AMERICA'S NEW FOREIGN COMPLIANCE REGIME: *Will it be Worth its Weight in Gold?*

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WAYNE R. JOHNSON, TEP is managing principal of Wayne R. Johnson & Associates, PLC, a law firm located in Los Angeles. Wayne's practice is concentrated in the areas of domestic and international wealth planning, family business planning, and tax controversy matters. Wayne earned B.S. degrees in accounting, business finance and economics from North Dakota State University in 1989; a Juris Doctorate (with Distinction) from the University of North Dakota School of Law in 1994; and a Master of Laws degree (LL.M.) in Taxation Law from New York University School of Law in 1995.

Wayne is a member of the State Bar of California, admitted to practice before the U.S. Tax Court, the U.S. District Courts for the Central and Eastern Districts of California, and the Ninth Circuit Court of Appeals. He is also an active member of several bar associations, including the Taxation Section of the State Bar of California, which he chaired from 2008-2009, and the Society of Trust & Estate Practitioners.

Wayne is a member of the University of Southern California's Tax Institute (serving as both a Member of the Institute's Executive Committee and as chair of the Institute's Subcommittee on Individual Income Taxation from 2006-2009), and the International Estate Planning Commission of the Union Internationale des Avocats. Wayne has also served on the Planning Committee for the Tax Controversy Institute of the University of California at Los Angeles.

Law and Politics Magazine and the publishers of *Los Angeles Magazine* named Wayne a SuperLawyer in the field of taxation law from 2009 to 2011. Prior to that, these same publishers named Wayne a "Rising Star" among Southern California lawyers from 2004 to 2006 - a designation reserved for attorneys 40 years of age or under, or who have practiced law for 10 years or less, that have shown themselves to be among the very best in their field of expertise.

Wayne has been selected to receive the V. Judson Klein Award for 2011. The V. Judson Klein Award is presented annually by the Taxation Section of the California State Bar to an outstanding California attorney in mid-career for excellence in the field of taxation law, professionalism, leadership and contributions made to the Bar.

Wayne frequently writes and lectures on tax, business and estate planning matters. He has served as adjunct professor of tax law at Loyola Law School's Graduate Tax Program (Estate and Gift Taxation I), and serves as a member of the Graduate Tax Program's Board of Advisors. Wayne has also served as an adjunct professor of law at the Los Angeles campus of Golden Gate University's Graduate Tax Program (Corporate Taxation, Mergers and Acquisitions, Introduction to Foreign Taxation, Introduction to State and Local Taxation); and at Western State University College of Law (Taxation of Business Entities, Personal Finance for Lawyers).

Prior to practicing law, Wayne spent several years as a public accountant, and continues to regularly consult to regional and national accounting firms with regard to tax matters.

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I. THE PROJECT ON HIGH NET WORTH INDIVIDUALS – OECD Identifies a Problem

In January 2008, the Organisation for Economic Cooperation and Development (the "OECD") published a report entitled, Study into the Role of Tax Intermediaries (the "Study").[2] Although the Study focused on tax issues associated with large corporate taxpayers, it was noted during writing and review that the problems and concerns identified in relation to large corporate taxpayers might just as easily apply in the case of high net worth individuals ("HNWIs").[3] As a result of this observation, OECD's Forum on Tax Administration established a focus group[4] to perform a separate study on this group of taxpayers. The focus group issued its report, entitled, The OECD's Project on High Net Worth Individuals (the "HNWI Study"), on 31 December 2008.

In the HNWI Study, OECD noted that "Taxpayers at the top of the wealth or income scale make a significant economic contribution to society", generally accounting for the largest part of income tax revenues generated by member nations. In Germany, for instance, the top 5% of taxpayers pay 40% of taxes. That number increases to 60% for the top 5% of American taxpayers.

Because this segment of the international taxpaying population is so important to the FISC of many nations, OECD observed that tax administrators devote "significant resources" to this segment of the taxpaying population. They do so out of fear for the impact non-compliance by these individuals might have on the communities. To enhance compliance, the focus group recognized that tax administrations must work cooperatively with HNWIs. Because dialogue with HNWIs rarely occurs directly between tax administrators and taxpayers, the focus group recognized that any efforts made to enhance cooperation and communication must be directed through the intermediaries with whom HNWIs work, namely, attorneys, accountants, trustees, etc.

To aid tax administrators in their effort to more efficiently police HNWIs, the HNWI Study raised several topics for discussion, each of which was intended to enhance cooperative compliance among HNWI taxpayers. Among the questions posed were:

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[2] The report was presented to OECD's Forum on Tax Administration at the group's meeting in Cape Town, South Africa on 10-11 January 2008.
[3] HNWIs are defined as persons with investible assets exceeding US$1 million. Ultra-high net worth individuals are those individuals with assets in excess of US$30 million.
[4] The following 14 countries were members of the focus group: Australia, Canada, Ireland, Italy, France, Germany, Japan, Mexico, the Netherlands, New Zealand, Norway, South Africa, the United Kingdom and the United States of America.

1. *How a tax administrative body might be re-organized to more effectively deal with the HNWI segment?* For instance, would it be beneficial for tax administrators to establish units dedicated to HNWI issues?

2. *What type of framework might a tax administration adopt to encourage HNWIs and their advisors to be more transparent about their activities, and volunteer current, relevant and reliable information to tax authorities?* This question addressed two separate situations: one, in which the taxpayer planned themselves into a grey area of law (unclear whether their activities required reporting) and the second, a situation in which the taxpayer planned outside the law in hopes of going undetected. To address these types of taxpayers, the focus group noted the benefits governments might obtain through programs intended to draw voluntary disclosure from taxpayers and their advisors. By drawing the information out in this manner, tax administrators could secure relevant and reliable information from HNWI taxpayers without increasing the cost of enforcement. Moreover, a program of voluntary disclosure would allow taxpayers without the appetite for aggressive planning to come in from the cold, if you will. Finally, it would allow tax authorities to better understand the nature of structures used by HNWIs in planning for their tax affairs – all in the hopes of enacting future laws and regulations intended to eliminate such abusive planning.

3. *Would Establishment of Voluntary Disclosure Programs be Attractive to HNWI Taxpayers who Participated in Tax Avoidance/Evasion Schemes.* The focus group suggested that governments offer programs through which taxpayers who participated in tax avoidance or evasion schemes might voluntarily approach tax authorities to confess their wrong-doing and settle up. As carrots, tax authorities might offer reduced civil penalties, no criminal prosecution and certainty in the way items will be treated. The focus group noted, however, that for any such program to be successful, it must walk a fine line between providing proper incentives for compliance and rewarding non-compliance.

In addition to the foregoing, the OECD focus group encouraged tax administrators to continue sharing information among themselves. Moreover, the focus group encouraged administrators to pursue other strategies to combat non-compliance among HNWI taxpayers. Among the measures suggested were: mandatory disclosure rules, promoter penalties, enhanced civil and criminal penalties and additional reporting requirements.

