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The 2011 OVDI: Is Voluntary Disclosure Really Better the Second Time Around?

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On February 8, 2011, the Internal Revenue Service announced[1] an offshore voluntary disclosure initiative ("2011 OVDI") for taxpayers with undisclosed foreign income. The 2011 OVDI is similar to the offshore voluntary disclosure program that was in effect from March 23, 2009, through October 15, 2009 ("2009 VDP"); but there are-significant differences as well. Some of the differences are favorable, and others are quite unfavorable, if not horrifying. A number of the key similarities and differences are discussed in detail below.

BACKGROUND: OBLIGATIONS RELATINGTO FOREIGN ACCOUNTS, FOREIGN ENTITIES, AND FOREIGN GIFTS

Unlike most other countries, the United States taxes its citizens and residents on their worldwide income. Thus, for example, a U.S. citizen living abroad must pay tax on his foreign interest income and capital gains from sales of stocks held in a foreign brokerage account. U.S. taxpayers may also be subject to a variety of complex income tax provisions, including (among many others) rules imposing tax on: (1) their share of any "subpart F income" earned by a "controlled foreign corporation"; or (2) distributions received from a foreign trust (including the imposition of an interest charge on income accumulated in prior years).

In addition to such complex provisions for determining income, U.S. taxpayers are subject to a daunting array of information reporting requirements. Most famous, as of late, is the obligation to report foreign financial accounts held during a calendar year by filing a foreign bank account report (FBAR) on Form TD F 90-22.1 by June 30 of the following year. But, of course, there are quite a few others as well. Some of the others are as follows:

- Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520)
- Annual Information Return of Foreign Trust with a U.S. Owner (Form 3520-A)
- Information Return of U.S. Persons With Respect to Certain Foreign Corporations (Form 5471)
- Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472)

- Return by a U.S. Transferor of Property to a Foreign Corporation (Form 926)
- Return of U.S. Persons With Respect to Certain Foreign Partnerships (Form 8865)
- Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (Form 8858)

The penalties for failing to satisfy applicable information reporting requirements can be quite severe, even if the taxpayer reported all of his income and paid all of the tax due. For example, the maximum civil penalty for a *willful* failure to report a foreign financial account on an FBAR ("willful FBAR violation") under current law is the *greater* of $100,000 and 50% of the account balance on the date the FBAR was due, i.e., June 30 of the following year.[2] By contrast, the maximum civil penalty for a *nonwillful* failure to report a foreign financial account on an FBAR ("nonwillful FBAR violation") is $10,000,[3] and Internal Revenue Manual guidelines indicate that, for smaller accounts, a reduced penalty is typically appropriate.[4] In each case, separate penalties may be imposed for each account and for each year that has not closed under the applicable statute of limitations (ending six years from the due date of the applicable FBAR).

The penalty for failing to disclose a transfer to or distribution from a foreign trust on Form 3520 is equal to the *greater* of $10,000 and 35% of the transfer or distribution; and the penalty for failing to disclose a reportable foreign gift on such form is 5% of the gift for each month in which the failure to report continues (subject to a maximum penalty of 25%).[5] In comparison, the penalty for failing to file Form 5471, to disclose certain interests in a foreign corporation, is often a bargain at $10,000 per corporation, per year.[6]

PAST VOLUNTARY DISCLOSURE PRACTICE AND OVERVIEW OF THE 2009 VDP

The IRS has a longstanding general voluntary disclosure policy, applicable to purely domestic as well as foreign tax issues. If a taxpayer comes forward voluntarily to report an omission (or other noncompliance) before the IRS is aware of the issue, the IRS will consider that factor in determining whether criminal prosecution will be recommended. It does not create any substantive or procedural rights, and taxpayers cannot rely on the fact that other similarly situated taxpayers may have received favorable treatment. As a practical matter, however, the degree of protection from criminal prosecution is quite high. One key aspect of the policy, however, is that taxpayers who failed to report illegal income are not eligible.

Generally, a voluntary disclosure occurs when the taxpayer comes forth in a truthful and complete manner, displays a willingness to cooperate, makes good faith arrangements with the IRS to pay in full the tax, interest, and any applicable penalties, and does so *before* the IRS has initiated a civil examination or criminal investigation of the taxpayer or has been alerted to the specific taxpayer's noncompliance through information from a third party (e.g., informant, other governmental agency, the media). The taxpayer may not come forward anonymously; it is not a voluntary disclosure until the identity of the taxpayer is disclosed.

Aggressive enforcement by the IRS with respect to UBS led to an increased number of people trying to make voluntary disclosures before their names were turned over by the foreign bank as individuals with hidden funds abroad. In order to resolve these cases in an organized, coordinated manner and make exposure to civil penalties more predictable, the IRS decided to centralize the processing of offshore voluntary disclosures with respect to foreign accounts and foreign entities. Thus, the IRS announced the 2009 VDP on March 23, 2009.

