

IRS Announces Sweeping Changes To Its Offshore Voluntary Disclosure Programs New Rules Effective July 1, 2014

By Attorney Morris N. Robinson, CPA, LLM¹
Updated July 16, 2014

Errata

The original article dated June 24, 2014 contained an error regarding the determination of “nonresidents” for purposes of the Streamlined Compliance Procedures. To qualify as “nonresidents,” individuals who are not citizens or green card holders must be outside the United States for at least 183 full days under the weighted average rules of Section 7701(b)(3) and must be present in the United States for less than 31 days. See page 5, below.²

The original article also contained an error regarding the computation of the miscellaneous penalty for taxpayers participating in the Resident Streamlined Compliance Procedures. See page 8, below, for a corrected description of the miscellaneous penalty base.

Executive Summary

On Wednesday, June 18, 2014 the Internal Revenue Service announced sweeping changes to its Offshore Voluntary Disclosure Programs, effective Tuesday, July 1, 2014. Some taxpayers are treated much more leniently under expanded “Streamlined Compliance Procedures.” Other taxpayers are being treated much more harshly under a modified “2014 Offshore Voluntary Disclosure Program” (“2014 OVDP”) John Koskinen, IRS Commissioner, explained it this way: “It’s important to keep in mind that the IRS is seeking a balanced approach with this program, particularly in light of our other work on offshore issues. Our aim is to get people to disclose their accounts, pay the tax they owe and get right with the government.”³ Based on my personal evaluation and practice experience, the most important changes and features of the 2014 OVDP are:

- (1) Most taxpayers domiciled and living outside the United States will take advantage of the Non-Resident Streamlined Compliance Procedures (sometimes referred to as the “SCP”). They will “certify” that their foreign bank account reports⁴ (“FBARs”) omissions and

¹ **Attorney Morris N. Robinson, CPA LLM** is President of M. Robinson & Company, a boutique tax law firm located at the Landmark Building on Federal Street in Boston’s Financial District. He is also President of the New England Chapter of the American Association of Attorney-CPAs. He conducted his first tax audit as an employee of Haskins & Sells (now Deloitte & Touche) over 40 years ago. **M. Robinson & Company** is a recognized leader in international tax defense for both businesses and individuals. See www.mrobinson.com for further details. I am grateful to Hacohen Wolf Law Offices of Jerusalem, Tel Aviv and New York for being the first group to bring the new rules to my attention with their email dated June 19, 2014.

² I am also grateful to Ronald Rice, CPA, MST, MBA of Weiner and Rice, P.C. for bringing this error to my attention.

³ Statement of IRS Commissioner John Koskinen. <http://www.irs.gov/uac/Newsroom/Statement-of-IRS-Commissioner-John-Koskinen>. Last visited June 23, 2014. <http://www.irs.gov/uac/Newsroom/Statement-of-IRS-Commissioner-John-Koskinen>

⁴ FinCEN Form 114, previously Form TD F 90-22.1.

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income tax-related omissions were “non-willful.” They will then pay their delinquent taxes and interest thereon for the most recent three years. They will avoid all penalties.⁵

- (2) Most other taxpayers will take advantage of the Resident Streamlined Compliance Procedures (sometimes referred to as the “SCP”). These taxpayers will “certify” that their foreign bank account reports (“FBARs”) omissions and income tax-related omissions were “non-willful.” They will pay their delinquent taxes and interest thereon for the most recent three years. They will pay a miscellaneous penalty with a 5 percent penalty rate and a penalty base limited to financial assets not reported on an FBAR whose income was not reported on their income tax returns. In addition, they will remain subject to the failure-to-file penalty and the failure-to-pay penalty.⁶ They will, however, avoid entirely the accuracy-related penalty, the information-return penalties and the FBAR penalty.
- (3) 2014 OVDP will be most useful for taxpayers who cannot certify that their tax omissions are “non-willful.” See above. These taxpayers are expected to seek protection under the 2014 OVDP from both criminal exposure and from the confiscatory FBAR penalties for “willfully” evading their tax and FBAR reporting obligations. For some of these taxpayers, the 2014 OVDP penalty rate on their miscellaneous penalty will increase from 27.5 percent to 50 percent.⁷
- (4) Taxpayers can avoid entirely the harsh \$10,000 penalty for failure to file international information return (e.g., Form 5471, Form 5472, Form 3520, Form 3520-A, etc.). To qualify, they must file a “reasonable cause statement” and certify that the related entity was not involved in tax evasion. This program is for those taxpayers who do not need to use either the Streamlined Compliance Procedures program or the 2014 OVDP.⁸
- (5) Taxpayers can also avoid entirely all FBAR penalties by filing the delinquent FBAR returns. This program is a carryover from the 2012 OVDP and is available if the income from the financial assets subject to FBAR reporting were reported to IRS. This program is also for those taxpayers who do not need to use either the Streamlined Compliance Procedures program or the 2014 OVDP.⁹

