

Undisclosed Foreign Accounts: A Second Chance

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HARRY S. MILLER

is a Partner in the Firm's Tax and Trusts & Estates Groups.



JENNIFER B. GREEN

is an Associate in the Firm's Tax Group.



Many people and companies with undisclosed foreign accounts failed to participate in the first voluntary disclosure program. The new voluntary disclosure program provides a second opportunity for taxpayers with undisclosed foreign accounts to come into compliance now rather than risk being identified by the IRS first. The IRS continues to actively investigate the identities of those with undisclosed foreign accounts. The consequences of failing to comply with the U.S. reporting, filing and disclosure requirements could lead to substantial penalties, and in some cases, even criminal prosecution.

The New IRS Offshore Voluntary Disclosure Initiative

The 2011 OVDI is modeled after the 2009 OVDP but with several modifications. To begin with, the disclosure period includes an eight year look back period instead of the previous six year period. Taxpayers seeking participation must file amended tax returns to include the unreported income, and foreign account information returns (FBAR returns) going back to 2003. The returns must be filed and all taxes and interest on the unreported income must be paid by August 31, 2011. Similar to the 2009 program, the IRS will assess an annual accuracy penalty of 20% of the underpayment of tax, with no reasonable cause exception allowed. Under the 2009 OVDP, in lieu of other penalties, including the virtually confiscatory penalties for failing to file the Form TD F 90-22.1,

Annual Report of Foreign Bank and Financial Accounts ("FBAR"), taxpayers were subject to a penalty equal to 20% of the highest aggregate balance in the foreign bank accounts during the period covered by the voluntary disclosure. Under the 2011 program, the IRS has increased the one time penalty from 20% to 25%.

The IRS may reduce the 25% penalty to either 12.5% or 5% in certain circumstances. If the highest account balance was less than \$75,000, it will qualify for a 12.5% penalty in lieu of the 25% penalty. Taxpayers who participated in the 2009 OVDP who would have qualified for the 12.5% reduced penalty of the 2011 OVDI, may submit a statement to request the reduced 12.5% penalty. A 5% penalty in lieu of the 25% penalty is available in certain situations for foreign residents, or persons who did not open the account, did not withdraw more than \$1,000 from the account in any year, and paid all U.S. taxes on funds deposited in the account.

In addition to the aforementioned penalties, the 2011 OVDI includes a possible assessment of penalties for failure to file and failure to pay taxes. But there is no clear standard as to which taxpayers would be subject to the failure to file and failure to pay penalties.

The Cost of Coming Clean

To understand the penalty framework, assume a taxpayer is in the 35% tax bracket and had the following amounts in a foreign account over the period covered by his voluntary disclosure:

Year	Amount on Deposit	Interest Income	Account Balance
2003	\$1,000,000	\$50,000	\$1,050,000
2004		\$50,000	\$1,000,000
2005		\$50,000	\$1,050,000
2006		\$50,000	\$1,200,000
2007		\$50,000	\$1,250,000
2008		\$50,000	\$1,300,000
2009		\$50,000	\$1,350,000
2010		\$50,000	\$1,400,000

On February 8, 2011, the IRS announced a new opportunity for taxpayers to voluntarily come forward to report undisclosed foreign accounts. The new program, entitled 2011 Offshore Voluntary Disclosure Initiative ("OVDI") is available until August 31, 2011. This program provides a second chance for people to come clean about unreported foreign accounts and qualify for partial amnesty from most penalties for the failure to report the accounts in the past. But in order to take advantage of this program people must act soon, as this is just a six month window of opportunity.

The IRS previously offered a foreign account voluntary disclosure program ("2009 OVDP") that closed in October, 2009. Over 15,000 taxpayers participated in the 2009 program. Even after the 2009 OVDP ended the IRS reported more than 3,000 additional taxpayers came forward under the traditional voluntary disclosure procedures.

IRS Commissioner Doug Shulman explained the reason for launching a second program now as follows: "The goal is to get people back into the U.S. tax system." Commissioner Shulman further stated, "Combating international tax evasion is a top priority for the IRS. We have additional cases and banks under review. The situation will just get worse in months ahead for those hiding assets and income offshore. The new disclosure initiative is the last, best chance for people to get back into the system."

If the taxpayer in the above example comes forward in the 2011 OVDI and it is accepted by the IRS, then the taxpayer would pay \$518,000 plus interest. This amount is based upon tax of \$140,000 (8 years at \$17,500), plus interest, an accuracy-related penalty of \$28,000 (i.e., \$140,000 x 20%), and an additional penalty, in lieu of the FBAR and other potential penalties that may apply, of \$350,000 (i.e., \$1,400,000 x 25%).

