US Voluntary Disclosure

what you need to know, and how we can help

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Introduction

Countries throughout the world have committed to redefining banking secrecy laws so as to no longer protect any form of tax offence and/or adopt more stringent information sharing standards in tax matters. The shift to greater transparency and information sharing has caused an increase in the number of individuals seeking to divulge previously unreported income. Several jurisdictions now offer various streamlined measures or amnesty programmes for such taxpayers in an effort to get individuals back into the tax net.

The United States has long had a 'voluntary disclosure' programme, but in the last few years has announced new rules for individuals with offshore investments wishing to 'come clean'.

In the current climate of increased information exchange, Congressional investigations, IRS lawsuits against international financial institutions and Justice Department investigations of individuals, an ever-increasing number of US taxpayers have expressed an interest in reviewing their tax and information reporting obligations. Likewise, many financial advisers and fiduciaries are reviewing their internal procedures in light of current 'best practice' in servicing their US clients.

On 8 February 2011, the IRS announced a new 'offshore' voluntary disclosure initiative ('OVDI') aimed at non-compliant US taxpayers with unreported 'offshore' bank accounts and assets. The initiative is a modified version of the programme offered in 2009 and gives taxpayers with unreported accounts a chance to come clean while mitigating the risk of criminal prosecution. Non-compliant taxpayers who fail to come forward before 31 August 2011, will face 'more dire' consequences, including higher civil penalties and the possibility of criminal prosecution.

What do you need to know now?

The 2011 OVDI borrows heavily from that issued in 2009, with several significant changes:

- The time period has been increased to eight years. Taxpayers will now be required to pay back taxes, interest and accuracy or delinquency penalties for tax years 2003 to 2010;

- Taxpayers must pay a penalty of 25% of the highest total asset value in all unreported foreign financial accounts and entities. The entire value of a foreign business that produces income will potentially be included for purposes with determining the 25% penalty along with other assets such as real estate, artwork and commodities;

- The IRS has expanded the group of individuals who may qualify for a reduced penalty rate. Individuals with offshore accounts less than $75,000 in all years from 2003 to 2010 may qualify for an 'in lieu of' penalty of 12.5%;

- Inherited accounts are eligible for a reduced 'in lieu of' penalty of 5% if the taxpayer did not set up the account, had minimal involvement with the account and did not withdraw more than $1,000 in any year from 2003 to 2010;

- Individuals classed as 'accidental Americans' may qualify for a 5% 'in lieu of' penalty if such persons were unaware that they had US citizenship.

The US Voluntary Disclosure timeline – what went before and where we are now?

On 23 March 2009, the IRS announced new guidance for individuals with untaxed offshore assets looking to 'get right with their government'. Although not technically an amnesty, the programme set out a standardised set of tax and penalty regimes providing for specific fixed consequences. The new guidance was only valid until 15 October 2009, and although taxpayers had penalties to pay, the programme was intended to be considerably less harsh than if the IRS pursued all possible penalties. By coming forward voluntarily, taxpayers could cap their liabilities at six years of back taxes, interest and standardised penalties and thus mitigate the risk of criminal prosecution.

During 2009, 2010 and as recently as 23 February 2011, the IRS continued to amend the rules relating to the scope of FBAR reporting requirements.

On 18 March 2010, President Obama signed the Hiring Incentives to Restore Employment Act of 2010 the ('HIRE Act') into law this Act included provisions similar to an earlier proposed bill called the Foreign Account Tax Compliance Act or 'FATCA'. This dramatically affected most non-US financial institutions, funds and collective investment structures as well as many trustees and family offices investing through these entities by providing the IRS with 'new tools to find and prosecute US individuals that hide assets overseas'. The HIRE Act includes a number of new provisions that significantly modify the US withholding tax and information reporting regimes affecting US persons, non-US banks and other financial intermediaries and their affiliates, non-US hedge and private equity funds, and certain other non-US investment structures.

On its face, the HIRE Act requires any entity classified as a 'foreign financial institution' ('FFI') (extremely broadly defined) to either enter into an arrangement by which the FFI agrees to determine which of its account holders are US citizens, green card holders or tax residents ('US persons'), or entities which are substantially owned by US persons, or suffer 30% gross withholding on all amounts invested into the US. A substantial US owner can have as little as a 10% ownership interest. The withholding would apply to virtually all amounts invested by the FFI into the US, whether for its own account or for the account of its 'account holders', regardless of whether or not they were US persons.

IRS Notice 2010-60 confirms that non-US trust companies are classified as FFIs (just like banks, financial institutions, brokerages, etc). Thus, absent a special exemption being issued in future guidance, any trust company not signing up to an FFI agreement (which would require it to determine whether its trusts, settlors and/or beneficiaries are US persons) would suffer 30% gross withholding on virtually all investments into the US with respect to any and all trusts for which they serve as trustee.

