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THE 2011 OFFSHORE VOLUNTARY DISCLOSURE INITIATIVE (APRIL 13, 2011)

On February 8, 2011, the IRS announced its 2011 Offshore Voluntary Disclosure Initiative (the “2011 OVDI”) for taxpayers with undisclosed or under-reported offshore accounts.¹ The terms of the 2011 OVDI are summarized in that announcement and documented in detail in a Frequently Asked Questions document posted to the IRS’s website.² The following is a summary of the 2011 OVDI, its benefits, and the process taxpayers wishing to participate need to follow.

Background

Generally, a U.S. citizen or permanent resident is required to report and pay tax on “all income from whatever source derived” which includes income on offshore assets.³ In addition, U.S. taxpayers⁴ are required to disclose the existence of all offshore financial accounts above a certain size both in their income tax returns⁵, but also to the U.S. Treasury in Form TD 90-22.1⁶. This disclosure requirement and the Treasury form for disclosure are referred to as FBAR (Foreign Bank Account Reporting). Failure in either

¹ IR 2011-14, February 8, 2011, available at <http://www.irs.gov/newsroom/article/0,,id=235695,00.html>.

² 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, available at <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html> (“2011 OVDI FAQ”).

³ IRC § 61(a).

⁴ While 31 C.F.R. § 103.24 applies to “[e]ach person subject to the jurisdiction of the United States,” Form TD 90-22.1 traditionally has only applied to U.S. citizens and residents. In October of 2008, the IRS published a revised TD 90-22.1 with instructions more in line with the regulations. After significant outcry, those instructions’ effective date has been delayed. See, e.g. Announcement 2009-51. For this article, I ignore the difference between this standard and U.S. taxpayers.

⁵ See, e.g. the 2010 Form 1040 Schedule B Part III available at <http://www.irs.gov/pub/irs-pdf/f1040sb.pdf>.

⁶ Available at <http://www.irs.gov/pub/irs-pdf/f90221.pdf>.

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the tax or FBAR requirements, as discussed in more depth below, gives rise to both civil monetary penalties as well as potential federal criminal prosecution.

Nevertheless, U.S. taxpayers sometimes move money and investment assets offshore and do not report income from those assets. Taxpayers that have not reported offshore assets for some time can find themselves too afraid of penalties for past failures to disclose to start complying. The 2011 OVDI allows these taxpayers a way to come forward in exchange for a significantly reduced monetary cost and no criminal prosecution.

In 2009, in connection with a lawsuit against UBS to identify U.S. taxpayers with offshore accounts, the IRS announced a similar program (the “2009 OVDI”). The 2009 OVDI closed October 15, 2009.⁷ As compared to the 2009 OVDI, however, the 2011 OVDI generally imposes a higher penalty and has tougher requirements. However, for any U.S. taxpayer with undisclosed offshore assets who did not participate in the 2009 OVDI, the 2011 OVDI is a great opportunity that should be taken seriously.

Penalty Framework

The key feature of the 2011 OVDI is its penalty framework. The cornerstone of the framework is a limited disclosure period from 2003 through 2010.⁸ Penalties and disclosures are required only for these years, and not for prior years. Participants in the 2011 OVDI are expected to pay:

- (a) the amount by which tax was understated on the taxpayers’ original (or amended as applicable) returns for each year of the disclosure period;
- (b) interest on that understatement of tax;
- (c) 20% of that understatement under the accuracy-related penalty of IRC § 6662(a);
- (d) if the taxpayer failed to file returns for those years or failed to pay the amount shown on their returns, any relevant failure to file or failure to pay penalties; and
- (e) in lieu of all other penalties, including penalties for failure to file FBAR returns, a general penalty equal to 25% (except in special cases discussed below) of the highest aggregate balance in foreign accounts and entities (the “Special Offshore Penalty”).⁹

These amounts are determined only with respect to the limited disclosure period. For example, tax on understated income from years before 2003 are not part of the penalty framework and higher aggregate balances from before 2003 are not considered for the Special Offshore Penalty.

