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FINANCIAL ADVISORY SUPPORT

2011 Offshore Voluntary Disclosure Program for U.S. Taxpayers

The August 31, 2011 deadline now extended to September 9

The U.S. government and the Internal Revenue Service (IRS) have increased their focus on U.S. citizens and U.S. green card holders (referred to in this article as U.S. taxpayers) that fail to file U.S. federal income tax returns and other information returns and disclosures related to offshore income and assets. There are about seven million U.S. taxpayers that live and work abroad and only about 6.6% of them actually file U.S. income tax returns on an annual basis. The U.S. government estimated in 2008 that it loses US$100 billion of tax revenue annually due to offshore tax abuse and non-compliance with U.S. tax reporting requirements.

Due to the significant number of U.S. taxpayers that do not file, the IRS announced on February 8, 2011, a new ***2011 Offshore Voluntary Disclosure Program (2011 OVDP)*** *aimed to provide encouragement through amnesty to U.S. taxpayers who resolve their U.S. filing and offshore disclosure obligations. This program is the second initiative of the IRS to obtain voluntary disclosure, the first initiative (2009 OVDP) closed in October of 2009.*

The content of this article is intended to provide a general guide for U.S. taxpayers, including U.S. citizens and U.S. green card holders, regarding the subject matter. U.S. taxpayers who are not compliant with their U.S. filing obligations should consult with a qualified professional to determine whether they are eligible to participate in the 2011 OVDP, and whether it would be appropriate for them to submit a voluntary disclosure based on their particular circumstances. This article is for information only and is not intended to be legal or tax advice.

U.S. filing obligations

Many U.S. taxpayers abroad are unaware of their filing obligations and others have chosen to ignore them for various reasons.

U.S. citizens and U.S. green card holders are required to file U.S. federal income tax returns annually (regardless of where they live in the world) when their gross worldwide income exceeds a few thousand dollars. A U.S. taxpayer resident in Canada may not actually have a U.S. income tax liability if their Canadian tax liability exceeds their U.S. tax otherwise payable since they may be able to claim foreign tax credits and the U.S. "foreign earned income exclusion" on their U.S. tax return.

In these circumstances the filing of a U.S. income tax return may appear to be an administrative burden for U.S. taxpayers but the filing is still necessary. U.S. taxpayers with offshore bank or financial accounts or interests in foreign entities may also be required to file information returns and disclosures. There may be substantial penalties, and in some cases criminal proceedings associated with failing to file U.S. income tax returns, information returns and other disclosures. The more years a U.S. taxpayer neglects to make the necessary filings the more overwhelming it may seem to consider the possible tax, penalties and interest involved in "coming clean" and facing the IRS. The IRS hopes the features of the 2011 OVDP will encourage compliance.

2011 Offshore Voluntary Disclosure Program (2011 OVDP)

Below are the main features of the 2011 OVDP for U.S. taxpayers:

1. A U.S. taxpayer must file any delinquent or amended income tax returns with the IRS, including all required foreign information filings, for an entire eight year look back period (2003 through 2010) by no later than August 31, 2011 (now September 9). Changes to the 2011 OVDP announced on June 2, 2011 include the ability for U.S. taxpayers to obtain a 90 day extension if they can provide evidence that they tried to fully comply with the August 31 deadline (now September 9).
2. The 2011 OVDP allows U.S. taxpayers to face a predictable level of additional tax and penalties, including:
    a. Any U.S. income tax liability determined from preparing eight years worth of personal income tax returns (from 2010 back to 2003) must be paid to the IRS, including interest, and any failure to file and failure to pay penalties.
    b. There is a 20 percent **accuracy-related penalty or delinquency penalty** on the amount of any U.S. income tax liability that should have been paid on any unreported income during the eight year period.
    c. There is a one-time 25 percent **offshore "in-lieu of" penalty** where there was failure to file offshore informational returns or other disclosures such as Form - TDF 90-22.1, Form 3520, Form 3520A, Form 8621 or Form 5471 discussed later. This one-time penalty is calculated on the highest aggregate balance in the unreported offshore accounts in the eight year period (2003 through 2010). This penalty may be reduced to 12.5 percent for taxpayers with smaller offshore accounts and in certain limited circumstances the rate may also be reduced further to 5 percent.
3. Since the program is based on an eight year period from 2010 back to 2003, U.S. taxpayers may avoid paying taxes, interest and penalties for tax years prior to 2003.
4. The program may allow U.S. taxpayers to avoid criminal prosecution (if applicable) in relation to prior non-disclosures and tax filings.
5. If the offshore penalty is unacceptable to a U.S. taxpayer, they may opt out of the program and have their case handled under the standard IRS audit process. Once made, this election is irrevocable. There may be a limited number of instances, where opting out may reflect a preferred approach. This would occur where a less severe result would occur under the standard audit process.
6. U.S. taxpayers who participated in the 2009 OVDP are also eligible to apply for the reduced 5 percent penalty regime if they meet the requirements.