The withholding obligations under the HIRE Act will take effect from 1 January 2013 but foreign financial institutions wishing to enter into client identification agreements will need to act immediately to begin the complicated process of implementing account holder identification processes.

Voluntary Disclosure – some history, new procedures and questions

What is Voluntary Disclosure?

A voluntary disclosure is an admission to the IRS that a taxpayer failed to properly report an item of income on his or her tax return or failed to disclose a required item on a reporting form. The IRS has a Voluntary Disclosure programme, which admits taxpayers who meet certain criteria and who follow a set of specific instructions. A voluntary disclosure will not automatically guarantee immunity from prosecution, however, a timely voluntary disclosure may result in prosecution not being recommended.

There are two methods for conducting a voluntary disclosure matter: (i) a 'Noisy Voluntary', whereby an attorney approaches the IRS Criminal Investigations Division ('CI') on a taxpayer's behalf to negotiate a waiver of prosecution prior to filing amended (or unfiled) income tax and information returns and the FBARs; and (ii) a 'Quiet Voluntary', whereby a taxpayer, or his representative, directly files unfiled or amended income tax returns and FBAR reports without contacting the IRS and Treasury beforehand. The IRS does not consider a 'Quiet' disclosure to be an adequate voluntary disclosure for the purposes of precluding criminal prosecution.

A 'Noisy' voluntary disclosure must be truthful, timely and complete, and the taxpayer must demonstrate a willingness to cooperate (and must in fact cooperate) with the IRS in determining the correct tax liability. The taxpayer must make good faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. Voluntary disclosures are not available to all taxpayers, including those with illegal source income (Al Capone need not apply), but may be a viable option for the vast majority of taxpayers with unreported income or unreported foreign accounts, for example.

A taxpayer with unreported foreign income is not eligible for the standard voluntary disclosure programme and must apply through the 2011 OVDI.

The voluntary disclosure programme requires the disclosure to be timely, that is, received before:

- 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.
- The IRS has received information from a third party (such as an informant, other governmental agency or the media) alerting the IRS to the specific taxpayer's non-compliance.
- The IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.
- The IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (eg search warrant or grand jury subpoena).

The 2009 programme

- A six-month period allowing taxpayers with unreported offshore income and offshore accounts to make a formal request for participation in the 2009 programme (3/23/09 – 10/15/09). The accepted disclosure had to be made before the IRS received information on the taxpayer. No illegal income would be involved and the taxpayer could not be under existing IRS audit or investigation.

- Initial screening was conducted by the Criminal Investigation Division and taxpayers were required to file up to six years of amended of returns and FBARs. Taxpayers were required to pay all past due taxes, interest and delinquency/accuracy penalties. In addition, there was a 20% penalty imposed on the highest aggregate balance of all unreported financial interests during the six year period. This penalty was in lieu of all other applicable penalties for failing to file information, returns and other reports.

- Taxpayers could choose either to be interviewed by the Criminal Investigation Division concerning their offshore assets or file a three-page letter which provided details of the offshore account and offshore advisers. Once the taxpayers were cleared by the Criminal Investigation Division, taxpayers were assigned a revenue agent who reviewed the tax and information returns and bank information and essentially certified the information on the returns. At the end of the certification process, penalties were determined not to exceed 20% of the highest aggregate value of the offshore asset and a closing agreement was entered into.

2009 programme results

- Nearly 15,000 taxpayers requested participation prior to 15 October 2009.

- Subsequent to 15 October 2009, an additional 3,000 taxpayers requested participation.

- Early participants in the 2009 programme suffered the glitches of a newly established government programme.

- IRS gradually reacted to the glitches and adopted new procedures, attempting to streamline the process.

- Obtaining information from foreign banks was difficult and time-consuming.

Second offshore voluntary disclosure programme – the 2011 OVDI

Formally announced by the IRS on 8 February 2011 and accompanied by new guidance in the form of 53 frequently asked questions, the new programme further centralises the application process.

- Preclearance is available by telephone, mail or fax by providing taxpayer identification information.

- Once cleared, the taxpayers must submit to a personal interview or submit the three-page letter disclosing additional information regarding unreported offshore income and unreported offshore assets.

- Taxpayers must file returns or amended returns as applicable for the years 2003 – 2010 no later than 31 August 2011 (eight years versus the prior six year programme). The 31 August 2011 submission must include payment of all taxes, interest and delinquency or accuracy penalties. FBARs or amended FBARs must also be filed for the period 2003 to 2010 (note that the 2010 FBAR is due by 30 June 2011). Other information returns for controlled foreign corporations, foreign trusts, etc. must also be filed by 31 August 2011.

