What Everyone Should Know About the
2011 Offshore Voluntary Compliance Initiative

Sidney Kess, CPA, JD, LLM

sidkess@verizon.net

Christopher M. Ferguson, JD

cferguson@kflaw.com

Kostelanetz & Fink, LLP

7 World Trade Center

New York, N.Y. 10007

www.kflaw.com

On February 8, 2011, the IRS announced that it had instituted a second offshore voluntary disclosure compliance program, the 2011 Offshore Voluntary Disclosure Initiative (the "2011 ODVI" or the "Program"), available to all taxpayers with previously undisclosed offshore assets. Similar to the IRS's earlier 2009 Offshore Voluntary Disclosure Program (the "2009 OVDP"), which closed on October 15, 2009, the new Program is intended to afford those taxpayers -- who, for whatever reason, failed to avail themselves of the 2009 OVDP -- an opportunity to become compliant with U.S. tax laws. The 2011 ODVI is a significant opportunity for taxpayers who still hold undisclosed foreign accounts. However, taxpayers who wish to participate must follow very explicit procedures for doing so. In addition, the costs of participating in this new Program can be significant and are not always apparent. Therefore, it is imperative that practitioners who are advising taxpayers with undisclosed foreign assets become familiar with the new Program and its requirements.

Why did the IRS institute the 2011 OVDI?

The IRS wants to capitalize on a number of factors which it believes will incentivize additional taxpayers to become compliant with the law by disclosing their foreign accounts. These factors include:

- The publicity and what the IRS perceives as the success of the 2009 OVDP;
- Additional developments in the law and in international enforcement -- such as the passage of the Foreign Account Tax Compliance Act (FATCA) and the relaxation of restrictions on obtaining foreign bank information in the U.S. government's tax treaty with Switzerland.

- Recent law enforcement successes, such as the Justice Department's announcement of its intent to issue "John Doe" summonses to HSBC in India seeking information on HSBC's U.S. account holders, as well as rumors of a similar initiative targeted at Credit Suisse customers.

At the same time,he new Program reflects the IRS's recognition that, notwithstanding its recent law enforcement successes, voluntary compliance remains the most effective way for the IRS to achieve its mission of closing the tax gap. The new Program therefore reflects a continuation of the IRS's carrot-and-stick approach to fostering compliance. It seeks to capitalize on the notoriety that the 2009 Program achieved, as well as the IRS's newly enhanced enforcement arsenal, to entice those who still remain in hiding to come forward under what is effectively a last chance opportunity for a reduced penalty.

Who should participate?

Any taxpayer with undisclosed foreign accounts or assets who is not already subject to a civil examination or criminal investigation is eligible to participate and should strongly consider doing so in light of the risks involved in failing to come forward. The mere fact that the IRS has served a John Doe summons on an institution that ultimately will lead to the IRS learning the taxpayer's identity as having an undisclosed foreign account does not disqualify the taxpayer from participating. Even those taxpayers who are ineligible to participate in the Program due to pendency of an exam or investigation should consider coming forward. Although the civil penalties imposed on such taxpayers will no doubt be more onerous than those offered under the Program, depending on the circumstances, the taxpayer may be able to substantially reduce the risk of a criminal prosecution by coming forward voluntarily.

Who should not participate?

Generally speaking, the voluntary disclosure program is only for taxpayers who willfully failed to disclose, and/or pay tax on, foreign assets. Taxpayers whose conduct was non-willful, or who did not fail to report income, may not need to avail themselves of the Program, although they should protect themselves by correcting past non-willful violations. For instance, the IRS has stated that taxpayers who failed to file Form TD F 90-22.1 (the "FBAR") reporting a foreign account, but who reported and paid tax on the income from that account, should not make a voluntary disclosure. Instead, such taxpayers are instructed to simply file the delinquent FBARs with the Service by August 31, 2011, in which case no penalties will be imposed.

Why should a taxpayer file?

As noted previously, the international climate has become increasing less hospitable to bank secrecy. For instance, on March 18, 2010, President Obama signed into law the Foreign Account Tax Compliance Act (FATCA). Part of the Hiring Incentives to Restore Employment ("HIRE") Act, FATCA imposes new reporting obligations on any taxpayer who "holds any interest" in a "specified foreign financial asset" where the aggregate value of all such assets exceeds $50,000. The information must be provided as part of the taxpayer's personal income tax return. This obligation is in addition to, not in lieu of, the obligation to report foreign account information on the FBAR on or before June 30 each year. In addition, beginning in 2013, FATCA will require all foreign financial institutions to provide information on all U.S. taxpayers holding accounts with the institution, or face onerous penalties.

