirectly held or controlled by the taxpayer through an entity, the penalty may be applied to the taxpayer's interest in the entity or, if the Internal Revenue Service determines that the entity is an alter ego or nominee of the taxpayer, to the taxpayer's interest in the underlying assets.

Tax noncompliance includes failure to report income from the assets as well as failure to pay U.S. tax that was due with respect to the funds used to acquire the asset. Some taxpayers own valuable land and artwork located in foreign jurisdictions that produce no income and therefore there were no U.S. tax reporting requirements with regard to the property. Whether the taxpayer must report the land and the artwork and pay the 25-percent penalty depends upon whether the non-income-producing assets were acquired with funds improperly not taxed. The offshore penalty is intended to apply to offshore assets that are related to tax noncompliance. *Thus, if offshore assets were acquired with funds that were subject to U.S. tax but on which no such tax was paid, the offshore penalty would apply regardless of whether the assets are producing current income.* Assuming that the assets were acquired with after-tax funds or from funds that were not subject to U.S. tax, if the assets have not yet produced any income, there has been no U.S.-taxable event and no reporting obligation to disclose. The taxpayer will be required to report any current income from the property or gain from its sale or other disposition at such time in the future as the income is realized. Because there has not been tax noncompliance, the 25-percent offshore penalty would not apply to these assets.

If the assets produced income subject to U.S. tax during 2003 through 2010 that was not reported, the assets will be included in the penalty computation regardless of the source of the funds used to acquire the assets. If the foreign assets were held in the name of an entity such as a trust or corporation, there could also have been an information-return filing obligation that may need to be disclosed.

Signatory-Authority-Only Accounts Not Included, with Some Exceptions

Accounts over which a taxpayer has mere signatory authority will be treated as unrelated to the tax noncompliance the taxpayer is voluntarily disclosing. The taxpayer may cure the FBAR delinquency for the account the taxpayer does not own by filing with the FBAR an explanatory statement by August 31, 2011. However, if: (1) the account over which the taxpayer has signatory authority is held in the name of a related person such as a family member or corporation controlled by the taxpayer; (2) the account is held in the name of a foreign corporation or trust by which the taxpayer had a reporting obligation; or (3) the account was related in some other way to the taxpayer's noncompliance, then in those cases, if the taxpayer is determined to have a direct or indirect beneficial interest in the accounts, the taxpayer will be liable for the 25-percent offshore penalty if there is unreported income on the account. On the other hand, if there is no unreported income with respect to the account, no penalty will be imposed.

In cases of multiple taxpayers as co-owners on an offshore account, a taxpayer making a voluntary disclosure will be liable for the penalty on his or her percentage of the highest aggregate balance in the account. The taxpayer's voluntary disclosure is effected only as to his or her tax liability and does not cover the other co-owners. The Internal Revenue Service may examine any co-owner who does not make a voluntary disclosure and those co-owners will be subject to all applicable penalties. In some instances, multiple individuals have signatory authority over a trust account. In those cases, only one 25-percent penalty will be applied with respect to the account. The penalty may be allocated among the taxpayers with beneficial interests making the voluntary disclosure in any way those individuals choose. The reporting requirements for filing an FBAR are the same, and every individual required to file an FBAR must do so.

The 5-Percent and 12.5-Percent Penalties

In some instances, the taxpayer will be liable for a reduced 5-percent offshore penalty. Taxpayers qualifying for this reduced penalty fall into two categories:

1. Taxpayers who: (a) did not open or cause the account to be opened (unless the bank required that a new account be opened, rather than allowing a change in ownership of an existing account, upon death of the owner of the account); (b) have exercised minimal, infrequent contact with the account, for example, to request the account balance, or update accountholder information such as a change of address, contact person or email address; (c) have, except for a withdrawal closing the account and transferring the funds to an account in the United States, not withdrawn more than $1,000 from the account in any year covered by the voluntary disclosure; and (d) can establish that all applicable U.S. taxes have been paid on funds deposited to the account (only account earnings have escaped U.S. taxation). For funds deposited before January 1, 1991, if no information is available to establish whether such funds were appropriately taxed, it would be presumed that they were appropriately taxed.

