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Act II: IRS Announces Another Offshore Voluntary Disclosure Program

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For years, the Internal Revenue Service (“IRS”) has been aggressively pursuing the disclosure of unreported foreign accounts and assets held by U.S. taxpayers, including offering certain voluntary disclosure programs featuring reduced penalties in exchange for U.S. taxpayer compliance. On February 8, 2011, the IRS announced the details of its latest voluntary disclosure program, known as the 2011 Offshore Voluntary Disclosure Program (the “2011 OVDP”). The 2011 OVDP follows on the heels of a similar program offered in 2009, which, by most accounts, attracted several thousand U.S. taxpayers. Similar to its predecessor, the objective of the 2011 OVDP is to bring U.S. taxpayers that have undisclosed foreign accounts and/or undisclosed foreign entities into compliance with U.S. tax laws.

The 2011 OVDP offers U.S. taxpayers the chance to resolve their U.S. tax liabilities associated with undisclosed foreign accounts and entities through a reduced penalty framework and a minimized chance of criminal prosecution. Although the penalty framework for the 2011 OVDP is generally higher than in 2009, it provides a fixed penalty framework that seems to remove any discretion from IRS examiners to negotiate a different offshore penalty percentage. Taxpayers that have voluntarily disclosed to the IRS financial

accounts after the October 15, 2009 deadline to participate in the first special voluntary disclosure program also will be eligible to take advantage of the special provisions of the 2011 OVDP.

Eligible U.S. taxpayers (both individuals and entities) participating in the 2011 OVDP have until August 31, 2011 to file all original and amended tax returns, make full payment (or make payment arrangements) of all unpaid U.S. taxes, interest, delinquency and/or accuracy-related penalties for tax years 2003-2010 (the "Reporting Period") and, to the extent applicable, enter into certain closing agreements and/or agreements to extend the period for which to assess U.S. tax. In addition to the penalties based on failure to pay U.S. taxes, there are several offshore-related information return penalties, including a civil penalty for failure to report foreign bank accounts, commonly known as an "FBAR." The existing FBAR-related civil penalty alone can be as high as the greater of US\$100,000 or 50% of the total balance of the foreign account per violation (i.e., each calendar year in which the failure to report occurs). Under the 2011 OVDP, U.S. taxpayers will not be required to pay any offshore-related information return penalties, including the FBAR-related penalty, but will be required to pay an in lieu civil penalty (the "In Lieu Penalty"), which penalty is less onerous than the offshore-related information return penalties, combined, in terms of percentage and number of violation years, as described below.

In general, under the 2011 OVDP, the In Lieu Penalty is equal to 25% of the highest aggregate balance of the U.S. taxpayer's previously undisclosed foreign account (including the fair market value of certain assets in undisclosed offshore entities and other foreign assets) held during the Reporting Period. Only one In Lieu Penalty will be applied to a voluntary disclosure relating to the same account or asset. The In Lieu Penalty may be allocated among multiple U.S. taxpayers holding beneficial ownership interests in the foreign account, offshore entity, or foreign asset in any manner chosen.

Under limited circumstances, U.S. taxpayers may be eligible for a reduced In Lieu Penalty. If a U.S. taxpayer maintains an aggregate foreign account balance for all years during the Reporting Period of less than US\$75,000 (including the fair market value of any assets in undisclosed foreign entities and the fair market value of any foreign assets that were either acquired with improperly untaxed funds or produced improperly untaxed income), the In Lieu Penalty is reduced to 12.5% of the highest aggregate foreign account balance (including the fair market value of certain assets in undisclosed offshore entities and other foreign assets) held during the Reporting Period.

Under even more limited circumstances, U.S. taxpayers may be eligible for a further reduced In Lieu Penalty. An In Lieu Penalty of 5% of a U.S. taxpayer's highest aggregate foreign account balance (including the fair market value of certain assets in undisclosed offshore entities and other foreign assets) held during the Reporting Period will be applied if such U.S. taxpayer meets either of the following criteria: (1) a foreign resident who was unaware he or she was a U.S. citizen; or (2) a U.S. taxpayer who (a) did not open or cause to be opened the foreign account, (b) exercised minimal, infrequent contact with the account, (c) except for a withdrawal closing the account and transferring the funds to a U.S.-based account, did not withdraw more than US\$1,000 from the account in any year during the Reporting Period, and (d) can establish that all applicable U.S. taxes have been paid on funds deposited to the account (i.e., only account earnings have been previously unreported). Based on the foregoing, it is unlikely that many U.S. taxpayers will qualify for the 5% In Lieu Penalty. U.S. taxpayers that participated in the 2009 special voluntary disclosure program who believe that the facts of their case qualify them for the 5% In Lieu Penalty, but who paid a higher penalty, also may qualify for this reduced penalty under the 2011 OVDP.

The 2011 OVDP penalty framework and benefits of participation may be illustrated by numerical example. Assume a U.S. taxpayer in the 35%

marginal tax bracket deposited US\$1,000,000 in a foreign account in 2003. The foreign account was unreported. The account earned \$50,000 of interest per year during the Reporting Period. By 2010, the account had a balance of \$1,400,000, which amount was the highest recorded value during the Reporting Period. If the U.S. taxpayer makes voluntary disclosure under the 2011 OVDP, and such disclosure is accepted by the IRS, the U.S. taxpayer would be expected to pay the following amounts: (1) income tax of \$140,000 (8 years at \$17,500 per year) plus interest, (2) an accuracy-related penalty of \$28,000 (i.e., \$140,000 x 20%), and (3) the In Lieu Penalty of \$350,000 (\$1,400,000 x 25%). The total payment would be \$518,000. If the U.S. taxpayer opted not to participate in the 2011 OVDP and the IRS subsequently discovered the foreign account, the U.S. taxpayer could be liable for approximately five times more than the amount paid under the 2011 OVDP (i.e., \$2,600,000) based on applicable taxes, interest and penalties. In addition, the U.S. taxpayer could be subject to criminal prosecution.

As such, a U.S. taxpayer with undisclosed foreign accounts, entities and/or other assets who is considering participating in the 2011 OVDP should carefully examine all potential penalties and evaluate potential exposure to criminal prosecution. For this purpose, it is strongly recommended that such person seek the advice of a qualified tax professional well in advance of the August 31, 2011 deadline.

If you would like more information concerning the 2011 OVDP, please do not hesitate to contact us.