

## You Gotta Have Good Faith - or at Least Non-Willfulness

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**CATEGORY:**  
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Recent Internal Revenue Service (IRS) updates to the terms of the 2011 Offshore Voluntary Disclosure Initiative (OVDI) provide a mechanism to obtain a 90-day extension of time to complete a voluntary disclosure submission, clarify procedures for opting out of a voluntary disclosure, and provide a reduced penalty for foreign residents who meet a three-part test.

### The 90-Day Extension Request

Before the recent updates, the terms of the OVDI provided no relief for those who would be unable to comply with the OVDI's August 31, 2011 deadline. An OVDI participant may now be entitled to a 90-day extension to submit the required material if they requests an extension in writing on or before August 31, 2011.

### Good Faith Required

The extension request must demonstrate a good faith attempt to fully comply with the terms of the OVDI in a timely manner, and must be accompanied by consent to extend the time to assess tax and FBAR penalties. The request must state the items that the participant will be unable to provide by the August 31<sup>st</sup> deadline, explain the reasons for the participant's inability to provide the missing items, and demonstrate the steps taken to secure such items. The 90-day extension mechanism could help individuals who are unable to obtain statements from non-U.S. banks timely but who have documented efforts to obtain such statements, or individuals for whom accounting complications may surface just before the August 31<sup>st</sup> deadline. The update should not be interpreted to provide an automatic 90-day extension; however, and each participant should make every effort to submit a full voluntary disclosure in a timely fashion.

### Opt-Out Guidance

The recent IRS update clarifies the procedures for opting out of the OVDI or the 2009 Offshore Voluntary Disclosure Program (OVDP) and highlights certain situations in which the IRS recognizes opting out to be justified (or in fact the preferred approach). This generally includes taxpayers with reasonable cause for failure to file their FBARs.

An opt-out guide was issued by the IRS on June 1, 2011, outlining the new formal procedure, which includes providing the IRS with a supported proposal of alternative penalties. A review committee will then evaluate the individual's proposal and the examiner's summary and will decide what level of examination will apply to the individual's case (potentially a full-scope examination, including an interview). Fortunately, the non-recommendation of criminal prosecution offered by the OVDI continues for those who opt out-so long as the individual fully and truthfully discloses the necessary information to the IRS.

### The Importance of Non-Willfulness

It is impossible to generalize from the update, but individuals who can prove that the failure to file an FBAR or other information return was non-willful, those who have few information return violations, and those who have reported substantially all of their income to a foreign jurisdiction and properly paid taxes there may consider opting out of the OVDI/OVDP. Opting out may allow such an individual to minimize compliance costs by avoiding the 25% offshore penalty on the highest aggregate account balance during the voluntary disclosure period, while maintaining reassurance of no referral for criminal prosecution. Since the decision to opt out is irrevocable, and as the individual may face more severe penalties outside of the OVDI/OVDP, the decision to opt out should be taken in consultation with a tax professional.

### Reduced Penalty Roadmap for Certain Foreign Residents

The update provides a new exception under which certain foreign residents may obtain a reduced 5% offshore penalty in lieu of a 25% offshore penalty.

### Good Faith Required

To qualify for the reduced 5% penalty, the individual: (i) must reside in a country other than the U.S., (ii) must have made a good faith effort to comply with tax reporting requirements and paid tax obligations to the country of residence, and (iii) must have had \$10,000 or less of U.S.-source income each year. Further guidance may be required where amounts, such as certain investment income, are not required to be reported on foreign tax returns. Those who qualify will be entitled to a lesser penalty, and will be permitted to exclude real property, art, business interests, and certain other property purchased with after-tax funds from the penalty base.

Amounts in foreign bank or brokerage accounts would still be subject to penalty. Taxpayers who have a closing agreement under the 2009 OVDI or who have closed their OVDI case that would have qualified for this reduced penalty may have their penalty revisited.

# Authors

Jay Krause

PARTNER | LONDON

Private client and tax

 +44 20 7597 6350

 [jay.krause@withersworldwide.com](mailto:jay.krause@withersworldwide.com)

Jay H. Rubinstein

PARTNER | GENEVA

Private client and tax

 +41 22 593 7716

 [jay.rubinstein@withersworldwide.com](mailto:jay.rubinstein@withersworldwide.com)