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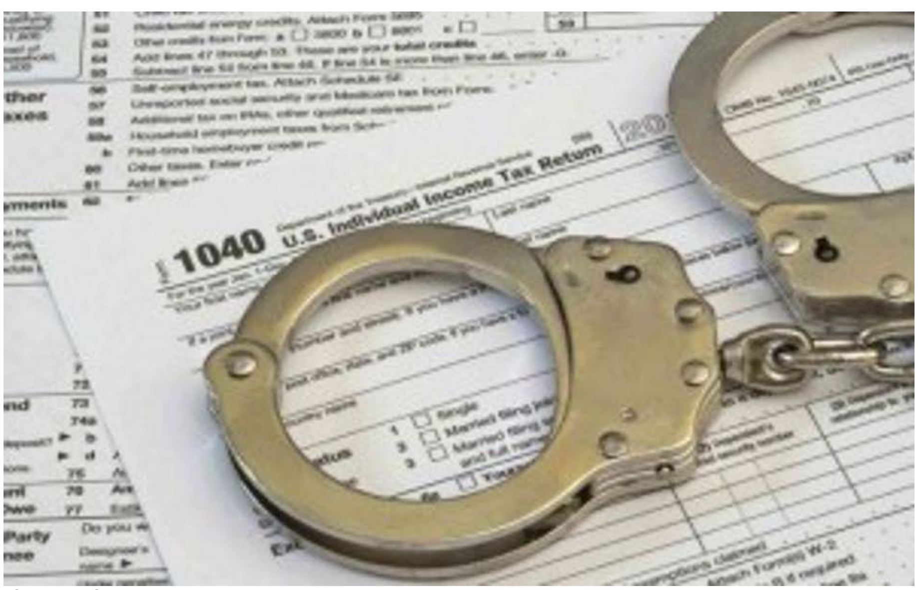
Can You Opt Out Of Big IRS Offshore Penalties?

Undisclosed foreign accounts or income can trigger significant civil penalties. They can even carry potential criminal penalties. Since 2009, many U.S. persons with foreign accounts and income have come within the IRS's enormous offshore enforcement efforts. Not everyone has entered the IRS Offshore Voluntary Disclosure Program (OVDP). Still, it can be the safest move, and the only one guaranteeing no prosecution. Moreover, the OVDP involves a formulaic deal where at least the penalties are capped.

The IRS OVDP isn't perfect, but it is a finite way of getting beyond the fear of discovery and prosecution. But as taxpayers slog through the details, more than a few start to grumble about penalty dollars and may rethink whether the OVDP is such a good deal after all. If you are evaluating the current 27.5% or 50% miscellaneous offshore penalty and cringing about how much it will hurt, what about opting out? There is much talk of opting-out but sparse data.



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The opt-out election is irrevocable, and is typically made after the IRS has calculated a proposed miscellaneous offshore penalty. That might be a year or more after you enter. You can try for no or reduced penalties, but once outside the program, the IRS may assess civil fraud penalties or information return penalties. Even criminal prosecution is conceivable after opting out, although that has evidently not happened. The IRS is also likely to demand an interview with the taxpayer, which is an unpleasant thought for many.

According to the Taxpayer Advocate Service, over 1,000 taxpayers opted out of the 2009 and 2011 offshore voluntary disclosure programs. One thing it meant was delays. For 2009 opt-outs, the IRS took about 590 days to close the case after the opt-out election. For 2010 OVDI opt-outs, the IRS took a more svelte 129 days. Most opt-outs involved small dollars, which seems counter-intuitive. The incentives to opt-out seem much higher if large dollars are at stake.

If you might pay a $50,000 penalty in the OVDP, opting out probably can't save you too much, especially if by opting out you end up with non-willful penalties. A $500,000 penalty within the OVDP, however, may make opting out hard to resist, particularly if you have good facts and no evidence of willfulness or evasion. And $1M or more may be even more compelling. On the other hand, the IRS may view larger dollar accounts with more suspicion, and may even be more likely to impose willful penalties in these cases. So it's a delicate decision.

Indeed, potential FBAR penalties for larger accounts can be high. If the maximum account balance exceeds $1 million, a willful FBAR penalty could be the greater of $100,000 or 50% of the account balance. The taxpayer can argue that FBAR penalties are inappropriate after opting-out. However, the IRS can conceivably seek FBAR penalties per account, per year.

Some say the IRS may apply rough justice by calculating FBAR penalties that approximate the 27.5% miscellaneous offshore penalty within the OVDP. Plus, if there are passive foreign investment company (PFIC) issues, the amended tax returns submitted as part of the OVDP will need to be modified to reflect statutory PFIC computations, not the OVDP's mark-to-market computations. Some advisers believe the IRS may be more likely to assert additional income tax penalties after an opt-out.

Civil fraud can trump the statute of limitations, so if you opt-out, the IRS could conceivably even examine tax years prior to the OVDP's 8-year disclosure period. Past admissions—even OVDP submissions themselves—can be used against the taxpayer if he or she opts-out. Thus, it is important to consider what you've told the IRS prior to making the opt-out election.

Bottom line? The OVDP is predictable. Opting out is much less so, so think about your facts. If you have no evidence of willfulness, the sheer numbers may make opting out attractive. Ask whether the potential risks of opting out offset the potential rewards. Individual advice about the particular facts is important. And facts that might suggest willfulness may be especially so. For example, be careful about:

- Setting up trusts or corporations to hide your ownership.
- Large amounts of unreported income.
- Filing some tax forms and not others.
- Keeping two sets of books.
- Telling your bank not to send statements.
- Using code words over the phone.
- Cash deposits and cash withdrawals.

All of these might suggest willfulness. So can moving money from one bank to another when the banks turned away undisclosed American accounts. Even if one can explain one failure to comply with the law, repeated failures can morph conduct from inadvertent neglect into reckless or deliberate disregard. Even willful blindness—a conscious effort to *avoid* learning about reporting requirements—may be enough. And failing to follow-up can provide evidence of willful blindness.

Despite these worries, for those with the right facts and a willingness to endure more risk than the OVDP, opting out can sometimes save large dollars.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.