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Expert Analysis

New Offshore Voluntary Disclosure Program: a Carrot Without a Stick?

By
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Since 2008, the Internal Revenue Service has used both the stick (the threat of criminal prosecution) and the carrot (a series of voluntary disclosure initiatives) to bring taxpayers into compliance with their obligations to report offshore accounts and assets. On June 26, 2012, the IRS issued two separate, but related, press releases. The first release touted the success of the IRS's recent initiatives, announcing that voluntary disclosures made under the 2009 Offshore Voluntary Disclosure Program (2009 OVDP) and the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI) have yielded more than $5 billion in back taxes, interest and penalties.[1] In connection with this announcement, the IRS released long-awaited guidance with respect to the third application of its use of the long-standing Voluntary Disclosure Practice to offshore reporting compliance: the 2012 Offshore Voluntary Disclosure Program (2012 OVDP). Simultaneously, the IRS's second press release announced new procedures to address the special challenges faced by U.S. and dual citizens who reside overseas.[2]

While both announcements will enable practitioners to more clearly advise previously non-compliant taxpayers, the success of the 2009 OVDP and the 2011 OVDI was largely attributable to taxpayer concerns that the IRS would discover their historical non-reporting. As a result, the level of participation in the 2012 OVDP will likely depend on whether noncompliant taxpayers perceive there to be a credible threat of detection.

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Compliance Initiatives

This column has tracked the IRS's efforts to eradicate the use of unreported offshore financial accounts to evade United States income taxes.[3] These efforts have focused on criminal prosecutions of non-compliant taxpayers and their advisors, the use of John Doe summonses and treaty requests to obtain records from foreign financial institutions and the issuance of grand jury subpoenas to taxpayers suspected of having undisclosed offshore accounts. The IRS has used publicity regarding its aggressive enforcement efforts as well as the anticipation of third-party reporting in connection with the Foreign Account Tax Compliance Act (FATCA) to incentivize taxpayers to come into compliance "voluntarily." In this regard, the IRS has combined its long-standing Voluntary Disclosure Practice with civil settlement initiatives designed to entice taxpayers to come clean before they are identified and subject to criminal investigation.

The 2009 OVDP and the 2011 OVDI offered taxpayers who came forward within a limited window a measure of protection from criminal prosecution and the ability to take advantage of defined civil penalty structures. While the 2011 OVDI closed on Sept. 9, 2011, the IRS announced the 2012 OVDP, which offered slightly harsher penalties than its predecessors, on Jan. 9, 2012.

According to the IRS, it received 33,000 voluntary disclosures under the first two programs and has already received 1,500 disclosures under the third program. Not only have these programs generated substantial revenues to date, but by bringing offshore assets back into the taxing system, they will continue to generate additional tax revenues in the future. In exchange, taxpayers making voluntary disclosures significantly reduced their risk of criminal prosecution and gained greater access and flexibility with respect to their previously secret assets. For many taxpayers, these benefits more than outweighed the cost of the back (and future) taxes, interest and penalties.

Guidance for the 2012 OVDP

In connection with the 2009 OVDP and the 2011 OVDI, the IRS issued extensive guidance in the form of Frequently Asked Questions or FAQs.[4] Unlike the first two programs, for which initial FAQs were issued shortly after they were announced, practitioners waited more than five months for the FAQs relating to the 2012 OVDP.[5] While the newly issued FAQs largely track those for the first two programs, there are several significant changes.

First, both the 2009 OVDP and the 2011 OVDI were subject to strict deadlines. While such deadlines encouraged non-compliant taxpayers to come forward, once the deadlines passed, practitioners were no longer able to counsel their clients regarding the likely civil consequences of disclosing their offshore accounts and assets. Because certainty regarding the civil consequences of disclosure was often an important consideration in the decision to come clean, the lapse in defined settlement terms inhibited disclosures between the programs.

