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On February 8, 2011, the IRS announced a new offshore tax compliance program appropriately named the 2011 offshore voluntary disclosure initiative (2011 OVDI).[1] The new initiative engineers several changes to the highly successful 2009 offshore voluntary disclosure program (2009 OVDP), which attracted some 15,000 noncompliant taxpayers. Though similar to the 2009 OVDP, the new initiative is more harsh. Since completion of the 2009 OVDP on October 15, 2009, more than 3,000 additional noncompliant taxpayers with offshore holdings have come forward to the IRS.[2] Under the terms of the 2011 OVDI, those taxpayers will be eligible to take advantage of the new penalty framework as well as other provisions in the 2011 OVDI.[3]

The policy reasons driving the new initiative stem from the dual objectives of the government's continuing efforts to combat offshore tax noncompliance and also to encourage taxpayers to use the voluntary disclosure program to ''get people back into the U.S. tax system.''[4] IRS Commissioner Douglas Shulman announced that fighting international tax evasion continues to be a top priority for the IRS, and he warned that the new disclosure initiative is the ''last, best chance'' for people to become compliant.[5]

The new program is more punitive than its 2009 counterpart. The 2011 OVDI extends the lookback period from six years to eight years (that is, 2003 through 2010) and modestly increases the offshore penalty exposure from 20 percent to 25 percent. Also, the 2011 OVDI requires that all aspects of a taxpayer's submitted voluntary disclosure (that is, federal tax reconstruction analysis, amended returns, and payment) must be completed no later than August 31, 2011.[6] The deadline is not realistic for taxpayers who have not yet filed an initial submission for voluntary disclosure and started to gather offshore bank documents to reconstruct the U.S. federal tax analysis of previously unreported income. Unfortunately, the new initiative provides no guidance on what will happen to taxpayers who make disclosures under the new program but are unable to tender all documents by August 31, 2011.

This article discusses the key areas of the new program, including the new penalty guidelines and the procedure for pursuing a voluntary disclosure, along with practical observations given the authors' experience in handling 2009 OVDP cases and prior IRS voluntary disclosure cases. It also provides constructive observations about the new initiative, including recommendations for immediate modification to the August 31 deadline and other provisions.

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

[2] *Id.*

[3] Subject to limited exceptions when the penalty resolution would have been less under the newer program as discussed below, the FAQs clarify that participants who sought relief under the 2009 OVDP are *not* eligible to participate in the 2011 OVDI. FAQ 19.

[4] IR-2011-14.

[5] *Id.*

[6] *Id.*

Tax and Penalty Framework

The 2011 OVDI contains many appropriate and necessary guidelines. The IRS's website includes the full terms and conditions of the 2011 OVDI, including an extensive set of questions and answers (FAQs) pertaining to the new program.[7]

FAQ 7 details the following framework for civil resolution of the voluntary disclosure matter, as follows:

- First, all applicable taxes and interest will be imposed for all tax years covering the voluntary disclosure period, which encompasses the eight-year lookback period of the 2003 through 2010 tax years.
- Second, 20 percent accuracy-related penalties under section 6662(a)[8] will be imposed on the full amount of the underpayment of tax for all years during the eight-year period. Also, failure-to-file or failure-to-pay penalties under section 6651(a)(1) and (a)(2) may also be imposed, if applicable, and the taxpayer may not rely on a reasonable cause exception to avoid these penalties.
- Third, in lieu of all other penalties that may apply (including FBAR[9] and offshore-related information return penalties), the IRS will impose a miscellaneous title 26 ''offshore penalty'' equal to 25 percent of the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the period covered by the voluntary disclosure (that is, the highest balance from the 2003 through 2010 tax years).[10]

Tiered Penalty Assessments

The 2011 OVDI contains refined tiered penalty assessments to downgrade the standard 25 percent offshore penalty amount to 12.5 percent or even 5 percent in some circumstances, as discussed below.

5 Percent Offshore Penalty

The 2011 OVDI provides for a new reduced 5 percent offshore penalty for two separate factual categories.

The first category for qualification under the reduced 5 percent offshore penalty involves a taxpayer who has a lower level of culpability regarding the undisclosed offshore financial arrangement and who can satisfy the following four-pronged test:

- The taxpayer did not open or cause the account in question to be opened, unless the bank at issue required that a new account be opened as a matter of policy instead of allowing a change of ownership, which is typically the practice in most offshore jurisdictions, including Switzerland.
- The taxpayer exercised ''minimal, infrequent contact with the account'' (that is, contacted the bank only to request the account balance or to update customary account holder information such as change of address or the contact person).
- The taxpayer did not withdraw more than $1,000 from the foreign account in question in any year covered by the voluntary disclosure, except for closing the account and transferring the funds to the U.S.
- The taxpayer can establish that all relevant U.S. taxes (presumably not just income tax but also estate and gift taxes) have been paid on the funds deposited into the account and thus only investment income on the account has escaped U.S. taxation. For funds deposited before January 1, 1991, if no information is available to establish whether the funds were after-tax funds, it will be presumed that all applicable U.S. taxes were paid on the funds.[11]

Although the new 5 percent offshore penalty guideline applicable to this de minimis account activity is

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[7] *See* http://www.irs.gov/businesses/international/article/0,,id=235699,00.html.

[8] All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

[9] Form TD F 90-22.1, ''Report of Foreign Bank and Financial Accounts'' (commonly referred to as the FBAR), is required to be filed by U.S. persons with either a financial interest in or signature authority (or other authority) over any foreign financial accounts if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year.

[10] FAQs 35 and 36 provide that the 25 percent offshore penalty is intended to apply to offshore assets that are related to tax noncompliance (that is, not only income-producing assets that were improperly untaxed but also on non-income-producing assets that were acquired with funds that were improperly untaxed).

[11] FAQ 52, at 1. The FAQs provide three separate examples of this four-pronged penalty protocol. In one example, the taxpayer withdrew $1,000 from one of the accounts and no more. The example provides that the taxpayer qualifies for this special treatment, because he didn't exceed the withdrawal limitation and otherwise met the conditions as noted above. In yet another example, the funds were deposited in the account in 1995, but the taxpayer had no information as to the source of the deposit and whether the funds were taxed in the U.S. (that is, in the event of an account transfer the funds were after-tax income or in the event of death the funds were subject to estate tax). As noted above, banks based in offshore financial centers (such as Switzerland and Luxembourg) do not retain records beyond 10 years, so it is no surprise that adequate substantiation of documentation does not exist to prove that such funds were subject to U.S. tax and thus in this example the taxpayer is not entitled to the reduced penalty. Furthermore, per the third example, in the event any investment instructions are given by the taxpayer to the relevant bank, the instructions, including a ''hold mail'' mandate, would disqualify application of the reduced 5 percent offshore penalty.

appropriate in principle, some of these conditions as a practical matter are simply not realistic. The more than 20-year lookback (for funds deposited before January 1, 1991) should be modified to a 10-year lookback. Bank records in most offshore financial centers such as Switzerland do not exist beyond 10 years. The January 1, 1991, benchmark means that there could be a documentary void for a 10-year span, from the benchmark date to 2000. This is inherently unfair because there simply is no way for taxpayers to meet their burden of proof unless they retained bank records, and if they retained records this action may show they were complicit in establishing and maintaining this account.

Further, the $1,000 de minimis rule is unrealistic and impractical. Typically, most noncompliant taxpayers withdrew more than $1,000 but less than $10,000. Accordingly, it would be preferable from an administrative viewpoint for this rule to be geared to the $10,000 threshold.

The second category for the reduced 5 percent offshore penalty involves foreign residents who were wholly unaware they were U.S. citizens. For example, this would pertain to a taxpayer who was born in the U.S. to parents of foreign citizenship but grew up in a foreign jurisdiction wholly unaware of his U.S. status. However, this special exemption would not apply to a taxpayer who always knew he was a U.S. citizen and never inquired about U.S. tax filing obligations.[12]

Query: If a dual national has been living abroad for decades, filing local law tax returns and paying all foreign taxes thereon, and maintaining no contacts with the U.S., then as a matter of tax policy why should that level of knowledge (or for that matter ignorance) affect this exception? This 5 percent penalty exception should be modified to provide that any dual national who substantiates that he has truly been a nonresident for a lengthy period is entitled to more favorable penalty treatment.

