



## Tax Notes Today

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New Offshore Voluntary Disclosure Initiative Features 25 Percent Penalty, Greater Clarity

by Marie Sapirie

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Summary by **taxanalysts**

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U.S. taxpayers with unreported offshore financial accounts have a second opportunity to turn themselves in to the IRS in exchange for reduced penalties, IRS Commissioner Douglas Shulman announced February 8.

The principal feature of the new Offshore Voluntary Disclosure Initiative (OVDI) is a 25 percent penalty that will be levied on the highest aggregate amount in the participant's foreign bank account between 2003 and 2010. This penalty represents a 5 percent increase over that offered in the 2009 special offshore voluntary disclosure program (OVDP). Also, taxpayers who come forward under the initiative will have to pay up to eight years of taxes owed plus interest.

The 20 percent and 25 percent penalties under the 2009 OVDP and the 2011 OVDI, respectively, are in lieu of the increased penalties incurred under Form TD F 90-22.1, "Report of Foreign Bank and Financial Accounts," and other penalties that would otherwise apply. The original, special OVDP ended in October 2009 after a nearly seven-month run and resulted in approximately 14,700 disclosures.

Practitioners gave the announcement a warm reception. "There are many taxpayers who have been anxiously awaiting the announcement of a new program that will continue to provide certainty in the process of reporting previously undisclosed interests in foreign financial accounts. We now have that certainty in the 2011 OVDI," said Charles P. Rettig of Hochman, Salkin, Rettig, Toscher & Perez PC.

The new penalty structure of 25 percent plus amended returns going back to 2003 "hits a good balance," said Scott D. Michel, a partner at Caplin & Drysdale.

Practitioners were generally pleased to see that the IRS had addressed some of their concerns about the OVDP as well. Caroline D. Ciruolo, a partner at Rosenberg Martin Greenberg LLP, said the Frequently Asked Questions that the IRS released "are very detailed and address many of the concerns raised by taxpayers and practitioners during the 2009 program."

### **New Penalty Framework**

The OVDI includes two provisions that implicitly recognize that some taxpayers are less culpable than others, which is a positive development, said Bryan C. Skarlatos, a partner at Kostelanetz & Fink LLP. The IRS said these provisions are available to taxpayers who participated in the 2009 OVDP. "Nobody will be disadvantaged because of the new rules," according to the IRS.

Taxpayers who own accounts with aggregate values of \$75,000 or less are eligible for a 12.5 percent penalty under the OVDI.

The OVDI also provides for a more generous application of the 5 percent penalty. Taxpayers are eligible for the reduced penalty under FAQ 52 if they did not open the account (unless the bank required them to open a new account), had minimal contact with the account, did not withdraw more than \$1000 in any year covered by the OVDI, and can establish that taxes were paid on funds deposited in the account. That FAQ also provides examples of how the mitigation factors will be applied, as practitioners had requested. (For prior coverage, see *Doc 2011-672* or *2011 TNT 9-3*.)

Because of the retroactivity of FAQ 52, which outlines the requirements for the 5 percent penalty, taxpayers who participated in the OVDI who qualify for the 5 percent penalty under the new OVDI can reopen their cases and have the lower penalty applied.

FAQ 52 also allows foreign residents who did not know they were U.S. citizens to receive the 5 percent penalty. That provision is meant to address the "accidental American" issue of taxpayers who live abroad who were not intentionally evading U.S. tax, but did not recognize that they had a filing requirement. However, the FAQ is too restrictive to be of help to many U.S. taxpayers who are foreign residents, said Skarlatos. Michel also questioned whether the OVDI sufficiently takes into account the issues faced by Americans who have lived overseas for many years.

### **August 31 Deadline**

Taxpayers who want the benefits of the OVDI must submit their tax returns, paperwork, and a check to the U.S. treasury by August 31, 2011, said Shulman. "Start now, not in August," he warned.

Practitioners said that new requirement may not be realistic. "The August 31 deadline will be difficult to meet in many cases, so the IRS should take steps to reduce the administrative burden of participation," said Mark E. Matthews, a partner at Morgan, Lewis & Bockius LLP.

