

Area of Focus #12 **The IRS's Offshore Voluntary Disclosure (OVD)-Related Programs Have Improved, But Problems Remain**

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Finality*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

The IRS's Offshore Programs Initially Imposed Disproportionate Penalties Against Unrepresented Taxpayers With the Smallest Accounts

Between 2009 and 2014, the IRS generally required “benign actors” — people who inadvertently failed to report foreign income and file one or more related information returns (*e.g.*, the *Report of Foreign Bank and Financial Accounts (FBAR)*) — to enter an OVD program and either pay an “offshore penalty” designed for “bad actors” or “opt out” and be audited, as described in prior reports (the “TAS OVD Reports”).² Uncertainty about what penalty might apply in the audit, the IRS's one-sided interpretation of the program terms, processing delays, and the cost of representation prompted some to pay a disproportionate penalty. Inside the 2009 OVD program, the median offshore penalty paid by those with the smallest accounts was nearly six times the median unreported tax, and unrepresented taxpayers generally paid even more — significantly more than represented taxpayers with the largest accounts.

- 1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR that was adopted by the IRS are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).
- 2 IRS, *Voluntary Disclosure: Questions and Answers*, (posted May 6, 2009), <https://www.irs.gov/uac/Voluntary-Disclosure:-Questions-and-Answers> [hereinafter “2009 OVD FAQ”]; IRS, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, http://www.steptoe.com/publications/2011_200VDI_20FAQs.pdf (posted to IRS.gov Feb. 8, 2011 and subsequently removed) [hereinafter “2011 OVD FAQ”]; IRS, *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers*, <https://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers> (posted June 26, 2012); IRS, *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers*, <https://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers-2012-Revised> (first posted in the summer of 2014, and effective for submissions made on or after July 1, 2014) [hereinafter “2014 OVD FAQ,” or collectively the “OVD programs”]. For several years, the National Taxpayer Advocate and other stakeholders have expressed concerns about the OVD programs. See, *e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 79-93; National Taxpayer Advocate 2013 Annual Report to Congress 228-37; National Taxpayer Advocate 2012 Annual Report to Congress 134-53; National Taxpayer Advocate 2011 Annual Report to Congress 191-205 and 206-72; National Taxpayer Advocate 2014 Objectives Report to Congress 36-39; National Taxpayer Advocate 2013 Objectives Report to Congress 9 and 21-29 [collectively, the “TAS OVD Reports”]. See also Taxpayer Advocate Directive 2011-1 (Aug. 16, 2011).

FIGURE 3.12.1, Comparison of Median Offshore Penalties to Unreported Tax by Median Account Size and Representation for the 2009 OVD Program³

	Bottom 10%	Middle 80%	Top 10%
Offshore account(s) balance	\$44,855	\$607,875	\$7,259,580
2009 OVD penalty	\$8,540	\$117,803	\$1,410,517
Additional tax, tax years 2002-2011	\$1,472	\$30,894	\$452,966
Offshore penalty as a percent of tax assessed	580%	381%	311%
Unrepresented percent	31%	11%	4%
Offshore penalty as a percent of tax assessed (unrepresented taxpayers only)	772%	474%	398%

Disproportionality increased under the 2011 OVD program, as taxpayers with the smallest accounts paid over eight times the unreported tax. Moreover, the size of the participant's accounts generally became smaller with each new program.

FIGURE 3.12.2, Comparison of Median Offshore Penalties to Unreported Tax by Median Account Size and Representation for the 2011 OVD Program⁴

	Bottom 10%	Middle 80%	Top 10%
Offshore account(s) balance	\$17,368	\$183,993	\$3,833,152
2011 OVD penalty	\$2,202	\$41,238	\$888,943
Additional tax, tax years 2002-2011	\$268	\$5,845	\$190,579
Offshore penalty as a percent of tax assessed	821%	706%	466%
Unrepresented percent	53%	30%	10%
Offshore penalty as a percent of tax assessed (unrepresented taxpayers only)	788%	736%	705%

The IRS Eventually Took Steps to Improve the Proportionality of the OVD Penalties By Giving Benign Actors Other Options

In 2012, the IRS began allowing certain “low risk,” nonresident non-filers — those with “simple” returns and owing less than \$1,500 in tax — to file the returns without triggering penalties (the

³ See National Taxpayer Advocate 2014 Annual Report to Congress 79, 86. All figures in Figures 3.12.1, 3.12.2, and 3.12.4 are medians rather than averages because the data contains extreme outliers. The unreported tax includes all tax assessed over a ten-year period, even if the assessment was unrelated to the OVD program. TAS did not update the 2009 or 2011 OVD program data to add subsequent closures because doing so would misrepresent the results of the programs for the period before the IRS took the corrective actions described below. For the purposes of this analysis (and Figures 3.12.1, 3.12.2, and 3.12.4), we consider unrepresented taxpayers to be those without a Transaction Code 960 present on the Compliance Data Warehouse (CDW) Individual Master File as of October 3, 2013. If the IRS Master File database indicated that a taxpayer had a representative on any tax module for any of tax years 2003-2012, then the taxpayer was considered represented, even though he or she may have been unrepresented in connection with the OVD program. *Id.* at 86 n.39.

⁴ See National Taxpayer Advocate 2014 Annual Report to Congress 79, 87. A slightly different methodology was used to pull the 2009 OVD program data, as discussed in the 2014 report. *Id.* at 87 n.40.