In essence, the HNWI Study laid a framework for nations to begin more effectively administering tax compliance by HNWIs, and it is against this background that we examine the efforts made by the United States and California since December 2008.[5]

[5] In addition to the efforts made by the U.S. and California, it should be noted that many other countries have taken the types of action suggested by the HNWI Study. For instance, Australia, France, Great Britain, and several other nations have announced voluntary disclosure programs intended to promote disclosure of previously non-compliant tax arrangements. Moreover, several "bank secrecy" countries have entered into information sharing agreements that effectively destroy the bank secrecy benefits previously available to taxpayers under local law. Among the bank secrecy (or tax haven) nations that have entered information sharing arrangements are Cyprus, Hong Kong, Panama, and Switzerland, to name a few.

II. THE OBAMA ADMINISTRATION GOES TO WORK!

A. The 2009 Offshore Voluntary Disclosure Practice is Announced

> "The cross-border migration of capital and people has made this a more integrated world and we all need to ensure that we have the tax administration capabilities to deal with the fast pace of change. This is an area where there are a number of vexing issues without easy answers."[6]
>
> *IRS Commissioner Douglas Shulman, June 9, 2008*

On March 23, 2009, just one year after OECD issued the Study, and only three to five months after it issued the HNWI Study, IRS introduced its first formal effort to promote enhanced compliance among HNWIs – the 2009 Offshore Voluntary Disclosure Practice (the 2009 OVDP). IRS' objective in announcing this program was to bring taxpayers that used undisclosed foreign accounts and undisclosed foreign entities into compliance with United States tax laws. Information gathered by IRS from the 2009 OVDP would be used to further IRS's understanding of how foreign accounts and foreign entities are promoted to United States taxpayers as ways to avoid or evade tax. As one reads the stated objectives of IRS' 2009 OVDP, he can quickly recognize they are virtually identical to the objectives set forth in the HNWI Study.

More than 14,000 U.S. taxpayers participated in the 2009 OVDP. Several thousand more filings came in after the program ended on October 15, 2009. Although more than a year and a half has passed since the 2009 OVDP closed, many taxpayers are still making their way through the trenches.

Relatively few criminal prosecutions have been brought to date, but many cases remain under investigation. In the end, the 2009 OVDP served its purpose of bringing attention to this issue and securing compliance by many previously non-compliant taxpayers. But the effort didn't stop here

B. The Foreign Account Tax Compliance Act (FATCA) Becomes Law –

> "Now that the politicians have had their say, the Act will be passed over to the technical administrators who will understand the disastrous effects of trying to implement this within two-and-a-half years. A lot of banks simply will not be able to do business in the US and that would cause considerable damage to the US economy. I expect the implementation of the Act will probably end up closer to QI with the loopholes closed."[7]
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> *Martin Naville, chief executive of the Swiss-American Chamber of Commerce, March 19, 2010*

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6 Remarks of Douglas Shulman before the Federation of Tax Administrators on June 9, 2008.

7 *New US tax law could have "disastrous effects",* Swissinfo.ch (March 19, 2010).

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment Act (a/k/a the "HIRE Act") into law. Section 501 of the HIRE Act set forth the Foreign Account Tax Compliance Act (FATCA), which makes sweeping changes to the way in which foreign accounts and assets are withheld upon and reported for U.S. Tax purposes. Before it became law, IRS Commissioner Doug Shulman described FATCA as the "next big thing" in international tax compliance.[8]

FATCA accomplishes the President's objective of cracking down on tax havens by adding a new chapter 4 (sections 1471 – 1474) to subtitle A of the Internal Revenue Code. These sections create an extensive reporting and taxing regime for foreign financial institutions with U.S. account holders, and by expanding the reporting requirements applicable to U.S. taxpayers with assets overseas.

Among the more significant provisions of FATCA are the following:

1. <u>Withholding Required on Payments to Foreign Financial Institutions.</u>

   New Code Section 1471(a) provides that a 30% tax shall be imposed on any "withholdable payment"[9] made to a foreign financial institution. For these purposes, a "foreign financial institution" is any financial institution (an entity that accepts deposits in the ordinary course of its business or, as a substantial part of its business, holds financial assets for the account of others)[10] which is a foreign entity.

2. <u>Exception for Foreign Financial Institutions that Enter FFI Agreement</u>.

   The withholding tax required under Code Section 1471(a) will not apply to a financial institution that enters into an agreement with the Secretary (referred to as a "FFI Agreement") pursuant to which the financial institution agrees to:

   a. Obtain information needed to identify United States accounts (a financial account held by one or more United States persons or U.S. owned foreign entities)[11];

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[8] *Tax From the Top: Q&A with IRS Commissioner Doug Shulman*, JOURNAL OF ACCOUNTANCY, April 2010, page 16.

[9] Code Section 1473(1)(A) provides that, except as otherwise provided by the Secretary, a "withholdable payment" is —

> (i) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States, and
>
> (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.

[10] Code Section 1471(d)(5).

[11] The term United States account does not include any deposit account maintained by an individual if the total value of all such accounts maintained by the individual do not exceed $50,000.

b. Comply with such other verification and due diligence procedures as the Secretary may require for identification of U.S. accounts;

c. Annually report to IRS the name, address and TIN of each U.S. account holder, the account number, account balance/value and the gross receipts and withdrawals made from the account during the year (like the 1099 provisions, but broader). FFIs can also elect to be subject to the same reporting requirements as U.S. financial institutions. *Query: would that be better from the account holder's perspective?;*

d. Deduct and withhold a 30% tax for passthru payments made to recalcitrant account holders (those who won't comply with routine requests) and foreign financial institutions that have not entered a withholding agreement; and

e. Comply with such other requests for information as the Secretary may make.

Where local law precludes the sharing of bank information, Code Section 1471(b)(1)(F) requires the FFI to either obtain a "valid and effective" waiver of such laws from the U.S. account holder or close the account.

3. <u>Exception for FFIs that do not have U.S. Account Holders</u>.

Section 1471(a) is also not applicable to FFIs without U.S. account holders. *Query: how can a financial institution be certain that none of its account holders is a U.S. person or an entity in which a U.S. person has a substantial interest (generally speaking, a 10% interest in the corporation's or entity's equity or vote)?*

4. <u>Section 6038D – Reporting Foreign Financial Assets</u>.

Title II of FATCA introduces section 6038D to the Code. Under Section 6038D(a), any *individual* who, during the taxable year, holds any interest in a specified foreign financial asset must make a report thereon with his or her personal income tax return if the aggregate value of all such assets exceeds $50,000. For these purposes, a "specified foreign financial asset" means (i) any financial account, (ii) any stock or security issued by a foreign person, (iii) any instrument or contract that has a foreign person as a counterpart, and (iv) any interest in a foreign entity.[12]

a. For financial accounts, the taxpayer must report the name and address of the FFI at which the account is maintained, as well as the account number.

b. For stock or securities of a foreign issuer, the taxpayer must report the name and address of the foreign issuer as well as the class or type of security involved.

