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What are the risks of Opting Out of the IRS Offshore Voluntary Disclosure Programs?

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Under the 2009 and 2011 federal voluntary disclosure programs, the penalties for failing to timely file Foreign Bank Account Reports, (FBAR's) and the penalties for failure to file information returns (such as Controlled Foreign Corporation tax returns) were combined into a single miscellaneous civil penalty. The penalty which varied depending on whether it was under the 2009 program or the 2011 program combined the FBAR penalty which is established under the Bank Secrecy Act (BSA) with penalties assessed under the Internal Revenue Code (Code) and the combined penalty is assessed under the Code. This is combination to be administered under the Code avoids the requirement that the FBAR be brought as a civil case in the United States District Court, rather than under the assessment provision of the Code.

The IRS in its FBAR Frequently Ask Questions (No.51) discusses the basis upon which a taxpyaer might "opt out of the offshore voluntary disclosure program. The IRS uses the term "reasonable cause" in defining whether a taxpayer's conduct is willful or non-willful. Because of the integration of BSA and Code penalties the participants in either the 2009 or 2011 offshore voluntary disclosure programs the tax cases that define reasonable cause may be the basis for determining whether it makes sense for taxpayers to "opt out" of the an offshore voluntary disclosure program when faced with failure to file Information Returns as well as failing to file FBAR's.

A recent case out of the United States District Court for the Eastern District of Texas is instructive on how the IRS will approach "reasonable cause" defenses in failure to file information returns involving controlled foreign corporations. Congdon v. U.S. 108 AFTR 2d 2011-xxxx. Congdon was argued on what constituted reasonable cause for failure to file a substantially complete Form 5471, Controlled Foreign Corporation Return in accordance with Treas. Re. § 1-6038-2(k). Under Code section 6038(b) the taxpayer has the burden of showing that the failure to file appropriate information returns

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was due to reasonable cause and that the taxpayer substantially complied with Code section 6038. According to the court, there is no statute or regulation on what constitutes "reasonable cause" under 6038. In the absence of a statute or regulation, the court referred to the Internal Revenue Manual (I.R.M. 20.1.1 and 20.1.9.1(4) for guidance. The IRM states:

Reasonable cause is based on all the facts and circumstances in each situation and allows the IRS to provide relief from a penalty that would otherwise be assessed . Reasonable cause relief is generally granted when the taxpayer exercises ordinary business case and prudence in determining their tax obligations but nevertheless is unable to comply with those obligations. I.R.M. 20.1.1.3.1 (1)
The issues of reasonable cause therefore comes down to a question of fact . New York Guangdong Finance Inc. v. Commissioner, 588 F.3d 889,896(104 AFTR 2d 2009-7492 (5th Cir 2009). Among the facts which the IRS in the IRM cites as examples of reasonable cause are: the taxpayer is unable to obtain records, or death or serious illness or unavoidable absence I.R.M. 20.1.1.3.1.2.4; I.R.M. 20.1.1.3.1.2.5; I.R.M. 20.1.1.3.2.4, but ignorance of the law, in and of itself, does not constitute reasonable cause. I.R.M. 20.1.1.3.1.2.1, but ignorance of the law may establish reasonable cause when combined with other facts. The most important factor was whether the taxpayer acted in good faith is what effort the taxpayer made to report the proper tax liability. Treas. Reg. §1.6664-4(b)(1); I.R.M. 20.1.5.6.2. This will be a pivotal point of inquiry for practitioners in advising clients on whether their conduct will be deemed reasonable. The question is what are the consequences for offshore voluntary disclosure participants who "opt out" and then cannot establish a reasonable cause defense?

One of the consequences is the likelihood that the taxpayers conduct will be viewed a potentially "willful" in which case the FBAR penalties dramatically increase. As stated in FBAR FAQ No. 10 "the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign account per violation. See 31 U.S.C. § 5321(a)(5). Non-willful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation. A penalty for failing to file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. Certain United States persons who are officers, directors or shareholders in certain foreign corporations (including International Business Corporations) are required to report information under IRC §§ 6035, 6038 and 6046.The penalty for failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return." These are the civil penalties and in an "opt out" there is still the potential for a criminal action for "willful" conduct.

The U.S. Supreme Court deal with the issue of "willfulness" in U.S. v. Pompino, et al., 38 AFTR 2d 76-5905 (97 S.CT.22) 10/12/1976. In Pompino the Court held that the word "willfully" means voluntary violation of a known legal duty. An example of how such an argument would be made is a taxpayer who answers No to the questions on Schedule B of Form 1040 which ask if the taxpayer has signature authority over a foreign financial account when the proper answer was Yes.

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FBAR FAQ's 51.1 – 51.3 discuss in limited detail the benefits and risks of "opting out" but as in all matters taxation, a full and careful understanding of what was done, when and why is essential to making any recommendation to a client to "opt out".

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