The Special Offshore Penalty is reduced from 25% to 5% for foreign residents that were unaware that they were U.S. citizens or for taxpayers who meet certain narrow and specific requirements intended to identify minor offshore holdings not actively managed by the taxpayer.¹⁰ Similarly, it is reduced to 12.5% for any

⁷ The 2009 OVDI deadline was originally September 23, 2009, but the IRS extended the deadline in IR-2009-84, Sept. 21, 2009.

⁸ 2011 OVDI FAQ # 9.

⁹ 2011 OVDI FAQ # 7.

¹⁰ 2011 OVDI FAQ # 52.

2011 OVDI participant who does not qualify for the 5% rate but whose highest aggregate account balance never exceeds \$75,000 during the disclosure period.¹¹ Finally if a 2011 OVDI participant would be subject to a lower penalty for failure to file FBAR returns outside of the 2011 OVDI, then the participant's Special Offshore Penalty will not exceed that lesser amount.¹² The penalty outside the 2011 OVDI for failure to file FBAR returns is discussed further below.

As part of the penalty framework, the IRS has also published a simplified method for passive foreign investment company ("PFIC") income.¹³ These PFIC rules often apply to offshore financial institutions' common investment management pools and other investment funds based outside of the U.S. Special rules apply to the PFIC income, which must be taken into consideration in determining the taxable income of a taxpayer holding interest in a PFIC. A significant number of 2009 OVDI cases included PFIC issues without sufficient information available to apply the ordinary PFIC rules. This simplified method is an attempt to resolve these problems. Taxpayers participating in the 2011 OVDI may, but are not required to, use this alternative method to determine their PFIC income during the limited disclosure period. It does not appear, however, that taxpayers participating in the 2011 OVDI will be allowed to continue to use this method in subsequent tax years.

Benefits

The primary benefit of the 2011 OVDI is the limited disclosure period. While there are statutory limitations on how far back the IRS can assess unpaid taxes, willful failure to report offshore assets is generally considered a form of fraud, which eliminates any such limitation on assessment.¹⁴ Accordingly, outside of an OVDI, the IRS often can assess taxes and penalties for all years, no matter how old the offshore accounts are. For taxpayers with a longer history of unreported offshore assets, the limited disclosure period can significantly reduce the underlying cost of coming into compliance, whether voluntary or not. In addition, it significantly reduces the cost in time for the taxpayer and his or her accountants and attorneys obtaining and reviewing banking records and preparing the amended tax returns.

Also of significant benefit is the 2011 OVDI's elimination of criminal penalties. For a taxpayer who has willfully failed to report offshore assets and income, the IRS can bring criminal charges for tax evasion¹⁵ and filing a false tax return¹⁶. The taxpayer can also be subject to criminal penalties for willful failure to file FBAR reports.¹⁷ For each of these charges, a taxpayer can be subject to between two and ten years in prison in addition to substantial criminal fines and civil monetary penalties. Even for taxpayers not concerned with the monetary penalties, eliminating the specter of criminal prosecution can justify participation in the 2011 OVDI.

¹¹ 2011 OVDI FAQ # 53.

¹² 2011 OVDI FAQ # 50.

¹³ 2011 OVDI FAQ # 10.

¹⁴ IRC § 6501(c)(1).

¹⁵ IRC § 7201.

¹⁶ IRC § 7206(1)

¹⁷ 31 U.S.C. § 5322(b).

The 2011 OVDI penalty framework, while significant, is still significantly lower than the monetary civil penalties for understating income or failure to file certain reports on offshore income or assets. These penalties are generally cumulative outside of the 2011 OVDI and are largely eliminated in the 2011 OVDI.

