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Walker**A guide to the IRS's new streamlined offshore compliance program**

The IRS makes major changes to its offshore disclosure procedures to encourage U.S. taxpayers with foreign financial assets to comply with their tax obligations.

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On June 18, the IRS announced major changes to its offshore voluntary compliance programs, providing new options to help taxpayers residing both overseas and in the United States. The changes are intended to give thousands of people a new avenue to comply with their U.S. tax obligations ([IR-2014-73](#)). Modifications were made in response to public comments that the existing program lacked a path to compliance for individuals whose failure to report offshore accounts was not willful.

Because taxpayers' non-U.S. investments vary widely, the IRS offers the following options for addressing previous failures to comply with U.S. tax and information return obligations:

1. The Offshore Voluntary Disclosure Program (OVDP);
2. Streamlined filing compliance procedures; and
3. Delinquent *Report of Foreign Bank and Financial Accounts* (FBAR) and delinquent international information return submission procedures.

Practitioners should be familiar with each of these options to effectively counsel clients as to which compliance path best fits the particular facts and circumstances of the case. Not every case is the same.

A key aspect is an expansion of the nonwillful certification program, referred to as the IRS streamlined filing compliance procedures. Under the expansion of the program, taxpayers residing in the United States whose failure to report foreign financial assets and pay all tax due on those assets was not the result of willful conduct are subject to only a 5% miscellaneous offshore penalty.

At the other end of the spectrum, taxpayers whose conduct was willful are directed to another path—the OVDP—where they pay a much higher 27.5% miscellaneous offshore penalty.

Notably, both paths are a one-way street. Once a taxpayer makes a submission under the streamlined program, the taxpayer may not participate in the OVDP (click [here](#) for further details). Likewise, a taxpayer who submits an OVDP voluntary disclosure letter on or after July 1, 2014, is not eligible to participate in the streamlined program. To avoid creating a bigger problem, taxpayers should choose their path to compliance wisely with the advice of competent tax counsel.

The IRS also made changes to its existing OVDP, which are highlighted below. In some cases, these modifications may make it more costly for certain taxpayers to become tax compliant.

Against this backdrop, the IRS states that it is continuing to work closely with the U.S. Department of Justice (DOJ) to investigate foreign financial institutions that may have assisted U.S. taxpayers in avoiding their tax filing and payment obligations (see [IR-2014-73](#)). U.S. taxpayers who fail to report their interest in financial accounts run the risk of substantial civil penalties and possibly criminal investigations. In addition, on July 1, when the new information reporting regime under the Foreign Account Tax Compliance Act (FATCA) went into effect, thousands of foreign financial institutions began to report to the IRS the foreign accounts U.S. persons held.

**U.S. income tax and reporting obligations**

The United States has strict income tax and reporting obligations for foreign financial accounts. U.S. citizens, lawful permanent residents, and individuals who are considered residents under the substantial presence test must:

- Report and pay tax on income earned from foreign financial accounts;
- Report on Schedule B, *Interest and Ordinary Dividends*, of Form 1040, *U.S. Individual Income Tax Return*, whether at any time during the year the person had a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country and the name of the foreign country where the account is located;
- File Form 8938, *Statement of Specified Foreign Financial Assets*, if the taxpayer holds specified foreign assets above certain thresholds, and other forms the taxpayer may be required to file, such as Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner (Under Section 6048(b))*; and
- File FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)* (formerly TD F 90-22.1), to report a financial interest in, or signature authority over, one or more financial accounts in a foreign country with an aggregate value of more than \$10,000 at any time during a particular year (see 31 C.F.R. §1010.350).

A trap for the unwary, the obligation to file an FBAR applies to a U.S. person, a term that includes not only citizens and residents, but also an entity, including but not limited to, a corporation, partnership, trust, or limited liability company (LLC) created, organized, or formed under the laws of the United States (31 C.F.R. §1010.350 (b); Sec. 7701(b)). Accordingly, a taxpayer may not escape the FBAR rules by forming, for example, an LLC that in turn owns a bank account in a foreign location such as Brazil or Hong Kong.

Taxpayers who fail to report foreign-source income and/or fail to report foreign financial assets may face civil penalties and possibly a criminal investigation.

### **IRS streamlined filing compliance procedures for U.S. taxpayers in the United States**

For the first time, the IRS has expanded the streamlined procedures to apply to U.S. taxpayers residing in the United States. Previously, the program was available only to nonresident nonfilers. Highlights of the new program are discussed below. Taxpayers and practitioners should consult the IRS website for more detailed information.

