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Changes to the Offshore Voluntary Disclosure Program

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Changes to the Offshore Voluntary Disclosure Program

Effective July 1, 2014, the IRS has made changes to its Offshore Voluntary Disclosure Program (“OVDP”), which affects both taxpayers who have offshore accounts that they have yet to disclose to the IRS, as well as those taxpayers that have already entered the OVDP and, because of their circumstances, may qualify in asking for examination under the new 2014 Program. The IRS is allowing those taxpayers currently in OVDP that have not yet had a closing agreement (Form 906), and may benefit from the new OVDP procedures, to elect to have their case considered under the new 2014 Frequently Asked Questions (“FAQs”).¹ The request would need to be communicated in writing to the examiner assigned the case.

The 2014 OVDP Changes

The IRS has updated their OVDP FAQs for 2014 and has made some significant changes. First, it should be understood that this is not a new program. The IRS has only made modifications to the terms of the program. Therefore, this is now referred to as the “2014 OVDP” by the IRS. The following are the most significant changes made from the 2012 OVDP to the 2014 OVDP:²

- Beginning on August 4, 2014, if the taxpayer has or had a foreign account in a foreign financial institution that is now under investigation, or is cooperating with a government investigation (or taxpayer worked with any facilitator of these accounts that are under investigation) and the account is found before the taxpayer comes forward, a 50% penalty on the amount in such account or accounts will be assessed.
- Prior 2012 OVDP FAQ #17 and #18 have been replaced by modified options the IRS has in place called “Options Available for U.S. Taxpayers with Undisclosed Foreign Financial Assets” (“OVDP Options Available”). These four options will be discussed in more detail below.
- The reduced penalty structure under former 2012 OVDP FAQ #52 and 52 has been eliminated. Under these former 2012 OVDP FAQs, the required 27.5% offshore penalty that would apply to the highest aggregate balance of the foreign accounts for any year in the prior 8-year OVDP period was reduced to 5% or 12.5%, provided the taxpayer met certain conditions. The IRS has eliminated these reduced penalties since those taxpayers that would have qualified for such reduction will now qualify under one of the OVDP Options Available.
- Additional information is required for preclearance into the OVDP.
- The instructions for calculating the asset base to which the offshore penalty applies has been modified for clarity and consistency of application. Also modified are the required Offshore Voluntary Disclosure Letter and attachment.

¹See *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers*, at <http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers-2012-Revised>, at FAQ # 1.3.

²*Id.*, at FAQ #1.1.

- All account statements must be provided for all foreign financial accounts during the OVDP period, regardless of the account balances. (If these statements are voluminous, a CD or DVD submission is allowed.)
- It is now required that the penalty be paid at the time of submission.

Options Available For U.S. Taxpayers with Undisclosed Foreign Financial Assets

The most import of these changes is the four OVDP Options Available that have replaced several of the former 2012 OVDP FAQs. The IRS has provided these options in response to the biggest complaint of the OVDP so far: that the program is punishing those taxpayers who had no willful intent to defraud the government. Generally, these are taxpayers who are simply inexperienced in tax matters and were unaware that they had a reporting requirement of their foreign account holdings.

The following four OVDP Options Available³ to taxpayers is to penalize those taxpayers that have willfully undisclosed their foreign accounts, while providing alternative options outside of the OVDP to those taxpayers that can show their delinquency was non-willful.

Option 1: OVDP

The first option is the OVDP. This option is for those taxpayers who have willfully failed to report foreign financial assets and need to pay taxes, interest and penalties due for the prior 8 tax years (the OVDP period). Conduct is seen as “willful” when the taxpayer has known, or should have known, they had a filing requirement and purposely failed to report or pay taxes on their foreign income. This is usually found where a taxpayer is knowledgeable of the tax laws, or should have knowledge of the tax laws as a result of their professional background. Entering into the OVDP still protects this type of taxpayer from criminal prosecution and provides terms for resolving their civil tax and penalties. The biggest penalty of the OVDP still being the 27.5% offshore penalty applied to the highest aggregate value of the OVDP assets during the OVDP period.

Option 2: Streamline Filing Compliance Procedures

³See *Options Available for U.S. Taxpayers with Undisclosed Foreign Financial Assets* at <http://www.irs.gov/Individuals/International-Taxpayers/Options-Available-For-U-S--Taxpayers-with-Undisclosed-Foreign-Financial-Assets>

This option is for those taxpayers who have not reported the income associated with their accounts and need to amend their returns and pay their tax and penalty obligations. It applies to those taxpayers whose conduct was non-willful, or “innocent,” in not disclosing their foreign accounts. Usually this is a taxpayer who wanted to correct the error as soon as they became aware of the reporting requirements, but would be hit with OVDP penalties so high that most of their account balances would likely be taken by the IRS in penalties once they were done with the program. These taxpayers were likely to “quietly disclose” by submitting amended returns for the years in question to report the foreign income and pay taxes, interest, and penalties in accordance with the amended return filings. The problem with this quiet disclosure is the taxpayer could get audited and be subject to even more fines by not entering the OVDP in addition to the fact that they were not protected from criminal prosecution.

The IRS tried a “streamlined filing compliance procedure” as an alternative to prior OVDPs, but the issue was if you did not qualify for this streamlined procedure you could not then enter OVDP. Furthermore, the qualifications for entering this streamlined filing approach was so narrow that almost no one could qualify. The old qualifications were (1) the taxpayer had to be living outside of the U.S., (2) they did not owe more than \$1,500 in taxes, and (3) they needed to go through a “risk assessment” to see if they were considered a “low risk” taxpayer. Only those found to be “low risk” taxpayers would qualify to use this streamlined procedure.