“Streamlined Nonresident Filing Initiative”).⁵ The IRS subsequently eliminated the \$1,500 threshold and risk-based requirements.⁶

On June 18, 2014, the IRS modified the terms of the 2012 OVD program (sometimes called the 2014 OVD) and created two new “streamlined” programs.⁷ Taxpayers who certified their violations were not willful, reported income from the unreported account(s), and paid any resulting taxes would be subject to a reduced penalty if they were U.S. residents (under the so-called Streamlined Domestic Offshore Procedures (SDOP)) or no penalty if they were non-residents (under the so-called Streamlined Foreign Offshore Procedures (SFOP)).⁸ Because taxpayers were not offered a closing agreement under the 2014 streamlined programs, the IRS could examine the years in question. Applicants to an OVD program whose closing agreements were unsigned as of June 30, 2014, could apply to “transition” into a streamlined program and receive a closing agreement, but only if the IRS agreed their violations were not willful.⁹

In addition, on May 13, 2015, the IRS instructed its examiners “in most cases” to limit penalties for FBAR violations to 50 percent of the highest aggregate balance of the unreported account(s) during the year(s) at issue if they are willful and \$10,000 per year if they are not.¹⁰ This guidance reduced the risk to benign actors of opting out of OVD programs. Although those who opted out had smaller tax underpayments with each new program, they faced even smaller Title 26 penalties, as shown below.¹¹

5 IRS, *New Filing Compliance Procedures for Non-Resident U.S. Taxpayers* (first posted June 28, 2012), <https://www.irs.gov/Individuals/International-Taxpayers/New-Filing-Compliance-Procedures-for-Non-Resident-U.S.-Taxpayers>. The IRS did not define “low risk” or “simple” returns, but it may have included returns that it would not have selected for audit. See IRS, Form 14438, *Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer Taxpayers* (Aug. 2013).

6 IRS, *Streamlined Filing Compliance Procedures*, <https://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures> (last updated, Aug. 6, 2015).

7 *Id.* IRS, *Transition Rules: FAQs*, <https://www.irs.gov/individuals/international-taxpayers/transition-rules-frequently-asked-questions-faqs> (last updated Apr. 8, 2016).

8 *Id.*

9 *Id.* (“A taxpayer eligible for treatment under the streamlined procedures who submits, or has submitted, a voluntary disclosure letter under the OVD (or any predecessor offshore voluntary disclosure program) prior to July 1, 2014, but who does not yet have a fully executed OVD closing agreement, may request treatment under the applicable penalty terms available under the streamlined procedures.”).

10 Interim Guidance Memo (IGM), SBSE-04-0515-0025, *Interim Guidance for Report of Foreign Bank and Financial Accounts (FBAR) Penalties* (May 13, 2015), [https://www.irs.gov/pub/foia/ig/spder/SBSE-04-0515-0025\[1\].pdf](https://www.irs.gov/pub/foia/ig/spder/SBSE-04-0515-0025[1].pdf); Internal Revenue Manual (IRM) 4.26.16.6.4.1 (Nov. 6, 2015); IRM 4.26.16.6.5.3 (Nov. 6, 2015). While this guidance did not directly apply to Appeals, it addresses litigating hazards already acknowledged by the government. See, e.g., Jeremiah Coder, *Taxpayers Face Hurdles and Risks When Opting out of OVD*, 2013 TNT 12-4 (Jan. 16, 2013) (“Asked to explain why the IRS believes a non-willful FBAR penalty can be applied to each unreported account, McDougal said that the statute, 31 U.S.C. § 5321(a)(5), refers to a single account. ‘The use of the singular is the basis for the Service’s position that you look at each account in deciding if a penalty applies,’ he said. ‘But I don’t think it’s been briefed and decided in a careful way by a court yet,’ he added, citing the absence of ‘reasoned analysis’ in recent judicial decisions on the issue. Caroline D. Ciraolo of Rosenberg Martin Greenberg LLP said a reasonable argument can be made that a civil non-willful FBAR penalty applies on a per-FBAR basis rather than for each unreported account. Only one FBAR must be filed per year, so the IRS’s stacking of penalties per account conflicts with the statute’s notion of a maximum penalty cap, she said.”). Thus, Appeals should clarify that its employees should apply this guidance.

11 IRS response to TAS information request (May 13, 2015).

FIGURE 3.12.3, Opt-Out and Removal Examination Results¹²

Program	Returns Examined	Avg. Tax Assessed	Avg. FBAR Penalty	Avg. Title 26 Penalty	Penalty to Tax Assessment Ratio
2009 OVD	1,865	\$13,667	\$2,288	\$10,633	95%
2011 OVD	2,632	\$9,855	\$9,864	\$2,976	130%
2012 OVD	467	\$6,595	\$4,740	\$1,470	94%
Canadian opt-out	11,162	\$258	\$3	\$9	5%

Perhaps because this guidance and the streamlined programs have provided alternatives to the OVD for benign actors, the disproportionality of the OVD penalty appears to have declined under the 2012 OVD program.

FIGURE 3.12.4, Comparison of Median Offshore Penalties to Unreported Tax by Median Account Size and Representation for the 2012 OVD Program¹³

	Bottom 10%	Middle 80%	Top 10%
Offshore account(s) balance	\$19,480	\$287,726	\$3,354,782
2012 OVD penalty	\$2,420	\$73,004	\$914,110
Additional tax, tax years 2003-2015	\$681	\$14,009	\$220,365
Offshore penalty as a percent of tax assessed	355%	521%	415%
Unrepresented percent	26%	16%	10%
Offshore penalty as a percent of tax assessed (unrepresented taxpayers only)	454%	515%	398%

At over three times the unpaid tax in all categories, the offshore penalties applied under the 2012 OVD program are still draconian, but no longer disproportionately applied to those with the smallest accounts, at least when analyzed on an aggregate basis. Rather, the offshore penalty represents a larger percentage of the unreported tax for those with the largest accounts (415 percent) than for those with the smallest accounts (355 percent). Those in the middle still pay the largest penalty as a percentage of their unreported tax (521 percent), however. For those with the smallest accounts, the penalty to unreported tax ratio was still larger for unrepresented taxpayers. For the largest accounts, however, the penalty was relatively smaller for unrepresented taxpayers. Notwithstanding improvement to the OVD program's proportionality, TAS still receives significant and valid complaints about them.