#### **Nonwillfulness certification**

At the heart of the streamlined procedures, taxpayers must certify that their failure to report foreign financial assets and pay all tax due was not the result of willful conduct (click [here](#) for further details). A taxpayer must complete and execute a certification form, [Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures](#).

The first step in determining whether a taxpayer is eligible to participate in the streamlined procedures is to ascertain whether the taxpayer's failure, including the failure to file an FBAR, was nonwillful. For these purposes, the IRS has [defined](#) "nonwillful conduct" as "conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law."

For failure to file FBARs, the analysis boils down to establishing knowledge of the law and evaluating indicators of willfulness (Internal Revenue Manual §4.26.7).

But what does willfulness mean? Willfulness in criminal tax cases generally means a voluntary, intentional violation of a known legal duty (*Cheek*, 498 U.S. 192 (1991)). The taxpayer does not have to have an improper motive or a bad purpose. All that is required is that the taxpayer knew of the duty and intended to violate it (*Pomponio*, 429 U.S. 10 (1976)).

While some taxpayers may believe that their conduct was nonwillful, certain cases may not be so clear. Willfulness means not only knowing violations, but reckless ones as well. For example, "[a] responsible person is reckless if he knew or should have known of a risk that the taxes were not being paid, had a reasonable opportunity to discover and remedy the problem, and yet failed to undertake reasonable efforts to ensure payment" (*Jenkins*, 101 Fed. Cl. 122, 134 (2011), *aff'd*, No. 2012-5019 (Fed. Cir. 2012)). "[W]illfulness has been found where 'the facts and circumstances of a particular case, taken as a whole, demonstrate' that the taxpayer 'knew or should have known that there was a risk [of noncompliance] and failed to take available corrective action,' with the result being the violation of the law" (*McBride*, 908 F. Supp. 2d 1186, 1209 (D. Utah 2012), citing *Jenkins* (citations omitted)).

Adding yet another layer of complexity to the question of whether a taxpayer willfully failed to file an FBAR or other return, "acting with 'willful blindness' to the obvious or known consequences of one's action also satisfies a willfulness requirement in both civil and criminal contexts" (*McBride*, 908 F. Supp. 2d at 1205, citing *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060 (2011)).

For example, “under the ‘willful blindness’ standard, a willfully blind defendant is one who takes deliberate actions to avoid confirming a high probability of wrongdoing and who can almost be said to have actually known the critical facts” (*McBride*, 908 F. Supp. at 1205, citing *Jewell*, 532 F.2d 697, 700 (9th Cir. 1976) (*en banc*)). Also, where a taxpayer makes a conscious effort to avoid learning about reporting requirements, evidence of this willful blindness is sufficient to establish willfulness (*McBride* at 1205, citing *Williams*, 489 Fed. Appx. 655 (4th Cir. 2012)).

In short, taxpayers with foreign accounts would be wise to retain competent tax counsel, who can ask the who, what, where, when, and why questions to better assess the taxpayers’ position. Whether a taxpayer’s conduct is nonwillful is a question of fact, and it turns on the taxpayer’s particular facts and circumstances.

### Additional points to consider

Taxpayers under a civil examination or criminal investigation are ineligible to use the streamlined procedures. The IRS had a procedure to request IRS Criminal Investigation clearance before a taxpayer submitted a voluntary disclosure, but the IRS modified the procedure to require additional information (e.g., identifying information of all financial institutions) (see IRS Offshore Voluntary Disclosure Program [Frequently Asked Questions and Answers](#), No. 23.)

The IRS states that tax returns submitted under the streamlined procedures will be processed like any other return. Receipt of the returns will not be acknowledged by the IRS and will not culminate in the signing of a closing agreement with the IRS. This means that a taxpayer will not know when the taxpayer submits the tax returns—and may never know—whether the IRS has accepted the taxpayer’s certification of nonwillfulness.

The tax returns will not be automatically subject to IRS audit, but they may be selected under existing selection processes for any U.S. tax return. Returns submitted through the program may also be subject to verification in that the accuracy and completeness of submissions may be checked against information received from banks, financial advisers, and other sources.