Furthermore, because of the disconnect between applicable U.S. tax law and applicable foreign tax law, the consequences of reconstructing the foreign-source income and deductions under U.S. tax provisions can be particularly punitive. For example, in the case of U.S.-Swiss nationals who reside in Switzerland, many items that are tax deductible under Swiss law would not be deductible under U.S. tax law, thereby giving rise to such a material disconnect and increasing the underlying U.S. tax on top of the 25 percent penalty on the maximum account balance.[13]

In summary, dual nationals living abroad should be treated in a completely different penalty position compared with their U.S. resident counterparts. The authors have handled cases in which dual nationals have approached counsel and then after learning of the substantial disconnect issues and the onerous 20 percent (now 25 percent) penalty, simply walked away, never to be heard from again. In Switzerland alone we are talking about tens of thousands of dual nationals, and worldwide this number clearly exceeds hundreds of thousands if not more than a million dual nationals.

12.5 Percent Offshore Penalty

In addition to the 5 percent offshore penalty exception, the FAQ guidelines provide for a reduced 12.5 percent offshore penalty for taxpayers whose highest aggregate foreign financial account balance is less than $75,000 in each of the years covered by the 2011 OVDI.[14] Under this calculation, the fair market value of assets in undisclosed offshore entities as well as the FMV of any foreign assets that were either acquired with improperly untaxed funds or produced improperly untaxed income must be taken into account, as further discussed below.

The 2011 OVDI guidance for the 12.5 percent penalty protocol provides clear-cut and straightforward examples. One example involves a U.S. citizen engaged in a U.S. business who transmits money to a foreign account that he jointly owns with his mother, who is apparently a non-U.S. person and a resident of the foreign jurisdiction where the account is held. So long as the account never exceeded $75,000, and so long as the taxpayer was tax compliant on his underlying activities, the 12.5 percent offshore penalty should apply. Another example involves the same case except that the account hits a high-water mark of $78,000, and the IRS strictly construes the $75,000 limit and rules that the reduced offshore penalty of 12.5 percent does not apply.[15]

Reduced Penalties for 2009 OVDP Participants

Taxpayers who participated in the 2009 OVDP and who qualify for the reduced 5 percent or 12.5 percent penalty as set forth in the 2011 OVDI may apply for a penalty reduction even if a Form 906, ''Closing Agreement,'' has been completed and fully executed by the taxpayers and the IRS.[16]

More on the Reduced Penalties Framework

Although the 2011 OVDI penalty framework appears to be an improvement over the one-size-fits-all 2009 OVDP, it still does not provide an opportunity to

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[12]FAQ 53.

[13]For a discussion of these tax disconnects regarding dual U.S.-Swiss nationals living in Switzerland, see William M. Sharp Sr. and Natalie Peter, ''Representing U.S.-Swiss Dual Passport Holders in IRS Voluntary Disclosure Cases,'' *Tax Notes Int'l*, Aug. 31, 2009, p. 753, *Doc 2009-19251*, or *2009 WTD 166-15*; and

(Footnote continued in next column.)

W. Sharp and N. Peter, ''More Information for U.S.-Swiss Dual Passport Holders,'' *Tax Notes Int'l*, Sept. 14, 2009, p. 935, *Doc 2009-19945*, or *2009 WTD 175-11*.

[14]FAQ 53.

[15]*Id.*

[16]FAQs 52 and 53.

appropriately deal with unique factual circumstances in appropriate cases. Moreover, the 5 percent penalty has proven illusory in application, and given the ''less than'' $75,000 threshold for the 12.5 percent penalty, it will likely affect a relatively small subset of disclosing taxpayers.

The IRS stated in the 2009 OVDP the objective of having a predictable and consistent penalty framework, and of course this approach has been adopted. Nonetheless, at the same time, the IRS had an excellent opportunity to provide a stratified yet more flexible approach that could have taken into account the material facts and circumstances of each case with the objective of having a more equitable penalty framework.

For example, the IRS should have promulgated a penalty framework that would provide for a predictable sliding scale of percentage penalties, as low as 5 percent and going as high as 25 percent (or even higher in more egregious cases). Consider the new penalty framework at the 25 percent level and its impact on a typical fact pattern involving a U.S. citizen who inherited an account from a nonresident alien relative only two years ago, and who required a couple of years to sort out the appropriate course of action to contact tax counsel to pursue a voluntary disclosure.

Compare that fact pattern with the situation involving a U.S. citizen who has been living abroad for more than 30 years, is a national or citizen of another country (typically the country in which he has resided), and who has little sophistication or knowledge of U.S. tax matters.

Finally, compare those factual vignettes with the situation in which a U.S. citizen residing domestically generates substantial pretax income and takes that income offshore over a period of 20 years.

As a matter of fairness and equity, how could the IRS apply the same one-size-fits-all percentage penalty to each of these three disparate fact patterns? IRS representatives have informally said that the policy of the penalty framework underlying the 2009 OVDP was to take into account all material factors so that the penalty should not exceed the maximum amount imposed by statute.[17] And yet practitioners and their clients have all felt the brunt of a rigid and inflexible penalty administration of the 2009 program. Further, the IRS has not administered the 2009 OVDP in a consistent manner so far as penalty determinations are concerned, given that in some cases ''reasonable cause'' issues have been entertained but in other cases only considered in a cursory manner. However, the failure of the IRS to develop a penalty framework that has a rational relationship to objective factors as illustrated above raises questions of how fairly this program will be judged based on the level of participation by noncompliant taxpayers with offshore holdings.

If the IRS incentivized unintentionally noncompliant taxpayers over those with a higher level of willfulness and concealment, then the overall program results in terms of taxpayer participation would be substantially greater. And this principle, if adopted in the 2011 initiative, could then still be available to those participating in the 2009 program similar to the manner in which the 5 percent and 12.5 percent penalty guidelines are being made available to 2009 ''closed'' cases.

Nevertheless, that cases closed under the 2009 OVDP may qualify for relief under these new rules is an inherently fair and unexpected result given the finality of a closing agreement.[18] Although this administrative benefit flies in the face of the statutory and regulatory framework of section 7121, this is a fair and appropriate result given that taxpayers who participated in the 2009 OVDP should benefit from the refined penalty framework in the 2011 OVDI. In a similar vein, the authors have handled cases under the 2009 OVDP in which signed final Form 906 closing agreements were ''unwound'' when the IRS changed its policy in administering the 2009 OVDP, specifically regarding changes in applying the passive foreign investment company rules.

Submission Deadline

The terms of the 2011 OVDI require that all aspects of submitted voluntary disclosures must be completed no later than August 31, 2011.[19] Accordingly, all signed amended income tax returns, offshore-related information returns and FBARs, schedules detailing the amount and types of previously unreported income, and full payment for tax, interest, and penalties must be submitted to the IRS by August 31, 2011.[20]

This onerous deadline is nearly impossible for anyone who has not previously entered the 2011 OVDI program given the time required to properly develop, analyze, and then submit a timely, complete, and accurate voluntary disclosure package, particularly in view of the time required to obtain complete foreign account statements and to accurately reconstruct foreign account activities in accordance with U.S. federal tax law. Per feedback received through the IRS voluntary disclosure hotline, taxpayers who have timely filed a

[17]FAQ 35 (issued under the 2009 OVDP) was frequently cited to support this policy.

[18]A closing agreement is a statutorily authorized settlement vehicle that is legally binding on both the IRS and the taxpayer absent fraud, malfeasance, or misrepresentation of material fact. Examination issues covered by the closing agreement may not be reopened by the IRS, and a court may not set aside the agreement or any ''determination, assessment, collection, payment, abatement, refund or credit'' made under the closing agreement. Section 7121.

[19]IR-2011-14; FAQ 1.

[20]FAQ 25.

valid extension for the 2010 income tax return will not be required to accelerate the filing date from the extended due date of October 15, 2011, to August 31, 2011, in order to satisfy the 2011 OVDI requirements.