For the assistance of the reader, this article is divided into the following sections:

- IRS Toughens the Offshore Voluntary Disclosure Program
- IRS Expands Streamlined Compliance Procedures for “Non-Willful” Taxpayers
- Filing Delinquent FBARs Where Tax Noncompliance Is Not Present

⁵ See **IRS Expands Streamlined Compliance Procedures for “Non-Willful” Taxpayers**, below.

⁶ Id.

⁷ See 2014 OVDP FAQ 35.1.

⁸ See **Filing Delinquent FBARs Where Tax Noncompliance Is Not Present**, below.

⁹ See **Filing Delinquent International Information Returns Where Tax Evasion Is Not Present**, below.

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- Filing Delinquent International Information Returns Where Tax Evasion Is Not Present
- Taxpayers Must Confront an Irrevocable Choice between the 2014 OVDP Rules and the Streamlined Compliance Procedures
- Use of 2012 OVDP Transitional Rules to Achieve Reduced Penalties
- Evaluation and Conclusions

IRS Toughens the Offshore Voluntary Disclosure Program (“OVDP”)

1. Effective Date of New Rules.

The new OVDP rules are effective for disclosure letters filed on or after Tuesday, July 1, 2014.¹⁰ Taxpayers filing disclosure letters before July 1, 2014 are subject to the present 2012 OVDP. This is critically important because the miscellaneous penalty rate on many 2014 OVDP filings may increase from 27.5 percent to 50 percent.¹¹

2. Significant Changes.

Some of the most significant changes in the 2014 OVDP follow:¹²

- (1) The miscellaneous penalty rate nearly doubles from 27.5 percent to 50 percent if either (i) the undisclosed foreign financial institution; or (ii) the “facilitator” who helped the taxpayer establish or maintain his or her offshore arrangement has been publically identified as being under investigation or as cooperating with a government investigation. See 2014 OVDP FAQs 1.1, 7 and 7.2.
 - **Caution:** “Once the 50-percent miscellaneous offshore penalty applies to any of the taxpayer’s accounts or assets in accordance with the terms set forth in the paragraph above, the 50-percent miscellaneous offshore penalty will apply to all of the taxpayer’s assets subject to the penalty (see [2014] FAQ 35), including accounts held at another institution or established through another facilitator for which there have been no events constituting public disclosures....” 2014 OVDP FAQ 7.2
 - **Caution:** See FAQ 7.2 for the imposition of the 50 percent penalty after August 4, 2014 under certain circumstances involving public disclosures involving financial institutions and others.

¹⁰ 2014 OVDP FAQ 1.2. The filing of a preclearance letter does not constitute a submission. See, also, 2014 OVDP Transitional FAQ 2.

¹¹ 2014 OVDP FAQ 1.1

¹²2014 OVDP FAQ 1.1

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- (2) The reduced penalty rates (12.5 percent and 5 percent) under 2012 OVDP FAQs 52 and 53 have been eliminated.
- (3) The miscellaneous penalty must now be paid at the time the disclosure letter is filed. See 2014 OVDP FAQ 7. Accommodations are made for taxpayers who lack the financial ability to pay in full their taxes, penalties and interest. See 2014 OVDP FAQ 20.
- (4) The description of the asset base for the miscellaneous penalty has been modified for clarity and consistency. See 2014 OVDP FAQs 31 through 41. While there are no surprises, these revised rules should be reviewed carefully when completing new OVDP submissions.
- (5) The amount of information required for preclearance has been increased to include the identifying information for all affected financial institutions and entities. See 2014 OVDP FAQ 23.
- (6) All foreign financial bank reports must be filed, regardless of account balance. See 2014 OVDP FAQ 25.
- (7) The OVDP submission letter and attachments have been modified.¹³

3. “Opt Out” Is Still Available.

