Coming clean - The US voluntary disclosure initiative in perspective

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US Voluntary Disclosure

On 17 October 1931, notorious gangster and bootlegger Al Capone was convicted of criminal tax evasion and sentenced to 11 years in jail, where he ultimately died. On 1 February 2008, actor Wesley Snipes was convicted on three counts of failing to file an income tax return and was later sentenced to three years in jail. The US has a long history of criminally prosecuting those who evade their tax obligations in addition to pursuing the unpaid taxes through civil courts. On 8 February 2011, the IRS announced its latest offshore voluntary disclosure initiative (the 2011 OVDI), which provides a path for US taxpayers with unreported foreign income or assets to come into compliance. Non-compliant taxpayers who come forward before 31 August 2011 will substantially reduce their risk of criminal prosecution in exchange for the payment of a penalty that is, in many cases, less than the payment that would be owed in a traditional audit. This article examines the terms of the 2011 OVDI and who will benefit from it.

Who is a US Person?

A US Person must annually file an income tax return disclosing their worldwide income and must also file a number of information returns. For these purposes a US Person includes US citizens and lawful permanent residents (so called "green card" holders), regardless of residence. That is, US citizens and lawful permanent residents are US Persons even if they live outside the United States for the entire year. Non-citizens who are physically present in the United States for more than 183 days in a calendar year are US Persons, as are those who fail the "substantial presence test," which looks at the total number of days a person was physically present in the United States over a three year period. Any US Person who is not fully compliant with his US tax and reporting obligations should consider taking advantage of the 2011 OVDI.

What must a US Person file?

While a complete discussion of the filing obligations of US Persons is beyond the scope of this article, some common reports and the associated civil penalties are worth noting.

Form 1040 is the basic income tax return required to be filed each year for a US Person. Failing to file the return can result in a penalty of up to 25% of the tax due, and failure to pay the tax when due can result in an additional penalty of up to 25%. If the failure to file a return is fraudulent, the failure to file penalty can be as high as 75%.

A Foreign Bank Account Report (Form TD F 90-22.1, commonly known as an "FBAR") is required to be filed by US Persons who have a financial interest in or signature authority over foreign financial accounts exceeding USD10,000 in the aggregate. The FBAR form is separate from any tax returns that must be filed and is due by June 30 for the prior calendar year (extensions are not available). Failure to file the FBAR can trigger a penalty of USD10,000 per account per year. A wilful failure to file the FBAR can result in a penalty equal to the greater of USD100,000 or 50% of the account balance at the time of the offence. The latest version of the FBAR was issued in March 2011 and includes new options for consolidated reporting and reduced reporting for some trust beneficiaries. It also clarifies that

disregarded entities, such as single member limited liability companies and grantor trusts, must file FBARs each year.

Form 3520 is required for taxpayers to report various transactions involving foreign trusts, including the receipt of distributions from foreign trusts. This return also reports the receipt of gifts from foreign persons. The penalty for failing to file is 35% of the gross reportable amount, except for returns reporting gifts, where the maximum penalty is 25% of the gift.

A Form 5471 must be filed by US Persons who are officers, directors or shareholders in certain foreign corporations. The penalty for failing to file each one of these information returns is USD10,000, with an additional USD10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of USD50,000 per return.

Form 926 is required to report transfers of property to foreign corporations and other information under section 6038B. The penalty for failing to file each one of these information returns is 10% of the value of the property transferred, up to a maximum of USD100,000 per return, with no limit if the failure to report the transfer was intentional.

What is a Voluntary Disclosure?

A voluntary disclosure begins with an admission to the IRS that a taxpayer failed to properly report an item of income on his tax return or failed to disclose required information on a reporting form. A voluntary disclosure substantially reduces the risk of criminal prosecution, although it does not guarantee immunity from prosecution.

There are currently two main methods for conducting a voluntary disclosure matter with respect to undeclared foreign assets during the next few months: (i) a 'Noisy' voluntary, whereby a taxpayer enters into the 2011 OVDI, and (ii) a 'Quiet' voluntary, whereby a taxpayer, or his representative, directly files unfiled or amended income tax returns and information reports without contacting the IRS and Treasury beforehand. The IRS does not consider a 'Quiet' disclosure to be an adequate voluntary disclosure for the purposes of precluding criminal prosecution.