According to the IRS, taxpayers who are concerned that their failure to report income, pay tax, and submit required information returns was due to willful conduct and who therefore seek assurances that they will not be subject to criminal liability and/or substantial monetary penalties should consider participating in the OVDP and consult their professional tax or legal advisers.

A taxpayer who is eligible to use these streamlined domestic offshore procedures will be subject to only a 5% penalty and no accuracy-related penalties, information return penalties, or FBAR penalties. The new 5% penalty is substantially lower than the 27.5% penalty offered under the OVDP.

Even if returns properly filed under the streamlined procedures are subsequently selected for audit under existing audit selection processes, the taxpayer will not be subject to accuracy-related penalties for amounts reported on those returns, or to information return penalties or FBAR penalties, unless the examination results in a determination that the original return was fraudulent and/or that the FBAR violation was willful. Avoiding these penalties is a key benefit of the new program.

Finally, the streamlined domestic offshore procedures also apply to taxpayers seeking relief for failure to timely elect deferral of income from certain retirement or savings plans under an applicable treaty. An example of this is Canadian registered retirement plans, which do not receive tax deferred treatment in the United States absent a treaty election.

### The streamlined domestic offshore procedures

U.S. persons (defined above) who are eligible to use the streamlined domestic offshore procedures must:

1. **Amend tax returns.** For each of the most recent three years for which the U.S. tax return due date (or properly applied for extended due date) has passed, file amended tax returns, together with all required information returns (e.g., Forms 3520, 3520-A, 5471, 5472, 8938, 926, and 8621);
2. **FBARs.** For each of the most recent six years for which the FBAR due date has passed, file any delinquent FBARs;
3. **Certification.** Complete and sign a statement certifying (1) that the taxpayer is eligible for the program; (2) all required FBARs have been filed; (3) the failure to report all income, pay all tax, and submit all required information returns was nonwillful; and (4) the penalty amount included with the filing is accurate;

4. **Pay 5% penalty.** On the highest aggregate balance/value of the taxpayer's foreign financial assets (click [here](#) for a description of the assets subject to the penalty); and
5. **Pay tax and interest.** Pay all tax due on the tax returns plus statutory interest for each of the late payment amounts.

### **Streamlined foreign offshore procedures for U.S. taxpayers outside the United States**

Under the streamlined foreign offshore procedures for U.S. taxpayers residing outside the United States, besides the added requirement that a taxpayer be a nonresident, another significant difference between the two programs is that taxpayers under the foreign program do not pay a 5% penalty. As in the domestic program, taxpayers will not be subject to failure-to-file and failure-to-pay penalties, accuracy-related penalties, information return penalties, or FBAR penalties. For additional information, see the [IRS website](#) for that program.

### **Delinquent FBAR and delinquent international information return submission procedures**

Two other IRS compliance paths are procedures for (1) delinquent FBAR submissions and (2) delinquent international return submissions. According to the IRS, taxpayers who are not required to use either the streamlined filing compliance procedures or the OVDP to file delinquent or amended tax returns to report and pay any additional tax may use these procedures. The IRS states that it will not impose a penalty for the failure to file delinquent FBARs if the taxpayer has reported and paid tax on all income from the foreign financial accounts and the IRS has not contacted the taxpayer for the years for which the FBARs are submitted. (For additional information, see the IRS's "[Delinquent FBAR Submission Procedures](#)" webpage.)

### **Significant changes to the IRS OVDP**

Finally, it is important to mention that the IRS has made significant changes to the OVDP, which is now referred to as the "2014 Offshore Voluntary Disclosure Program." The changes are found on the IRS website in the IRS Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers, effective for OVDP submissions made on or after July 1, 2014. One key change is a new 50% offshore penalty that applies if either a foreign financial institution at which the taxpayer has or had an account, or a facilitator who helped the taxpayer establish or maintain an offshore arrangement, has been publicly identified as being under investigation or as cooperating with a government investigation. This new penalty likely changes the calculus for taxpayers with accounts (including closed accounts) at banks that are either cooperating with the DOJ or are under investigation.

### **Conclusion**

These expanded options for U.S. taxpayers underscore the IRS's continued enforcement efforts aimed at U.S. taxpayers who have unreported foreign-source income. Taxpayers with unfiled foreign bank account reports or unreported income from offshore accounts would be wise to seek the advice of competent tax counsel, who can evaluate the case, explain the options, and develop a defense strategy. Practitioners should be familiar with the new procedures so that they are prepared to advise clients how to solve these problems.

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