[12] A "foreign entity" is given the same meaning as that given for the term in Code Section 1473.

c. The taxpayer must also report the maximum value of the asset (regardless of type) during the taxable year.

d. A penalty of $10,000 will be imposed against any Taxpayers who, without reasonable cause, fails to make the information filing required by Section 6038D. This penalty can be increased to up to $50,000 where failure to report continues for more than 90 days after notification from the Secretary.

e. Section 6501(e) has also been amended to extend to six years the statute of limitations applicable to the assessment where the assessment exceeds $5,000 and results from the taxpayer's omission of assets from a required Section 6038D report.

f. Section 6662 has also been amended to permit assessment of an accuracy related penalty to failures to report under Code Section 6038D.

5. New Section 1298(f) – Annual Report of PFIC Shareholders.

   Section 513(b) of FATCA added a new Section 1298(f) to the Code, under which each person who is a shareholder of a passive foreign investment company (PFIC) must annually file an information report – the contents of which are to be later determined by the Secretary.

6. Foreign Trusts.

   FATCA also affected the treatment of foreign trusts for U.S. purposes. Under existing regulations, a foreign trust established by a U.S. grantor is presumed to be a grantor trust under Code Section 679. Additionally, the regulations create a rebuttable presumption that the trust has U.S. beneficiaries. FATCA amends Code Section 679 to codify these regulatory provisions.

7. 3520 Reporting – Increased Penalties.

   For Forms 3520 required to be filed after December 31, 2009, the penalty for failing to file is increased to the *greater* of $10,000 or 35% of the reportable amount. The penalty is subject to increase where the taxpayer fails to file Form 3520 after notice from the Secretary.

Although the full impact of these new rules will not be known until after December 31, 2012, when they go generally into effect, the impact of FATCA is likely to be far reaching – and, as the quotation above suggests, not everyone is happy about that!

On August 27, 2010, IRS issued *Notice 2010-60*[13] to provide preliminary guidance for public comment. Some interesting points are made in Notice 2010-60, in particular:

[13] 2010-37 IRB (August 27, 2010).

a. IRS reiterates its previously announced belief that cash value life insurance policies and annuities may present an opportunity for taxpayers to evade tax, then goes on to suggest that the definition of "financial account" is broad enough to encompass these types of instruments.

b. Treasury suggests that the definition of foreign financial institution is broad enough to include private trusts or private equity companies. Because the reporting burden of an FFI Agreement would be too great for these types of entities, IRS believes they should be treated as deemed-compliant FFIs under Code Sections 1471 and 1472.

c. CFCs should not be treated as deemed-compliant FFIs because the reporting requirements are more extensive under the new withholding rules.

d. IRS hasn't yet figured out the basis or frequency for determining account/asset values.

Consider the impact of this requirement on U.S. payors – after all, they will be required to determine whether foreign financial institutions are in compliance with the new withholding rules. Notice 2010-60 sets forth grandfathering rules, but the complexity is significant.

C. <u>HOLD YOUR HORSES! Treasury Delays FATCA's Implementation</u>

In light of FATCA's breadth and complexity, and in response to numerous comments received, Treasury issued Notice 2011-53 on July 14, 2011 to provide a revised timeline for FATCA's implementation. Under the Notice, Treasury announced that, to ensure adequate processing time, IRS will accept FFI applications from January 1, 2013 (the original implementation date) through June 30, 2013, though applications can be filed after the June 30 deadline. In any case, no withholding will be required for payments made to FFIs until January 1, 2014.

The effective date of FFI applications filed on or before June 30, 2013 will be July 1, 2013. The effective date of FFI applications filed after June 30, 2013 will be the date the FFI enters into the FFI. The effective date of the FFI agreement will be important because it will establish the time frame for due diligence reporting. For pre-existing private bank accounts having a value of $500,000 or more, due diligence procedures will need to be completed within one year of the FFI agreement's effective date. For private banking accounts having a value of less than $500,000, due diligence requirements must be met by the later of December 31, 2014 or one year from the FFI agreement effective date. For all other accounts, the due diligence requirements must be met within 2 years of the FFI agreement effective date. *Query: does this timeline incentivize FFIs to delay application?*

Where an FFI has received a Form W-9 from an account holder on or before June 30, 2014, the FFI must report the account as a U.S. account to IRS on or before September 30, 2014. First year reporting will be abbreviated, however, and include only:

a. the name, address and U.S. TIN for each U.S. account holder;

b. the account balance as of December 31, 2013 (if the account was closed before the effective date of the FFI agreement, the FFI need only report the closing balance); and

c. the account number.

With exception for payments made to pass-thru entities, withholding will be required on all payments made to FFIs on or after January 1, 2014. For passthru entities, withholding will commence on January 1, 2015.

Notwithstanding Treasury's apparent recognition of FATCA's complexity and the need for more time to implement this mammoth legal requirement, the criticisms of FATCA continue. According to Reuters, "FATCA has drawn criticism of the world's banks and business people, who dismiss it as imperialist and 'the neutron bomb of the global financial system'."[14] Governments and financial institutions throughout the world, including those of Australia, Canada, Hong Kong, and Switzerland, have criticized FATCA as a dramatic over reach. Some believe these criticisms are meeting their mark, and there now seems to be genuine belief that FATCAs implementation is jeopardized.

D. <u>LMSB Gets Restructured</u>

> "The realigned organization will let us focus on high-risk international compliance issues and handle these cases with greater consistency and efficiency as we continue to increase our work in this area."
>
> IRS Commissioner Doug Shulman, August 4, 2010.

On August 4, 2010, as part of its continuing effort to improve global tax administration efforts, IRS announced that it would be changing the focus of LMSB to include international tax compliance.[15] Commencing October 1, 2010, LMSB became known as the Large Business & International (LB&I) division.

The new LB&I organization enhances the current International program, adding about 875 employees to the existing staff of nearly 600. Most of the additional examiners, economists and technical staff are current employees who specialize on international issues within other parts of LMSB.

IRS initiated this realignment to strengthen its international tax compliance for individuals and corporations in several ways, including:

1. Identifying emerging international compliance issues more quickly;

2. Increasing international specialization among IRS staff by creating economies of scale and improving IRS international coordination; and

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[14] Terry Hayes, <u>Criticism of FATCA Laws comes from Australia, Hong Kong and elsewhere</u>, Vol. 3, No. 37 International Taxes Weekly Newsletter (September 13, 2011).
[15] IR-2010-88, August 4, 2010.