Under the terms of the 2009 VDP, eligible taxpayers were required to file amended (or original) returns for 2003-2008[7] and pay: (1) all taxes due on such amended returns; (2) an accuracy penalty equal to 20% of each underpayment of tax; (3) interest on such underpayments of tax and accuracy penalties; and (4) an "offshore penalty" equal to 20% (or, in extraordinarily rare cases, 5%) of the highest value of the undeclared foreign accounts (and certain other foreign assets, referred to below as "penalty assets") during the six-year voluntary disclosure period.

In addition to (a high degree of) protection against criminal prosecution, the key benefit of the 2009 VDP was a relatively certain penalty structure that provided participants with downside protection against the most severe civil penalties that could potentially be imposed, such as multiple penalties for willful FBAR violations. As indicated above, the maximum penalty for such a willful violation is the *greater* of: (1) $100,000 and (2) 50% of the account balance on the date the FBAR was due. Separate penalties may be imposed for each year (and each account); thus, for example, if an account had a value of $1,000,000 at all relevant times, the maximum penalty for four years worth of willful FBAR violations would be $2,000,000, which is *double* (!) the entire account. In comparison with the potential for $2,000,000 of FBAR penalties, a 20% "offshore penalty" of $200,000 under the 2009 VDP is quite reasonable.[8]

This comparison is most appropriate, however, only if a taxpayer's FBAR violations were willful. For taxpayers whose noncompliance was wholly innocent, forfeiting 20% of the maximum account value is outrageous. Thus, the 20% accomplished what may derisively be termed "rough justice"—an overly lenient result for the worst offenders, and highway robbery for the innocents.

COMPARISON OF 2009 VDP AND 2011 OVDI

Like the 2009 VDP, the 2011 OVDI permits taxpayers to resolve their offshore "problem" in a way that provides (a high degree of) protection against criminal prosecution and a relatively certain penalty structure. Certain key similarities and differences between the two programs are addressed below.

Voluntary Disclosure Period

In contrast with the six years covered under the 2009 VDP (2003-2008), eight years are covered under the 2011 OVDI (2003-2010). This is arguably less favorable, since newcomers have to go back eight years instead of six, but the IRS was understandably unwilling to reward taxpayers who declined to come forward in 2009 by taking 2003 or 2004 off the table. Taxpayers under both programs must "make good" going back to 2003, so the eight-year look-back under the 2011 OVDI is equivalent to the six-year look-back under the 2009 VDP.

General Penalty Structure

Taxpayers who wish to participate in the 2011 OVDI must file amended returns for 2003-2010 and pay: (1) all taxes due on such amended returns; (2) an accuracy penalty equal to 20% of each underpayment of tax; (3) interest on such underpayments of tax and accuracy penalties; and (4) an "offshore penalty" equal to 25% (or, in certain limited cases addressed below, a lower percentage) of the highest value of the undeclared foreign accounts, plus certain other foreign assets (sometimes referred to herein as "penalty assets") during the eight-year voluntary disclosure period.[9] This penalty structure is very similar to that under the 2009 VDP, with the key exception that the offshore penalty has increased from 20% to 25%.

It is difficult to argue that an increased penalty is good news, but frankly the 25% penalty came as an extremely pleasant surprise. Virtually all practitioners in the area anticipated that the 20% penalty under the 2009 VDP would be increased to 30% or 35% (if not more) once a new program was announced.

For willful taxpayers, the 25% offshore penalty under the 2011 OVDI will in many cases still be a great deal, given the risks of criminal prosecution and far greater civil penalties that could apply, such as multiple willful FBAR penalties. For those whose failures were wholly nonwillful, however, the 25% offshore penalty will understandably seem absurd.

Reduced Offshore Penalty

The 2009 VDP theoretically permitted a reduced offshore penalty of 5% if:

> (a) the taxpayer did not open or cause any accounts to be opened or entities formed; (b) there has been no activity in any account or entity (no deposits, withdrawals, etc.); and (c) all applicable U.S. taxes have been paid on the funds in the accounts/entities (where only account/entity earnings have escaped U.S. taxation)[.][10]

We say "theoretically" because advisors in the area are collectively aware of very few instances in which the IRS actually permitted the reduction to 5%. The term "unicorn" has been used many times to convey the rarity of this event.

The 2011 OVDI appears to be more favorable in this respect. Pursuant to FAQ 52, two classes of taxpayers will qualify for the reduction to 5%. The first class consists of taxpayers who:

> (a) did not open or cause the account to be opened (unless the bank required that a new account be opened, rather than allowing a change in ownership of an existing account, upon the death of the owner of the account); (b)have exercised minimal, infrequent contact with the account, for example, to request the account balance, or update account holder information such as a change in address, contact person, or email address; (c) have, except for a withdrawal closing the

account and transferring the funds to an account in the United States, not withdrawn more than $1,000 from the account in any year covered by the voluntary disclosure; and (d) can establish that all applicable U.S. taxes have been paid on funds deposited to the account (only account earnings have escaped U.S. taxation). For funds deposited before January 1, 1991, if no information is available to establish whether such funds were appropriately taxed, it will be presumed that they were.

