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The IRS's Offshore Voluntary Disclosure Program "Bait and Switch" May Undermine Trust for the IRS and Future Compliance Programs

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DEFINITION OF PROBLEM

U.S. persons are generally required to report foreign accounts on Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*, and to report income from such accounts on U.S. tax returns. The IRS "strongly encouraged" people who failed to file these and similar returns and report income from foreign accounts to participate in the 2009 Offshore Voluntary Disclosure Program (OVDP), rather than quietly filing amended returns and paying any taxes due.¹ It warned that taxpayers making "quiet" corrections could be "criminally prosecuted," while OVDP participants would generally be subject to a 20 percent "offshore" penalty in lieu of various other penalties, including FBAR.² The IRS announced, however, that "[u]nder no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes."³ Taxpayers who would not have been subject to significant penalties because their violations were not willful or because they qualified for the "reasonable cause" exception believed this statement applied to them.

On March 1, 2011, more than a year after the 2009 OVDP ended, the IRS "clarified" its seemingly unambiguous statement. It would no longer consider whether taxpayers in the 2009 OVDP would pay less under existing statutes on the basis of non-willfulness or reasonable cause except in narrow circumstances. IRS leaders communicated the change in a memorandum that they did not disclose to the public, in violation of the Freedom of Information Act (FOIA), leaving IRS revenue agents (*i.e.*, auditors or examiners) to deliver the bad news to practitioners one at a time. This was, no doubt, particularly uncomfortable for agents who had agreed to settle on more favorable terms with a practitioner's other clients just the week before.

¹ See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (Feb. 9, 2011) (first posted May 6, 2009) (hereinafter "OVDP FAQ").

² OVDP FAQ #10.

³ OVDP FAQ #35.

Taxpayers who believed they should pay less under existing statutes could either agree to pay more than they thought they owed or "opt out" of the 2009 OVDP and face the possibility of excessive civil penalties and criminal prosecution. Both options were problematic. Opting out would waste all of the resources already expended on the 2009 OVDP application by both the taxpayer and the IRS without bringing the taxpayer closure or certainty, as advertised. Moreover, in any future examination the IRS might have to request and review the items that were before the examiner processing the 2009 OVDP submission.⁴

The pressure that taxpayers who would pay less under existing statutes felt to remain in the program and pay more than they owed was even worse. It violated longstanding IRS policy along with most conceptions of fairness and due process.⁵ The IRS's inconsistency and failure to follow its public guidance damaged its credibility with practitioners and could be subject to legal challenge. Moreover, all practitioners will now be obliged to advise clients who are considering participating in any future IRS settlement initiatives about how the IRS "clarified" this one. Thus, the IRS is likely to have much more difficulty gaining participation in any future settlement initiatives, as more people opt to "lie low" and make "quiet" corrections, if any.

ANALYSIS OF PROBLEM

Background

What is an FBAR and why might someone fail to file it?

U.S. persons are generally required to report foreign accounts on the FBAR form by June 30 of each year.⁶ For various reasons, which often have nothing to do with taxes, many do not. For example, some people living abroad and using a local checking account are not aware they are required to file an FBAR.⁷ Others living in the U.S. may simply inherit an overseas account or open one to send money to friends and relatives abroad while remaining oblivious to the FBAR filing requirement. Still others who have immigrated to the U.S. from repressive regimes may simply have an account containing "flee money," that they do not disclose to anyone (particularly a government) because they are holding it in case they are again persecuted by the government and need to flee.⁸

The U.S. government has greatly increased FBAR-related penalties and enforcement.

Perhaps because some people use offshore accounts for intentional tax evasion, money laundering, or terrorist financing, the U.S. government has greatly increased both

⁴ This contradicted the portion of 2009 OVDP FAQ #35 that stated "[T]hese examiners [the OVDP examiners] will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer."

⁵ Policy Statement 4-7, reprinted at IRM 1.2.13.1.5 (Feb. 23, 1960).

⁶ See, e.g., 31 U.S.C. § 5314; 31 C.F.R. § 1010.350(a); 31 C.F.R. § 1010.306(c).

⁷ An FBAR is required if the aggregate value of the foreign accounts exceeds \$10,000. *Id.*

⁸ See, e.g., Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 44 (2010) (specifically describing four examples of persons stashing secret "flee money" in offshore accounts for nontax reasons after coming to the U.S. from Iraq, Indonesia, Mexico, or after having experienced the Holocaust).

