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IRS Issues New Guidance for Offshore Voluntary Disclosures

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On March 13, 2018, the IRS announced that it would end its long-running Offshore Voluntary Disclosure Program ("OVDP") on September 28, 2018. With the closure of one of the IRS's most successful compliance enforcement programs, practitioners were anxious for the IRS to announce a new program to take its place. On November 20, 2018, the IRS issued a memorandum titled "Updated Voluntary Disclosure Practice," which announced new guidance for the way the IRS would process new voluntary disclosure applications made after the closure of the OVDP. The November memorandum provides some guidance and clarification for taxpayers and their professionals seeking to make a voluntary disclosure. However, as compared to the OVDP's guidance, which was very detailed and rigid, the November Memorandum is far less detailed and lacking in specificity. This lack of certainty will likely result in unpredictability, but may also allow for more flexibility.

Background

The IRS has a long-standing policy contained within its Internal Revenue Manual ("IRM") to not criminally prosecute those taxpayers who come forward and confess their tax sins before the IRS catches up with them. To qualify under this policy, a taxpayer must disclose his or her conduct before the IRS learns of it, cooperate with the IRS in determining the correct amount of tax due, and pay or make arrangements to pay the amount of tax, interest, and penalties determined to be due. This voluntary disclosure policy, however, only applies to income that is legally earned. Thus, unreported income from illegal conduct such as narcotics trafficking, embezzlement, money-laundering, and others, cannot be cleansed through an IRS voluntary disclosure. The mere failure to pay taxes, however, does not make otherwise legally obtained income illegal. Thus, a landlord who illegally (in violation of the tax laws) fails to report cash rent can come clean and avoid criminal prosecution by making a voluntary disclosure.

While a voluntary disclosure will allow a taxpayer to avoid criminal prosecution, a voluntary disclosure does not in itself provide any relief from the civil penalties that may be applicable to a taxpayer's conduct. Thus, taxpayers who make a voluntary disclosure under the IRM's voluntary disclosure policy are left with uncertainty as to the financial costs of doing so.

The OVDP

In an effort to address this uncertainty and the resulting lack of consistency, the IRS introduced the first iteration of the OVDP in March 2009. The OVDP combined the IRM's criminal voluntary disclosure policy with a civil penalty framework that provided certainty. Taxpayers who participated in the OVDP generally faced a predictable, but often rigid, outcome. Under the OVDP, a taxpayer was required to amend his income tax returns for eight years, and pay the tax due along with interest and a penalty equal to 20% of the additional tax due. In addition, the OVDP required taxpayers to pay either a 27.5% or 50% penalty (depending on whether the taxpayer held assets at certain foreign banks) based on the value of the taxpayer's foreign assets.

For most taxpayers, this penalty amounted to the largest portion of the OVDP's overall financial cost. This penalty applied to any noncompliant foreign asset. Thus, if a taxpayer owned a foreign rental property from which the taxpayer derived unreported income, the value of the property was subject to a penalty of either 27.5% or 50%. As would be expected, this penalty structure led to disproportionate results for some taxpayers, whereby a large penalty was imposed with respect to conduct that resulted only in minimal tax savings. For example, under the OVDP, a rental property that generated only minimal taxable income would still be subject to a penalty based on the value of the property.

The OVDP's rigid penalty structure, however, also meant predictability. Taxpayers who participated in the OVDP generally knew in advance what the OVDP would cost. The OVDP's penalty structure provided certainty and relief from the myriad of penalties that could otherwise apply to a taxpayer's noncompliant offshore activities. These benefits included avoiding the civil fraud penalty (75% of the tax due), penalties for failing to file Reports of Foreign Bank and Financial Accounts ("FBAR" or Form FinCEN 114) (up to 50% of the balance in the account for each year), penalties for failing to file International Information Returns (such as Forms 3520, 3520-A, and 5471), and the possibility that the IRS would pursue the taxpayer's tax liabilities for a period beyond the OVDP's eight-year look-back period.

Judging by the OVDP's success, its rigid but predictable formula was the right panacea for the times. The timing of the OVDP overlapped with the timing of the IRS's and Department of Justice's very public attack on secret offshore banking, in particular, banks in secrecy jurisdictions, such as Switzerland. During this time period, many taxpayers needed to come forward and disclose tax noncompliance stemming from the ownership of unreported foreign bank accounts. Early on, the IRS correctly determined that a fixed and predictable OVDP was the best option because it provided certainty for taxpayers and allowed for simplified administration of those disclosures. The IRS was right, and it attracted more than 56,000 disclosures, collecting over $11.1 billion in taxes, interest, and penalties through the OVDP.

