

## TAX LITIGATION ISSUES

## Expert Analysis

# Voluntary Disclosure of Offshore Accounts: Yet Another 'Last' Chance

**O**n Feb. 8, 2011, the Internal Revenue Service announced the terms of the latest in a series of “last-chance” programs designed to encourage non-compliant taxpayers to disclose secret foreign bank accounts.<sup>1</sup> The new program, labeled the Offshore Voluntary Disclosure Initiative (OVDI)—distinguishing it from its most recent predecessor, the 2009 Offshore Voluntary Disclosure Program (OVDP)—offers taxpayers an opportunity to avoid criminal prosecution by curing past tax deficiencies and paying significant civil penalties by Aug. 31, 2011.<sup>2</sup>

About 14,700 taxpayers made voluntary disclosures under the OVDP regime,<sup>3</sup> which was perceived as a great success for the IRS. However, many eligible taxpayers did not participate in the OVDP,<sup>4</sup> and since the program’s close on Oct. 15, 2009, nearly 3,000 offshore account holders have come forward under the IRS’s long-standing Voluntary Disclosure policy.<sup>5</sup> Some of these latecomers may have come forward to alleviate pangs of conscience; many others likely did so because their offshore accounts were about to be disclosed to the IRS.

The OVDI gives taxpayers yet another opportunity to come clean, avoid criminal punishment, and face reduced—albeit certain and harsh—monetary penalties. According to IRS Commissioner Doug Shulman, the OVDI’s goal “is to get people back into the U.S. tax system” by offering “those hiding money in foreign accounts a tough, fair way to resolve their tax problems once and for all...before we find them.”<sup>6</sup> However, given the OVDI’s punitive terms, taxpayers will have little incentive to come forward unless they perceive a legitimate threat of criminal sanction.

### Program Terms

The OVDI is open to all taxpayers “who have undisclosed offshore accounts or assets,” with the exception of those taxpayers who already are under civil or criminal investigation by the IRS.<sup>7</sup> The terms governing the OVDI and other relevant documents can be found at the IRS’s website ([www.irs.gov](http://www.irs.gov)) and are amplified in a series of questions and answers (FAQs) issued

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by the IRS. The basic terms are similar to those that governed the OVDP.

First, the taxpayer’s representative contacts IRS Criminal Investigation (CI) to ascertain whether the taxpayer is eligible for the OVDI. This inquiry serves as a placeholder for the timeliness of the taxpayer’s disclosure. Unless the taxpayer is already under investigation, he will likely be “pre-cleared” for voluntary disclosure.

Next, the taxpayer must complete and submit to CI an “Offshore Voluntary Disclosure Letter,” providing information about the nature of the accounts in question, including their size and the amount of income they have generated. CI then informs the taxpayer, generally within 30 days, whether he has been preliminarily accepted into the program.

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This preliminary acceptance, if granted, is conditioned on the taxpayer’s completion of the civil aspects of the OVDI by Aug. 31 of this year. This second phase of the program requires participating taxpayers to file or amend tax returns for any of the past eight tax years (2003-2010) in which they failed to report the existence of (and/or income derived from) any foreign bank accounts and foreign entities.<sup>8</sup> These filings must include, for each applicable year, a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), and other documents described in the IRS FAQs.<sup>9</sup>

Unlike the OVDP, in which penalties were only

imposed after a civil examination, taxpayers participating in the OVDI must self-assess (1) a 20 percent accuracy-related penalty on previously underpaid taxes and/or any applicable failure-to-pay or failure-to-file penalties,<sup>10</sup> and (2) a one-time additional penalty generally equal to 25 percent of the highest annual aggregate balance of all foreign bank accounts (or the value of certain foreign assets) during the period covered by the voluntary disclosure.<sup>11</sup> All taxes, interest, and penalties that are owed must be paid at the time the taxpayer submits the voluntary disclosure package (although deferred payment plans can be arranged).