Under the 2014 OVDP, it is still possible to “opt out.” As under the 2012 OVDP, the election, once made, is irrevocable.

4. Future Modifications of the 2014 OVDP

IRS reserves the right to eliminate or modify the 2014 OVDP, and its rates, at any time.¹⁴

IRS Expands Streamlined Compliance Procedures for “Non-Willful” Taxpayers¹⁵

1. Streamlined Compliance Procedures: In General

The Streamlined Compliance Procedures (SCP) apply only to individual and estates:¹⁶

- (1) Who have not been subject to a “civil examination”¹⁷ for “any” taxable year;

¹³ 2014 OVDP FAQ 25.

¹⁴ 2014 OVDP FAQ 1

¹⁵ See Streamlined Filing Compliance Procedures <http://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures>. Last visited June 24, 2014.

¹⁶ Entities, such as corporations, are not accepted under this program. Entities, however, are accepted explicitly under the 2014 OVDP. See 2014 OVDP FAQ 13.

¹⁷ Regardless of whether the examination related to undisclosed foreign financial assets.

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- (2) Who hold valid Social Security numbers or Individual Taxpayer Identification Numbers;
and
- (3) Who are not under criminal investigation by IRS Criminal Investigation.

Participants must “certify” that their conduct was “nonwillful” as a precondition for entering the SCP. The IRS defines “nonwillful conduct” as “conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.”

- **Caution:** This definition is considerably narrower than the definition of “reasonable cause” found in the Internal Revenue Manual: 20.1.1.3.2 (11-25-2011). Thus, some taxpayers who might deserve our sympathy may not qualify for relief. For example, assume a taxpayer became aware of the FBAR filing obligation in 2011 but chose not to file an FBAR for 2011 and 2012 out of fear or because of poor advice received from foreign bank officials. It is very possible that this taxpayer will not qualify for participation in the SCP program.

The program divides “non-willful” taxpayers into two groups: residents and non-residents. Residents are taxpayers who are not defined as non-residents. The definitions for nonresidents follow.

- (1) U.S. citizens and lawful, permanent residents (i.e., “green card” holders) are treated as non-residents only if they meet both of the following two criteria:
 - a. The taxpayer was physically present outside the United States for at least 330 full days in any one calendar year;¹⁸ and
 - b. The taxpayer was domiciled outside the United States.¹⁹
- (2) Individuals who are not U.S. citizens or lawful, permanent residents are treated as non-residents only if they are outside the United States for at least 183 days under the weighted average rules of Section 7701(b)(3) and, in addition, were present in the United States for less than 31 days in the calendar year.

¹⁸ These days are determined under Section 911 and its regulations. Also, see IRS Publication 54 cited in footnote 19, immediately below.

¹⁹ IRS document cited in footnote 18, above, incorporates the definition of “abode” as used in IRS Publication 54: Tax Guide for U.S. Citizens and Resident Aliens Abroad. An “[a]bode” has been variously defined as one's home, habitation, residence, domicile, or place of dwelling. It does not mean your principal place of business. ‘Abode’ has a domestic rather than a vocational meaning and does not mean the same as ‘tax home.’ The location of your abode often will depend on where you maintain your economic, family, and personal ties. (Emphasis added.) IRS Publication 54. http://www.irs.gov/publications/p54/ch04.html#en_US_2013_publink100047401. Last visited June 23, 2014.

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Both categories of taxpayers are treated as nonresidents if they meet the non-resident test for at least one or more of the most recent three taxable years for which the due date (including extensions, if requested) for income tax returns has passed without a filing.

2. Streamlined Compliance Procedures for Non-Residents

Non-Residents who qualify under the Streamlined Foreign Offshore Procedures listed above are required to:

- (1) File income tax returns for the most recent three taxable years for which the due date (including extensions, if requested) for income tax returns has passed without a filing.
- (2) File all required information returns (e.g., Forms 3520, 3520-A, 5471, 5472, 8938, 926, and 8621).
- (3) Pay the income taxes shown to be due, plus interest thereon. Individual checks should accompany the newly filed income tax returns.
- (4) File delinquent FBARs for each of the most recent 6 years for which the FBAR due date has passed.