3. Centralizing and enhancing the IRS's focus on transfer pricing.

The new international unit will include a transfer pricing director, who will continue piloting the new transfer pricing practice, and a chief economist, who will oversee the IRS's economic positions pertaining to transfer pricing.

LB&I is also charged with overseeing the implementation of FATCA.

E. <u>2011 Offshore Voluntary Disclosure Initiative Announced</u>

From almost the moment the 2009 OVDP ended on October 15, 2009, rumors of a second initiative began to spread throughout the tax community. The truth of these rumors was confirmed when Commissioner Shulman announced in December 2010 that a second program was forthcoming.

On *February 8, 2011*, IRS announced the long awaited second offshore voluntary disclosure initiative (2011 OVDI). The objective of the 2011 OVDI remains the same as the one given for the 2009 OVDP, namely, "to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws." How will IRS accomplish this objective? The devil is in the details, and the details appear best described in the series of questions and answers, 53 in total, IRS issued in conjunction with the new program (hereafter referred to as the "2011 Q&A).

A detailed review of the 2011 Q&A reveals a great deal both about the new program and, maybe as importantly, the difficulties IRS encountered during its administration of the 2009 OVDP. From the description of the program objectives, to the questions of whether quiet or anonymous disclosures could be made, the answers given to comparable questions raised under each of the 2009 and 2011 OVDI are extremely helpful in shaping our understanding of the parameters of the new program. In many instances, the answers provided under the 2011 Q&A reveal the 2011 OVDI's boundaries are broader than those of the 2009 OVDP.

The 2011 OVDI covers tax years 2003 through 2010, inclusive and is available only to those taxpayers (and other similarly situated taxpayers) who come forward *and complete all requirements* on or before August 31, 2011.[16] Under the terms of the 2011 OVDI, to *complete all requirements*, the taxpayers must:

1. Provide copies of previously filed original (and, if applicable, previously filed amended) federal income tax returns for tax years covered by the voluntary disclosure;

2. Provide complete and accurate amended federal income tax returns (for individuals, Form 1040X, or original Form 1040 if delinquent) for all tax years covered by the voluntary disclosure, with applicable schedules detailing the amount and type of previously unreported income from the account or entity (e.g., Schedule B for interest and dividends,

[16] 2011 OVDI, FAQ No. 7.

Schedule D for capital gains and losses, Schedule E for income from partnerships, S corporations, estates or trusts);

3. File complete and accurate original or amended offshore-related information returns (see FAQ 29 for certain dissolved entities) and Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, commonly known as an "FBAR") for calendar years 2003 through 2010;

4. Cooperate in the voluntary disclosure process, including providing information on offshore financial accounts, institutions and facilitators, and signing agreements to extend the period of time for assessing tax and penalties;

5. Pay 20% accuracy-related penalties under IRC § 6662(a) on the full amount of your underpayments of tax for all years;

6. Pay failure to file penalties under IRC § 6651(a)(1), if applicable;

7. Pay failure to pay penalties under IRC § 6651(a)(2), if applicable;

8. Pay, in lieu of all other penalties that may apply, including FBAR and offshore-related information return penalties, a miscellaneous Title 26 offshore penalty, equal to 25% (or in limited cases 12.5% (see FAQ 53) or 5% (see FAQ 52)) of the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the period covered by the voluntary disclosure;

9. Submit full payment of all tax, interest, accuracy-related penalty, and, if applicable, the failure to file and failure to pay penalties with the required submissions set forth in FAQ 25 or make good faith arrangements with the IRS to pay in full, the tax, interest, and these penalties (see FAQ 20 for more information regarding a taxpayer's ability to fully pay) (the suspension of interest provisions of IRC § 6404(g) do not apply to interest due in this initiative); and

10. Execute a Closing Agreement on Final Determination Covering Specific Matters, Form 906.

WHEW!!! You need a recovery breath just to read that list.

So, what happens if the taxpayer can't complete all these requirements by the appointed deadline? Thankfully, IRS announced on June 2, 2011 that it would allow taxpayers to request up to a 90 day extension so long as "the taxpayer can demonstrate a good faith attempt to fully comply with FAQ 25 on or before August 31, 2011."[17] The good faith attempt to fully comply must include the properly completed and signed agreements to extend the period of time to assess tax (including tax penalties) and to assess FBAR penalties.[18] The request for extension must include "a statement of those items that are missing, the reasons why they are not included,

[17] 2011 OVDI, FAQ No. 25.1.
[18] Id.

and the steps taken to secure them."[19] Requests for extensions must be made in writing and sent to the Austin Campus on or before August 31, 2011.
When IRS announced the possibility of extensions under the 2011 OVDI, it also gave some examples of "opt out" scenarios that may be of particular benefit to taxpayers and advisors struggling with the question of whether continued participation in the program is beneficial. Rather than devote significant time to these examples, I refer the reader to Appendix 1 of these materials. There you will find a complete set of FAQs 49 through 51.3, which discuss the case resolution process. Of special interest to the taxpayer considering an opt out from the program are FAQs 51.1 through 51.3. These frequently asked questions provide examples of what might happen to the opting out taxpayer under different circumstances.

F. FINAL FBAR REGULATIONS ISSUED[20]

On February 23, 2011 issued final FBAR regulations under the Bank Secrecy Act. A detailed discussion of the new FBAR regulations is beyond the scope of this program, so I will only note for these purposes that the regulations:

1. became effective on March 28, 2011 and will generally apply to taxpayers required to file FBARs on or before June 30, 2011;

2. address the scope of FBAR filings, the nature of reportable accounts (including certain insurance and annuity products); and

3. provide additional rules intended to curtail circumvention of these rules. A copy of the amended regulations.

G. IS ANY OF THIS HAVING AN EFFECT?

So, what is the net effect of all this effort? Some believe the effect has been a positive one. About 14,000 taxpayers participated in IRS' 2009 disclosure offering, and many more must certainly have undertaken alternative reporting. Others doubt this is having the positive effect anticipate; and in fact, is generating a tsunami of financial backlash. American are now blackballed from opening financial accounts in other parts of the world. Virtually no financial institution in Europe will accept a U.S. customer, and HSBC recently announced that it was suspending private banking services outside the U.S. for American residents.

FFIs are also advising their clients not to invest in U.S. markets or securities due to the perceived aggression of U.S. Treasury officials. Whether foreigners are heeding this advice is unknown, but it should be noted that IRS recently announced the U.S. source income of foreign taxpayers

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[19] Id.
[20] The final FBAR regulations have been recodified and consolidated at 31 CFR Part 1010.

declined by 22% in 2009. If American's can't participate in the global financial markets, and foreigners won't invest here, can we say IRS' efforts are successful?