As further discussed below, the challenge practitioners and their clients will face with the new initiative is not so much what is required but rather the compressed timing for completing the process. Because the unrealistic deadline will most certainly dissuade many taxpayers from coming forward, it is seemingly contradictory to the objective of the voluntary disclosure initiative reflected in the commissioner's public remarks that the IRS as a matter of policy wants to "get people back into the U.S. tax system."[21]

Highlights and Observations

An Impractical Deadline

As noted above, to participate in the 2011 OVDI, noncompliant taxpayers must submit the entire list of documents required and tender payment on or before August 31, 2011. This timeline is impractical for taxpayers choosing to enter the voluntary disclosure program between now and August 31, 2011, not to mention those taxpayers who applied for voluntary disclosure treatment in the past few months.[22]

Whoever approved the August 31, 2011, deadline either has no understanding of the time required to properly prepare an offshore voluntary disclosure case submission, or has no real interest in attracting new participants into the program. This is because it takes a significant amount of time to properly analyze, develop, and submit an accurate, truthful, and complete voluntary disclosure case, particularly in more complex offshore noncompliance cases.

Thus, the practical effect of this deadline is that unless taxpayers immediately initiate the process through tax counsel, it will be physically impossible to conduct a full and prudent debriefing of the facts surrounding the offshore activities, retrieve all relevant offshore data, conduct the necessary analysis of all issues, reconstruct the federal tax aspects of the last eight years (not just the last six years applicable in the 2009 OVDP), and then draft, finalize, and execute truthful, accurate, and complete tax returns, information returns, and related statements along with payment of all amounts owed as required under the new program.

Further, the IRS should understand that any major pronouncement such as the February 8, 2011, press release for the 2011 OVDI requires a gestation period of at least a few months if not a year before the public even hears about the program and has opportunity to contact counsel. By way of historical analogy, the IRS committed a horrendous timing error in 2003 when it issued Rev. Proc. 2003-14 on January 14, 2003, with an unreasonable deadline of April 15, 2003.[23] Thus, it was no surprise when the IRS later reported that slightly more than 1,000 cases were brought in under that offshore voluntary disclosure program.[24] The IRS should learn from the failed 2003 program, as well as other failed initiatives, such as the Last Chance Compliance Initiative,[25] that such a quick step timingwise will simply not work.

It is also ironic that the IRS mandates such an unreasonable due date when thousands of voluntary disclosure cases submitted to the IRS under the 2009 OVDP have been backlogged for more than a year and in some cases as long as two years even though all relevant information has been tendered by the taxpayers. A policy change needs to be adopted as soon as possible because otherwise the 2011 OVDI is destined to fail. Clearly the IRS and its leadership at the commissioner level did not intend the 2011 OVDI to be a meaningless venture.

The authors recommend that the IRS take swift action to modify the 2011 ODVI to permit taxpayers to *initiate* the voluntary disclosure program by August 31, 2011, and set a date further out for the completion of all steps (for example, December 31, 2011). Otherwise, it is unlikely that the 2011 OVDI will yield much of a turnout for further offshore account disclosures.

Expanded Scope of Lookback Period

As explained above, the voluntary disclosure lookback period under the 2011 OVDI is expanded to include two additional years beyond the lookback required under the 2009 OVDP and beyond what the IRS historically imposed in voluntary disclosures.[26] In the spirit of making the process more costly and punitive to those who hold out longer, the added two years

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[21]IR-2011-14.

[22]The terms of the 2011 OVDI nevertheless apply to any taxpayer who has initiated a voluntary disclosure since October 15, 2009. *See* FAQ 19.

[23]*See* Rev. Proc. 2003-14, 2003-11 C.B. 311. The 2003 program was named the Offshore Voluntary Compliance Initiative (OVCI); note also that the OVCI only required a "notification" filing and not the full package by its April 15, 2003, due date.

[24]*See* "Selected Issues Relating to Tax Compliance With Respect to Offshore Accounts and Entities Before the Senate Committee of Finance" (prepared by the Joint Committee on Taxation), July 23, 2008 (reporting that the IRS had received OVCI applications from only 1,299 taxpayers); *see also* Martin Sullivan, "Keeping Score on Offshore — U.K. 60,000, U.S. 1,300," *Tax Notes Int'l*, July 9, 2007, p. 146, *Doc 2007-15466*, or *2007 WTD 129-7*.

[25]The Last Chance Compliance Initiative was an informal limited amnesty program through which the IRS issued "last chance letters" (IRS Letter 3549 (rev. 6-2003)) to U.S. taxpayers who were identified by the IRS as holding offshore credit cards or participating in offshore financial arrangements. It is the authors' understanding that the IRS collected an enormous number of credit card records from offshore sources yet pursued relatively few cases.

[26]FAQ 9.

of required compliance is arguably appropriate. However, it also raises practical issues.

For example, the added two years means that taxpayers must obtain an additional two years' worth of foreign financial account statements and related documentation. It also means that the taxpayer's representatives must reconstruct an additional two years of foreign financial account activity to reconstruct omitted income amounts, as well as deductions and foreign tax credits (not to mention the appropriate PFIC analysis), and prepare accurate amended returns. All these tasks take considerable time and the expanded scope will only add stress in an already compressed time frame.

Moreover, as a practical matter, the inclusion of the 2009 *and* 2010 tax years may significantly increase the offshore penalty cost as the stock markets were particularly strong in those years and the maximum balance on which the penalties are imposed may likely be much greater. The IRS has informally indicated, however, through the IRS voluntary disclosure hotline that it will exclude the 2009 and 2010 tax years from the offshore penalty calculation if timely and accurate income tax returns were filed for those years that reflected all foreign account or asset activity.[27] For penalty calculation purposes, taxpayers may not rely on the ''low water'' years in which the stock market dropped because of the global recession, typically from 2007 through early 2009. Once again, the new program extracts the maximum pound of flesh that was similarly extracted in the 2009 voluntary disclosure initiative.

Despite the expanded scope of coverage, the new program's FAQs provide that any pre-2003 noncompliant conduct may not be taken into account regarding the lookback period from 2003 through 2010 so long as certain conditions are met, as further discussed below.[28]

Given that the 2011 OVDI reaches back eight years, covering all tax years from 2003 through 2010, a key statutory procedural question arises: What authorizes this eight-year bandwidth to clearly exceed the otherwise applicable three- or six-year statute of limitations?[29] The IRS explains that taxpayer agreement with the assessment of tax and penalties for all years covered by the lookback period is part of the resolution offered by the IRS under the 2011 OVDI, and the IRS mandates that the taxpayer must agree to assessment of the liabilities for each of the eight years in the lookback period in exchange for the benefit of the reduced penalty framework.[30] Moreover, participating taxpayers must complete and sign agreements to extend the period to assess tax, including penalties, and also to assess FBAR penalties for any years that are otherwise set to expire during the pendency of the voluntary disclosure application.[31]

Procedural Changes

As the voluntary disclosure process evolved over the past 2-1/2 years, the IRS struggled to search for ways to streamline the handling of these cases.[32] With the announcement of the 2011 OVDI, the IRS further refined the voluntary disclosure process for handling previously undeclared offshore accounts.

Under the 2011 OVDI, taxpayers and their counsel must run the gauntlet of a three-step process, as summarized below.

- *Step 1*: Counsel submits via fax a ''pre-clearance'' disclosure notice to a new unit known as the Criminal Investigation Lead Development Center. This notice must contain basic taxpayer identifying information.[33] The IRS Criminal Investigation division will then notify legal counsel via fax whether the taxpayers are cleared to make an offshore voluntary disclosure.[34] Based on early experience of the authors in handling cases under the new initiative, this pre-clearance may be given as quickly as within 24 hours — and this in turn triggers the running of a new 30-day timeline as described in Step 2.
- *Step 2*: After a taxpayer is pre-cleared, counsel must submit an offshore voluntary disclosure letter within 30 days from receipt of the pre-clearance fax notification.[35] In contrast to the 2009 OVDP under which the so-called optional format letter was submitted directly to an assigned special agent within CI, all offshore voluntary disclosure letters under the 2011 OVDI are required to be mailed to the Offshore Voluntary Disclosure Coordinator in Philadelphia.[36] Upon receipt, CI

[27]In contrast the IRS refused to exclude the 2008 tax year from the offshore penalty calculation under the 2009 OVDP even if such return accurately and timely reflected all offshore activity.

[28]FAQ 34.

[29]Section 6501(a) and 6501(e)(1).

