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# Who Should Opt Out of the Offshore Voluntary Disclosure Program and Why.

May 31, 2011

In this newsletter I will relate a story which is illustrative of some of the problems that I seen clients facing who are citizens of the United States and another country as well, (dual nationals). Dual nationals differ from each other in that they either are originally from another country and emigrated to the United States to become U.S. citizens or are United States citizens who emigrated to another country and became citizens and live there. In one case domicile is the United States in the other it is the new country. Regardless of whether domicile is in the United States or it is in the new country if the individual has offshore bank accounts which aggregate $10,000 or more in a calendar year a Report of Foreign Bank Account (FBAR) is due by June 30 of the subsequent year. Many dual nationals did not file FBAR's and are now trying to comply with current reporting obligations and past omissions.

In 2009 the IRS offered a Voluntary Disclosure program which concluded with over 14,500 participants. The 2009 program required, among other things, the payment of a civil penalty that was calculated based upon 20% of the "penalty assets". Penalty assets included foreign financial accounts for which FBAR's were due but unfiled, interests in foreign partnerships, trusts and corporations for which information returns were due but not filed and foreign income producing assets (like real property) for which no income was reported. In addition to the civil penalty income tax on the unreported income was assessed along with a 20% accuracy related penalty and interest.

Many dual nationals did not participate in the 2009 program among them people who are domiciled in their new country. In March 2011 the IRS announced a Second Supplemental Offshore Voluntary Disclosure program. The new program expires August 31, 2011. The 2011 program differs from the 2009 program in that the civil penalty is increased to 25% of "penalty assets" for most cases, but the income tax, accuracy related penalty and interest calculations remain the same. Another key difference is that the taxpayer must submit amended returns, and payment of the civil penalty, tax, interest and accuracy related penalty and other required documents by the August 31, 2011 due

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date. The choices that are often presented to taxpayers are (1) participate in program whether your conduct was willful or not, (2) do not participate in the program and risk criminal and civil penalties which can be both be imposed. The question is are these the only options or is there another approach for dual nationals? The answer is it depends on whether all income on foreign financial accounts was reported and taxed in the new country. If the taxpayer's actions nonwillful then filing previously unfiled FBAR's and amending returns to pick up and unreported interest or capital gains may be a reasonable approach. What are the penalty risks if the FBAR violation is nonwillful?

The civil penalty for a nonwillful FBAR violation is a maximum of $10,000 per violation (per year). The statute of limitation on the civil penalty is six (6) years. If the civil penalty were imposed for six year the maximum FBAR penalty would be $60,000 regardless of account size. By contrast, the civil penalty for a willful FBAR violation is the great of $100,000 or 50% of the account balance on the date that the FBAR was due. Therefore, account balance figures greatly into the calculation and for an account with the same balance at the due date for just two years, the penalty would be the greater of $200,000 or 100% of the account balance! If the account had a consistent balance for all six years the balance due would be 300%!!! The key difference is what the taxpayer knew about their FBAR filing requirements and when he knew it. If what is thought to be a nonwillful FBAR violation is ultimately established by the government to be willful in a lawsuit in federal court, the decision to not make a Voluntary Disclosure could prove to be disastrous. The following are examples of when a taxpayer might consider not making a Voluntary Disclosure:

Assume the following:

Scenario A. Taxpayer is a U.S. citizen who became a dual national after moving permanently to country X. He has lived and worked in country X for in excess of 10 years and is citizen ot that country. At all times he reported his country X income in accordance with country X's laws. He has maintained banking relationships in country X and included his interest and capital gain income in his country X tax returns. The income tax rates in country X are comparable to those of the U.S. Since moving to country X taxpayer filed U.S. income tax returns, but did not file FBAR's and did not report earnings on his country X interest and capital gains. At all times his account balances were greater than $10,000. He states that he consulted with a country X professional who did not advise him to file an FBAR and the same professional did not advise him to report his country X interest and capital gains for U.S. income tax purposes.

Scenario B. Taxpayer is a citizen of country Y and emigrated to the U.S.in 2000 and became a permanent resident to avoid religious, ethnic and political persecution. He ultimately became a U.S. citizen. In 1998, and before leaving his country of origin he sold his business and deposited the sale proceeds in a bank in country Z. At the time of the sale, 1998, he was not a U.S. resident. Since moving to the U.S., in 2000 he has reported all his U.S. income, including interest and capital gains, He did not file FBAR's and did not report earnings on his account in country Z. At all time that accoutn balance in country Z was greater than $10,000.

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The choices:

Scenario A and B. These fact patterns are typical of some that I have seen, and in each the taxpayer faces tough choices. Does he enter the Voluntary Disclosure program or prepare and file the unfiled FBAR's and amend U.S. income tax returns where necessary, or do nothing?

What to do:

Scenario A. The judgment that the taxpayer must make is difficult, for if he makes the wrong decision he faces prosecution, or willful FBAR civil penalties or possibly both. What he must balance is the cost of Voluntary Disclosure program against his ability to establish his actions were not willful. What would be helpful, perhaps, would be a declaration under penalty of perjury from the professional advisor, that he or she was the person who advised the taxpayer that either (a) he or she was unaware of the FBAR filing requirement and incorrectly advised the taxpayer, or (b) was aware of the FBAR filing requirement and advised the taxpayer that he had no filing obligation. The absence of such a declaration, while not fatal, would seem to leave open the possibility that the government would argue willfulness. In the event that the government does pursue the willful FBAR penalty, it has the burden of proof, but that will be of little solace to the taxpayer faced with huge penalties and expensive litigation.

Scenario B. The situation is somewhat complex. If the taxpayer can establish that the purpose of opening the account was related to his efforts to flee ethic, religious or political persecution, then the establishment of the account in country Z may fall within an exception to willful characterization for purposes of the FBAR penalty. The activity into and out of the account will be essential to determining if the willfulness penalty would apply and therefore whether the taxpayer should make a Voluntary Disclosure.

The Cost Benefit Analysis:

In each scenario, both of which have been greatly simplified for illustrative purposes, the risk of not entering the Voluntary Disclosure program must be balanced against the cost of the program and the potential costs of alternative outcomes, such as prosecution or imposition of a willfulness penalty. There is no one size fits all approach, and some apparently similarly situated taxpayers may come to different conclusions facing the same choices.

Conclusion:

My objective in presenting these illustrations is to provide a general outline of some of the choices that dual nationals face when confronting FBAR compliance issues. This is not an exclusive list of options and the consequences of any given choice need to be carefully considered. The alternatives

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presented assume that the taxpayer would otherwise meet the criteria for a Voluntary Disclosure. If the taxpayer is under investigation , audit or has illegal source income then he or she would not qualify for a voluntary disclosure.

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