The Streamlined Programs Still Exclude Some Benign Actors

Some benign actors are not eligible for either of the streamlined programs. For example, so-called “accidental” citizens (*i.e.*, born in the U.S., but living abroad and sometimes unaware of their citizenship, or at least of their U.S. filing requirements) may not qualify for any streamlined program even if

12 IRS response to TAS information request (June 23, 2016). TAS received aggregate figures from the IRS and then divided them by the number of closed returns to compute averages. The penalty-to-tax assessment percentage is the sum of the average FBAR and Title 26 tax penalties divided by the average tax assessment. The IRS recorded data on Canadians who opted out separately from other taxpayers. It also combined streamlined examination results with the results of examinations of Canadians who opted out. In addition, the 2011 OVD opt out data may be skewed by extreme outliers.

13 AIMS Database (Mar. 7, 2016). TAS used the same methodology to pull this 2012 OVD program data as we did for the 2011 OVD program data (above). These figures do not include taxpayers who entered the 2012 OVD program before the IRS announced the 2014 streamlined program, but ultimately transitioned into the streamlined program.

their violations were not willful. They are ineligible for the SFOP if they are not physically outside the U.S. for at least 330 days (*e.g.*, Canadian “snowbirds” who visit the U.S. during the winter months for at least 35 or 36 days) during the year, and are also ineligible for the SDOP if they have not previously filed a U.S. tax return.¹⁴

Others are concerned they cannot timely apply to a streamlined program because if they are eligible for a Social Security number (SSN), they are required to obtain one before the IRS will process their streamlined application.¹⁵ It may take anywhere from six to 15 months for a taxpayer to receive an SSN, during which time the IRS may initiate an audit, which would make the individual ineligible for the streamlined process.¹⁶

The IRS Promulgated OVD-Related Rules by FAQ, Without Addressing Stakeholder Concerns

Another problem is the IRS’s overreliance on OVD Frequently Asked Questions (FAQs). Before the 2009 OVD program, the IRS generally published settlement initiatives in documents approved by the Treasury Department, which were incorporated in the Internal Revenue Bulletin (IRB) after considering comments from stakeholders.¹⁷ Beginning March 23, 2009, however, the IRS issued an internal memo and a series of FAQs to promulgate 2009 OVD program terms, which were not vetted by internal or external stakeholders,¹⁸ and all subsequent OVD programs have been governed by FAQs posted to the IRS website.¹⁹

An appropriate use of FAQs is to explain existing formal guidance to the public in plain language, to provide ministerial procedural guidance (*e.g.*, to update a mailing address), or to issue guidance in an emergency that is quickly improved and formalized.²⁰ However, the IRS has increased its use of FAQs to put out substantive guidance quickly, even when there is no emergency.²¹ The flip side to this advantage is that the guidance is not subject to the normal review process, does not incorporate comments, and as a

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- 14 American Bar Association (ABA) Section of Taxation, *Comments on 2014 Offshore Voluntary Disclosure Program and the Streamlined Programs* (Oct. 14, 2015), <https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/101415comments.authcheckdam.pdf>; Paul Barba, Moodys Gartner Tax Law LLP, *Firm Analyzes IRS FAQ on Streamlined Filing for Amnesty Programs*, 2014 TNT 204-28 (Oct. 14, 2014); Amanda Athanasiou, *Confusion Over Offshore Accounts Prompts IRS Response*, 2015 TNT 207-4 (Oct. 27, 2015).
- 15 American Bar Association (ABA) Section of Taxation, *Comments on 2014 Offshore Voluntary Disclosure Program and the Streamlined Programs* 18-19 (Oct. 14, 2015).
- 16 *Id.* Individuals above the age of 12 must apply for an SSN in person and may be required to provide voluminous background information such as education, employment, and residence history. Social Security Administration, *Learn What Documents You Need to Get a Social Security Card*, <https://www.ssa.gov/ssnumber/ss5doc.htm>. (last visited June 23, 2016) Anyone age 12 or older requesting an original Social Security number must appear in person for an interview. *Id.*
- 17 See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (describing the terms of the Offshore Voluntary Compliance Initiative, a predecessor to the OVD programs).
- 18 Memorandum, from Deputy Commissioner for Services and Enforcement to Commissioner, Large and Mid-Size Business (LMSB) Division and Commissioner, Small Business/Self-Employed (SB/SE) Division, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Offshore Accounts and Entities* (Mar. 23, 2009); Memorandum, from Deputy Commissioner, to SB/SE Examination Area Directors and LMSB Industry Directors, *Emphasis on and Proper Development of Offshore Examination Cases, Managerial Review, and Revocation of Last Chance Compliance Initiative* (Mar. 23, 2009).
- 19 The National Taxpayer Advocate has recommended that the IRS improve the transparency of the OVD and streamlined programs by publishing guidance that incorporates comments from the public, by formally disclosing and/or publishing interpretations of guidance, and by incorporating instructions to staff into the IRM. See, *e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 79, 93.
- 20 See, *e.g.*, IRS, *Ponzi Scheme Questions and Answers* (Feb. 3, 2006), <https://www.irs.gov/uac/Ponzi-Scheme-Questions-and-Answers> (referencing Rev. Rul. 2009-9 and Rev. Proc. 2009-20).
- 21 See, *e.g.*, Jeremiah Coder, *How Do FAQs Fit Into the Guidance Puzzle?*, 2011 TNT 64-1 (Apr. 4, 2011).

result it may not be well thought out, can violate taxpayer rights, and may produce arbitrary results that invite controversy and litigation.