In response to the complaint that too few taxpayers would meet the prior qualification, the IRS has now modified its streamline filing procedure, and has (1) extended eligibility to U.S. taxpayers living in the U.S., (2) eliminated the \$1,500 threshold, and (3) eliminated the risk assessment process.⁴ This is available only to individual taxpayers, but does include estates and trusts. However, the IRS has still put the limitation on the taxpayer using this streamlined procedure, will not be able to enter the OVDP later.

The taxpayer will use either a “Streamlined Foreign Offshore Procedure” for those living overseas, or a “Streamlined Domestic Offshore Procedure” for those living in the U.S. Both procedures require that the taxpayer submit amended returns; pay the applicable tax, interest and penalties on unreported income in accordance with amending these tax years; file all delinquent FBARs on FinCEN Form 114 (previously Form TD F 90-22.1) for those years; and submit a certified statement that the failure to report and pay taxes was due to non-willful conduct.

The IRS has stated they will process these submissions like they would any other amended return submitted to the IRS. These returns will not be subject to an IRS audit automatically, but the IRS cannot guarantee that these returns will not be audited. There is no protection from criminal prosecution if the IRS does audit the submission and finds that the failure to report was in fact willful.

Option 3: Delinquent FBAR Submission Procedures

⁴See *Streamlined Filing Compliance Procedures* at <http://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures>

This option is for those taxpayers who do not fall under the first two options because they have reported on their tax returns (and paid all associated taxes on) all foreign income associated with their foreign accounts, but have just failed to report these accounts using the FBAR forms (currently FinCEN Form 114, previously Form TD F 90-22.1). To qualify for using this option, the following must be true for the taxpayer:

- (1) Has not filed a required FBAR form
- (2) Is not under a civil examination or criminal investigation by the IRS, and
- (3) Has not already been contacted by the IRS about delinquent FBARs.⁵

If the above qualifications are met, the taxpayer should file the delinquent FBARs accordingly and include a statement explaining why the FBARs are filed late. All FBARs must be filed electronically on the FinCEN website and on the cover page of the electronic form they must select the reason for the late filing.

The IRS has stated they will not impose any penalties for the delinquent filings, as long as the income associated with those accounts have previously been correctly reported on the taxpayer's prior tax returns; the taxpayer has not been contacted by the IRS regarding the delinquent FBAR filings; and is currently under examination for the same reason. FBARs are not subject to audit, but the IRS warns that they may be selected for audit through the existing audit selection procedures for tax information returns.

Option 4: Delinquent International Information Return Submission Procedures

This option is for those taxpayers who do not fall under the first two options because they have reported on their tax returns (and paid all associated taxes on) all foreign income associated with the foreign companies they have interest in, but failed to provide international information returns with their tax returns in those years. To qualify for using this option, the following must be true for the taxpayer:

- (1) Has not filed one or more required international information returns,
- (2) Have reasonable cause for not timely filing the information returns,
- (3) Are not under a civil examination or a criminal investigation by the IRS, and
- (4) Have not already been contacted by the IRS about the delinquent information return.⁶

If the above qualifications are met, the taxpayer must file the delinquent information returns and provide a statement establishing all the facts of the reasonable cause for failure to file. The statement

⁵ See *Delinquent FBAR Submission Procedures* at <http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-FBAR-Submission-Procedures>

⁶ See *Delinquent International Information Return Submission Procedures* at <http://www.irs.gov/Individuals/International-Taxpayers/Delinquent-International-Information-Return-Submission-Procedures>

must also certify that any entity for which the information return is filed has not been engaged in tax evasion. Penalties may be assessed if this statement is not part of the submission (usually this is \$10,000 for each delinquent information return filing).

These delinquent information forms will need to be attached to an amended return (with the exception of Forms 3520 and 3520-A) and filed in accordance with the amended return. (Forms 3520 and 3520-A should be filed in accordance to those forms instructions.) A reasonable cause statement must be attached to each delinquent information return for which reasonable cause is being requested.

The submission of delinquent information returns with amended returns will not be automatically subject to audit, but the IRS warns that they may still be selected for audit through existing processes that are in place for information returns.

Final Thoughts

It seems that the IRS is making a concerted effort to provide options to those taxpayers that have “innocently” failed to disclose their foreign accounts or foreign interests and now want to correct this mistake. Modifying the streamlined procedures to offer an option outside of OVDP where penalties and interest are limited to that of an amended return, rather than additional offshore penalties of 27.5% of the highest balance of the foreign accounts in the OVDP period, is less burdensome to these innocent taxpayers and will likely entice more taxpayers to use this approach rather than try to “quietly disclose” and hope they never find an IRS notice in the mail. Even more appealing is the third and fourth options that will have not penalties associated with them if all associated taxes have previously been paid in the prior years and all that needs to be submitted is the delinquent informational filings of either the FBAR or international information form.

With the changes provided in the 2014 OVDP FAQs, the IRS has done what has been asked for since the program started: to truly penalize those who have willfully undisclosed their foreign accounts and foreign financial holdings and for those taxpayers whose non-disclosure was non-willful, have them be subject to fairer taxes and penalties.

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