# The Last, Best Chance to Disclose Foreign Financial Accounts and Assets–The 2011 Offshore Voluntary Disclosure Program and Beyond!

*By Charles P. Rettig and Kathryn Keneally*

Charles P. Rettig and Kathryn Keneally examine the current state of voluntary disclosure of foreign financial accounts and assets.

The IRS has long been aggressively increasing its domestic and international enforcement activities, partially as a result of strong, ongoing Congressional interest. However, history confirms that heightened enforcement efforts and increased penalties for noncompliance must be coupled with some type of initiative to have a realistic impact on what is believed to be a large internationally noncompliant taxpayer community.

Following on the success of the 2009 Offshore Voluntary Disclosure Program (OVDP), on February 8, 2011 the IRS announced the 2011 Offshore Voluntary Disclosure Initiative (OVDI)—yet another initiative targeting U.S. taxpayers having previously undisclosed interests in foreign financial accounts and assets. These voluntary disclosure programs offer reduced income tax and foreign account reporting penalties in exchange for taxpayers voluntarily coming into compliance before the IRS is aware of their prior tax and financial account reporting indiscretions. The initial and long-term success of such initiatives often depends on those coming forward being treated fairly coupled with the perception of heightened future civil and criminal tax enforcement efforts designed to ferret out a significant proportion of the remaining noncompliant taxpayer community.

Under the Bank Secrecy Act,[1] U.S. 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 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). 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 high balance in an unreported foreign account, per year for each year since 2004 for which an FBAR wasn't filed.

Many U.S. taxpayers and their advisors have long been unaware of or have simply ignored the FBAR information reporting requirements. On the eve of cracking into centuries old Swiss bank secrecy, IRS Commissioner Douglas H. Shulman gained worldwide publicity in announcing commencement of the 2009 OVDP and 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

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> 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 … We believe this is a firm, but fair resolution of these cases … 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.[2]

At least 14,700 U.S. taxpayers (disclosing accounts in more than 60 countries) participated in the 2009 OVDP by knocking on the front door of IRS Criminal Investigation while untold thousands of others came into compliance through a process of quietly filing amended or delinquent income tax returns and FBARs. 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 percent accuracy-related or 25 percent delinquency penalty on the delinquent taxes. The IRS also imposed what is likely the highest penalty in the history of IRS initiatives—a single "FBAR-related" offshore penalty equivalent to 20 percent of the highest aggregate value of each undisclosed financial account at any time during 2003 and 2008. In limited situations, the offshore penalty could be reduced to five percent of the account value or $10,000 per tax year.

Participants in the 2009 OVDI were required to provide relevant information 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. This information significantly enhanced the ongoing civil and criminal enforcement efforts of the IRS and the Department of Justice targeting foreign financial institutions and advisors throughout the world.

In announcing the October 15, 2009 conclusion of the 2009 OVDP, Commissioner Shulman stated:

> If you are a U.S. individual holding overseas assets, you must report and pay your taxes or we will be increasingly focused on finding you … A key aspect of our future international offshore work will be mining the voluntary disclosure information from people who have come forward. We will be scouring this information to identify financial institutions, advisors, and others who promoted or otherwise helped U.S. taxpayers hide assets and income offshore and skirt their tax responsibilities at home.[3]

The criminal "pre-clearance" OVDP voluntary disclosure process of submitting the taxpayer's name, address, date of birth and taxpayer identification number to Criminal Investigation remained available after October 15, 2009. Representatives of numerous taxpayers having undisclosed interests in foreign financial accounts continued to contact Criminal Investigation although there was no certainty in any potential civil resolution of the issues involved. However, likely far more taxpayers did not come forward out of concern that the IRS might assert draconian FBAR (and other offshore related) penalties of up to 50 percent of the high account balance, per year. Practitioners around the country called for the IRS to issue some form of future guidance regarding the potential penalties that might be asserted for taxpayers seeking to come into compliance with their foreign account reporting requirements.

During much of 2009 through 2010, the IRS, taxpayers and their representatives struggled to administratively process matters submitted under the 2009 OVDP. Information necessary to prepare returns, FBARs and verify ownership interests and balances in foreign financial accounts was often difficult to obtain in a timely manner; cases were assigned and reassigned among examining agents spread throughout the country while case files often lagged behind; delays sprang up associated with requests to modify already submitted IRS Form Powers of Attorney to include reference to "civil penalties" and the FBAR and to extend the applicable statute of limitations; the statutory Passive Foreign Investment Company (PFIC) liabilities associated with the undisclosed foreign investments were nearly impossible to determine for many taxpayer representatives and examining agents; numerous participants desired to tell the agents their life story on the often mistaken belief that they would be entitled to relief from the stated 20 percent offshore penalty because the foreign funds

were not part of some tax evasion scheme separate from the failure to be disclosed; some representatives asserted that all of their clients were entitled to relief from the stated 20 percent offshore penalty notwithstanding the clear conditions for such relief under the 2009 OVDP, etc.

Life continues regardless of an IRS examination. Special handling was required for many of the OVDP participants who became involved in divorce proceedings (with spouses sometimes unaware of the existence of the foreign account that had been disclosed under the OVDP), taxpayers dying (often having spouses and relatives completely unaware of the existence of the foreign account), being diagnosed with severe mental or physical health issues (including Alzheimer's, dependency issues, *etc*.). These issues compounded the inherent difficulty of getting information necessary to close cases and have resulted in many open examinations remaining for participants in the 2009 OVDP.

## Overview of the 2011 OVDP

Recognizing the ongoing desire for some degree of certainty for taxpayers seeking to come into compliance with the foreign account reporting requirements, Commissioner Shulman announced the 2011 OVDP on February 8, 2011 and 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 U.S. 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 … .

Under the 2011 OVDI, eligible taxpayers have until August 31, 2011 to file all original and amended tax returns for 2003 to 2010 and to make payment (or good faith arrangements to pay) of income taxes, interest and accuracy-related and/or delinquency penalties. The new penalty framework requires a 25 percent "FBAR-related" offshore penalty equivalent to the highest value of each financial account and certain foreign assets at any time between 2003 and 2010. A single 25 percent offshore penalty will be applied with respect to voluntary disclosures relating to the same foreign financial account and assets. It may be allocated among the taxpayers with beneficial ownership making the voluntary disclosures in any manner they determine. Subject to certain conditions, financial transactions occurring before 2003 are generally irrelevant. The 2011 OVDI and penalty framework are identified in a series of Frequently Asked Questions (FAQ) available at *irs.gov*.[4]

IRS examiners have no authority to negotiate a different offshore penalty other than as specifically stated in the 2011 OVDI.[5] However, taxpayers who are foreign residents and who were unaware they were U.S. citizens may qualify for a reduced five percent offshore penalty. Others will qualify for the five percent offshore penalty if they: (i) 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); (ii) have exercised minimal, infrequent contact with the account, for example, to request the account balance, or update accountholder information such as a change in address, contact person, or email address; (iii) 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 (iv) 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 will be presumed that they were taxed.[6]

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 qualify for a 12.5 percent offshore penalty.[7] However, 2009 OVDP participants whose cases have been resolved and closed with a Form 906 closing agreement who believe the facts of their case qualify them for the five percent or 12.5 percent reduced offshore penalty, but paid a higher penalty

amount under the 2009 OVDP, have the opportunity to request reconsideration of the penalty under the 2011 OVDP.[8]

