tax notes international

Volume 67, Number 7 ■ August 13, 2012

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Reprinted from *Tax Notes Int'l*, August 13, 2012, p. 681

SPECIAL REPORTS

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The authors gratefully acknowledge the review comments of their colleague David S. Barnhill.

On January 9, the IRS announced yet another offshore tax compliance program as a follow-up to the predecessor compliance programs released in 2009 and 2011.[1] When Commissioner Douglas Shulman announced in February 2011 the release of the 2011 offshore voluntary disclosure initiative (2011 OVDI), he warned that the 2011 program was the ''last, best chance'' for U.S. taxpayers to become compliant.[2] Given the release of the 2012 offshore voluntary disclosure program (2012 OVDP), the earlier program may have been the ''best'' chance to seek compliance given the new program's penalty increases, but certainly was not the ''last chance'' to become compliant in light of the new program. Commissioner Shulman also recently announced that the two predecessor initiatives resulted in the collection of more than $5 billion in taxes, interest, and penalties.[3] This collection tally will most certainly increase given that the 2011 program is still processing many cases, with 95 percent of the cases from the 2009 program closed.[4] And clearly the 2012 program will add more to this treasure trove.

Contrary to its predecessor compliance programs, the new initiative has no ''last chance'' deadline, although the IRS ominously warned that the new program could be terminated at any time or in lieu of termination the program's terms could be modified, presumably to the detriment of the noncompliant taxpayer seeking relief. The 2012 OVDP represents a substantial improvement over its prior two predecessor initiatives by eliminating the overaggressive time frames imposed by the IRS under those programs. The good news here is that the IRS apparently recognized that unreasonable and unattainable deadlines in the context of technically intricate offshore compliance programs are not productive administrative compliance tools.[5]

[1]IR-2012-5, *available at* http://www.irs.gov/newsroom/article/0,,id=252162,00.html. *See also* IR-2011-14, *available at* http://www.irs.gov/newsroom/article/0,,id=235695,00.html; and ''Memorandum for Commissioner, Large and Mid-Size Business Division, Commissioner, Small Business/Self-Employed Division,'' *Doc 2009-6775* or *2009 WTD 57-32.* The above-mentioned voluntary disclosure programs were preceded by the 2003 Offshore Voluntary Compliance Initiative, Rev. Proc. 2003-14, 2003-11 C.B. 311, and the Last Chance Compliance Initiative, IRS Letter 3549 (rev. 6-2003).

[2]IR-2011-14.

[3]IR-2012-64, *available at* http://www.irs.gov/newsroom/article/0,,id=258430,00.html.

[4]IR-2012-5, *supra* note 1.

[5]*See* William M. Sharp Sr., Larry R. Kemm, and Andrea D. de Cortes, ''The 2011 Voluntary Disclosure Initiative: Truly the 'Last, Best Chance'?'' *Tax Notes Int'l*, Mar. 14, 2011, p. 865, *Doc 2011-3931*, or *2011 WTD 49-11*. The 2009 OVDP was announced on March 23, 2009, and taxpayers participating in that program were required to submit the required notification to the IRS initially by the September 23, 2009, deadline, which was extended by the IRS to October 15, 2009, only two days before the original deadline. The terms of the 2011 OVDI announced on February 8, 2011, initially required taxpayers to submit a completed voluntary disclosure package to IRS Civil by August 31, 2011 (extended to September 9, 2011, because of Hurricane Irene); however, taxpayers were eventually allowed to apply for a 90-day

(Footnote continued on next page.)

Despite this ''no deadline'' improvement, the 2012 OVDP's penalty framework continues the inherently defective and inflexible penalty mandates of both the 2009 and 2011 initiatives. Not surprisingly, the new overall offshore penalty is ratcheted up to 27.5 percent in comparison with 25 percent in the 2011 initiative and before that 20 percent in the 2009 program. The authors previously have voiced concern over this inflexible and inappropriate one-size-fits-all penalty framework.[6] Although the IRS has made some progress in moderating the penalty framework in its recently released Frequently Asked Questions[7] for certain classes of taxpayers, these limited exceptions fall woefully short of an equitable and due-process-driven approach for penalty determination.[8] The fallout of this one-size-fits-all penalty framework necessitates in appropriate cases an opt-out of the 2012 program in which a more legally appropriate result should be achieved in the follow-up IRS examination, or if not resolved, then in IRS Appeals and if necessary U.S. Tax Court or other federal court litigation.

In addition to eliminating the last chance deadline and continuing the inflexible penalty framework, the new program institutes a series of new guidelines designed to enhance efforts of the IRS and Justice Department to pursue criminal prosecution of international tax evasion as well as to support the government's continuing efforts to combat offshore tax noncompliance by bringing American taxpayers back into the U.S. tax system. As discussed below, the 2012 program requires a more significant level of disclosure to arm the IRS and the Justice Department with a fresh arsenal of information to combat offshore tax evasion and avoidance. The FAQs and the new version of the offshore voluntary disclosures letter enable the IRS to gather and develop from applying noncompliant taxpayers more information and documentation regarding offshore compliance of not only the applicants themselves but also those playing an advisory role, such as bankers, fiduciaries, attorneys, accountants, return preparers, or corporate service providers and others, both within and outside the United States.