Unlike its predecessors, the 2012 OVDP does not include a deadline for taxpayers to participate, thereby providing some certainty with respect to the civil penalty structure for the foreseeable future. Perhaps recognizing that the absence of a firm deadline will lead to procrastination, FAQ 3 provides that "the terms of this program could change at any time going forward. For example, the IRS may increase penalties or limit eligibility in the program for all or some taxpayers or defined classes of taxpayers—or decide to end the program entirely at any point." As a practical matter, this vague threat is unlikely to give previously recalcitrant taxpayers a real push to come forward. Rather, participation will likely be driven by publicity regarding the IRS's enforcement efforts or fear that financial institutions will start disclosing account information in response to John Doe summonses or treaty requests or pursuant to FATCA.

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Second, as with the prior programs, while neither the service of a John Doe summons nor a treaty request disqualifies all members of the John Doe class or the group identified in the treaty request from participating in the 2012 OVDP, once the IRS or Department of Justice obtain information regarding a specific taxpayer's noncompliance, that taxpayer is no longer eligible to make a voluntary disclosure. Many foreign governments offer judicial or administrative procedures to challenge disclosure of account records. However, under §3506 of Title 18 of the U.S. Code, U.S. nationals and residents are required to provide the Attorney General with copies of any documents filed in a foreign country opposing an official request for evidence. Enforcement of this provision, however, has proven problematic due to the lack of a sanction for non-compliance.[6] The 2012 OVDP addresses this shortcoming by providing that "if a taxpayer appeals a foreign tax administrator's decision authorizing the providing of account information to the IRS and fails to [comply with 18 U.S.C. §3506], the taxpayer will be ineligible to participate" in the 2012 OVDP.[7]

Third, the FAQs make clear that taxpayers participating in the 2012 OVDP must also address any noncompliance unrelated to their offshore accounts or assets. While it is entirely unremarkable that an amended return—whether filed pursuant to a voluntary disclosure program or otherwise—must be complete and accurate, the IRS has clarified that taxpayers with issues relating to both offshore accounts and unreported domestic-source income (or some other undisclosed tax liability) "should follow the process for offshore voluntary disclosures, but indicate that they are also making a domestic voluntary disclosure." Moreover, the domestic component of this hybrid disclosure may be assigned to a different civil examiner for assessment of tax, interest and penalties.[8]

Fourth, the newly issued FAQs address which years must be included in the voluntary disclosure. Under the 2009 OVDP, participants were required to amend six years of returns, and the FBAR penalty was based on the highest annual balance from 2003 through 2009. The 2011 OVDI continued the requirement that taxpayers go back to 2003, perhaps out of concern that calculating financial penalties based on the most recent six years would reward taxpayers who complied with their 2009 and 2010 filing obligations without participating in the 2009 program.

The 2012 OVDP makes this policy choice explicit, providing that the voluntary disclosure period is eight years, but excludes (a) current years for which there has not yet been non-compliance, or (b) "[f]or taxpayers who establish that they began filing timely, original, compliant returns that fully reported previously undisclosed offshore accounts or assets before making the voluntary disclosure, the voluntary disclosure period will begin with the eighth year preceding the most recent year for which the return filing due date has not yet passed, but will not include the compliant years."[9] FAQ 9 provides an example of a taxpayer who, after years of omitting income from an undisclosed offshore account, filed accurate income tax and information reporting returns in 2009 and 2010. If that taxpayer participates in the 2012 OVDP, his voluntary disclosure period will be 2003 through 2008.

One Size Does Not Fit All

The Voluntary Disclosure Practice has traditionally been used by taxpayers concerned about possible criminal prosecution, as opposed to those who learn of some technical error in their tax returns. There is, of course, a broad spectrum of tax violators and rather than attempting to draw fine distinctions between those who used undisclosed offshore accounts to evade their U.S. tax obligations and those who were genuinely unaware of their reporting obligations, the 2009 OVDI treated all offshore non-compliance identically. While this "one-size-fits-all" treatment may have made sense given the program's roots in the criminal investigation of UBS bankers and clients, it soon became apparent that imposing the same penalties on people with different levels of culpability was unwarranted.

