Practice

By Charles P. Rettig

The 2012 IRS Offshore Voluntary Disclosure Initiative

For years, the IRS has been pursuing—with mixed success—the disclosure of information regarding undeclared interests of U.S. taxpayers (or those who ought to be U.S. taxpayers) in foreign financial accounts. On January 9, 2012, the IRS announced yet another offshore voluntary disclosure program (the 2012 OVDI) following on the success of the 2009 Offshore Voluntary Disclosure Program (the 2009 OVDP) and the 2011 Offshore Voluntary Disclosure Initiative (the 2011 OVDI), which were announced many years after the 2003 Offshore Voluntary Compliance Initiative (OVCI) and the 2003 Offshore Credit Card Program (OCCP).[1]

Voluntary disclosure initiatives typically offer reduced penalties in exchange for taxpayers voluntarily coming into compliance before the IRS is aware of their prior tax indiscretions. In part, the success of such initiatives often depends on the perception that they will be followed by strong government tax enforcement efforts. In announcing the 2012 OVDI, IRS Commissioner Douglas Shulman stated "Our focus on offshore tax evasion continues to produce strong, substantial results for the nation's taxpayers ... We have billions of dollars in hand from our previous efforts, and we have more people wanting to come in and get right with the government. This new program makes good sense for taxpayers still hiding assets overseas and for the nation's tax system ... .As we've said all along, people need to come in and get right with us before we find you ... . We are following more leads and the risk for people who do not come in continues to increase."[2]

Data Mining Continues

Participants in the 2009 OVDP and the 2011 OVDI were required to provide relevant information

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related to the creation and maintenance of their foreign financial accounts. Specifically, participants were required to provide information identifying any and all foreign financial institutions where they maintained accounts; list the dates the accounts were opened and/or closed together with the taxpayer's point of contact at each financial institution; explain all face-to-face meetings, and any other communications they had regarding the accounts or assets with the financial institution(s); explain all face-to-face meetings or communications regarding the accounts or assets with independent advisors/investment managers not from the financial institution(s) where the funds were held including the names, locations and dates of these meetings and/or communications.

Many participants in the 2009 OVDP and the 2011 OVDI have been subjected to interviews by representatives from the IRS and the Department of Justice inquiring about the knowledge and possible assistance of others in creating the foreign financial account. These interviews have significantly focused on specific foreign financial institutions located in Europe (beyond Switzerland), Asia (Hong Kong, China, Singapore, India, and China) and the Middle East (Israel, the United Arab Emirates—Dubai, Iran and Egypt). There have long been rumors of a consortium of Swiss financial institutions attempting to coordinate some form of global resolution with the United States that would include delivery of information regarding U.S. account-holders and payment of fines believed to exceed $1 billion in exchange for not receiving individualized "UBS treatment."[3]

2012 OVDI

The 2012 OVDI is patterned after the 2011 OVDI but increases the maximum "FBAR-related" penalty from 25 percent to 27.5 percent of the highest account value at any time during an eight-year period. The 2012 OVDI does not have a stated expiration date but can be terminated by the IRS at any time as to specific classes of taxpayers or as to all taxpayers. In all, the IRS has seen at least 33,000 voluntary disclosures from the 2009 and 2011 offshore initiatives. Since the 2011 program closed in September 2011, hundreds of taxpayers have come forward to make voluntary disclosures. Those who have come in since the 2011 program closed last year will be able to be treated under the provisions of the new 2012 OVDI.

The FBAR

Under the Bank Secrecy Act, U.S. citizens, residents or a person in and doing business in the United States must file a 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 noting the account on their income tax return and by filing Form 90-22.1, the FBAR. Willfully failing to file an FBAR can be subject to both criminal sanctions (*i.e.*, imprisonment) and civil penalties equivalent to the greater of $100,000 or 50 percent of the balance in an unreported foreign account—for each year since 2004 for which an FBAR wasn't filed. If asserted for one or more years, the penalty is not limited to the amount of funds in the account, etc. FBARs for each calendar year are due on June 30 of the next calendar year, without extension. Extensions of time to file federal income tax returns do not extend the time for filing FBARs—there is presently no statutory or regulatory provision granting an extension beyond June 30 to file an FBAR.