Separate but related to the 2012 OVDP and the new FAQs, on June 26, 2012, the IRS announced a new program intended to assist U.S. citizens residing overseas, including dual citizens, to catch up on U.S. tax filing obligations (the Overseas Americans Program).[9] Although the details of this program will not be released until sometime before the stated September 1, 2012, effective date, Commissioner Shulman recognized that a special protocol is required for Americans living overseas to provide for ''a series of common-sense steps to help U.S. citizens abroad get current with their tax obligations and resolve pension issues.''[10]

The Overseas Americans Program will be separate from the 2012 OVDP and will generally apply to Americans living overseas who are low compliance risks and who generally will have simple tax returns with $1,500 or less in tax for any of the covered years. Eligible taxpayers would be required to file tax returns along with appropriate related information returns for the past three years as well as to file delinquent FBARs for the past six years. The IRS notes that these submissions will be more significantly scrutinized than submissions made under the 2012 OVDP, but the good news is that most penalties should be waived.[11] Importantly, the new program will be in lieu of participation in the 2012 OVDP; this point raises several issues as to how pending as well as closed voluntary disclosure cases relate to this new program.

This article discusses the most significant aspects of the 2012 OVDP and the FAQs, focusing on variations from the predecessor compliance programs. It also provides constructive criticisms regarding the new program and the FAQs with the hope that the IRS will modify the 2012 program to provide a more legally sound and equitable program. Finally, it discusses the Overseas Americans Program and how it should be crafted to maximize U.S. tax compliance and fairness to participants.

Overview of Key Differences

The FAQs explain the differences between the 2012 OVDP in comparison with the earlier compliance initiatives as well as the relationship to the traditional and long-standing voluntary disclosure practice of IRS CI. As noted above, one of the primary differences between the new initiative and the prior programs is the absence of a set deadline for taxpayers to apply for

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extension in which to submit the completed voluntary disclosure so long as their initial disclosure to IRS CI and extension request were received by the September 9, 2011, deadline. The deadlines imposed under the 2009 OVDP and the 2011 OVDI were designed to prod noncompliant taxpayers into compliance, but in reality these shortsighted deadlines did not seem to achieve this objective in light of what appears to be a substantial community of noncompliant taxpayers. If anything, these unwarranted deadlines forced applying taxpayers' legal counsel to unduly rush intricate and technical analysis of client cases with the resulting hastily submitted case files to the detriment of both the IRS and the applying taxpayers. For a discussion of the 2009 program, see Sharp and Kemm, ''IRS Guidance on Offshore Voluntary Disclosures: Further Refinements,'' *Tax Notes Int'l*, May 18, 2009, p. 595, *Doc 2009-10774*, or *2009 WTD 95-8*.

[6] Sharp et al., *supra* note 5, at 868.

[7] The IRS released the 2012 OVDP FAQs on June 26. Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers, *available at* http://www.irs.gov/businesses/small/international/article/0,,id=256774,00.html.

[8] *See* Sharp et al., *supra* note 5, at 867-868.

[9] IR-2012-65, *available at* http://www.irs.gov/newsroom/article/0,,id=258431,00.html.

[10] *Id.*

[11] *Id.*

relief under the 2012 OVDP. As further noted above, the IRS warns that the penalty framework may be increased and eligibility may be narrowed for certain classes of taxpayers and in the end the IRS may decide to end the program entirely.[12] Further, the IRS clarifies that the current program is a counterpart to the traditional voluntary disclosure practice of IRS CI.

Although the FAQ guidance is somewhat ambiguous on the application under the traditional voluntary disclosure practice versus the application under the 2012 OVDP, the guidance suggests that if a taxpayer with undisclosed offshore accounts or assets is otherwise eligible to apply under the IRM 9.5.11.9 voluntary disclosure practice, such taxpayers also may apply for relief under the 2012 OVDP penalty regime.[13] FAQ 19 states that a taxpayer who made a voluntary disclosure after September 9, 2011, but before January 9, 2012, is eligible for the OVDP, so long as the applicant otherwise meets the requirements of IRM 9.5.11.9.

Similar to the earlier FAQ guidance in the 2009 and 2011 compliance programs, the new FAQs include the laundry list of the relevant civil penalties that could arise in case a noncompliant taxpayer does not seek relief under the 2012 OVDP and is subsequently examined by the IRS. FAQ 5 updates this list to include penalty exposure for failure to file Form 8938 beginning with the 2011 tax year as required by section 6038D.[14]

Both the 2009 and 2011 compliance initiatives required participating taxpayers to supply an extensive list of tax return, information return, and related data and information, including copies of previously filed tax returns as well as amended tax returns along with information reporting forms. The new program continues this mandate with some additional items to be included in the new package, including an agreement to cooperate with IRS offshore enforcement efforts by providing information and documentation pertaining to offshore financial institutions, offshore service providers, and other facilitators upon request by the IRS.[15]

Given the pre-closing agreement and post-closing agreement interviews conducted by the IRS as well as the Justice Department over the past year-plus, this new provision seems to put taxpayers on notice that the government will continue to seek cooperation even after the closing agreements are long completed. Based on past experience, the focus of such interviews is to develop additional information and documentation regarding the foreign and domestic bankers, fiduciaries, lawyers, and other advisers.