There are many considerations before a taxpayer should determine whether to participate in the 2011 OVDI. Is the taxpayer a realistic candidate for a criminal prosecution referral by the IRS or prosecution by the Department of Justice? (If so, the determination to participate should be simple and quick). Can that prospect somehow be reduced or eliminated by filing amended or delinquent returns and FBARs in lieu of a direct participation in the OVDI? (and what would be the potentially applicable penalties upon a examination of such returns and FBARs?). Could the government carry the burden of demonstrating that the taxpayer "willfully" violated the FBAR filing requirements? Since the OVDI asserts an offshore penalty based on foreign financial accounts and asset valuations, would the actual offshore penalty determination somehow be less outside the OVDI if limited to financial accounts? Will the government pursue noncompliant taxpayers through the required judicial process following assessment of an FBAR penalty?[9] Might the FBAR related mitigation guidelines set forth in the Internal Revenue Manual (IRM) somehow benefit the taxpayer outside the framework of the 2011 OVDI? Do these mitigation guidelines have any continued viability? How will various of the FAQs under the 2011 OVDI be interpreted in specific taxpayer situations?

Many taxpayers will decide to participate in the OVDI based on a personal desire to come into compliance now that they are aware of the FBAR and other foreign account reporting requirements. Others recognize an opportunity to repatriate stagnant foreign funds into a domestic recessionary economy or may simply want to move on with their lives. The ability to properly advise a client regarding participation in the 2011 OVDI requires at least a general 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.

## Overview of Foreign Account Reporting and the FBAR

U.S. citizens and residents are taxed on their worldwide income whether they live inside or outside of the United States. Foreign income must be reported on a U.S. tax return whether or not the person receives a Form W-2, Wage and Tax Statement, a Form 1099 (information return) or the foreign equivalent of those forms. Foreign source income includes but is not limited to earned and unearned income, such as wages and tips, interest, dividends, capital gains, pensions, rents, and royalties.

It is not a violation of U.S. law to have a legal or beneficial interest in a foreign financial account. However, failure to knowingly report the earnings on the account and to file an FBAR may be a violation. 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.[10] Schedule B and the instructions provide the government with what some consider an important link between an income tax return and the FBAR filing requirements.

The Bank Secrecy Act requires the filing of the FBAR by U.S. citizens, residents or a person in and doing business in the U.S. if: (i) the person has a financial interest in, signature authority, or other authority over one or more accounts in a foreign country, and (ii) the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.[11] The FBAR must be filed by June 30 of each year for the prior calendar year. Extensions of time to file federal income tax returns do not extend the time for filing FBARs. There is currently no statutory or regulatory provision granting an extension of time for filing FBARs.

The authority to enforce the FBAR provisions of 31 U.S.C. § 5314[12] has been re-delegated from the Financial Crimes Enforcement Network (FinCEN) to the IRS by a Memorandum of Understanding (MOU) between FinCEN and IRS. The MOU includes the authority to: (i) Investigate possible civil violations of 31 U.S.C. § 5314; (ii) Assess and collect civil FBAR penalties; (iii) Employ the summons power of subpart F of part 103; (iv) Issue administrative rulings under subpart G of 31 C.F.R. part 103; and, (v)

Take any other action reasonably necessary for the enforcement of the foregoing and related provisions, including pursuit of injunctions. As of April 8, 2003, the authority to assess and collect FBAR civil penalties was delegated to the IRS.[13] IRS Criminal Investigation has been delegated the authority to investigate possible criminal violations of the Bank Secrecy Act.[14]

When performing the foregoing functions, the IRS is not acting under Title 26 but, instead, is acting under the authority of Title 31. Provisions of the Internal Revenue Code ("Code") generally do not apply to FBARs. As such, the FBAR is not subject to the confidentiality and nondisclosure protections of Code Sec. 6103. Regardless of the location of the taxpayer, the FBAR is filed at: U.S. Department of Treasury, P.O. Box 32621, Detroit, MI 48232-0621. It is considered filed when received in Detroit—not when postmarked.[15] Generally, each U.S. person jointly maintaining an account (or if several persons each own a partial interest in an account) must file an FBAR. However, the IRS will accept a single FBAR only for an account jointly held by a husband and wife.

## Determining Whether an FBAR Is Required to Be Filed

The FBAR is required to be filed when: (i) the filer is a U.S. Person; (ii) the U.S. Person (a) has a foreign financial account or (b) the U.S. Person has a financial interest in the account or signature or other authority over the foreign financial account; and (iii) the aggregate amount(s) in all foreign account(s) valued in U.S. dollars exceeds $10,000 at any time during the calendar year.[16]

A "U.S. Person" includes a citizen or resident of the United States. Citizenship is generally determined by a U.S. birth certificate or naturalization papers. For non-U.S. citizens, the residency determination may be somewhat problematic.[17] A person living in and doing business in the United States includes individuals and all forms of business entities, trusts, and estates. A certificate of incorporation from a U.S. state establishes that the corporation is a U.S. Person. A foreign subsidiary of a U.S. Person is not subject to the FBAR filing requirements. A corporation that owns directly or indirectly more than a 50 percent interest in one or more other entities is permitted to file a consolidated FBAR.

A "financial account" includes bank, savings and checking accounts, time deposits, securities accounts; mutual funds, brokerage and securities derivatives accounts; accounts where the assets are held in a commingled fund and the owner holds an equity interest in the fund; any other account maintained in a foreign financial institution or with a person doing business as a financial institution; and a foreign insurance policy having a cash surrender value.[18] The term does not include individual bonds, notes or stock certifications in the physical possession of the U.S. Person.[19]

An account is "foreign" if located outside all geographical areas of the United States. The United States includes the states of the United States, the District of Columbia, the Indian lands (as defined in the Indian Gaming Regulatory Act) and the territories and insular possessions of the United States. Examples include the Commonwealth of Puerto Rico, the United States Virgin Islands, Guam, American Samoa and the Commonwealth of the Northern Marianna Islands.[20] The location of an account, not the nationality of the financial institution with which the account is held, determines whether the account is in a foreign country.[21] Any financial account (except accounts maintained with a U.S. military banking facility) that is located in a foreign country should be reported, even if the account is held with a branch of a U.S. financial institution located abroad. The FBAR is not required for an account maintained with a branch, agency or other office that is located in the United States even though the financial institution itself may be foreign. An account is not considered foreign if held in an institution known as a "United States military banking facility" (or "United States military finance facility") operated by a U.S. financial institution designated by the U.S. Government to serve U.S. Government installations abroad, even if the United States military banking facility is located in a foreign country.[22]

The term "financial interest" includes accounts for which the U.S. Person is the owner of record or has legal title, whether the account is maintained on their own benefit or for the benefit of others that might include non-U.S. persons; accounts where the owner of record or holder of legal title is a person acting as an agent, nominee or in some other capacity on behalf of a U.S. Person; a corporation in which a U.S. Person directly or indirectly owns more than 50 percent of the total value of the shares of stock; and an account where the owner of record or holder of legal title is a partnership in which the U.S. Person owns interest in more than 50 percent of the profits

or a trust in which the U.S. person either has a present beneficial interest in more than 50 percent of the current income.[23]