Schedule B and the instructions provide the government with what may be an important "willfulness" link between an income tax return and the FBAR filing requirements. "Willfulness" is generally determined by "a voluntary, intentional violation of a known legal duty."[4] The Internal Revenue manual (IRM) provides that willfulness is demonstrated by the person's knowledge of the FBAR reporting requirements coupled with the person's conscious choice not to comply with the requirements.[5] Under the concept of "willful blindness," willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and record keeping requirements.[6] The IRM provides an example involving willful blindness where a person admits knowledge of but fails to answer the question concerning signature authority at foreign banks on Schedule B of his income tax return.[7] To impose a willful FBAR penalty, the Government has the burden of proving that the taxpayer was "willful" in that they somehow made a "voluntary, intentional violation of a known legal duty."[8]

Taxpayers are required to acknowledge their interest in the foreign financial account and identify the foreign country where the account is maintained on Schedule B, Line 7 of their income tax return. Line 7a of Schedule B of Form 1040 generally asks the taxpayer for a somewhat unsophisticated "yes" or

"no" answer to the question: "At any time during [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? See instructions on back for exceptions and filing requirements for Form TD F 90-22.1." The instructions to Schedule B provide a general description of the FBAR and how to obtain a copy of the FBAR.[9]

Previous Offshore Initiatives

In 2003, following significant publicity regarding the use of foreign accounts and credit card arrangements by U.S taxpayers, the IRS offered significant penalty relief for taxpayers participating in the OVCI which coincided with strong tax enforcement efforts under the OCCP. Eligible OVCI taxpayers were required to file amended or delinquent returns for three tax years (1999-2001) but could choose to bring tax years 1996-1998 into the OVCI (and would not be examined for any earlier years). Approximately 1,321 taxpayers from 48 countries participated in the OVCI identifying approximately 400 offshore promoters. The IRS agreed to not assert any 75 percent civil fraud penalties and the Financial Crimes Enforcement Network (FinCEN) agreed to not assert any civil penalties for the failure to timely file a Report of Foreign Bank and Financial Accounts (FBAR).

> The government is to be highly commended for its ongoing enforcement efforts which are destroying the ability of a U.S. taxpayer to maintain an undisclosed, "secret" foreign financial account.

The 2009 OVDP brought in at least 14,700 U.S. taxpayers (disclosing accounts in more than 60 countries) through the front door of IRS Criminal Investigation and untold thousands through a process of quietly amending returns and filing delinquent FBARs with the government. For eligible taxpayers who ventured through the front door, the OVDP provided the certainty of no criminal prosecution and civil penalty relief—they were required to pay back-taxes from 2003 to 2008, interest and a 20-25 percent penalty on the delinquent taxes. The IRS also imposed a 20 percent "FBAR-related" penalty equal to the highest aggregate value of the financial account between 2003 and 2008. In limited situations, the FBAR-related penalty could be reduced to five percent of the account value or $10,000 per tax year.

The 2011 OVDI, brought in an additional 12,000 eligible taxpayers who filed original and amended tax returns and agreed to make payments (or good faith arrangements to pay) for taxes, interest and accuracy-related penalties. The 2011 OVDI FBAR-related penalty framework required a 25 percent "FBAR-related" penalty equal to the highest value of the financial account between 2003 and 2010. Under the 2011 OVDI, only one 25 percent offshore penalty was to be applied with respect to voluntary disclosures relating to the same financial account. The penalty could be allocated among the taxpayers with beneficial ownership making the voluntary disclosures in any way they choose. Participants in the 2011 OVDI also had to pay back-taxes and interest for up to eight tax years as well as paying accuracy-related and/or delinquency penalties. Subject to certain limitations, financial transactions occurring before 2003 were generally irrelevant for those participating in the OVDI.

