BY CHARLES P. RETTIG AND DENNIS PEREZ

The IRS 2011 Offshore Voluntary Disclosure Initiative

FOR THE PAST SEVERAL YEARS, the Internal Revenue Service has been waging a fierce battle against taxpayers who fail to report earnings on foreign bank accounts. The IRS is now giving taxpayers who fall into that category until August 31, 2011, to come clean without imposition of criminal penalties and with reduced civil penalties. The reduced penalties apply to taxpayers who comply with the Internal Revenue Service's Offshore Voluntary Disclosure Initiative (2011 OVDI), but only if they do so before the IRS becomes (or already is) aware of their prior tax-related indiscretions. This is the second IRS initiative focused on undeclared interests in foreign financial accounts. The 2009 IRS Offshore Voluntary Disclosure Program (2009 OVDP) offered a more taxpayer friendly resolution than the 2011 OVDI for taxpayers who contacted the IRS before October 15, 2009.

U.S. citizens and residents are taxable on their worldwide income and are subject to the full jurisdiction of the laws of the United States.[1] Under the Bank Secrecy Act,[2] U.S. citizens, residents, or persons in and doing business in the United States must file an information report with the government if they have a financial account in a foreign country with a value exceeding $10,000 at any time during the calendar year. Taxpayers comply with this law by acknowledging the account on Schedule B of their income tax return and by filing Form TD F 90-22.1, the Report of Foreign Bank and Financial Accounts (FBAR). Having a legal or beneficial interest in a foreign financial account does not violate U.S. law. However, intentionally failing to report the earnings on the account and to file an FBAR with the IRS may be a violation.

Many U.S. taxpayers and their advisers have long been unaware of or have simply ignored the FBAR information reporting requirements. Willfully failing to file an FBAR can subject the taxpayer to both criminal sanctions, including imprisonment, and civil penalties equivalent to the greater of $100,000 or 50 percent of the highest balance in an unreported foreign account per year for each year since 2004 for which an FBAR was not filed. The requirement is addressed in Schedule B of IRS Form 1040. Line 7a asks the taxpayer to mark "yes" or "no" to the question: "At any time during the [tax year], did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account?" The instructions to Schedule B provide a general description of the FBAR and how to obtain a copy of the form.[3] This question and the corresponding instructions provide the government with what some consider important evidence that a failure to file a FBAR was willful, because taxpayers are deemed to know the information contained in their income tax return.[4]

When IRS Commissioner Douglas H. Shulman announced the 2011 OVDI on February 8, 2011, he stated, "As we continue to amass more information and pursue more people internationally, the risk to individuals hiding assets offshore is increasing. As I've said all along, the goal is to get people back into the United States tax system.... Combating international tax evasion is a top priority for the IRS. We have additional cases and banks under review. This new disclosure initiative is the last, best chance for people to get back into the system....Tax secrecy continues to erode....We are not letting up on international tax issues, and more is in the works. For those hiding cash or assets offshore, the time to come in is now. The risk of being caught will only increase."[5]

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Under the 2011 OVDI, eligible taxpayers must contact IRS Criminal Investigation (CI) by August 31, 2011, and request participation in the program. Taxpayers must file all original and amended income tax returns (generally including tax years 2003 through 2010) and pay taxes (or make good-faith arrangements to pay taxes), interest, and 20 percent accuracy-related penalties on the income tax deficiencies. If applicable, delinquency penalties for the failure to file returns or pay the tax may also be required. Financial transactions occurring before 2003 are mostly irrelevant for those participating in the 2011 OVDI.