A U.S. person has account "signature authority" if that person can control the disposition of money or other property in the account by delivery of a document containing his signature to the bank or other person with whom the account is maintained.[24] A person with "other authority" over an account is one who can exercise power that is comparable to signature authority over an account by direct communication, either orally or by some other means, to the bank or other person with whom the account is maintained.[25]

The FBAR is required for each calendar year during which the aggregate amount(s) in the account(s) exceeded $10,000 valued in U.S. dollars at any time during the calendar year. The maximum value of an account is the largest amount of currency and nonmonetary assets that appear on any quarterly or more frequent account statement issued for the applicable year. For example, if the statement closing balance is $9,000, but at any time during the year a balance of $15,000 appears on a statement, the maximum value is $15,000.[26] If the periodic account statement is not issued, the maximum is the largest amount of currency and/or monetary instruments in the account at any time during the year. Foreign currency is converted by using the official exchange rate in effect at the end of the year in question for converting foreign currency into U.S. dollars. The value of stock, other securities, or other nonmonetary assets in an account reported on the FBAR is the fair market value at the end of the calendar year, or if withdrawn from the account earlier in the year, at the time of the withdrawal.[27] If the filer had a financial interest in more than one account, each account is valued separately in accordance with the foregoing analysis.

Each person having an FBAR filing requirement must maintain records which include the name in which the account is maintained; the number or other designation of the account; the name and address of the foreign bank or other person with whom the account is maintained; the type of account; and the maximum value of each account during the reporting period.[28] Retaining a copy of the FBAR is not required. However, a copy of the current FBAR form contains most of the required information. The records must be kept for five years and be available at all times for inspection as provided by law.[29] The FBAR penalties apply to both a failure to file the FBAR as well as a failure to maintain required records and make them available upon request.

## FBAR Civil Penalties

A FBAR filing violation occurs on June 30th of the year following the calendar year to be reported (that is, on the due date for filing the FBAR). A recordkeeping violation occurs on the date when the records are requested by the IRS examiner if the records are not later provided. The IRM provides that "examiners are to use discretion, taking into account the facts and circumstances of each case, in determining whether a warning letter or penalties that are less than the total amounts provided for in the mitigation guidelines are appropriate." The IRM further provides that FBAR penalties should be "asserted only to promote compliance with the FBAR reporting and recordkeeping requirements."[30] In exercising their discretion, examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARs, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future. The IRS has discretion in determining the amount of the penalty, if any, because the total amount of statutory FBAR penalties can greatly exceed an amount that would be appropriate in view of the violation.[31]

The two primary civil FBAR penalties are referred to as "nonwillful" and "willful."[32] The "nonwillful" penalty is up to $10,000 for each negligent violation of the FBAR filing or recordkeeping requirements and may be waived if "such violation was due to reasonable cause" and "the amount of the transaction or the balance in the account at the time of the transaction was properly reported."[33] This means that the examiner must receive the delinquent FBARs from the nonfiler in order to avoid application of the nonwillfulness penalty.[34]

For "willful" violations occurring prior to October 23, 2004, a penalty up to the greater of $25,000 or the amount in the account (up to $100,000) may be asserted.[35] For "willful" violations occurring after October 22, 2004, a penalty may be imposed up to the greater of $100,000 or 50 percent of the amount in the account at the time of the violation.[36] If asserted for one or more years, the penalty is not limited to the amount of funds in the account, etc.

The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty.[37] If it is determined that the violation was due to reasonable

cause, the willfulness penalty should not be asserted. The IRM provides that willfulness is demonstrated by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements.[38]

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 recordkeeping requirements.[39] 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.[40] Since Schedule B refers taxpayers to the instructions for the FBAR, the government can be anticipated to assert that the foregoing supports a conclusion that the person could have learned of the FBAR filing and recordkeeping requirements. The failure to learn of the filing requirements coupled with other factors, such as the efforts taken to conceal the existence of the accounts and the amounts involved may lead the government to a conclusion that the violation was due to willful blindness. However, the IRM 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.[41]

Willfulness can rarely be proven by direct evidence, since it is a state of mind. It is usually established by drawing a reasonable inference from the available facts which might include information showing that income related to funds in a foreign bank account was not reported; a copy of the signed income tax return with Schedule B attached (showing whether or not the box pertaining to foreign accounts is checked or unchecked); copies of statements for the foreign financial account; correspondence with the account holder's tax preparer that may address the FBAR filing requirement; copies of previously filed FBARs; copies of Information Document Requests identifying items that were not provided by the account holder and explanations given as to why the requested information was not provided; etc.[42]

FBAR civil penalties can apply to each person with a financial interest in, or signature or other authority over, the foreign financial account. Thus there may be multiple penalty assessments if there is more than one account owner or if a person other than the account owner has signature or other authority over the foreign account. Each person can be liable for the full amount of the penalty. However, the IRM provides that given the magnitude of the maximum penalties permitted for each violation, the assertion of multiple penalties and the assertion of separate penalties for multiple violations with respect to a single FBAR form, should be considered only in the most egregious cases.[43]

## Other Potentially Applicable Offshore-Related Civil Penalties

***Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts—Code Sec. 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 §§ 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 Sec. 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 Sec. 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 §§ 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 Sec. 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 10 percent of the value of any transferred property that is not reported, subject to a $100,000 limit.

***Fraud penalties—Code Sec. 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.

## How to Make a Voluntary Disclosure Under the 2011 OVDI

Critically, the 2011 OVDI limits application of the foregoing penalties to those specifically stated within the OVDI. As such, following a thorough analysis of the potential civil penalties and criminal sanctions, some may decide to participate in the 2011 OVDI (others may decide to pursue other methods of becoming compliant). For those desiring to participate, a pre-clearance request and identifying information (name, date of birth, taxpayer identification number and address) and Power of Attorney, if represented, must be submitted by fax to the IRS Criminal Investigation Lead Development Center (LDC) at (215) 861-3050. If the taxpayer is already within the Criminal Investigation data base, the effort to participate in the OVDI will be untimely. As such, it would be unwise to initially provide Criminal Investigation with any information beyond the taxpayer's name, date of birth, taxpayer identification number and address until there has been an initial determination that the taxpayer may be eligible to participate.

Criminal Investigation will then notify taxpayers or their representatives via fax whether or not they have been cleared to make a voluntary disclosure using the Offshore Voluntary Disclosures Letter.[44] Taxpayers or representatives with questions regarding the pre-clearance can call (215) 861-3759 or contact their nearest Criminal Investigation Office. Pre-clearance is merely the initial phase and does not guarantee a taxpayer acceptance into the 2011 OVDI.

Within 30 days following notification of pre-clearance by Criminal Investigation, the taxpayer must submit their completed Offshore Voluntary Disclosures Letter to IRS Criminal Investigation, Attn: Offshore Voluntary Disclosure Coordinator, 600 Arch Street, Room 6404, Philadelphia, PA 19106. The IRS will review the Offshore Voluntary Disclosures Letters and notify the taxpayer or representative by mail whether the voluntary disclosure has been preliminarily accepted or declined.