FBAR-related penalties and FBAR enforcement in recent years.⁹ Prior to October 22, 2004, there was no penalty for a non-willful failure to file and the maximum civil penalty for willful violations was capped at \$100,000.¹⁰ Now, the maximum civil penalty is \$10,000 for each non-willful failure;¹¹ and if the government establishes the failure was willful, the maximum penalty is the greater of \$100,000 or 50 percent of the balance of the undisclosed account each year.¹² Thus, a person may be liable for FBAR penalties of 300 percent of the account balance for willful failures continuing over a six-year period.¹³ Criminal penalties of up to \$500,000 and 10 years in prison may also apply.¹⁴

The Financial Crimes Enforcement Network (FinCen) delegated responsibility for FBAR enforcement to the IRS in April 2003.¹⁵ Before then, the FBAR filing requirements were not well known, noncompliance was the norm, and the requirements were rarely enforced.¹⁶ Consequently, even tax preparers sometimes failed to advise taxpayers about the FBAR filing requirement. The OVDP and the publicity surrounding it increased public awareness of the FBAR filing requirement. This publicity likely prompted many people whose failure to file FBARs was not willful to make voluntary disclosures.¹⁷

Existing statutes, as implemented in the IRM, do not authorize the IRS to assert the maximum FBAR penalty in every case.

Even before Congress increased FBAR penalties in 2004, the IRS published tiered penalty mitigation guidelines in the Internal Revenue Manual (IRM), directing examiners to apply less than the statutory maximums.¹⁸ In 2008 the IRS updated these guidelines, explaining that the maximum FBAR penalty amounts can "greatly exceed an amount that would be appropriate in view of the violation."¹⁹ It required examiners to apply even lesser penalties or a warning letter in lieu of penalties in many cases.²⁰ It explained that applying multiple

⁹ See, e.g., Joint Committee on Taxation, JCS-5-05, *General Explanation of Tax Legislation Enacted in the 108th Cong.* 377-378 (May 2005).

¹⁰ The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 821(a), 118 Stat. 1586 (Oct. 22, 2004) (amending 31 U.S.C. § 5321(a)(5)) established a penalty for non-willful violations, subject to a reasonable cause exception, and increased the penalty for willful violations.

¹¹ 31 U.S.C. § 5321(a)(5)(A)-(B).

¹² 31 U.S.C. § 5321(a)(5)(C).

¹³ A six-year statute of limitations applies to the civil FBAR penalty. See 31 U.S.C. § 5321(b)(1).

¹⁴ 31 U.S.C. §§ 5321(a)(5)(C) and 5322; 31 C.F.R. § 1010.840(b).

¹⁵ See 68 Fed. Reg. 26,489 (May 16, 2003) (codified at 31 C.F.R. § 1010.810); IRM 4.26.16.1(2) (July 1, 2008) (same).

¹⁶ A 2002 Treasury report estimated the FBAR compliance rate at less than 20 percent. U.S. Department of the Treasury, *A Report to Congress in Accordance with § 361(B) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 6 (Apr. 26, 2002). The government considered civil penalties in only 12 cases from 1993 to 2002. *Id.* at 8-10. Of those 12, only two taxpayers ultimately received penalties, four were issued "letters of warning," and the remaining six were not pursued. *Id.* Similarly, the U.S. Department of Justice filed just nine indictments related to FBAR violations, between 1996 and 1998, and none during 1999 and 2000. *Id.*

¹⁷ The IRS received 15,364 applications to the 2009 OVDP. IRS response to TAS information request (Sept. 14, 2011). By comparison, it only received 1,326 applications to the 2003 Offshore Voluntary Compliance Initiative (OVCI), and (as of May 20, 2011) about 4,107 to the 2011 Offshore Voluntary Disclosure Initiative (OVDI), discussed below. IRS response to TAS information request (Sept. 14, 2011).

¹⁸ See Memorandum for Acting Deputy Director, Compliance Field Operations, from Acting Deputy Director, Compliance Policy, SB/SE 2004-1, *Anti-Money Laundering Policy and Procedural Change Regarding Civil Examinations of the Reporting and Recordkeeping Requirements Respecting the Foreign Bank and Financial Accounts Report* (Apr. 15, 2004) (attachment 4).

¹⁹ IRM 4.26.16.4(5) (July 1, 2008).

²⁰ *Id.*; IRM Exhibit 4.26.16-2 (July 1, 2008). As of this writing the July 1, 2008, IRM had not been updated or superseded.

FBAR penalties is to be "considered only in the most egregious cases."²¹ Because the statute only specifies "maximum" FBAR penalty amounts that the IRS "may" impose, it would be inconsistent with the statute for the IRS to assert the maximum penalty amounts in every case.²² Some have gone so far as to suggest that in the absence of these taxpayer-favorable IRM provisions, the FBAR penalties can be so disproportionate as to violate the Excessive Fines Clause of the Eighth Amendment to the U.S. Constitution.²³ Thus, examiners have long been required (under "existing statutes," as implemented by the IRM) to assert FBAR penalties of significantly less than the statutory maximums in all but the most egregious cases.