Under the 2011 OVDI, taxpayers who are foreign residents and who were unaware they were U.S. citizens qualified for a reduced five-percent FBAR-related penalty (FAQ 52). Others qualified for the five-percent penalty if they: (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 the 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 account-holder information such as a change in 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 is presumed that they were.

Taxpayers whose highest aggregate account balance (including 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 produced improperly untaxed income) in each of the years covered by the 2011 OVDI is less than $75,000 qualified for a 12.5 percent FBAR-related penalty (FAQ 53). Under the 2011 OVDI, IRS examiners have had no authority to negotiate a different FBAR-related penalty.

Taxpayers who reported and paid tax on all their taxable income but did not file FBARs, should not participate in the 2012 OVDI but should merely file the delinquent FBARs with the Department of Treasury, P.O. Box 32621, Detroit, MI 48232-0621 (and attach a statement explaining why the reports are filed late). Under the 2011 OVDI, the IRS agreed not to impose a penalty for the failure to file the delinquent FBARs if there were no underreported tax liabilities and the FBARs were filed by August 31, 2010 (FAQ 17). Presumably, the IRS will follow the same course under the 2012 OVDI since those with no underreported tax liabilities are not truly within the range of taxpayers the IRS is trying to identify.

Other Potentially Applicable Offshore-Related Civil Penalties

Anyone considering an offshore voluntary disclosure submission must carefully examine all potential civil penalties and evaluate the risk of criminal prosecution. Under the 2011 OVDI, taxpayers were not to be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes (FAQ 50). A similar provision in the 2009 OVDP has caused considerable frustration among taxpayers and their representatives.[10] The understanding of potentially applicable penalties may differ greatly in the eyes of a taxpayer as compared to an examiner.

In addition to the FBAR related penalties, there are numerous other potentially applicable penalties that might be associated with varying interests in foreign financial accounts and structures designed to hold title to such accounts. Various potentially applicable civil penalties include:

- Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts—Code Secs. 6048 and 6039F—Taxpayers must also report various transactions involving foreign trusts, including creation of a foreign trust by a U.S. person, transfers of property from a U.S. person to a foreign trust and receipt of distributions from foreign trusts under Code Sec. 6048. This return also reports the receipt of gifts from foreign entities under Code Sec. 6039F. The penalty for failing to file each one of these information returns, or for filing an incomplete return, is 35 percent of the gross reportable amount, except for returns reporting gifts, where the penalty is five percent of the gift per month, up to a maximum penalty of 25 percent of the gift.
- Form 3520-A, Information Return of Foreign Trust With a U.S. Owner—Taxpayers must also report ownership interests in foreign trusts, by U.S. persons with various interests in and powers over those trusts under Code Sec. 6048(b). The penalty for failing to file each one of these information returns or for filing an incomplete return, is five percent of the gross value of trust assets determined to be owned by the U.S. person.
- 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 Code Secs. 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.
- 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—Code Secs. 6038A and 6038C—Taxpayers may be required to report transactions between a 25 percent foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by Code Secs. 6038A and 6038C. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, 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.
- Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation—Code Sec. 6038B—Taxpayers are required to report transfers of

property to foreign corporations and other information under Code Sec. 6038B. The penalty for failing to file each one of these information returns is ten percent of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional.

- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships—Code Secs. 6038, 6038B, and 6046A—U.S. persons with certain interests in foreign partnerships use this form to report interests in and transactions of the foreign partnerships, transfers of property to the foreign partnerships, and acquisitions, dispositions and changes in foreign partnership interests under Code Secs. 6038, 6038B, and 6046A. Penalties include $10,000 for failure to file each return, 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, and ten percent of the value of any transferred property that is not reported, subject to a $100,000 limit.
- Fraud penalties—Code Secs. 6651(f) or 6663—Where an underpayment of tax, or a failure to file a tax return, is due to fraud, the taxpayer is liable for penalties that, although calculated differently, essentially amount to 75 percent of the unpaid tax.
- Failure-to-file a tax return—Code Sec. 6651(a)(1)—Generally, taxpayers are required to file income tax returns. If a taxpayer fails to do so, a penalty of five percent of the balance due, plus an additional five percent for each month or fraction thereof during which the failure continues may be imposed. The penalty shall not exceed 25 percent.
- Failure-to-pay the tax shown on the return—Code Sec. 6651(a)(2)—If a taxpayer fails to pay the amount of tax shown on the return, he or she may be liable for a penalty of 0.5 percent of the amount of tax shown on the return, plus an additional 0.5 percent for each additional month or fraction thereof that the amount remains unpaid, not exceeding 25 percent.
- Accuracy-related penalty on underpayments of tax—Code Sec. 6662—Depending upon which component of the accuracy-related penalty is applicable, a taxpayer may be liable for a 20 percent or 40-percent penalty.

