IRS Offshore Voluntary Disclosure Program – Practical Q&A

March 2012

On January 9, 2012, the IRS reopened its Offshore Voluntary Disclosure Program (**"OVDP"**), a limited federal income tax amnesty for unreported foreign assets and income. This newsletter identifies key features of the OVDP for U.S. taxpayers and highlights the risks and issues that all taxpayers should consider in evaluating the OVDP.

If you have unreported foreign assets or income, or otherwise would like to discuss the OVDP, please contact your primary Kleinberg Kaplan attorney or one of our tax attorneys listed in this newsletter. We can help you evaluate your options.

What is the OVDP?

The OVDP is a limited federal income tax amnesty for unreported foreign assets and income.

By successfully completing the OVDP, a U.S. taxpayer escapes certain potential criminal and civil penalties. These civil penalties may be unpredictable and substantially exceed the taxpayer's offshore assets or income. In exchange, the taxpayer reports the foreign assets and income and is subject to more predictable and (generally) more proportionate civil penalties. In limited circumstances, a taxpayer may escape civil penalties altogether.

The OVDP is closely connected with the IRS's Swiss bank account initiative and is generally viewed as a means for U.S. taxpayers to become current with their foreign bank account reporting obligations. It also is relevant to U.S. taxpayers with other unsatisfied information reporting and/or tax obligations relating to foreign assets, such as investments in "controlled foreign corporations" or "passive foreign investment companies."

Who qualifies?

U.S. taxpayers qualify for the OVDP unless they are presently under audit or on an audit list (e.g., being investigated by the IRS for an offshore account) or their foreign assets were funded from illegal sources.

What is the deadline?

There is presently no deadline for applying to the OVDP, although the IRS could end the program or change its terms at any time. Precedent suggests that the OVDP penalty may be raised in the future.

What is required?

For the 8-year period preceding the OVDP application (e.g., for a 2012 OVDP application, the period 2004 through 2011), an applicant must do the following, among other things:

- disclose previously unreported foreign assets and income;
- disclose persons who helped to hide the foreign assets and income, such as bankers, accountants, attorneys, business associates and family members;
- file amended federal income tax returns;
- pay previously unpaid federal income tax, plus (in general) a 20% penalty and interest; and
- pay a separate OVDP penalty, generally equal to 27.5% of the highest combined value of the taxpayer's previously-unreported foreign financial accounts and certain other assets. (The OVDP which closed in 2011 imposed a penalty of 25%.)

How does a taxpayer participate?

Participation typically follows these three steps:

Step 1: Pre-clearance: Basic information about the taxpayer is provided to the IRS. The taxpayer should know whether the taxpayer is eligible to participate in the OVDP within several days. The taxpayer must complete the filing required by Step 2 within 30 days of receiving notice of eligibility, or pre-clearance lapses.

Step 2: Criminal review: Basic information about the taxpayer and offshore assets is provided to the IRS's criminal investigation ("CI") office, typically through a form letter. CI's primary concern is that the offshore assets were not funded from illegal sources. CI review is supposed to be completed within 30 days, but often takes longer. When CI approves the application, the taxpayer has 30 days (often extended to 90 days) to complete the filing required by Step 3.

Step 3: Civil review: Substantial additional information and materials must be submitted to a special IRS processing center in Texas, including original and amended tax returns for the years covered and copies of account statements (which may be difficult to obtain if the accounts are

not in the taxpayer's name). The preparation of these materials may require substantial time and typically should be substantially completed before the taxpayer initiates Step 1.

Typically, an OVDP application is a purely "paper" procedure, but the IRS may require an interview of the taxpayer.

What issues should be considered?

The OVDP may offer substantial benefits to a U.S. taxpayer with unreported foreign assets or income, including relief from criminal and certain onerous civil penalties.

Participating in the OVDP involves costs and other issues, however, which need to be carefully considered in connection with an OVDP application. For example, the taxpayer may need to find a source of funds to pay OVDP penalties or may need to obtain records required by the application. The Following list of issues should be considered (and there are many others):

1. It is expensive. Generally-applicable OVDP costs are substantial (even if lower than the penalties imposed outside the OVDP). It would not be unusual for these costs to approach or even exceed half of the current account balance.

