

Client Alert

Latham & Watkins Tax Department

IRS Provides Guidance for Ongoing Offshore Voluntary Disclosure Program

The Internal Revenue Service (IRS) recently announced the terms of its new Offshore Voluntary Disclosure Program (OVDP) for taxpayers with unreported foreign bank accounts and other assets. The new OVDP follows two successful offshore voluntary disclosure programs, which closed in 2009 and 2011. The IRS collected more than US\$5 billion in back taxes, interest and penalties from the 33,000 voluntary disclosures made under the first two programs. The large participation in the first two programs was driven, in part, by a US government investigation of several Swiss banks, the enactment of The Foreign Account Tax Compliance Act (FATCA) and taxpayers desiring to avoid the risk of criminal prosecution. FATCA has further diminished the availability of bank secrecy by requiring foreign financial institutions to provide information about their US clients. Hoping to continue to capitalize on this trend toward transparency, the IRS continues its voluntary disclosure program to encourage taxpayers to come back into compliance.

The latest OVDP is similar to the 2011 offshore voluntary disclosure initiative in many ways, but with several key differences. The program will remain open indefinitely, but the IRS cautions that its terms could change at any time or the program may end at any point. The penalty framework is similar to the 2011 program and requires participants to pay a penalty of 27.5 percent based on the highest aggregate balance in their foreign bank accounts/entities or value of foreign assets during the disclosure period.¹ A very limited number of taxpayers may qualify for reduced 12.5 percent or 5 percent penalties.² Participants must also file amended returns,³ various other information forms and pay all back-taxes, interest and accuracy-related and applicable delinquency penalties.

The IRS will continue its practice of accepting delinquent foreign bank account reports (FBARs) and other information reporting forms without penalties in cases where there was no unreported income and all taxes were timely paid. The IRS also added two new examples in FAQ 51.1 indicating that dual citizens with little tax due should consider an "opt-out."⁴ The examples imply that, while taxes and interest will still be due, the IRS is not likely to assert accuracy-related, information return or FBAR penalties.

"It is likely that a significant number of taxpayers will be ineligible for the new OVDP. When a taxpayer is denied eligibility, there are still several remaining options to come into tax compliance and reduce the risk of criminal prosecution."

Heightened Eligibility Requirements

The new OVDP contains two significant eligibility modifications. Taxpayers are ineligible to participate once the government obtains taxpayer-specific evidence of non-compliance via a treaty request, John Doe summons or similar method. Further, the IRS plans to announce that certain taxpayer groups with accounts at specific foreign banks will be ineligible to participate due to US government actions with respect to such foreign banks. These two changes put pressure on a taxpayer to enter the program as soon as possible. A taxpayer who hesitates faces the risk of the IRS putting the subject bank on the ineligibility list or obtaining information regarding the account via treaty request or John Doe summons, either of which would make him ineligible to enter the OVDP.

The IRS has also attempted to limit taxpayers' ability to challenge disclosure of their tax or banking information in a foreign jurisdiction. Federal law requires a taxpayer to notify the US Justice Department if the taxpayer challenges in a foreign court the disclosure of tax information by that foreign government. Taxpayers failing to notify the US government of any such foreign appeal will no longer be eligible for the OVDP.

It is likely that a significant number of taxpayers will be ineligible for the new OVDP. When a taxpayer is denied eligibility, there are still several remaining options to come into tax compliance and reduce the risk of criminal prosecution. A taxpayer excluded from the OVDP should seek experienced legal counsel to evaluate these options.

The New Non-Resident Program

For non-resident taxpayers who have not been filing tax returns and FBARs, the IRS has announced a new procedure, effective September 1, 2012, that avoids the penalties imposed under the OVDP. IRS Commissioner Doug Schulman noted that the program involves a series of "...common-sense steps to help US citizens abroad get current with their tax obligations and resolve pension issues." Under the new procedure taxpayers must file delinquent tax returns, with appropriate information returns, for the past three years and file six years of delinquent FBARs. The IRS' description of the new non-resident program⁵ states that for "low risk" taxpayers, the IRS will not assert penalties or pursue follow-up actions.⁶ Higher risk taxpayers may be subject to a more thorough review and possibly a full exam, which may cover more than a three-year period. Tax, interest and appropriate penalties will be imposed for higher risk taxpayers.

The procedures allow for the reasonable cause defense, which must be explained in a statement signed under penalties of perjury. Taxpayers may also request relief for failure to timely elect deferral of income from certain retirement or savings plans.

This new non-resident procedure is technically outside the OVDP and will not guarantee the disclosing taxpayer is entitled to protection from criminal prosecution, although we anticipate the risk of prosecution to an eligible disclosing taxpayer to be extremely low. Once a submission is made under the non-resident program, the OVDP is no longer available. Also, a taxpayer who is ineligible for the OVDP is also ineligible for the non-resident program. Taxpayers should carefully consider whether the non-resident program is a better fit than the OVDP.

