

## Alerts and Updates

### IRS VOLUNTARY DISCLOSURE "PENALTY FRAMEWORK" FOR OFFSHORE ACCOUNTS

March 31, 2011

On March 1, 2011, the U.S. Internal Revenue Service (IRS) **announced** a "penalty framework" to be applied to voluntary disclosure requests containing "offshore issues." This "penalty framework" applies to all participants in the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI). Duane Morris provides a detailed explanation of the program in the February 9, 2011, *Alert*, "[IRS Announces New Voluntary Disclosure Program](#)." In another recent *Alert*, Duane Morris provides [translations](#) of the program in Chinese, German, Korean, Spanish, Farsi, Hindi, Russian and Vietnamese.

#### Is Voluntary Disclosure Right for You?

The factors that go into determining whether a taxpayer should make a voluntary disclosure are numerous and complex. A taxpayer considering making a voluntary disclosure may want to discuss the matter with an experienced attorney. That discussion would be protected from disclosure by attorney-client privilege, which is vital particularly in instances where the taxpayer ultimately decides not to make the disclosure. However, a consultation regarding the voluntary disclosure program with a taxpayer's accountant is not a privileged communication. If the decision were made not to enter the OVDI, and the IRS discovers the foreign financial account, the taxpayer's accountant could become a witness for the IRS against the taxpayer. This would not be the case if an attorney, rather than an accountant, had been consulted.

A taxpayer contemplating a voluntary disclosure also may want to consider the differences in the financial consequences of participating in the OVDI, opting out of the OVDI or making a traditional voluntary disclosure. (It is unclear, but it appears that the IRS may initially process all voluntary disclosures regarding offshore issues through the OVDI). In many instances, the OVDI would involve more years, higher taxes and significantly larger penalties than a traditional voluntary disclosure. Taxpayers participating (willingly or not) in the OVDI may face an IRS unwilling to negotiate notwithstanding facts supporting the reduction or elimination of penalties. Taxpayers who believe their situation warrants reduced penalties may be advised by the OVDI agents that they can opt out of the OVDI and take their chances in a full-blown examination. Before that decision is made, however, a taxpayer must perform a very careful analysis of the facts surrounding the case. That analysis should be directed at determining:

- exactly what years are open under the statute of limitations (possibly less than the 8 years under the OVDI),
- the magnitude of additional tax and interest due,
- what tax penalties are applicable (fraud, accuracy-related or none) and
- what additional information-return penalties may apply in cases involving foreign accounts, trusts, gifts, corporations and other business entities.

Key to this analysis are issues regarding negligence, fraud, willfulness, mitigation, burden of proof (on the taxpayer or

on the IRS) and quantum of proof (clear and convincing, or mere preponderance of the evidence).

Once all this analysis is completed, the decision whether to make a voluntary disclosure can be made and, if disclosure is made, whether it might be under the inflexible OVDI or through potentially less-rigid traditional means.

### **Potential Candidates for the OVDI**

The OVDI applies primarily to U.S. persons and entities who have not complied with all of their U.S. tax reporting obligations, including the following:

- Dual citizens of the U.S. and another country
- U.S. citizens living or doing business abroad
- U.S. green card holders
- Closely-held U.S. businesses with operations abroad
- U.S. recipients of gifts and bequests from foreign persons
- U.S. beneficiaries of foreign trusts
- U.S. immigrants, particularly those who may have fled their home countries in times of strife

While the IRS is not targeting any specific ethnic groups for this program, the IRS has translated information about the program into:

- Chinese (both [traditional](#) and [simplified](#))
- [German](#)
- [Korean](#)
- [Spanish](#)
- [Farsi](#)
- [Hindi](#)
- [Russian](#)
- [Vietnamese](#)