Indeed, the 2009 OVD FAQs were issued in such haste and so poorly drafted that the IRS had to clarify them repeatedly. As a result, it treated similarly situated taxpayers inconsistently, as described in prior TAS OVD Reports. The OVD FAQs also drained resources, as TAS tried to advocate for taxpayers based on the plain language of FAQs, while the IRS resisted on the basis that they should be interpreted in accordance with what the drafters meant to write and how they were being applied in other cases.²²

In addition, the IRS is currently being sued because of its failure to adhere to the Administrative Procedure Act (APA) in promulgating the rules governing taxpayers seeking to “transition” into a streamlined program from an OVD program.²³ Unlike taxpayers who apply directly to a streamlined program, these taxpayers are denied access if the IRS does not agree that their violations were not willful. The IRS does not provide taxpayers with any substantive basis or explanation for a denial or with the right to an appeal. Regardless of what the APA requires, an agency should explain why it has decided to adopt a rule — particularly one viewed as unfair — and address suggestions to improve it, as would be the case with formal guidance. It should also provide taxpayers with explanations for any adverse determinations it makes in their cases. The IRS’s failure to take these simple steps violates most of the recently-enacted taxpayer rights.²⁴

Another problem with issuing OVD FAQs instead of more formal guidance is that the IRS can and does change them without discussion or any public record of the change, except records kept by practitioners whose firms take screen shots of the FAQs on a regular basis.²⁵ This creates a kind of secret law that is not fair to everyone else. Although the IRS may have felt an urgent need to provide OVD guidance as FAQs in 2009, there is no excuse for it to continue to run the OVD programs this way for so long.

The IRS Recently Asked the Public for Comments on the OVD Programs, Revealing Significant Stakeholder Concerns

To its credit, the IRS recently asked stakeholders for comments on the OVD programs, though the request was limited to narrow aspects of OVD program forms.²⁶ In response, stakeholders identified broader concerns such as the unnecessary burden associated with the forms, unnecessarily burdensome passive foreign investment company (“PFICs”) computations, a lack of guidance concerning how a taxpayer may demonstrate a violation was not willful, excessively long processing times and requests for

22 See, e.g., TAS OVD Reports (discussing controversy over the IRS’s strained interpretation of its FAQs); Taxpayer Advocate Directive 2011-1 (Aug. 16, 2011) (same).

23 See, e.g., *Maze et al. v. IRS et al.*, No. 1:15-cv-01806 (D.D.C. Oct. 26, 2015) (challenging the rules governing transition to the streamlined programs as violating the APA, 5 U.S.C. §§ 553 and 706(2)(D)); *Green et al. v. IRS et al.*, No. 1:16-cv-01085 (D.D.C. June 9, 2016) (same).

24 See IRC § 7803 (a). For example, it violates the *Rights to Be Informed, Quality Service, Pay No More Than the Correct Amount of Tax, Challenge the IRS’s Position and Be Heard, Appeal an IRS Decision in an Independent Forum, Finality, Privacy, and A Fair and Just Tax System*.

25 Certain practitioners received undisclosed internal documents in response to Freedom of Information Act (FOIA) requests. See, e.g., Andrew Velarde, *FOIA Response Shows Hints of IRS Thinking on OVDP*, 2015 TNT 192-1 (Oct. 5, 2015). Obviously, other FOIA responses might not have been as well covered in the media, raising similar concerns, discussed below. Further, as of this writing the 2011 OVDP FAQs had been removed from irs.gov. See IRS, *2011 Offshore Voluntary Disclosure Initiative Documents and Forms* (updated Jan. 29, 2016), <https://www.irs.gov/uac/2011-offshore-voluntary-disclosure-initiative-documents-and-forms> (last visited May 19, 2016) (indicating the 2011 OVD FAQs are “no longer available”). As a result, the current version of the 2011 OVDP FAQs are only available on private sector websites.

26 See *Proposed Collection; Comment Request on Information Collection Tools Relating to the Offshore Voluntary Disclosure Program (OVDP)*, 80 Fed. Reg. 47998-02 (August 10), corrected, 80 Fed. Reg. 51874-01 (Aug. 26, 2015).

extension of the applicable limitations periods, an excessively broad penalty base for the streamlined program, and the one-sided requirement for OVD participants to pay taxes on income in years for which the statute of limitations period is closed without allowing them to reduce the amount by deductions that would apply to those same years.²⁷ Separately, taxpayers also raised concerns about whether and how to report foreign social security accounts.²⁸ A broader request for comments accompanied by a proposed revenue procedure and published in the IRB would likely generate even more specific and helpful comments.

Some OVD Program Guidance Was Shrouded in Secrecy

A related problem is that some internal OVD-related guidance directly affecting taxpayers was withheld from the public.²⁹ Even information designated as “official use only” (OUO) must be vetted by and accessible to internal stakeholders, such as TAS. IRS business units are supposed to vet and distribute such information by incorporating it into the Internal Revenue Manual (IRM).³⁰ Over the last seven years, however, the IRS has avoided publishing OVD-related guidance in the IRM, instead distributing program guidance using memos designated as OUO, training materials, technical advisors, conference calls, and secret committees.³¹ This lack of transparency and due process fosters the impression that the IRS administers the OVD programs in an arbitrary and capricious manner, without regard to taxpayer rights. Moreover, when the IRS does not provide TAS with the same access to procedural information as other IRS employees, it obstructs TAS’s statutory mission to help taxpayers and address problems under IRC §§ 7803(c) and 7811.

