

Private Wealth Services

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Alert

Will Taxpayers Ante Up to Participate in Round Two?:
The IRS Offers a New Voluntary Disclosure Program

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On February 8, 2011, the IRS announced the creation of a second voluntary disclosure program for taxpayers with unreported foreign assets (2011 VDP).¹ In reality, however, the program is designed for taxpayers with unreported foreign income, as the failure to report the existence of non-income producing foreign assets can be cured without participating in the newly announced program. The 2011 VDP differs significantly from the 2009 voluntary disclosure program (2009 VDP), which was announced on March 23, 2009, and terminated on October 15, 2009.

While there are a number of differences between the two programs, these are the three most significant:

- 1. Years Applicable.** The 2009 VDP required taxpayers to correct their noncompliance during the six-year period of 2003-2008. Of course, if the noncompliance involved fewer than six years, only those years needed to be resolved. In order to participate in the 2011 VDP, taxpayers will be required to resolve any noncompliance occurring during the eight-year period of 2003-2010. One again, however, if the noncompliance involves fewer than eight years, only those years with noncompliance must be cured.
- 2. Deadline.** As indicated above, the 2009 VDP terminated on October 15, 2009. Simply stated, taxpayers only had to identify themselves to the IRS and express their desire to participate in the 2009 VDP by that deadline. On the other hand, the 2011 VDP not only terminates on August 31, 2011, but taxpayers have to submit all of the appropriate returns to the IRS by that date.
- 3. Payments.** The 2009 VDP required taxpayers to pay all of the following: (1) income tax deficiencies during the six-year period, (2) interest on the deficiencies, (3) a 20 percent accuracy related penalty on the total deficiency, and (4) a 20 percent penalty on the highest aggregate balance held within the foreign accounts during the six-year period. The highest aggregate balance on which the penalty was based also included the value of any income producing assets, whether held in or outside of an entity.

Taxpayers participating in the 2011 VDP are responsible for the same payments, but instead of paying a 20 percent penalty on the value of offshore assets, the penalty is increased to 25 percent. The 2011 VDP also contains a reduced penalty structure of 5 percent and 12.5 percent for eligible taxpayers. Procedures exist in the 2011 VDP so that taxpayers who participated in the 2009 VDP can receive the benefits of the reduced penalty structure provided such taxpayers can otherwise satisfy the requirements.

Reduced Penalties

Shortly after the IRS announced the 2011 VDP to the media, it added a new website for 2011 Offshore Voluntary Disclosure Initiative Documents and Forms (2011 VDP Website).² From this website, there is a link to the 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers (Q/As).³ These Q/As flesh out the 2011 VDP, and certainly detail the requirements to qualify for the reduced penalty structure. Q/A #52 provides two examples demonstrating that the 5 percent penalty is available to two classes of taxpayers: those who inherited the accounts and those who did not know they were U.S. citizens.

- 1. Inherited Accounts.** Taxpayers must satisfy all four of the following requirements in order to qualify for the reduced penalty:
 - The taxpayers did not open the account or cause the account to be opened. If the bank required a new account to be opened following the death of the initial account owner, this is permitted, and the taxpayer will not be disqualified from qualifying for the reduced penalty.
 - The taxpayers have had infrequent contact with the account and have exercised minimal control over it. Thus, the taxpayers can contact the bank to provide new contact information or to request the account balance but may not make investment decisions. Similarly, if the taxpayers provided a “hold mail” document to the bank, this will disqualify them from the reduced penalty.

- During the years covered by the VDP, the taxpayers did not withdrawal more than \$1,000 in any calendar year, unless closing the account and transferring the funds to the United States.
- Prove to the IRS that all applicable U.S. taxes have been paid on the funds deposited in the account. If the funds were deposited into the account prior to January 1, 1991, the IRS will presume that all applicable taxes were paid. However, if there are any deposits subsequent to that date, taxpayers will have to identify the source of the deposit and, if that source was taxable in the United States, prove that tax was paid on it.

2. Foreign Resident U.S. Citizens. If a taxpayer was born to foreign parents – but within the United States, such that the taxpayer is a U.S. citizen – and the taxpayer grew up in the foreign jurisdiction, the taxpayer is entitled to the 5 percent penalty provided he/she did not know he/she was a U.S. citizen. However, if the taxpayer satisfies the same facts, but did know he/she was a U.S. citizen, then the penalty is not entitled to the reduced penalty. Apparently, the IRS believes that all such persons should have proactively sought out tax guidance to determine their U.S. tax obligations.

Q/A #53 indicates that taxpayers can qualify for the 12.5 percent penalty provided that during the years covered by the 2011 VDP: (1) the highest aggregate account balance, (2) the fair market value of assets generating income, which were not reported in the United States, and (3) the fair market value of assets in undisclosed foreign entities, if procured with untaxed funds, at no point exceeded \$75,000.