One of the key issues is whether and to what extent the government has the legal authority to compel such a taxpayer interview. The preferred course of conducting the interview is for counsel to provide an attorney proffer to the government interviewers after receipt of confirmation that the interviewee is merely a witness (and not a target or subject). In some cases the government will press for an in-person interview, but in general these should not be compelled given that the spirit of cooperation is voluntary by the inherent nature of the voluntary disclosure program.

[12]FAQ 3.

[13]FAQ 12.

[14]The penalty for failure to file each one of these information returns is $10,000 with an additional $10,000 added for each month the failure continues, beginning 90 days after the taxpayer is notified of the delinquency with a maximum of $50,000 per return. Form 8938 requires taxpayers to report their interest in certain foreign financial assets, including foreign financial accounts containing certain foreign securities as well as ownership interests in foreign entities and other foreign-related assets.

[15]FAQ 7.

Domestic Tax Compliance Issues

In some voluntary disclosure cases the noncompliant taxpayer not only has offshore-related noncompliance through the use of undisclosed foreign financial accounts or other foreign financial assets but also related or even unrelated domestic tax issues. For example, the noncompliant taxpayer with an undisclosed foreign financial account might also have claimed false tax deductions on Schedule A or mischaracterized long-term capital gains instead of short-term capital gains on Schedule D. The new IRS guidance clarifies that even if the domestic-related elements are unrelated to the offshore aspects of the case, the relevant taxpayer should still disclose both the offshore and domestic issues as a part of the 2012 OVDP.[16] Although the new guidance states this was the case in the 2009 OVDP and the 2011 OVDI, the guidance relevant to those programs did not include this specific reference. Consistent with FAQ 7.1, taxpayers making both offshore voluntary disclosure and domestic voluntary disclosure submissions should follow the 2012 OVDP process.[17]

Voluntary Disclosure Period

The new guidance clarifies that the eight-year disclosure period covers the most recent tax years for which the due date has already passed, and this eight-year time frame does not include current years for which there has been no noncompliance.[18] For example, for taxpayers who disclose after the due date or the extended due date for 2011 (that is, after April 15, 2012, or October 15, 2012), the disclosure time frame must include the 2004 through 2011 tax years. The FAQs establish in effect a rolling eight-year time frame depending on the timing of the disclosure relevant to the due date or extended due date.

[16]FAQ 7.1.

[17]FAQ 24.

[18]FAQ 9.

The new guidance clarifies that the eight-year time frame will not include any compliant years in which the taxpayers timely filed original compliant returns that fully reported previously undisclosed offshore accounts or assets before making the voluntary disclosure. Accordingly, if a taxpayer files compliant returns for 2009 and 2010, but noncompliant returns for earlier years, then the voluntary disclosure period will be 2003 through 2008.

Narrowing OVDP Eligibility

The 2012 OVDP imposes heightened restrictions to eligibility for noncompliant taxpayers to participate in the new program. In general, taxpayers with undisclosed offshore accounts or assets who otherwise meet the requirements of IRM 9.5.11.9 are eligible to apply for the IRS CI's voluntary disclosure practice and the 2012 OVDP penalty regime, subject to certain restrictions on eligibility and certain limitations, as discussed below.

Consistent with the 2009 and 2011 guidance, the new FAQs allow entities such as corporations, partnerships, and trusts to participate in the OVDP.[19] Not surprisingly, and also consistent with the 2009 and 2011 guidance, any taxpayer already under IRS examination is ineligible to participate in the new program, and any taxpayer under criminal investigation is similarly ineligible.[20]

Also consistent with the predecessor compliance programs, the penalty framework of the 2012 initiative is not available to taxpayers who have filed ''quiet'' disclosures by filing amended returns and paying any related tax and interest for the previously unreported offshore income but without otherwise notifying the IRS.[21] The FAQs state that quiet taxpayers may, however, cure previously made quiet disclosures by submitting an application under the 2012 OVDP along with all required elements thereof. The FAQs again encourage taxpayers who submitted quiet filings to come forward to avoid the risk of being examined and potentially being criminally prosecuted for all applicable years.[22]