Also, the government has seen its enforcement arsenal expand over recent years. For instance, in September 2009 the U.S. and Swiss governments executed a Protocol amending Article 26 of the Tax Convention between the U.S. and Swiss governments. Among other things, the amendments enhance the U.S. government's ability to receive banking information with respect to U.S. accountholders when certain threshold requirements are satisfied. Citizens also have been availing themselves of the Internal Revenue Code's whistle-blower statute at an increasing rate. The law permits the government to pay monetary awards to whistle-blowers who provide information leading to the collection of additional taxes from non-compliant taxpayers, subject to certain requirements.

As these developments illustrate, and as Commissioner Shulman has stated, the momentum in international banking is unmistakably toward greater transparency, and this trend does not appear likely to reverse itself. These waters are increasingly perilous for someone who continues to conceal their assets abroad. Not only does this climate increase the likelihood of getting caught, but it also forces taxpayers who remain non-compliant to invent ever more elaborate artifices to conceal their assets, making it even harder to access those monies.

In addition, besides the risk of criminal prosecution, the civil statutory penalties which may be imposed for failing to report overseas assets can be economically ruinous. For instance, the statutory penalty for willfully failing to file an FBAR is the greater of $100,000 or 50 percent of the highest aggregate balance of all undisclosed accounts for *each violation*. Thus, after two years of non-compliance, the statutory penalties may wipe out a taxpayer's entire account. Although the terms of the 2011 OVDI certainly exact a price, for many taxpayers, that price looks much more attractive when compared to the increased risks, and high price, of apprehension.

What is the deadline for participation?

The 2011 OVDP expires on August 31, 2011. What this deadline entails differs considerably from the 2009 OVDP deadline. The 2009 OVDP deadline of October 15, 2009 was a deadline only for seeking entry into the Program. There was no specific deadline imposed for taxpayers to meet their civil requirements under the Program. By contrast, taxpayers seeking to participate in the 2011 OVDI must complete the civil requirements of the Program by August 31, 2011, including submitting amended tax returns reporting all foreign income and filing all appropriate forms (such as FBARs or other applicable forms), by that date. Completing these requirements can be a time consuming process, especially when overseas account information is not immediately available. Accordingly, practitioners with clients who continue to remain on the fence about participating in the Program should advise their clients that waiting any longer could jeopardize their ability to comply in a timely fashion with the Program's requirements.

What are the terms of the 2011 ODVI and what are its costs?

Taxpayers who wish to participate in the 2011 OVDI must:

(1) File amended tax returns reporting all worldwide income dating back to 2003 and pay all additional tax owed on those amended returns.[1]
(2) Pay an accuracy-related (or delinquency) penalty of 20 percent of the additional tax owed dating back to 2003, pursuant to IRC § 6662(a).
(3) If applicable, pay failure to file or failure to pay penalties under IRC §§ 6651(a)(1)-(2);
(4) Pay statutory interest on the additional tax and penalties.
(5) Pay a one-time "miscellaneous" penalty (in lieu of all other applicable reporting penalties) of 25 percent of the highest aggregate balance of all foreign accounts for the period covered by the voluntary disclosure.[2]

Notwithstanding the imposition of a 25 percent penalty, the IRS continues to maintain that taxpayers will not be made to pay in excess of what they would otherwise be required to pay under applicable law outside the parameters of the Program. However, in determining the applicable penalty outside the Program, examiners are directed to calculate the applicable penalties at their maximum levels and without regard to mitigating factors such as reasonable cause or non-willfulness. Under such circumstances, instances in which the applicable penalties would be lower outside the Program's penalty framework will be exceedingly rare.

What are the procedures for participation? What must be filed?

Taxpayers who wish to make a voluntary disclosure must:

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[1] For taxpayers whose accounts include holdings in passive foreign investment companies (PFICs) the amended returns must include a calculation of PFIC income. The terms of the 2011 OVDI contain an alternative method for calculating PFIC income that participating taxpayers may elect to use. The alternative PFIC procedures can be found with the IRS's "Frequently Asked Questions and Answers" published in connection with the 2011 OVDI and available on the IRS's website at http://www.irs.gov/businesses/international/article/0,,id=235699,00.html.

[2] It should be noted that, included in the calculation of the "miscellaneous penalty" is the value of the taxpayers' interest in *all other foreign assets* (e.g., real estate, corporations) as to which the taxpayer was non-compliant with U.S. tax law. This can be a significant "hidden" cost of the program for some taxpayers.