HISTORIC VOLUNTARY DISCLOSURE PRACTICE

Pursuant to its longstanding voluntary disclosure practice, the IRS takes a voluntary disclosure into account in determining whether to refer a person for criminal prosecution.²⁴ To qualify, the person must (a) make a timely disclosure (*i.e.*, generally before the government begins an investigation or learns of the noncompliance), (b) cooperate with the IRS, and (c) arrange to pay the liability in full.²⁵ Historically, taxpayers who made a voluntary disclosure could often avoid civil penalties as well.²⁶ Some practitioners advised that if penalties did apply to a voluntary disclosure involving an offshore account, they would typically amount to 12 to 15 percent of the balance of the undisclosed account in question.²⁷ However, people could often achieve a similar result (*i.e.*, no criminal penalties and little or no civil penalties) by making a "quiet" disclosure – filing an amended return and paying any tax delinquency – without making a formal voluntary disclosure.²⁸

²¹ See, e.g., IRM 4.26.16.4.7 (July 1, 2008) ("If there was an FBAR violation but the examiner determines that a penalty is not appropriate, the examiner should issue the FBAR warning letter.... When a penalty is appropriate, IRS has established penalty mitigation guidelines to aid the examiner in applying penalties in a uniform manner.... Given the magnitude of the maximum penalties permitted for each violation, the assertion of multiple penalties and the assertion of separate penalties for multiple violations with respect to a single FBAR form, should be considered only in the most egregious cases."); IRM Exhibit 4.26.16-1 (July 1, 2008).

²² 31 U.S.C. § 5321(a)(5).

²³ See 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).

²⁴ IRM 9.5.11.9 (Dec. 2, 2009). Technically, the IRS can still refer a taxpayer who makes a voluntary disclosure for criminal prosecution, but it must consider the disclosure in making that decision. *Id.*

²⁵ *Id.* The voluntary disclosure practice is not available to those with illegal-source income. *Id.*

²⁶ See, e.g., Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1, 4 (Sept. 21, 2010) (noting that before the OVD, "taxpayers rarely paid any penalties in connection with voluntary disclosures on offshore accounts. Indeed, most taxpayers, relying on the advice of skilled tax professionals, many of whom have decades of prior experience in the Justice Department or IRS, simply filed amended returns and paid the tax and interest. They were never audited. No penalties were ever asserted....").

²⁷ Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 43 (2010).

²⁸ See, e.g., Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010); Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 43 (2010) ("most practitioners generally recommended to their clients the use of informal or 'quiet' disclosure. In theory, the taxpayer ran the risk of being 'caught' but, in practice, the taxpayer rarely heard anything back from the Service or DOJ. Further, if one did participate in the formal voluntary disclosure process, most, if not all, penalties generally were abated.").

2003 OFFSHORE VOLUNTARY COMPLIANCE INITIATIVE (OVCI)

Between January 14, 2003, and April 15, 2003, the IRS offered the Offshore Voluntary Compliance Initiative (OVCI) to persons using offshore payment cards or similar arrangements to improperly avoid paying taxes.²⁹ OVCI provided more certainty than the long-standing voluntary disclosure practice about what civil penalties would apply and when disclosures would be deemed timely in cases where the IRS was already actively pursuing the names of offshore credit card account holders (*e.g.*, accounts with UBS in Switzerland). Participants would have to pay six years of back taxes, interest, and certain accuracy and delinquency penalties, but would not face any civil fraud or information return penalties (including FBAR).³⁰

LAST CHANCE COMPLIANCE INITIATIVE (LCCI)

Between 2003 and 2009, the IRS issued letters to taxpayers specifically identified as holding an offshore payment card (or similar arrangement), offering them the so-called Last Chance Compliance Initiative (LCCI). Under the LCCI, the IRS would waive a number of penalties for failure to file information returns and, even if they otherwise applied to multiple years, would only impose the civil fraud and FBAR penalties for a single year.³¹ Naturally, the IRS would not require people to pay more in FBAR penalties under LCCI than would be due under existing law and in most cases would accept less.³² Examiners were expressly authorized to use discretion and apply FBAR mitigation guidelines to avoid inappropriately high FBAR penalties.³³

The IRS has departed from its historic voluntary disclosure and settlement practices.