III. CALIFORNIA JOINS THE FRAY

Generally speaking, California residents are subject to taxation on their income, no matter the nature or source of the income. Prior to 2011, California had no voluntary disclosure program directed specifically at those of its residents who maintained undisclosed foreign accounts. The reason probably stemmed from the fact that any change made to the federal return of a California resident would also be required to be made on the tax returns filed with California for those same years. Notwithstanding the foregoing, because California does not conform to the federal subpart F rules, this won't be true in the case of taxpayers who held accounts through offshore corporations. Thus, some disparity exists between the manner in which disclosing taxpayers are treated under federal and state revenue laws.

To address this and other concerns, the California legislature adopted SB 86 on March 23, 2011 to, among other things:

> *Voluntary Compliance Initiative No. 2* - Article 3 of SB 86 requires Franchise Tax Board to develop, administer and conduct a second voluntary compliance initiative (VCI 2) the period from August 1, 2011, to October 31, 2011, inclusive, pursuant to R&TC Section 19764. VCI 2 applies to any taxpayer who, during the period from August 1, 2011, to October 31, 2011, makes an election as described in R&TC Section 19762 and does both of the following:
>
> d. Files an amended tax return for each taxable year for which the taxpayer has previously filed a tax return using an abusive tax avoidance transaction or an offshore financial arrangement to underreport the taxpayer's tax liability for that taxable year or failed to include income from the offshore financial arrangement[21]; and
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> e. Unless qualified to pay any understatement on installments,[22] pays the entire understatement plus interest in full.
>
> Each amended return shall report all income from all sources, without regard to the abusive tax avoidance transaction, including all income from offshore financial arrangements. No deduction shall be allowed for transaction costs associated with an abusive tax avoidance transaction or for transaction or other costs associated with unreported income from the tax liabilities attributable to taxpayer use of abusive tax avoidance transactions and unreported income from the use of offshore financial arrangements, as specified, for taxable years beginning before January 1, 2011.

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[21] For these purposes, an "offshore financial arrangement" means any transaction involving financial arrangements that in any manner rely on the use of offshore payment cards, including credit, debit, or charge cards, issued by banks in foreign jurisdictions or offshore financial arrangements, including arrangements with foreign banks, financial institutions, corporations, partnerships, trusts, or other entities to avoid or evade income or franchise tax."

[22] Final payment under the terms of the installment payment agreement must be paid no later than June 15, 2012.

For those taxpayers who elect to participate in VCI 2, FTB will waive or abate all penalties imposed by this part, for all taxable years where the taxpayer elects to participate in the initiative, as a result of the unreported tax liabilities attributable to the use of abusive tax avoidance transactions and to unreported income from the use of offshore financial arrangements. Moreover, no criminal action will generally be brought against the taxpayer for the taxable years with respect to issues for which the taxpayer voluntarily complies under this article.[23]

Financial Institution Record Match System – The bill adds new Section 19266 to the Revenue and Taxation Code, which requires FTB to establish and operate, in coordination with financial institutions doing business in this state, a Financial Institution Record Match System utilizing automated data exchanges to the maximum extent feasible. The purpose of this program is to provide FTB (and, presumably, other taxing authorities, with information needed to levy funds of delinquent California tax payers). If a financial institution fails to comply, it can be held responsible for the amount of tax FTB might have collected through compliance. Yet another reason for businesses to leave the tragically misguided confines of the California economy?

R&TC Section 6452.1 (Use Tax) is Amended to Impose Use Tax on Individual Taxpayers – Every person storing, using, or otherwise consuming in this state tangible personal property purchased from a retailer for storage, use, or other consumption in this state is liable for use tax, and must pay the use tax to the State Board of Equalization, unless that person has paid the use tax to a retailer registered to collect the tax. For taxable years beginning on or after January 1, 2011, individual taxpayers will be required to pay use tax on nonbusiness purchases of individual items of tangible personal property each with a sales price of less than $1,000. The tax can be paid either by estimating the amount of use tax due on the person's purchases (based as a percentage of the taxpayer’s adjusted gross income) or by paying the actual amount of use tax that was not paid to a registered retailer. The use tax will be paid with the taxpayer’s personal income tax return. What does one say about a statute of this sort? The reach and complexities are hard to justify, as are the appropriateness of the tax measure. Who among us keeps this sort of detail to ensure no more than the actual amount of use tax payable will be paid. Expect a good deal of activity in this area.

IV. RECENT DEVELOPMENTS OF NOTE

The past several months saw a number of notable developments in the international tax compliance arena. Some of the most notable of these are as follows:

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[23] Notwithstanding the foregoing, penalties imposed under Section 19138 or 19777.5 may not be waived. Additionally, no penalty assessed after July 31, 2011, may be waived or abated under this article if the penalty imposed is attributable to an assessment of taxes that became final prior to July 31, 2011. For purposes of this paragraph, assessment of taxes does not include taxes self-assessed on an original or amended return filed before August 1, 2011.

A. **FATCA Expansion:** On July 12, Senator Carl Levin (D-Mich.) introduced new legislation intended to extend FATCA reporting requirements to non-FFIs. The legislation would add a new subchapter to FATCA that would create rebuttable assumptions that: (1) a U.S. person who formed, transferred assets to, was a beneficiary of, or held a beneficial interest in or received money from a foreign entity that holds a foreign account was in control of the subject entity; and (2) that anything of value received by a U.S. person from a foreign entity that holds a foreign account constitutes income for the year of receipt. These presumptions could be raised only by *clear and convincing evidence.*

B. **The Fifth Amendment Privilege Doesn't Extend to Foreign Bank Records**: In M.H. v. United States (August 19, 2011), the Ninth Circuit Court of Appeals held that a taxpayer under grand jury investigation for maintaining undisclosed foreign accounts could not use the Fifth Amendment privilege against self-incrimination to avoid producing records related to the foreign account. Under the "required records doctrine" a taxpayer is required to produce records so long as (1) the purpose for the government's inquiry is regulatory, *not criminal*; (2) the information requested is of a type customarily kept; and (3) the records have public aspects. Here, the Court determined that the inquiry was a regulatory one – FBAR reporting, and the fact it might lead to criminal charges did not convert its nature. The Court also found the bank records sought – basic account information – to be of a nature customarily kept by bank account holders. Finally, the Court found the regulatory requirement that foreign bank records be kept for 5 years sufficient to meet the public aspect prong of the test. My understanding is this case has been appealed to the full Ninth Circuit. I'm also told of similar cases being argued back east. Look for more developments soon.

C. **Credit Suisse Becomes Bell of the Government's Ball**: On July 15, 2011, DOJ announced that it was investigating possible criminal wrong-doing at Swiss banker, Credit Suisse. On that same day, IRS indicted several current and former Credit Suisse employees, and others who had some connection to the bank, alleging they violated American tax and financial laws by providing unlicensed and unregistered banking services in the United States. Interestingly, the indictments were announced after continuing talks between the U.S. and Swiss governments broke down. Look for more indictments soon.