The failure to include all income in a filed return carries significant civil monetary penalties. These penalties can range from the 20% understatement penalty discussed above to a penalty of 75% of any understatement “attributable to fraud.”¹⁸ In the case of willfully concealed offshore accounts, the IRS is likely to assert the full 75% penalty. These penalties are in addition to tax and interest on the understatement, and can significantly increase the exposure for undeclared offshore assets. The 2011 OVDI penalty framework is limited to the 20% penalty, a significant savings over the potential 75% penalty.

Willful failure to file required FBAR reports carries a civil penalty, in addition to criminal penalties, as high as the greater of \$100,000 or 50% of the total balance for that year.¹⁹ This penalty applies for each annual form not filed, so could apply once for each year the offshore account existed. For offshore assets above a minimum amount for which no FBAR reports are filed, this can be a significant source of exposure. This penalty is waived as part of the Special Offshore Penalty, which cannot exceed the amount of this penalty.

In addition to including income from offshore accounts and entities in a taxpayer’s tax return and FBAR reports, taxpayers are required to file a series of information returns with the IRS based on their offshore activities. For example, there is Form 8865 Return of U.S. Persons With Respect to Certain Foreign Partnerships, Form 5471 Information Return of U.S. Persons with Respect to Certain Foreign Corporations, and Form 3520 Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Failure to file any of these forms where appropriate carries potentially significant penalties. For example, failure to file Form 3520 Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts carries a penalty of up to 25% of the unreported gift.²⁰ These penalties are also waived as part of the Special Offshore Penalty.

Deadline and Timeline

The 2011 OVDI application deadline is August 31, 2011.²¹ While the IRS extended the 2009 OVDI deadline, there is no indication that the IRS will similarly extend the 2011 OVDI deadline. While this seems like a significant amount of time, taxpayers wishing to take advantage of the 2011 OVDI must start the process quickly.

Unlike the 2009 OVDI, the taxpayer’s application must be complete and submitted by this date, including all disclosures, amended tax returns, and payment.²² In the 2009 OVDI, taxpayers merely had to request

¹⁸ IRC § 6663(a).

¹⁹ 31 U.S.C. § 5321(a)(5)(C).

²⁰ IRC § 6039F(c)(1)(B).

²¹ 2011 OVDI FAQ # 1.

²² 2011 OVDI FAQ # 25.

admission into the program by the deadline and were then given a reasonable amount of time to complete the application.

Gathering all of the information needed to prepare the returns takes a significant amount of time. While some taxpayers with offshore assets have kept detailed records, most have not. In fact, some offshore banks go out of their way to prevent customers from taking bank statements out of the bank. While this seems odd, it is based on the assumption that if those statements leave, they may no longer be protected by local bank secrecy laws. Even for offshore banks aware of the 2009 OVDI and going out of their way to help clients prepare for it, it took weeks or months to obtain complete sets of records. Some smaller institutions have difficulty gathering the necessary documentation. Because U.S. taxpayers are responsible for maintaining sufficient books and records to prepare their returns²³, the lost information is assumed to cut against the taxpayer²⁴. In addition, for taxpayers over a minimum amount of offshore assets discussed below, these records must be provided to the IRS as part of the 2011 OVDI.²⁵

After all of the information is gathered, it may not be in a suitable format or maintained according to U.S. tax accounting principles. Domestic banks are required to prepare and provide customers statements which summarize all relevant information for U.S. tax purposes.²⁶ These are often built into an end-of-year statement or take the form of a Form 1099. Offshore banks may not do so, and if they do, these statements may not be prepared according to U.S. tax accounting principles. So, while accountants ordinarily use these bank-provided U.S. tax summaries to reduce the amount of time required to prepare returns, for OVDI returns they must often review every transaction in detail and create these summaries themselves. As many offshore banks actively trade assets on behalf of clients, sometimes through common investment funds subject to the PFIC rules, this can be significant numbers of transactions requiring significant efforts to prepare tax returns. Also, while domestic banks generally maintain accounts in U.S. dollars, offshore institutions frequently do not do so. This further complicates determining income, because currency fluctuations must be taken into consideration.