- The 'in lieu of' penalty is 25% versus 20% in the 2009 programme, which is imposed on the highest aggregate balance of all unreported accounts and certain offshore assets during the period 2003 to 2010.

- The 25% miscellaneous penalty can be reduced to a 12.5% penalty if the aggregate accounts for the years involved did not exceed $75,000. The miscellaneous penalty may also be reduced to 5% in limited circumstances, including where taxpayers inherited the account, were not actively involved in the account and did not withdraw more than $1,000 in any year from the account. A 5% penalty will also be available to certain 'accidental' Americans.

Additional features of the 2011 OVDI

- Taxpayers who made 'Noisy' voluntary disclosures subsequent to 15 October 2009 will automatically be swept into the new programme.

- The FAQs make it clear that prior 'Quiet' disclosures are at risk for criminal penalties and higher civil penalties unless they come forward and formally apply for participation in the 2011 OVDI.

- As IRS investigation into a taxpayer's bank does not make the taxpayer ineligible as long as the bank has not yet turned over information concerning the specific taxpayer.

- In addition to filing initial or amended tax returns, information returns and FBARs for the period all taxpayers participating in the 2011 OVDI must file signed extensions for income tax and information returns and FBARs by 31 August 2011. If the taxpayers have offshore accounts aggregating more than $500,000, they must file copies of their bank statements.

- There is no grace period for the filing deadline of 31 August 2011.

- There is no de minimis exception for taxpayers regarding unreported income.

- Foreign real estate and other assets are also potentially covered in the penalty base if purchased with offshore unreported funds, even if such purchase occurred prior to 2003. Income-producing real estate will be included for purposes of determining the penalty under the 2011 OVDI.

Key differences between the 2009 programme and the 2011 OVDI

- 2009 programme included FAQ 35 which appears to have granted revenue agents discretion to impose normal audit penalties as an alternative to the 20% in lieu of penalty if such penalties were lower than 20%.

- FAQ 50 issued as part of the 2011 OVDI appears not to allow any discretion in determining penalties. In any event, it clearly indicates that agents are not to consider reasonable cause in determining applicable penalties.

- Bank statements will not be required to be submitted along with returns by 31 August 2011 if the aggregate accounts are less than $500,000. The statements, however, must be available if requested.

- Under the 2011 OVDI, revenue agents will not be assigned until the taxpayer files the complete disclosure package. Under the 2009 programme, revenue agents were assigned once the case was transferred from the Criminal Investigation Division to the Revenue Division.

- Similar to the 2009 programme, the 2011 OVDI confirms that taxpayers who reported and paid taxes on all income, but failed to file foreign bank account reports or other information returns should not participate in the programme. Instead, they should file the delinquent reports or returns no later than 31 August 2011 with a letter of explanation. The 2010 FBAR must be filed by 30 June 2011. No penalties for failure to file information returns will be imposed on such taxpayers.

- Similar to the 2009 programme, if a taxpayer and the revenue agent disagree on the imposition of penalties, taxpayers may opt out of the 2011 OVDI. Such taxpayers will be assigned for a full audit. While lower penalties may result based upon the facts and circumstances, IRS will not be limited to the six or eight years under the respected programmes. If the IRS determines that the taxpayer's returns were fraudulent, there is no applicable statute of limitations. IRS has advised it will assess higher penalties such as the 75% fraud penalty and the wilful FBAR penalty (greater of $100,000 or 50% of the account balances per year).

2011 OVDI - questions

Is this a programme that people might refuse? Why?

Yes, we have had experiences where individuals, upon receiving a projection of the numbers involved, have said 'thanks but no thanks'. The 25% of highest aggregate balance penalty can be a very bitter pill to swallow.

Certain taxpayers may be reluctant to participate because participation in the programme requires complete co-operation including disclosure of the names of relatives, private bankers and other offshore advisers.

What is the difference between a 'Quiet' and a 'Noisy' disclosure?

As mentioned above, there are two methods for conducting a voluntary disclosure matter: (i) a 'Noisy Voluntary', whereby an attorney approaches the IRS Criminal Investigations Division ('CI') on a taxpayer's behalf to negotiate a waiver of prosecution prior to filing amended (or unfiled) income tax returns and the FBARs; and (ii) a 'Quiet Voluntary', wherein a taxpayer, or his representative, directly files unfiled or amended income tax returns and FBAR reports with the IRS and Treasury without contacting them beforehand.

'Quiet' voluntary disclosure are frowned upon by the IRS. A 'Quiet' disclosure leaves the taxpayer open to being examined and potentially criminally prosecuted for all years, whereas after a 'Noisy' disclosure, the taxpayer can be certain that their case is over.