The IRS apparently intended the 2009 Offshore Voluntary Disclosure Program (described below) to represent a significant departure from its historic practice of not requiring people to pay more inside an initiative than outside of it. Notwithstanding this intention, the unambiguous public terms of the 2009 OVDP were more consistent with its historic practice of attracting taxpayers to an initiative by offering a better deal than they would be likely to receive after an examination. Thus, taxpayers and practitioners felt the OVDP was a "bait and switch" when they learned the IRS changed the terms in mid-stream so that many taxpayers whose cases had not been processed by March 1, 2011, would be required to pay

²⁹ 2003 IR-2003-5 (Jan 14, 2003).

³⁰ See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311. A 2003 OVCI submission would also be treated as an application for the longstanding voluntary compliance practice, minimizing the risk of criminal prosecution. *Id.* The IRS received about 1,326 OVCI applications and the program resulted in collections of about \$225 million. Response to TAS information request (Sept. 14, 2011).

³¹ See Notice 1341 (2007); Letter 3649 (2007); IRM 4.26.16.4.6.4 (July 1, 2008).

³² See, *e.g.*, CCA 200603026 (Sept. 1, 2005) (noting: [the LCCI letter] "says, 'Also, civil penalties for violations involving [FBARs] will be imposed for only one year and we may resolve the FBAR penalty for less than the statutory amount based on the facts and circumstances of your case.' The instructions to agents contained in the Guidelines for Mitigation of the FBAR Civil Penalty for LCCI Cases provide: 'The examiner may determine that the facts and circumstances of a particular case may warrant that a penalty under these guidelines is not appropriate or that a lesser amount than the guidelines would otherwise provide is appropriate.' If agents follow these guidelines we need not be imposing the FBAR penalty arbitrarily in cases in which it clearly does not apply").

³³ See, *e.g.*, IRM Exhibit 4.26.16-4 (July 1, 2008) (LCCI penalty mitigation guidelines).

more inside the program than outside.³⁴ This reversal seemed even more unfair because many similarly situated taxpayers whose applications were processed before March 1 received a better deal than those whose applications were processed later.³⁵

2009 OFFSHORE VOLUNTARY DISCLOSURE PROGRAM – THE “BAIT”

On March 23, 2009, the IRS ended the LCCI and issued a memo announcing the 2009 OVDP, which was similar to the LCCI.³⁶ As noted above, people whose noncompliance was non-willful or who qualified for the reasonable cause exception typically did not need to participate in a settlement initiative because in most cases, significant penalties would never have been on the table. In the case of the OVDP, however, the IRS “strongly” encouraged people who had unreported income to participate rather than quietly correcting any discrepancies by filing amended returns and paying any taxes due. IRS “frequently asked question” (FAQ) #10 states:

Taxpayers are **strongly encouraged** to come forward under the Voluntary Disclosure Practice.... Those taxpayers making “quiet” disclosures should be aware of the risk of being examined and potentially **criminally prosecuted for all applicable years**.... The IRS will be closely reviewing these returns to determine whether enforcement action is appropriate. [Emphasis added].³⁷

Even so, taxpayers who had reasonable cause or whose failures were not willful would not want to participate if they would be subject to lower penalties outside of the program. They took comfort, however, in IRS guidance that indicated they would not have to pay more inside the program. Examiners were authorized to assess a single penalty (called the “offshore penalty”) equal to 20 percent of the amount in the foreign bank account in the year with the highest balance. This offshore penalty was “in lieu of all other penalties that may apply, including FBAR and information return penalties...” over a six-year period. Some practitioners reasoned that the offshore penalty would not apply “in lieu” of other penalties if the other penalties did not apply (*i.e.*, the taxpayer would not pay a 20 percent penalty under OVDP if under the existing statutes, he or she would be obligated to pay a

³⁴ See, e.g., Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010); Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011); CCH Federal Taxes Weekly, Practitioners' Corner: *Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13., 153, 155 (Mar. 31, 2011).

³⁵ TAS formally requested that the IRS provide: “The number of 2009 OVDP agreements accepted for less than the 20 percent offshore penalty on the basis that the violation was not willful or was subject to reasonable cause.” TAS request for IRS information (June 2, 2011). The IRS responded that this “number is not tracked and therefore cannot be determined.” IRS response to TAS information request (Sept. 14, 2011).

³⁶ Memorandum for Commissioner, Large and Mid-Size Business (LMSB) Division and Commissioner, Small Business/Self-Employed (SB/SE) Division from Deputy Commissioner for Services and Enforcement, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Offshore Accounts and Entities* (Mar. 23, 2009); Memorandum for SB/SE Examination Area Directors and LMSB Industry Directors from Deputy Commissioner, *Emphasis on and Proper Development of Offshore Examination Cases, Managerial Review, and Revocation of Last Chance Compliance Initiative* (Mar. 23, 2009).

