Offshore Voluntary Disclosure–The Next Generation

By Dennis Brager

Dennis Brager examines the next generation of partial tax amnesty for taxpayers who have failed to meet the myriad of disclosure requirements imposed on owners of foreign assets: Offshore Voluntary Disclosure Initiative (OVDI).

In February of 2011 the IRS announced a partial tax amnesty for owners of offshore financial accounts, and others who have failed to meet the myriad of disclosure requirements imposed on owners of foreign assets. This new partial tax amnesty dubbed the "Offshore Voluntary Disclosure Initiative" (OVDI) is the successor to the previous partial tax amnesty known as the "Offshore Voluntary Disclosure Program (OVDP), and is designed to be more onerous than the OVDP.

Before discussing the nuts and bolts of the OVDI it is useful to examine how we came to this point. Over the years an ever expanding reporting regime has been imposed on owners of offshore investments. This has been due to a perception that the use of foreign accounts is a prevalent means of tax evasion. In addition, law enforcement agencies believe that the use of foreign accounts disguises a host of non-tax crimes including money laundering, drug smuggling, and international terrorism.

The failure to file the appropriate reporting forms can result in substantial if not ruinous penalties even if there are no tax consequences. These penalties include:

- A penalty for failure to file Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.* Generally, U.S. persons are required to report transactions involving foreign trusts including the creation of foreign trusts, transfers of property to a foreign trust, and receipt of distributions from a foreign trust.[1] The penalty for failing to file, or for filing an incomplete form is the greater of $10,000 or 35 percent of the gross reportable amount.[2]
- A penalty for failure to report the receipt of a gift or bequest of more than $100,000 from a non-resident alien individual or a foreign estate.[3] The penalty is five percent of the gift per month, up to a maximum penalty of 25 percent of the gift.[4]
- A penalty for failing to file Form 3520-A, *Information Return of Foreign Trust With a U.S. Owner*. This form reports ownership interests in foreign trusts by United States persons with various interests in and powers over those trusts.[5] The penalty for failing to file, or for filing an incomplete return, is five percent of the gross value of trust assets owned by the United States person.[6]
- A penalty for failing to file Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*. This form is required to be filed by certain United States persons who are officers, directors or shareholders in certain foreign corporations.[7] The penalty for failing to file each

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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.[8]

- A penalty for failing to file 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*. 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.[9] The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, plus an additional $10,000 per month for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency.[10] There is no maximum additional penalty.
- A penalty for failing to file Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*. United States 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 Secs. 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 ten percent of the value of any transferred property that is not reported, subject to a $100,000 limit.[11]

The big kahuna is the penalty for the failure to file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). Any U.S. citizen or resident who has signatory authority over, or a financial interest in, a financial account located in another country is required to file an FBAR if the balance in the account was more than $10,000 at any time during the calendar year. The willful failure to do so is a felony punishable by a fine of $250,000 or five years in jail or both.[12] The civil penalty for the willful failure to file the FBAR is the *greater* of $100,000 or 50 percent of the account balance; and the penalty can be imposed on an annual basis, which can easily exceed the amount in the account.[13] However, if there is reasonable cause for the failure to file then no penalty is imposed.[14]

Even a negligent failure to file an FBAR is subject to a civil penalty of $10,000 per violation.[15] Of course if any of these foreign accounts generate income that income must be reported on the relevant income tax return. A willful failure to report the income can be treated as the evasion of tax which is felony punishable by a fine of as much as $100,000 or five years in jail, or both.[16] On the civil side the willful failure to report could constitute tax fraud with a penalty of 75 percent of the tax evaded.[17]

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It is against this dark background which the OVDI must be considered. Under OVDI the vast bulk of these potential penalties, and some additional ones will disappear. OVDI is not, however a free lunch. The guidelines for the OVDI are set forth in a series of Frequently Asked Questions published on the IRS Web site in early February of 2011.[18] A person who enters the OVDI program must agree, *inter alia*, to the following:

- The filing of amended income tax returns for the years 2003 through 2010[19]
- Payment of all taxes due on the returns, plus interest[20]
- An accuracy related penalty of 20 percent of the tax due pursuant to Code Sec. 6662, and if applicable, the failure to file and failure to pay penalties under Code Sec. 6651(a)(1) and (a)(2)
- A "miscellaneous Title 26 offshore penalty" equal to 25 percent of the highest aggregate balance in foreign bank accounts/entities or the value of foreign assets during the period covered by the voluntary disclosure[21]

The 25-percent penalty is reduced in several narrow circumstances. If the highest aggregate offshore balance does not exceed $75,000 at any time during the OVDI disclosure period then the penalty will be

12.5 percent of the highest aggregate balance.[22] All other terms of the OVDI remain unchanged.