Thereafter, if notified that their voluntary disclosure has been preliminarily accepted, the taxpayer has until August 31, 2011 to submit the remaining information and payment of their full Voluntary Disclosure

Package[45] for all applicable years to IRS, 3651 S. I H 35 Stop 4301 AUSC, Austin, TX 78741 ATTN: 2011 Offshore Voluntary Disclosure Initiative.

## 2011 OVDI Submission Requirements

As a condition to being accepted into the 2011 OVDI, applicants must provide the following information to the IRS for those tax years covered by the voluntary disclosure (generally 2003 through 2010):

***All Applicants.***

- Copies of originally filed tax returns for all years.
- Amended returns with applicable schedules of the amount and type of previously unreported income from the account or entity (*e.g.*, Schedule B for interest and dividends, Schedule D for capital gains and losses, Schedule E for income from partnerships, S corporations, estates or trusts).
- FBARs for foreign accounts maintained during calendar years covered by the voluntary disclosure and/or copies of previously filed FBARs.
- Copy of signed Offshore Voluntary Disclosure Letter.
- Payment of the tax, interest [interest suspension under Code Sec. 6404(g) is stated to be not applicable], accuracy-related penalty, and, if applicable, the failure to file and failure to pay penalties (plus Collection Information Statements, Forms 433-A and 433-B, if unable to pay in full).
- Foreign Account or Asset Statement[46] for each previously undisclosed foreign account or asset.
- Penalty Computation Worksheet[47] signed by the applicant and the applicant's representative, if the applicant is represented, setting forth a determination of the aggregate highest account balance of the undisclosed offshore accounts, fair market value of foreign assets, and penalty computation.
- Properly completed and signed agreements48 to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties.

***Disclosures involving foreign accounts.***

- If the highest aggregate account balance exceeds $1 million in any year, the applicant must submit the Foreign Financial Institution Statement[49] for each foreign financial institution with which the taxpayer had undisclosed accounts or transactions.
- If the highest aggregate account balance exceeds $500,000 in any year, the applicant must submit copies of offshore financial account statements reflecting all account activity for each tax year with an explanation of any differences between the amounts reported on the account statements and the tax returns.
- If the highest aggregate account balance is less than $500,000 in any year, copies of offshore financial account statements reflecting all account activity for each tax year must be available upon request (but need not be submitted absent a specific request).

***Disclosures involving foreign entities.***

- Statement identifying all offshore entities for the tax years covered by the voluntary disclosure, whether held directly or indirectly, and the share of ownership or control for each entity.
- For accounts or assets held in the name of a foreign entity, complete and accurate amended (or original, if delinquent) information returns required to be filed, including, but not limited to, Forms 3520, 3520-A, 5471, 5472, 926 and 8865 for all tax years covered by the voluntary disclosure. However, if the applicant is requesting waiver of the information reporting requirements on the basis that the entity had no purpose other than to conceal the taxpayer's ownership of assets, submit a completed and signed Statement on Dissolved Entities.[50]

***Disclosures involving estates and certain executors or advisors.***

- If the applicant is a decedent's estate, or is an individual who participated in the failure to report the foreign account, foreign asset, or foreign entity in a required gift or estate tax return, either as executor or advisor, provide complete and accurate amended estate or gift tax returns (original estate or gift tax returns, if not previously filed) for tax years covered by the voluntary disclosure necessary to correct the underreporting of assets held in or transferred through undisclosed foreign accounts or foreign entities.

***Disclosures involving PFICs.***

- For disclosures involving Passive Foreign Investment Company (PFIC) issues, the applicant must provide a statement whether the amended returns involve PFIC issues during the tax years covered by the 2011 OVDI period, and if so, whether the applicant chooses to elect the alternative to the statutory PFIC computation that resolves PFIC issues on a basis that is consistent with the mark-to-market (MTM) methodology authorized in Code Sec. 1296, but does not require complete reconstruction of historical data (a description of this alternative method is included in FAQ 10 of the 2011 OVDI).

## Highlights of the FAQs

Announcement of the 2011 OVDI included issuance of FAQs that have been and will likely continue to be revised during administration of the program. The FAQs should be thoroughly reviewed before submission of a request to participate in the OVDI. Further, representatives should not assume that the processing under the 2011 OVDI will be similar to that under the 2009 OVDP. Following receipt of the foregoing information, a formal examination of the information provided is not contemplated although the disclosure will be assigned to a civil examiner to certify the tax returns for accuracy, completeness and correctness.[51] The examiner may ask any relevant questions, request any relevant documents, and contact third parties, if necessary, without converting the certification to an examination. There are no appeal rights with respect to the OVDI determination.[52]

***Conversion rate.*** When calculating the 25 percent offshore penalty, foreign currency is converted by using the foreign currency exchange rate at the end of the year. In valuing currency of a country that uses multiple exchange rates, use the rate that would apply if the currency in the account were converted into U. S. dollars at the close of the calendar year. Each account is to be valued separately.[53]

***De minimis income.*** There is no *de minimis* unreported income exception under the 2011 OVDI. As such, any amount of unreported income will be considered for purposes of determining whether there has been tax noncompliance with respect to an account or asset and whether the account or asset should be included in the base for the 25 percent offshore penalty.[54] Gain realized on a foreign transaction occurring before 2003 is not includible in the base for the 25 percent offshore penalty unless the untaxed proceeds remained offshore.[55] Depending on all circumtances, many taxpayers with interests in accounts having relatively *de minimis* income will likely decide not to participate in the OVDI. The 25 percent offshore penalty will often be grossly disproportionate to the nature of the underlying violation.

***Asset inclusions.*** The 25 percent offshore penalty is intended to apply to all of the taxpayer's offshore holdings that are related in any way to tax noncompliance, regardless of the form of the taxpayer's ownership or the character of the asset. The penalty applies to all assets directly owned by the taxpayer, including financial accounts holding cash, securities or other custodial assets; tangible assets such as real estate or art; and intangible assets such as patents or stock or other interests in a U.S. or foreign business. If such assets are indirectly held or controlled by the taxpayer through an entity, the penalty may be applied to the taxpayer's interest in the entity or, if the IRS determines that the entity is an alter ego or nominee of the taxpayer, to the taxpayer's interest in the underlying assets. Tax noncompliance is stated to include failure to report income from the assets, as well as failure to pay U.S. tax that was due with respect to the funds used to acquire the asset.[56]

If foreign assets were 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. Assuming that the assets were acquired with after tax funds or from funds that were not subject to U.S. taxation, if the assets have not yet produced any income, there has been no U.S. taxable event and no reporting obligation to disclose. The taxpayer will be required to report any current income from the property or gain from its sale or other disposition at such time in the future as the income is realized. If the foreign assets produced income subject to U.S. tax during 2003–2010 which was not reported, the assets will be included in the offshore penalty computation regardless of the source of the funds used to acquire the assets. If the foreign assets were held in the name of an entity such as a trust or corporation, there would also have been an information return filing obligation that may need to be disclosed.[57]