## The Pre-clearance Process

If the decision is made to make a voluntary disclosure, the first step is "pre-clearance." IRS Criminal Investigation (CI) will make a preliminary determination that a taxpayer is eligible to make a voluntary disclosure. This "pre-clearance" is secured by sending a request to the IRS CI office in Philadelphia, Pennsylvania. So long as the request is "timely," the taxpayer will receive "pre-clearance." Voluntary disclosures made after the IRS has secured information regarding a taxpayer's specific noncompliance are "untimely," and a taxpayer will not qualify for the benefits of voluntary disclosure (most notably the almost-guarantee of no criminal prosecution). Obviously, part of the discussion between counsel and the taxpayer regarding the OVDI must include whether the disclosure will be "timely" since taxpayers who do not "pre-clear" have alerted the IRS to their noncompliance and may subject themselves to otherwise-unlikely examinations or criminal investigations. Accordingly, once a decision to make a voluntary disclosure is made, application to the OVDI should be made promptly.

## The OVDI Inflexible "Penalty Framework"

For those taxpayers who conclude that the OVDI is appropriate to their situation and who pre-clear, IRS CI will forward the taxpayer's voluntary disclosure request to IRS Examination for processing. Those requests will be distributed to and worked by IRS examiners who specialize in offshore examinations.

All offshore voluntary disclosures received after October 15, 2009, which was the last day to apply for the 2009 Offshore Voluntary Disclosure Program (2009 OVDI), will be processed in the following non-negotiable manner:

1. All taxes and interest due for the years 2003 through 2010 will be assessed (*exception*: for accounts opened or received by the taxpayer within this period, the assessment will start with the year the account was opened or received).

### *Commentary*

The eight years required by the OVDI may include years which would otherwise be outside the civil statute of limitations. The typical statute of limitations for assessing additional tax is three years. This can be extended to six years if the taxpayer has omitted more than 25 percent of gross income. There is no statute of limitations if the IRS can prove that the taxpayer filed a fraudulent return or did not file a particular return, including information returns.

2. The taxpayer will be required to file or amend all returns, including income tax returns (Form 1040), information returns for certain foreign trusts and gifts (Forms 3520 and 3520A) and foreign corporations (Form 5471), and Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, commonly known as an "FBAR."

### *Commentary*

These forms can be quite complex to complete. Dual citizens need to take into account existing treaties between the United States and the other country of their dual citizenship. Issues regarding Passive Foreign Investment Companies (PFIC) and the optional OVDI method for reporting related PFIC income must be considered.

3. The submission by August 31, 2011, of all other documents set forth in the Submission Requirements. Those documents include, among others, detailed information regarding foreign assets, including the value

of real estate and art, and financial statements for all subject foreign accounts.

#### ***Commentary***

Securing financial account records is not an easy task. It takes persistence and knowledge of whom to contact at the subject financial institution. Also, banks that are themselves the targets of U.S. criminal investigations are unlikely to be willing to provide records regarding undisclosed/untaxed accounts.

4. Taxpayers will be assessed an accuracy-related penalty of 20 percent on all years (no reasonable-cause exception may be applied), and assessed failure-to-file and failure-to-pay penalties when applicable.

#### ***Commentary***

Taxpayers with bona fide explanations for underreporting income or not filing returns will be forced to pay these significant penalties under the OVDI, even though the penalties would not be asserted under the provisions of the Internal Revenue Code or the internal guidelines of the IRS. Thus, such taxpayers may want to consider other options available to them, such as traditional voluntary disclosure.

5. In lieu of all other penalties that may apply, including FBAR and information-return penalties, an OVDI offshore penalty will be imposed equal to 25 percent (or 12.5 percent or 5 percent if the required conditions are met) of the amount in foreign financial accounts/entities and the value of foreign assets acquired with untaxed funds or producing untaxed income in the year with the highest aggregate account/asset value.

#### ***Commentary***

The value of financial accounts is generally determined by the values in account statements. But determining the highest aggregate value when dealing with multiple accounts can be labor intensive, requiring the taxpayer to determine the account value on every day of the eight-year period covered by the program.