Certainly, it appears that the new FAQ 52 is intended to be less strict than the standard applicable under the 2009 VDP. In particular, "minimal, infrequent contact with the account" will not by itself be a disqualifier, nor will minimal withdrawals of up to $1,000 in a given year (though it is not clear whether the $1,000 threshold applies separately to each account or to all of the accounts in the aggregate). Nevertheless, it remains to be seen what level of contact with the account will be regarded by the IRS as minimal and infrequent.[11] It is also unclear how high the IRS will set the bar for establishing that the funds deposited into the account were subject to all applicable U.S. taxes.

The second class of taxpayers who qualify for the reduction to 5% are those taxpayers "who are foreign residents and who were unaware that they were U.S. citizens."[12] Taxpayers who knew that they were citizens, but did not, for example, have any idea that citizens must file income tax returns and FBARs, do not qualify. Of course, this does *not* mean that such taxpayers must pay the 25% offshore penalty. Depending upon the specific facts and circumstances, such taxpayers may do best to avoid the voluntary disclosure program like the plague.

To the extent that participants in the 2009 VDP satisfy the requirements above, new FAQ 52 includes a pleasant surprise. It provides that taxpayers who already executed closing agreements and paid the 20% offshore penalty under the 2009 VDP may, in effect, reopen their cases to claim the reduced penalty. Taxpayers in this position are instructed to send their closing agreements and other pertinent information to an IRS address in Austin, Texas. "Upon receipt of this information, the case will be assigned to an examiner to review and make a determination."[13] Presumably, participants in the 2009 VDP who have not yet executed closing agreements may claim the 5% under the standard of new FAQ 52 without having to first pay 20% and then seek a refund, but this is not expressly stated in the FAQ.

The 2011 OVDI also introduces a reduced 12.5% penalty for small accounts that had no counterpart under the 2009 VDP. Pursuant to FAQ 53, the 25% offshore penalty is reduced to 12.5% for taxpayers whose highest aggregate foreign accounts balance (plus the fair market value of any penalty assets) was less than $75,000 at all times during the voluntary disclosure period. Taxpayers who participated in the 2009 VDP and believe they fall within this "small account" threshold may similarly reopen their cases to claim the reduced 12.5% penalty. The authors suspect that most taxpayers with undisclosed foreign accounts (or other penalty assets) small enough to qualify probably concluded (with some justification) that they had no business making voluntary disclosures in the first place.

"Penalty Assets" Subject to the Offshore Penalty

For taxpayers participating in the 2009 VDP, the "penalty assets" included in the base for the 20% offshore penalty generally consisted of: (1) foreign financial accounts for which FBARs were required but not filed; (2) interests in foreign entities for which other information returns were required but not filed; and (3) other, foreign income-producing property for which no income was reported.[14] Non-income-producing property held directly by the taxpayer was excluded. With respect to such property, FAQ 37 stated that "[b]ecause there has as yet been no tax noncompliance, the 20 percent offshore penalty would not apply to those assets."

Treating interests in foreign entities and other income-producing property as penalty assets dramatically increased the cost of participating in the 2009 VDP. For example, suppose that a taxpayer had a single year of noncompliance, 2004, in which he had a foreign account with a maximum value of $1,000,000 and income-producing real estate with a maximum value of $9,000,000. The foreign account was closed on December 30, 2004. Under the 2009 VDP, both the account and the real estate would be penalty assets, so the penalty would come to a staggering $2,000,000. By contrast, the penalty due for failing to file the FBAR would be no more than $100,000, and that amount would be owed only if it were determined that the taxpayer was willful.[15]

The 2011 OVDI goes even further by expanding the class of penalty assets to include "all of the taxpayer's offshore holdings that are related in any way to tax noncompliance, regardless of the form of the taxpayer's ownership or the character of the asset."[16] For this purpose, tax noncompliance "includes failure to report income from the assets, as well as failure to pay U.S. tax that was due with respect to the funds used to acquire the asset." Thus, for example, FAQ 36 provides that penalty assets include land or artwork located in a foreign country, even where no income has been produced and no reporting requirements apply, if such property was "acquired with funds that were subject to U.S. tax but on which no such tax was paid[.]" Taxpayers who believe the 25% offshore penalty may represent the "least of all evils" must pay careful attention to this point to make sure there are no unhappy surprises.