Non-resident participants are excused from:

- (1) Failure-to-file penalties;
- (2) Failure-to-pay penalties;
- (3) Accuracy-related penalties;
- (4) Information return penalties; and/or
- (5) FBAR penalties.

In addition, non-residents will be provided with “retroactive relief ... for failure to timely elect income deferral on certain retirement and savings plans where deferral is permitted by the applicable treaty. The proper deferral elections with respect to such plans must be made with the submission.” IRS also encourages these taxpayers to come forward by promising: “Even if returns properly filed under these procedures are subsequently selected for audit under existing audit selection processes, the taxpayer will not be subject to failure-to-file and failure-to-pay penalties or accuracy-related penalties with respect to amounts reported on those returns, or to information return penalties or FBAR penalties, unless the examination results in a determination that the original tax noncompliance was fraudulent and/or that the FBAR violation was willful.”

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3. Streamlined Compliance Procedures for Residents

Residents are taxpayers who do not meet the above-listed criteria for non-residents. Under the Streamlined Domestic Offshore Procedures, these taxpayers are subject the following additional qualifications:

- (1) The taxpayers have already filed income tax returns for the most recent three taxable years for which the due date (including extensions, if requested) for income tax returns has passed;
- (2) The taxpayers have failed to report gross income from a foreign asset;
- (3) The taxpayers may have failed to file FBARs and/or one or more international information returns (e.g., Forms 3520, 3520-A, 5471, 5472, 8938, 926, and 8621) with respect to the foreign financial asset; and
- (4) If a joint return was filed, at least one of the spouses was not a resident.

Residents who qualify under the Streamlined Compliance Procedures qualification rules listed above are required to:

- (1) File amended income tax returns for the most recent three taxable years for which the due date (including extensions, if requested) for income tax returns has passed without a filing to reflect all omitted income.
- (2) File all required information returns, described above.
- (3) File any delinquent FBARs for each of the most recent 6 years for which the FBAR due date has passed (FinCEN Form 114, previously Form TD F 90-22.1).
- (5) Pay the income taxes shown to be due on the amended returns, plus interest thereon. Individual checks should accompany the amended income tax returns.
- (6) Pay 5 percent miscellaneous penalty as described immediately, below. A check in payment of the miscellaneous penalty should also accompany the amended income tax returns.

The miscellaneous penalty rate is 5 percent of the penalty base. Only foreign financial assets are included in the 5 percent miscellaneous penalty base. Foreign financial assets are defined in the instructions to the FBARs or the Form 8938. IRS lists these foreign financial assets, generally, as:

- Financial accounts held at foreign financial institutions;

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- Financial accounts held at a foreign branch of a U.S. financial institution;
- Foreign stock or securities not held in a financial account;
- Foreign mutual funds; and
- Foreign hedge funds and foreign private equity funds.

The penalty base for the 5 percent miscellaneous penalty is comprised of the highest balances of foreign financial assets, above, that meet the following additional criteria:

- (1) The foreign financial assets are financial assets that should have been but were not reported on previously filed FBARs irrespective of whether there was non-compliance with the income tax laws of the United States.²⁰
- (2) Foreign financial assets are financial assets that should have been but were not reported on a Form 8938: Statement of Specified Foreign Financial Assets.²¹
- (3) Foreign financial assets are financial assets that were properly reported on previously filed FBARs and Forms 8938 but whose related income was not properly reported.²²

The benefits of resident participants are less than the benefits of non-resident participants. Specifically, residents (unlike non-residents) will be subject to the failure-to-file and failure-to-pay penalties. Thus, residents who participate in the program will avoid entirely the following listed penalties:

- (1) Accuracy-related penalties;
- (2) Information return penalties; and/or
- (3) FBAR penalties.

Like non-residents, resident participants in the Streamlined Compliance Procedures will be provided with “retroactive relief ... for failure to timely elect income deferral on certain

²⁰ “A foreign financial asset is subject to the 5-percent miscellaneous offshore penalty in a given year in the covered FBAR period if the asset should have been, but was not, reported on an FBAR (FinCEN Form 114) for that year.” <http://www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-in-the-United-States> (last visited July 15, 2014). Unlike the recently revised 2014 OVDP, there is no exclusion where some of the income was reported but all of the income was not reported. But if all income was properly reported, see Filing Delinquent FBARs Where Tax Noncompliance Is Not Present, below.