[30]FAQ 42. Presumably this extended limitations period could be legally justified based on the civil fraud exception of section 6501(c)(1).

[31]FAQ 43. *See also* FAQ 25.

[32]Indeed, before 2009, voluntary disclosures were commonly submitted and negotiated by counsel on an anonymous basis. For historical developments on voluntary disclosures, see William M. Sharp Sr. and Larry R. Kemm, ''News Analysis: IRS Reduces Penalties on Offshore Voluntary Disclosures,'' *Tax Notes Int'l*, Apr. 6, 2009, p. 7, *Doc 2009-7193*, or *2009 WTD 64-6*.

[33]FAQ 23.

[34]*Id.*

[35]FAQs 23 and 24. The offshore voluntary disclosure letter is substantially similar to the optional format letter released in connection with the 2009 OVDP. However, the offshore voluntary disclosure letter is not optional as it was in the 2009 OVDP.

[36] FAQ 24.

will review the letter and thereafter notify legal counsel by mail whether the subject disclosure has been preliminarily accepted or declined. Although no firm timetable is prescribed, the FAQs note that the IRS ''intends'' to complete this step within 30 days of receipt of the offshore voluntary disclosure letter.[37]

- *Step 3*: The final stage of the voluntary disclosure procedure is to submit a ''full voluntary disclosure'' package to the IRS office in Austin, Texas.[38] This includes a list of items for the 2003 through 2010 tax years, including previously filed tax returns, complete and accurate amended tax returns, a completed foreign account or asset statement for each previously undisclosed foreign account or asset, a completed and executed foreign financial institution statement (for cases involving accounts with an aggregate highest balance in any year of $1 million or more), an executed taxpayer account summary with penalty calculation, and a check payable to the Department of Treasury for the total amount of tax, interest, and penalties owed.[39]

Copies of offshore financial account statements reflecting all account activity for each of the tax years covered (that is, 2003 through 2010) must also be provided when the aggregate highest balance of the accounts exceeded $500,000 for any year. If taxpayers are under this threshold, however, bank statements need not be submitted but they still must be readily available on request. Finally, the package must include executed extension agreements to extend the period to assess tax and to assess FBAR penalties.[40] The IRS reserves the right to contact participating taxpayers for specific additional information if needed on a case-by-case basis.[41]

After a complete submission of the items described above, the case will be assigned to an IRS revenue agent or ''examiner'' (as that term is used in the FAQs) to complete the ''certification'' of all tax returns for accuracy, completeness, and correctness.[42] The 2011 OVDI clarifies that the IRS does not conduct a full examination, but rather a certification as to the correct, accurate, and complete nature of the submission as well as a verification as to the mathematics involved in computing the tax, interest, and civil penalties.[43]

Nevertheless, as noted above the IRS makes it clear that it reserves the right to conduct an examination.[44] Because the certification process falls short of a formal examination, the taxpayer does not have the rights and legal consequences of an examination.[45] Thus, the IRS examiner will not transmit the statutorily and administratively required taxpayer notices, nor will the certification process constitute ''a second examination'' if one or more years of the prior eight years has been examined. Furthermore, a decision made by the examiner will not be subject to IRS appeal rights.[46] Even though taxpayer ''rights'' of an examination do not apply, the IRS reserves the right to ask any relevant questions, request any relevant documents, and even make third-party contacts if necessary and appropriate to complete the certification process, and the third-party contacts and other activities will not constitute an examination.[47]

The IRS states that even though steps have been taken to improve the voluntary disclosure process and its efficiency, there is ''no way to predict'' how long the process will take for a particular taxpayer given that each case involves a different fact pattern.[48] Although the IRS comment that the timing for handling a given case's certification and verification process will vary depending on the facts of each case, at the very least the IRS should provide some general timing guidelines for processing cases submitted under the 2011 OVDI.

Taxing PFIC Investments

The IRS formalized the treatment in the 2011 OVDI for taxing an account that holds an investment in a PFIC. In particular, the IRS has extended the application of an alternative mark-to-market (MTM) method that was informally adopted as part of the 2009 OVDP.

Under the MTM method adopted for purposes of a voluntary disclosure, unrealized gains reflected in the market value of PFIC investments are taxed on a current basis at a 20 percent tax rate.[49] Similarly, unrealized losses generate a tax benefit at a 20 percent tax rate to the extent of prior unreversed income inclusions. For the first year in the voluntary disclosure period (typically 2003), an additional 7 percent carrying charge is added to the tax in lieu of the interest charge that ordinarily applies under the statutory PFIC rules.[50]

The MTM method is a welcome development in resolving offshore account disclosures because it has been common for Swiss banks to direct their account

[37] *Id.*

[38] FAQ 25.

[39] *Id. See also* FAQ 20, which authorizes the IRS to consider other payment arrangements under the 2011 OVDI in the event that a taxpayer is unable to make full payment of his liabilities.

[40] FAQ 25.

[41] FAQ 27.

[42] FAQ 26.

[43] FAQs 25 and 27.

[44] FAQ 27.

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] FAQ 28.

[49] FAQ 10.

[50] *See id.* and section 1291.

holders' assets into investments that would be classified as a PFIC for U.S. federal income tax purposes. Further, the MTM method often produces a significant tax savings to the taxpayer compared with the statutory excess distribution regime in the PFIC rules.

The IRS states that for any PFIC investment retained beyond December 31, 2010, the taxpayer must continue to use the MTM method by applying the normal statutory rules of section 1296 as well as the provisions of sections 1291 through 1298 as applicable.[51] In most instances, this presumably will mean that the taxpayer must revert to the excess distribution regime since the vast majority of foreign mutual fund investments that are common in Swiss account portfolios typically do not represent ''marketable stock'' that is eligible for MTM treatment under section 1296.

The IRS also mandates that any prior unreversed income inclusions will be reduced to zero at the end of the 2011 OVDI period (that is, in most cases at the end of calendar year 2010).[52] As a matter of U.S. federal tax consistency, this makes sense for the continued application of the MTM method in years beyond the voluntary disclosure period because it prevents taxpayers from potentially claiming ordinary losses in post-OVDI years at a 35 percent rate when the prior income inclusions were taxed at only a 20 percent rate. However, for investments that cannot continue to apply an MTM method beyond 2010 because they do not constitute ''marketable stock'' under section 1296, the prior unreversed income inclusions should still support a higher tax basis in the taxpayer's investment in order to avoid potential double taxation. The following example provides a practical understanding of this issue.

Assume that a PFIC investment is purchased with an initial cost of $10,000 and that the taxpayer recognizes aggregate MTM gains of $8,000 and MTM losses of $3,000 during the voluntary disclosure period ending December 31, 2010. As a result, the taxpayer ordinarily under statutory PFIC rules would have $5,000 of prior unreversed income inclusions (representing the difference between MTM gains of $8,000 and MTM losses of $3,000) as of December 31, 2010. However, under the 2011 OVDI guidance, the prior unreversed income inclusions are reduced to zero. Thus, if the value of the PFIC investment decreases in the 2011 tax year, the taxpayer would be precluded from claiming any MTM losses realized in 2011. Nevertheless, the taxpayer should have tax basis for the prior MTM income inclusions, so that the tax basis of the PFIC investment at the end of 2010 would be $15,000 (initial cost of $10,000 plus income inclusions of $8,000, less MTM losses recognized of $3,000). As a result, if the taxpayer then sells the PFIC investment in 2011 for $13,000, the taxpayer would recognize a capital loss of $2,000.

[51]FAQ 10.

[52]*Id.*

Disregarded Foreign Entities

A key issue that often arises in voluntary disclosure cases involving foreign corporations, foreign trusts, and other foreign entities is whether and to what extent the entities are disregarded for U.S. federal tax purposes. The advantage of disregarded entity treatment is that affected cases can typically be resolved on a more expedited basis because the time-consuming functions of preparing applicable foreign information reporting forms are avoided.[53] Furthermore, from the perspective of the IRS, this also saves time in connection with the review of the information reporting forms. Moreover, if disregarded treatment is permitted, the IRS directly traces reconstructed foreign-source income directly to the taxpayer's Form 1040 and thus bypasses the relevant yet unduly complicated information reporting forms, such as Form 5471.