2011 VDP: Not the Only Option

The 2011 VDP is not required to correct all forms of noncompliance. Q/A #17 indicates that taxpayers may file delinquent Report of Foreign Bank and Financial Accounts (FBARs) and avoid penalties provided there is no unreported taxable income associated with the account. However, the delinquent FBARs must be filed by August 31, 2011. Q/A #18 provides similar benefits to taxpayers who failed to file Forms 5471 or 3520 reporting their connection to a controlled foreign corporation and/or foreign trust. Such taxpayers must file the delinquent informational returns with the appropriate service center by August 31, 2011. Q/A #38 indicates taxpayers may file delinquent FBARs and avoid penalties if the purpose of that FBAR is to report signature authority over an account in which the taxpayer has no beneficial interest. These delinquent FBARs must also be filed by August 31, 2011. Taxpayers filing the delinquent informational returns in accordance with Q/As #17, #18 or #38 must also submit a letter along with the delinquent return explaining the reason behind the noncompliance; such

taxpayers would be wise to reference the particular Q/A under which the delinquent return is being filed.

For taxpayers whose noncompliance is not cured by the Q/As, the 2011 VDP is not the only option. The 2011 VDP Website makes clear that taxpayers may still make a voluntary disclosure in accordance with the Internal Revenue Manual (IRM) section 9.5.11.9.⁴ The Internal Revenue Manual defines a voluntary disclosure as having taken place when the taxpayer's communication is truthful, timely, and complete.⁵ These terms require that the taxpayer show a willingness to cooperate (and does in fact cooperate) with the Service in determining the correct tax liability. The taxpayer also has to make good faith arrangements with the IRS to pay in full the tax, interest, and any penalties the Service determines are applicable.⁶

When successful, taxpayers can use the voluntary disclosure program to come into compliance and avoid criminal prosecution. Taxpayers need to be aware that not all voluntary disclosure submissions are accepted, and thus criminal prosecution is a potential outcome from a disclosure which is found not to qualify.⁷ Cases involving illegal source income will not qualify.⁸

Disclosures are timely if they are received before the occurrence of any of the following:

- (1) The IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.
- (2) The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance.
- (3) The IRS has initiated a civil examination or criminal investigation that is directly related to the specific liability of the taxpayer.
- (4) The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).⁹

Taxpayers should be aware that Q/A #11 indicates that civil penalties may apply for tax years prior to 2003 for any taxpayers who make a voluntary disclosure subsequent to August 31, 2011, in accordance with the IRM. It is not clear if the IRS intends to pursue civil penalties prior to 2003 for taxpayers who submit a voluntary disclosure in accordance with the IRM prior to August 31, 2011. While the statute of limitations is forever tolled until the required informational return is filed, the IRS is somewhat limited by the statute of limitations when it comes to assessing income tax. Generally, the IRS has three years from the filing of a return in which to audit a taxpayer and assess additional tax (section 6501(a)).

This statute of limitations also applies to information required to be reported on certain foreign transfers. As a result of the

Foreign Tax Compliance Act (FATCA), the period is increased to six years if a taxpayer omits 25 percent or more of gross income (section 6501(e)). Section 513 of FATCA amended section 6501(e) to also extend the statute of limitations to six years where a taxpayer omits more than \$5,000 of income attributable to one or more assets required to be reported under section 6038D. Thus, even if the taxpayer does not have a substantial understatement, the IRS will have six years in which to investigate and audit the taxpayer. In addition, however, the three-year and six-year statutes of limitations will be suspended until the information required to be reported under sections 1295(b), 1298(f), 6038, 6038A, 6038B, 6038D, 6046, 6046A or 6048 is provided to the IRS. (See [Holland & Knight's August 28, 2009 Alert](#), "Time to Act for U.S. Taxpayers in Violation of Offshore Tax Compliance Requirements," for a detailed summary of the many informational returns, and analysis as to when they must be filed.)

Problems with the 2011 VDP

Although there are a number of problems with the 2011 VDP, the following are of the greatest concern:

1. **Punishing Dual Citizens.** One of the main problems with the 2011 VDP is that it subjects accidental Americans to penalty. These can be persons born in the United States to foreign parents, but who otherwise grew up in the foreign country. Under certain circumstances it can also include persons born outside of the United States if one of the parents is a U.S. citizen and files the necessary paperwork with the U.S. Embassy in the foreign country.

If a taxpayer is otherwise off the U.S. radar, imposing unjustified penalties for coming forward will likely serve to further keep these individuals underground. If these dual citizen taxpayers do not consider themselves U.S. citizens, or in certain instances even realize they have such status, there is simply no justification for punishing them, much less drawing a distinction in the penalty amount. The 2011 VDP appears to be designed to punish these taxpayers who receive none of the benefits of U.S. citizenship. However, the penalty is disproportionate.

The typical U.S. citizen who fails to report foreign assets under the 2011 VDP will pay a 25 percent penalty on the value of these foreign holdings. This contrasts with dual citizen taxpayers who never hid money or assets, but rather who hold such assets in their home country. Further compounding the problem is this penalty imposed on the assets held by dual citizen taxpayers on their entire net worth provided such taxpayers have no U.S. holdings. The net result is a dual citizen taxpayer is punished more severely under the 2011 VDP than a domestic-based U.S. citizen taxpayer.