The 2011 OVDI penalty framework requires a 25 percent offshore

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penalty equal to the highest value of the financial account and assets between 2003 and 2010. Only a single 25 percent offshore penalty will be applied with respect to voluntary disclosures relating to the same account and assets. Taxpayers with beneficial ownership interests in the account and making the voluntary disclosures may then allocate the offshore penalty in any manner they choose. Potential penalties are limited to those that are specifically stated in the 2011 OVDI.[6]

Preclearance Requests

Taxpayers may seek participation in the program by submitting a preclearance request, including identifying information (name, date of birth, taxpayer identification number, and address) and Power of Attorney (if represented) by fax to the IRS CI Lead Development Center at (215) 861-3050. Taxpayers who are already listed in the CI database—due to an ongoing IRS examination of the taxpayer (or related entity) that already gives the IRS information about the taxpayer's foreign account—will not be cleared to participate in the 2011 OVDI. As such, a taxpayer would be unwise to submit to the CI any information beyond the taxpayer's name, date of birth, taxpayer identification number, and address until the CI has made an initial determination that the taxpayer may be eligible to participate.

Following receipt of a request to participate in the 2011 OVDI, CI will notify taxpayers or their representatives via fax whether or not the taxpayer has been cleared to make a voluntary disclosure using the Offshore Voluntary Disclosures Letter.[7] Presently, such notifications are being sent within approximately 10 days after submission of the request to participate. Taxpayers or representatives with questions regarding their 2011 OVDI preclearance request can call (215) 861-3759 or contact the nearest CI office. Preclearance is merely the initial phase and does not guarantee a taxpayer acceptance into the 2011 OVDI.

Within 30 days following notification of preclearance by CI, a taxpayer must submit a completed Offshore Voluntary Disclosures Letter to the IRS Criminal Investigation.[8] The IRS will review the document and notify the taxpayer or representative by mail whether the voluntary disclosure has been preliminarily accepted or declined. If notified that their voluntary disclosure has been preliminarily accepted, the taxpayer has until August 31, 2011, to submit the remaining information, including payments indicated in the full Voluntary Disclosure Package[9] for all applicable years to the IRS office in Austin, Texas.[10]

In the Offshore Voluntary Disclosures Letter, the taxpayer must identify or provide the following information:

- The reason the offshore account was created or opened.
- The source of deposited funds.
- An estimated annual range of the highest aggregate value for the accounts or assets.
- An estimated potential annual unreported income from the account.
- The foreign financial institutions and foreign advisers relating to the account.
- Other affiliated account holders.
- An explanation of meetings with others regarding the account or assets.

Similar information provided by participants in the expired 2009 OVDP continues to serve the government well in ongoing civil and criminal investigations of foreign financial institutions and advisers. In turn, each new investigation uncovers additional leads to other institutions and advisers who have assisted U.S. taxpayers avoid their reporting obligations. Information provided under the 2009 OVDP and the 2011 OVDI will continue to provide the government with a target-rich environment for many years.

Taxpayers who are foreign residents and who were unaware they were U.S. citizens may qualify for a reduced 5 percent offshore penalty instead of the mandatory 20 percent offshore penalty.[11] The 5 percent offshore penalty will also apply to taxpayers who:

1) 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 the death of the original owner of the account).
2) Have exercised only minimal and infrequent contact with the account, for example, solely to request the account balance, or update account holder information such as a change in address, contact person, or e-mail address.
3) Have, except for a withdrawal to effect the closing of 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.
4) Can establish that all applicable U.S. taxes have been paid on funds deposited to the account, with the result that only account earnings have escaped U.S. taxation. Funds deposited before January 1, 1991, will be presumed to have been appropriately taxed if no information is otherwise available.[12] This presumption might work against taxpayers pursuing the 5 percent reduced offshore penalty for accounts that include post-1990 deposits where information is not available.

If the highest aggregate account balance in each of the years covered by the 2011 OVDI is less than $75,000, the taxpayer will qualify for a 12.5 percent offshore penalty.[13] The highest aggregate account balance includes the 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 yielded improperly untaxed income. IRS examiners will have no authority to negotiate a different offshore penalty.