Once all of the information is gathered and summarized, preparing the returns can also be more time consuming than returns based on purely domestic assets and income. Multiple years' returns are required for the 2011 OVDI. Individually those returns can require more work due to the fact that they must incorporate specialized U.S. international tax rules.

Applicability

The 2011 OVDI is not appropriate for all taxpayers with unreported income. First, the 2011 OVDI only applies to “[t]axpayers who have undisclosed offshore accounts or assets,” so taxpayers whose underreported

²³ IRC § 6001.

²⁴ IRC § 7491(a)(1) (burden of proof shifts to IRS once the taxpayer has introduced credible evidence).

²⁵ 2011 OVDI FAQ # 7.

²⁶ See, e.g. IRC § 6049 (information returns of persons paying interest, such as in a Form 1099-INT).

income is only from domestic sources may not participate.²⁷ Similarly, taxpayers whose unreported income is from offshore services, not offshore assets, may not participate. Also, the 2011 OVDI is not available for taxpayers for whom the IRS has initiated either civil or criminal examinations.²⁸

In addition, the 2011 OVDI is not appropriate for taxpayers that have correctly reported all income from offshore accounts but failed to file FBAR reports. However, in the 2011 OVDI FAQ, the IRS has provided for these taxpayers, stating that they should instead merely file the delinquent FBAR reports. The IRS “will not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities and the FBARs are filed by August 31, 2011.”²⁹ The same applies to taxpayers that have correctly reported income but failed to file information returns with respect to offshore entities, such as the Form 5471 Information Return of U.S. Persons With Respect To Certain Foreign Corporations.³⁰

However, taxpayers who have previously amended returns to include previously unreported offshore accounts and income without otherwise notifying the IRS of the nature of the issue (a so-called “quiet” or “silent” disclosure) may apply for the 2011 OVDI and take advantage of its reduced penalty framework.³¹

Process

Generally, the OVDI process starts with a taxpayer sending an application letter to the IRS’s Criminal Investigation division Voluntary Disclosure Coordinator. This letter must contain specific information and statements. The IRS provides a form letter with all of the requirements.³² The 2011 OVDI form is generally similar to the 2009 OVDI form, although there are some significant differences, such as the different voluntary disclosure period. The letter starts out by identifying the taxpayer by name, social security number, date of birth, address, passport number, and occupation. The taxpayer must answer certain questions regarding whether or not they are aware of relevant audits or investigations. The letter must include a history of the offshore assets including brief explanations of the source of the funds, the purpose for establishing the accounts, and lists of affiliated persons and entities. The letter must also include details of the communication with offshore banking institutions, including names, dates, and locations of meetings. While the letter requires estimates of unreported income by year and highest aggregate value by year, the taxpayer only needs to indicate the relative sizes of these figures by checking a box for the applicable range (“\$0 to \$100,000,” “\$100,000 to \$1,000,000”, etc.).

One problem with the 2009 OVDI was that taxpayers sending in the application letter did not necessarily know if they qualified for the program. Like the 2011 OVDI, the 2009 OVDI was not open to taxpayers for whom the IRS had initiated criminal investigation. At the time, the IRS was in the process of obtaining names of US taxpayers with UBS Swiss accounts, and there was some question whether a UBS Swiss

²⁷ 2011 OVDI FAQ # 12.

²⁸ 2011 OVDI FAQ # 14.

²⁹ 2011 OVDI FAQ # 17.

³⁰ 2011 OVDI FAQ # 18.

³¹ 2011 OVDI FAQ # 15.

³² Available at <http://www.irs.gov/pub/irs-utl/2011-ovdi-irs-ci-letter-01-31-2011.doc>.

account holder had yet been disclosed and whether the IRS had yet initiated a criminal investigation into that taxpayer. But this problem was and is not limited to UBS account holders. Both the 2009 and 2011 form application letter ask the taxpayer if they are aware of any criminal investigation, but taxpayers are not always immediately aware when a criminal investigation starts.

