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IRS Offshore Voluntary Disclosure Program

IRS Launches Third Offshore Voluntary Disclosure Program

SUMMARY

On January 9, 2012, the Internal Revenue Service (the “IRS”) issued a news release announcing that the IRS is opening a third Offshore Voluntary Disclosure Program (the “OVDP”) for taxpayers that come forward to report previously undisclosed foreign accounts, assets and income. The program is similar in structure to the recently closed 2011 Offshore Voluntary Disclosure Initiative (the “2011 OVDI”), but unlike the previous program, there is no set deadline for taxpayers to apply for the new program. Taxpayers coming forward under the OVDP will pay penalties under the 2011 OVDI structure, but taxpayers in the highest penalty category will face penalties of 27.5 percent, rather than 25 percent as under the 2011 OVDI. Taxpayers who applied for the 2011 OVDI after that program closed will be handled under the provisions of the new OVDP.

As under the previous offshore disclosure programs, the OVDP provides an opportunity for taxpayers to disclose unreported foreign accounts, assets and income with fewer penalties than might be applied without the program, while avoiding criminal prosecution. Previous offshore disclosure programs have also provided amnesty for taxpayers without unreported income that are delinquent in filing of Reports of Foreign Bank and Financial Accounts (“FBARs”) and information returns with regard to controlled foreign corporations or foreign trusts, and it appears the OVDP will also offer this amnesty. Further information and updated Frequently Asked Questions (“FAQs”) will soon be made available on the IRS website. The IRS news release further states that its voluntary disclosure programs and success in offshore enforcement have increased awareness of U.S. tax filing obligations, including awareness by dual citizens and others “who may be delinquent in filing, but owe no U.S. tax.” Accordingly, the IRS is currently developing procedures by which these taxpayers may come into compliance with U.S. tax law.

BACKGROUND

In February 2011, the IRS announced the 2011 OVDI, which provided a uniform penalty structure for taxpayers that voluntarily came forward to report previously undisclosed foreign accounts, assets and income.¹ The penalty structure was similar to, but provided for overall higher penalties than, the 2009 Offshore Voluntary Disclosure Program (the “2009 OVDP”). According to the IRS, taxpayers have made approximately 33,000 voluntary disclosures under either the 2009 OVDP or 2011 OVDI, and the IRS has collected \$4.4 billion from these taxpayers. This amount is expected to increase as the 2011 cases are processed; the IRS has closed approximately 95 percent of the cases under the 2009 OVDP, and \$3.4 billion of the total was collected under the 2009 OVDP.

According to the IRS, since the close of the 2011 OVDI in September 2011, hundreds of taxpayers have come forward to make voluntary disclosures. These taxpayers will be included in the new OVDP.

THIRD IRS OFFSHORE VOLUNTARY DISCLOSURE PROGRAM

The IRS has reopened the OVDP without providing many specific details, instead referring taxpayers to the 2011 OVDI. The IRS news release states that the program is similar to the 2011 OVDI in many ways, but lists “a few key differences.” One of these differences is that there is no deadline set for taxpayers to apply to the program, though the IRS could decide to end the program at any time. In addition, the IRS stated that the IRS could change the program terms at any point, including increasing the penalties applied under the program. The IRS news release states that more details will be available within the next month on the IRS website. The IRS will also update the offshore disclosure program FAQs.

Taxpayers participating in the OVDP, in addition to paying any taxes and interest due (including certain accuracy-related and delinquency penalties)², must pay an “offshore penalty” equal to 27.5 percent of the highest aggregate balance in foreign bank accounts and/or entities or the value of foreign assets during the look-back period covered by the voluntary disclosure.³ This look-back period is eight years. The IRS

¹ A detailed discussion of the 2011 OVDI can be found in the Sullivan & Cromwell LLP publication entitled “2011 Offshore Voluntary Disclosure Initiative” (February 9, 2011), which may be obtained by following the instructions at the end of this publication.

² The FAQ for the 2011 OVDI lists the following penalties, which, if applicable, must be paid in addition to the offshore penalty: (a) 20% accuracy-related penalties under IRC § 6662(a) on the full amount of the taxpayer’s underpayments of tax for all eight years, (b) failure to file penalties under IRC § 6651(a)(1), and (c) failure to pay penalties under IRC § 6651(a)(2).