D. **Switzerland and U.K., Germany agree to Tax (Not Disclose) Undisclosed Accounts**: In August, 2011, the Swiss government announced it entered into tax agreements with the U.K. and Germany concerning undisclosed accounts located in that country. Both agreements call for withholding to be taken from earnings made on the undisclosed accounts, but no disclosure is generally required. For U.K. residents, withholding will be taken at the source with rates ranging from 27-48 percent (depending on the type of income earned). For German account holders, withholding rates will range from 19-34 percent (depending on the type of income earned). The Swiss/German compact also permits the German government to direct 750-999 requests in a two-year period. In neither case, are "fishing expeditions" allowed. This "fishing expedition" issue is precisely the point on which talks between the U.S. and Switzerland broke down. *Query: Why doesn't the U.S. take the money and shut the hell up?*

E. **Another Guilty Plea**: On August 3, 2011, a northern California man, Robert Greeley, plead guilty to filing a false income tax return. He maintained two foreign bank accounts at UBS between 2002 and 2008, the highest aggregate balance of which exceeded $13 million. Mr. Greeley agreed to pay $6.8 million and penalties.   Sentencing is pending. His former banker was promptly indicted.

APPENDIX 1

2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers

#	Questions	Answers
* * * **CASE RESOLUTION**		
49.	If the taxpayer and the IRS cannot agree to the terms of the 2011 OVDI closing agreement, will mediation with Appeals be an option with respect to the terms of the closing agreement?	No. The penalty framework and the agreement to limit tax exposure to years 2003 through 2010 are package terms under the 2011 OVDI. If any part of the offshore penalty is unacceptable to the taxpayer, the case will be examined and all applicable penalties will be imposed (see FAQ 51). After a full examination, any tax and penalties imposed by the Service on examination may be appealed, but the Service's decision on the terms of the 2011 OVDI closing agreement may not.
50.	Will examiners have any discretion to settle cases?	No. Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. However, because the 25 percent offshore penalty is a proxy for the FBAR penalty, other penalties imposed under the Internal Revenue Code, and potential liabilities for years prior to 2003, there may be cases where a taxpayer making a voluntary disclosure would owe less if the special offshore initiative did not exist. Under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for under the maximum penalties imposed under existing statutes. For example, if a taxpayer had $100,000 in an offshore bank account in only one year and foreign income-producing real estate with a fair market value of $1,000,000, only the bank account would be subject to the FBAR penalty. Consequently, the maximum FBAR penalty would only be $100,000 (that is, the greater of $100,000 or 50% of the amount in the foreign account), which is substantially less than the offshore penalty of $275,000 (25% of $1,100,000). If this FBAR penalty, plus tax, interest and all other applicable penalties, are less than what is due under this offshore initiative, the taxpayer will only pay the lesser amount. Examiners will compare the amount due under this offshore initiative to the tax, interest, and applicable penalties (at their maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability) for all open years that a taxpayer would owe in the absence of the 2011 OVDI penalty regime. The taxpayer will pay the lesser amount. If the taxpayer disagrees with the result, the taxpayer may request that the case be referred for an examination of all relevant years and issues (see FAQ 51).
51.	If, after making a voluntary disclosure, a taxpayer disagrees with the application of the offshore penalty,	If the offshore penalty is unacceptable to a taxpayer, that taxpayer must indicate in writing the decision to withdraw

	what can the taxpayer do?	from or opt out of the program. Once made, this election is irrevocable. An opt out is an election made by a taxpayer to have his or her case handled under the standard audit process. It should be recognized that in a given case, the opt out option may reflect a preferred approach. That is, there may be instances in which the results under the applicable voluntary disclosure program appear too severe given the facts of the case. There will be other instances where this is less clear. In the latter cases, the Service will look to ensure that the best interests of the Service and the integrity of the voluntary disclosure program remain intact. In these cases, it is expected that full scope examinations will occur if opt out is initiated. It is expected that opt out will be appropriate for a discrete minority of cases. Moreover, to the extent that issues are found upon a full scope examination that were not disclosed by the taxpayer, those issues may be the subject of review by Criminal Investigation. In either case, opting out is at the sole discretion of the taxpayer and the taxpayer should not be treated in a negative fashion merely because he or she chooses to opt out. The specific procedures for opting out are set forth in a separate guide titled Opt Out and Removal Guide for the 2009 OVDP and 2011 OVDI. The guide is posted to the website. Taxpayers are reminded, that even after opting out of the Service's civil settlement structure, they remain within Criminal Investigation's Voluntary Disclosure Practice. Therefore, taxpayers are still required to cooperate fully with the examiner by providing all requested information and records and must still pay or make arrangements to pay the tax, interest, and penalties they are ultimately determined to owe. If a taxpayer does not cooperate and make payment arrangements, or if after examination, issues exist that were not disclosed prior to opt out, the case may be referred back to Criminal Investigation.
51.1	Under what circumstances might a taxpayer consider opting out of the civil settlement structure of the 2011 OVDI?	The following scenarios are provided to illustrate the effect of a taxpayer opting out of the civil settlement structure. Opting out of the civil settlement structure does not affect the status of a taxpayer's voluntary disclosure under Criminal Investigation's Voluntary Disclosure Practice, so long as the taxpayer is fully cooperative in the examination process, by providing all requested foreign records and submitting to interviews, as requested, and as long as no new issues are uncovered that were previously not disclosed. The facts of each example were chosen to illustrate particular issues and do not represent a full analysis of a taxpayer's particular situation. Consequently, they may not be relied upon in dealing with any taxpayer's actual case. For all of the following examples, assume a 35% tax rate on all unreported income. *Example 1 – Unreported Income But No Tax Deficiency* The taxpayer, a U.S. citizen who worked and resided in Country A, had a brokerage account in Country A that he opened in 1999. The account had a high balance of $2

million and generated income of $150,000 each year. The taxpayer did not report any of the income on his U.S. return because he mistakenly assumed he only had to report it on a Country A tax return. The taxpayer's amended Form 1040 returns showed that, after applying the foreign tax credit for taxes paid to the government of Country A, he had no tax deficiency with respect to the unreported income. Because the taxpayer had unreported income, he does not qualify for FAQ 17. In addition, assume the taxpayer does not otherwise qualify for a reduced penalty under FAQ 52 or 53.

The Offshore Penalty under 2011 OVDI is $500,000 (i.e., 25% of $2 million), even though there was no tax owed to the U.S. Government and no other indication of wrongdoing.

If the taxpayer elected to opt out and, upon examination, IRS determined that the FBAR violation was not willful, he would be subject to an FBAR penalty of up to $10,000 per year ($60,000 total for six years). If IRS determines that the violation was due to reasonable cause (for example, the taxpayer reasonably acted on the written advice of an independent legal advisor after having disclosed the account to the advisor), the taxpayer would be subject to no FBAR penalty.