³⁷ In contrast to OVDP FAQ #9, which notes that those who did not underreport any income should not participate, OVDP FAQ #50 affirmatively advised “... the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts...” Notably, it did not carve out taxpayers whose unreported income was offset by a net operating loss or foreign tax credit resulting in little or no net tax liability or those who would be eligible for a penalty waiver or a reduced penalty under FBAR mitigation guidelines.

lesser penalty).³⁸ The IRS published key terms of the program as "frequently asked questions" (FAQs), which were more explicit.³⁹ On June 24, 2009, it added FAQ #35, which directly addressed the question of whether the IRS would agree to a penalty of less than 20 percent if a lower penalty would apply under existing statutes. It stated:

Q35. Will examiners have any discretion to settle cases? For example, if a penalty for failing to file a Form 5471 for 6 years is \$10,000 per year, will that be compared to 20 percent of the corporation's asset value? Would the lesser amount apply?

A35. **Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes.** If the taxpayer disagrees with the IRS's determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues. At the conclusion of this examination, all applicable penalties, including information return penalties and FBAR penalties, will be imposed. If, after the standard examination is concluded the case is closed unagreed, the taxpayer will have recourse to Appeals. See Q&A 34. [Emphasis added.]⁴⁰

As discussed below, the IRS's subsequent reinterpretation of this language has generated significant controversy. While the 2009 OVDP ended on October 15, 2009, the IRS continued to process submissions throughout 2011.⁴¹

2011 OFFSHORE VOLUNTARY DISCLOSURE INITIATIVE (OVDI)

On February 8, 2011, the IRS announced the 2011 Offshore Voluntary Disclosure Initiative.⁴² The terms were similar to those of the 2009 OVDP, except that the offshore penalty rate was 25 percent. In limited circumstances a special 5 percent or 12.5 percent

³⁸ See Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs* (Part 2), 21 J. Int'l. Tax'n 36, 39 (2010) ("The 20% penalty should be imposed only 'in lieu of all other penalties that may apply.' It should not, and cannot, be imposed if no such 'other penalties' apply, or if the 'other penalties that may apply' do not exceed 20% ...").

³⁹ See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (posted May 6, 2009) (adding FAQ #35 on June 24, 2009). For a discussion of the problem with issuing this guidance solely as an FAQ, see Most Serious Problem: *The IRS's Failure to Consistently Vet and Disclose its Procedures Harms Taxpayers, Deprives the IRS of Valuable Comments, and Violates the Law, infra*.

⁴⁰ The "discretion" language in the first sentence could be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, *reprinted at*, IRM 1.2.17.1.6 (Aug. 28, 2007).

⁴¹ See OVDP FAQ (preamble). According to IRS data, it received 15,364 applications to the 2009 OVDP and 6,577 remained open as of March 1, 2011. IRS response to TAS information request (Sept. 14, 2011).

⁴² IRS, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html> (Aug. 29, 2011) (first posted Feb. 8, 2011) (hereinafter OVDI FAQ).

offshore penalty would apply.⁴³ In addition, instead of assuring taxpayers that a lower penalty would be used if applicable to a "particular taxpayer" under "existing statutes," in answer to the same question as OVDP FAQ #35, OVDI FAQ #50 provides, in relevant part:

A50: ...Under no circumstances will taxpayers be required to pay a penalty greater than what they would otherwise be liable for **under the maximum penalties imposed under existing statutes...** Examiners will compare the amount due under this offshore initiative to the tax, interest, and applicable penalties (**at their maximum levels and without regard to issues relating to reasonable cause, willfulness, mitigation factors, or other circumstances that may reduce liability**) for all open years that a taxpayer would owe in the absence of the 2011 OVDI penalty regime. The taxpayer will pay the lesser amount. [Emphasis added].

This was a significant departure from the IRS's historic practice of not applying significant civil penalties to taxpayers making voluntary disclosures; the terms of the 2003 OVCI, which did not impose FBAR penalties; the terms of the LCCI, which allowed examiners to consider willfulness and the mitigation guidelines; and the express terms of the 2009 OVDP, which promised to require no more than "a particular taxpayer" would be liable for under "existing statutes."

We have been informed that the IRS meant to draft 2009 OVDP FAQ #35 in the way that it actually drafted 2011 OVDI FAQ #50.⁴⁴ While the IRS can obviously make one initiative more restrictive than another, it should not change the terms of a voluntary disclosure program or initiative after taxpayers have expended resources to apply for it in reliance on published terms that were more favorable.