***Signature authority.*** A taxpayer having signature authority over an account will be liable for the 25 percent penalty if there is unreported income from the account and they are determined to have a direct or indirect beneficial interest in the account, if the account: (i) is held in the name of a related person, such as a family member or a corporation controlled by the taxpayer; (ii) is held in the name of a foreign corporation or trust for which the taxpayer had a Title 26 reporting obligation; or (iii) was related in some other way to the taxpayer's tax noncompliance. However, if there is no unreported income with respect to the account, no penalty will be imposed.[58]

***Multiple accountholders.*** Only one 25 percent penalty will be applied with respect to voluntary disclosures relating to the same account. Each taxpayer who makes a voluntary disclosure will be liable for the 25 percent penalty on their percentage of the highest aggregate balance in the account. If there are multiple individuals with signature authority over a

trust account, the penalty may be allocated among the taxpayers with beneficial ownership making the voluntary disclosures in any way they choose. The reporting requirements for filing an FBAR, however, do not change—every individual required to file an FBAR must do so.[59]

***Practitioner responsibilities.*** If a taxpayer seeks the advice of a tax practitioner, the practitioner 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 that taxpayer of going forward. If the taxpayer decides to proceed with the disclosure, the practitioner must exercise due diligence in determining the correctness of any oral or written representations that the practitioner makes during the representation. A practitioner whose client declines to make full disclosure of the existence of, or any taxable income from, a foreign financial account, may not prepare a current or future income tax return for that taxpayer without being in violation of Circular 230.[60] It is uncertain how this provision will actually be applied. A preparer should be allowed to prepare accurate future returns even if their client failed to participate in the 2011 OVDI with respect to earlier tax years. Also, Circular 230 does not (yet) include the FBAR responsibilities.

***Package deal.*** The OVDI penalty framework and the agreement to limit tax exposure to years 2003 through 2010 are "package terms" under the 2011 OVDI. If any part of the offshore penalty is unacceptable to the taxpayer, the case will be examined and "all applicable penalties will be imposed" (Should we anticipate swift "justice" for those who opt out?) After a full examination, any tax and penalties imposed by on examination may be appealed, but the decision on the terms of the 2011 OVDI closing agreement may not (*i.e.*, the OVDI civil resolution will not be available in Appeals).[61] The anticipation of examinations for those opting out extending to tax years before 2003, related entities, etc. should be discussed with clients before entering the OVDI. The decision should likely be between participating or not rather than participating and later deciding on possibly opting out of the OVDI.

***No examiner discretion.*** The OVDI examiners do not have discretion to settle cases for amounts less than what is properly due and owing. Participants should be aware that offshore OVDI penalties will not be reduced simply because there is a legitimate source of the deposited funds, inherited funds, *etc.* FAQ 50 provides:

> Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. However, because the 25 percent offshore penalty is a proxy for the FBAR penalty, other penalties imposed under the Internal Revenue Code, and potential liabilities for years prior to 2003, there may be cases where a taxpayer making a voluntary disclosure would owe less if the special offshore initiative did not exist. Under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes. For example, if a taxpayer had $100,000 in an offshore bank account in only one year and foreign income-producing real estate with a fair market value of $1 million, only the bank account would be subject to the FBAR penalty. Consequently, the maximum FBAR penalty would only be $100,000 (that is, the greater of $100,000 or 50 percent of the amount in the foreign account), which is substantially less than the offshore penalty of $275,000 (25 percent of $1.1 million). If this FBAR penalty, plus tax, interest and all other applicable penalties, are less than what is due under this offshore initiative, the taxpayer will only pay the lesser amount.
>
> Examiners will compare the amount due under this offshore initiative to the tax, interest, and applicable penalties (at their maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability) for all open years that a taxpayer would owe in the absence of the 2011 OVDI penalty regime. The taxpayer will pay the lesser amount. If the taxpayer disagrees with the result, the taxpayer may request that the case be referred for an examination of all relevant years and issues.



> If the taxpayer disagrees with the result, the taxpayer may request that the case be referred for an examination of all relevant years and issues.[62]

In practice, FAQ 35 of the 2009 OVDP provided an opportunity to explain unique circumstances supporting an offshore penalty resolution different that as specified in the 2009 OVDP. Specifically,

> Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what

is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes. If the taxpayer disagrees with the IRS's determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues. At the conclusion of this examination, all applicable penalties, including information return penalties and FBAR penalties, will be imposed. If, after the standard examination is concluded the case is closed unagreed, the taxpayer will have recourse to Appeals.[63]

Under the 2009 OVDP, some matters were resolved utilizing offshore penalty determinations that were significantly less than as set forth in the 2009 OVDP. Subject to review by IRS technical advisors, examiners made penalty determinations on a case-by-case basis. However, some practitioners made "FAQ 35 submissions" for penalty relief in every case, regardless of the underlying factual scenario. As such, it became increasingly difficult to have unique factual situations properly considered by the IRS.

Following announcement of the 2011 OVDI, the IRS began eliminating agent discretion in the administration of open matters submitted under the 2009 OVDP. Instead, representatives have been advised that FAQ 50 of the 2011 OVDI has replaced FAQ 35 of the 2009 OVDP, unless "substantial information" supporting the FAQ 35 was provided before the February 8, 2011 announcement of the OVDI.

How could that be? Certainly, taxpayers submitting an application under the 2009 OVDP have the right to have the 2009 FAQs applied to their matter. Eliminating FAQ 35 consideration for taxpayers who submitted an application under the 2009 OVDP is simply unacceptable and does not support the perception of fairness in tax administration. It is believed that the foregoing is currently under reconsideration by the IRS.

***Opting out.*** If the offshore penalty is unacceptable to a taxpayer, that taxpayer must submit an irrevocable written election "opting out" of the OVDI. At that point, the examiner and manager will consider the facts of the case and how the audit process will proceed. In referring the case for examination, the examiner and manager will decide whether to refer the case for a normal examination or to a Special Enforcement Program agent. In considering the facts of the case and referring the case for examination, the examiner and manager will consult with technical advisors. All relevant years and issues will then be subject to a complete examination. At the conclusion of the examination, "all applicable penalties will be imposed."[64] Those penalties could be substantially greater than the 25 percent offshore penalty (*see* FAQ 5). If the case is unagreed, the taxpayer will have recourse to Appeals.

Even after opting out of the 2011 OVDI, taxpayers remain within Criminal Investigation's Voluntary Disclosure Practice. Therefore, they are still required to cooperate fully with the agent by providing all requested information and records and must still pay or make arrangements to pay the tax, interest and penalties they are ultimately determined to be due. If a taxpayer does not cooperate or make payment arrangements, the case may be referred back to Criminal Investigation.[65]

***Reduced five percent offshore penalty.*** Eligible taxpayers qualify for a reduced five percent offshore penalty (Examiners have no authority to negotiate a different offshore penalty percentage) if they: (i) are foreign residents and who were unaware they were U.S. citizens, or (ii) meet all four of the following conditions: (a) They 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) They have not withdrawn more than $1,000 from the account in any year covered by the voluntary disclosure except for a withdrawal closing the account and transferring the funds to an account in the United States; (c) They exercised minimal, infrequent contact with the account, for example, to request the account balance, or update accountholder information such as a change in address, contact person, or email address (this exception is not applicable if they gave the bank instructions on how to invest the funds in the accounts and signed a "hold mail" agreement to prevent the mailing of statements to the US); and (d) They 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, it will be presumed that they were funds were appropriately taxed if no information is otherwise available.