For purposes of the 2011 OVDI, disregarded foreign entity treatment will be appropriate if the following conditions are satisfied:

- the taxpayer certifies under penalty of perjury that the entity had no purpose other than to conceal the taxpayer's ownership of assets; and
- the IRS agrees to waive the requirement to file delinquent information returns based on an IRS conclusion that a waiver is in the IRS's interest to do so.

To disregard the existence of foreign entities, a taxpayer must first submit the statement on dissolved entities.[54] If the taxpayer does not provide the required certification by way of an executed statement on dissolved entities, all normal information reporting requirements and associated income tax consequences will apply.

The certification required to claim disregarded entity treatment is potentially troublesome. Suppose that a taxpayer was advised by his foreign banker to organize an entity for purposes of concealing the account and avoiding local law probate problems and to facilitate succession planning issues in the event of the taxpayer's demise. (This is a common fact pattern the authors see with noncompliant Swiss accounts, and typically involves use of a Liechtenstein *stiftung*, also

[53]For example, forms 5471, ''Information Return of U.S. Persons With Respect To Certain Foreign Corporations,'' 8865, ''Return of U.S. Persons With Respect to Certain Foreign Partnerships,'' 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,'' and 3520-A, ''Annual Information Return of Foreign Trust With a U.S. Owner,'' would not be prepared, nor would Form 8858, ''Information Return of U.S. Persons With Respect to Foreign Disregarded Entities.''

[54]FAQ 29.

known as a foundation.) Suppose further that the taxpayer submits the certification under penalty of perjury that the entity was established solely to conceal offshore assets, because the taxpayer wants to avoid the complexity of information reporting obligations for the foreign entity.

If, for whatever reason, the voluntary disclosure falls apart even after the issuance of the CI conditional preclearance letter (or even at a later stage), query whether the statement made under penalty of perjury concerning the concealment of offshore assets may irreversibly subject the taxpayer to greater criminal exposure. The IRS guidance does not address this fact pattern and does not state whether the executed statement of dissolved entities is restricted or remains ''as is.'' The more prudent course of action in appropriate cases would be to file the information reporting returns and to not make such an admission against interest.

The authors are handling several cases in which the voluntary disclosure application did not pass such preclearance or were later declined from participation in the voluntary disclosure program primarily because of the ''timeliness'' condition.[55] Fortunately, in these cases the taxpayer did not sign such a certification that would represent an admission against interest and completely expose the client to greater potential criminal sanctions; and assuming such criminal sanctions do not apply, the taxpayer would undoubtedly be exposed to a higher level of civil penalties to resolve such a ''declined'' case.

Co-Owned Assets

In the event multiple taxpayers are co-owners of a noncompliant offshore account, the IRS prescribes that each taxpayer who makes a voluntary disclosure will be liable for the penalty based on his particular percentage of the highest aggregate balance in the account and thus the voluntary disclosure is effective only for his particular tax liability.[56] In other words, a particular taxpayer's voluntary disclosure will not cover or cleanse the other co-owners, and indeed the co-owners must make their own voluntary disclosures; otherwise they will be subject to examination by the IRS and subject to maximum penalties as described in FAQ 5.[57]

For the common situation of foreign accounts for which the account holders have named their children as authorized signators on the account, the new IRS guidance provides that if no beneficial ownership exists, the children should file delinquent FBARs as described in FAQ 17.[58] The parents will be jointly subject to only one 25 percent offshore penalty; that is, each parent will not be encumbered with separate 25 percent offshore penalties.[59] Furthermore, the parents at their option will be able to pay a single 25 percent penalty by having one parent pay the total amount or by each parent paying a portion.[60]

The IRS also addresses a situation involving multiple individuals with signature authority over a trust account in which the individuals do not necessarily have a beneficial interest in the underlying funds. In this fact pattern, only one 25 percent offshore penalty will be applied to voluntary disclosures involving the same account, and this should apply not only to trust accounts but also to multiple parties owning an interest in a foreign financial account or for that matter multiple parties owning portions of a foreign corporation or other entity owning unreported foreign financial accounts.[61] The IRS prescribes that the penalty may be allocated among taxpayers with beneficial ownership making the voluntary disclosure ''in any way they choose.''[62] Thus, each of the taxpayers must file an FBAR, but payment of the offshore penalty may be arranged among the parties.[63]

Although the above IRS guidance provides welcome direction for co-owner voluntary disclosure cases, at the same time the IRS could have gone a step further by providing guidance on those cases in which foreign financial accounts are not technically co-owned but are ''successively'' owned. For example, suppose that a noncompliant taxpayer owns an undisclosed foreign financial account for many years. Suppose further that the noncompliant taxpayer dies in a later year during the voluntary disclosure period at issue (for example, 2009 or 2010) and that the noncompliant taxpayer's spouse and children inherit the account.

The issue is who pays the 25 percent offshore penalty, and whether the ''innocent'' successors bear responsibility for the penalty. In this case, it is clear as a matter of law that the offshore penalty could be imposed on the estate, but only to the extent that the estate has control or custody of the necessary funds from the offshore account to pay the penalty. If the funds from the undisclosed foreign financial account pass to other successors, then as a matter of transferee liability (and other applicable U.S. federal tax rules), the successors in interest should be responsible for paying their

[55] *See, e.g.,* Robert F. Katzberg and William M. Sharp Sr., ''Representing U.S. Taxpayers in List or Declined UBS Voluntary Disclosure Cases,'' *Tax Notes Int'l*, Feb. 22, 2010, p. 703, *Doc 2010-957*, or *2010 WTD 34-13*.

[56] FAQ 40.

[57] *Id.*

[58] FAQ 39.

[59] *Id.* This is similar to the principle set forth in FAQ 37 discussed further below in which funds are transferred from one account to another and the IRS clarified that the funds will be subject to the 25 percent penalty only once.

[60] *Id.*

[61] FAQ 41.

[62] *Id.*

[63] *Id.*

pro rata share of the penalty just as co-owners are liable in a co-owned account scenario as explained above.

Interplay With Estate Tax

The inherent nature of the 2009 OVDP and the 2011 OVDI raise several issues concerning the interplay between the implications associated with an estate and the heirs who have initiated a voluntary disclosure to report an inherited offshore account.

For example, if the original foreign account owner has died during the voluntary disclosure period, should the estate taxes (as well as penalties and interest) be deducted from the maximum account balance during the subsequent years that the account is held by the decedent's heirs for purposes of calculating the offshore account penalty? Logically, the decedent's heirs could not inherit more assets than would be available after the payment of estate taxes and associated penalties and interest. Therefore, if the offshore account penalty is to be calculated by reference to the maximum account balance that was achieved in a year after the foreign account holder's demise, it is fair and appropriate to allow a deduction of the estate tax and associated liabilities from the foreign account's maximum balance.

Another issue encountered in the estate context involves the application of the reduced 5 percent offshore account penalty. The IRS has taken the position in some cases under the 2009 OVDP that the 5 percent penalty is not available to a taxpayer who inherits a foreign account if the original account holder died during a year in the voluntary disclosure period. Although a cogent explanation for this particular position has never been given, one rationale provided was that the IRS could always still pursue the estate for any penalty deficiencies since the statute of limitations would still be open.

The foregoing approach does not seem logical in the application of the voluntary disclosure offshore account penalty. In essence, the IRS is saying that it will reward those individual taxpayers who have continued to conceal an offshore account for a longer period (that is, at least six years under the 2009 OVDP and presumably at least eight years under the 2011 OVDI).

Apart from the foregoing, there are several other fact patterns involving estates that raise interesting and important issues in the application of the offshore voluntary disclosure program. Some guidance from the IRS in this area would be welcomed.

Assets Included in 25 Percent Penalty

The IRS adopts, as expected, a broad interpretation as to the nature and scope of assets included in the 25 percent offshore penalty calculation. In general, the penalty is intended to apply to all the taxpayer's offshore holdings that are related in any form or manner to the subject noncompliance.[64] This broad inclusion of offshore holdings is determined regardless of the form of ownership or character of the asset.