2. The taxpayer may owe substantial penalties, even if all taxes have been paid. Under the prior OVDP, which closed on September 9, 2011, taxpayers often were not assessed any civil penalty if they had reported and paid tax on all of their offshore income, but failed to file certain information returns (for example, for an interest in a foreign trust). This exception was important for many taxpayers who, typically due to an oversight by their return preparer, reported all of their income but failed to file certain forms. However, the IRS has (informally) indicated that this penalty waiver may not be available under the current OVDP. Definitive guidance on this point has yet to be released.

3. The taxpayer does not have the money (part 1). The OVDP looks back 8 years, and the OVDP penalty is based on the highest account balance during that 8 year period. The taxpayer may have lost or spent the offshore assets during that period. For example, taxpayers with (unexceptional) investment losses during the 2008 financial crisis may have a substantially lower account balance now than they did in 2007; they may not even have enough left in the offshore account to pay OVDP penalties.

4. The taxpayer does not have the money (part 2). Non-financial assets are included in the penalty base under certain circumstances. For example, the value of a foreign residence purchased with unreported income is included in the penalty base; this situation may present liquidity or other difficulties.

5. The taxpayer must identify persons who facilitated the offshore accounts. The application may require identifying family members and business associates. Co-ownership of accounts raises additional issues.

6. The taxpayer is concerned about filing amended tax returns. The taxpayer may have concerns that tax return positions may be scrutinized in the course of the OVDP application, although the IRS states that "normally" no examination is made beyond confirming the accuracy and completeness of the OVDP application.

7. The taxpayer may face multiple penalties for the same funds. If the taxpayer transferred funds between offshore accounts during the OVDP period, the taxpayer will need to prove this fact or else potentially pay an OVDP penalty on both accounts for the year of the transfer.

8. It takes a long time. 1 to 2 years is not an unusual lifespan for an OVDP application, with potentially significant upfront work and compliance costs.

9. It may cover a longer period than an audit. The OVDP covers a period (8 years) which may substantially exceed the normal audit period.

10. There may be state and local tax issues. OVDP is a federal program. An OVDP filing may trigger state/local tax obligations, or a state/local tax audit. Certain jurisdictions have tax amnesty programs, some modeled on the OVDP (e.g., the New York Voluntary Disclosure and Compliance program).

11. It may be difficult to obtain required documents. Generally, it seems that Swiss banks have been cooperative in providing account information to former account holders. But a taxpayer may have difficulty obtaining this information, in particular if the account was in another person's name.

12. Applying does not guarantee approval. Although most timely-filed applications have, in the past, been approved (according to a 2011 taxpayer inspector general survey, more than 90% of timely filings under the prior OVDP were accepted), there is no guarantee that an application will be approved. For example, the IRS may have concerns about the truthfulness of an application. A taxpayer whose OVDP application is rejected would not have any protection against an assertion of civil or criminal penalties by the IRS.

Beyond OVDP - offshore compliance more generally.

The IRS's (and Congress's) focus on offshore assets and income has greatly increased in recent years. More disclosure is being required, and penalties (or the threat of application of penalties) are increasing. The ability of U.S. taxpayers to hide assets has been greatly reduced, and the risk of detection seems to be steadily growing: The IRS is using the OVDP and other avenues to collect information about foreign accounts and other foreign assets, foreign banks and promoters, and this information is expected to be used in future enforcement actions against noncompliant U.S. taxpayers.

Noncompliance can trigger significant penalties, even if it does not affect a taxpayer's federal income tax liability. For example, there is potentially a $10,000 penalty for each failure to file a

Form 5471 (a separate Form 5471 is required for each investment in a controlled foreign corporation).

Forms that may be required to report offshore assets include Form TD F 90-22.1 (aka "FBAR"), new Form 8938 (statement of specified foreign financial assets), Form 8621 (for investments in passive foreign investment companies), Form 926 (for transfers of cash or other property to foreign corporations), Form 8865 (for investments in controlled foreign partnerships) and Form 5471.

To discuss further, please contact your primary Kleinberg Kaplan attorney or:

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