Taxpayers who participated in the 2009 OVDP whose cases have been resolved and closed with a Form 906 closing agreement who believe the facts of their case qualify them for the five percent reduced penalty criteria of the 2011 OVDI, but paid a higher penalty amount under the 2009 OVDP should provide a statement to this effect including all pertinent contact information (name, address, SSN, home/cell phone numbers), the name of the Revenue Agent assigned to their case, and a copy of their closing agreement to Internal Revenue Service, 3651 S. I H 35 Stop 4301 AUSC, Austin, TX 78741 Attn: 2009 OVDP Determination.[66]

***Reduced 12.5 percent offshore penalty.*** 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 will qualify for a 12.5 percent offshore penalty. Examiners have no authority to negotiate a different offshore penalty percentage. Taxpayers who participated in the 2009 OVDP whose cases have been resolved and closed with a Form 906 closing agreement who believe the facts of their case qualify them for the 12.5 percent reduced penalty criteria of the 2011 OVDI, but paid a higher penalty amount under the 2009 OVDP should provide a statement to this effect including all pertinent contact information (name, address, SSN, home/cell phone numbers), the name of the Revenue Agent assigned to their case, and a copy of their closing agreement to Internal Revenue Service, 3651 S. I H 35 Stop 4301 AUSC, Austin, TX 78741 Attn: 2009 OVDP Determination.



## Opting-Out: FBAR Penalty IRM Mitigation Guidelines–Still Applicable?

Taxpayer's considering opting out of the 2009 OVDP or the 2011 OVDI (or not even considering participation in the OVDI) should consult competent tax professionals. If discovered, the taxpayer may be subjected to a civil examination or a criminal investigation/prosecution. There would likely be no limit on the issues considered during these proceedings, and tax, penalty and interest could be asserted on unreported income for all affected years. The IRS may seek interview of the taxpayer and preparer (whether the taxpayer and the preparer consent to such an interview would be subject to consideration of their constitutional rights and various privileges).

Because FBAR penalties do not have a set amount, only a cap, the IRM has historically set forth penalty mitigation guidelines to assist examiners in the exercise of their discretion in applying these penalties.[67] The guidelines have a historical significance that should not be ignored in the decision to participate in or opt out of participation in the OVDI. However, the present applicability of these guidelines may be questionable given the announcement of the 2009 OVDI and the 2011 OVDP.

The mitigation guidelines have long been intended as an informal aid for the IRS examiner in determining an appropriate penalty amount. For most FBAR cases, the IRS has historically determined that if a person meets four threshold conditions they may be subject to less than the maximum FBAR penalty depending on the account balances. The threshold conditions varied slightly depending on the date of the asserted violation. For violations occurring prior to October 23, 2004, these threshold conditions are: (i) the person has no history of past FBAR penalty assessments; (ii) no money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose; (iii) the person cooperated during the examination (*i.e.*, the IRS did not have to resort to a summons to obtain nonprivileged information; the taxpayer responded to reasonable requests for documents; meetings, and interviews; or the taxpayer back-filed correct reports); and (iv) the IRS did not sustain a civil fraud penalty against the person for an underpayment for the year in question due to the failure to report income related to any amount in a foreign account. For violations occurring after October 22, 2004, the first condition was expanded to add no history of criminal tax or BSA convictions for the preceding ten years as well as no history of past FBAR penalty assessments. Otherwise, the four conditions are the same.[68]

For Pre-October 23, 2004 willful violations, the IRM mitigation guidelines provide:

- Level I: If the highest aggregate balance for all unreported accounts does not exceed $20,000, the penalty is five percent of the maximum balance during the year for each of the unreported accounts.
- Level II: If the maximum balance of an unreported account does not exceed $250,000, the penalty is 10 percent of the maximum amount during the

year for each unreported account. The maximum Level II penalty is $25,000.

- Level III: If the maximum balance of an unreported account is greater than $250,000 but does not exceed $1 million, the penalty is the lesser of: (a) 10 percent of the maximum amount in each unreported account during the year, or (b) the amount in the account as of the last day for filing the FBAR, unless this amount is less than or equal to $25,000 (in which case the penalty is $25,000, the maximum penalty in such cases, under section 5321).
- Level IV: If the maximum balance of an unreported account is greater than $1 million, the amount of the penalty is the lesser of: (a) $100,000 for each unreported account or (b) the amount in the account as of the last day for filing the FBAR unless this amount is less than $25,000 (in which case the penalty is $25,000).[69]

For violations occurring after October 22, 2004, the IRM mitigation guidelines provide:

***Nonwillful violations.***

- Level I: If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 at any time during the year, the Level I penalty would be $500 for each violation, not to exceed an aggregate penalty of $5,000 for all violations.
- Level II: If the maximum aggregate balance for all accounts to which the violations relate did not exceed $250,000 at any time during the year, the Level II penalty would be $5,000 for each violation, not to exceed not to exceed 10 percent of the maximum balance in the account during the year.
- Level III: If the maximum aggregate balance for all accounts to which the violations relate at any time during the calendar year was more than $250,000, the Level III penalty would be $10,000 for each Level III account violation, the statutory maximum for nonwillful violations.[70]

***Willful violations.***

- Level I: If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 at any time during the year, the Level I penalty would be the greater of $1,000 per violation or five percent of the maximum balance during the year of the account to which the violations relate for each violation.
- Level II: If the maximum aggregate balance for all accounts to which the violations relate did not exceed $250,000 at any time during the year, the Level II penalty would be the greater of $5,000 per violation or 10 percent of the maximum balance during the calendar year for each Level II account.
- Level III: If the maximum aggregate balance for all accounts to which the violations relate at any time during the calendar year exceeded $250,000 but did not exceed $1,000,000, the Level III penalty would be the greater of: (a) 10 percent of the maximum balance during the calendar year for each Level III account, or (b) 50 percent of the closing balance in the account as of the last day for filing the FBAR.
- Level IV: If the maximum aggregate balance for all accounts to which the violations relate at any time during the calendar year exceeded $1 million, the Level IV penalty would be the greater of: (a) $100,000 or (b) 50 percent of the closing balance in the account as of the last day for filing the FBAR.[71]

Interest does not accrue on FBAR penalties prior to assessment, therefore only the penalty amount would be owed if full payment is made in a pre-assessment case or if payment is made within 30 days after the date a notice of the penalty amount due is first mailed to the filer. Interest begins to accrue on the date the FBAR notice of penalty assessment is mailed but no interest is owed on payments received within thirty days from the date a notice of the penalty amount due is first mailed to the filer. In addition to interest, a six percent delinquency penalty applies to amounts remaining unpaid ninety days from the date a notice of the penalty amount due is first mailed to the filer.