A Noisy voluntary disclosure must be truthful, timely and complete, and the taxpayer must demonstrate a willingness to co-operate (and must in fact co-operate) with the IRS in determining the correct tax liability. During the 2011 OVDI, the taxpayer must also submit all documents required under the OVDI by 31 August 2011. A Noisy voluntary disclosure is not available to all taxpayers, including those with illegal source income, but is a viable option for the vast majority of taxpayers with unreported income or unreported foreign accounts.

The 2011 Offshore Voluntary Disclosure Programme

The details of the 2011 OVDI can be found on the IRS website, in the form of 53 frequently asked questions (FAQs). Notice this programme is not based on the Internal Revenue Code, Treasury Regulations that require public comment, or even a formal IRS Notice published in the Federal Register. The only guidance is in the current FAQ, which can be modified at any time. In fact, since the FAQs were issued on 8 February 2011, they have already been changed three times (10 February, 14 February and 14 March) as of the date this article went to print. If taxpayers find the terms acceptable, the 2011 OVDI represents an opportunity to have some certainty (bearing in mind the risk of FAQ modification) with regards to the penalties they will face for becoming tax compliant. Taxpayers are always free to exercise their rights under the law and do not need to participate in the 2011 OVDI.

Taxpayers must understand that because the 2011 OVDI is completely within the purview of the IRS, they can change the rules over time, even to the detriment of a taxpayer who relied on the FAQ framework in making the decision to come forward and who has fully and completely complied with their obligations in the 2011 OVDI. Taxpayers have no recourse within the 2011 OVDI to address such rule changes. The 2011 OVDI is a modified version of the 2009 OVDI, which appeared straightforward in concept. Nonetheless, during 2009, 2010 and as recently as 28 March 2011, the IRS continued to amend the rules relating to both the calculation of penalties and the situations in which certain returns were required. The two most notable examples of this are: (i) the scope of FBAR reporting requirements; and (ii) whether or not taxpayers could seek to have the statutory penalties applied (where the statutory assessment would be less than the "deal" through the 2009 OVDI) by demonstrating reasonable cause or lack of wilfulness in failing to make prior filings. Administration of the 2009 OVDI has therefore been confusing at times, and similarly situated taxpayers have achieved materially different results. All changes have not been bad, however. As the programme progressed, many taxpayers were unable to produce the information required to complete Form 8621, which is required for taxpayers who dispose of interests in or receive distributions from Passive Foreign Investment Companies (PFICs). In September 2010, the IRS provided an optional method for reporting PFICs through the 2009 OVDI that is often more favourable for taxpayers than what the law generally requires. While it is reasonable to expect adjustments to the 2011 OVDI in the coming months, similar to what was observed during the course of the 2009 OVDI, we cannot know what they will be.

The 2011 OVDI borrows heavily from the terms offered in 2009, with several significant changes:

- Like the 2009 programme, the 2011 OVDI requires disclosures to be timely, which means the disclosure must be made before: (1) the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation; (2) the IRS has received information from a third party (such as an informant, other governmental agency or the media) alerting the IRS to the specific taxpayer's non-compliance; (3) the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or (4) the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (eg search warrant or grand jury subpoena).
- The time period at issue has been increased from six to eight years. The taxpayers will now be required to pay back taxes, interest, and a 20% accuracy penalty for tax years 2003 to 2010. Under the 2009 OVDI, the time period was 2003 to 2008.
- Taxpayers must now pay a penalty of 25% of the total asset value in all unreported foreign financial accounts, entities and certain foreign assets, increased from the 20% penalty in the 2009 programme (which did not include foreign assets not held in an account or an entity). Such penalty is calculated by reference to the year in which the value of such accounts, entities and assets was the highest during the eight year period of the programme. Since a taxpayer's

foreign real estate or foreign held art may be on the table (in addition to the higher rate), this penalty will be significantly higher for most taxpayers.