What About Innocent Taxpayers? The Infamous Bait-and-Switch

Advisors representing clients with "good" facts (indicating nonwillfulness) struggled with whether a voluntary disclosure was necessarily the right thing to do in each case. For example, consider the following scenario:

> *Abe is a dual citizen who has lived outside the United States, in a high-tax jurisdiction, for nearly his entire life. Abe has filed U.S. tax returns (Form 1040) each year but never filed FBARs and never reported his foreign interest income, which amounted to $20,000 during the 2003-2008 period. Abe maintains he had no idea he was required to report foreign interest income and never heard of an FBAR. He reported the interest each year in his country of residence and paid foreign taxes on the interest that, due to foreign tax credits, would have eliminated all but $150 of his U.S. tax on the unreported interest. Abe's U.S. tax returns did not include Schedule B. During the 2003-2008 period, Abe's one*

foreign account (at his local branch of a well respected bank with no "UBS issues") hit its "high water mark" of $3,000,000 on December 31, 2008. On October 1, 2009, Abe consulted a U.S. tax attorney about whether he should make a voluntary disclosure under the 2009 VDP.

Abe must, of course, report his foreign interest and file FBARs going forward, but a strong case was to be made against a voluntary disclosure under the 2009 VDP.[17] Clearly, there seemed to be no criminal exposure, and the (admittedly simplified) facts above suggest little basis for concluding that Abe's failure to file FBARs was willful.[18] The fact that he was paying local tax at very nearly the U.S. rate suggests he had little to gain by deliberately hiding the income, and the absence of a Schedule B takes away one of the government's favorite "gotchas."[19] Outside the 2009 VDP, Abe's penalty exposure on audit should have been limited to a $10,000 "nonwillful penalty" for each relevant year, for a total of $40,000, and, of course, an audit was far from inevitable.[20]

Notwithstanding the favorable facts noted above, many advisors in this type of scenario strongly urged their clients to make voluntary disclosures under the 2009 VDP, because they were terrified of the downside risk of multiple 50% penalties (which could easily total more than double the account) in the event that the failure to file FBARs might conceivably be considered willful. Moreover, they believed, with some justification, that their clients could avoid paying the full 20% offshore penalty.

FAQ 35 provided in part that voluntary disclosure examiners "will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes." Many advisors understood this to mean that the IRS would: (1) consider nonwillfulness; and (2) apply reasonable standards, so that most of their truly innocent clients could qualify for reduced penalties. Ultimately, they proved wrong on both counts.

At first, the IRS gave some consideration to non-willfulness, but somehow relatively few disclosures actually resulted in FAQ 35 relief. In this regard, the IRS apparently believes that filing a Form 1040 with the "no" box checked on Schedule B[21] is a "smoking gun" all but proving that the taxpayer's failure to file an FBAR was deliberate. This view seems extraordinarily detached from reality,[22] but taxpayers had little recourse if the IRS chose to be unreasonable, unless they wished to opt out of the 2009 VDP penalty structure altogether.[23]

Opting out, however, could be dangerous. FAQ 28 provided in part as follows:

> The penalty framework and the agreement to limit tax exposure to the most recent 6 years are package terms. If any part of the penalty framework is unacceptable to the taxpayer, the case will be examined and all applicable penalties may be imposed.

Thus, taxpayers who opt out must potentially concern themselves with pre-2003 years, and cannot fall back on the 20% offshore penalty if they don't like how things are going on audit.

Eventually, the IRS grew weary of being asked to consider (and, on some occasions, actually considering) nonwillfulness arguments. FAQ 50 of the 2011 OVDI includes a successor to the old FAQ 35, but indicates that the statutory penalties to be compared with the 25% offshore penalty are determined "at maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability[.]"

At about the same time, the IRS conformed its policy under the 2009 VDP to the 2011 OVDI policy. Closing agreements that had already been approved were executed, but, from that point on, the IRS refused to consider nonwillfulness, reasonable cause, etc. under old FAQ 35. Taxpayers who had previously hoped for favorable treatment under old FAQ 35 were told that they must either pay the 20% offshore penalty or opt out and take their chances. The 2011 OVDI policy is not necessarily the right one, but at least the IRS gave up the "bait-and-switch."

Treatment of Controlled Entities

As noted above, the 2009 VDP limited the look-back to 2003, with the result that all pre-2003 income was in effect a "freebie." Consider the following example:

> *Ben opened an offshore account with $100,000 in 1991. He realized $1,000,000 of investment income from 1991 through 2002 and $300,000 of investment income from 2003 through 2008. Ben never withdrew any funds from the account, which has no unrealized gains or losses, and is worth $1,400,000 as of December 31, 2008. Ben participates in the 2009 VDP and amends returns for 2003 through 2008. He is not required to amend his pre-2003 returns, and the $1,000,000 earned by Ben from 1991 through 2002 is never taxed.*

Advisors who are well-versed in the cross-border rules soon realized that clients with foreign entities would have difficulty achieving comparable results. Suppose that Carl has identical facts to Ben, except that instead of holding the foreign account directly, Carl formed a Panamanian corporation to open the account. Like Ben, Carl amends his returns for 2003 through 2008,[24] and is not required to amend his pre-2003 returns. Unfortunately, Carl owns stock of a Panamanian corporation with a value of $1,400,000 (subject to any post-2008 changes) and a tax basis of only $400,000.[25] Thus, if he were to liquidate the Panamanian corporation, he would recognize gain of $1,000,000.