In connection with the 2011 OVDI, the IRS expanded the number of participants eligible for reduced penalties. Among other things, the FAQs issued in connection with that program provided a 5 percent penalty for accountholders who (a) did not open the account, (b) exercised minimal contact with the account; (c) other than transactions closing the account and transferring the balance to the United States, did not withdraw more than $1,000 from the account in any year covered by the voluntary disclosure; and (d) can establish that U.S. income taxes were paid on funds deposited into the account. In addition, the 5 percent penalty was made available to foreign residents who either were unaware that they were U.S. citizens or had complied with all tax reporting and payment obligations in their country of residence and had $10,000 or less of U.S. source income in each year.[10]

In addition, on June 1, 2011, the IRS provided guidance on how it would treat taxpayers who "opt out" of the 2009 OVDP and the 2011 OVDI.[11] As with the amended 2011 FAQs, the 2012 FAQs provide detailed guidance for OVDP participants considering opting out from the penalty structure. FAQs 51 and 51.3 provide that taxpayers who opt out of the civil settlement structure remain in the Criminal Investigation's Voluntary Disclosure Practice and are still required to cooperate with the IRS examiner and pay, or make arrangements to pay, the tax, interest and penalties ultimately determined to be

owed. While failure to do so may result in referral of the taxpayer back to Criminal Investigation, the clear implication is that a taxpayer can opt out without losing the protection from criminal prosecution that caused him to participate in the OVDP.

> On June 26, the IRS announced a new procedure designed to help U.S. citizens residing overseas catch up with their tax filing obligations. Under this procedure, which will go into effect on Sept. 1, such taxpayers can become compliant by filing three years' worth of delinquent tax returns and related information returns and six years of FBARs.

FAQs 51.1 and 51.2 give several examples of situations when the settlement structure will result in greater (or lesser) penalties than if the taxpayer "opts out." In each example a taxpayer whose conduct is ultimately determined to have been willful is better off within the settlement structure, while the taxpayer whose conduct is found to have been non-willful is better off outside the program. Thus, the value of this guidance depends on the practitioner's ability to accurately predict how the IRS will judge the facts of the particular case.

While there are many cases in which the ultimate conclusion will prove difficult to predict, in cases where the client's conduct was clearly non-willful, rendering a criminal prosecution unlikely, the client might reasonably decide to comply with her reporting obligations going forward without participating in the OVDP. By contrast, where the taxpayer's conduct is so egregious that there appears to be a genuine risk of criminal prosecution, the protections offered by the OVDP and its civil settlement structure are substantial, and the taxpayer would generally be ill-advised to opt out.[12] Of course, there are many cases in the middle, where the risk of criminal prosecution warrants participation in the OVDP, while the mitigating facts are sufficiently powerful to justify opting out and hoping the financial penalties ultimately imposed are less than would have been applied under the civil settlement structure.

U.S. Citizens Residing Abroad

The IRS's focus on undisclosed offshore accounts has had a disproportionate impact on U.S. citizens residing abroad who were unaware of their tax obligations to the United States.

On June 26, the IRS announced a new procedure designed to help U.S. citizens residing overseas catch up with their tax filing obligations. Under this procedure, which will go into effect on Sept. 1, such taxpayers can become compliant by filing three years' worth of delinquent tax returns and related information returns and six years of FBARs. Taxpayers who present "low compliance risks" (i.e., those with simple tax returns and who owe $1,500 or less in taxes for any of the covered years) will be subject to expedited review and the IRS will not assert penalties. By contrast, higher compliance risk taxpayers will be subject to more thorough review and potentially a full audit, which could cover more than three years.[13]

Finally, the June 26 press release also announced a plan to resolve issues relating to foreign retirement plans. Under the new procedure, which will likewise go into effect in September, taxpayers who failed to timely elect income deferral on certain retirement accounts may be eligible for retroactive relief.