THE MARCH 1, 2011 OVDP MEMO – THE "SWITCH"

On March 1, 2011, after IRS leaders learned that examiners were agreeing to penalties of less than the 20 percent offshore penalty based on OVDP FAQ #35, they issued an internal memo (the "March 1 memo") intended to extinguish what they perceived as an ambiguity.⁴⁵ Nonetheless, the March 1 memo provided that examiners could in fact continue to agree to

⁴³ See OVDI FAQ # 52; OVDI FAQ #53; Memorandum for Commissioner, Large Business and International (LB&I) Division and Commissioner, Small Business/Self-Employed (SB/SE) Division from Deputy Commissioner of Services and Enforcement, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests with Offshore Issues* (Mar. 1, 2011). The IRS also offered to amend 2009 OVDP settlements to provide these special rates to qualifying persons who had previously entered that program. *Id.*

⁴⁴ The IRS eventually began to inform the public of its intention. See Jeremiah Coder, *No Factual Determinations Made In Offshore Disclosure Initiative*, *IRS Official Says*, 2011 TNT 90-2 (May 10, 2011).

⁴⁵ Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011). Issuing guidance in the form of an FAQ, which is subject to even less review than an interim guidance memorandum or IRM revision presents problems. Correcting it by issuing an undisclosed and unreviewed memo presents further difficulties. For a discussion of these issues, see *The IRS's Failure To Consistently Vet and Disclose Its Procedures Harms Taxpayers, Deprives It of Valuable Comments, and Violates the Law, infra*. The IRS eventually posted the March 1 memo in response to a Taxpayer Advocate Directive issued by the National Taxpayer Advocate on August 16, 2011. See Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The March IRS memo is now available at http://www.irs.gov/pub/irs-drop/ovdi_memo_use_of_discretion_3-1-11.pdf.

penalties of less than 20 percent in some situations, such as where substantive "discussions concerning the assertion of an offshore penalty lower than 20 percent have taken place" with certain officials and were documented in the case file before Feb. 8, 2011 – the day the IRS announced the 2011 OVDI. Even so, the IRS had not processed closing agreements for 6,577 taxpayers who had applied for the 2009 OVDI, many of whom had applied in reliance on FAQ #35.⁴⁶

In addition, a number of taxpayers who had discussions with examiners prior to February 8, 2011, concerning the assertion of an offshore penalty of less than 20 percent sought TAS's assistance because they had difficulty getting the IRS to apply a lesser penalty. Such difficulties may have resulted because IRS examiners sometimes asserted the discussions were undocumented or not "substantive," faced difficulty in getting approval from IRS technical advisors to apply a lesser offshore penalty, and were under pressure to close cases quickly either by agreement or by removing taxpayers from the program.

Even in cases where the IRS claimed to have done the comparison, its process for doing so seemed unfair to taxpayers. In order to avoid undertaking exam-like activities inside the OVDI "certification" process, the IRS simply assumed all violations were willful unless a taxpayer presented evidence to establish that a violation was not willful.⁴⁷ Even though participating taxpayers were obligated to cooperate, it did not bother to establish procedures for requesting evidence of reasonable cause or non-willfulness.⁴⁸ Moreover, it provided no guidance as to what evidence taxpayers could provide to establish non-willfulness or reasonable cause. Under existing statutes, however, the IRS could not impose the willful FBAR penalty unless it proved the violation was willful.⁴⁹ Thus, these procedures inverted the burden of proof.

When doing the comparison, the IRS also sometimes declined to apply some or all the taxpayer-favorable provisions contained in the IRM.⁵⁰ Consequently, a taxpayer would

⁴⁶ IRS response to TAS information request (Sept. 14, 2011). However, a number of taxpayers who believed they should pay less than 20 percent under the OVDI have requested assistance from TAS.

⁴⁷ IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDI cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty."). This critical aspect of the program was not included in the FAQs nor was it available to taxpayers or IRS employees in any written form. Moreover, it is contrary to the IRS's interpretation of the first sentence of FAQ #35 which states: "Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing."

⁴⁸ Although the IRS did not have a nationwide checklist of information that it would accept in determining what the penalty would be under existing statutes (e.g., whether the violation was willful), some revenue agents created their own checklists and routinely requested such information before the IRS issued the March 1 memo.

⁴⁹ *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994); *U.S. v. Williams*, 2010-2 USTC ¶ 50,623 (E.D. VA. 2010); CCA 200603026 (Sept. 1, 2005); IRM 4.26.16.4.5.3 (July 1, 2008) ("The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty. A finding of willfulness under the BSA must be supported by evidence of willfulness. The burden of establishing willfulness is on the Service.").

