

The U.S. Internal Revenue Service's 2011 Offshore Voluntary Disclosure Initiative

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On February 8, 2011, the U.S. Internal Revenue Service (IRS) announced the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI). It did not announce an amnesty. According to the Oxford English Dictionary, an "amnesty" is an official pardon or "an undertaking by the authorities to take no action against specified offences during a fixed period."

2011 OVDI is part of the IRS strategy to bring in revenue – overdue taxes, civil penalties for not filing required forms or reporting all income, interest on late-paid taxes, interest on penalties, and penalties for not reporting the existence of offshore accounts. To understand why 2011 OVDI is not an amnesty requires an understanding of the IRS definition of "voluntary disclosure."

BACKGROUND

"Voluntary Disclosure" has long been a part of Internal Revenue Service (IRS) procedure. Traditionally, persons who want to avoid being charged with the serious crimes of tax evasion, filing fraudulent returns, and failing to file tax returns have been able to ask IRS to accept their full disclosure and remediation in exchange for non-prosecution. Such requests always been lodged with the Criminal Investigation Division (CID) of IRS. The Internal Revenue Manual explains at Section 9.5.11.9 that

"A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended. This practice does not apply to taxpayers with illegal source income."

Undertaking a voluntary disclosure has always been a serious undertaking.

The 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI) marks the third time the Internal Revenue Service (IRS) has tried mass marketing to bring taxpayers into compliance with tax return filing requirements and the obligation to file Reports of Foreign Bank and Financial Accounts (FBARs). Hardly anyone recalls the 2003 program. The 2009 Voluntary Disclosure Program (2009 VDP) attracted 14,700 applicants. The Internal Revenue Service has still not finished processing the 2009 VDP applications. Some 2009 VDP applicants are still waiting for IRS to assign a Revenue Agent to examine their tax returns, FBARs and financial records. Other 2009 VDP applicants have successfully completed the program and received closing agreements from IRS. Some of these successful applicants are now being contacted by Special Agents of the IRS Criminal Investigation Division (CID) so that IRS can debrief them about their dealings with offshore banks, institutions, bankers and brokers.

The 2011 OVDI offers people the chance to come clean with IRS by declaring all their unreported offshore income and accounts for years 2003-2010. Instead of facing the risk of criminal prosecution or loss of their entire multi-million dollar Swiss bank accounts, they may be able to limit their exposure to paying taxes on unreported income, various penalties arising from the unpaid taxes, interest, and 25% of their total offshore bank and financial account balances in the year with the highest balance. The precise benefits of the 2011 OVDI and the civil penalty exposure for eligible taxpayers who do not apply for the 2011 OVDI are detailed in the FAQs on the IRS website:

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

2011 OVDI PROCEDURES

The starting point for understanding 2011 OVDI is reading the IRS website www.irs.gov program description , procedures and FAQs. The five stages of the 2011 OVDI process are outlined below:

1. Contacting CID. The first step in applying for 2011 OVDI is for the taxpayer or his or her legal representative (accountant or attorney) to contact IRS CID to confirm that the IRS will even consider the application. Taxpayers who are already under IRS audit or criminal investigation will not be cleared to apply. Taxpayers should realize that in this preliminary contact step they are providing IRS with their name, date of birth, Social Security Number, and address. They are effectively advising IRS that they are worried. If they chose not to follow through with the application after they are cleared, IRS will still have their data in its database. This contact step is not required. Would-be applicants can proceed to the second step without pre-clearance. However, the second-step requires the provision of detailed information. Thus, taxpayers need to consider not only whether they will apply for 2011 OVDI but also how they will initiate the application – CID contact or detailed letter.

2. Filing Offshore Voluntary Disclosure Letter. The template for this letter is on the IRS website and is unchanged from the 2009 VDP. In the letter, which covers years 2003-2010, the taxpayer provides identifying information, estimates of the greatest amount in offshore accounts for each year, estimates of the amount of unreported income in each year, and identifies all banks and institutions at which accounts were/are located. The taxpayer is also asked to provide details on his contacts with the banks and institutions , dates of opening and closing accounts, and source of funds. The letter is signed under penalty of perjury.

3. Preliminary Acceptance or Declination by IRS. As in the 2009 VDP, after reviewing the letter, IRS sends a notification letter. The 2009 VDP preliminary acceptance letter included these points:

- This acceptance is conditioned upon the information provided by the applicant being, and remaining, truthful, timely and complete.

- A voluntary disclosure will not automatically guarantee immunity from prosecution; however, a voluntary disclosure may result in prosecution not being recommended.
- The taxpayer must fully cooperate with IRS in determining the correct tax liability, paying or making arrangements to pay all tax, interest and penalties, producing all requested records, and submitting to an interview if requested.
- Additional civil sanctions and/or criminal investigation can be imposed if IRS determines the taxpayer has not cooperated or has provided materially false information.