Accordingly, any assets directly owned by the taxpayer would be included in the penalty calculation, including cash, securities, or other custodial accounts, for example. This category also extends to tangible assets such as real estate or art, as well as intangible assets such as patents or stock, including interest in a U.S. or foreign business, as explained below.[65] This broad swath also includes assets indirectly held or controlled by the taxpayer through a structured entity, and in this case the penalty would typically be applied to the taxpayer's interest in the entity.[66]

The IRS also adopts a broad definition of what constitutes ''tax noncompliance'' to include not only failure to report income from assets, but also the failure to pay U.S. tax that was due regarding funds used to acquire the assets. Therefore, if a taxpayer uses after-sale proceeds to acquire an asset but did not pay tax on the underlying sale, the asset in question remains ''tainted'' for penalty calculation purposes.[67] This is directly substantiated by FAQ 34 in the case of a pre-2003 disposition of an asset when the noncompliant proceeds are then ''parked'' in a foreign financial account into one or more post-2002 tax years.[68]

Non-Income-Producing Assets

The 2011 OVDI FAQs address the situation of a taxpayer owning offshore valuable assets such as land and artwork. Of course, in most cases these assets are unable to produce active or even passive income. The issue is whether the value of the land and artwork must be included for 25 percent penalty calculation purposes.

FAQ guidance provides that the 25 percent offshore penalty is intended to apply to offshore assets that are related to tax noncompliance and not so much dependent on whether the assets are non-income-producing assets. Accordingly, the central focus is whether the non-income-producing assets were acquired with funds that were noncompliant, that is, improperly nontaxed.[69] Therefore, in the case of non-income-producing properties (such as valuable land or artwork) acquired with funds that were subject to U.S. tax but for which no such tax was paid, the offshore penalty would apply to the value of the land or artwork. Again, the key determining factor is whether the non-income-producing

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[64]FAQ 35.

[65]*Id.*

[66]*Id.* Alternatively, if the IRS determines that the structured entity constitutes an alter ego or nominee of the taxpayer, the taxpayer's penalty is linked to the underlying assets.

[67]FAQ 35.

[68]*Id.*

[69]FAQ 36.

assets were acquired with noncompliant funds for which tax was not properly paid, even if the noncompliance occurred before 2003.[70]

In contrast, if the non-income-producing assets were acquired with after-tax funds or from funds that were not subject to U.S. income taxation, and assuming that the offshore assets have not yet produced any income (whether on a current basis or through a recognition event such as a sale or disposition of the assets), then given the absence of a U.S. taxable event there would have been no reporting obligation. Accordingly, a 25 percent penalty would not apply.[71] However the IRS guidance cautions that such a taxpayer will be required to fully report any triggered gain recognition or otherwise applicable income associated with the property when those recognition events occur.[72]

'Duplicated' Accounts

The FAQs provide welcome guidance regarding the common fact pattern of a noncompliant offshore structure or account relationship that involves multiple foreign financial accounts. For example, suppose a taxpayer transferred funds from one unreported foreign financial account to another offshore account between 2003 and 2010. Then suppose the taxpayer also transferred the unreported foreign account to a third foreign financial account. The IRS guidance provides that so long as the taxpayer can establish that the funds were transferred from one account to another and even to another financial institution account (or in theory to multiple accounts), any ''duplication'' will be removed or consolidated before calculating the 25 percent penalty, though the burden of establishing any potential duplication in the calculation will be on the taxpayer.[73]

[70] *Id.*

[71] *Id.*

[72] *Id.* The FAQ guidance goes on to provide that if the subject property produced income that was *not* reported even though properly subject to U.S. tax during the 2003-2010 voluntary disclosure period, such as valuable land that is subject to a sharecropping lease, the income-producing property would be included in the 25 percent penalty computation regardless of the source of funds used to acquire the assets. From a tracing of funds perspective, this means that if the taxpayer used after-tax or otherwise tax-compliant funds (such as funds not otherwise subject to tax) to acquire a foreign asset for which even a modest amount of income was not reported, the acquired assets would be fully subject to the offshore penalty despite the original tracing of the funds used to acquire those assets as being tax compliant. Furthermore, holding the assets in the name of an entity such as a foreign trust or foreign corporation would also have triggered an information reporting filing obligation to disclose the assets and thereby would draw such assets within the scope of the offshore penalty without regard to the tax-compliant nature of funds used to acquire the assets.

[73] FAQ 37.

'Mere Signature' Authority Accounts

A person who simply fails to file an FBAR to report signature authority over a foreign financial account generally would not be an appropriate candidate for the voluntary disclosure program (that is because absent a beneficial ownership interest, there is no unreported income). This often occurs when a taxpayer is employed by an employer having multiple foreign accounts for which the taxpayer has signature authority but no other beneficial interests. It also often occurs when an account holder names a relative as an authorized signator as a matter of convenience. The issue is whether the 25 percent offshore penalty applies to the foreign financial accounts for which the taxpayer only has signature authority.

The IRS guidance provides that the 25 percent offshore penalty will not apply to those accounts for which the taxpayer merely has signature authority but no beneficial interest.[74] Thus, by way of administrative grace, such a ''mere signature authority'' account relationship will be treated as unrelated to other noncompliance for which the taxpayer initiates a voluntary disclosure.[75]

However, that result might go in a different direction under several scenarios. For example, if the account for which the taxpayer has mere signature authority is held in the name of a related person, such as a family member or in the name of a foreign corporation, trust, or other offshore vehicle for which the taxpayer had a title 26 reporting obligation, the account relationship might be taken into account for purposes of calculating the 25 percent offshore penalty.[76]

In each of these scenarios, if the taxpayer is determined to have a direct or indirect beneficial interest, the 25 percent penalty will be levied on the putative mere signature authority account if a finding is made that unreported income is applicable to the account through a related party or otherwise, as explained above. However, if at the end of the day no unreported income exists regarding the putative mere signature authority account, no penalty will be imposed.[77]

Practitioners and their clients should be highly circumspect regarding application of the mere signature authority account exception to the 25 percent penalty application in the scenarios mentioned above. To effectively represent a client, the practitioner must conduct extensive due diligence in developing an accurate and complete picture of what happened regarding what appears to be a mere signature authority account profile, and to ascertain whether the client may be deemed

[74] FAQ 38. This rule is consistent with FAQ 9 under the 2009 OVDP.

[75] *Id.*

[76] *Id.*

[77] *Id.*

to hold a direct or indirect beneficial interest. Note that the practitioner may not simply accept verbal representations of his client, but instead must conduct a thorough review of all documents, records, and other information regarding the account relationship. Clients who are unwilling or unable to authorize counsel to conduct a complete ''legal audit'' of the offshore file create serious potential malpractice and Circular 230 risks for their practitioner, not to mention the adverse implications that ensue when the IRS discovers that an incomplete voluntary disclosure is made.

Furthermore, in appropriate circumstances, when the taxpayer has signature authority over a foreign financial account of his employer, the practitioner might obtain an affidavit or other statement from a representative of the taxpayer's employer. However, these cases give rise to some hazards. Caution must be used not to jeopardize the fundamental employer-employee relationship in this scenario. Furthermore, foreign employers in this regard tend to become quite alarmed when such a request is made. Thus, these cases need to be handled very carefully.

The 'All or Nothing' Approach

The IRS guidance addresses an interesting but not unusual fact pattern involving a noncompliant taxpayer who has two or more offshore accounts and who has reported all income from one or more accounts but not from another. One alternative would be to split the disclosure into two segments; that is, merely submit a delinquent FBAR filing for the reported account so long as all income was reported on the taxpayer's tax return, and separately initiate a voluntary disclosure to address the account for which no income was reported on the tax return.

The new guidance reasons that because the annual FBAR filing obligation is a single report to account for all foreign accounts, it is not possible to split the corrected filing.[78] Accordingly, the voluntary disclosure should include all accounts and the delinquent FBARs would include all such accounts, even though on one or more of the accounts the associated income was fully reported on the taxpayer's tax returns.

However, the IRS indicated that no penalty will be assessed (based on the otherwise applicable 25 percent offshore penalty) regarding the account whose income was fully reported on the taxpayer's tax return because this account is ''unrelated to the taxpayer's noncompliance,''[79] and no income was omitted.

Limited 'Less Than' Relief

Similar to FAQ 35 as set forth in the 2009 OVDP, the new initiative prescribes that under no circumstances ''will taxpayers be required to pay a penalty greater than what they would otherwise be liable under the maximum penalties imposed under existing statutes.''[80] But a closer reading of this and related provisions in the FAQs shows that the IRS is limiting the application of this ''less than'' relief valve.