### Benefits of Participation

In exchange for the 25 percent penalty, taxpayers are relieved from paying “all other penalties that may apply, including FBAR and offshore-related information return penalties.”<sup>12</sup> Depending on the circumstances, this relief can be substantial: The penalties that could otherwise be imposed can include, simply for failure to file FBARs, 50 percent of the value of the undisclosed account(s) for each year in which accurate FBARs were not filed.<sup>13</sup> Thus, for many taxpayers, the FBAR penalties could easily wipe out the current balance of the foreign accounts in question. And, OVDI participants might also otherwise be subject to additional penalties relating to other offshore assets, foreign corporations, and foreign trusts.<sup>14</sup>

More importantly, participants in the OVDI effectively eliminate their exposure to criminal prosecution for their past tax offenses. Although the IRS promises only that it “will not recommend criminal prosecution to the Department of Justice” for taxpayers who enter OVDI and comply with all OVDI provisions, as a practical matter those accepted into the program are likely to avoid criminal sanctions.<sup>15</sup>

Thus, for those taxpayers who, in conjunction with their lawyers, determine that the risk of criminal exposure is real, OVDI is an extremely attractive option. Most clients would eagerly trade the near certainty of avoiding criminal prosecution for a substantial one-time financial penalty. But not all taxpayers with undisclosed offshore accounts are equally likely to face criminal prosecution. For those taxpayers who have strong defenses to potential criminal charges (or significant mitigating circumstances), the decision to participate in the OVDI is more complicated.

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## Problems With One Size for All

To the IRS's credit, the OVDI responds to several of the tax bar's complaints about the OVDI: it eliminates the requirement of a time-consuming and costly examination, expands the application of the 5 percent FBAR penalty for taxpayers who had minimal contact with their accounts, and adds a 12.5 percent penalty category for smaller accounts.<sup>16</sup> However, the OVDI does not address a major flaw in the OVDI: the inability of IRS examiners to exercise discretion in assessing civil penalties.

In connection with the OVDI, the IRS suggested that civil agents would have the ability to reduce penalties to reflect the reality of individual taxpayers' situations. Thus, while FAQ 35 for the OVDI stated that examiners would "not have discretion to settle cases for amounts less than what is properly due and owing," it further provided that "[u]nder no circumstances [would] a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes."<sup>17</sup> This provision "appeared to operate as a sort of fail-safe procedure for unusual cases,"<sup>18</sup> and practitioners believed that taxpayers who could demonstrate that they had not willfully failed to file FBARs (and thus would not be penalized 50 percent under normal circumstances) could avoid even the "reduced" 20 percent penalty. But the IRS saw it differently, effectively treating all participants as though they had the same level of culpability. FAQ 35 relief was rarely granted, and harsh civil penalties were imposed even upon minimally culpable taxpayers who were making good-faith voluntary disclosures with the intention of becoming fully tax-compliant.

The FAQs issued along with last week's announcement of the OVDI indicate that nothing has changed. FAQ 50 repeats the caution that examiners will not have any discretion to settle cases and, while repeating the promise that taxpayers will not be required to pay more than would be mandated under existing statutes, adds that the penalties imposed under the OVDI will be compared to "applicable penalties (at their maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability)."<sup>19</sup> While practitioners and taxpayers will benefit from the clarity of a defined penalty structure, the severity of that penalty structure will likely drive some participants away.

Consider the cases of Taxpayers A and B. Taxpayer A is a successful businessman who each year deposited part of his pre-tax income into an offshore account. Although he filed tax returns each year, he intentionally did not disclose his offshore account or file FBARs. Taxpayer B, by contrast, was born in the United States to immigrant parents and left this country as a child. While he knows that he is a U.S. citizen by birth, he had dual citizenship, rarely visited this country, never worked or maintained a bank account here, and was genuinely unaware that he was obligated to file U.S. tax returns (and FBARs).

Under the OVDI, as under the OVDI, Taxpayers A and B would be treated as though they were equally culpable in their tax delinquency. For Taxpayer A, the OVDI is a panacea for his

potential criminal exposure; he will gladly pay the civil penalty to avoid prosecution. By contrast, because Taxpayer B did not consciously shirk his U.S. tax obligations, and as such likely has no criminal exposure, the cost of paying eight years' worth of back taxes and associated failure-to-file and failure-to-pay penalties, plus the one-time 25 percent OVDI penalty, is unduly harsh.<sup>20</sup> Taxpayer B's option of proceeding outside the OVDI will cost him substantial professional fees, and his ultimate exposure would remain uncertain.