Skarlatos said the requirement to file all paperwork by August 31 was intended to help the IRS manage the workflow from the OVDI by allowing managers to assign cases to agents based on the level of complexity and issues involved. He noted, however, that the requirement that taxpayers file amended returns when they enter the OVDI will likely prevent most taxpayers from filing before July or August, and it will force taxpayers who learn about the program in August to file estimated amended returns, "which will only complicate the process."

### **Interim Filings Eligible**

The roughly 3,000 taxpayers who came forward after the OVDI ended will be eligible for the terms of the new OVDI. Ciralo expressed concern that taxpayers who made a post-October 15, 2009, traditional voluntary disclosure and submitted all of their documents for review will have to submit another application for the 2011 OVDI and reproduce the entire package outlined in FAQ 25. "I am hopeful that the Service will simply allow those taxpayers to submit a letter requesting that their case be brought in to the 2011 OVDI," she said.

### **Certainty Appreciated**

Practitioners welcomed the lengthy set of FAQs as a positive development. "I am happy to see that [the IRS is] moving forward with a program that is user-friendly," said Robert E. McKenzie, a partner at Arnstein & Lehr LLP. Michel also said that "with a set penalty formula, practitioners can now advise clients on what their maximum exposure will be."

The FAQs reflect some of the solutions to problems that had arisen in the OVDI. For example, FAQ 10 explains how the IRS will treat passive foreign investment company investments under the OVDI. The resolution offered is essentially a carbon copy of the one reached in the OVDI. (For prior coverage, see *Doc 2010-20058* or *2010 TNT 177-3*.) Ciralo said, "I remain hopeful that the IRS will designate a special group within the program to handle PFIC-related questions."

The FAQs also follow the solution reached in the OVDI for sham entities. Taxpayers who held assets through an entity that had no other purpose than to conceal ownership of the assets can dissolve the entity and avoid having to file delinquent information returns for it.

The pre-clearance process begun under the OVDI will continue in the OVDI. FAQ 23 outlines the procedure for

filing a pre-clearance request. The IRS said February 8 that the IRS has centralized the pre-clearance process in two units that represent the criminal and civil sides of the OVDI. The centralized process would mean increased speed and certainty for taxpayers, according to the IRS.

### Continuing Enforcement Efforts

The announcement appears to herald the second phase of international enforcement efforts at the IRS. The first phase, which coincided with the UBS investigation and original offshore VDP, was defined by the headline-grabbing litigation and heightened public awareness of offshore reporting obligations. (For previous coverage, see *Doc 2010-17826* or *2010 TNT 154-2*.)

A harbinger of the second phase came late in 2010 as reports circulated that the Justice Department had begun to investigate Swiss cantonal banks for assisting American taxpayers in hiding income abroad. Shulman said February 8 that the IRS and DOJ are continuing to investigate banks in several jurisdictions, and that more is in the works regarding offshore tax evasion.

As the investigations continue, information also streams in from whistleblowers, the most recent, and public, example of which was Rudolf Elmer's giving two compact discs containing Swiss bank data to WikiLeaks on January 17. (For prior coverage, see *Doc 2011-1099* or *2011 TNT 12-1*.)

"Given that [the Foreign Account Tax Compliance Act] takes effect in a short time and the IRS position after August 31, 2011, is not clear, this may be the last window for Americans with undeclared offshore accounts to come forward," Michel said.

But some practitioners said the new initiative would not likely reduce offshore tax evasion by sophisticated individuals. "In cases where the taxpayer actively sought to avoid U.S. taxes, the taxpayer often believes they are smarter than the average bear and will not be caught up in information sharing," said Gregory S. Lynam of the Ferraro Law Firm. Because those types of cases don't involve inherited foreign bank accounts, "a well-informed tax whistleblower can mean the difference between conviction and non-detection," he said.

"Given the difficulties the IRS has had in obtaining quality information on the accounts in question, including the UBS cases, it suggests to us that even fewer high-income taxpayers will come forward under the harsher initiative," Lynam said. "While it is great that the IRS is stepping up use of all of its enforcement tools, there is a danger that the IRS may focus on the little fish that voluntarily swim into the net."

*Jeremiah Coder contributed to this article.*

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#### Tax Analysts Information

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