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- 27 American Bar Association (ABA) Section of Taxation, *Comments on 2014 Offshore Voluntary Disclosure Program and the Streamlined Programs* (Oct.14, 2015). The Treasury Inspector General for Tax Administration (TIGTA) recently found that “[I]n part due to the lengthy processes in CI and the OVD Unit, the time to complete the entire OVD process for the 20,587 voluntary disclosures averaged nearly two years.” TIGTA, Ref. No. 2016-30-030, *Improvements Are Needed in Offshore Voluntary Disclosure Compliance and Processing Efforts* 15 (June 2, 2016). TIGTA recommended among other things that the IRS establish one mailing address for taxpayer correspondence. *Id.*
- 28 See, e.g., Roy A. Berg and Marsha-laine Dungog, State Bar of California Taxation Section, *The United States Income Tax Treatment of Australian Superannuation Funds Owned By U.S. Persons* (Apr. 2016); National Taxpayer Advocate 2013 Annual Report to Congress 228, 237 (Most Serious Problem: *Offshore Voluntary Disclosure: The IRS Offshore Voluntary Disclosure Program Disproportionately Burdens Those Who Made Honest Mistakes*) (recommending the IRS issue guidance about what, if any, information reporting applies to AFOREs (i.e., privatized social security accounts held by those who have worked in Mexico)).
- 29 The e-FOIA rules and IRS policy generally require the authors to clear such guidance internally and post it on the IRS website. See 5 U.S.C. § 552(a)(2)(C) (requiring the agencies to post “administrative staff manuals and instructions to staff that affect a member of the public,” unless an exemption applies); IRM 1.11.1.3 (Nov. 1, 2011) (disclosure laws). The only seemingly relevant exemption applies to instructions that “could reasonably be expected to risk circumvention of the law.” See 5 U.S.C §§ 552(b)(7)(E) and (b)(2). If an item is not properly posted and indexed, it may not be “relied on, used, or cited as precedent” by the IRS against a taxpayer unless the taxpayer has actual and timely notice of its terms. See 5 U.S.C. § 552(a)(2)(flush). As an example, the IRS was recently required to release OVD material in response to a FOIA request. See, e.g., Andrew Velarde, *FOIA Response Shows Hints of IRS Thinking on OVD*, 2015 TNT 192-1 (Oct. 5, 2015).
- 30 See generally IRM 1.11.9 (Dec. 4, 2014) (clearance process); IRM 1.11.10.6.3 (Apr. 25, 2014) (same); IRM 1.11.10.8 (Apr. 25, 2014) (“The author/originating office must incorporate permanent guidance into a published IRM by the expiration date of the interim guidance.”).
- 31 As an example, the IRS was recently required to release OVD training material in response to a FOIA request. See, e.g., Andrew Velarde, *FOIA Response Shows Hints of IRS Thinking on OVD*, 2015 TNT 192-1 (Oct. 5, 2015). See generally IRM 1.11.9 (Dec. 4, 2014) (clearance process); IRM 1.11.10.6.3 (Apr. 25, 2014) (same); IRM 1.11.10.8 (Apr. 25, 2014) (“The author/originating office must incorporate permanent guidance into a published IRM by the expiration date of the interim guidance.”).

The Government Is Eviscerating the Statutory Requirement for It to Prove Willfulness Before Imposing the Penalty for “Willful” Failures to Report Foreign Accounts

Another problem with the IRS’s administration of the FBAR rules is that it may drive more benign actors into the OVD if they fear it can deem their violations willful and impose even more draconian penalties without really proving anything. A court may require the government to meet its burden of proof by producing evidence that supports its allegation: (1) beyond a reasonable doubt (approximately 80 percent–95 percent); (2) by clear and convincing evidence (approximately 60 percent–80 percent); or (3) by a preponderance of the evidence (approximately 50 percent).³² According to a recent suit, the IRS improperly assessed a penalty against a person for “willfully” failing to file an FBAR for 2008 because the agency applied the “preponderance” standard instead of the “clear and convincing” standard.³³

Mr. Bernhard Gubser, a Swiss-born naturalized U.S. citizen, reportedly opened foreign accounts while he lived and worked in Switzerland, using them to hold his savings and pay his day-to-day expenses, eventually transferring them to other foreign institutions.³⁴ He said he did not know he had an FBAR and disclosure requirement. His CPA of 20 years had not asked him about his foreign accounts when the FBAR filing was due for 2008. The CPA prepared Mr. Gubser’s return and checked “no” in the box on Schedule B, Form 1040, which asks whether the taxpayer had a financial interest in, or signature or other authority over, a foreign account. Mr. Gubser’s attorneys said he did not learn of the FBAR filing requirement until 2010, at which time he made a timely voluntary disclosure to the IRS for the 2009 tax year.

A penalty of up to \$10,000 could apply to a “non-willful” failure to report the foreign account, unless Mr. Gubser had reasonable cause.³⁵ However, the maximum value in the account during 2008 was \$2.7 million and the IRS was seeking to impose a 50 percent “willful” penalty of \$1,363,336, draining his lifetime retirement savings, according to press accounts.

The IRS’s Appeals Officer reportedly acknowledged that while the IRS would not be able to meet the burden of establishing Mr. Gubser’s failure to file was willful under the clear and convincing standard, it would probably be able to satisfy this burden under the preponderance of the evidence standard. The National Taxpayer Advocate believes the government should have to establish a taxpayer’s willfulness by clear and convincing evidence, as articulated in Chief Counsel Advice (CCA) issued in 2006, especially since the IRS automatically meets a significant portion of its burden if the taxpayer filed a return that included a Schedule B, which references the FBAR filing requirement.³⁶

32 Although there are outlying views, these percentages are rough approximates based on a survey of judges. See John Gamino, *Tax Controversy Overburdened: A Critique of Heightened Standards of Proof*, 59 *Tax Law.* 497, 519-521 (Winter 2006).

33 All of the facts concerning this case are drawn from press reports or public filings. See William Hoke, *Suit Challenges Preponderance of Evidence Standard in FBAR Case*, 2015 *TNT* 243-9 (Dec. 17, 2015). The suit was ultimately dismissed for lack of standing because the court was not convinced that its determination concerning the burden of proof would prevent the assessment. See *Gubser v. IRS*, No. 5:15-CV-00298 (S.D. Tex., May 4, 2016).

34 *Id.*

35 See, e.g., 31 U.S.C. §§ 5314, 5321; 31 C.F.R. §§ 1010.350, 1010.306(c); FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR), http://www.fincen.gov/forms/bsa_forms/.