- Prepare and submit complete and accurate amended tax returns for the voluntary disclosure period (i.e., 2003 – 2010), with schedules detailing the nature and amount of previously unreported income.
- Provide copies of the taxpayers' original tax returns for the disclosure period.
- Provide complete and accurate original or amended FBARs for the voluntary disclosure period.
- Prepare and submit a completed Foreign Account or Asset Statement (a copy of which can be found on the IRS Web site at http://www.irs.gov/pub/irs-utl/2011ovdiforeignaccountstatement.pdf) for each undisclosed account or asset;
- Prepare and submit a Foreign Institution Statement (a copy of which can be found on the IRS Web site at http://www.irs.gov/pub/irs-utl/2011ovdifinancialinstitutionstatement.pdf). This requirement only applies to taxpayers disclosing accounts with aggregate highest balances in excess of $1 million in any given year.
- If applicable, prepare and submit any other required schedule or form related to the taxpayer's ownership of the foreign account or asset for the voluntary disclosure period, such as
    - Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts);
    - Form 3520-A (Information Return of Foreign Trust with a U.S. Owner);
    - Form 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations);
    - Form 5472 (Information Return of a 25 percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business);
    - Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation);
    - Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships).[3]
- Obtain account statements from each foreign financial institution. For taxpayers disclosing accounts with aggregate highest balances exceeding $500,000, those statements must be provided by August 31, 2011.

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[3] Taxpayers who held one or more assets through sham corporations may avoid filing one or more of these forms by filing a "Statement of Dissolved Entities" (a copy of which can be found on the IRS website at http://www.irs.gov/pub/irs-utl/2011ovdidissolutionstatement.pdf) in which the taxpayer takes the position that the entity was nothing more than a sham and that the assets held by the entity should be treated as having been owned individually by the taxpayer.

Taxpayers disclosing accounts with aggregate balances of less than $500,000 must have the statements available on request.

- Execute requested extensions of the statute of limitations for assessment of tax and FBAR penalties for the voluntary disclosure period.

In addition to the foregoing, any participant in the Program must cooperate fully with the IRS with respect to the voluntary disclosure process in general. This entails providing information to the IRS concerning the taxpayer's offshore banking activities (including the identities of facilitators), if requested. It also entails executing a closing agreement with respect to all years covered by the voluntary disclosure period and paying all tax, penalties and interest due or, if the taxpayer qualifies to do so, entering an agreement to pay the liability over time.

How does a taxpayer gain entry into the Program?

The procedures for initiating a voluntary disclosure have become more streamlined under the 2011 OVDI. A taxpayer initiates a voluntary disclosure under the 2011 OVDI by mailing an Offshore Voluntary Disclosure Letter, a sample of which can be found on the IRS's Web site at www.irs.gov/pub/irs-utl/2011-ovdi-irs-ci-letter-01-31-2011.doc, to:

Offshore Voluntary Disclosure Coordinator
600 Arch Street, Room 6404
Philadelphia, PA 19106

The new Program also offers taxpayers the opportunity to be pre-cleared by the Criminal Investigation Division prior to making a voluntary disclosure. A taxpayer does so by faxing his or her name, date of birth, social security number addressed to the Criminal Investigation Lead Development Center (LDC) at (215) 861-3050.

What are the benefits of participation?

The primary benefit of participating is the assurance that the IRS Criminal Investigation Division will not recommend the taxpayer's matter for criminal prosecution which, for all intents and purposes, means the taxpayer will not be prosecuted. On the civil side, one of the benefits of participating is the promise that the IRS will look back no further than 2003. Otherwise, the IRS could look back for as long as the taxpayer held the undisclosed account, since the civil statute of limitations for assessment does not expire with respect to a fraudulent return. The other principal economic benefits of participating consist of the otherwise statutorily applicable penalties that the IRS agrees to forego in exchange for the taxpayer's compliance with the terms of the Program. These include, without limitation:

- Civil fraud penalties under IRS §§ 6663 or 6651(f), comprised of 75 percent of the underpayment of tax.

- A penalty for failing to file Form TD F 90-22.1 (the FBAR form), which is the greater of $100,000 or 50 percent of the highest aggregate balance in the undisclosed accounts for each year of non-compliance.
- Penalties for failing to file various information returns, if applicable. For instance, the penalty for failing to file Forms 5471 or 8865 are $10,000 for each return that was not filed, while the penalty for failing to file Form 3520 is 35 percent of the gross reportable amount on the return or, in the case of gifts, 5 percent of the gift amount per month, not to exceed 25 percent of the total gift amount.

How does this Program differ from the 2009 OVDP?

In addition to modifying some of the voluntary disclosure procedures to make them more streamlined, some of the key differences between this Program and the 2009 Program are as follows:

1. Additional Years Covered

   The 2011 OVDI covers more years than its predecessor. Whereas the 2009 OVDP was expressly a six year program, the 2011 OVDI is an eight year program, covering the years 2003 through 2010.[4]

2. 25 Percent Miscellaneous Penalty

   Whereas the 2009 OVDP imposed a "miscellaneous" penalty of 20 percent of the highest aggregate balance/value of the taxpayer's undisclosed accounts /assets, that penalty has been increased to 25 percent under the new Program.