Eligibility Hazards — Overview

The 2009 and 2011 compliance programs addressed in their FAQs the relationship of a John Doe summons and program eligibility but did not address the issue of what happens when the U.S. government makes a request for administrative assistance under an income tax treaty or a tax information exchange agreement. Consistent with the John Doe summons guidance in the predecessor programs, the 2012 OVDP guidance specifies that the mere fact that the IRS initiates a treaty request or takes similar action does not make every member of the class or group identified in the treaty request ineligible to participate in the voluntary disclosure program.[23] However, once the requested information is obtained and this information includes evidence of a specific taxpayer's noncompliance with not only Title 26 but also Title 31 reporting requirements, then such a taxpayer will become ineligible under both the 2012 OVDP as well as the IRS CI's traditional voluntary disclosure practice.[24]

The above warning regarding treaty requests and similar undertakings comes as no surprise given the ongoing efforts of the IRS and Justice Department to seek information from various Swiss, Liechtenstein, Israeli, and other foreign jurisdictions' banks regarding U.S. taxpayer/customer relationships. For example, on May 11, 2012, the Justice Department served a request for administrative assistance under the Liechtenstein-U.S. TIEA to the Liechtenstein government regarding undeclared accounts at Liechtensteinische Landesbank AG.[25] The purpose of this new guidance is to provide a warning to U.S. taxpayers with undisclosed financial account relationships with such banks. Once the administrative assistance is granted and the turnover of information occurs to the U.S. government, affected taxpayers will no longer be in a position to meet the timeliness requirement set forth in the voluntary disclosure program.[26]

The new guidance further expands the grounds to render a taxpayer ineligible based on two separate scenarios, as discussed below.

Eligibility Hazards

Foreign Turnover Proceedings

The first scenario involves a U.S. taxpayer appeal of a foreign tax administration's decision to authorize the handover of offshore account information to the IRS, assuming the taxpayer fails to serve notice as required under 18 U.S.C. section 3506 of such appeal on the U.S. attorney general. This notice must be given at the time of the appeal, and if this notice is not given, the taxpayer is ineligible to participate in the 2012 OVDP.[27]

Targeted Offshore Financial Institutions

The second scenario that can render a taxpayer ineligible is somewhat more generalized but certainly

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[19]FAQ 13.

[20]FAQ 14.

[21]FAQ 15.

[22]*Id.*

[23]FAQ 21.

[24]*Id.*

[25]*See* Kemm, Sharp, and William T. Harrison III, ''Liechtenstein and the U.S.: The Long Road to Full Disclosure,'' *Tax Notes Int'l*, July 23, 2012, p. 355, *Doc 2012-14573*, or *2012 WTD 148-16*.

[26]*Id.*

[27]FAQ 21. Further, the notice must include all relevant documents relating to the appeal.

ominous. Under this scenario the IRS has the latitude to announce that certain taxpayer groups that have previously maintained accounts at specific targeted financial institutions will be ineligible because of U.S. government actions (not just IRS) directed to the specific targeted financial institution. The only saving grace of this specific ground for ineligibility is that the IRS announcements will provide notice of the ''prospective date'' upon which eligibility for the targeted taxpayer groups will be in danger.[28]

As noted above, the U.S. government reportedly is aggressively investigating several Swiss, Israeli, Liechtenstein, and other foreign jurisdictions' banks regarding their activities involving the tax noncompliance of U.S. taxpayers. Accordingly, it would come as no surprise if specific targeted financial institutions were deemed to taint a particular taxpayer's eligibility for voluntary disclosure if the submission is not made before an announced warning date. As noted above, the Justice Department served a request for administrative assistance on the Liechtenstein government in May 2012 under the Liechtenstein-U.S. TIEA. Even though this treaty request has been served and is being actively processed by the Liechtenstein government, the IRS has not listed (as of press time) this financial institution as a targeted bank under this particular FAQ.

Pre-Clearance and OVD 'Letter' Changes

In general, the 2012 OVDP continues the pre-clearance and then full voluntary disclosure submissions steps that were applicable in the 2011 OVDI. The new guidance clarifies that in the case of jointly filed returns, each spouse should request pre-clearance if the intent is to include both spouses.[29] The new guidance also allows spouses to either pursue the case jointly or separately.[30] The new guidance also clarifies the submission procedure of the offshore voluntary disclosure letter, as discussed below.

Deadlines

From a timing perspective, the new guidance explains that IRS CI intends to complete its review within 45 days of receipt of the offshore voluntary disclosure letter. Accordingly, the criminal phase will generally consume about 90 days of effort, given that the offshore voluntary disclosure letter must be submitted within 45 days of the pre-clearance notice being issued, plus the follow-on 45 days of review of the offshore voluntary disclosure letter by the IRS.

Also from a timing perspective, the complete IRS civil package must be submitted to the Austin, Texas, IRS campus within 90 days of the date of the preliminary acceptance letter issued by IRS CI.[31] Fortunately, the new guidance provides that an extension may be requested for an additional 90 days within which to submit the civil package for the case. The extension request must be submitted before the 90th day set forth in the IRS CI clearance letter.[32] This will be of particular importance in complex noncompliant offshore structures with foreign financial holdings in which the federal tax reconstruction and related legal analysis requires additional time and effort.