²¹ “A foreign financial asset is subject to the 5-percent miscellaneous offshore penalty in a given year in the covered tax return period if the asset should have been, but was not, reported on a Form 8938 for that year.” <http://www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-in-the-United-States> (last visited July 14, 2014).

²² “A foreign financial asset is also subject to the 5-percent miscellaneous offshore penalty in a given year in the covered tax return period if the asset was properly reported for that year, but gross income in respect of the asset was not reported in that year.” <http://www.irs.gov/Individuals/International-Taxpayers/U-S-Taxpayers-Residing-in-the-United-States> (last visited July 15, 2014)

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retirement and savings plans where deferral is permitted by the applicable treaty. The proper deferral elections with respect to such plans must be made with the submission.” Similarly, IRS also encourages these taxpayers to come forward by promising: “Even if returns properly filed under these procedures are subsequently selected for audit under existing audit selection processes, the taxpayer will not be subject to accuracy-related penalties with respect to amounts reported on those returns, or to information return penalties or FBAR penalties, unless the examination results in a determination that the original tax noncompliance was fraudulent and/or that the FBAR violation was willful.”

Filing Delinquent FBARs Where Tax Noncompliance Is Not Present²³

In some cases, taxpayers are in full compliance with their income tax obligations but have not filed FBARs out of ignorance or negligence. IRS will waive the non-willful FBAR penalties entirely where there is no noncompliance with the income tax laws of the United States. Taxpayers are simply requested, when e-filing, to explain why the returns are being filed late. Taxpayers should also indicate that the taxpayer was in full compliance with their income tax obligations and that no penalties are due.²⁴ To qualify for penalty avoidance, taxpayers must come forward and file their FBARS before (1) they come under civil examination or criminal investigation by IRS; and (2) they have not been contacted by IRS regarding the delinquent FBARs.

Filing Delinquent International Information Returns Where Tax Evasion Is Not Present²⁵

International information returns include Form 5471 (U.S. Ownership in Foreign Corporation); Form 5472 (Foreign Ownership in United States Corporation); Form 3520 (Transactions with Foreign Trusts and Receipt of Foreign Gifts); Form 3520-A (United States Ownership of Foreign Trust); and Form 8865 (Foreign Partnership). The penalties for failure to timely file these returns start at \$10,000 per year per delinquent form. The requirements for penalty forgiveness are:

- (1) The taxpayer must certify that any entity for which information returns are being filed was not involved in tax evasion.
- (2) There is reasonable cause for the late filing. Unlike the Streamlined Compliance Procedures, IRS does not define “reasonable cause.” Thus, “reasonable cause” is arguably as broad as the definition of reasonable cause found in the Internal Revenue

²³ See Delinquent FBAR Submission Procedures. <http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-FBAR-Submission-Procedures>. Last visited June 23, 2014.

²⁴ If penalties are due, but the FBAR omission is “non-willful” the taxpayers will want to consider the FBAR penalty mitigation rules in the Internal Revenue Manual. Penalties can range from a “warning letter” without monetary penalty to \$10,000 per account per year for the omission of financial accounts with a value in excess of \$250,000. See also, 2014 OVDP FAQ 4 and 5.

²⁵ See Delinquent International Information Return Submission Procedures <http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-International-Information-Return-Submission-Procedures>. Last visited June 23, 2014.

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Manual: 20.1.1.3.2 (11-25-2011). A “reasonable cause” statement must be attached to each delinquent return.

- (3) The taxpayer must come forward and file their FBARS before (i) they come under civil examination or criminal investigation by IRS; and (ii) they have not been contacted by IRS regarding the delinquent information returns.

Taxpayers Must Confront an Irrevocable Choice between the 2014 OVDP Rules and the Streamlined Compliance Procedures

Qualified taxpayers²⁶ who file submission letters on or after July 1, 2014 will be required to make an irrevocable election. They may choose to request admission into the 2014 Offshore Voluntary Disclosure Program (“2014 OVDP”); or they may choose to participation in the Streamlined Compliance Procedures, described above. Their election, once made, cannot be revoked or reconsidered.²⁷

- **Observation:** Taxpayers who file their submission letters before July 1, 2014 do not need to make this choice and are subject to the 2014 OVDP transition rules, described above.