3. New Reduced Penalty Category

   The 2011 OVDI has implemented a 12.5 percent "miscellaneous" penalty (in lieu of the 25 percent penalty) for taxpayers whose highest aggregate account balance never exceeded $75,000 during the period covered by the voluntary disclosure.

4. Expanded Criteria for Application of 5 Percent Penalty

[4] However, the IRS will not consider the 2010 year for purposes of calculating the miscellaneous penalty if the taxpayer properly reported, and paid all applicable taxes on, his or her foreign assets in 2010.

The IRS also slightly expanded the situations in which a taxpayer may qualify for a 5 percent miscellaneous penalty (in lieu of the 25 percent penalty). Under the 2009 OVDP, taxpayers could qualify for the reduced penalty only if: (1) they did not open or cause the account(s) to be opened; (2) there was no activity (deposits, withdrawals, etc.) in the account while controlled by the taxpayer; and (3) all applicable taxes were paid on the amounts that funded the account.[5] This reduced penalty came to be dubbed the "unicorn penalty" because virtually no taxpayer was able to satisfy it. This was especially true given that the IRS took the position that taxpayers whose only activity consisted of withdrawing monies to close the account nevertheless failed to satisfy the second of these criteria.

The 2011 OVDI amended these criteria to permit taxpayers to qualify for the 5 percent penalty if there was only "minimal, infrequent" contact with the account. The 2011 ODVI also specifies that the act of closing the account and moving the funds to the U. S. will not disqualify a taxpayer from the 5 percent penalty (although moving the funds to another offshore account will disqualify a taxpayer). Nor will making withdrawals of less than $1,000 disqualify a taxpayer from meriting the 5 percent penalty. While these changes will no doubt allow some taxpayers to qualify for the 5 percent penalty who otherwise would not have qualified, this exception remains a very narrow one which has been very strictly applied by the IRS in practice.

Finally, the 2011 OVDI creates an additional category of taxpayers who may qualify for the 5 percent reduced penalty: taxpayers who are foreign residents and who were unaware that they were U.S. citizens. Needless to say, it is unlikely that many taxpayers will satisfy this exception either.

What is the impact of the 2011 OVDI on the 2009 OVDP?

The 2011 OVDI is a separate program from the 2009 OVDP. Taxpayers who came forward after October 15, 2009 can only qualify for treatment under the 2011 OVDP. However, taxpayers who came forward under the 2009 OVDP may avail themselves of certain terms of the 2011 OVDI. For instance, taxpayers who were not able to take advantage of the reduced 5 percent or 12.5 percent miscellaneous penalties under the 2009 OVDP, but who would qualify under the terms of the 2011 OVDI, may apply for the reduced penalty. This is true even if the taxpayer executed a closing agreement as to their voluntary disclosure under the terms of the old Program.

[5] For funds deposited prior to January 1, 1991, it will be presumed that all applicable taxes were paid on the funds absent evidence to the contrary.

What are the practitioner's obligations with respect to the voluntary disclosure program?

Practitioners must exercise due diligence in determining the correctness of any oral or written representations made to the client about the Program and the implications for the participating taxpayer. If the taxpayer decides to participate, the practitioner must exercise due diligence in determining the correctness of representations made to the IRS in processing the disclosure and must avoid giving false or misleading information to the IRS or the taxpayer. If the client decides not to participate, Circular 230 requires that the practitioner advise the client of the consequences of non-compliance and prohibits the practitioner from preparing any current tax return or similar form for the non-compliant taxpayer.[6]

What happens after August 31, 2011?

Although eligibility for the 2011 OVDI will come to an end on August 31, 2011, the IRS's voluntary disclosure program continues. Taxpayers may still avoid criminal prosecution by voluntarily reporting their prior tax non-compliance, regardless of whether it involves the failure to disclose foreign accounts. However, such taxpayers will be subject to the full range of statutorily applicable civil penalties. For cases involving undisclosed foreign accounts, this includes the Draconian penalty for willfully failing to file an FBAR, consisting of the greater of $100,000 or 50 percent of the highest aggregate account balance for each violation. Taxpayers who remain on the fence as to whether to come forward under the 2011 OVDI should be made aware of these potential penalties.[7]

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[6] The initial FAQ's issued in connection with the 2011 OVDI stated that practitioners could not prepare the current or future tax returns of a taxpayer who refused to disclose their foreign account without running afoul of Circular 230. The IRS subsequently amended the FAQs only to prohibit a practitioner from preparing a taxpayer's return for the year in which the taxpayer failed to report the foreign account. One can infer from this modification that the IRS does not believe it is a violation of Circular 230 to prepare future (accurate) returns for taxpayers who previously failed to report their foreign account.

[7] If interested, readers may obtain a free compact disk outlining the rules governing the reporting of foreign bank accounts by emailing Lynne Farber at Kostelanetz & Fink, LLP, lfarber@kflaw.com.