Bifurcation of Domestic vs. Offshore

Under the new program, the IRS requires taxpayers to submit all domestic noncompliance issues as a part of the offshore noncompliance case even if the domestic element is not directly related to the offshore case. The offshore portion of the voluntary disclosure will not ordinarily be subject to a full IRS examination; instead, the voluntary disclosure will be subject to a certification review, and according to the new guidance, this review is less formal than an examination and thus does not implicate the rights and legal consequences of an IRS examination.[33] Similar to the prior guidance, the ''certifying'' examiner will be allowed to ask any relevant questions, request any relevant documents, and if necessary even make third-party contacts in order to ''certify the accuracy'' of these submissions without treating this process as an examination.[34]

The FAQs also provide new guidance indicating that if a domestic voluntary disclosure is included as a part of the offshore case, the domestic disclosure will be treated as a disclosure under the IRS long-standing voluntary disclosure practice rather than the 2012 OVDP and an examination may be opened for the domestic part of the disclosure.[35] This represents a major hazard because the IRS could expand the number of years under review and increase the penalty base well beyond the OVDP's package terms although such an expansion would seem contrary to the IRS's long-standing voluntary practice to review only the past six years and also to take all relevant factors into account, such as reasonable cause to mitigate penalties.

Absence of Beneficial Ownership

Similar to the predecessor programs, the 2012 OVDP includes guidance regarding a foreign financial account in which a taxpayer has mere signature authority and does not have any financial interest in such

[28]*Id.*

[29]FAQ 23.

[30]FAQ 24.1.

[31]FAQ 25. Note that the IRS now requires that payment of the tax, accuracy penalty, and interest be mailed to a separate department at the IRS campus in Austin, Texas.

[32]FAQ 25.1.

[33]FAQ 27.

[34]*Id.*

[35]*Id.*

account. Assuming the taxpayer has other tax noncompliance, the guidance allows the taxpayer to cure the FBAR delinquency for such account by filing the FBAR with an explanatory statement, provided however, this action must be completed before any contact is made by the IRS or other governmental agency regarding an income tax examination or a request for delinquent returns.[36] This timing aspect is a new qualification in the 2012 FAQs.

Continuation of 'No Discretion'

Unfortunately, the 2012 OVDP guidance continues the harsh limitation of the 2011 program and the post-FAQ 35 reversal of the 2009 program by flatly stating that offshore voluntary disclosure examiners ''do not have discretion to settle cases for amounts less than what is properly due and owing.''[37] The IRS then explains that because the 27.5 percent offshore penalty is a proxy for the FBAR penalty and other penalties imposed under Title 26, there may be cases when a taxpayer making a voluntary disclosure would owe less if the 2012 OVDP penalty framework did not exist. Along these lines, the IRS indicates that under no circumstances will taxpayers be required to pay a penalty greater than the amount they would otherwise be liable to pay under the maximum penalties imposed under existing statutes.[38] This statement is a continuation of the old program guidance, and the IRS provides helpful updated examples to illustrate this application. This is a key area that practitioners need to closely review because the maximum penalties could be significantly less under existing statutes versus the program.

Regarding the 27.5 percent offshore penalty, this inflexible one-size-fits-all IRS penalty framework for all offshore voluntary disclosure cases simply defies logic. The IRS once again has failed to take advantage of an opportunity to institute a legally appropriate and factually fair system by which the 27.5 percent penalty is administered on a graduated basis depending on the level of willfulness, as determined by a combination of objective and even certain subjective factors. Disabling the voluntary disclosure examiners from having any discretion is simply poor tax administration. Further, this denial of any examiner discretion means that a more substantial pool of voluntary disclosure participants will be forced to opt out and argue their positions through an IRS examination, IRS appeals, and eventually Tax Court or federal district court litigation. Voluntary disclosure cases that clearly involve at most mere negligence and not willfulness will likely clog IRS examination resources, as well as IRS appeals and the judiciary for many years to come.

The IRS should immediately reconsider an alternative to FAQ 50 based on a legally appropriate and factually fair framework. To this end, the IRS has allowed reduced 5 percent and 12.5 percent penalty amounts under some circumstances and recently announced the upcoming Overseas Americans Program to be effective by September 1, 2012 (which can result in reduced penalties). However, the IRS has not gone far enough, and further consideration of facts surrounding willfulness should be allowed and discretionary authority vested in examiners.

When to Opt Out?

The new program offers guidance by way of additional examples of circumstances under which a taxpayer might consider opting out of the civil settlement structure. Similar to the 2011 program, the guidance reinforces that opting out of the civil settlement structure does not affect the status of a taxpayer's submission under the traditional voluntary disclosure practice, and thus IRS criminal protection should still apply. The new examples assume that the voluntary disclosure started in January 2012 and therefore affects the 2003 through 2010 tax years, with the implication that 2011 is being filed in a compliant manner.[39]

Dual Citizen Examples

One of the FAQ's new scenarios to the opt-out portion of the 2012 OVDP provides additional guidance for the so-called dual citizen of the U.S. and a foreign country and offers insight as to the likelihood that the IRS would assert accuracy-related and FBAR penalties. This example references IRS Fact Sheet 2011-13[40] and also references the New Filing Compliance Procedures for Non-Resident U.S. Taxpayers (defined above as the Overseas Americans Program) to determine whether such dual citizen taxpayers qualify for the new procedure, as discussed below.