Moreover, such gain would be taxed in a particularly unfavorable manner pursuant to certain punitive tax rules applicable to passive foreign investment companies (PFICs).[26] Under these rules, the gain would be allocated over Carl's holding period for the stock. The portion, of the gain allocated to the year of the liquidation would be taxed at Carl's marginal tax rate for such year. The portion allocated to any prior year would be taxed at the maximum statutory ordinary income rate for such year (regardless of Carl's marginal rate); and tax determined at such maximum rate would then be subject to an interest charge, as if there had been an underpayment of tax for such year.

Under the 2009 VDP, the IRS informally permitted taxpayers to disregard their own foreign corporations (and foreign trusts), provided that, among other requirements, they formally dissolved them prior to executing their closing agreements. Based on the IRS's willingness to "sham" the foreign entities, taxpayers such as Carl enjoyed the same favorable treatment as Ben for pre-2003 income. The apparent purpose of such favorable treatment was ease of administration. The IRS was concerned that preparing the necessary information returns for 2003 through 2008 was slowing the voluntary disclosure process and wished to eliminate the logjam.

The 2011 OVDI appears to continue the policy of permitting taxpayers to "sham" their own foreign entities. FAQ 29 provides that "in cases where the taxpayer certifies under penalty of perjury that the entity had no purpose other than to conceal the taxpayer's ownership of assets, and where the taxpayer dissolves the, entity, the Service may agree to waive the requirement that delinquent information returns be filed if it concludes it is in the Service's interest to do so." While the FAQ does not expressly state that such foreign entities may be disregarded for any purpose other than excusing the taxpayer from filing the relevant information returns, presumably such foreign entities are disregarded for all other tax purposes as well.

Treatment of Foreign Mutual Funds

To the great surprise of a great many taxpayers, foreign mutual funds are PFICs to which the punitive tax rules described above also apply. Gain from the sale of a PFIC is not eligible for long-term capital gain treatment. Instead, as discussed above, the gain is allocated over the taxpayer's holding period for the stock. The portion of the gain allocated to the year of the sale is taxed at the taxpayer's marginal tax rate for such year. The portion allocated to any prior year would be taxed at the maximum statutory ordinary income rate for such year (regardless of the taxpayer's marginal rate), and tax determined at such maximum rate is then subject to an interest charge, as if there had been an underpayment of tax for such year.[27]

For many early participants in the 2009 VDP, their PFIC problems never materialized because the IRS agents processing their amended (or original) returns had never heard of PFICs. Moreover, if their tax preparers or other tax advisors had ever heard of PFICs, they kept that to themselves. These taxpayers executed closing agreements that treated PFIC gains as regular capital gains, and were blissfully unaware of the fate they escaped.

Eventually, the IRS woke up to the issue, gave its agents a mini-course in PFICs, and instructed them to look out for foreign mutual funds. For taxpayers with such investments, this slowed the process down considerably. First, neither the IRS agents nor most return preparers had a particularly firm grasp on how to apply the PFIC rules. Second, to the extent that taxpayers' return preparers and other advisors did know about the PFIC rules, they were reluctant to apply them. Third, even where both the expertise and the will to apply the PFIC rules were present, calculating the tax imposed on a sale of PFIC stock requires not only the historic cost basis but also the precise acquisition date.

In order to move cases through the system, the IRS informally allowed participants in the 2009 VDP to apply, at their election, less burdensome PFIC rules, loosely based on a mark-to-market election generally available under the Code.[28] At first, however, the IRS did not advertise the election. You had to be with the in-crowd (or have a nice agent). Eventually, the IRS posted the basic rules on its website.[29]

In very general terms, the elective regime required the taxpayers' PFIC investments to be marked to market each year. During the 2003-2008 voluntary disclosure period, mark-to-market gains, and gains from actual sales, were taxed at a 20% rate, and certain mark-to-market losses were allowed at the same rate (with 20% of such losses being allowed as a credit). Mark-to-market losses were limited to "unreversed inclusions," i.e., total mark-to-market gains, less total mark-to-market losses, with respect to the same PFIC. Losses recognized on actual dispositions during the voluntary disclosure period similarly gave rise to a credit at the 20% rate, but only to the extent of unreversed inclusions for the same PFIC.[30] Following the 2003-2008 voluntary disclosure period, taxpayers were to remain subject to the mark-to-market regime, but under the rules of §1296, including application of the normal tax rates applicable to ordinary income, instead of the 20% rate.

Taxpayers who participate in the 2011 OVDI are permitted to make a similar election, pursuant to FAQ 10. It should be emphasized, however, that the elective regime permitted under FAQ 10 is not necessarily more favorable in all circumstances. A detailed analysis of the advantages and disadvantages of each method is beyond the scope of this article.