The statute of limitations to assess a FBAR civil penalty is six years[72] even if the FBAR has not been timely filed, and once assessed, the government must bring an action in court to recover the assessed FBAR penalty within two years from the date of assessment. The statute of limitations for criminal FBAR violations is five years.[73]

## District Court Rejection of the FBAR Penalty–Helpful?

In *J. B. Williams,*[74] the district court for the Eastern District of Virginia considered the government's action to enforce its assessment of two penalties against the defendant for failing to file the FBAR in connection with two Swiss bank accounts. The district court in *Williams* concluded that the government did not meet

its burden of showing that the defendant had acted willfully. While some of the language in *Williams* may appear helpful, the facts are somewhat limiting since the government knew about the offshore accounts, the defendant knew the government knew about the offshore accounts, and the defendent's attorneys knew all of the above, and apparently didn't advise the filing of FBARs.[75] Accordingly, practitioners should exercise caution when referencing *Williams* while advising clients about the decision to participate in the OVDI or to opt out of participation.

## Historic Voluntary Disclosure Practice–Still Applicable?

Since 1952, when the first voluntary disclosure policy was established, practitioners are unaware of any situation whereby the IRS has referred a timely, truthful and complete voluntary disclosure to the Department of Justice for criminal prosecution. A truthful, timely and complete voluntary disclosure is a factor considered in the IRS decision re a possible criminal prosecution referral to the U.S. Department of Justice.[76] The taxpayer must fully cooperate with the government, make good faith arrangements to pay any tax, interest, and penalties determined to be applicable, and must disclose every aspect of noncompliance.

A disclosure is timely if it is received before the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation; the IRS has received information from a third party (*e.g.*, informant, other governmental agency or the media) alerting the IRS to the specific taxpayer's noncompliance; the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (*e.g.*, search warrant, grand jury subpoena).[77]

Importantly, IRS Voluntary Disclosure Practice describes a voluntary disclosure to include:

> (6) Examples of voluntary disclosures include: a. a letter from an attorney which encloses amended returns from a client which are complete and accurate (reporting legal source income omitted from the original returns), which offers to pay the tax, interest, and any penalties determined by the IRS to be applicable in full and which meets the timeliness standard set forth above. This is a voluntary disclosure because all elements … above are met.[78]

The Department of Justice maintains a voluntary disclosure policy that provides:

> Whenever a person voluntarily discloses that he or she committed a crime before any investigation of the person's conduct begins, that factor is considered by the Tax Division along with all other factors in the case in determining whether to pursue criminal prosecution. If a putative criminal defendant has complied in all respects with all of the requirements of the Internal Revenue Service's voluntary disclosure practice, the Tax Division may consider that factor in its exercise of prosecutorial discretion. It will consider, inter alia, the timeliness of the voluntary disclosure, what prompted the person to make the disclosure, and whether the person fully and truthfully cooperated with the government by paying past tax liabilities, complying with subsequent tax obligations, and assisting in the prosecution of other persons involved in the crime.[79]

Further, the Department's Policy Directives and Memoranda provides:

> … the Service's voluntary disclosure policy remains, as it has since 1952, an exercise of prosecutorial discretion that does not, and legally could not, confer any legal rights on taxpayers. If the Service has referred a case to the Division, it is reasonable and appropriate to assume that the Service has considered any voluntary disclosure claims made by the taxpayer and has referred the case to the Division in a manner consistent with its public statements and internal policies. As a result, our review is normally confined to the merits of the case and the application of the Department's voluntary disclosure policy set forth in Section 4.01 of the Criminal Tax Manual.[80]

FAQ 50 provides that even after opting out of the 2011 OVDI, the taxpayer will remain within Criminal Investigation's Voluntary Disclosure Practice. Therefore, they are still required to cooperate fully with the agent by providing all requested information and records and must still pay or make arrangements to

pay the tax, interest, and penalties they are ultimately determined to be due. If a taxpayer does not cooperate or make payment arrangements, the case may be referred back to Criminal Investigation.

The voluntary disclosure practice of the IRS and the Department are designed to encourage noncompliant taxpayers to come forward into compliance. Our system of tax administration requires a perception of fairness and respect for those who make a voluntary, conscious decision to come into compliance before being contacted about their previous tax indiscretions. The 2009 OVDI and the 2011 OVDP represent a formalization of the historic voluntary disclosure practice in effect for limited taxpayers and for a limited timeframe. However, these initiatives represent an important opportunity for the government to publically demonstrate the benefits to taxpayer's voluntarily coming into compliance.

## Closing Observations

The 2011 OVDI emphasizes maximum penalties by eliminating examiner discretion. It specifically includes foreign assets, real estate, foreign entities, *etc.*, in the offshore penalty calculation—especially if assets/property 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. Assuming that the assets were acquired with after tax funds or from funds that were not subject to U.S. taxation, if the assets have not yet produced any income, there has been no U.S. taxable event and no reporting obligation to disclose.

Those contemplating participation in the 2011 OVDI should immediately begin coordinating relevant information—do not wait until August 31, 2011. Consider utilizing estimates in returns if actual information is not available and, if using estimates, clearly disclose and identify, in writing, that estimates are being utilized. Tax year 2010 is included in the offshore penalty calculation (both accuracy and miscellaneous) even though the 2010 return and FBAR may be timely filed (there are exceptions to the calculation for proper reporting). There are no *de minimis* income exceptions (will the government actually pursue a taxpayer who had *de minimis* income associated with previously taxed funds in an otherwise undisclosed foreign account?).

For 2009 OVDP participants, FAQ 35 considerations seem to have been replaced in current field examinations by FAQ 50 of the 2011 OVDI although there is an implied right within 2009 OVDP for FAQ 35 consideration. Hopefully the IRS will reconsider this position.

What to expect for those opting-out of the 2009 OVDP or the 2011 OVDI or for those who fail to participate in the OVDI by August 31, 2011? Full examinations? How many tax years? Taxpayer and return preparer interviews? Maximum civil penalties? Criminal investigations? Will Congress later enact a death penalty for noncompliant taxpayers?

With respect to the reduced five percent offshore penalty for funds deposited after December 31, 1990, it will be difficult to demonstrate whether such funds were appropriately taxed before being deposited. The taxpayer would have to identify the source of the deposit and, if the source was taxable in the U.S., prove that US income tax was paid on those funds. In the absence of such proof, per FAQ 52, the taxpayer is not entitled to the reduced five percent offshore penalty.

Example 3 of FAQ 52 provides that a taxpayer will not be entitled to the reduced five percent offshore penalty if they gave the bank instructions on how to invest the funds in the accounts and signed a "hold mail" agreement to prevent the mailing of statements to the U.S. Many taxpayers gave "hold mail" instructions to the foreign institutions. What if the taxpayer either gave the bank instructions on how to invest the funds in the accounts or signed a "hold mail" agreement to prevent the mailing of statements to the U.S. Would they be entitled to the reduced penalty?

The IRS maintains an FBAR Hotline at 800.800.2877 (Select option 2). Further, questions can be submitted about the FBAR rules by e-mail addressed to *FBAR-Questions@irs.gov*. Practitioners having questions regarding the 2011 OVDI should call the OVDI Practitioner Hotline at 267-941-0020 or contact the nearest IRS Criminal Investigation office.

Without secrecy, tax havens have little purpose. For various tax and nontax reasons, some wealthy Americans continue to maintain undisclosed financial interests in supposedly secret foreign accounts having believed claims that bank secrecy in certain tax haven countries was "impenetrable." Many felt such secrecy could be further enhanced through layers of foreign trusts and corporations designed to conceal the actual ownership

and control of the foreign accounts. This remains a target-rich environment for the government.

