To Our Clients and Friends: **July 3, 2012**

IRS Provides Detailed Guidance on 2012 Offshore Voluntary Disclosure Program And Announces New Alternative Procedure for Certain Taxpayers Living Abroad

Guidance on 2012 Offshore Voluntary Disclosure Program

On January 9, 2012, the Internal Revenue Service ("IRS") announced a new offshore voluntary disclosure program ("2012 OVDP"). The January 9 announcement indicated that the 2012 OVDP would involve a larger penalty than the 2011 offshore voluntary disclosure initiative ("2011 OVDI") but did not disclose the details of how the 2012 OVDP would operate. On June 26, 2012, the IRS finally provided detailed guidance, in the form of Frequently Asked Questions ("FAQs").

Taxpayers who participate in the 2012 OVDP generally will avoid criminal prosecution and, depending on the circumstances, may substantially reduce their exposure to civil penalties. The 2012 OVDP is similar to the 2011 OVDI in most respects, but there are several key differences.

Perhaps the most notable difference is that the 2012 OVDP has no set deadline for participation. However, the IRS has indicated that it may close the program, without warning, at any time. Moreover, even if the 2012 OVDP is not terminated, there are two circumstances in which a taxpayer (who is not under any examination) may become ineligible.

First, a taxpayer that appeals a foreign tax administrator's decision authorizing the provision of account information to the IRS and fails to provide a certain notice to the IRS, or to the Attorney General of the United States, in accordance with 18 U.S.C. 3506, will be ineligible to participate.

Second, the IRS may announce that certain taxpayer groups that have or had accounts at specific financial institutions will be ineligible due to U.S. Government actions in connection with the specific financial institution. This is a critical change, because many taxpayers who would prefer not to come forward have chosen to wait until they receive notices from their financial institutions indicating that the turnover of documentation with respect to their accounts to the U.S. Government is imminent. The 2012 OVDP is apparently designed to prevent taxpayers from taking such a "wait and see" approach.

According to the FAQs, "[s]uch announcements will provide notice of the prospective date upon which eligibility for specific taxpayer groups will be posted to the IRS website**.**" Although not entirely clear, it *appears* that the IRS will warn specific taxpayer groups in advance of the "drop dead date" by which they must either make voluntary disclosures or become ineligible.

Eligible taxpayers who wish to participate in the 2012 OVDP must, among other things, file complete and accurate amended (or original) returns and FBARs (and other applicable information returns) for each year during a specified eight-year period in which they have undisclosed foreign accounts and/or undisclosed foreign entities.

Participants in the 2012 OVDP generally must pay (i) all tax due with interest, (ii) an accuracy penalty equal to 20% of the underpayment of tax for each year, and (iii) an "offshore" penalty equal to 27.5% of the highest aggregate balance in the undeclared foreign accounts (plus the value of the taxpayer's interests in certain foreign entities and other foreign assets) during the period covered by the voluntary disclosure. The 27.5% offshore penalty is higher than the 25% penalty that applied in the 2011 OVDI.

In certain limited circumstances, the 27.5% offshore penalty may be reduced to 5%. Taxpayers who may be eligible for the reduced rate of 5% include:

- Certain taxpayers who (i) did not open (or cause anyone else to open) the foreign account (unless a bank required a new account to be opened, instead of allowing a change in ownership, upon the death of a prior account holder), (ii) have had minimal, infrequent contact with the financial institution about the account, (iii) have not withdrawn more than $1,000 from the account in any year covered by the voluntary disclosure, and (iv) can sustain the burden of establishing that all applicable U.S. taxes were paid on the funds deposited in the account. It is anticipated that the IRS will construe these requirements very strictly, and that the reduction to 5% will not be available unless such requirements are satisfied for all of the taxpayer's undeclared foreign accounts.

- Certain taxpayers who are foreign residents and were unaware of their status as U.S. citizens.

- Certain taxpayers who (i) are foreign residents, (ii) have timely complied with all tax reporting and payment requirements in their country of residency, and (iii) had $10,000 or less of U.S.-source income in each relevant year. For these taxpayers, certain non-financial assets that could otherwise be subject to the 5% penalty may be excluded.

