GLOBALTAX SOLUTIONS

The New Streamlined Domestic Off-Shore Procedures (SDOP)

The New Streamlined Domestic Offshore Procedures (SDOP) rewards taxpayers that disclose their offshore assets with a lower penalty. The Streamlined Domestic Offshore Procedures apply to U.S. taxpayers who reside in the United States: U.S. citizens, lawful permanent residents, and those meeting the substantial presence test under IRC § 7701(b)(3). In order to apply for these procedures, eligible taxpayers must take certain steps. First, the taxpayer must calculate the "covered tax return period."
Here, the covered tax return period is equal to the most recent 3 years for which the tax return due date has passed. For the covered tax return period, any taxpayer using the streamlined domestic procedures should file amended tax returns as well as all required informational returns, such as Forms 3520, 3520-A, 5471, 5472, 8938, 926, and 8621. Next, the taxpayer should calculate the "covered FBAR period" which is equal to each of the most recent 6 years for which the FBAR due date has passed. For this period, the taxpayer needs to file any delinquent FBAR reports. Finally, the taxpayer must pay a Title 26 miscellaneous offshore penalty.

To Qualify for SDOP you must first pass a test

It is extremely important that a taxpayer's eligibility is carefully analyzed because once the SDOP is elected and the taxpayer claims the violations were non-willful*. There are possible risk factors that need to be considered and analyzed such as the evidence of willfulness including intent of laws, knowledge and violations.

In order to participate in the Streamlined Domestic Offshore Procedures, individual U.S. taxpayers, or estates of individual U.S. taxpayers must meet general eligibility criteria for the streamlined procedures in addition to certain requirements specific to domestic applicants. These additional requirements are as follows:

- The individual taxpayer must fail to meet the non-residency requirements described in the instructions for the Streamlined Foreign Offshore Procedures;
- The individual taxpayer must have previously filed a U.S. tax return for each the most recent 3 years for which the U.S. tax return due date has passed;

- The individual taxpayer applying for streamlined domestic procedures must have failed to report gross income from a foreign financial asset or account and pay the U.S. tax required for that asset or account;
- The individual taxpayer may have failed to file FBAR forms or other informational reporting obligations for foreign financial assets or accounts; and
- The omissions must result from non-willful conduct, where "[n]on-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law."

Although filing an SDOP does not automatically select the taxpayer for an IRS audit, the taxpayers is still subject to the possibility of a normal audit. The taxpayer needs to be prepared to defend filing a SDOP and be able to demonstrate their non-willfulness and show there was no fraud.

Non-willful Certification

The taxpayers must certify that their failure to report foreign financial assets and pay all tax due was not the result of willful conduct. A taxpayer must complete and execute a certification form.

The most important first step in analyzing whether a taxpayer is eligible to participate in the streamlined procedures is to ascertain whether the taxpayer's compliance failure, including the failure to file an FBAR, was actually non-willful. The IRS has defined "non-willful conduct" as "conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law." This definition is a little different from other legal cases. For failure to file FBARs, the IRS must establish knowledge of the law and evaluating indicators of willfulness (Internal Revenue Manual (IRM) §4.26.7).
Willfulness in criminal tax cases generally means a voluntary, intentional violation of a known legal duty (*Cheek*, 498 U.S. 192 (1991)). The taxpayer does not have to have an improper motive or a bad purpose. All that is required is that the taxpayer knew of the duty and intended to violate it (*Pomponio*, 429 U.S. 10 (1976)).

Willfulness means not only knowing violations, but reckless ones as well. For example, "[a] responsible person is reckless if he knew or should have known of a risk that the taxes were not being paid, had a reasonable opportunity to discover and remedy the problem, and yet failed to undertake reasonable efforts to ensure payment" (*Jenkins*, 101 Fed. Cl. 122, 134 (2011), aff'd,

No. 2012-5019 (Fed. Cir. 2012)). “[W]willfulness has been found where ‘the facts and circumstances of a particular case, taken as a whole, demonstrate’ that the taxpayer ‘knew or should have known that there was a risk [of noncompliance] and failed to take available corrective action,’ with the result being the violation of the law” (*McBride*, 908 F. Supp. 2d 1186, 1209 (D. Utah 2012).