Use of 2012 OVDP Transitional Rules to Achieve Reduced Penalties

Taxpayers who otherwise qualify for the Streamlined Compliance Procedure rules, will be able to take advantage of the lower miscellaneous offshore penalty terms of the Streamlined Domestic Offshore Procedures. These penalty terms reduce both the penalty rate from 27.5 percent to 5 percent and reduce the penalty base by eliminating non-financial assets that would otherwise be included under the OVDP penalty base under 2014 OVDP FAQ 35. As noted above, taxpayers who filed their submissions on or after July 1, 2014 are required to elect between the harsh 2014 rules and the more lenient Streamlined Compliance Procedure rules.²⁸ But taxpayers (hereafter, “transitional taxpayers”) who filed their submissions on or before June 30, 2014 may remain in the 2012 OVDP while taking advantage of the favorable penalty structure of the expanded streamlined procedures.²⁹

The new transitional rules are not automatic.³⁰ Rather, the taxpayer must make an appropriate request³¹ and convince the OVDP that all information submitted is consistent with the taxpayer’s

²⁶ The qualification criteria for taxpayers under the OVDP are listed in 2014 OVDP FAQs 12 through 21. The qualification criteria for participation in the Streamlined Compliance Procedures are listed above in this article.

²⁷ **Coordination with treatment under OVDP:** Once a taxpayer makes a submission under either the Streamlined Foreign Offshore Procedures or the Streamlined Domestic Offshore Procedures, the taxpayer may not participate in OVDP. Similarly, a taxpayer who submits an OVDP voluntary disclosure letter pursuant to OVDP FAQ 24 on or after July 1, 2014, is not eligible to participate in the streamlined procedures. From Streamlined Filing Compliance Procedures. <http://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures>. Last visited June 23, 2014.

²⁸ Id.

²⁹ 2014 OVDP Transition FAQs 1 through 3.

³⁰ 2014 OVDP Transition FAQ 7.

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certification that the failure to file the FBAR was “non-willful.”³² A successful taxpayer must convince the IRS examiner and the examiner’s supervisor. Some cases will be forwarded to a “central review committee.” In these cases, the taxpayer will be asked to make a written submission but will not be able to address the committee. The decision of the committee will be final and the taxpayer will be left with the option to either remain within the 2012 OVDP or “opt out.”³³

All other terms of the OVDP in which the taxpayer is currently participating will continue to apply, including, but not limited to, the following:

- The OVDP disclosure period remains the same;
- Execution of a Form 906 Closing Agreement is required;
- Payment of accuracy-related, failure-to-file, and/or failure-to-pay penalties, if applicable, are required; and
- The alternative mark-to-market resolution of PFIC (foreign mutual fund) income will continue to be available.³⁴

Evaluation and Conclusions

When IRS began its 2009 Offshore Voluntary Disclosure Program, they were stunned by the massive noncompliance disclosed as taxpayers began to come forward. IRS responded to the challenge of enforcing our international tax and information disclosure laws in two ways:

- (1) IRS, through the Department of Justice, has negotiated FATCA (Foreign Account Tax Compliance Act) agreements with foreign countries and financial institutions that permit the electronic transfer of tax data needed by IRS to administer our income tax laws efficiently.
- (2) IRS is now helping most “non-willful” taxpayers come into compliance without significant penalties, while ratcheting up the adverse consequences for those who choose not to come forward.

My main concern is the continued lack of meaningful appeal rights– aside from “opting out” of the above-described programs. But given the severe financial constraints currently facing IRS, they had no realistic alternative. The major responsibility for the lack of appeal rights lies with Congress, which has consistently refused to fund IRS adequately. Aside from the lack of appeal

³¹ [2014 OVDP Transition FAQ 6.](#)

³² [2014 OVDP Transition FAQ 8.](#)

³³ [Id.](#)

³⁴ [2014 OVDP Transition FAQ 18.](#)

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rights, the 2014 OVDP and related Streamlined Compliance Procedures represent an important step forward in helping most taxpayers come into compliance. These rules should therefore be welcomed by all taxpayers, including those taxpayers who are already in compliance.

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