- The IRS has expanded the group of individuals who may qualify for a reduced penalty rate from the 2009 programme.
  - Individuals with smaller offshore accounts (i.e., where the value of the unreported accounts or assets did not surpass USD75,000 in any year during the period) may qualify for a penalty of 12.5% instead of 25%.
  - Inherited accounts are eligible for a reduced penalty of 5% if the taxpayer did not set up the account, had minimal involvement with the account, did not withdraw more than USD1,000 in any year from 2003 to 2010 except to close the account and transfer funds to a US account, and can establish all applicable US taxes had been paid on the funds originally deposited in the account. It is not clear how much documentation the IRS will require to establish this final element.
  - Individuals classified as "accidental Americans" may qualify for a 5% penalty if such persons where unaware that they had US citizenship. While not entirely clear, this probably requires the person to have discovered their US citizenship in 2010 or 2011.
- 2009 OVDI participants can reopen their case should any of the reduced penalties introduced in the 2011 OVDI apply to them.
- The deadline of the 2011 OVDI is 31 August 2011, and the IRS must receive all amended income tax returns, amended information filings, full payment of the amount due, as well as various other documents by that date. This is in contrast to the 2009 OVDI in which the taxpayer needed to do little more than identify themselves before the programme closed and could both file tax returns and make payment thereafter.
- The 2011 OVDI, like the 2009 OVDI, continues to state that if the penalties owed by a taxpayer outside of the OVDI would be less than the 25% penalty, the lesser penalties will be imposed. FAQ 50, however, directs examiners to compare the amount due under the 2011 OVDI to the tax, interest and penalties at their maximum levels without regard to mitigating factors like reasonable cause in determining which set of penalties is larger. This is a significant change from the 2009 OVDI, although agents in recent weeks have become far more reluctant to accept a reasonableness claim or to consider any other mitigating factors even for taxpayers who timely entered the 2009 OVDI.
- Under the 2011 OVDI, revenue agents will not be assigned until the taxpayer files the complete disclosure package. Under the 2009 programme, revenue agents were assigned once the case was transferred from the IRS Criminal Investigations Division to the Revenue Division.
- Similar to the 2009 programme, if a taxpayer and the revenue agent disagree on the imposition of penalties, taxpayers may opt out of the 2011 OVDI and face full audit. While lower penalties may result based upon the facts and circumstances, the IRS may not be limited to the six or eight years under the respective programmes. The IRS has advised it will assess higher penalties, such as the 75% fraud penalty and the wilful FBAR penalty (greater of USD100,000 or 50% of the account balances per year) for those who leave an OVDI programme. However, the statute of limitations may protect a taxpayer on audit, limiting the IRS in certain circumstances to three years of look back rather than six (or eight) years. On the other hand, if certain information reports have not been filed there may be no statute of limitations and the IRS could go back more than eight years. Additionally, and if appropriate under the circumstances, the taxpayer may be able to present a reasonable cause argument or other penalty mitigating factors.

Limited window for missed reporting

The 2011 OVDI confirms that taxpayers who reported and paid taxes on all income, but failed to file FBARs or other information returns should not participate in the programme. Such taxpayers should file the delinquent reports or returns no later than 31 August 2011 with a letter of explanation. If they do so, FAQ 18 says the IRS will not impose a penalty if there are no under reported tax liabilities. The IRS specifically mentions corporate accounts over which an employee had signatory authority as qualifying for this window of no penalties, likely because it is common and would not cause income omission.

What other measures should people be thinking about?

- It may be possible to restructure the holdings of a taxpayer to reduce or eliminate the burden of ongoing tax reporting requirements. This may involve transferring funds into a US bank and out of any offshore structure involved after fully completing the voluntary disclosure.
- Make sure any individual that has a financial interest in or has signatory authority over a foreign account is aware of their reporting obligations, because once a taxpayer's total foreign accounts are over USD10,000 each account must be reported by 30 June 2011.
- Carefully review the number of accounts a taxpayer has in foreign jurisdictions. Ironically, taxpayers with more than 25 accounts have a different and less onerous filing obligations.
- Consider expatriating and surrendering the taxpayers US citizenship or green card.
- Order bank statements well in advance of filing deadlines. It's not too late to prepare for June 2011.

Conclusion

Until 31 August 2011, the 2011 OVDI provides an opportunity to rectify all prior US non-compliance issues. This may represent the best chance for US Persons to come into compliance at a fixed cost without criminal exposure. While that cost is significant, often 40-50% of the current value of offshore assets, the cost of non-compliance may be even greater.

As the financial world grows more transparent and jurisdictions share ever more information, taxpayers who continue to hold undeclared taxable accounts are increasingly at risk of being discovered. In addition to IRS enforcement efforts, the G20 has focused additional scrutiny on numerous international financial centres, including Switzerland, Liechtenstein, Luxembourg, Monaco, Singapore and Hong Kong, all of which have agreed to modify their international information sharing agreements to comply with OECD standards and, where applicable, alter their banking secrecy laws. This radical shift in the contours of private banking has put those with undeclared offshore accounts at a heightened risk of discovery and prosecution. According to IRS Commissioner Shulman, "for taxpayers who continue to hide their head in the sand, the situation will only become more dire." As such, consider a voluntary disclosure carefully in the next few months.