Offshore Penalty Under the Streamlined Domestic Procedures

The taxpayers who apply under the streamlined domestic offshore procedures are required to pay a Title 26 miscellaneous offshore penalty. To calculate this penalty, you must first compute the highest aggregate balance/value of the taxpayer’s foreign financial assets and accounts that would be covered by the penalty during the “covered tax return period” and the “covered FBAR period.” The aggregate balance/value of the foreign financial accounts and assets is determined by looking at all of the year-end balances of the foreign financial assets and accounts over the years covered by the tax return period and the FBAR period, and adding the highest aggregate values over those years.

Once that balance is calculated, the miscellaneous offshore penalty is equal to 5 percent of that highest aggregate balance or value.

A financial account or asset is subject to the 5 percent miscellaneous offshore penalty if it would have been subject to the **FBAR reporting requirement**, but no FBAR was ever filed. It may also be subjected to the offshore penalty if it should have been reported on a Form 8938 for a given year, but where no form was ever filed. Finally, the financial account or asset may be subject to the offshore penalty during a covered tax return period if the account or asset was properly reported, but the gross income associated with that asset or account was not properly reported for the given tax year. Foreign financial assets subject to this offshore penalty include the following:

- Financial accounts in foreign financial institutions or the foreign branch of a U.S. financial institution;
- Foreign stocks, securities, and mutual funds;
- Foreign hedge funds or equity funds.

The Benefit of Using the Streamlined Domestic Offshore Procedures

The streamlined procedures can be very beneficial for taxpayers because they allow the taxpayer to comply with income tax rules and regulations in a relatively easy manner. It is similar to the Offshore Voluntary Disclosure Program, but the process is less extensive. Another advantage of the streamlined procedures is that it protects the taxpayer from having to pay certain penalties, including accuracy-related penalties, information return penalties, or FBAR penalties. Although the taxpayer must pay the Title 26 miscellaneous offshore penalty, the return will not be subject to those additional penalties. This is true even if the taxpayer is later selected for an audit and should be subjected to those penalties. The only exception to this rule relates to the willfulness of the taxpayer's omissions. If the failure to file FBARs or other informational returns, or pay tax on foreign assets and accounts was willful, then the taxpayer may be liable for accuracy-related penalties, FBAR penalties, or information returns penalties.

Conclusion

The IRS states that tax returns submitted under the streamlined procedures will be processed like any other return. Receipt of the returns will not be acknowledged by the IRS and will not culminate in the signing of a closing agreement with the IRS. This means that a taxpayer will not know when the taxpayer submits the tax returns—and may never know—whether the IRS has accepted the taxpayer's certification of non-willfulness.

The tax returns will not be automatically subject to IRS audit, but they may be selected under existing selection processes for any U.S. tax return. Returns submitted through the program may also be subject to verification in that the accuracy and completeness of submissions may be checked against information received from banks, financial advisers, and other sources.

According to the IRS, taxpayers who are concerned that their failure to report income, pay tax, and submit required information returns was due to willful conduct and who therefore seek assurances that they will not be subject to criminal liability and/or substantial monetary penalties should consider participating in the OVDP and consult their professional tax or legal advisers.

A taxpayer who is eligible to use these streamlined domestic offshore procedures will be subject to only a 5% penalty and no accuracy-related penalties, information return penalties, or FBAR penalties. The new 5% penalty is substantially lower than the 27.5% penalty offered under the OVDP.

Even if returns properly filed under the streamlined procedures are subsequently selected for audit under existing audit selection processes, the taxpayer will not be subject to accuracy-

related penalties for amounts reported on those returns, or to information return penalties or FBAR penalties, unless the examination results in a determination that the original return was fraudulent and/or that the FBAR violation was willful. Avoiding these penalties is a key benefit of the new program.

Finally, the streamlined domestic offshore procedures also apply to taxpayers seeking relief for failure to timely elect deferral of income from certain retirement or savings plans under an applicable treaty. An example of this is Canadian registered retirement plans, which do not receive tax deferred treatment in the United States absent a treaty election.

Global Tax Solutions
1934 Old Gallows Road, Suite 350
Tyson's Corner, VA 22182
info@globaltax.solutions
(703) 717-5000