To resolve this problem, the IRS added a pre-clearance option to the 2011 OVDI. Before a taxpayer sends in the application letter, he or she can, but is not required to, request a pre-clearance from the IRS Criminal Investigation Lead Development Center (“IRS LDC”). The LDC will notify the taxpayer if they are cleared to enter the 2011 OVDI. This notice is not an acceptance into the program or a guarantee that the taxpayer is eligible—it only provides that the taxpayer has not yet under investigation and therefore become affirmatively disqualified from the 2011 OVDI. The pre-clearance notice is effective for 30 days, and taxpayers failing to submit the OVDI application letter within that time may be disqualified by investigations commenced after the pre-clearance was issued or which were overlooked in issuing the pre-clearance.³³

Once Criminal Investigations has received the application letter, whether or not the taxpayer participated in the pre-clearance option, it will make a preliminary determination whether the taxpayer should be accepted or declined admission to the 2011 OVDI. This determination is, of course, subject to the taxpayer completing the remaining requirements for the 2011 OVDI before the August 31 deadline. The IRS has stated that “it is intended that Criminal Investigation will complete [this preliminary determination] within 30 days” of receipt of the application letter, although there are no guarantees. Taxpayers up against the August 31 deadline may be forced to submit the remaining information and payment before the preliminary determination has been made.

While some state and federal tax voluntary disclosure programs allow taxpayers to start the process anonymously, the 2011 OVDI does not.³⁴ The pre-clearance request requires certain identifying information including name and social security number, as does the application letter. Generally, this is true of all IRS voluntary disclosure practice, not just the OVDI programs. Some taxpayers worry that a failed voluntary disclosure will provide the IRS a road-map for audit and collections. For most cases, there is little that can be done about this risk other than making sure to make a complete disclosure and fully comply with the terms of the 2011 OVDI. If, however, a taxpayer’s situation poses specific complications, the IRS is generally willing to discuss anonymous hypotheticals with taxpayer’s representative on a non-binding basis, helping to reduce the uncertainty around novel situations. However, these discussions should only be considered a preliminary to a 2011 OVDI application for special circumstances.

³³ 2011 OVDI FAQ # 23.

³⁴ While 2011 OVDI FAQ # 22 discusses the IRS’s willingness to discuss anonymous hypotheticals through taxpayer representatives, it specifically mentions that “posing a situation as a hypothetical does not satisfy the requirements for making a voluntary disclosure.”

The preliminary acceptance into the 2011 OVDI is only the beginning of the application process. The taxpayer must still provide a package of information to the IRS containing the following³⁵:

- (a) previously filed original, and amended if applicable, returns for each year of the disclosure period;
- (b) amended returns for each year of the disclosure period correctly reflecting the income from the previously undisclosed offshore assets;
- (c) a 2011 OVDI specific form Foreign Account or Asset Statement³⁶ for each previously undisclosed account or asset;
- (d) if the taxpayer's aggregate highest account balance in any year is \$500,000 or more, a copy of offshore account statements reflecting all account activity during the voluntary disclosure period;
- (e) if the taxpayer's aggregate highest account balance in any year is \$1,000,000 or more, a 2011 OVDI specific form Foreign Financial Institution Statement³⁷ for each financial institution involved in previously undisclosed financial accounts or transactions;
- (f) a 2011 OVDI specific form Penalty Computation Worksheet³⁸ ;
- (g) a taxpayer executed consent to extend the period of time to assess tax³⁹;
- (h) a taxpayer executed consent to extend the period of time to assess FBAR penalties⁴⁰; and
- (i) a check payable to the Department of Treasury in the amount due under the penalty framework described above or other arrangements to pay.

The 2011 OVDI allows participating taxpayers who cannot afford to make a full payment to make alternative arrangements for payment. To qualify, the taxpayer must prove that he cannot pay, based on "full disclosure of all assets and income sources, domestic and offshore, under the taxpayer's control."⁴¹ While the IRS will negotiate with the taxpayer, the taxpayer must come to an arrangement acceptable to the IRS in order to be accepted into the 2011 OVDI.⁴² Failure to do so could mean disqualification from the 2011 OVDI.

