

## The OVDP and Streamlined Programs Explained

### How and why to declare foreign income to the IRS

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**T**he Internal Revenue Code (IRC) requires that U.S. resident aliens or U.S. citizens (collectively U.S. taxpayers) are required to report their worldwide income to the IRS. This includes any interest income or earnings from savings or investment accounts held in any foreign account, and any other foreign asset-producing income.

The Currency and Foreign Transactions Reporting Act of 1970, Pub. L. 91-508, 84 Stat. 1118 (1970), generally known as the Bank Secrecy Act (BSA), requires U.S. taxpayers to report their foreign accounts to the Financial Crimes Enforcement Network (FinCEN). Holders of foreign accounts who have deliberately or unintentionally failed to accurately report their foreign accounts have two options: do nothing and hope not to get caught, or file under one of the currently available programs and pay certain penalties but avoid a myriad of others. The first option—do nothing—is a very bad option, especially following a recent Third Circuit decision.

#### The "Do Nothing" Option

The Third Circuit in *U.S. v. Chabot*, — F.3d — 116 AFTR 2d 2015-5060 (3d Cir. July 17, 2015), has just affirmed a decision of the U.S. District Court for the District of New Jersey and held that the "required records" exception to the Fifth Amendment privilege against self-incrimination applies to permit the IRS to enforce a summons of foreign bank account records. The six other U.S.

circuits that have ruled on the issue have all come to the same conclusion. As such, the IRS will be able to ascertain your foreign account holdings with a summons enforcement proceeding. This case makes it all the more compelling to come forward voluntarily before the IRS finds you first.

The BSA regulates offshore banking and contains a number of record-keeping and inspection provisions. 31 CFR 1014.420 requires taxpayers to use the Report of Foreign Bank and Financial Accounts (FBAR) to report a financial interest in, or signature or other authority over, one or more financial accounts in foreign countries. No report is required if the aggregate value of the accounts does not exceed \$10,000.

Some of those who did not disclose such accounts have tried to fight IRS summons actions claiming that to produce these records could be an affront to their Fifth Amendment privilege against self incrimination. The Fifth Amendment states that "[no] person ... shall be compelled in any criminal case to be a witness against himself." Unfortunately, for those persons, there is a "required records exception" to the Fifth Amendment. In *Shapiro v. U.S.*, 335 U.S. 1 (1948), the Supreme Court explained that there was little danger of Congress abrogating the Fifth Amendment privilege by requiring that taxpayers maintain records as long as the records closely served the purpose of a valid, civil regulation.

The Third Circuit in *Chabot* has now joined the Second, Fourth, Fifth,

Seventh, Ninth and Eleventh Circuits in applying the required records exception to enforce summonses for FBAR records that account holders are required to keep. In *re Grand Jury Subpoena Dated Feb. 2, 2012*, 741 F.3d 339 (2d Cir. 2013); *Under Seal*, 737 F.3d 330 (4th Cir. 2013); In *re Grand Jury Subpoena*, 696 F.3d 428 (5th Cir. 2012); In *re Special Feb. 2011-1 Grand Jury Subpoena Dated Sept. 12, 2011*, 691 F.3d 903 (7th Cir. 2012); In *re Grand Jury Investigation M.H.*, 648 F.3d 1067 (9th Cir. 2011); In *re Grand Jury Proceedings*, 707 F.3d 1262 (11th Cir. 2013).

#### The OVDP

Due to the fact that many U.S. taxpayers have not reported their income from foreign financial accounts, the IRS has implemented two programs that allow U.S. taxpayers to bring themselves into compliance with the IRC and BSA. Each program has its own ramifications and penalties discussed below. The programs are mutually exclusive; if you participate in one, you cannot participate in the other.

The first is the Offshore Voluntary Disclosure Program (OVDP). The second is the Streamlined Offshore Disclosure Program.