The OVDP's rigidity was partly mitigated in 2014, when the IRS announced the Streamlined Compliance Procedures, the Delinquent International Information Return Submission Procedures, and the Delinquent FBAR Submission Procedures. These newer offshoots of the

OVDP, which, unlike the OVDP, remain open to taxpayers, can be used by taxpayers whose conduct was not willful and whose noncompliance stems from mistake or innocent lack of knowledge. Under these procedures, taxpayers can cure noncompliance with limited or no penalties. However, these programs do not provide protection from criminal prosecution and are thus not appropriate for taxpayers whose conduct could be deemed criminal.

At the height of the OVDP, 18,000 applications were received in a single year; by 2017, only 600 new applications were received. The IRS cited the decline in new applications as one of the reasons for closing the OVDP.

The New Voluntary Disclosure Guidance

On the surface, the new guidance issued in the November Memorandum seems intended to more harshly punish those who are only now coming forward with their noncompliance. But at the same time, the new guidance will allow for flexibility that was absent in the OVDP. For certain taxpayers, the terms of the new guidance may actually prove to be more favorable than the OVDP.

Under the new guidance, taxpayers seeking to make an offshore related voluntary disclosure generally will be required to correct their tax returns for the past six years. In addition, these taxpayers will be subject to “interest, and penalties under existing law and procedures.” The 75% civil fraud penalty under IRC Section 6663 and 6651(f), however, will only apply to the one tax year with the highest tax liability. The remaining five tax years will instead be subject to the ordinary accuracy penalty, which, for offshore income, will generally be 40%. As is typical of the new guidance, this result is not an absolute certainty, as the guidance notes that in limited circumstances the fraud penalty may be applied to multiple years.

Moving on to the FBAR penalty, the November memorandum provides that FBAR penalties will be applied in accordance with the IRS’s existing guidelines, which generally cap willful FBAR penalties at 50%, but allow for a 100% FBAR penalty in certain circumstances. With respect to the penalties that may apply for the failure to file Foreign Information Returns (such as IRS Forms 3520, 3520-A, 5471, and 8938), which often arise in the context of an offshore voluntary disclosure, the memorandum notes that such penalties will not be “automatically” assessed. Rather, “[e]xaminer discretion will take into account the application of other penalties (such as civil fraud penalty and willful FBAR penalty) and resolve the examination by agreement.” Again, this language indicates flexibility. Information return penalties, which can apply for each year and for each entity that was not reported, can add a significant sum to the total cost of making a voluntary disclosure. Under the OVDP, these penalties were all eliminated in exchange for its one-size-fits-all approach.

For most taxpayers, the flexibility of the new guidance will likely result in an overall increase to the cost of making a voluntary disclosure. This was likely the intent of the IRS as it would be deemed unfair to impose a lower cost on those whose noncompliance has continued despite the OVDP’s near ten-year existence. However, this increased flexibility may ultimately work to address some of the shortcomings of the otherwise successful OVDP, which mainly stemmed from the rigidity of its penalty structure. Take, for example, the taxpayer noted above who entered the OVDP to disclose a small amount of rental income from a foreign property. Under the OVDP, the full value of the property was subject to a penalty, and examiners had no discretion to mitigate that penalty, even if the income from the property was minimal. Under the new guidance, only the tax liability at issue would be subject to a penalty. Similarly, under the OVDP, examiners had no discretion to exclude certain bank accounts from the OVDP's penalty base, even if the circumstances surrounding one account were different than the circumstances surrounding other foreign accounts held by the taxpayer. Under the new guidance, a taxpayer may be subject to a large willful FBAR penalty for any foreign accounts that were willfully not reported, but can seek leniency with respect to any accounts where the noncompliance was not willful.

Conclusion

In issuing new guidance for the voluntary disclosure of offshore matters, the IRS is sending a clear message that the door remains open for those taxpayers looking to come clean. The IRS and the DOJ have also made clear that they will continue seeking out, penalizing, and, if appropriate, prosecuting taxpayers who continue to hold noncompliant offshore assets. Taxpayers and their advisors need to carefully consider all options available to a taxpayer with prior noncompliance. Taxpayers whose conduct may result in criminal prosecution should utilize the new voluntary disclosure guidance. However, other options including the Streamlined Compliance Procedures and the Delinquent Submission Procedures, may be more appropriate for those taxpayers who simply made a mistake and have not engaged in any willful or criminal conduct.

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