36 CCA 200603026 (Jan. 20, 2006).

Building Circumstantial Evidence into Forms Has Already Eroded the Requirement for the Government to Prove Willfulness

As Mr. Gubser's case shows, even seemingly inadvertent failures to file an FBAR can trigger severe civil penalties — up to the greater of \$100,000 or 50 percent of the account per violation — for *willful* violations because the government can rely on circumstantial evidence (or willful blindness) to prove willfulness.³⁷ Circumstantial evidence is nearly always available because the filing of Form 1040, Schedule B, which references the FBAR filing requirement, is circumstantial evidence that any subsequent failure to file an FBAR is willful.³⁸ The IRM provides no guidance about how taxpayers may disprove an inference of willful blindness, though it acknowledges that the mere existence of the check-box on a Schedule B filed by the taxpayer is insufficient to prove willfulness.³⁹

The Mere Possibility That the Government Could Rely on Circumstantial Evidence of Willful Blindness Has Prompted Some to Agree to Pay More Than They Should

Because the IRS has not provided any meaningful assurance that the penalty for a willful failure to file an FBAR will be treated as anything other than a strict liability penalty under a theory of willful blindness, some who inadvertently failed to file an FBAR have agreed to pay disproportionate penalties in the OVD programs, as discussed above.⁴⁰ These results seem to be an unintended consequence of the civil FBAR penalty regime, which was designed to address criminal conduct.⁴¹

For these reasons the National Taxpayer Advocate proposed legislation to clarify that only violations that the IRS proves are actually willful (without relying on circumstantial evidence of willful blindness represented by boilerplate language on Form 1040, Schedule B) are subject to a willful FBAR penalty. Such

37 See, e.g., *U.S. v. Williams*, 489 Fed. App'x. 655, 659 (4th Cir. 2012) (unpublished). In this context, willfulness means "a voluntary intentional violation of a known legal duty." *Ratzlaf v. U.S.*, 510 U.S. 135, 142 (1994) (citing *Cheek v. U.S.*, 498 U.S. 192, 201 (1991)); IRM 4.26.16.4.5.3 (July 1, 2008).

38 See, e.g., *U.S. v. Williams*, 489 Fed. App'x. 655, 659 (4th Cir. 2012) (unpublished) ("Evidence of acts to conceal income and financial information, combined with the defendant's failure to pursue knowledge of further reporting requirements as suggested on Schedule B, provide a sufficient basis to establish willfulness on the part of the defendant," quoting *U.S. v. Sturman*, 951 F.2d 1466, 1476 (6th Cir. 1992)); *U.S. v. McBride*, 908 F. Supp. 2d 1186 (D. Utah 2012). Under these authorities, a person might conclude that a reckless failure to read the instructions on Schedule B is akin to willfulness. In a criminal context, a person generally may be charged with knowledge of a violation by reason of willful blindness if he or she is aware of a "high probability" of its existence, unless he actually believes that it does not exist. See, e.g., Jonathan L. Marcus, *Model Penal Code Section 2.02(7) and Willful Blindness*, 102 YALE L.J. 2231 (1993) (discussing various interpretations of the willful blindness standard).

39 IRM 4.26.16.6.5.1(5) (Nov. 6, 2015) ("It is reasonable to assume that a person who has foreign bank accounts should read the information specified by the government in tax forms. The failure to act on this information and learn of the further reporting requirement, as suggested on Schedule B, may provide evidence of willful blindness on the part of the person.... The failure to learn of the filing requirements coupled with other factors, such as the efforts taken to conceal the existence of the accounts and the amounts involved, may lead to a conclusion that the violation was due to willful blindness. The mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, in itself, to establish that the FBAR violation was attributable to willful blindness."). The IRM's description leaves a reader with the (mis)impression that willful blindness is nearly automatic where the taxpayer has filed Schedule B and failed to report offshore income or otherwise tried to conceal the accounts. In fact, willful blindness cannot be established on the basis that a person was objectively reckless in not learning about a filing requirement, but must be based on a determination the person's actually knew that a filing requirement was highly likely to exist and that he or she deliberately avoided learning about it. See *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060, 2070 (2011) (requiring two findings to establish willful blindness: "(1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact;" and rejecting a formulation that would apply the doctrine to merely reckless conduct). However, the concept was borrowed from criminal cases where the government must establish willfulness beyond a reasonable doubt. See, e.g., *Fiore v. Comm'r*, T.C. Memo. 2013-21. Because of the government's heavy burden of proof in criminal cases, there is less risk that a person without willful intent would need to try to prove a negative — that his or her conduct was not willful.

40 See, e.g., TAS OVD Reports.

41 See, e.g., Pub. L. No. 91-508, § 241, 242 (1970); S. REP. No. 91-1139, at 2-4, 8-9 (1970); H. REP. No. 91-975, at 12 (1970).

clarification would reduce the excessive discretion afforded the IRS. It would also support the taxpayer's *right to be informed*, which includes the right to a clear explanation of the law.⁴²

The Government Is Now Arguing That Its Already-Easy-To-Establish Burden of Proof Should Be Reduced

At least in 2006, IRS attorneys believed that the government had to prove willfulness by clear and convincing evidence (*i.e.*, the standard generally applied to civil fraud penalties) rather than a mere preponderance of the evidence (*i.e.*, the standard applied to tax deficiencies).⁴³ They reasoned that like other civil fraud penalties, the FBAR penalty is not a tax to which the IRS's general presumption of correctness applies and it would be difficult for taxpayers to prove the negative (*i.e.*, that a failure to file an FBAR was not willful).⁴⁴

Subsequently, in the *Williams* and *McBride* cases where the standard of proof was not necessarily dispositive, government attorneys convinced two district courts that the lower preponderance standard was applicable.⁴⁵ However, the district court in *Williams* held that the government had not proven willfulness even under the preponderance standard, merely remarking without analysis that “in enforcement actions brought by the Government in other contexts ... the Government is required to prove its case by a preponderance of the evidence.”⁴⁶ The applicable burden of proof appears to have been similarly unimportant in *McBride* because the court found that Mr. McBride admitted he knew about the FBAR reporting requirement and intentionally concealed foreign accounts.⁴⁷ Thus, discussion of the burden of proof in these cases may be construed as dicta.