The IRS is committed to enforcement concerning offshore accounts and can be expected to continue to enhance these efforts. Recent enforcement efforts and the changing environment concerning bank secrecy may lead the government to many overly optimistic taxpayers with undisclosed interests in foreign financial accounts. However, the IRS simply will not be able to locate the vast majority of foreign account holders through enforcement efforts alone. The government should provide ongoing guidance for civil penalties and criminal sanctions to encourage future voluntary disclosures following the August 31, 2011 conclusion of the 2011 OVDI. Enhancing overall future compliance is an extremely worthwhile endeavor, even if a few volunteers are allowed to survive in the process.

Tax evasion, in any form, is not for the faint of heart. Wealthy taxpayers stashing funds in hidden foreign accounts are not typically sympathetic figures but they will usually recognize the longterm benefits of coming into compliance, if properly advised. Be prepared … for heightened IRS enforcement in the international arena … to continue indefinitely!

## Endnotes

1 *See* 31 U.S.C. § 5311–5330 and 31 CFR Chapter X (Effective March 1, 2011; formerly 31 CFR Part 103 through February 28, 2011).
2 IRS Commissioner Douglas H. Shulman, March 26, 2009.
3 Statement by IRS Commissioner Douglas H. Shulman (IR-2011-14, October 26, 2009).
4 *See* 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers (FAQ).
5 *Id.*
6 FAQ 52 of the 2011 OVDI.
7 FAQ 53 of the 2011 OVDI.
8 FAQ 52 and 53 of the 2011 OVDI.
9 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: (i) The date the penalty was assessed; or (ii) 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).
10 Available online at *www.irs.gov/pub/irs-pdf/f90221.pdf*.
11 31 U.S.C. § 5314; 31 C.F.R. §§103.24 and 103.32.
12 31 C.F.R. §§103.24 and 103.32.
13 31 C.F.R. § 103.56(g); The delegation includes the authority to investigate possible FBAR civil violations, provided in Treasury Directive No. 15-41 (December 1, 1992), and the authority to assess and collect the penalties for violations of the reporting and recordkeeping requirements.
14 31 C.F.R. §103.56(c)(2).
15 IRM 4.26.17.
16 31 U.S.C. § 5314.
17 *See* Michael Karlin, *FBAR Ram You: The meaning of Residence for FBAR Purposes*, Journal of Tax Practice and Procedure (March–April 2011) and IRM 4.26.16.3.1.1 (07-01-2008).
18 IRM 4.26.16.3.2 (07-01-2008).
19 *Id.*
20 IRM 4.26.16.3.3 (07-01-2008).
21 *Id.*
22 *Id.*
23 IRM 4.26.16.3.4 (07-01-2008).
24 IRM 4.26.16.3.5 (07-01-2008).
25 *Id.*
26 IRM 4.26.16.3.6 (07-01-2008).
27 *Id.*
28 31 C.F.R. 103.32; IRM 4.26.16.3.8 (07-01-2008).
29 *Id.*
30 IRM 4.26.16.4 (07-01-2008).
31 *See* Steve Toscher and Barbara Lubin of Hochman, Salkin, Rettig, Toscher & Perez, PC, *When Penalties Are Excessive—The Excessive Fines Clause as a Limitation on the Imposition of the Willful FBAR Penalty*, Journal of Tax Practice and Procedure (December 2009–January 2010).
32 31 U.S.C. § 5321(a)(5).
33 31 U.S.C. § 5321(a)(5)(B).
34 IRM 4.26.16.4.4 (07-01-2008).
35 31 U.S.C. § 5321(a)(5)(C); IRM 4.26.16.5.5 (07-01-2008).
36 *Id.*
37 IRM 4.26.16.5.3 (07-01-2008).
38 *Id.*
39 *Id.*
40 *Id.*
41 *Id.*
42 IRM 4.26.16.5.4 (07-01-2008).
43 *Id.*
44 The 2011 Offshore Voluntary Disclosures Letter is available online at *www.irs.gov/pub/irs-utl/2011-ovdi-irs-ci-letter-01-31-2011.doc*.
45 The 2011 Offshore Voluntary Disclosures Package includes various documents and forms available online at *www.irs.gov/newsroom/article/0,,id=235584,00.html*.
46 The Foreign Account or Asset Statement is available online at *www.irs.gov/pub/irs-utl/2011ovdiforeignaccountstatement.pdf*.
47 The Penalty Computation worksheet is available online at *www.irs.gov/pub/irs-utl/2011ovdioffshorepenaltycomputationworksheet.xls*.
48 The Form 872 is available online at *www.irs.gov/pub/irs-utl/f872ovdi.pdf* and the Consent to Extend the Time to Assess Civil Penalties Provided by 31 U.S.C. §5321 for FBAR Violations is available online at *www.irs.gov/pub/irs-utl/2011_ovdi_consent_to_extend_fbar_statute.pdf*.
49 The Foreign Financial Institution Statement is available online *at www.irs.gov/pub/irs-utl/2011ovdifinancialinstitutionstatement.pdf*.
50 The Statement on Dissolved Entities is available online at *www.irs.gov/pub/irs-utl/2011ovdidissolutionstatement.pdf*.
51 FAQ 27 of the 2011 OVDI.
52 *Id.*
53 FAQ 31-32 of the 2011 OVDI.
54 FAQ 33 of the 2011 OVDI.
55 FAQ 34 of the 2011 OVDI.
56 FAQ 35 of the 2011 OVDI.
57 FAQ 36 of the 2011 OVDI.
58 FAQ 38-39 of the 2011 OVDI.
59 FAQ 40-41 of the 2011 OVDI.
60 FAQ 47 of the 2011 OVDI.
61 FAQ 49 of the 2011 OVDI.
62 FAQ 50 of the 2011 OVDI.
63 FAQ 35 of the 2009 OVDP.
64 FAQ 51 of the 2009 OVDP.
65 FAQ 69 of the 2011 OVDI.
66 FAQ 52 of the 2011 OVDI.
67 IRM 4.26.16.4.5.6 and IRM 4.26.16.4.6 (07-01-2008).
68 IRM 4.26.16.4.6.1 (07-01-2008).
69 IRM 4.26.16.4.6.2 (07-01-2008).
70 IRM 4.26.16.4.6.3 (07-01-2008).
71 *Id.*
72 31 USC § 5321(b)(1).
73 18 U.S.C. § 3282. This section provides that except as otherwise expressly provided by law, no person shall be prosecuted, tried, or punished for any noncapital offense, unless the indictment is found or the information is instituted within five years next after such offense shall have been committed.
74 J.B. Williams, DC-VA, 2010-2 USTC ¶50,623, 2010 U.S. Dist. LEXIS 90794.
75 *See* Kathryn Keneally and Charles Rettig, *The*

## ENDNOTES

*FBAR Penalty: One Court Disagrees with the IRS,* JOURNAL OF TAX PRACTICE AND PROCEDURE (December 2009–January 2010).

[76] IRM 9.5.11.9 (June 26, 2009).

[77] *Id.*

[78] *Id.*

[79] Section 4.01, Criminal Tax Manual, U.S. Department of Justice (2008).

[80] Section 3, Policy Directives and Memoranda, Tax Division, U.S. Department of Justice (02/17/1993).