Increased Complexity

The increased complexity of the new OVDP, the “opt-out” process and the new non-resident program require taxpayers to seek sophisticated legal and tax advice. Taxpayers should evaluate the new environment of banking transparency and the increased chances of being denied eligibility for the voluntary disclosure programs. Taxpayers also need to understand the strength and viability of any mitigating factors and whether various alternatives to the OVDP might be a better option.

Attorneys at Latham and Watkins have significant government experience and have resolved hundreds of offshore disclosure cases. Several attorneys have a depth of knowledge and experience with tax fraud cases and criminal prosecutions and can assist taxpayers in reducing their chance of facing serious criminal penalties. We have relationships with high-quality accounting specialists who can assist in evaluating a taxpayer’s exposure and charting the best course to reduce the taxpayer’s total risk.

Endnotes

- ¹ The Frequently Asked Questions (FAQs) issued on June 26, 2012 make clear that Canadian retirement plans may be excluded from the penalty computation.
- ² The 12.5 percent reduced penalty applies to taxpayers whose highest aggregate account balance during the voluntary disclosure years is less than US\$75,000. A taxpayer seeking the 5 percent reduced penalty must meet stringent requirements. The 5 percent penalty is intended to apply to a taxpayer who had minimal interaction with his foreign account and withdrew less than US\$1,000 from the account in any voluntary disclosure year.
- ³ Amended returns must be filed for the most recent eight years for which the due date for the return (including extensions) has already passed. For taxpayers who started filing correct returns during the eight year period, the compliant years will not be included in the program.
- ⁴ When a taxpayer disagrees with the OVDP penalty, the taxpayer may withdraw from, or “opt-out” of, the program. This irrevocable election does not revoke the taxpayer’s protection from criminal prosecution but does exclude the availability of the reduced civil penalty structure of the OVDP. After an “opt-out” the taxpayer’s case will be handled under the standard audit process, and the IRS will have discretion to consider the full range of applicable penalties. An “opt-out” may be advantageous in several circumstances. A taxpayer should seek legal counsel before making the decision to “opt-out.”
- ⁵ See New Filing Compliance Procedures for Non-Resident U.S. Taxpayers, available at <http://www.irs.gov/businesses/small/international/article/0,,id=256772,00.html>.
- ⁶ A low risk taxpayer is one with “simple returns” with little or no US tax due. If returns show less than US\$1,000 of tax due in each of the years, the submission will be treated as low risk. The risk level will rise as the income and assets of the taxpayer rise, if there are indications of sophisticated tax planning or if there is material economic activity in the United States. The IRS promises additional detail regarding the risk factors closer to the program start date in September 2012.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Miriam L. Fisher
+1.202.637.2178
miriam.fisher@lw.com
Washington, D.C.

Brian C. McManus
+1.202.637.2173
brian.mcmanus@lw.com
Washington, D.C.

Theodore Joshua Wu
+1.202.637.2349
theodore.wu@lw.com
Washington, D.C.

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorney with whom you normally consult. A complete list of our *Client Alerts* can be found on our website at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit <http://events.lw.com/reaction/subscriptionpage.html> to subscribe to our global client mailings program.

Abu Dhabi

Villiers Terblanche
+971.02.813.4800

Barcelona

Jordi Domínguez
+34.93.545.5000

Beijing

Allen C. Wang
+86.10.5965.7000

Boston

David O. Kahn
+1.617.948.6000

Brussels

Jean Paul Poitras
+32.2.788.6000

Chicago

Diana S. Doyle
+1.312.876.7700

Doha

Villiers Terblanche
+974.4406.7700

Dubai

Villiers Terblanche
+971.4.704.6300

Frankfurt

Anders Kraft
+49.69.6062.6000

Hamburg

Tobias Klass
Götz T. Wiese
+49.40.4140.30

Hong Kong

Michael S. L. Liu
+852.2522.7886

Houston

C. Timothy Fenn
+1.713.546.5400

London

Sean Finn
Daniel Friel
+44.20.7710.1000

Los Angeles

Orange County
Pardis Zomorodi
+1.213.485.1234

Madrid

Jordi Domínguez
+34.91.791.5000

Milan

Fabio Coppola
+39.02.3046.2000

Moscow

Christopher J. Allen
+7.495.785.1234

Munich

Thomas Fox
Stefan Süß
+49.89.2080.3.8000

New York

New Jersey
David S. Raab
Lisa G. Watts
+1.212.906.1200

Paris

Olivia Rauch-Ravisé
Xavier Renard
+33.1.40.62.2000

Riyadh

Mohammed Al-Sheikh
+966.1.207.2500

Rome

Fabio Coppola
+39.06.98.95.6700

San Diego

Laurence J. Stein
+1.619.236.1234

San Francisco

Kirt Switzer
+1.415.391.0600

Shanghai

Rowland Cheng
+86.21.6101.6000

Silicon Valley

Kirt Switzer
+1.650.328.4600

Singapore

Stephen McWilliams
+65.6536.1161

Tokyo

Joseph Bevas
+81.3.6212.7800

Washington, D.C.

Gerald A. Kafka
+1.202.637.2200

* In association with the Law Office of Mohammed A. Al-Sheikh