Administration of the Program

IRS administration of the 2009 VDP was fairly haphazard. Once taxpayers were granted preliminary clearance by the criminal investigation division, cases were assigned to agents all across the country with no rhyme or reason. Agents who had never been involved in any international issues were being swamped with PFIC computations and other complicated foreign tax issues that they were ill-equipped to handle. Worse, they were instructed to waste their time, and everyone's time, with silly paperwork.

Due to internal IRS procedures that no one was willing to change, agents spent many hours asking taxpayer representatives to execute Forms 872 (Consent to Extend the Time to Assess) for the 2006 year, and then the 2007 year. Taxpayers who would ultimately sign closing agreements would eventually agree to be assessed for all years 2003-2008, so the Forms 872 could be relevant only for those very few taxpayers who might opt out. Agents also spent their time requiring revised Forms 2848 (Power of Attorney) from nearly every taxpayer in the program, needlessly running up fees for taxpayers who were then left to wonder why their attorneys or other tax advisors had not prepared the powers of attorney correctly in the first place.

More fundamentally, the basic procedure for taxpayers to complete their voluntary disclosures consisted of waiting for an agent to be assigned (which in some cases has happened only very recently), waiting for the agent to request original returns, amended returns, FBARs, account statements, and other items, and then providing (or, where necessary, obtaining or preparing) the requested items. If an agent was not assigned, or not engaged, the process stalled. As of the date of this writing, a substantial percentage of the voluntary disclosures commenced under the 2009 VDP remain incomplete.

The IRS believes that it has learned from its earlier effort and has dramatically changed the operating procedure for the 2011 OVDI. Rather than waiting for agents and submitting returns and other documents on request, participants in the 2011 OVDI must prepare and submit a complete package, generally including payment, by August 31, 2011. There is one centralized location for submitting all of the necessary documentation rather than dealing with revenue agents all over the country. The files will be dealt with on a first-come, first-served basis, so the sooner everything is completed and submitted, the sooner a given case will be reviewed and closed.[31]

Pursuant to FAQ 25, taxpayers participating in the 2011 OVDI must submit all of the following:

1. Copies of previously filed original (and, if applicable, previously filed amended) returns.
2. Amended returns with schedules detailing the amount and type of previously unreported income.
3. A Foreign Account or Asset Statement for each previously undisclosed foreign account or asset during the voluntary disclosure period.
4. For each taxpayer disclosing offshore financial accounts with an aggregate highest account balance in any year of $1 million or more, a Foreign Financial Institution Statement for each foreign financial institution with which the taxpayer had undisclosed accounts or transactions during the voluntary disclosure period.
5. A Taxpayer Account Summary with Penalty Calculation.[32]
6. With limited exceptions, a check payable to the Department of the Treasury for the total tax, interest, and penalties due.
7. For each taxpayer disclosing offshore financial accounts with an aggregate highest account balance in any year of $500,000 or more, copies of offshore financial account statements reflecting all account activity for each year covered by the voluntary disclosure.[33]
8. Executed agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties.

If the foreign account was held through a foreign entity such as a corporation or a foundation, and the taxpayer wishes to disregard the entity under FAQ 29, a Statement on Dissolved Entities must also be included.

In some circumstances, providing all of the required documentation by the August 31, 2011, deadline will be extraordinarily burdensome, if not impossible. Setting a firm “drop-dead date” for providing complete submissions may be convenient for the IRS, but it will deter some taxpayers who wish to make good, and are willing to pay substantial penalties, but worry about meeting the deadline. This will be particularly true for taxpayers who no longer have accounts at their foreign banks, as many such institutions feel little obligation (legal or moral) to help their former clients.

FAQ 26 provides that, once the submission is made, a taxpayer’s case will be assigned to a “civil examiner” to complete the certification of the tax returns for accuracy, completeness, and correctness. FAQ 27 provides that, normally, no examination will be conducted under the 2011 OVDI. The certification process will be less formal than an examination, but the examiner will still have the right to ask any relevant questions, request any additional relevant documents, and even make third-party contacts, if necessary, to certify the accuracy of the amended returns. Last but not least, the taxpayer will not have any appeal rights.

FAQ 51 provides that, if the taxpayer and the IRS cannot agree on the proper resolution of the case, “that taxpayer must indicate in writing the decision to withdraw from the program. Once made this decision is irrevocable.” The FAQ provides that if a taxpayer has withdrawn, the examiner and manager will consider the facts of the case and how the audit will proceed, including whether to refer the case for a normal examination or to a Special Enforcement Program agent. At that point, all relevant years (potentially including pre-2003 years) and issues will be subject to a complete examination and “all applicable penalties will be imposed.”[34]

Changing Rules in the Middle of the Game

In administering the 2009 VDP, the IRS occasionally threw taxpayers and their advisors a complete curveball. As discussed above, for example, the IRS initially did a feeble job of applying FAQ 35, and ultimately refused to consider nonwillfulness arguments altogether. The IRS’s refusal to consider whether a taxpayer’s FBAR violation was willful or nonwillful is extraordinarily difficult to reconcile with its implied promise in FAQ 35 to compare the 20% offshore penalty to “the total penalties that would otherwise apply to a particular taxpayer.” [35]

Similarly, the IRS has reportedly insisted in some cases that directly held, non-interest-bearing checking accounts be treated as penalty assets. This position seems unsustainable in light of FAQ 37, which clearly provides that the 20% offshore penalty does not apply to a directly held, non-income-producing asset “[b]ecause there has as yet been no tax noncompliance[.]”