A five-percent penalty is available in two very limited situations.[23] To qualify for the first category the taxpayer must (a) not have opened or caused 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) have exercised minimal, infrequent contact with the account (*e.g.*, to request the account balance or update accountholder information such as a change in address, contact person, or e-mail address); (c) 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 (d) be able to establish that all applicable U.S. taxes have been paid on funds deposited to the account (*i.e.,* only account earnings have escaped U.S. taxation). This category is intended to apply to persons who inherit their foreign bank accounts. It appears to address some of the criticisms leveled at the five-percent penalty established under the OVDP.[24]

Item (d) may be a sticking point if the owner of the foreign account was a U.S. resident or citizen at any time during the past 20 years. In cases where funds were deposited before January 1, 1991, the presumption is that they were properly taxed.[25] However for deposits made after that date it is up to the taxpayer to prove the funds had been taxed, or were not subject to U.S. tax. Depending on the degree of proof required it could be difficult to establish the source of deposits into the foreign account. This is especially true because it is highly unlikely that foreign bank records will be available going all the way back to 1991.

The second category of taxpayer who will qualify for the five-percent penalty is a person who was a foreign resident, and was "unaware" he was a U.S. citizen.[26] It is hard to understand the IRS' reasoning in including this category. A taxpayer who did not know he was a U.S. citizen would presumably have reasonable cause for not filing the FBAR, and would not be subject to any penalties.

The OVDI does not apply to those taxpayers who reported all of their taxable income, but simply failed to file the FBAR, or one of the foreign information returns such as the Form 5471, or Form 3520, and owed no tax.[27] This includes taxpayers who had an FBAR requirement solely as a result of being a signatory on a foreign financial account, but did not have a financial interest in the account.[28] These taxpayers are to follow a separate procedure which involves the filing of delinquent forms by August 31, 2011. These taxpayers will not incur any penalties.[29]

The penalty base for the miscellaneous offshore penalty is not limited to foreign financial accounts required to be reported on an FBAR. Instead the 25-percent (or 12.5-percent or five-percent) penalty applies to all of the taxpayer's offshore holdings that are related in any way to "tax noncompliance." The penalty applies to all assets directly owned by the taxpayer, including 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 the 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.[30]

Tax noncompliance is defined to include a 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.[31] For example, a taxpayer owns real estate in Israel worth $1 million. If the taxpayer rents it out, and fails to report the income the value of the real estate will be included in the penalty base despite the fact that there was no FBAR filing requirement for the real estate.[32] The result is unchanged even though as a result of foreign tax credits there would have been no tax due had the income been reported.[33] If the real estate generated no income, but was acquired with assets that improperly escaped U.S. taxation the real estate would also be included in the penalty base.[34]

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A foreign account over which the taxpayer has only signature authority would not be included in the penalty base since there is no tax noncompliance because there was no income to report.[35] However, there is no such thing as being a "little bit pregnant." FAQ 33 states there is no "*de minimis*" amount of unreported income which will provide an exception

to the 25-percent penalty. Thus a taxpayer with a $100,000 account earning one percent can expect to pay a $25,000 penalty even though both the income earned, and the tax due would be minimal.

Taxpayers who wish to enter the OVDI must submit all necessary documents to the IRS no later than August 31, 2011.[36] These documents are detailed in FAQ 25 , and also on the IRS Web site at *www.irs.gov/businesses/international/article/0,,id=235690,00.html.* In general the package must include all of the following:

- Copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure
- Amended federal income tax returns with applicable schedules detailing the amount and type of previously unreported income from the account or entity
- A completed "Foreign Account or Asset Statement" for each previously undisclosed foreign account or asset during the voluntary disclosure period (available on the IRS Web site)
- For taxpayers disclosing offshore financial accounts with an aggregate highest account balance in any year of $1 million or more, a completed "Foreign Financial Institution Statement" for each foreign financial institution with which the taxpayer had undisclosed accounts or transactions during the voluntary disclosure period (available on the IRS Web site)
- "Taxpayer Account Summary With Penalty Calculation" (available at on the IRS Web site)
- A check in full payment of the total tax, interest and all applicable penalties[37]
- For taxpayers disclosing offshore financial accounts with an aggregate highest account balance in any year of $500,000 or more, copies of offshore financial account statements reflecting all account activity for each of the tax years covered by the voluntary disclosure
- For those taxpayers disclosing offshore financial accounts with an aggregate highest account balance of less than $500,000, copies of offshore financial account statements reflecting all account activity for each of the tax years covered by the voluntary disclosure must be readily available upon request
- Waivers extending the time for the IRS to assess Title 26 tax, interest and penalty as well as FBAR penalties

Once the package has been submitted a civil examiner will review the submission to "certify the accuracy and completeness" of the disclosure.[38] Generally there will be no audit of the tax return.[39] The IRS is not predicting how long the process of certification will take,[40] and practitioners should expect questions regarding the submission.[41]

Practitioners, however, should advise their clients before they submit OVDI applications that there appears to be little wiggle room.