Once the IRS has received the complete package, the agent assigned to review the OVDI application will review the amended returns in depth, correlating them to the financial records and other information provided. If the agent needs clarification on some aspect of the returns or documentation, he generally will discuss that clarification with the taxpayer or with his representative. It is possible that the agent will require additional written information or amendments to the OVDI application, which may or may not be required before the August 31 deadline. It is normally at this point that any differences of application of tax law, interpretation of the facts, or methodology for assembling the returns are hashed out between the

³⁵ 2011 OVDI FAQ # 25.

³⁶ Available at <http://www.irs.gov/pub/irs-utl/2011ovdiforeignaccountstatement.pdf>.

³⁷ Available at <http://www.irs.gov/pub/irs-utl/2011ovdifinancialinstitutionstatement.pdf>.

³⁸ Available at <http://www.irs.gov/pub/irs-utl/2011ovdioffshorepenaltycomputationworksheet.xls>.

³⁹ Available at <http://www.irs.gov/pub/irs-utl/f872ovdi.pdf>.

⁴⁰ Available at http://www.irs.gov/pub/irs-utl/2011_ovdi_consent_to_extend_fbar_statute.pdf.

⁴¹ 2011 OVDI FAQ # 20.

⁴² Id.

taxpayer and the IRS. In order to proceed, the agent will be required to certify the returns as accurate, signing off on their correctness given the information available.⁴³

As with a general voluntary disclosure the process ends with a closing agreement on IRS Form 906.⁴⁴ In a general voluntary disclosure case, this agreement is often negotiated and exchanged multiple times between the IRS and the taxpayer. However, in an OVDI case, the penalty framework is well-defined and not subject to individual IRS agent discretion, so the closing agreement is much less likely to be the subject of discussion.⁴⁵ Any such issues are most likely resolved during the review of the amended returns. Generally, the IRS agent will send three copies of the closing agreement to the taxpayer. One is for the taxpayer to retain and two copies must be returned to the IRS with original taxpayer signatures. A designated IRS employee will then execute the returned copies on behalf of the Commissioner, returning one fully-executed copy to the taxpayer for his or her records. In cases involving multiple taxpayers, these numbers are adjusted to make sure that all taxpayers receive a fully executed copy. The closing agreement is not effective until signed on behalf of the Commissioner.⁴⁶

Summary

The 2011 OVDI provides a significant opportunity for taxpayers with undisclosed offshore accounts to come into compliance and reduce civil and criminal monetary penalties as well as eliminate criminal prosecution for tax fraud or filing a fraudulent return. While the 2011 OVDI is not available to everyone with offshore accounts, and application requires significant efforts, the 2011 OVDI is intended to be highly available and inclusive. However, in order to make the August 31 deadline, you need to start as soon as possible.

However, there are still opportunities if you miss the 2011 OVDI. From quiet disclosure to the IRS's general voluntary disclosure practice, it may still be possible to manage possible consequences while addressing historic noncompliance.

If you have any questions about this article, are interested in more information about the 2011 OVDI, or would like to explore alternatives to the 2011 OVDI, please do not hesitate to contact me. If you do not but still have undisclosed offshore assets or other noncompliance, please discuss the 2011 OVDI and other options with your tax advisors.

⁴³ 2011 OVDI FAQ # 25.

⁴⁴ Available at http://www.irs.gov/pub/irs-utl/form_906.pdf.

⁴⁵ 2011 OVDI FAQ # 49 specifically discusses the fact that closing agreement mediation through the IRS Appeals division is not available in the 2011 OVDI. By comparison, Appeals mediation is a not uncommon feature of a general voluntary disclosure case.

⁴⁶ Rev. Proc. 68-16 § 6.06.