Unfortunately, the 2009 VDP imposed no constraints on the IRS’s ability to play fast and loose with the rules. At the end of the day, the IRS determined what taxes and penalties it would accept, and taxpayers had two choices: take it or leave it. Taxpayers could not, for example, agree to the 20% penalty structure but challenge the IRS’s inclusion of a directly held checking account in penalty assets.[36] If the IRS chose to be unreasonable, a taxpayer’s only recourse was to opt out. For taxpayers who were unwilling to do so, the rules of the 2009 VDP effectively became advisory, and the IRS could write a blank check.

These concerns apply equally well under the 2011 OVDI. In the absence of an opt-out, the IRS is effectively free to change the rules as it sees fit, so taxpayers and their advisors should be on notice to expect the unexpected. In circumstances where proceeding under the 2011 OVDI is a close question, the possibility of such "hidden charges" must be factored into the cost-benefit analysis.

CLOSING OBSERVATIONS

For some taxpayers, the 2011 OVDI represents a great opportunity to avoid criminal prosecution and avoid the maximum possible civil penalties. This is particularly true for those who not only knew they should have included their foreign income but actually knew there was something called an FBAR that they were required to file. Indeed, many folks who were previously ignorant about such matters may have crossed the line sometime over the last two or three years, when the news (at least in some quarters) was full of stories about tax evasion, a lawsuit against UBS, and the 2009 VDP.

Nevertheless, even if the IRS does not care to admit it, there are quite a few folks who, even to this day, have never heard of an FBAR and do not realize that foreign interest income must be reported on their U.S. returns. Indeed, there are citizens living abroad who, for whatever reason, are blissfully unaware that the United States (one of the few countries to tax its nonresident citizens on worldwide income) requires them to file U.S. returns. Taxpayers in such circumstances, and in many others that reasonably indicate their noncompliance was innocent, should carefully consider their options.

In this regard, taxpayers and their advisors are cautioned to focus carefully on certain key differences between the 2009 VDP and the 2011 OVDI. As noted above:

- New FAQ 50 makes clear that (in comparing statutory penalties with the 25% offshore penalty), statutory penalties will be determined without regard to key factual issues such as nonwillfulness and reasonable cause, which will, of course, be conclusively presumed against the taxpayer (absent an opt-out).
- New FAQ 35 expands the class of penalty assets to include, quite broadly, all foreign assets associated with tax compliance in any way. Depending on the taxpayer's foreign assets, the 25% offshore penalty may greatly exceed the taxpayer's FBAR penalties, for all open years, even if the taxpayer's FBAR violations are determined to be willful.
- Pursuant to FAQ 25, all required returns and other documents must be completed and/or submitted, generally with payment, by August 31, 2011. At the moment, no relief is promised to taxpayers who genuinely try but are unable to meet this deadline

Complying with the law on a going-forward basis is mandatory, but advertising your past sins to the IRS through a formal voluntary disclosure is elective. If, for example, the possibility of criminal exposure is remote, and the total taxes and penalties likely to be imposed under the applicable statutes in the taxpayer's particular circumstances are substantially less than the taxes and penalties applicable under the one-size-fits all terms of 2011 OVDI,[37] proceeding under the 2011 OVDI may be highly undesirable.

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1 IR-2011-14, posted at http://www.irs.gov/newsroom/article/0,,id=235695,00.html.

2 31 USC §5321(a)(5)(C). The failure to file an FBAR and the filing of a false FBAR are also subject to criminal penalties. These penalties could have resulted in up to 20 years in prison and fines of more than $1,000,000.

3 31 USC §5321(a)(5)(A).

4 See IRM 4.26.16.4.6.2.

5 See §6677 of the Internal Revenue Code of 1986, as amended (the "Code"). Except as otherwise may be indicated, all "section" and "§" references herein are to the Code.

6 §6038(b).

7 By limiting the look-back to 2003, the 2009 VDP allowed a "freebie" for all income earned in prior years. This was a huge bonus for many taxpayers who had funded their offshore accounts with unreported earnings.

8 Moreover, as discussed below, there was the promise of more lenient treatment in certain cases under FAQ 35. "2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers" is posted at http://www.irs.gov/businesses/international/article/0,,d=235699,00.html.

9 *See* FAQ 7. They must also pay failure-to-file penalties, under §6651(a)(1), and failure-to-pay penalties, under §6651(a)(2), if applicable.