The penalty for a nonwillful failure to file an FBAR would apply with respect to FBARs that were due on or after June 30, 2005. For this example, this would include FBARs that were filed to report foreign financial accounts maintained during calendar years 2004 through 2009.

	Civil Settlement Structure	Opt out and 6 years nonwillful FBAR penalty
Income Tax Due (not including interest)	0	0
20% Accuracy-related penalty	0	0
25% Offshore Penalty	$500,000	0
FBAR Penalty	0	$60,000
Total	$500,000	$60,000

Example 2 - Unreported Income and Failure to File FBAR

The taxpayer is a U.S. citizen, who lived abroad in 2007, 2008 and 2009. While living abroad, the taxpayer opened an account in 2007 with a bank located in Country X. Assume that the highest account balance during the three years (2007, 2008 and 2009) was $200,000. The taxpayer filed U.S. income tax returns for all years but only filed an

FBAR for 2008 and 2009, not for 2007. The taxpayer was unaware of his FBAR filing obligation until having his return professionally prepared in 2008. The taxpayer failed to report approximately $2,000 of interest income from the account, and, is therefore, unable to simply file a delinquent FBAR for 2007 as provided in FAQ 17. The tax deficiency was $700. In addition, assume the taxpayer does not otherwise qualify for a reduced penalty under FAQ 52 or 53.

The Offshore Penalty under 2011 OVDI will be $50,000 (i.e., 25% of $200,000). The taxpayer would also be required to pay the tax deficiency for each year, interest on the deficiency, and the 20% accuracy-related penalty on the deficiency.

If the taxpayer elected to opt out, the taxpayer will be subject to tax, penalties, and interest on the unreported income and, if, upon examination, IRS determines that the failure to file the FBAR was not willful, the taxpayer will be subject to a non-willful FBAR penalty of no more than $10,000 for failing to file an FBAR for 2007. If IRS determines that the FBAR violation was due to reasonable cause, then no FBAR penalty will be imposed.

	Civil Settlement Structure	Opt out and 1 year nonwillful FBAR penalty	Opt out and assume the civil fraud penalty applied
Income Tax Due (not including interest)	$700	$700	$700
20% Accuracy-related penalty	$140	$140	0
25% Offshore Penalty	$50,000	0	0
Civil Fraud Penalty	0	0	$525
FBAR Penalty	0	$10,000	$10,000
Total	$50,840	$10,840	$11,225

Example 3 - Unreported Controlled Foreign Corporation

The taxpayer, a U.S. citizen who lives in the United States, owns a 100% interest in a foreign corporation that has substantial operations in Country A and a foreign bank account. The foreign corporation is not required to file an FBAR and does not file one. The taxpayer also has signature authority over the foreign bank account. The taxpayer did not file an FBAR to report his financial interest in, or signature authority over, the foreign bank account of the corporation that he controls. The interest income earned on the foreign account was $5,000 for each year. The tax deficiency for each year was $1,750. The balance in the foreign bank account during the calendar years 2003 through 2010 was a constant $1 million. The value of the taxpayer's controlling interest in the foreign corporation is determined to be $100 million (including the value of the $1 million foreign bank account).

The taxpayer did not file a Form 5471 to report his interest in the controlled foreign corporation. Instead, he wrongly treated the foreign corporation as a disregarded entity and reported the corporation's income on a Schedule C. The income he reported from the foreign corporation did not include interest income earned on the corporation's foreign bank account. Otherwise, the individual was fully compliant in reporting all other taxable income, including income from the controlled foreign corporation. The statute of limitations for assessing tax and tax penalties with respect to the controlled foreign corporation remained open under IRC § 6501(c)(8) because the Form 5471 was not filed.

	Civil Settlement Structure	Opt out and 6 years of the § 6038(a) penalty plus 6 years of the FBAR nonwillful penalty	Assume the civil fraud penalty applied for six years and the FBAR willful penalty applied for 6 years
Income Tax Due (not including interest)	$14,000	$14,000	$14,000
20% Accuracy-related penalty	$2,800	$2,800	0
25% Offshore Penalty	$25,000,000	0	0
§ 6038(a) Penalty	0	$60,000	$60,000
Civil Fraud Penalty	0	0	$10,500
FBAR Penalty	0	$60,000	$3,000,000
Total	$25,016,800	$136,800	$3,084,500

51.2	Under what circumstances might opting out of the civil settlement structure of the 2011 OVDI be a disadvantage for the taxpayer? Total	The following scenarios are provided to illustrate the effect of a taxpayer opting out of the civil settlement structure. Opting out of the civil settlement structure does not affect the status of a taxpayer's voluntary disclosure under Criminal Investigation's Voluntary Disclosure Practice, so long as the taxpayer is fully cooperative in the examination process, by providing all requested foreign records and submitting to interviews, as requested, and as long as no new issues are uncovered that were previously not disclosed. The facts of each example were chosen to illustrate particular issues and do not represent a full analysis of a taxpayer's particular situation. Consequently, they may not be relied upon in dealing with any taxpayer's actual case. For all of the following examples, assume a 35% tax rate on all unreported income. *Example 4 - Large Unreported Gain* The taxpayer, a U.S. citizen, opened a bank account in Country A in 2008 with funds upon which U.S. taxes were paid. The taxpayer discloses that he had failed to report the sale, in 2008, of an apartment building in Country A that he owned. The apartment building was valued at $10 million and the taxpayer's unreported gain on the sale was $6 million. The related tax deficiency was $2,100,000. The taxpayer deposited the entire $10 million in the checking account with the foreign bank and, the next day, transferred the funds to his bank account in the U.S. The apartment building that was sold was held in a foreign trust that was a grantor trust (with the taxpayer as the grantor). The taxpayer established the trust in 2008, just prior to the sale of the apartment building, and transferred the building to the trust. The taxpayer did not file a Form 3520 to report the creation of the trust and the transfer of property. The Offshore Penalty under 2011 OVDI will be $2,500,000 (i.e., 25% of $10 million). The taxpayer would also be required to pay the $2,100,000 tax deficiency, interest, and a 20% accuracy-related penalty. A 20% penalty on a $2,100,000 deficiency is $420,000. If the taxpayer elected to opt out, he could face an FBAR penalty with respect to the 2008 calendar year of $5,000,000 (i.e., a 50% willful FBAR penalty on the checking account, which included $10 million in sale proceeds). Taxpayer will also owe tax, penalties, and interest with respect to the $2,100,000 deficiency. The taxpayer would also be subject to FBAR penalties for all other open years, if the aggregate balance in the checking account exceeded $10,000 during each year. Upon examination, the revenue agent may determine that the nonreporting was due to fraud. In that case, the civil fraud penalty on the $2.1 million tax deficiency attributable to fraud would be $1,575,000 (i.e., 75% of $2,100,000). The IRC § 6677 penalty for failing to file the Form 3520 information return would be an additional $3.5 million (i.e., 35% of $10 million).