⁵⁰ IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause exception); IRM 4.26.16.4.7(3) (July 1, 2008) (guidance on when to issue a warning letter in lieu of an FBAR penalty); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines for applying lesser penalties to low-dollar accounts); IRM 4.26.16.4.7 (July 1, 2008) ("the assertion of multiple penalties ... should be considered only in the most egregious cases.").

often be required to pay more inside the program than he or she would "otherwise be liable for under existing statutes" outside of the program, even in cases where the IRS claimed to have done the comparison required by FAQ #35.

While it is reasonable to try to streamline the OVDP process, the IRS should have disclosed such significant aspects of the program.⁵¹ The mere fact that the IRS referred to the process as a "certification" rather than an "examination" was not sufficient to put taxpayers on notice that it would make such significant deviations from existing statutes, as implemented by procedures described in the IRM.

The IRS's reinterpretation of FAQ #35 harms taxpayers and the IRS.

Taxpayers were concerned that withdrawal from the 2009 OVDP could subject them to the assertion of disproportionate civil and criminal penalties.

Some taxpayers were initially concerned that opting out of the 2009 OVDP would disqualify them from the Criminal Investigation Division's longstanding voluntary disclosure practice on the basis that they would be deemed as not "cooperating," as required by the IRM.⁵² In addition, the IRS's FAQs could have been interpreted as modifying the IRM's discussion of the voluntary disclosure practice for taxpayers with offshore accounts.⁵³ Various FAQs refer to the 2009 OVDP itself as the "voluntary disclosure practice," "Voluntary Disclosure Practice," or "voluntary disclosure program," and to participation in the 2009 OVDP as a "voluntary disclosure."⁵⁴ The FAQs suggest that people who do not use the 2009 OVDP might be prosecuted, even if they would otherwise have qualified for the voluntary disclosure practice.⁵⁵ Initially, the IRS did not provide clear and unequivocal assurance that if a taxpayer withdrew from the 2009 OVDP, he or she would not be deemed to have withdrawn from the voluntary disclosure practice, even if he or she would otherwise have been

⁵¹ A former federal prosecutor involved in the UBS case apparently agrees. See Jeffrey A. Neiman, *Opting Out: The Solution for the Non-Willful OVDI Taxpayer*, 2011 TNT 176-6 (Sept. 7, 2011) ("While the IRS does not have unlimited resources, an expedited review process could have been established to compare the facts and circumstances of an individual taxpayer's overseas account to a set of predetermined objective factors that would have allowed the IRS to assess a reasonable and fair FBAR-related penalty and avoided higher penalties for non-willful taxpayers.").

⁵² IRM 9.5.11.9 (Dec. 2, 2009). For example, according to one major firm, "three revenue agents have asserted that an 'opt out' would mean that the taxpayer had not cooperated and that the case would be returned to CI for further consideration of whether a criminal prosecution would be recommended." Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 41 (2010). However, the IRM requires that the taxpayer cooperate "in determining his/her correct tax liability," rather than by agreeing to pay more in penalties than necessary. IRM 9.5.11.9(3)(a) (Dec. 2, 2009).

⁵³ IRM 9.5.11.9 (Dec. 2, 2009).

⁵⁴ See, e.g., OVDP FAQ#6 (suggesting that taxpayers should make a "voluntary disclosure" by either contacting CI or submitting a letter, which states that the submission is "[T]o assist in a timely determination of my acceptance into the Voluntary Disclosure Program"); FAQ #9 (referencing "the voluntary disclosure practice" and "the voluntary disclosure process" without making a distinction between them); FAQ #10 (strongly encouraging taxpayers to come forward under the "Voluntary Disclosure Practice"); FAQ #18 (noting: "The penalty framework described in the March 23 memorandum will apply to all voluntary disclosures in process within the 6-month timeframe"); FAQ #19 ("entities are eligible to participate in the IRS's Voluntary Disclosure Practice").

⁵⁵ See, e.g., FAQ #17 ("Taxpayers who wait until the end of the 6-month period run the risk that they will be disqualified from the Voluntary Disclosure Practice" and thus, will not have protection from criminal prosecution.).

eligible.⁵⁶ Moreover, 2009 OVDP FAQ #34 stated that "[A]ll relevant years and issues will be subject to a *complete examination ...[and] all applicable penalties (including information return and FBAR penalties) will be imposed*" [emphasis added] against those who opt out. This seemed to suggest that the IRS might seek criminal penalties against them, as well as the maximum civil penalties applicable to willful violations, without regard to the taxpayer-favorable provisions contained in the IRM.