Prior to submitting documents or information it would be wise to take advantage of the IRS pre-clearance process. Pre-clearance is accomplished through Criminal Investigation, and allows for taxpayers to make certain that they are likely to be eligible for the OVDI.[42] The pre-clearance process is important because not all taxpayers are eligible for the OVDI. It could be a disaster to submit detailed information to the IRS, and waive various privileges including Fifth Amendment rights only to discover that the IRS is unwilling to proceed under the OVDI. If the IRS has initiated a civil examination of a taxpayer he is not eligible to participate even if the audit has nothing to do with foreign income. Taxpayers under criminal investigation by the IRS are also not eligible to participate.[43] If the IRS obtains information under a John Doe summons regarding the taxpayer's noncompliance he may also be ineligible for the OVDI.[44]

There are many more details to the OVDI which can be ascertained only by a complete reading of the entire set of 53 FAQs, and by the time you read this article the IRS may have issued additional clarifications and guidance.

Practitioners, however, should advise their clients before they submit OVDI applications that there appears to be little wiggle room. Clients who would clearly qualify for reduced penalties because their conduct was not willful may not wish to enter the OVDI because the IRS has made it clear that it will not consider any reasonable cause or willfulness arguments.[45] Thus it is entirely possible that making a disclosure under OVDI will result in higher penalties then if no disclosure had been made. This is especially so because of the inclusion of non-financial assets in the penalty base.

On the other hand because reasonable cause, and willfulness determinations are inherently factual, even practitioners who have had experience with dozens and dozens of voluntary disclosures will be hard pressed in some cases to predict with the certainty that their clients would like whether the failure to disclose will result in the imposition of draconian penalties, both civil and criminal. It is this uncertainty, and the very high cost, both financial and emotional, of the IRS discovering an undisclosed foreign account which will make OVDI the lesser of the two evils for some clients.

Endnotes

1 Code Sec. 6048.
2 Code Sec. 6677(a)(2).
3 *See* Code Sec. 6039F, and instructions to Form 3520.
4 Code Sec. 6039F(c).
5 *See* Code Sec. 6048(b).
6 Code Sec. 6677(b).
7 Code Secs. 6035, 6038 and 6046.
8 Code Sec. 6679.
9 Code Secs. 6038A and 6038C.
10 Code Secs. 6038A(d) and 6038C(c).
11 Code Secs. 6038(b), 6038B(c) and 6679.
12 31 USC §5322. The penalties are imposed pursuant to the Bank Secrecy Act, codified as part of Title 31 of the U.S. Code, and not Title 26, the Internal Revenue Code.
13 31 USC §5321(a)(5)(C).
14 31 USC §5321(a)(5)(B)(ii).
15 31 USC §5321(a)(5)(A). This penalty applies only to violations occurring after Oct. 22, 2004. *See* IRM 4.26.16.4.4 (July 1, 2008).
16 Code Sec. 7201.
17 Code Sec. 6673.
18 All references to FAQs are to the 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers as published on the IRS' Web site at *www.irs.gov/businesses/international/article/0,,id=235699,00.html* as of March 1, 2011. If past experience is any guide there will be a series of additions and tweaks to these FAQs as time goes on.
19 Generally the OVDI framework applies to the 2003 to 2010 tax years, however, if in any year the foreign accounts, or foreign entities are disclosed then those years are not part of the OVDI disclosure period. FAQ 9.
20 Many taxpayers and their advisors will be shocked to learn that foreign mutual funds are generally classified as Passive Foreign Investment Companies (PFICs) subject to taxation even if no distributions are received. *See* Code Sec. 1291 *et. seq.* The IRS is allowing for a simplified mark to mark method of calculating the tax due on PFICs under the OVDI. FAQ 10.
21 FAQ 7.
22 FAQ 53.
23 FAQ 52.
24 For example, most owners of inherited accounts could not qualify for the five-percent penalty under the OVDP because once the funds were inherited a new foreign account was opened to receive the proceeds of the decedent's foreign account. Expect issues to arise under the OVDI as to whether the bank "required" the opening of the new account, or was done at the request of the estate administrator.
25 FAQ 52.
26 The FAQ makes clear that it does not apply to someone who is aware he is a U.S. citizen, but fails to inquire into his U.S. reporting obligations.
27 FAQs 17 and 18.
28 FAQ 17.
29 FAQs 17 and 18.
30 FAQ 35.
31 *Id.*
32 *See* FAQ 36.
33 *See* FAQ 36: "Tax noncompliance includes 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." (Emphasis supplied.) *See also* FAQ 17 "… if you reported and paid tax on all taxable income but did not file FBARs, do not use the voluntary disclosure process." (Emphasis supplied.) The OVDP contained similar verbiage; many practitioners read the word "and" in the disjunctive. The IRS did not.
34 *Id.*
35 FAQ 38.
36 FAQ 1.
37 Taxpayers who cannot afford to pay the entire amount are to submit IRS financial statements on Form 433-A and/or Form 433-B. FAQ 35. It is unclear whether in appropriate cases the IRS will enter into an Offer in Compromise or whether payment arrangements will be limited to installment agreements.
38 FAQ 27.
39 *Id.*
40 FAQ 28.
41 *See* FAQ 27.
42 FAQ 23.
43 FAQ 14.
44 FAQ 21.
45 FAQ 50.