In one of the new examples, the taxpayer is a dual citizen of the U.S. and a foreign jurisdiction and lived and worked in the non-U.S. jurisdiction for 10 years.[41] The taxpayer had no income from U.S. sources during the 10 years of working abroad and maintained a checking and savings account in the foreign jurisdiction with an aggregate balance of approximately $50,000 each year. Most importantly, the taxpayer complied with the foreign jurisdiction's tax laws and fully reported his salary as well as foreign financial account interest income.

The example indicates that the taxpayer earned income in excess of the applicable exemption amount

[36]FAQ 38. If there is no tax noncompliance, FAQ 17 provides a similar procedure.

[37]FAQ 50.

[38]*Id.*

[39]FAQ 51.1.

[40]IRS Fact Sheet, *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.,* FS-2011-13 (Dec. 2011), *available at* http://www.irs.gov/newsroom/article/0,,id=250788,00.html.

[41]FAQ 51.1, Example 4.

(presumably referring to not only the standard exemption but perhaps also the section 911(a) foreign earned income exclusion) but did not timely file U.S. income tax returns or FBARs for the 10 years he lived abroad. The taxpayer ''learned of his U.S. filing obligations,'' although the example doesn't say exactly when this revelation occurred, and thereafter immediately consulted with counsel who appropriately determined that the taxpayer would not qualify for the expedited procedure under FAQ 17 because of the omission from gross income of the foreign-source salary and passive income associated with the foreign financial account. Presumably based on the advice of counsel, the taxpayer applied for voluntary disclosure treatment under the 2012 OVDP and reported tax for each year, and he also filed delinquent FBARs.

The IRS concludes that the taxpayer qualifies for a reduced penalty of 5 percent under FAQ 52, and therefore the offshore penalty will be 5 percent of $50,000 or $2,500. Under the package terms of the 2012 OVDP, the taxpayer also would be required to pay the tax deficiency for each year, together with a 20 percent accuracy-related penalty. The example goes on to state that if the taxpayer elects to opt out, the taxpayer would still be required to pay the tax deficiency and interest thereon regarding the unreported income but ''upon examination, IRS is not likely to assert accuracy related or FBAR penalties.''[42]

This example illustrates possible penalty abatement by the IRS upon opting out of the 2012 OVDP, and this lenient treatment presumably would be based on a factual finding that the taxpayer did not intentionally and voluntarily disregard a known legal duty to file U.S. income tax returns as well as FBARs, and that if anything, the taxpayer's conduct was negligent. The discussion of the degree to which a taxpayer is deemed to be willfully in violation of U.S. tax law versus mere negligence is beyond the scope of this article. However, it is worth noting that the sophistication of the taxpayer would need to be examined, including his education, experience, expertise in tax and accounting matters, and general background, as well as analyzing the particular facts and circumstances of each element of the specific case.

For example, in the above example, the taxpayer worked abroad for at least 10 years and had no U.S.-source income during this 10-year period. This suggests that the U.S. taxpayer had cut ties with the U.S. Compliance with the applicable foreign jurisdiction's tax laws is also a crucial factor. It is not clear from the example when the taxpayer learned of his required U.S. filing obligations, but the way the example is drafted one can infer that the taxpayer was unaware of these obligations during the 10 years while living abroad (the reference to ''after learning of his U.S. filing obligations'' suggests that the taxpayer may have been unaware of the requirement to continue to file U.S. tax returns and FBARs). Many times Americans who live abroad and file foreign tax returns genuinely believe such filings are in lieu of a U.S. filing obligation.

In contrast, new example 5 is based on the same facts as mentioned above in FAQ 51.1 except that the taxpayer also owned interests in offshore entities for which forms 5471 or 3520 should have been filed, and the value of such unreported offshore entities was approximately $200,000 each year. The fact pattern also notes that the taxpayer acquired his interest in the unreported offshore entities with tax-compliant funds and the entities' assets did not produce any income.

Because relief under FAQ 18 would not be available because of the presence of unreported foreign-source income, the taxpayer was forced to pursue a voluntary disclosure. The example walks through the applicable offshore penalty of $2,500 (that is, 5 percent of $50,000) and the likely application of the package terms to pay the tax deficiency, along with a 20 percent accuracy-related penalty (which as noted should be the delinquency penalty due to the nonfilers status) on the tax deficiency. Finally, if the taxpayer elects to opt out, the taxpayer would still be subject to tax and interest on unreported income, but the IRS is not likely to assert the accuracy-related penalty, FBAR, or other information reporting penalties on examination.