If the taxpayer didn't come forward and the IRS discovered the foreign account, then the IRS has an arsenal of potential penalties that it could impose upon the taxpayer, resulting in a possible assessment of up to \$4,543,000 in taxes, accuracy-related penalties, and FBAR penalties. The taxpayer would also be liable for interest and possibly additional penalties such as the fraud penalty of 75%, and could also be subject to criminal prosecution.

Based upon the 2009 OVDP, the IRS reported a significant number of cases that involved investments in Passive Foreign Investment Companies ("PFIC"). A PFIC is any foreign company that derives at least 75% of its gross income from passive activities or that derives passive income from at least 50% of its assets. Dividend and capital gains from investments in foreign mutual funds and foreign hedge funds may be subject to adverse U.S. tax consequences, if such funds are PFICs. Gain that is subject to the PFIC rules is allocated over the taxpayer's entire holding period as if it was received ratably over that time, and is taxed at the highest ordinary income tax rate for each year. Interest is then computed on the deemed underpayment each year.

Many taxpayers who participated in the 2009 OVDP had difficulty obtaining the historical data such as cost basis and holding period information. The 2011 OVDI offers an alternative to the statutory PFIC computation that does not require complete reconstruction of historical data.

Taxpayers who desire to participate in the 2011 program but are unable to pay the taxes, interest and reduced penalties in full by August 31, 2011, must submit a proposed payment plan along with a completed financial information statement.

Eligibility to Participate

Not all taxpayers are eligible to participate in the 2011 OVDI. If the IRS already has information relating to the undisclosed foreign account, or if the IRS has initiated a civil tax examination of the taxpayer (regardless of whether or not the examination relates to undisclosed foreign accounts), then the taxpayer is not eligible to participate in the 2011 OVDI. Anybody under criminal investigation by the IRS is also ineligible for the program. However, a taxpayer who came forward after the 2009 OVDP and sought relief under the IRS' traditional voluntary disclosure practice is eligible to apply for the 2011 OVDI.

Procedures to Apply for the 2011 OVDI

Taxpayers or their representatives may file an initial notice with the IRS Criminal Investigation Division to request pre-clearance approval of their eligibility to participate in the program. Pre-clearance does not guarantee a taxpayer acceptance into the 2011 OVDI, but it is very important to make the initial request for pre-clearance approval, because if the IRS discovers information about the taxpayer's foreign accounts after that date it generally won't disqualify them from participation in the program.

After the taxpayer receives a pre-clearance notification, they have 30 days from receipt of the notification to complete an Offshore Voluntary Disclosures Letter. The taxpayer must then submit the Offshore Voluntary Disclosures Letter, including basic information regarding the foreign accounts, to the Office of the Offshore Voluntary Disclosure Coordinator. The IRS will then notify the taxpayer or representative whether the voluntary disclosure has been preliminarily accepted or declined.

Once accepted into the voluntary disclosure program, the taxpayer must provide documentation to the IRS on or before August 31, 2011. The documentation is extensive. The taxpayer is also required to file amended federal income tax returns reporting the income from the foreign accounts, and payment for the tax, interest, and certain penalties. Information

statements on each foreign account or foreign asset held must be submitted, along with a penalty computation worksheet showing the determination of the aggregate highest account balance of the accounts, value of foreign assets, agreements to extend the period of time to assess tax (including penalties), and Forms TD F 90.22-1 (FBARs) for all foreign accounts maintained during the years covered by the voluntary disclosure. Additional documentation requirements apply to taxpayers whose foreign accounts had a balance in any year of \$500,000 or more, as well as for taxpayers who own an interest in foreign entities, and PFIC elections if relevant. The IRS may also request copies of all foreign financial account statements for each year covered by the disclosure period.

Conclusion

This opportunity for a second chance should not be overlooked. If you have an undisclosed foreign account, you should immediately consult with your tax adviser about your eligibility to participate in the 2011 OVDI. In addition to calculating the federal tax cost of participating in the program, taxpayers need to also consider the state tax impact.

Eligible taxpayers should not wait too long to take advantage of this window of opportunity. The cost of coming clean and participating in this program may seem high, but if the IRS finds you first, you could face substantially harsher penalties which may be in excess of the account values, and even possible criminal proceedings.

For questions regarding this Tax Update, please contact either of the following attorneys:

Harry S. Miller
617.345.3236 / hmiller@burnslev.com

Jennifer B. Green
617.345.3324 / jgreen@burnslev.com

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