The practitioner advising Taxpayer B—knowing she will be unable to argue that, because his conduct was not willful, Taxpayer B's penalties outside the program would be substantially less than those imposed within the OVDI—will discuss the costs and benefits of participating in the program, as well as the risks of forgoing the opportunity. Taxpayer B might decide to make a "quiet" disclosure of his past tax deficiency or simply to file accurate returns going forward and do nothing else. In the event he is audited, he is unlikely to be referred for criminal prosecution because his tax delinquency was quite clearly unintentional. The civil penalties imposed in an audit are unlikely to be substantially harsher than those to be self-assessed in the OVDI, and his arguments regarding his lack of willfulness will be addressed during the course of the audit (and subsequent appeals). From a tax-enforcement perspective, this is hardly a desirable outcome.

Participants in the OVDI effectively eliminate their exposure to criminal prosecution for their past tax offenses. But for those taxpayers who have strong defenses to potential criminal charges, the decision to participate in the OVDI is more complicated.

## Conclusion

The OVDI has, thus far, received a lukewarm reaction from the practitioner community. Practitioners consulted regarding previously undisclosed offshore accounts must, of course, tell their clients about the OVDI as well as about their obligation to file complete and accurate returns going forward (including their 2010 returns that will be due this April). However, whether clients decide to participate in the OVDI will likely reflect an assessment of their criminal exposure. As such, the ultimate success of the OVDI will largely depend upon the IRS's ability to generate concern among taxpayers that they are in imminent danger of detection and prosecution.

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1. Internal Revenue Service, Press Release IR-2011-14, "Second Special Voluntary Disclosure Initiative Opens; Those Hiding Assets Offshore Face Aug. 31 Deadline" (Feb. 8, 2011) (available at <http://www.irs.gov/newsroom/article/0,,id=235695,00.html>).

2. When the OVDI's deadline was extended from Sept. 23, 2009, to Oct. 15, 2009, it was touted by the IRS as a "one-time extension." Internal Revenue Service, Press Release IR-2009-84, "IRS Extends Deadline For Disclosing Hidden Offshore Accounts" (Sept. 21, 2009) (available at <http://www.irs.gov/newsroom/article/0,,id=213463,00.html>). Other previous

programs have also been referred to as the "last chance" for delinquent taxpayers to make amends. See Jeremy H. Temkin, "Offshore Banking: The End of the World as We Know It?" n.3, NYLJ (Jan. 14, 2010).

3. Lynnley Browning, "14,700 Disclosed Offshore Accounts," *The New York Times* (Nov. 18, 2009).

4. Temkin, "Offshore Banking," supra note 2.

5. Laura Saunders, "IRS Sets Offshore Amnesty, Part II," *The Wall Street Journal* (Feb. 9, 2011). These disclosures will now be treated as though they were made under the terms of OVDI. See IR-2011-14.

6. IR-2011-14.

7. *Id.* Q12.

8. Internal Revenue Service, "2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers" ("2011 FAQ"), Q7 (available at <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html>). Under the OVDI, the same requirements existed, but the relevant period was only six years long. Internal Revenue Service, "Voluntary Disclosure: Questions and Answers" ("2009 FAQ"), Q13 (available at <http://www.irs.gov/newsroom/article/0,,id=210027,00.html>).

9. *Id.*

10. *Id.*

11. 2011 FAQ, Q7. Certain taxpayers will only have to pay 12.5 percent of the highest year's aggregate balance—if the aggregate balance during the 2003-2010 period never exceeded \$75,000—or 5 percent—if the taxpayer did not establish the account, used it infrequently, and meets certain other criteria. 2011 FAQ, Q52 & Q53. While the 5 percent carve-out for passive account holders existed under the OVDI, the 12.5 percent carve-out for small accounts is new to the OVDI. *Id.*; see generally 2009 FAQ.

12. 2011 FAQ, Q7.

13. *Id.* Q5.

14. *Id.*

15. *Id.* Q4.

16. See Mark E. Matthews & Scott D. Michel, "IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year," *BNA Daily Tax Report*, at 8-10 (Sept. 21, 2010) (discussing concerns relating to examination process under OVDI); 2011 FAQ, Q52 (addressing 5 percent penalty); *id.* Q.53 (addressing 12.5 percent penalty).

17. 2009 FAQ, Q35.

18. Matthews & Michel, supra note 16.

19. 2011 FAQ, Q50; see also *id.* Q33.

20. If, however, Taxpayer B had been unaware that he was a U.S. citizen, he will be eligible for the 5 percent penalty. This reduced penalty is unavailable to taxpayers who know of their citizenship, but do not inquire as to their tax obligations. See 2011 FAQ, Q52.