2. Taxpayers who were foreign residents and who were unaware they were U.S. citizens.

Taxpayers who participated in the 2009 OVDP and whose cases have been resolved and closed with a Form 906 closing agreement and who believe that the facts of their case would qualify them for the 5-percent penalty under the above criteria but have already paid a higher amount under the 2009 OVDP should provide a statement to this effect, including all pertinent contact information, the name of the revenue agent assigned to their case and a copy of the closing agreement to the Internal Revenue Service. Upon receipt of the information, the case will be assigned to an examiner who will review and make a determination.

In some instances, the taxpayers will qualify for a reduced 12.5-percent offshore penalty under the 2011 OVDI. Qualifying taxpayers are those whose highest aggregate account balance (including fair market value of assets in undisclosed offshore entities and the fair market value of any foreign assets that were either acquired with improperly untaxed funds or produced improperly untaxed income) in each of the years covered by the 2011 OVDI is less than $75,000. Similarly, those taxpayers who participated in the 2009 OVDP whose cases have been resolved and who believe they qualify for this reduced penalty should send the appropriate information to the Internal Revenue Service, who will assign an examiner and make a determination.

What Happens If the Taxpayer Disagrees with the Internal Revenue Service Determinations?

Taxpayers who do not agree to the tax, penalty and interest proposed by the voluntary disclosure examiner will have their cases referred to the field for a complete examination of all issues. In that examination, normal statute-of-limitation rules will apply. If no exception to the normal three-year statute of limitations on assessment of additional tax applies, the Internal Revenue Service will only be able to assess tax penalty interest for those three years. However, if the period of limitations is open beyond the three years, then as much as six years of liability may be assessed. Similarly, if there is a failure to file certain information returns such as a Form 3520 or 5471, the statute of limitations will not have begun to run. If fraud can be demonstrated by the Internal Revenue Service, no statute of limitations will apply. In addition, the statute of limitations for asserting FBAR penalties is six years from the date of the violation, which would in most cases be the date the unfiled FBAR was due to have been filed.

If the taxpayer disagrees with the result of the 2011 OVDI, the taxpayer may request that the case be referred for an examination of all relevant years and issues. This is accomplished by the taxpayer indicating in writing his or her decision to withdraw from the 2011 OVDI. Once made, the election is irrevocable. At that point, the examiner or manager will consider the facts of the case and how the audit process will proceed. In referring the case for exam, the examiner or manager will decide whether to refer the case for a normal examination or to a Special Enforcement Program agent. In considering the facts of the case and referring the case for examination, the examiner or manager will consult with technical advisors. All relevant years and issues will be subject to a complete examination. At the conclusion of the examination, all applicable penalties will be imposed. Those penalties could be substantially greater than the 25-percent penalty offered under the 2011 OVDI. In addition, taxpayers who opt out of the 2011 OVDI remain with Criminal Investigation's voluntary disclosure practice. Therefore, they are still required to cooperate fully with the agent by providing all requested information and records, and must still pay or make arrangements to pay the tax penalty and interest they are ultimately determined to owe. If the taxpayer does not cooperate or make payment arrangements, the case may be referred back to Criminal Investigation.

Quiet Disclosures

Taxpayers who did not participate in the 2009 OVDP, but who made so-called "quiet disclosures" by filing amended returns and paying taxes, are eligible for the 2011 OVDI by making application to the initiative along with submitting copies of their previously filed returns. Taxpayers who continue to make "quiet disclosures" and do not participate in the 2011 OVDI face the risk of civil examination and criminal prosecution for all applicable years. Where a taxpayer who has made a "quiet disclosure" is selected for examination, the taxpayer will not be eligible for the penalty structure set forth in the 2011 OVDI.

Conclusion

According to the commissioner of the Internal Revenue Service, the 2011 OVDI is "the last, best chance for people to get back into the system." U.S. citizens, residents and entities who are not currently in compliance with their U.S. tax reporting obligations with respect to their non-U.S. assets and financial affairs may want to take immediate action to consider whether they are good candidates for the 2011 OVDI. The window of opportunity to take advantage of the 2011 OVDI is very small and requires such persons to take action long before the August 31, 2011, deadline for submissions.

For Further Information

If you would like more information about voluntary disclosure for offshore accounts, please contact Thomas W. Ostrander, the author of this *Alert*, Hope P. Krebs or Stanley A. Barg in Philadelphia, Jon Grouf in New York, Anthony D. Martin in Boston, any member of the International Practice Group, Michael A. Gillen of the Tax Accounting Group or the attorney in the firm with whom you are regularly in contact.