Because this example is premised on the same facts as the earlier example above, it is likely that the taxpayer initially learned of his U.S. filing obligations just before retaining counsel and entering the voluntary disclosure program. What if the taxpayer knew this all along? At what point does mere negligence cross over into willfulness, that is, an intentional violation of a known legal duty? This is the reason substantial due diligence must be undertaken in each case to recognize that if the taxpayer pursues this course of voluntary disclosure that on opting out the taxpayer will be subject to severe examination testing.

The examples provided in FAQs 52 and 53 pertaining to qualification for the reduced 5 percent and 12.5 percent offshore penalties remain essentially unchanged from the 2011 OVDI, with the exception that the IRS has now specifically stated that a taxpayer who would otherwise qualify for reduced offshore penalty treatment will not be guaranteed such treatment if the taxpayer elects to opt out of the 2012 OVDP.

Canadian RRSP Update

The 2012 OVDP guidance also addresses the issue of how to treat Canadian registered retirement savings plans (RRSP) under which a timely election under

[42]*Id.* This example erroneously states the accuracy-related penalty. Because this involves a nonfiler, the correct penalty is the delinquency penalty.

Article XVIII(7) of the Canada-U.S. income tax treaty was not made to defer the income earned on the retirement account.[43]

For those taxpayers participating in the 2012 OVDP, the taxpayer must submit a statement requesting an extension to make the election to defer income tax and also provide Forms 8891 for each of the tax years and the type of plan covered under the voluntary disclosure. Further, the taxpayer must submit a dated statement signed under penalties of perjury to explain what events occurred that led to the failure to make the election, what events occurred that led to the discovery of the failure, the nature and extent to which the taxpayer relied on a professional adviser, including a discussion of the nature of the adviser's engagement and responsibilities, and presumably any other information that is requested by the IRS. Upon receipt of this requested information, the case will be assigned to an IRS examiner, and this examiner will be the reviewing person and will provide the taxpayer further instructions on making the election if warranted.

Note that the new guidance indicates that making this election does not preclude a taxpayer from opting out of the civil settlement structure of the program.[44] Further, if the election is granted, the Canadian retirement plan or similar retirement arrangement will not be included in the offshore penalty base.[45] The new guidance also provides for direction for those taxpayers who are participating in the 2011 OVDI as well as for those who participated in the 2009 OVDP and whose cases have not yet been closed and resolved. In the latter case, if the taxpayer now wishes to make an election, the taxpayer should provide the statement as described above plus all other information, including the name of the examiner assigned to the case and a copy of the closing agreement, with the package to be sent to the IRS Service Center in Austin with the attention ''2009 OVDP Determination.''

Those taxpayers who maintain retirement or pension plans in a foreign country other than Canada who believe that the foreign retirement or pension plan should be not included in the new program's offshore penalty base are directed to contact the OVDI hotline.[46]

New Compliance Procedures

The IRS first indicated in December 2011 that it would provide guidance and new procedures for U.S. taxpayers living abroad who have failed to file U.S. tax returns for one or more years.[47] Recently, the IRS issued such guidance in IR-2012-65, which describes new procedures for filing delinquent U.S. federal income tax returns and FBARs by nonresident U.S. taxpayers, including dual citizens. The newly announced procedures, however, are not effective until September 1, 2012, apply only to a limited group of income earners, and lack critical details concerning how the new procedures will be applied. Thus, although arguably a step in the right direction, these procedures as announced are nothing to cheer about assuming the IRS fails to implement flexible, broad, and inclusive conditions for participation in this new initiative.

Under the basic terms of the new compliance procedures, a U.S. taxpayer currently living abroad may file delinquent U.S. federal income tax returns for the past three years and file delinquent FBARs for the past six years. If the taxpayer presents a low compliance risk, the IRS will process such returns with an expedited review and will neither assert penalties nor pursue follow-up actions against the taxpayer.

For this purpose, a taxpayer is deemed to be ''low risk'' if the tax returns submitted under the program show less than $1,500 of tax due in each year. However, even though the tax due in each year may be less than $1,500, the taxpayer will not be considered low risk as the income and assets of the taxpayer rise, if the taxpayer has implemented sophisticated tax planning, or if there is material economic activity in the U.S. Moreover, a history of prior U.S. tax noncompliance as well as the type and amount of U.S.-source income might affect the taxpayer's risk profile, thereby rendering the taxpayer ineligible to use the new procedures.

If a taxpayer is not determined by the IRS to be low risk, the IRS will assess tax, interest, and penalties in accordance with applicable U.S. tax law. Curiously, the announced procedures require taxpayers to submit a dated signed statement under penalties of perjury to explain any reasonable cause for previous failures to file tax returns, information returns, and FBARs.[48] Since the procedures only are available to taxpayers with a determined low-risk profile, it is not clear whether the relief from penalties for taxpayers with less than $1,500 of tax due in each year is subject to the IRS's scrutiny of any reasonable cause explanations.