³ According to the FAQ under the 2011 OVDI, this value encompasses “all of the taxpayer’s offshore holdings that are related in any way to tax non-compliance, regardless of the form of the taxpayer’s ownership or the character of the asset.” Tax non-compliance with regard to any asset includes both failure to report income from the assets and failure to pay U.S. tax that was due with respect to the funds used to acquire the asset. The value of foreign assets includes, for example, the value of a taxpayer’s interest in a foreign business, or if the entity is determined to be an alter ego of the taxpayer, the value of the taxpayer’s interest in the underlying assets of the business.

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news release states that the overall penalty structure for the new program is the same as the structure in the 2011 OVDI, except for the 27.5 percent penalty that applies to taxpayers who fail to qualify for a lower penalty. The highest “offshore penalty” under the 2011 OVDI was 25 percent.

Taxpayers in specific limited situations, such as foreign residents who were unaware they were U.S. citizens, or foreign residents who fulfilled the tax payment and reporting requirements of their country of residence and meet certain other requirements, or taxpayers who have specific types of limited contact with the account,⁴ will pay a 5 percent penalty. Taxpayers whose highest aggregate account balance in each of the eight years covered by the OVDP is less than \$75,000 will pay a 12.5 percent penalty.

The OVDP penalty structure applies in lieu of other applicable civil penalties, including penalties for failing to file an FBAR, penalties for failing to file information returns, and fraud penalties. The IRS has stated in past offshore disclosure programs that taxpayers who come in voluntarily under these programs can avoid criminal prosecution.

Based on the structure of past programs, taxpayers will not be required to pay more under the OVDP than they would be required to pay in tax, interest, and applicable penalties in the absence of the OVDP regime. However, under the 2011 OVDI regime that came to an end last year, for purposes of calculating the cap on the 2011 OVDI penalty amount, the amount to be paid in absence of the 2011 OVDI regime was calculated at the maximum amount of the relevant penalty, without taking into account factors that otherwise might have reduced the taxpayer’s penalty amount, such as reasonable cause for the violation, lack of willfulness, and other mitigation factors or circumstances. (Outside the OVDP regime, for example, it may be possible for a taxpayer to claim a reduced penalty applies because there was reasonable cause for the violation or the violation was not willful.) The IRS news release does not suggest that a change in the IRS’ position on calculating the cap under the OVDP will be forthcoming, but does suggest that a potential new regime may apply to dual citizens and others who may be delinquent in filing, but owe no U.S. tax. As under the prior programs, the news release indicates that taxpayers who feel that the OVDP penalty is disproportionate may opt to withdraw from the program and be examined under the regular, full-scope examination procedures.

⁴ Under the 2011 OVDI structure, taxpayers that meet four conditions may qualify for the 5 percent rate. These taxpayers are those who: (a) did not open the account or cause the account to be opened, (b) exercised minimal, infrequent contact with the account, (c) did not withdraw more than \$1,000 from the account in any year covered by the voluntary disclosure, except in the case of a withdrawal closing the account and transferring the funds to an account in the U.S., and (d) can establish that all applicable U.S. taxes have been paid on the funds deposited to the account (*i.e.*, where only account earnings have escaped U.S. taxation).

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The IRS website currently provides instructions for making an offshore voluntary disclosure under the 2011 OVDI previously in effect.⁵ In the news release, the IRS indicated that more details about the newly announced program will be available within the next month on their website, www.irs.gov, and that they will be updating the version of the FAQ currently appearing on that website and providing additional specifics on the newly announced program.

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⁵ <http://www.irs.gov/compliance/enforcement/article/0,,id=205909,00.html?portlet=108> (page last reviewed or updated December 19, 2011).

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CONTACTS

New York

James I. Black III	+1-212-558-3948	blackj@sullcrom.com
Charles T. Dowling	+1-212-558-3845	dowlingc@sullcrom.com
Andrew S. Mason	+1-212-558-3759	masona@sullcrom.com
Andrew P. Solomon	+1-212-558-3783	solomona@sullcrom.com
Zena M. Tamler	+1-212-558-1675	tamlerz@sullcrom.com
Basil P. Zirinis	+1-212-558-3848	zirinisb@sullcrom.com
Judith R. Fiorini	+1-212-558-4987	fiorinij@sullcrom.com
Adrienne D. Maxwell	+1-212-558-7919	maxwella@sullcrom.com

Washington, D.C.

Donald L. Korb	+1-202-956-7675	korbd@sullcrom.com
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London

S. Eric Wang	+44-20-7959-8411	wangs@sullcrom.com
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