It should be pointed out that the IRS and Congress have recognized in related circumstances the tenuous relationship that certain citizens may have with the United States. For this reason, there are two exceptions to the exit tax imposed under the expatriation law enacted by the Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245, 6/17/08; the "HEART legislation"). The first exception applies to individuals, who became dual citizens at birth. In order to qualify for exemption from the exit tax: (1) the individual must have obtained United States citizenship solely by reason of birth, as well as citizenship of another country, (2) at the time of the expatriation the individual must remain both a citizen and income tax resident of the other country, and (3) the individual was not a U.S. resident under the substantial-presence test for more than 10 years out of the 15-year period ending with expatriation. Section 877(c)(2)(A). The 2011 VDP is not a statutory creation, it is simply a program announced by the IRS. The IRS should follow the logic of the HEART legislation, and permit such dual citizen taxpayers to come into compliance without imposing any penalties.

2. **Penalty Computation.** Q/A #50 states "under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes." Revenue Agents will be charged with making the determination as to whether penalties would be lower outside of the program. However, Revenue Agents will be required when making this determination to assume in all open years that the maximum penalties could be assessed by the IRS. Unless the taxpayer was actively involved in evading tax, it is doubtful that reasonable cause or other mitigating factors would not help reduce the size of any assessed penalty. The Q/A goes on to indicate that the penalties will be determined "without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability." Consequently, it is not clear as to when a 50 percent FBAR penalty, which is the maximum that could be imposed, would ever be less than the penalties provided under the 2011 VDP.

The Importance of Compliance

During the announcement introducing the 2011 VDP, IRS Commissioner Doug Shulman stated, "As we continue to amass more information and pursue more people internationally, the risk to individuals hiding assets offshore is increasing. This new effort gives those hiding money in foreign accounts a tough, fair way to resolve their tax problems once and for all. And it gives people a chance to come in before we find them."

He continued to urge those taxpayers with noncompliance to utilize the 2011 VDP when he stated, “[c]ombating 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 the months ahead for those hiding assets and income offshore. This new disclosure initiative is the last, best chance for people to get back into the system.”

Previously Commissioner Shulman in prepared remarks given at the 23rd Annual Institute on Current Issues in International Taxation on December 9, 2010¹⁰ stated, “[w]e have been scouring the vast quantity of data we received from the VDP [referring to the 2009 VDP] applicants and from other sources. Although more data mining is still to be done, this information has already proved invaluable in supplementing and corroborating prior leads, as well as developing new leads, involving numerous banks, advisors and promoters from around the world, including Asia and the Middle East.”¹¹

Considering the warning provided in Q/A #11 that the IRS will consider civil penalties in years prior to 2003 for taxpayers who come forward subsequent to August 31, 2011, and Commissioner Shulman’s comments, taxpayers are well advised to come into compliance. See “Part VII: IRS Investigation and Examination Tools” in the [outline available online](#) for an overview of tools available to revenue agents to catch taxpayers who are paying less than their share of tax, whether as a result error or intent to cheat.

Whether you have an undeclared foreign account, other international noncompliance, or have already been contacted by the IRS, [Holland & Knight’s Offshore Tax Compliance Team](#) is well placed to offer assistance. Please contact us if you have questions.

For more information, contact:

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¹ <http://www.irs.gov/newsroom/article/0,,id=235695,00.html>

² <http://www.irs.gov/newsroom/article/0,,id=235584,00.html>

³ <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html>

⁴ <http://www.irs.gov/newsroom/article/0,,id=104361,00.html>

⁵ IRM 9.5.11.9.3.

⁶ IRM 9.5.11.9.3.A and B.

⁷ IRM 9.5.11.9.2.

⁸ *Id.*

⁹ IRM 9.5.11.9.4.

¹⁰ IR-2010-122, <http://www.irs.gov/irs/article/0,,id=232223,00.html>

¹¹ *Id.*

About the Author

Kevin E. Packman, a partner in Holland & Knight’s Private Wealth Services Section, chairs the firm’s Offshore Tax Compliance Team and focuses his practice on IRS tax controversies. He also assists domestic and international clients with estate and gift tax planning, as well as pre-immigration planning for international clients.

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The U.S. Justice Department has stepped up efforts to stem tax evasion by taxpayers who fail to disclose foreign bank accounts and other offshore investments. As a result, the Internal Revenue Service launched a voluntary disclosure program in March 2009 for taxpayers with undeclared foreign income and bank accounts. A similar program (the focus of the above article) was introduced on February 8, 2011. Holland & Knight's Offshore Tax Compliance Team counsels clients regarding the IRS's voluntary disclosure program, as well as on the numerous compliance issues required by the Foreign Account Tax Compliance Act (FATCA). We also defend against accusations of structuring, and advise, investigate and defend clients in Foreign Corrupt Practices Act (FCPA) matters. In addition, we assist taxpayers in tax penalty prevention and in cases involving the IRS.

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