Under the OVDP, the taxpayer requests permission to participate in the program and a partial disclosure is made. The government then determines whether the taxpayer is currently under audit or investigation and, if not, the taxpayer is conditionally permitted to enter the program. As a

condition, the taxpayer must disclose the source of the income that resulted in the offshore accounts and the location and identity of the accounts. This information is then incorporated into a narrative. To the extent that the offshore account is not attributable to illegal sources of funds, the taxpayer will be permitted to participate in the OVDP.

Under the OVDP, taxpayers must file amended income tax returns and FBAR filings for the previous eight years, identifying foreign accounts, foreign real estate and any other foreign income-producing assets to the extent that the foreign assets resulted in unreported income. The taxpayer must pay all tax on the unreported income and interest on the additional tax plus a 20 percent accuracy-related penalty as the penalty for the income tax violation. With regard to the bank secrecy provision of the OVDP, a penalty is assessed on the highest account balance plus any foreign asset that generated unreported income during the eight-year period. This penalty is normally 27.5 percent of the highest account balance. There are a handful of banks that are listed as facilitator banks, and if any such institution holds any funds of the taxpayer, then the penalty becomes 50 percent for all foreign assets held.

The primary advantage to the OVDP is that the taxpayer is assured that the U.S. will not prosecute criminally.

The disadvantage is, one must file eight years of returns and pay income tax, interest and penalties for those eight years of income, and a 27.5 or 50 percent bank secrecy penalty on the highest account balance.

## The Streamlined Program

Effective July 1, 2014, the U.S. Treasury instituted a second program called the Streamlined Offshore Disclosure Program. This program is only available for nonwillful filers. The government has not defined what constitutes "nonwillful." One's status as nonwillful will be based in part on a narrative contained on Form 14654 that must be submit-

ted. Form 14654 contains the following language to be submitted under penalty of perjury:

Provide specific reasons for your failure to report all income, pay all tax, and submit all required information returns, including FBARS. If you relied on a professional advisor, provide the name, address, and telephone number of the advisor and a summary of the advice.

Under the streamlined program, amended tax returns for the last three years and FBAR filings for the last six years must all be filed. Only the tax and interest are required, and the penalty for the offshore account is only 5 percent of the highest balance.

The primary advantage of the streamlined program is the fact that the penalty structure is much smaller. Under the streamlined program, you will file three years of amended returns, not eight. There is no 20 percent miscellaneous penalty on the tax due. The bank secrecy penalty is 5 percent of the foreign accounts, versus 27.5 or 50 percent of the foreign accounts including the fair market value of any foreign real estate or any other foreign income-producing asset not previously reported.

The disadvantage of the streamlined program is the lack of definition and guidance for "nonwillful" taxpayers. Additionally, there is no assurance up front that the government does not intend to prosecute the taxpayer for criminal or civil tax fraud and/or evasion.

For the streamlined program, the government has not provided anyone with guidance as to what constitutes nonwillful and has stated it has no intention of ever providing guidance. The government has deliberately not provided guidance in order to ensure that people are cautious and thorough in their decision to use the Streamlined Program as opposed to the OVDP.

## The Choice

The choice of program should be guided by the facts and circumstances. It is a

function of the source of your offshore funds, the nature of the failure of your disclosure and whether your behavior was willful or nonwillful. Questions to ask include:

- Did I have a purpose of avoiding or evading U.S. Tax? Did I provide false information to my return preparer? Could my actions appear that I had a purpose of avoiding or evading tax? Examples: bringing funds into or out of the U.S., using cash or mules rather than checks or wires, moving assets between institutions.
- What is the amount of foreign assets? What is the source of the funds? Were they ever reported when first earned? Are the funds licit or illicit funds to begin with?
- Were the taxpayers living abroad when the accounts were set up? When the accounts were funded?
- Were FBARS filed for some accounts but not others?
- Is the taxpayer in law enforcement, politics or a professional?
- What is the risk tolerance for the taxpayer?
- Will the spouses have different answers to these questions? (Separate counsel may be needed.)

The choice between the streamlined program, with its much lower penalty structure, and the safer OVDP is a distressing one and can never be made lightly. After all, once you elect a program, the other is no longer available as a fallback. The choice between the programs must be made only after a careful examination of the facts and circumstances with the client.

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