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IRS Offshore Voluntary Disclosure Initiative — Round Two

On February 8, 2011 the US Internal Revenue Service (the IRS) announced its second, much anticipated, offshore voluntary compliance program, now called the 2011 Offshore Voluntary Disclosure Initiative (the 2011 Initiative). It follows the IRS' successful 2009 Offshore Voluntary Disclosure Program (the 2009 Program). (See the Squire Sanders Tax Alert: *US Foreign Tax Compliance — IRS Releases New Guidance Regarding Offshore Amnesty* .) The purpose of these programs has been to encourage US persons to disclose their previously unreported, non-US financial accounts and ownership of foreign entities. As an incentive, some of the civil penalties, which would otherwise be imposed, would be reduced and criminal penalties could be avoided.

Since the 2009 Program closed, more than 3,000 taxpayers have made subsequent offshore voluntary disclosure filings. Some uncertainty exists as to what penalty structure would be imposed by the IRS. The 2011 Initiative addresses this question with a 25-percent offshore penalty, an increase of 5 percent from the 2009 Program, and, for certain very limited situations, a lower penalty of either 5 percent or 12.5 percent. The offshore penalty is paid instead of various individual late filing penalties for certain other annual tax filings. The 2011 Initiative provides similar incentives for non-compliant US taxpayers to disclose unreported foreign income and assets, provided the submission of various taxpayer disclosure documents and the accompanying payments are made by an

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August 31, 2011 deadline. The IRS Commissioner emphasized that US taxpayers' continued failure to report foreign income or assets could subject the taxpayers to substantial civil penalties and possibly criminal penalties.

The 2011 Initiative closely follows the procedures of the earlier 2009 Program and has attempted to address several problems with that Program. The 2011 Initiative, however, has increased taxpayer compliance obligations and set a deadline of August 31, 2011 for the submission of all compliance and disclosure documents, including several new detailed worksheets, and the payment of all amounts due under the 2011 Initiative. The new worksheets are available at the IRS website.

The 2011 Initiative, like the earlier 2009 Program, is available only to US taxpayers who are not subject to a current IRS examination or are not the subject of a pending criminal tax investigation. Thus, there is an incentive for interested taxpayers to proceed as soon as possible before the IRS independently discovers their non-compliance. The 2011 Initiative also has an optional 30-day pre-clearance procedure for persons to submit their name, address, date of birth and Social Security number to the IRS Criminal Investigation group to determine if the taxpayer would be eligible. If eligible, the taxpayer then has 30 days to submit a Voluntary Disclosure Submission to enter the 2011 Initiative. Following the taxpayer's initial Voluntary Disclosure Submission, the IRS Criminal Division would make a preliminary determination to accept the taxpayer.

At this point, if a taxpayer is accepted, the 2009 Program and the 2011 Initiative differ significantly. Previously, taxpayers initially provided certain summary foreign income and asset information and then waited for their file to be assigned to an IRS Revenue Agent for a detailed review and processing of the supporting documentation, including any amended or past due income tax returns or reports and the filing of any past due Reports of Foreign Bank and Financial Accounts (FBARs). The IRS Agent then prepared computations of the additional tax, interest and penalties including the determination of the offshore 20-percent penalty, if not previously computed and paid by the taxpayer.

Under the 2011 Initiative, unlike the 2009 Program, the taxpayer or the taxpayer's representative, not the IRS Agent assigned to the taxpayer's case, will be required to prepare timely the detailed account analysis and calculations to determine the highest annual account balance for the computation of the offshore penalty.

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Consequently, all of the supporting foreign account information, the amended and past due income tax returns, other past due IRS forms disclosing foreign assets, if any, and past due FBARs, together with the payment of any additional income tax, interest and penalty amounts thereon, including the offshore 25-percent penalty amount, are to be submitted and paid to the IRS prior to the August 31, 2011 deadline. Payment arrangements will be available for taxpayers who can establish an inability to pay at that time. After all of these documents and the accompanying payment have been submitted, the taxpayer's file will then be assigned to a civil examiner to certify the taxpayer's submissions for accuracy, completeness and correctness.