FBARs for 2010 are due on June 30, 2011, and no extensions are available. Taxpayers who reported and paid taxes on all their taxable income for 2010 but did not file FBARs should not participate in the 2011 OVDI but should merely file the delinquent FBARs with Department of Treasury and attach a statement explaining why the reports are filed late.[14] The IRS will not impose a penalty for the failure to file a delinquent FBAR if there are no underreported tax liabilities and the FBAR is filed by August 31, 2011.[15]

Under the 2011 OVDI, taxpayers are not required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes.[16] A similar provision in the 2009 OVDP has caused considerable frustration among taxpayers and their representatives. The understanding of potentially applicable penalties may differ greatly in the eyes of a taxpayer as compared to an IRS examiner. Anyone considering a 2011 OVDI submission must carefully examine all potential civil penalties and evaluate the actual risk of criminal prosecution.

Tactical Considerations

Criminal prosecutions generally require a voluntary, intentional violation of a known legal duty. For many taxpayers, the actual risk of criminal prosecution might not be high. Many taxpayers with foreign bank accounts are immigrants or descendants of immigrants who are unfamiliar with the filing and reporting requirements. The determination of whether the government might be able to demonstrate a voluntary, intentional violation of a known legal duty to appropriately report an interest in a foreign account or asset must be carefully considered before determining whether to participate in the 2011 OVDI. Taxpayers and their advisers should ask whether the prospect of a criminal prosecution can be reduced or eliminated merely by filing amended or delinquent returns and FBARs in lieu of a direct participation in the 2011 OVDI.

Potential civil penalties associated with undisclosed interests in foreign accounts and assets can far overshadow the current value of these accounts and assets. This raises several questions: Is there some method of reducing the potentially applicable penalty exposure without participating in the 2011 OVDI? Could filing amended or delinquent returns and FBARs in lieu of a direct participation in the 2011 OVDI reduce these civil penalties? What would be the potentially applicable penalties upon an examination of such returns and FBARs? In any such examination, would the government exact retribution, since the taxpayer effectively declined participating in the 2011 OVDI? Will the government pursue noncompliant taxpayers through the required judicial process following assessment of an FBAR penalty?[17]

In answering these questions, it is important to consider that the ability of a U.S. taxpayer to maintain an undisclosed, "secret" foreign financial account is fast becoming nonexistent. Information regarding undisclosed interests in foreign financial accounts and assets flows into the government on an almost daily basis. Financial mercenaries (i.e., whistleblowers or informants) are lurking within substantially every foreign institution. Tax treaties and information exchange agreements, information developed through submissions and interviews of 2009 OVDP participants and those who will participate in the 2011 OVDI, information provided by foreign institutions and advisers (whether indicted or not) all continue to generate additional leads to taxpayers and their advisers. Additional information will become available as the Foreign Account Tax Compliance Act (and foreign financial asset reporting)[18] become effective in the next few years.

The 2011 OVDI, by limiting and fixing in place the penalties that can be imposed, eliminates IRS discretion. There are typically no exceptions based on reasonable cause. If taxpayers desire to pursue potentially lesser penalties, they could opt out of the 2011 OVDI and take their chances in the normal IRS administrative process.

The 2011 OVDI specifically includes foreign assets, real estate, foreign entities, and the like in the offshore penalty calculation, especially if assets are acquired with funds subject to U.S. taxation. Contents of foreign safe deposit boxes may be subjected to the offshore penalty together with other foreign assets 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. If the assets were acquired with after-tax funds or from funds that were not subject to U.S. taxation and if the assets have not yet produced any income, there has been no U.S. taxable event and no reporting obligation to disclose.

It is not possible to know exactly what will happen to taxpayers who decide not to participate in the 2011 OVDI and to risk detection by the IRS and the imposition of substantial civil penalties, including the civil fraud penalty, numerous foreign information return penalties, and the potential risk of criminal prosecution. Full examinations? For how many tax years? Taxpayer and return preparer interviews? Maximum civil penalties? Criminal investigations? Will Congress later enact a strict-liability death penalty (i.e., one that doesn't permit a defense of "reasonable cause") for taxpayers who are noncompliant?