However, a 'Quiet' disclosure may be the only choice for a taxpayer who does not qualify for a 'Noisy' voluntary disclosure.

What other things must be considered in deciding how to go forward?

Cost - 'Noisy' voluntary disclosures cost significantly more that a 'Quiet' voluntary disclosure in terms of legal fees.

Risk - 'Noisy' voluntary disclosures are significantly less risky that a 'Quiet' voluntary dislosure.

Qualification - not all taxpayers qualify for a 'Noisy' voluntary disclosure. Furthermore, some taxpayers who have merely neglected to file an FBAR, for example, while reporting all of the income on their tax returns, have a special programme to allow them to file back FBARs with no penalty.

What about people outside the United States? Who should be concerned?

Any US citizen, resident or green card holder should be concerned regardless of where they live, along with non-US individuals who do business in the US regularly.

What are the procedures for people who did not realise they were US citizens?

'Accidental Americans' (taxpayers who did not realise until recently that they were US citizens) may face a reduced penalty of 5% but an analysis of their individual situation will be required. Assuming they were living in Europe, for example, and paying tax there, they may owe little or no US tax. If they owe no tax, it maybe a simple matter of filing the back FBARs under the OVDI. Because there is no argument for reasonable cause under the OVDI, if they owe tax, they face the same decision other US people, although they may tend to decide to choose the 'Quiet' method more frequently because they may feel the risk is worth it.

What other measures should people be thinking about?

- Restructuring assets to simplify their reporting in future years.
- After fully completing their voluntary disclosure (and NOT before), transferring funds into a US bank and out of any 'sham' structures.
- For any new foreign accounts established, making sure any individual that has a financial interest in or has signatory authority over such account is aware of their reporting obligation.

- Because once a taxpayer's total foreign accounts are over $10,000 each account must be reported, ensure that any new account established – however small – is reported.

- Order bank statements for the prior year well in advance of filing deadlines.

What are some of the penalties for commonly known obligations under the US tax code?

- FBAR – Foreign Bank Account Report (TD F 90-22.1), which is required to be filed by all US citizens and residents, green card holders, and 'persons' (a term of art that includes entities) 'in and doing business in' the US who have a financial interest in or signature authority over financial accounts in foreign countries exceeding $10,000 in the aggregate. The FBAR form is separate from any tax returns that must be filed and is due by 30 June for the prior calendar year (extensions are not available).

  - Negligent failure to file the FBAR form for foreign accounts can trigger a penalty of $10,000 per account per year.

  - Wilful violation of the FBAR reporting requirement can result in a civil penalty equal to the greater of $100,000 or 50% of the account balance at the time of the offense. Wilful violations are not subject to the reasonable cause exception.

  - If failure to file the FBAR is deemed to be a criminal violation, the penalty can include a fine of up to $250,000, imprisonment for up to five years, or both. If the failure to file is deemed to be part of a criminal activity (ie it occurs during the violation of another law or is part of an illegal activity involving more than $100,000 in a 12 month period), the maximum fine increases to $500,000 and the possibility of imprisonment increases to up to 10 years.

  - Each unreported bank account and each calendar year constitutes a separate violation, so, with multiple accounts unreported for several years, a taxpayer could face literally dozens of separate penalties - each of which could potentially trigger the maximum fine.

- Failing to file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. Taxpayers must also report various transactions involving foreign trusts, including the creation of a foreign trust by a United States person, transfers of property from a United States person to a foreign trust and receipt of distributions from foreign trusts under section 6048. This return also reports the receipt of gifts from foreign persons under section 6039F. The penalty for failing to file each one of these information returns, or for filing an incomplete return, is 35% of the gross reportable amount, except for returns reporting gifts, where the penalty is 5% of the gift per month, up to a maximum penalty of 25% of the gift. The penalty may be excused if reasonable cause for failure to report can be established.

- Failing to file Form 3520-A, Information Return of Foreign Trust With a U.S. Owner. United States persons with various interests in and powers over foreign trusts must report under section 6048(b). The penalty for failing to file each one of these information returns or for filing an incomplete return is 5% of the gross value of trust assets determined to be owned by the United States person.

- Failing to file Form 5471, Information Return of U.S. Person with Respect to Certain Foreign Corporations. Certain United States persons who are officers, directors or shareholders in certain foreign corporations (including International Business Corporations) are required to report information under sections 6035, 6038, and 6046. The penalty for failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

- Failing to file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Taxpayers may be required to report transactions between a 25% foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party, as required by sections 6038A and 6038C. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return.

- Failing to file Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation. Taxpayers are required to report transfers of property to foreign corporations and other information under section 6038B. The penalty for failing to file each one of these information returns is 10% of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional.

Our Voluntary Disclosure team

Our team are happy to help with any queries you may have. For further information please contact:

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