If the government's objective is to entice nonresident U.S. taxpayers to come forward and become compliant, these new procedures will likely be a failure. First, the threshold at which taxpayers become ineligible for the new procedures is simply too low. At current tax rates, a U.S. taxpayer could reach the $1,500 tax threshold with as little as $5,000 of previously untaxed income (that is, income for which U.S. tax is not offset by foreign tax credits).

[43]FAQ 54.

[44]*Id.*

[45]FAQ 54.1.

[46]FAQ 55.

[47]*See* IRS Fact Sheet, *supra* note 40.

[48]Additional requirements are imposed for taxpayers seeking relief under the new procedures for failure to timely elect deferral of income from certain retirement or savings plans when deferral is permitted by treaty.

Second, a U.S. taxpayer with less than $1,500 in tax due is still not assured that he is eligible to file under the new filing compliance procedures. Specifically, as noted above, a taxpayer may not be treated as low risk if other high-risk factors exist. Notably, such high-risk factors include a substantial amount of income or assets. Thus, a successful individual who regularly pays enough taxes in another country to substantially cover his U.S. tax liability through foreign tax credits may nevertheless be ineligible for the new procedures even though the residual U.S. tax liability is less than $1,500.

Third, the newly announced procedures expressly do not provide protection from criminal prosecution. The IRS release indicates that even with the filing of returns under the new procedures, a person nonetheless may be prosecuted if the IRS and Justice Department determine that prosecution is warranted under the circumstances.

Moreover, once a taxpayer submits returns under the new procedure, the taxpayer is no longer eligible to participate in the 2012 OVDP (but no reference is made to the IRS voluntary disclosure practice). This puts a significant premium on determining whether a taxpayer has circumstances that warrant prosecution. Tax practitioners would be well advised to steer their clients away from the new compliance procedures if there is even a hint that the circumstances might warrant prosecution. Unfortunately, in today's environment it is difficult to predict what the IRS or Justice Department might consider circumstances warranting prosecution relative to tax noncompliance associated with offshore assets and income.

Many of these nonresident U.S. taxpayers are not even on the IRS radar screen. For example, consider an individual born in the U.S. who moves abroad as a young child. Although that individual may have spent the better part of his life paying taxes in another country, through neglect or lack of knowledge he may not have filed U.S. tax returns and paid U.S. tax. The same reasoning extends to an American taxpayer who moved abroad many years or even decades ago, and lost all connectivity with the U.S. but at the same time followed all applicable local country tax and other legal requirements. The new procedures provide little incentive for such individuals to come forward, particularly when the IRS states that there will be no protection from criminal prosecution. Moreover, even if the U.S. government randomly discovers the existence of such a person, there are hurdles to effectively enforce U.S. criminal tax statutes from abroad. Thus, the new procedures do little to provide incentives for such individuals.

Finally, the IRS states:

> additional information regarding the specific factors the IRS will use to assess the level of compliance risk, and how information regarding those factors should be presented in the submission, will be released prior to the effective date of the new procedure.[49]

As a result, there are substantial unknowns at this point as to how the new procedures will be administered. Accordingly, the U.S. taxpayers living abroad are left wondering what to do as the IRS dribbles out the guidance over time.

Another question is whether taxpayers who either completed a voluntary disclosure under the 2009 and 2011 programs or are currently pursuing a voluntary disclosure may seek relief under these new compliance procedures in appropriate circumstances. Under both the 2009 and 2011 programs, the IRS maintained that a taxpayer could not avoid the miscellaneous offshore account penalty if there was any unreported income for the years at issue. It seems unjust that taxpayers who came forward under the prior voluntary disclosure programs should be subject to arguably excessive penalties when they may have avoided them entirely by holding out until these new more favorable procedures became available.

Despite the laudable goal of providing relief to nonfilers living abroad and procedures for coming into compliance, these newly announced procedures are not likely to draw a large response. To the extent U.S. taxpayers do take advantage of such procedures, they may achieve higher compliance objectives but will have little impact on government fiscal management because of the low-tax threshold at stake.

Conclusion

The 2012 OVDP's refinement of the penalty framework as applied to certain classes of taxpayers together with the newly introduced Overseas Americans Program demonstrate progress on the part of the IRS in developing an equitable and due-process-driven approach for penalty determination under the voluntary disclosure program. However, the new program's continued use of an inflexible penalty framework for *most* OVDP applicants is ill advised. Further, this one-size-fits-all penalty protocol likely will clog the exam, appeals, and judicial systems with unnecessary opt-out cases in which taxpayer willfulness does not exist. On a more favorable note, the IRS appears to be providing noncompliant offshore taxpayers with an ongoing as opposed to a deadline-based last chance remedial program.

Tax practitioners should closely review the 2012 OVDP FAQs and the terms of the Overseas Americans Program once they are announced because despite the increased financial exposure associated with returning to compliance for noncompliant taxpayers, the escalating efforts of the IRS and Justice Department in the area of offshore tax noncompliance are clearly increasing both the criminal as well as the civil tax risks for noncompliant taxpayers with offshore holdings. The days of bank secrecy are over. ◆

[49]IR-2012-65, *supra* note 9.