The Road Ahead

Most individuals wrongly believe that prior tax indiscretions can somehow be routinely resolved in a purely civil manner, without a criminal investigation or prosecution. However, within the past few years, at least 40 U.S. taxpayers and another 20 advisors (bankers, lawyers, consultants, etc.) have been criminally indicted for activities associated with U.S. persons holding undeclared interests in foreign financial accounts. Untold others are targets or subjects of ongoing federal criminal investigations.

If the initial taxpayer contact is from the IRS, a purely civil tax resolution is no longer certain and the likelihood of substantial civil penalties is significant. If the initial taxpayer contact regarding an undisclosed interest in a foreign financial account is from the Department of Justice, a purely civil tax resolution is anything but certain and is perhaps unlikely. Actions designed to avoid detection by the government will surely increase the potential for criminal prosecution. In July 2010, various individuals around the country received a letter from the U.S. Department of Justice, Tax Division stating, in part:

> Re Investigation of undeclared Foreign Financial Accounts
>
> The Department of Justice is conducting an investigation of U.S. taxpayers who may have violated federal criminal laws by failing to report they had a financial interest in, or signature authority over, a financial account located in a foreign country. We have reason to believe that you had an interest in a financial account in India that was not reported to the IRS on either a tax return or FBAR, Department of Treasury Form TD F 90-22.1, report of Foreign Bank and Financial Account. You are advised that the destruction or alteration of any document that may relate to this investigation constitutes a serious violation of federal law, including but not limited to obstruction of justice ... You are further advised that you are a subject of a criminal investigation being conducted by the Tax Division [of the Department of Justice].

There are many considerations before a taxpayer should determine whether to pursue a voluntary disclosure of prior tax indiscretions. When reviewing the OVDP and the OVDI, many made decisions based on whether they could be considered a realistic candi-

date for a criminal prosecution referral by the IRS or prosecution by the Department of Justice? (If so, the determination to participate was relatively quick and easy). Is there a possibility of reducing that prospect by filing amended or delinquent returns and FBARs in lieu of a direct participation in the OVDP/OVDI? What would be the potentially applicable penalties upon an examination of such returns and FBARs? Could the government actually carry their burden of demonstrating that the taxpayer "willfully" violated the FBAR filing requirements?

Since the 2012 OVDI asserts an offshore penalty based on foreign financial accounts *and* asset valuations, for many with smaller financial account values the aggregate offshore penalty determination, even for multiple years, may likely be less outside the OVDI. Indications are that those opting out will be treated fairly, based upon any unique factual scenario. For those participating in the OVDI, is an "opt out" based on a unique factual scenario a viable alternative to the OVDI?

> Anyone considering an offshore voluntary disclosure submission must carefully examine all potential civil penalties and evaluate the risk of criminal prosecution.

The government is to be highly commended for its ongoing enforcement efforts which are destroying the ability of a U.S. taxpayer to maintain an undisclosed, "secret" foreign financial account. Foreign account information is flowing into the government through the development of relationships with corresponding taxing agencies in other countries; treaty based information exchanges; use of the civil summons process seeking identification of account holders in foreign institutions operating within the jurisdiction of the United States; indictments of foreign institutions and their bankers operating within the jurisdiction of the United States; receipt of information from whistleblowers and informants; cooperation from taxpayers, advisors, foreign banks and bankers who have been criminally prosecuted; the threat of future disclosures pursuant to the Foreign Account Tax Compliance Act (FATCA) and Foreign Financial Asset Reporting (Form 8938 and new Code Sec. 6038D); and data mining submissions received from participants in initiatives designed to encourage voluntary compliance.