10 *See* March 23, 2009, internal IRS memorandum by Linda Stiff.

11 In this regard, FAQ 52 includes an example in which the taxpayer gave the bank instructions on how to invest the funds in the accounts and signed a "hold mail" agreement to prevent the mailing of statements to the United States. The example concludes that the reduced 5% penalty is not available, but does not explain how this conclusion was reached, e.g., whether the hold mail agreement itself would have been a sufficient disqualifier.

12 FAQ 52.

13 *Id.*

14 FAQs 20 & 37.

15 As noted above, the penalty for a willful failure to disclose a foreign account on an FBAR is the greater of: (1) $100,000; and (2) 50% of the value of the account on the date the FBAR was due, i.e., June 30 of the following year. Because the account was no longer open on June 30, 2005, the penalty would be only $100,000.

16 FAQ 35.

17 In that event, a separate question is whether it would nevertheless be desirable to make a quiet disclosure by amending prior returns and possibly filing late FBARs.

18 It should be emphasized that, if the government wished to impose a "willful FBAR" penalty, the burden of proof would be on the government to show that the failure to file was willful. *U.S. v. Williams*, 106 AFTR2d 2010-6150 (DC VA, 9/1/10).

19 See below regarding the significance of checking the "no" box on Schedule B.

20 Note that penalties would apply only for 2004-2007. The statute-of-limitations period for years prior to 2003 would have been closed and, moreover, only a willful penalty existed for years prior to 2004. Presumably, no penalty would apply for 2008, because FAQ 43 allowed an extension of the FBAR filing deadline until September 23, 2009, which later was further extended to October 15, 2009.

21 Schedule B includes a box to check (yes or no) indicating whether the taxpayer has a financial interest or signature authority with respect to any foreign accounts. If the yes box is checked, the Schedule B refers to the need to file an FBAR.

22 For an excellent discussion of how little checking the "no" box can mean, see Gottfried, "Proving Willfulness in FBAR Reporting—Checking 'No' Ain't Apropos," *Tax Notes Int'l* (10/4/10). The Government also lost the one case that has been litigated on this issue. *U.S. v. Williams*, 106 AFIR2d 2010-6150 (DC VA, 9/1/10).

23 Speaking of unreasonable, one of the authors personally dealt with an agent who refused to concede nonwillfulness, and thus refused to allow FAQ 35 relief, for a taxpayer whose return preparer confirmed in writing that the taxpayer had advised him of her foreign accounts and that he did not prepare FBARs because he never heard of an FBAR until 2009. There were other extraordinarily favorable facts as well that the agent chose to disregard.

24 The foreign corporation would be a controlled foreign corporation (CFC) within the meaning of §957, and the investment income earned during these years would be "subpart F income" taxable to Carl under §951(a).

[25] Pursuant to §961(a), he receives an increased tax basis in his stock for the Subpart F income reflected in his amended 20032008 returns, but *not* for the Subpart F income he should have included for prior years.

[26] *See* §1291.

[27] Special rules also apply to certain "excess distributions" with respect to PFIC stock.

[28] *See* §1296. Participants in the 2009 VDP who wished to apply this elective regime were required to do so for all of their PFICs. Cherry-picking was not permissible.

[29] http://www.irs.gov/newsroom/article/0,,id=228621,00.html.

[30] Any further losses were treated as capital losses under the normal rules of the Code.

[31] FAQ 28.

[32] This form arose during the audits of participants in the 2009 VDP. Requests (i.e., demands) for this form were particularly infuriating when the taxpayer had only one offshore account.

[33] Other taxpayers must keep their account statements "readily available upon request."

[34] Regarding the imposition of "all applicable penalties," see also FAQ 49. With regard to the question of how many years may be open, it should be emphasized that there is no statute of limitations for a false or fraudulently filed return with the intent to evade tax. §6501(c)(1). Furthermore, §6501(c)(8) tolls the statute of limitations period indefinitely if the taxpayer failed to file certain information returns, such as Form 5471 relating to certain interests in foreign corporations. The FBAR, however, is not one of the information returns specified in this provision.

[35] The authors were less surprised than others at such developments, but only because they suspected that the IRS had inadvertently promised more than it intended to in FAQ 35 and correctly judged that the IRS would not feel constrained to keep its unintended promise.

[36] Nor, to take another example, could a taxpayer accept the 20% penalty structure but challenge the IRS's determination that 2008 should be taken into account for purposes of the 20% offshore penalty. Before the IRS insisted otherwise, most if not all advisors understood that 2008 would not be taken into account if all of the taxpayer's foreign accounts and other foreign assets were properly reported for that year. the unexpected. In circumstances where proceeding under the 2011 OVDI is a close question, the possibility of such "hidden charges" must be factored into the cost-benefit analysis.

[37] Of course, it should be emphasized that determining the penalties likely to apply (or the varying likelihood of different penalties applying) under the governing statutes will often be extremely difficult, particularly where determinations of the taxpayer's intent are involved.