Potential penalties outside the 2011 OVDP

Choosing to participate in the 2011 OVDP may substantially reduce the number and magnitude of penalties and interest that would otherwise result if the IRS were to conduct an examination. For example, if a U.S. taxpayer has not filed U.S. income tax returns for the last 15 years and willfully neglected to file IRS Form - TDF 90-22.1 (FBAR), the civil penalties outside the 2011 OVDP for willfully failing to file the FBAR can be as high as the greater of $100,000 or 50% of the total balance of the foreign account. This penalty would be calculated in each of the 15 years where the requirement to file was not satisfied. In addition, the U.S. taxpayer may have to pay income tax on any unreported income in each year including, penalties and interest for all 15 years.

Let's illustrate the difference in penalties outside the 2011 OVDP for willfully failing to file Form – TD 90-22.1 using a numerical example. Let's assume a U.S. taxpayer and resident of Canada for tax purposes who failed to file U.S. returns or the FBAR for 15 years had a balance in the foreign investment account of US$3 million every year. The one-time penalty under the 2011 OVDP for the eight year period (2003 -2010) would be 25% of $3 million or US$750,000. The penalty may be reduced to 5% or US$150,000 if the taxpayer (in each of the eight years under the program) has been compliant in filing their Canadian tax returns (reporting all offshore income) and their U.S. source income is less than US$10,000. In contrast, the penalty outside the 2011 OVDP would be US$22.5 million (50% of the total balance in the account each year or 50% of $3 million X 15 years).

Note: if the above U.S. taxpayer had filed all the required U.S. income tax returns and reported and paid tax on all the taxable income (including income from these foreign accounts) they may not need to file under the 2011 OVDP for simply neglecting to file FBARs. Instead, they should file the delinquent FBARs and attach a statement explaining why they were filed late. The IRS has said it will not impose a penalty for the failure to file the delinquent FBARs if there are no underreported tax liabilities and the FBARs are filed by August 31, 2011 (now September 9). However, FBARs for 2010 were due on June 30, 2011 and had to be filed by that date.

Common U.S. information returns and disclosures

In addition to the U.S. income tax return filing requirement, the 2011 OVDP covers a wide range of foreign informational returns and disclosures that U.S. taxpayers must file applicable to offshore income and assets. The following list, which is not an exhaustive list, identifies some of the more common filing obligations that may exist for U.S. taxpayers resident in Canada:

1. Canadian Financial Accounts – U.S. taxpayers must report annually their direct or indirect financial interest in or signature authority over, a financial account that is maintained with a financial institution located in a foreign country when the aggregate value of all foreign accounts exceeded US$10,000 at any time during the year. This includes Canadian bank accounts, registered retirement accounts (RRSP, RESP), locked-in retirement accounts (LIRA, LIF, LRIF and PRIF) and Tax Free Savings Accounts (TFSA). U.S. taxpayers may need to file IRS Form - TDF 90-22.1 - *Report of Foreign Bank and Financial Accounts (FBAR).*