When valuing "foreign assets," will appraisals be necessary? Will mortgage liens on real property reduce the value? If the taxpayer owns a foreign corporation, how will that value be determined? These issues have not yet been addressed by the IRS.

6. If a taxpayer meets all four of the following conditions, then the OVDI offshore penalty is reduced from 25 percent to 5 percent:
  - Taxpayer 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);
  - Taxpayer has 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;
  - Taxpayer has, 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

- Taxpayer 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.

### **Commentary**

What if the foreign bank "kicked" the account out of the bank and the funds were transferred to another bank to an account in the taxpayer's name? Will this be considered opening an account simply because the initial bank refused to permit a new account to be opened, but required that the funds "leave" the bank?

Will "minimal, infrequent contact" include periodic discussions on asset management and occasional visits by bank officers to the United States to meet with account holders?

Is the \$1,000 annual withdrawal limit for all the persons affiliated with the account or is it determined on an individual-by-individual basis (e.g., four persons with signature authority can withdraw \$1,000 each or a total of \$1,000)?

If the subject bank only maintains records back to, for instance, 1995, for an account opened before that date, will there be any leniency regarding the requirement that the taxpayer establish that the account deposits have been taxed?

7. If a taxpayer is a foreign resident who was unaware that he or she was a U.S. citizen, then the offshore penalty is reduced to 5 percent.

### **Commentary**

What evidence will be required to prove that the foreign resident was "unaware that he or she was a U.S. citizen"? Will an affidavit from the taxpayer suffice?

8. If a taxpayer's 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, then the offshore penalty is reduced to 12.5 percent.

Examiners and their managers have no authority to negotiate different offshore penalty percentages for 2011 OVDI cases.

These outlined terms are only applicable to taxpayers that make voluntary disclosure requests, and who fully cooperate with the IRS, both civilly and criminally.

The IRS has stated that cases involving offshore issues, whether under standard examination or subject to

"certification" under the 2011 OVDI, must be assigned and worked on a priority basis. In addition, to foster taxpayer confidence and to encourage taxpayers to come forward voluntarily to self-correct prior tax noncompliance, the IRS has stated that it is incumbent on the IRS to ensure that similarly situated taxpayers are treated in a fair and consistent manner within the 2011 OVDI.

### **Reduced Penalties for Cases Closed Under the 2009 OVDP**

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 cases qualify them for the 5-percent or 12.5-percent reduced-penalty criteria of the 2011 OVDI, but who paid a higher penalty amount under the 2009 OVDP, should provide a statement to this effect to the IRS including all pertinent contact information (name, address, SSN, home/cell phone numbers), the names of the revenue agents assigned to their cases, and a copy of their closing agreements. Upon receipt of this information, the case must be assigned to an examiner to review and make a determination. If a 2009 OVDP case is still open and the facts meet the criteria for the reduced 5-percent or 12.5-percent penalty of the 2011 OVDI, the examiner will assert the reduced penalty as appropriate.

### **Conclusion**

The 2011 OVDI is an inflexible process imposing significant penalties that in many cases are not authorized by the Internal Revenue Code. At the same time, it provides certainty regarding a taxpayer's financial exposure for not reporting foreign accounts. Whether participation in the 2011 OVDI or opting out of the initiative is the appropriate way to resolve offshore compliance issues is a complex question that may only be answered by experienced counsel after extensive due diligence.

### **For Further Information**

If you would like more information about voluntary disclosure for offshore accounts, please contact [Thomas W. Ostrander](#), the author of this *Alert*; [Hope P. Krebs](#) or [Stanley A. Barg](#) in Philadelphia; [Jon Grouf](#) in New York; [Anthony D. Martin](#) in Boston; any member of the [International Practice Group](#); [Michael A. Gillen](#) of the [Tax Accounting Group](#) or the attorney in the firm with whom you are regularly in contact. Our [February 9, 2011, Alert](#) also gives a more detailed explanation of the 2011 OVDI.

*As required by United States Treasury Regulations, the reader should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.*

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