The 27.5% offshore penalty may be reduced to 12.5% for taxpayers whose undeclared foreign accounts (and other foreign assets to which the 27.5% penalty would apply) had an aggregate value that was less than $75,000 at all times during the years covered by the voluntary disclosure.

The 2012 OVDP provides new relief for certain taxpayers with Canadian registered retirement savings plans ("RRSPs"), registered retirement income fund ("RRIFs"), or other similar Canadian plans. Under the 2012 OVDP, taxpayers who have such plans, and who failed to elect to defer U.S. federal income tax on the earnings within such plans under the U.S.-Canada Income Tax Treaty, may request permission to make late deferral elections under the treaty. A taxpayer requesting permission for such late deferral election must submit (i) IRS Form 8891 for each tax year and description of the type of plan covered by the submission, and (ii) a statement describing, among other things, the events that led to the failure to make the election.

In the case of any taxpayer whose election with respect to an RRSP or RRIF is granted, such RRSP or RRIP will not be subject to the 27.5% (or other) offshore penalty. The FAQs also suggest that other non-

U.S. retirement plans may potentially be excluded from the offshore penalty. It appears, however, that such exclusion will only be available in circumstances where there was "no U.S. reporting requirement" with respect to the plan.

For many taxpayers with undeclared foreign accounts and/or unreported foreign income, the penalty structure under the 2012 OVDP is extremely favorable in comparison with the civil penalties that could otherwise be imposed. There are, however, cases in which such penalty structure would be relatively unfavorable. For each taxpayer considering participation in the 2012 OVDP, the advantages and disadvantages must be carefully considered based on all of the facts and circumstances particular to such taxpayer.

New Alternative Procedure for Certain Taxpayers Living Abroad

The IRS also made another announcement on June 26, 2012, promising a new alternative procedure (with details to follow) for certain taxpayers living outside the United States. The new procedure will take effect on September 1, 2012.

The new procedure will be available for "current non-residents including, but not limited to, dual citizens who have not filed U.S. income tax and information returns." Whether the new procedure will also be available to taxpayers who reside abroad but filed returns incorrectly excluding their offshore income is not yet clear. Taxpayers who are not eligible to participate in the 2012 OVDP will also be ineligible for the new procedure.

Taxpayers who are eligible for the new procedure will be required to submit (i) delinquent tax returns, with appropriate related information returns, for the past three years, (ii) delinquent FBARs for the past six years, and (iii) payment of any tax and interest due.

Participating taxpayers who are determined to represent a "low compliance risk" will not be subject to FBAR or other penalties. For those who do not qualify as a low compliance risk, penalties will be imposed "in accordance with U.S. federal tax laws based on a review of the submission."

In this regard, the announcement provides the following limited guidance:

- Low risk will be predicated on "simple returns" with little or no U.S. tax due.
- Absent high risk factors, if the submitted returns and application show less than $1,500 in tax due in each of the years, they will be treated as low risk.
- In general, the risk level will rise as the income and assets of the taxpayer rise, if there are indications of sophisticated tax planning or avoidance, or if there is material economic activity in the United States.
- Additional risk factors include any additional history of noncompliance with United States tax law and the amount and type of United States source income.

Unfortunately, this guidance is not sufficient to provide a clear idea of who will actually qualify as a "low compliance risk" eligible for penalty relief. The announcement promises that additional information regarding the specific factors the IRS will use to assess the level of compliance risk, and how information

regarding those factors should be presented in the submission, will be released prior to the effective date of the new procedure.

The new procedure also offers the possibility of relief for taxpayers who are participants in certain retirement or savings plans and who failed to elect to defer U.S. federal income tax on the earnings within such plans in accordance with an applicable U.S. income tax treaty. A taxpayer who participates under the new procedure and wishes to request permission for a late deferral election under a treaty will be required to submit: (i) for relevant Canadian plans, IRS Form 8891 for each tax year and description of the type of plan covered by the submission, and (ii) a statement describing, among other things, the events that led to the failure to make the election.

The announcement emphasizes that the new procedure provides no protection from criminal prosecution, and that taxpayers who make submissions under the new procedure will no longer be eligible for the 2012 OVDP.

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