Another significant difference between the 2009 Program and the 2011 Initiative is the number of years that will require corrected tax filings and accompanying payments. The 2009 Program covered a maximum of six tax years, 2003-2008. The 2011 Initiative also starts with 2003, so there is no benefit for a taxpayer to have delayed his or her participation, and continues until 2010 — a maximum period of eight tax years. In addition, the taxpayer will have to submit by the August 31, 2011 deadline a written consent to extend the period of time to collect any additional income taxes, interest and penalties for tax years that would otherwise not be subject to further assessments by the IRS. A refusal to do so would disqualify the taxpayer from participation in the 2011 Initiative.

With respect to the computation of the amounts to be paid by the taxpayer under the 2011 Initiative, the requirements are similar to the 2009 Program, except for the determination of the offshore penalty amount. Thus, the taxpayer will have to pay for each of the eight years any additional income taxes attributable to previously undisclosed foreign income or assets, the interest on the additional income tax and certain penalties, the 20-percent accuracy-related penalty based on the additional tax due, and any failure to file and failure to pay penalties. One difference from the 2009 Program is that a taxpayer could be liable for both the accuracy penalty of 20 percent of the additional tax due and the statutory late filing and late payment penalties, if the latter two penalties apply to the taxpayer. In addition, in lieu of all other penalties that may apply, an offshore penalty will be payable equal to 25 percent of the highest aggregate annual balance of the sum of the taxpayer's foreign bank and investment accounts plus the fair market value of the taxpayer's interest in previously undisclosed foreign entities or other foreign assets that produced the unreported foreign source income during the eight-year voluntary

disclosure period. In this case, a valuable foreign asset that produces a minimal amount of foreign income could trigger a substantial penalty based on the fair market value of the foreign asset.

Like the 2009 Program, the 2011 Initiative has a lower offshore penalty percentage but only if specific conditions are satisfied. A 5-percent offshore penalty would apply if four specific conditions related to the taxpayer's extremely limited contact with the foreign account are satisfied, including a maximum aggregate withdrawal during the disclosure period of not more than $1,000 from the account in any one year prior to terminating the account and transferring the funds to the United States, provided all US income taxes have been paid on the funds deposited in the foreign account. The 5-percent offshore penalty would also apply to taxpayers who are foreign residents and were unaware of their US citizenship and their consequent US tax compliance obligations. A foreign resident who had been aware of their US citizenship but failed to inquire concerning any US tax obligations would not be eligible for the 5-percent penalty. A higher 12.5-percent offshore penalty would apply if the taxpayer's highest aggregate annual account balance for the determination of the offshore penalty is less than $75,000. If such account balance is $75,000 or more, the 25-percent offshore penalty applies. If a taxpayer participated in the 2009 Program and believes that either of these lower penalties could apply, the taxpayer's 2009 Program penalty computation would be reviewed by the IRS. If the taxpayer's maximum penalties imposed by existing statutes would be lower than the computed offshore penalty, the actual penalty amount would apply. The IRS stated that the offshore penalty determinations are non-negotiable. If the taxpayer disagrees, the only alternative would be to abandon the 2011 Initiative. In that case, their submission probably would be assigned for a further IRS examination.

If a US taxpayer has reported and fully paid his or her income tax obligations but has failed to file an accompanying information return or FBAR, these returns may be filed by the same August 31, 2011 deadline without the imposition of any filing penalty. The June 30, 2011 deadline for the 2010 FBAR is not extended.

The foregoing is a brief summary of the new 2011 Initiative. As was the case with the 2009 Program, further guidance from the IRS could be forthcoming as taxpayers start to comply with the 2011 Initiative and problems are encountered. The key consideration for taxpayers who are considering a possible submission is that the taxpayer must act promptly. Taxpayers will

have approximately six months to assemble all of the required foreign account information possibly dating back to 2003; to prepare the relevant income tax returns and other US tax compliance filings; to compute the taxes, interest and penalties, possibly for eight prior years, including the 25-percent offshore penalty (or determine if a lower penalty rate applies); and to arrange for the payment of the total amount due, all prior to the August 31, 2011 deadline.

Each taxpayer's situation is different and should be reviewed on a case-by-case basis to determine if advantages could be obtained by making a Voluntary Offshore Disclosure under the 2011 Initiative. If you would like to discuss these matters, please contact your principal Squire Sanders lawyer or any of the persons listed in this Alert.