The example in the FAQs contemplates a taxpayer with a relatively small offshore bank account in only one year of $100,000 as well as separately owned foreign income-producing real estate with an FMV of $1 million. Based on the maximum FBAR penalty of only $50,000 (50 percent for one year) in comparison with the 25 percent offshore penalty of $275,000 (that is, 25 percent of $1.1 million), the FBAR penalty would be substantially less than what would be due under the 2011 OVDI, and thus the taxpayer could pay the lesser amount.[81] If under these same facts, however, the offshore account had been held for six years rather than one year, the full 25 percent penalty would apply (that is, six years of a $50,000 FBAR penalty would exceed the $275,000 penalty calculated as a percentage of offshore assets).

The FAQs contemplate that examiners will assess the amount due under the 2011 OVDI regarding tax, interest, and prescribed penalties for all open years that the taxpayer would owe *in absence of* the special penalty regime and make a preliminary determination.[82] The FAQs clearly specify that the taxpayer will pay the lesser amount, but again, if the taxpayer disagrees with the proposed penalty amount, the taxpayer may request that the case be referred to examination for all relevant years and issues.[83]

Unagreed Cases — IRS's No-Discretion Policy

In what could be construed as a substantial downgrade to the 2009 OVDP, the new FAQ guidance explicitly states that IRS examiners will *not* have discretion to settle cases for amounts less than what is ''properly due and owing.''[84] Accordingly, if the taxpayer and the examiner cannot agree to the final terms and conditions of the 2011 OVDI closing agreement, neither further IRS examiner consideration of case issues nor IRS Appeals consideration will be an option regarding final conclusion of the terms and conditions of the closing agreement unless the taxpayer agrees to ''opt out,'' as discussed below.[85] Most importantly, the

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[78]FAQ 45.

[79]*Id.*

[80]FAQ 50.

[81]*Id.*

[82]*Id.*

[83]*See* FAQs 50 and 51.

[84]FAQ 50.

[85]FAQ 49. By way of background, the guidance also explains that in many cases in which the taxpayer makes a voluntary disclosure the taxpayer would likely owe substantially greater penalties if the 2011 OVDI penalty framework were not available.

examiner will not consider reasonable cause, willfulness, mitigation factors, or other circumstances that might reduce the ultimate tax liability or penalties.[86]

The IRS justifies this harsh stance because the reduced and more favorable penalty framework and the agreement to limit tax exposure to years in the look-back period (from 2003 through 2010 tax years) are dubbed ''package terms'' (buzzwords also used in the 2009 OVDP), and thus must be accepted in such a package resolution. The IRS further provides that no carveout of any issues will be allowed and that if ''any part of the offshore penalty is unacceptable to the taxpayer,'' then the case will be examined and all applicable penalties will be imposed.[87] As noted above, the IRS confirms that IRS Appeals rights are available upon conclusion of an examination but only outside the 2011 OVDI.[88]

This harsh IRS no-discretion policy is not only unjustified based on the shallow reasoning described above but in the end is penny-wise and pound-foolish. Examiners should be authorized to at least make a prima facie penalty reduction or abatement determination of fact patterns involving the factors noted above — reasonable cause, willfulness, mitigation factors, and other circumstances. In some cases, this prima facie determination with the submission of corroborating evidence may even merit such a reduction or abatement.

In some casework handled by the authors under the 2009 OVDP, examiners exhibited such a degree of discretion and, in fact, when appropriate, concluded that the applicable 20 percent overall offshore penalty amount should be abated and a negligence penalty should be imposed in lieu thereof. This harsh IRS policy detailed in the 2011 OVDI is nothing short of an adhesion offer for revenue agents to bully taxpayers into a shotgun resolution of case facts that merit at least a preliminary analysis by the examiner.

Unagreed Cases — The Opting Out Process

Under FAQ 51, the ''opting out'' taxpayer must inform the IRS of this decision in writing to withdraw from the program, and once this election is made it is irrevocable. Procedurally, the examiner and his manager will review the facts of the case to determine how to proceed with the audit process.[89] The examiner and manager will make a decision to either refer the case for a ''normal examination'' or to a ''Special Enforcement Program agent.''[90] FAQ 51 cautions that on completion of the examination, the assessed penalties could be ''substantially greater'' than the otherwise applicable 25 percent penalty that would have applied under the 2011 OVDI. FAQ 51 further confirms that in an unagreed case, the taxpayer will have recourse to IRS Appeals.[91]

In an effort to rattle the governmental saber and to dissuade taxpayers from opting out, the IRS puts taxpayers on notice that they remain within CI's voluntary disclosure practice.[92] Accordingly, taxpayers are required to cooperate fully with the IRS by providing information, records, arranging for payments, and ultimately discharging the obligation to cooperate. If the taxpayer does not cooperate or make final payment arrangements, the ''case may be referred back to Criminal Investigation.''[93]

Warning on Continuing Noncompliance

The new FAQs provide an array of warnings and hazards to noncompliant taxpayers with offshore holdings who do not participate in the 2011 OVDI. The IRS warns that those who do not voluntarily submit will be subject to the risk of detection; in those cases the taxpayer will suffer stiffer penalties, such as the fraud and information return penalties, along with increased risk of criminal prosecution.[94]

The IRS affirms its continuing efforts to actively engage in ''ferreting out the identity'' of U.S. taxpayers owning undisclosed offshore holdings.[95] The risk of detection is also enhanced through information available under tax treaties (no doubt referring to the Switzerland-U.S. protocol signed on September 23, 2009, which, when ratified, will allow the U.S. to override bank secrecy in the case of treaty requests), as well as the Foreign Account Tax Compliance Act and the new reporting rule under section 6038D.[96]

Similar to the 2009 OVDP, the new FAQ guidelines also enunciate the complete and ugly picture of what happens if a noncompliant taxpayer with offshore holdings is tagged for examination and suffers the worst, with a detailed summary of the penalties for failure to file the FBAR. The guidelines also review the various cascading penalties for failure to file forms 3520, 3520-A, 5471, 5472, 926, and 8865, as well as

[86]*Id.*

[87]*See* FAQ 49, referencing FAQ 51, which provides for a full array of potential penalties to be assessed on examination.

[88]FAQ 51.

[89]*Id.*

[90]*Id.* In connection with this process, and when appropriate, technical service advisers will be consulted, and all relevant years and issues will be subject to complete examination.

[91]*Id.*

[92]*Id.*

[93]*Id.*

[94]FAQ 4.

[95]*Id.*

[96]*Id.*

penalties imposed under sections 6651(f), 6663, 6651(a)(1), 6651(a)(2), and 6662.[97]

Quiet Filings — Beware!

The 2011 OVDI addresses taxpayers who have made ''quiet'' voluntary disclosures, consistent with the guidance provided with the 2009 OVDP. In these cases, the taxpayers filed amended tax returns and made appropriate payments of tax and perhaps even interest but otherwise did not put the IRS on notice of such submission. The 2009 OVDP clearly stated that quiet disclosures were ineligible for voluntary disclosure treatment, and the IRS continues this position in the 2011 OVDI.[98] The IRS in the new program goes a step further by providing that taxpayers who previously made quiet disclosures are now eligible to seek refuge under the 2011 OVDI by submitting an application together with copies of previously filed tax returns to the IRS's voluntary disclosure coordinator on or before August 31, 2011.[99]

Although many practitioners before the release of the 2009 OVDP advocated the use of quiet filings by noncompliant taxpayers, such a course of action in the view of the authors has always been treacherous. Not only do these cases risk potential identification and examination by the IRS, but these submissions do not result in a final Form 906 closing agreement, thus the statute of limitations remains open for at least three to six years, if not longer.[100] Accordingly, the taxpayer is still exposed to IRS civil review of the case with the likelihood of additional penalties as well as a possibility of a referral to the Justice Department for criminal prosecution.