2. Canadian Trusts – U.S. taxpayers must disclose interests held by them in trusts resident outside the U.S. and certain transactions associated with them. The existence of a Canadian trust under U.S. tax law generally includes family trusts resident in Canada, RESPs, TFSAs and other trusts formed in Canada or outside the U.S. U.S. taxpayers may need to file IRS Forms 3520 – *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts* and/or Form 3520A – *Information Return of Foreign Trusts with a U.S. Owner*

3. Canadian Corporations – Certain U.S. taxpayers who are officers, directors or shareholders in certain foreign corporations are required to report specific information related to the corporation. These foreign corporations may be classified in the U.S. as Controlled Foreign Corporations ("CFC"). U.S. taxpayers may be required to file IRS Form 5471 - *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*
4. Canadian Mutual Funds – Canadian mutual funds are classified as a Passive Foreign Investment Company ("PFIC") under U.S. tax law. Holding Canadian mutual funds may result in adverse U.S. tax implications. U.S. taxpayers may be required to file IRS Form 8621 – *Returns By Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund*. The IRS will be issuing a revised Form 8621, which will broaden the filing requirements for this form.

Note: Starting with the 2011 tax year, a U.S. taxpayer may be required to file an additional disclosure using a newly created Form 8938 – *Statement of Foreign Financial Assets* with their tax returns, where a U.S. taxpayer has more than US$50,000 held or invested in foreign banks, financial institutions, foreign stocks, securities, contracts or other foreign financial instruments.

2011 OVDP versus "quiet disclosure" or no disclosure

Some U.S. taxpayers may continue to ignore their U.S. tax filing obligations while others may have chosen to make a "quiet disclosure". A quiet disclosure is made by filing delinquent or amended tax returns and reporting the additional unreported income and other required disclosures without participating in either the 2009 and 2011 OVDP.

U.S. non-filers and taxpayers choosing quiet disclosures are required to pay taxes, interest and penalties for all tax years including those prior to 2003, and run the risk of possible criminal prosecution (where the IRS deems it appropriate). There are also civil and other penalties that may be incurred, such as the FBAR civil penalties discussed earlier for failure to file the required foreign information returns or disclosures.

A quiet disclosure does not constitute a voluntary disclosure. U.S. taxpayers who have already made "quiet" disclosures are eligible to take advantage of the penalty framework applicable in the 2011 OVDP by submitting an application, along with copies of their previously filed returns (original and amended) to the IRS by August 31, 2011 (now September 9). However, if the IRS has selected the U.S. taxpayer's amended return for examination the 25 percent offshore penalty framework may not be available.

If you have made a quiet disclosure or you are considering whether you should come forward, you should speak to a professional tax or legal professional to discuss your options including whether the new 2011 OVDP is right for you.

U.S. taxpayers identified through the Foreign Account Tax Compliance Act ("FATCA")

On 28 March 2010, President Obama signed the *Foreign Account Tax Compliance Act* (FATCA) into law. Starting in 2014, (originally was to start in 2013) FATCA may require non-U.S. financial institutions such as foreign brokerage firms, banks, insurance companies and other Canadian or foreign financial institutions with clients that are U.S. citizens or U.S. green-card holders to identify them and provide information to the IRS. This

will allow the IRS to identify U.S. taxpayers who have failed to file U.S. federal income tax returns and other information returns and disclosures.

FATCA is intended to combat offshore tax evasion through increased information reporting and tax withholding requirements related to payments made to U.S. taxpayers owing accounts in non-U.S. financial institutions.

A detailed discussion of FATCA is beyond the scope of this article. Many financial institutions in Canada and abroad are reviewing the rules, determining the requirements and lobbying for changes that would soften the impact for their clients. With this new level of enforcement, it may be difficult for many U.S. taxpayers to ignore their U.S. filing obligations any longer.

Conclusion

The IRS has devoted, and will continue to devote, significant resources towards identifying taxpayers abroad that have failed to meet various U.S. filing obligations. U.S. taxpayers with these outstanding filing obligations should contact a professional tax or legal advisor, to seek an understanding of their required filing obligations, the risks associated with non-compliance, and the opportunities presented with the 2011 OVDP to resolve their U.S. filing obligations.

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