42 See TBOR, www.TaxpayerAdvocate.irs.gov/taxpayer-rights. One article acknowledged the benefits of the proposed clarification, but nonetheless supported allowing fact finders to rely on circumstantial evidence of willful blindness. See Peter Hardy and Carolyn H. Kendall, *Between the National Taxpayer Advocate and the Courts: Steering a Middle Course to Define “Willfulness” in Civil Offshore Account Enforcement Cases Part 2*, PROCEDURALLY TAXING BLOG (Mar. 24, 2015), <http://procedurallytaxing.com/between-the-national-taxpayer-advocate-and-the-courts-steering-a-middle-course-to-define-willfulness-in-civil-offshore-account-enforcement-cases-part-2/>. Legislation would need to go further than merely clarifying that (1) the IRS must prove an “intentional violation of a known legal duty” and (2) that the “fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient” to establish willfulness to prevent a fact finder from, in effect, assuming willfulness when a taxpayer has filed a Schedule B unless the taxpayer can prove otherwise, as the IRM already contains those statements. See IRM 4.26.16.6.5.1 (Nov. 6, 2015) (discussed above). Because the willful FBAR penalty is especially severe, it merits special procedural protections.

43 CCA 200603026 (Jan. 20, 2006).

44 *Id.* (“Courts have traditionally applied the clear and convincing standard with respect to fraud cases in general, not just to tax fraud cases, because, just as it is difficult to show intent, it is also difficult to show a lack of intent. The higher standard of clear and convincing evidence offers some protection for an individual who may be wrongly accused of fraud. The burden of proof the Service has with respect to civil tax fraud penalties represents an exception to the general presumption of correctness that the courts have afforded to tax assessments ... Because the FBAR penalty is not a tax or a tax penalty, the presumption of correctness with respect to tax assessments would not apply to an FBAR penalty assessment for a willful violation — another reason we believe that the Service will need to meet the higher standard of clear and convincing evidence.”).

45 See *U.S. v. Williams*, 106 A.F.T.R.2d (RIA) 6150 (E.D. VA. 2010), *rev'd*, 489 Fed. App'x. 655 (4th Cir. 2012) (unpublished); *U.S. v. McBride*, 908 F. Supp. 2d 1186, 1201 (D. Utah 2012).

46 *U.S. v. Williams*, 106 A.F.T.R.2d (RIA) 6150 (E.D. VA. 2010), *rev'd*, 489 Fed. App'x. 655 (4th Cir. 2012) (unpublished). The Fourth Circuit reversed, finding that Mr. Williams willfully failed to file an FBAR, in part, because he admitted as much when pleading guilty to tax evasion, but the Fourth Circuit did not discuss the burden of proof. *U.S. v. Williams*, 489 Fed. App'x. at 657 and 660.

47 *U.S. v. McBride*, 908 F. Supp. 2d 1186, 1208-09 (“*McBride* had actual knowledge of his duty to file an FBAR for any account in which he had a financial interest prior to filing his 2000 and 2001 tax returns. *McBride* even testified that ‘the purpose of Merrill Scott’ was to avoid disclosure and reporting the existence of interests ‘because ... if you disclose the accounts on the form, then you pay tax on them, so it went against what [he] set up Merrill Scott for in the first place.’”).

There Is No Good Reason to Lower the Burden of Proof, Except to “Win” Cases

The *McBride* decision explained that “[B]ecause the FBAR penalties at issue in this case only involve money, it does not involve ‘particularly important individual interests or rights.’”⁴⁸ While preponderance of the evidence is a default standard, courts have long required civil fraud to be proven by clear and convincing evidence.⁴⁹ Because all civil fraud cases involve money and *McBride* did not distinguish the FBAR penalty from them, its analysis seems incomplete, though it cited two Supreme Court cases that applied the preponderance standard in cases of fraud upon investors under securities laws and upon creditors under the bankruptcy laws.⁵⁰ However, those statutes may be distinguishable because they allow a person other than the government to recover for fraud.⁵¹

According to the Supreme Court,

“[O]ne typical use of the [clear and convincing] standard is in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff’s burden of proof.”⁵²

Under this reasoning, a higher burden should apply where the government’s allegation of fraud is a substitute for a criminal penalty, which it would have to prove “beyond a reasonable doubt.” In the context of an allegedly willful failure to file an FBAR, the government is attempting to impose a civil penalty for allegedly willful conduct as a substitute for criminal sanctions (“quasi-criminal wrongdoing”) that apply to the same conduct, essentially branding him a criminal and tarnishing his reputation. This is the type of situation where the accused should have greater procedural due process protections.⁵³ Some commentators have speculated that the willful FBAR penalty, which could reach 300 percent of any unreported account, could violate the Excessive Fines Clause of the Eighth Amendment.⁵⁴ Procedural protections are particularly important where willful intent is a component of the allegation because it is difficult for the accused to prove a negative — the absence of willful intent.

48 *U.S. v. McBride*, 908 F. Supp. 2d 1186, 1201 (D. Utah 2012). Of course, money is generally necessary to obtain food, shelter, clothing, transportation, medical care, counsel in a civil proceeding, and to avoid poverty in retirement.

49 See, e.g., *Woodby v. Immigration and Naturalization Service*, 385 U.S. 276, 284, 285 n.18 (1966) (the “clear, unequivocal, and convincing evidence ... standard, or an even higher one, has traditionally been imposed in cases involving allegations of civil fraud . . .” (citing 9 *Wigmore*, Evidence, § 2498 (3d ed. 1940))).

50 See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) (violations of Securities Exchange Act Rule 10b-5 established by preponderance); *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (fraud on bankruptcy creditors established by preponderance).

51 See *id.*

52 *Addington v. Texas*, 441 U.S. 418, 424 (1979).

53 Although Congress expressly eliminated the “clear and convincing” standard under the False Claims Act, scholars have argued that the legislation violates principles of procedural due process. See, e.g., Frank Lasalle, *Comment: The Civil False Claims Act: The Need for a Heightened Burden of Proof as a Prerequisite for Forfeiture*, 28 AKRON L. REV. 497 (Spring 1995). Fortunately, Congress has not eliminated the clear and convincing evidence standard in the context of willful FBAR violations.