The FAQs encourage those taxpayers who previously made quiet disclosures to make timely, accurate, and complete disclosures while pointing out the risk of being examined and potentially criminally prosecuted for all possible years.[101] The IRS also clarifies that if quiet disclosures are selected for examination, the 25 percent offshore penalty would not be available and that if ''criminal behavior is evident'' and the disclosure does not otherwise meet the requirements under IRM 9.5.11.9, the IRS may recommend criminal prosecution to the Justice Department.[102]

The IRS is crystal clear that those who made quiet disclosures will be subject to the full array of additional penalties, and thus will not be protected by the new 25 percent offshore penalty. Furthermore, the reference to criminal behavior noted above could be interpreted two ways. One argument is that assuming the quiet voluntary disclosure provided a timely, accurate, and complete disclosure (meeting the criteria of IRM 9.5.11.9), it is possible that ongoing criminal behavior will not be evident and that the IRS would not likely make a criminal referral.

The contrary argument is that if the underlying subject matter of the quiet disclosure is imbedded with criminal behavior beyond tax violations, detection of the quiet disclosure package could result in a criminal referral. The FAQs do not provide guidance on the scope of referenced criminal behavior. Therefore, even in the former case, practitioners who advise taxpayers to make quiet filings should seriously revisit these situations and at the very least warn their clients in writing that the IRS has made it clear that if such returns are detected and reviewed, a criminal referral might take place.

John Doe Summons

From a timeliness perspective, the IRS in the 2011 OVDI confirms that the prior issuance of a John Doe summons does not automatically exclude every member of the applicable summons class from participating in a voluntary disclosure.[103] Similar to the situation confronting UBS account holders after the IRS issued a John Doe summons to UBS,[104] this timeliness confirmation in the 2011 OVDI is significant given the impending action against other foreign financial institutions.

The IRS is armed with an enormous treasure-trove of information stemming from the 2009 OVDP, and it is no secret that the IRS and Justice Department are

[97]*See* FAQ 5 for a listing and description of the civil penalties that could apply to a taxpayer outside of the voluntary disclosure context.

[98]FAQs 15 and 16.

[99]FAQ 15.

[100]If an omission of income by a taxpayer on his income tax return constitutes a substantial omission of income, the typical three-year statute of limitations is extended to six years after the income tax return was filed. Section 6501(e)(1). However, if the taxpayer files false or fraudulent tax returns, the three-year statute of limitations never expires and the IRS may assess taxes, interest, and penalties at any time. Section 6501(c)(1).

[101]FAQ 15.

[102]FAQ 16.

[103]FAQ 21.

[104]*In the Matter of the Tax Liabilities of John Doe et al.*, U.S. District Court for the Southern District of Florida, Case No. 08-21864-MC-Lenard/Garber Order, July 1, 2008. On February 19, 2009, the Justice Department petitioned the court to enforce the summons and claimed there were 52,000 UBS U.S. client names that should be produced. This case was settled by all parties on August 19, 2009. *See also* http://www.justice.gov/opa/documents/bank-agreement-consent.pdf. On November 16, 2010, Shulman announced the withdrawal by the IRS of its John Doe summons that was executed on UBS in view of recent success in obtaining requested U.S.-related account holder information stemming from the August 19, 2009, settlement agreement between the U.S., UBS, and the Swiss Confederation. For further discussion of this topic, see *Doc 2010-24513* or *2010 WTD 221-1* and http://www.irs.gov/newsroom/article/0,,id=231520,00.html.

actively mounting attacks on other Swiss and non-Swiss financial institutions to obtain information about noncompliant U.S. account holders.[105] Thus, the IRS is giving taxpayers this last, best chance to enter the system before the U.S. authorities might obtain specific information concerning their identity and foreign asset holdings. The IRS approach to timeliness is generous since a disclosure is arguably no longer ''voluntary'' once there is the imminent threat that a taxpayer's identity will otherwise be detected by the IRS.

However, the IRS also warns that once information is provided under a John Doe summons as evidence of a specific taxpayer's noncompliance, that taxpayer becomes ineligible for voluntary disclosure treatment. The IRS cautions that if a taxpayer has awareness or concern that a party (that is, a foreign bank) served with a John Doe summons might provide information, the taxpayer should submit a voluntary disclosure as soon as possible.[106]

Streamlined Cases

Similar to the guidance released under the 2009 OVDP, the new program also provides a streamlined method for resolving cases in which taxpayers reported all taxable income but failed to file information returns, including FBARs, in prior years to report a foreign financial account.[107] This situation typically arises when the taxpayer has a financial interest, that is, an ownership interest, in a foreign financial account and simply fails to file an FBAR but otherwise reports the income on its tax return.

Alternatively, this situation arises when the taxpayer does not have a financial interest but has signature or other authority over a foreign financial account, such as a foreign financial account owned by an employer. Because the purpose of the voluntary disclosure practice is to provide taxpayers who do not report taxable income to come forward and resolve their tax matters, the IRS directs that if all income was reported and all tax is paid on taxable income but FBARs were not filed, the taxpayer should not use the voluntary disclosure process.

In that case, taxpayers should file delinquent FBARs with the Treasury Department in Detroit, noted in the FBAR instructions, and attach a statement explaining the reasons why reports were not filed.[108] The FAQs state that the IRS will not impose a penalty for failure to file delinquent FBARs so long as there are no underreported tax liabilities and the applicable FBARs are filed by August 31, 2011; provided further that 2010 FBARs are due on June 30, 2011, and must be filed by that date.[109] It is clear that the purpose of this guideline is to carry on the policy of FAQ 9 applicable under the 2009 OVDP for taxpayers who maintain a financial interest in an offshore account.[110]

Similarly, consistent relief is provided for taxpayers who failed to file Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations,'' or Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,'' when no tax is due, and in this case the appropriate late information returns should be filed with the appropriate IRS service center.[111] In the case of a Form 5471, this dilatory return should be submitted with an amended return showing no change to the underlying income tax liability.[112] If these conditions are met, the IRS will not impose a penalty for failure to file information returns, again assuming that there were no underreported tax liabilities and that the returns are filed by August 31, 2011.[113]

Conclusion

The highly anticipated 2011 OVDI has been met with little enthusiasm and far less fanfare than the 2009 OVDP. Although practitioners welcome a structured program and penalty framework for handling the continuing flow of offshore account disclosures, the terms of the program coupled with the administrative difficulties of the 2009 OVDP leave many disappointed.

There are two principal reasons why the 2011 OVDI will not attract the same level of participation enjoyed in the 2009 OVDP. First, the penalty levels mandated by the 2011 OVDI coupled with the inflexible administration of the 2009 OVDP will dissuade noncompliant taxpayers who otherwise might have willingly come forward. Many noncompliant taxpayers may choose to bypass voluntary disclosure and simply dig deeper or seek to unwind their ownership of foreign assets and hope to avoid detection. Second, the aggressive time frame imposed by the IRS will cause many would-be participants to further delay a decision on coming forward. The unrealistic August 31, 2011, deadline for completing all aspects of the disclosure puts taxpayers in a precarious situation. What if they initiate a disclosure but cannot complete the process by the deadline?

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[105] *See* Larry R. Kemm and William M. Sharp Sr., ''Pending Approval of UBS Agreement Threatens to Expose U.S. Account Holders of Other Swiss Banks,'' *Tax Notes Int'l*, May 31, 2010, p. 753, *Doc 2010-10812*, or *2010 WTD 104-12*.

[106] FAQ 21.

[107] FAQ 17. *See also* FAQ 9 in the 2009 OVDP.

[108] FAQ 17.

[109] *Id.* As originally issued, the FAQs used an erroneous due date of August 31, 2010; however, the IRS recently amended the FAQs to reflect an August 31, 2011, due date.

[110] For taxpayers who held only signature authority over a foreign financial account, the IRS extended the due date for filing all delinquent FBARs until June 30, 2011, under Notice 2010-23, 2010-11 IRB 1 (Feb. 26, 2010).

[111] FAQ 17.

[112] *Id.*

[113] *Id.*

They could be devastated by penalties that would not be limited by the protections of the voluntary disclosure program.

Given the ever-increasing access to information on a global basis, there is no doubt that the U.S. government will be successful in its efforts to detect and pursue noncompliant offshore accountholders. Nevertheless, this latest effort to draw taxpayers in voluntarily is unlikely to entice many of the holdouts to come forward. The deadline for submission of all items required for the voluntary disclosure is unreasonable and should be modified immediately. Surely the IRS would be better served to provide an administrable voluntary disclosure program than to rely on investigations and the pursuit of noncompliant taxpayers that will require enormous government resources. ◆