4. Provide the complete OVDI package to IRS. Based on its experience in the 2009 VDP, IRS is now requiring all kinds of detailed information and documents up front:

- Copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure.
- Complete and accurate amended federal income tax returns (for individuals, Form 1040X, or original Form 1040 if delinquent) for all tax years covered by the voluntary disclosure, with applicable schedules detailing the amount and type of previously unreported income from the account or entity.
- A check made out to the U.S. Treasury. The check must include the amount of tax, interest, and accuracy-related penalty, and, if applicable, the failure to file and failure to pay penalties. Taxpayers who cannot write such a check must provide detailed financial statements describing all their assets and financial information.
- Completed Foreign Account or Asset Statements for each offshore account. (A new form.)
- Completed penalty computation worksheet. (A new form.)
- Agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties.
- Foreign Financial Institution Statements for accounts with balances in excess of \$1 million. (A new form)
- FBARs for all years covered by the voluntary disclosure.
- All records of account activity for accounts in excess of \$500,000. IRS may later request records for smaller accounts.
- Information returns for all involved entities – corporations, partnerships, trusts etc.
- Information on Passive Foreign Investment Company (PFIC) issues.

5. **Case assigned to an IRS Revenue Agent (civil examiner).** The Revenue Agent may request additional records and will ultimately prepare a report and closing agreement.

GETTING HELP WITH 2011 OVDI

While a taxpayer could arguably contact IRS CID on his own or prepare the voluntary disclosure letter, the 2011 OVDI requires the submission of computations and forms which go beyond that required by any prior IRS voluntary disclosure program. An accountant will be needed to prepare amended tax returns, calculate penalties and interest, and identify technical issues – such as possible Passive Foreign Investment Companies. Depending upon the size of offshore accounts, existence of offshore entities, and relationships between the offshore banks and the taxpayer, a criminal tax lawyer may be needed to explain the significance of the questions on the new Foreign Financial Institution Statement.

REMEDICATION WITHOUT 2011 OVDI

The most important decision for olim who are not presently in compliance with tax return and FBAR obligations is whether they can get into compliance without entering the 2011 OVDI. One common situation is expressly addressed in IRS FAQ No. 17:

Q. I have properly reported all my taxable income but I only recently learned that I should have been filing FBARs in prior years to report my personal foreign bank account or to report the fact that I have signature authority over bank accounts owned by my employer. May I come forward under this new initiative to correct this?

A. The purpose for the voluntary disclosure practice is to provide a way for taxpayers who did not report taxable income in the past to come forward voluntarily and resolve their tax matters. Thus, if you reported and paid tax on all taxable income but did not file FBARs, do not use the voluntary disclosure process.

For taxpayers who reported and paid tax on all their taxable income for prior years but did not file FBARs, you should file the delinquent FBAR reports according to the instructions (send to Department of Treasury, Post Office Box 32621, Detroit, MI 48232-0621) and attach a statement explaining why the reports are filed late. The IRS will not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities and the FBARs are filed by August 31, 2011. However, FBARs for 2010 are due on June 30, 2011 and must be filed by that date.

Before relying on this FAQ, olim need to consider two questions:

- Am I certain I have reported all my world-wide income for years 2003-2010?
- Do I know which of my bank and financial accountants outside of the U.S. need to be reported on FBARs for years 2003-2010?

Olim need to review their filed tax returns to see if the information in Schedule B, Part III on foreign reports is answered accurately. They need to consider whether they have income from investment or pension accounts that need to be reported. They need to consider whether they failed to file information returns related to receipt of gifts in excess of \$100,000 from foreign nationals or entities, and whether they have reported interests in foreign partnerships, trusts, and corporations. (See 2011 OVDI FAQ 18) This review is best accomplished with the tax preparer or accountant who prepared the returns. If the return was self-prepared, it may be appropriate to consult with an accountant for the review. The review may raise concerns that

actually necessitate application into the 2011 OVDI and/or the preparation and filing of amended tax returns.

Identifying the accounts which need to be reported on the FBARs is not so easy. Personal, business and joint accounts of varying types must be reported. Joint accounts need to be reported. Accounts for which one has a power of attorney or signature authority need to be reported. And not all tax professionals agree on what accounts have to be reported. Some Israeli CPAs advise clients and post on their websites that keren pensia, keren hishtalmut and other pension accounts must be reported. Other CPAs advise that they need not be reported.

Also, in order to prepare accurate FBARs, filers need to have the information and financial statements from their accounts – when was the account opened? Closed? What was the largest balance in the account in each year (2003-2010)? Was an FBAR required for every year in the 2003-2010 range? Many people will need to go to their financial institutions for the historic information. This takes time.

CONCLUSION

Dual U.S.-Israeli citizens need to comply with U.S. income tax return and FBAR requirements. It is the law and the U.S. Department of Justice, through the U.S. Attorney Offices, can be expected to file criminal charges against flagrant violators even if they reside in Israel.

Remediation needs to be considered. Many olim will be able to come into compliance without the need for application to the 2011 OVDI. Because it takes time to get financial records, prompt review of filings or non-filings for years 2003-2009 is recommended. Timely filing of accurate 2010 FBARs and income tax returns in 2011 is essential.

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