The ability to properly advise a client regarding participation in the 2011 OVDI requires an understanding of the potentially applicable foreign-related penalties for nonparticipants, the historic IRS and Department of Justice voluntary disclosure practice and policies, and a healthy respect for the ongoing governmental international tax enforcement efforts within a shrinking global community. Also, the representative must be aware that relevant processes and procedures seem to change frequently—and often without notice.

Many taxpayers will decide to participate in the 2011 OVDI and comply with the tax reporting laws now that they are aware of the FBAR and other foreign account reporting requirements. Others may wish to take advantage of an opportunity to repatriate stagnant foreign funds or simply move on with their lives. The IRS is committed to enforcement concerning offshore accounts and can be expected to continue to enhance these efforts. Through these enforcement efforts, along with the changing environment concerning bank secrecy, the IRS will undoubtedly uncover the otherwise undisclosed foreign accounts of many overly optimistic taxpayers. Nevertheless, the IRS simply will not be able to locate the vast majority of foreign account holders through enforcement efforts alone. But each noncompliant taxpayer that the IRS detects will no doubt forever regret missing the opportunity to participate in the "the last, best chance...to get back into the system." ■

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1 26 U.S.C. §§61 *et seq.*

2 *See* 31 U.S.C §§5311-5330 *and* 31 C.F.R. ch. X (Effective Mar. 1, 2011) (formerly 31 C.F.R. pt. 103).

3 *Available at* http://www.irs.gov/pub/irs-pdf/f90221.pdf.

4 INTERNAL REVENUE MANUAL [IRM] 4.26.16.5.3 (July 1, 2008), specifically provides that the mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness. However, taxpayers should exercise caution in asserting a lack of willfulness when the wrong box has been checked on Schedule B. All relevant facts and circumstances must be developed and carefully considered.

5 Douglas H. Shulman, Commissioner, Internal Revenue Service, Feb. 8, 2011 (IR-2011-14).

6 The applicable 2011 OVDI penalties are identified in a series of Frequently Asked Questions [hereinafter the 2011 OVDI FAQs] *available at* http://www.irs.gov/businesses/international/article/0,,id=235699,00.html.

7 The 2011 Offshore Voluntary Disclosures Letter is available at http://www.irs.gov/pub/irs-utl/2011-ovdi-irs-ci-letter-01-31-2011.doc.

8 The letter should be addressed to Attn: Offshore Voluntary Disclosure Coordinator, 600 Arch Street, Room 6404, Philadelphia, PA 19106.

9 The 2011 Offshore Voluntary Disclosures Package includes various documents and forms identified at http://www.irs.gov/newsroom/article/0,,id=235584,00.html.

10 The mailing address is: IRS, 3651 S. I H 35 Stop 4301 AUSC, Austin, TX 78741. ATTN: 2011 Offshore Voluntary Disclosure Initiative.

11 The 2011 OVDI FAQs, *supra* note 6, FAQ 52.

12 *Id.*

13 The 2011 OVDI FAQs, *supra* note 6, FAQ 53.

14 Mail to: Department of Treasury, Post Office Box 32621, Detroit, MI 48232-0621.

15 The 2011 OVDI FAQs, *supra* note 6, FAQ 17.

16 The 2011 OVDI FAQs, *supra* note 6, FAQ 50.

17 The period of limitation on collection of FBAR penalties is found in 31 U.S.C. §5321(b)(2). The government may commence a civil action to recover a civil penalty assessed under subsection (a) at any time before the end of the two-year period beginning on the later of 1) the date the penalty was assessed or 2) the date any judgment becomes final in any criminal action under 31 U.S.C. §5322 in connection with the same transaction with respect to which the penalty is assessed. The date the FBAR penalty is assessed is the date that the IRS-designated official stamps IRS Form 13448. *See* IRM 4.26.17.5.5.2 (01-01-2007).

18 26 U.S.C. §6038D.