While the IRS promises that additional details will be forthcoming, both of these changes reflect its desire to provide relief to less culpable violators.

Conclusion

While measured against reports that there were as many as 52,000 accounts at UBS alone, it is difficult to view the 33,000 voluntary disclosures under the 2009 OVDP and the 2011 OVDI as an unqualified success. However, the fact that these programs have generated over $5 billion in revenues is a positive development. The FAQs for the 2012 OVDP provide useful guidance to practitioners and some common-sense changes that address flaws in its predecessors. However, the 2012 OVDP's ability to generate the level of interest of the earlier programs will, in large part, depend on the government's ability to wield the big stick of the genuine threat of criminal prosecution.

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1. See IR-2012-64, "IRS Says Offshore Effort Tops $5 Billion, Announces New Details on the Voluntary Disclosure Program and Closing of Offshore Loophole," available at http://www.irs.gov/newsroom/article/0,,id=258430,00.html.

2. See IR-2012-65, "IRS Announces Efforts to Help U.S. Citizens Overseas Including Dual Citizens and Those With Foreign Retirement Plans," available at http://www.irs.gov/newsroom/article/0,,id=258431,00.html

3. Jeremy Temkin, "FATCA: New Front in the IRS's Battle Against Offshore Accounts," NYLJ (May 12, 2011); Jeremy Temkin, "Voluntary Disclosure of Offshore Accounts: Yet Another 'Last' Chance," NYLJ (Feb. 17, 2011); Jeremy Temkin, "Offshore Banking: the End of the World as We Know It?" NYLJ (Jan. 14, 2010); Jeremy Temkin, "One Last Chance for Offshore Account Holders," NYLJ (May 14, 2009).

4. The FAQs for the 2009 OVDP (the 2009 FAQs), which were initially posted on May 6, 2009, and were amended several times through Jan. 8, 2010, are available at http://www.irs.gov/newsroom/article/0,,id=210027,00.html. The FAQs for the 2011 OVDI (2011 FAQs), which were initially posted on Feb. 8, 2011, and were amended several times through March 5, 2012, are available at http://www.irs.gov/businesses/international/article/0,,id=235699,00.html.

5. The FAQs for the 2012 OVDP (the 2012 FAQs) are available at http://www.irs.gov/businesses/small/international/article/0,,id=256774,00.html.

6. See Jeremy H. Temkin, "Another Catch-22 for Swiss Accountholders," NYLJ (Jan. 12, 2012); see also In re Grand Jury Investigation (M.H.), No. 10 gj 2011 (Dec. 6, 2011 S.D. Cal.) (granting government's motion to compel production of documents under 18 U.S.C. §3506).

7. See 2012 FAQ 21.

8. See 2012 FAQs 7.1, 24 and 26.

9. See 2012 FAQ 9.

10. See 2011 FAQ 52 (updated June 2, 2011).

11. See Memorandum of Steven T. Miller, Deputy Commissioner for Services and Enforcement, regarding "Guidance for Opt out and Removal of Taxpayers From the Civil Settlement Structure of the 2009 Offshore Voluntary Disclosure Program (2009 OVDP) and the 2011 Offshore Voluntary Disclosure Initiative (2009 OVDI)," available at http://www.irs.gov/pub/newsroom/2011_ovdi_opt_out_and_removal_guide_and_memo_june_1_2011.pdf.

12. But see Williams v. Commissioner, No. 09-cv-437, 2010 WL 3473311 (Sept. 9, 2010 E.D. Va.) (rejecting application of "willful" FBAR penalties to taxpayer who pled guilty to conspiracy and tax evasion charges in connection with funds held in undisclosed account).

13. See "New Filing Compliance Procedures for Non-Resident U.S. Taxpayers," available at http://www.irs.gov/businesses/small/international/article/0,,id=256772,00.html.

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