	Civil Settlement Structure	Opt out and 1 year willful FBAR penalty	Opt out and assume the civil fraud penalty applied
Income Tax Due (not including interest)	$2,100,000	$2,100,000	$2,100,000
20% Accuracy-related penalty	$420,000	$420,000	0
25% Offshore Penalty	$2,500,000	0	0
Civil Fraud Penalty	0	0	$1,575,000
§ 6677 Penalty	0	$3,500,000	$3,500,000
FBAR Penalty	0	$5,000,000	$5,000,000
Total	$5,020,000	$11,020,000	$12,175,000

Example 5 – Civil Fraud Penalty Warranted

In 2002, Taxpayer sold a building located in Country X for $400,000 short term capital gain, which he intentionally failed to report on his 2002 Form 1040. Assume the taxpayer's basis in the building was zero. He deposited the sales proceeds in an offshore account with a bank located in Country Y. The account with the bank in Country Y is in the name of a trust the taxpayer established in Country Z in 2000. The account earned $12,000 in interest each year from 2003 through 2010. The taxpayer closed the account with the bank in Country Y in 2010 and brought the funds back into the United States, disguising the funds as a loan from an allegedly unrelated entity.

The highest balance in the foreign account was $496,000. The Offshore Penalty under 2011 OVDI is $124,000 (i.e., 25% of $496,000). The total of the tax deficiencies for the years 2002 through 2010 was $173,600. This consisted of a tax deficiency of $140,000 for the 2002 year (for the unreported gain of $400,000) and a total of $33,600 for the tax years 2003 through 2010 (for the unreported interest income). The 75% civil fraud penalty would otherwise apply with respect to the related tax deficiencies. There is no statute of limitations for assessments of tax attributable to fraud.

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The total of the IRC § 6677 penalty for failing to file a Form 3520 to report the $400,000 transfer to the account (35% of $400,000) and the failure to file Forms 3520-A (5% of the $400,000 plus the interest income added each year) was $495,200.
The statute of limitations for assessing FBAR penalties for willful violations in each year is open for the 2004 through 2010 calendar years. The total amount of willful FBAR penalties that may be assessed is $1,362,000 (50% of the balance in the account for each year, including the $12,000 in interest income added to the account each year).
<table>
<tr><td></td><td>Civil Settlement Structure</td><td>Opt out and 8 years § 6677 penalty and 6 years FBAR Penalty</td></tr>
<tr><td>Income Tax Due (not including interest)</td><td>$33,600</td><td>$173,600</td></tr>
<tr><td>75% Civil Fraud Penalty</td><td>0</td><td>$130,200</td></tr>
<tr><td>20% Accuracy Related Penalty</td><td>$5,040</td><td>0</td></tr>
<tr><td>25% Offshore Penalty</td><td>$118,000</td><td>0</td></tr>
<tr><td>§ 6677 Penalty</td><td>0</td><td>$495,200</td></tr>
<tr><td>FBAR Penalty</td><td>0</td><td>$1,362,000</td></tr>
<tr><td>Total</td><td>$156,640</td><td>$2,161,000</td></tr>
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<td>51.3</td>
<td>If I opt out of the 2011 OVDI and undergo a regular examination, is there a chance my case could be referred back to Criminal Investigation for penalties or prosecution?</td>
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Yes. Criminal Investigation’s Voluntary Disclosure Practice provides a recommendation that you not be prosecuted for violations up to the date of your disclosure. If your disclosure is ultimately determined to have not been complete, accurate, and truthful, or if you commit a crime after the date of your voluntary disclosure, you are subject to penalties and prosecution. The facts of the example were chosen to illustrate particular issues and do not represent a full analysis of a taxpayer’s particular situation. Consequently, the example may not be relied upon in dealing with any taxpayer’s actual case. For the following example, assume a 35% tax rate on all unreported income.
Example 6 - IRS Learns of Unreported Income and False Statements After Opt Out
Taxpayer made a voluntary disclosure for tax years 2003 through 2010 under the 2011 OVDI to report a foreign bank account he opened while working outside the United States. The highest aggregate balance in the account was $1,000,000. The account earned a total of $350,000 over the 8 years that was not reported on his tax returns.
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On his voluntary disclosure application, the taxpayer stated that he worked full-time overseas as a consultant from 1989 through 1999, but he had to return to the United States permanently after a medical condition prevented him from continuing to work. He stated that he currently lives on his savings from the foreign account and a small disability pension.

The taxpayer elected to opt out of the 2011 OVDI because he believed the total tax, interest, and penalties were too high. Particularly, the taxpayer stated that the $250,000 offshore penalty (25% of $1,000,000) was too severe. He would rather take his chances being audited so he could argue reasonable cause and that he did not willfully fail to file the FBARs.

The assigned examiner placed tax years 2003 through 2010 under regular examination. As part of the examination, the examiner performed the gross income tests required by the Internal Revenue Manual. The analysis disclosed that the income reported by the taxpayer from 2003 through 2010 was much less than his expenditures during the same period. The examiner's analysis disclosed that over the 8 year period, the taxpayer spent approximately $750,000, roughly $50,000 per year more than he earned during the same period.

When the examiner asked the taxpayer how he was able to support himself, the taxpayer stated that because he was unable to be gainfully employed due to his medical condition, he received gifts and help from family members and friends. He could not, however, provide any proof of the gifts or even recall the names of the family members and friends who helped him.

Ultimately, through third-party contacts the examiner located a business owner for whom the taxpayer performed consulting services. The business owner admitted that he paid the taxpayer approximately $50,000 a year "under the table."

Due to the pattern of significant amounts of unreported income over an 8 year period and the false statements made by the taxpayer in his application and to the examiner, the case could be referred to Criminal Investigation for investigation and possible prosecution and assertion of the civil fraud penalty.

The income tax due is computed on the unreported offshore interest income ($350,000) and the unreported wages ($400,000). $750,000 at a 35% tax rate = $262,500	Civil Settlement Structure assuming the taxpayer had voluntarily disclosed all unreported income [1]	Opt out and the civil fraud penalty and willful FBAR applied

	Income Tax Due (not including interest)	$262,500	$262,500
	20% Accuracy-related penalty	$24,500	0
	25% Offshore Penalty	$250,000	0
	Civil Fraud Penalty [2]	$105,00	$196,875
	FBAR Penalty ($500,000/yr 2004-2009)	0	$3,00,000
	Total	$642,000	$3,459,375

Footnotes for answer 51.3:

[1] It is assumed that the "under the table" income was reported on the properly prepared amended returns as required by the terms of the OVDI.

[2] Civil fraud penalty computed on "under the table" income in OVDI and on all unreported income after opt out.