There are rumors regarding ongoing "John Doe" summons activity seeking to force foreign financial institutions to deliver account-holder information to the U.S. government as well as possible indictments of foreign financial institutions. Recently, several foreign institutions have advised their account holders to consult U.S. tax advisors regarding the IRS offshore voluntary disclosure program and their U.S. tax reporting relating to their foreign financial accounts. It is reasonable to assume that such institutions will take whatever action is necessary to avoid being indicted, beginning with the delivery of information regarding account holders to the U.S. government.

It is likely that ongoing enforcement efforts will require foreign financial institutions doing business in the United States to disclose account holders having relatively small accounts and earnings. There have been rumors of discussions regarding accounts having a high balance of the equivalent of $50,000 at any time between 2002 and 2010. U.S. persons having interests in foreign financial accounts should not find comfort in a belief that their foreign financial institution will somehow refrain from disclosing very small accounts in the current enforcement environment. Those who think too long may be sorely surprised at the high level of ultimate cooperation of their institution with the U.S. government.

Taxpayers having undisclosed interests in foreign financial accounts must consult competent tax professionals before deciding to participate in the 2012 OVDI. Many taxpayers will decide to submit a voluntary disclosure based on a personal desire to come into compliance now that they are aware of the FBAR and other foreign account reporting requirements. Others may simply want to move on with their lives. Some may decide to risk detection by the IRS and the imposition of substantial penalties, including the civil fraud penalty, numerous foreign information return penalties, and the potential risk of criminal prosecution. Although the 2012 OVDI penalty regime may seem overly harsh for many, the decision to participate should include an economic analysis of the taxpayers projected future earning power that could be generated from the funds held offshore. Participating taxpayers may well benefit by repatriating stagnant foreign funds into a recessionary domestic economy with a suffering real estate market and business opportunities lurking behind every corner.

When the 2009 OVDP was announced, IRS Commissioner Douglas Shulman stated "My goal has

always been clear—to get those taxpayers hiding assets offshore back into the system ... We draw a clear line between those individual taxpayers with offshore accounts who voluntarily come forward to get right with the government and those who continue to fail to meet their tax obligations. People who come in voluntarily will get a fair settlement ... For taxpayers who continue to hide their head in the sand, the situation will only become more dire. They should come forward now under our voluntary disclosure practice and get right with the government."[11]

This is an extremely target rich environment for the government. The IRS is committed to ongoing enforcement concerning offshore accounts and the changing environment concerning bank secrecy will continue to uncover overly optimistic U.S. persons. Coming into past compliance through a voluntary disclosure, or at least prospective compliance, is the right thing to do. The IRS has provided yet another opportunity for formerly non-compliant taxpayers to "get right with the government." Since the current OVDI may be terminated at any time, waiting is simply not a viable option.

Endnotes

1 IR-2012-5 (Jan. 9, 2012).
2 *Id.*
3 UBS was the subject of a criminal Deferred Prosecution Agreement, paid fines and penalties totaling almost $780 million and, after the Swiss parliament changed their law, delivered information to the U.S. government regarding approximately 4,450 U.S. account holders.
4 IRM 4.26.16.5.3 (07-01-2008).
5 *Id.*
6 *Id.*
7 *Id.*
8 *See* CCA 200603026 (Sept. 1, 2005); IRM 4.26.16.4.5.3 (07-01-2008); *See also J.B. Williams*, DC-VA, 2010-2 USTC ¶50,623.
9 www.irs.gov/pub/irs-pdf/f90221.pdf.
10 *See* National Taxpayer Advocate's 2011 Annual Report to Congress available at: http://www.irs.gov/newsroom/article/0,,id=252284,00.html.
11 IRS Commissioner Douglas H. Shulman, March 26, 2009.