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Tax Law: The 2011 Offshore Voluntary Disclosure Initiative

By Eric L. Morgenthal

As you read this article, someone, somewhere in the world, is gathering strength. Hoping and working toward someday coming to America to seek out a better life. As the expression goes, these people have taken their first steps down the road of their future "armed with nothing but their own vision." They pray that with years of hard work and perseverance, they too can obtain success and prosperity. Oftentimes, their motivation is to transfer money back home to their families in the old country. But today this Ellis Island narrative plays out far differently than it did in generations past. Now, with the Patriot Act and the Financial Crimes Enforcement Network (FinCEN), the U.S. government wants to know about these transfers.

Eric L. Morgenthal

I would like to describe the Federal Foreign Bank Account Reporting ("FBAR") Voluntary Disclosure program as a pathway back for tax evading criminals and financiers who intended to circumvent the U.S. tax system. And it is for many clients. But based upon significant experience in this area of International Tax practice, it hasn't always been the case. Often, I have heard from Holocaust survivors, refugees and immigrants from impoverished parts of the globe who are first learning about the compliance and financial reporting burdens that come when combining U.S. residency with money. (Note: the standard for compliance is U.S. residency, not U.S. citizenship.)

Due to their success in receiving 15,000 applications under the 2009 enforcement initiative ("OVDP"), the Federal Government has recently unveiled Round II: *The 2011 Offshore Voluntary Disclosure Initiative ("OVDI")*. And if anything, it proves Will Rogers was wrong. Sometimes you do get a second chance to make a first impression. Under the program, U.S. "persons"[1] making a "voluntary disclosure" can again avoid criminal liability by declaring their offshore bank accounts and reporting certain foreign transactions. And of course, it wouldn't feel like an FBAR disclosure program without a whole new list of IRS FAQ's to follow. But like before, not all nuances about the application of tax law set forth in the Code and Regulations are addressed in the IRS list of FAQ's about the OVDI.

The origins of the FBAR filing requirements are rooted in the Bank Secrecy Act of 40 years ago but were not heavily enforced. In 2003, the IRS was provided authority by FinCEN to police these provisions. In 2004, Congress assisted the IRS by raising the ante for those who failed to comply with the FBAR compliance provisions. And failure carried some severe penalties, raising the potential liability to the greater of $100,000 or 50 percent of the account balance per offense, as well as potential criminal exposure. In fact, even tax return preparers can now

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Bridging The Gap

Photo by Arthur Schulman

A. Craig Purcell, Wende Doniger, and James Fagan explain the basics of civil practice at the Academy's recent CLE weekend for new lawyers. More photos on page 16.

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incur penalties for preparing a tax return that fails to disclose a client's offshore account/activity that they knew or should have known about.

The 2011 OVDI contains a firmer deadline than the 2009 program. Under this new initiative, taxpayers must do far more than just submit an initial statement of intent to disclose their activity at a later time. They must provide corrected tax returns and remit tax, interest and penalties owed by August 31, 2011. A difficult deadline to meet when considering offshore bank takes weeks or months to provide back-year bank statements. A question remaining is whether a mad rush will occur, followed by an ambush of amended tax returns for statements which arrived after the deadline.

The framework for the OVDI was created with cognizance that it was also the IRS's second chance at the plate. The accuracy-related penalty on unreported income remains. However, in fairness to those who had already complied with the deadline for the 2009 program, the penalty on the highest asset balance was increased to 25% (from 20% in 2009). But it's not all bad. Relief was provided for some taxpayers. A reduced 12.5% penalty was created for account balances under $75,000 and the 5% penalty bargain still remains for those with dormant accounts which meet certain requirements. The IRS has even recognized that it would be unfair for deminimis transactions (less than $1,000 with certain conditions) to prevent taxpayers from qualifying for the reduced 5% rate. Formerly, instances of a single small ATM withdrawal had disqualified taxpayer's from obtaining the reduced rate benefits. Relief was also provided for Passive Foreign Investment Companies ("PFIC's"). Under the 2011 initiative, the IRS addressed the lack of cost basis information for PFIC's with an opportunity to instead calculate its gains or losses using Mark-to-Market methodologies.

An aspect of uncertainty with the 2009 program was whether individuals or entities even had the obligation to report an offshore bank account at all. The Federal signatory authority and financial interest provisions were not clearly defined. Unfortunately, the government had deferred setting forth the final criteria until long after the initial disclosure program had expired.[2] Taxpayer's screaming for clarity asserted that not all beneficial interests carried access to or control over the underlying funds. Finally, the new provisions recently set forth by the FinCEN "more clearly delineate both the scope of individuals and entities that would be required to file the FBAR and the types of accounts for which such reports should be made".[3]

It should be noted that although the disclosure initiatives certainly mitigate taxpayer criminal exposure, the predesignated rate structure may not prove a bargain for some clients who clearly lacked intent and willfulness for the failure-to-file the FBAR.[4] FAQ35, set forth by the IRS to explain the 2009 program specifically provided that "under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable under existing statutes." In other words, a comparison was to be conducted between the application of the disclosure penalty regime and the penalties otherwise normally applied. The taxpayer was only supposed to be responsible for the lesser of the two. But the IRS became inundated with disclosure applications. They were short staffed, and unfortunately, agents to whom these case matters had ultimately been directed insisted upon comparison with higher "intentional" tax penalties (even when intent was not demonstrated) in lieu of the traditional civil penalties imposed under statute. The result is that taxpayer's were oftentimes locked into the OVDP penalty regime structure. Going forward under the OVDI, it will be interesting to see if the redistribution of these cases to central processing centers coupled with the addition of more IRS auditors will enable this comparison to be viewed as intended.

The world is shrinking. Even small businesses now operate globally. And to protect its revenue stream, the IRS was forced to expand its reach into financial institutions worldwide. The IRS investigations started with Swiss banks but have since broadened their probes to include Israeli and Asian banks as well. And in my opinion, the program will continue to expand. I use my trusty standard of measurement to determine the IRS's future direction with its enforcement efforts. I read the descriptions of their job postings. One quick glimpse and you'll find that the vast majority of positions sought to be filled are not for Lawyers, Accountants or Tax Examiners, but rather, for Computer Scientists and Computer Engineers. This increases the likelihood that electronic banking activity will continue to be investigated and that the global hunt for tax dodgers will remain a hot button source of enforcement activity in the future.

Note: Eric L. Morgenthal, Esq., CPA, M.S. (Taxation) maintains his Tax Law practice in Melville specializing in Federal and New York State Tax Controversy Matters. He formerly served as Chair of the Suffolk County Bar Association Taxation Law Committee, is a member of the Nassau County Bar Association Tax Law Committee, New York State Bar Association Tax Section and the American Institute of Certified Public Accountants. Comments can be directed to his firm at info@litaxlaw.com.

1 "Persons" includes Individuals, Trusts, Estates, Partnerships, Corporations, PFIC's, CFC's and other entity forms.

2 IRS Notice 2009-62 extended the FBAR filing for tax years 2008 and prior to June 30, 2010; however, it did not clarify the filing requirement in time for the October 2009 initial voluntary disclosure filing deadline.

3 *See* 31 U.S.C. 5314 and the regulations at 31 CFR 103.24, 103.27, 103.32

4 Nonetheless, IRS Circular 230 sets forth additional requirements for Offshore Disclosures, i.e. notification in writing to the client of the costs and risks for the failure to comply.