54 See, e.g., Steven Toscher and Barbara Lubin, *When Penalties Are Excessive — The Excessive Fines Clause as a Limitation on the Imposition of the Willful FBAR Penalty*, J. TAX PRACTICE & PROCEDURE 69-74 (Jan. 2010). Perhaps to avoid this issue, the IRS will not assert a penalty of more than 100 percent of the unreported account. IRM 4.26.16.6.5.3 (Nov. 6, 2015) (“After May 12, 2015, in most cases, the total penalty amount for all years under examination will be limited to 50 percent of the highest aggregate balance ... In no event will the total penalty amount exceed 100 percent...”).

Indeed, the government generally has the burden to prove by clear and convincing evidence that a person engaged in tax fraud before it may impose a civil fraud penalty under IRC §§ 6663 or 6701.⁵⁵ For penalties under IRC § 6663, Tax Court Rule 142(b) prescribes the clear and convincing standard, but this standard is routinely applied by circuit courts that are not subject to those rules.⁵⁶ A majority of the circuits also require the government to meet the clear and convincing standard before applying civil fraud penalty for aiding and abetting under IRC § 6701.⁵⁷ Thus, there does not appear to be a good reason to retreat from the clear and convincing standard in the context of allegedly willful FBAR violations, unless the goal is to help the government “win” cases against taxpayers more likely to have made inadvertent errors.

Reducing the Burden of Proof Is Inconsistent With the Statutory Scheme

More importantly for tax administration, however, the government has not explained how lowering the government’s burden of proof while nearly-assuming willful blindness for those who have filed a Schedule B is consistent with the statutory scheme. The statutory scheme provides a wide range of sanctions: civil and criminal penalties for willful FBAR violations, a lower civil penalty for non-willful violations, agency discretion to apply penalties below the statutory maximums, and also contemplates that the government will waive penalties when the violation was due to reasonable cause.⁵⁸ If the clear and convincing standard is eliminated and the government is still allowed to rely on circumstantial evidence, nearly any FBAR violation will be subject to what amounts to a draconian strict liability penalty that is misleadingly characterized as a penalty reserved for willful violations.⁵⁹

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- 55 See, e.g., *McGraw v. Comm’r*, 384 F.3d 965, 970 (8th Cir. 2004) (taxpayer civil fraud penalty under IRC § 6663); *Carlson v. United States*, 754 F.3d 1223, 1227-28 (11th Cir. 2014) (IRC § 6701). See also IRM 25.1.1.2.2 (Jan. 23, 2014) (“In civil fraud cases, the Government must prove fraud by clear and convincing evidence.”). In the context of the civil fraud penalty under IRC § 6663, IRC § 7454(a) counters the IRS’s general presumption of correctness by providing “[I]n any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary.” However, neither IRC § 7454(a) nor Treas. Reg. § 301.7454-1 prescribe any particular burden of proof.
- 56 See e.g., Tax Court Rule 142(b) (“In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue is on the respondent, and that burden of proof is to be carried by clear and convincing evidence. See Code sec. 7454(a).”); *McGraw v. Comm’r*, 384 F.3d 965, 970 (8th Cir. 2004) (taxpayer civil fraud penalty under IRC § 6663); *Estate of Burton W. Kanter v. Comm’r*, 337 F.3d 833, 847 (7th Cir. 2003), *rev’d sub nom.* on other grounds, *Ballard v. Comm’r*, 544 U.S. 40 (2005) (same); *Gandy Nursery, Inc. v. United States*, 318 F.3d 631, 638 (5th Cir. 2003) (same); *Clayton v. Comm’r*, 102 T.C. 632, 646 (1994) (same).
- 57 See *Carlson v. United States*, 754 F.3d 1223, 1227-28 (11th Cir. 2014) (applying the clear and convincing standard to violations under IRC § 6701 and identifying several other circuits that apply that standard, while acknowledging that its decision was at odds with the Second and the Eighth Circuits).
- 58 See, e.g., 31 U.S.C. §§ 5314, 5321; 31 C.F.R. §§ 1010.350, 1010.306(c); FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)*, http://www.fincen.gov/forms/bsa_forms/.
- 59 Accord Caroline Ciralo, *The FBAR Penalty: What Constitutes Willfulness?*, MARYLAND BAR JOURNAL 43 (May 2013), http://www.rosenbergmartin.com/Portals/0/PDFs/MBJ_May13_ciralo.pdf (“McBride may be a classic example of bad facts making bad law. Still, we now have a published decision essentially imposing strict liability for the willful FBAR penalty on anyone who signs a federal tax return with a Schedule B attached and fails to file a required FBAR.”).

FOCUS FOR FISCAL YEAR 2017

In Fiscal Year 2017, TAS will continue to:

- Advocate for taxpayers experiencing problems with the IRS's OVD and streamlined programs;
- Advocate for more transparency and common sense in the IRS's administration of the FBAR rules and OVD-related programs (including guidance concerning the treatment of foreign social security accounts in the OVD programs and the IRS's burden of proof in FBAR penalty cases);
- Advocate for the IRS to declassify and release any undisclosed OVD-related guidance; and
- Advocate for the IRS to post the annual FBAR report to Congress on its website, as the Treasury Department's Financial Crimes Enforcement Network (FinCEN) did before the IRS began administering the FBAR rules.⁶⁰

⁶⁰ The annual FBAR Report to Congress is required by Section 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act) of 2001, Pub. L. No. 107-56. The first few FBAR Reports to Congress were prepared by FinCEN and are posted on its website. See, e.g., Secretary of the Treasury, *A Report to Congress in Accordance with §361(B) of the USA Patriot Act (2004)*, http://www.fincen.gov/news_room/rp/files/fbar_report_2004.pdf (2003 FBAR Report to Congress).