The IRS's use of memos and frequently-revised FAQs left taxpayers confused, and even more hesitant to opt-out.

To its credit, on June 1, 2011, the IRS issued a memo that sought to allay taxpayer concerns about opting out. It sought to clarify that a "taxpayer should not be treated in a negative fashion merely because he or she chooses to opt out," and that opting out of the 2009 OVDP or 2011 OVDI would not remove the taxpayer from the criminal voluntary disclosure practice.⁵⁷ However, the memo was not very explicit about whether the IRS would apply the taxpayer-favorable provisions of the IRM to those who opted out. Further, according to the New York State Bar Association (NYSBA),

many revenue agents in the field have indicated that taxpayers who opt out of the voluntary disclosure programs will have a very difficult time convincing the Service not to impose maximum civil penalties. As a result, many taxpayers feel compelled to stay in the voluntary disclosure programs and accept inappropriately large penalties because they fear that if they opt out, they automatically will be assessed with huge information return penalties....⁵⁸

Moreover, when viewed in context, this opt-out memo was merely one of a large number of items containing sometimes contradictory messages. Historically, settlement initiatives have been published in the Internal Revenue Bulletin.⁵⁹ However, the IRS described the OVDP and OVDI programs by posting informal FAQs and memos on its website. It posted or changed the terms of these programs 19 times, as follows:

⁵⁶ In answer to the question "[I]s the IRS really going to prosecute someone who filed an amended return and correctly reported all their [sic] income?," FAQ #49 provides no clear assurance, stating in relevant part: "When criminal behavior is evident and the disclosure does not meet the requirements of a voluntary disclosure under IRM 9.5.11.9, the IRS may recommend criminal prosecution to the Department of Justice." By contrast, 2011 OVDI FAQ #51 affirmatively stated that taxpayers who opt out of the 2011 OVDI "remain within Criminal Investigation's Voluntary Disclosure Practice."

⁵⁷ See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011); 2011 OVDI FAQ #51 (revised June 2, 2011).

⁵⁸ Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative*, 2011 TNT 153-13 (Aug. 9, 2011) (hereinafter "NYSBA Letter"). As noted above, according to one major firm, "three revenue agents have asserted that an 'opt out' would mean that the taxpayer had not cooperated and that the case would be returned to CI for further consideration of whether a criminal prosecution would be recommended." Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. Int'l. Tax'n 36, 41 (2010).

⁵⁹ See, e.g., Rev. Proc. 2003-11, 2003-1 C.B. 311 (OVCI); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative). Such documents are subject to significantly more internal clearance and commentary than changes to the IRS.gov website. The NYSBA has recommended the IRS more explicitly address taxpayer concerns about how the IRS will apply FBAR penalties to those who opt out. See NYSBA Letter. Because voluntary disclosure questions will arise long after the current programs close, it has also recommended the IRS issue a revenue procedure that incorporates public comments. *Id.*

Timeline of Offshore Voluntary Disclosure Guidance

1. March 23, 2009 – issued a memo announcing the general terms of the 2009 OVDP⁶⁰
2. May 6, 2009 – posted OVDP Q&A 1-30⁶¹
3. June 24, 2009 – modified OVDP A26 and added Q&A 31-51 (including FAQ #35)
4. July 31, 2009 – modified OVDP A6, A21, and A22
5. August 25, 2009 – added OVDP Q&A 52
6. January 8, 2010 – added OVDP Q&As 53-54 (after the OVDP ended)
7. March 1, 2011 – issued the undisclosed "March 1 memo" regarding OVDP FAQ #35⁶²
8. March 1, 2011 – issued a memo announcing the general terms of the 2011 OVDI⁶³
9. February 8, 2011 – posted OVDI FAQ 1-53⁶⁴
10. February 10, 2011 – modified OVDI FAQ 8
11. February 14, 2011 – modified OVDI FAQs 5 and 50
12. March 14, 2011 – modified OVDI A47
13. June 1, 2011 – issued a memo addressing opt-out and removal procedures for both the OVDP and OVDI⁶⁵
14. June 2, 2011 – modified OVDI A52, A51, A32, A35
15. June 2, 2011 – posted OVDI Q&A 25.1, Q&A 51.1, Q&A 51.2, Q&A 51.3
16. August 19, 2011 – modified OVDI A51.2
17. August 26, 2011 – posted OVDI Q&A 24.1
18. August 26, 2011 – revised OVDI Q&A 25.1
19. August 29, 2011 – revised OVDI A1, A11, A15, A17, A18, and A38

Given the informal and constantly-shifting guidance the IRS issued in the form of FAQs and memos, it is no wonder that those taxpayers who would pay less under existing statutes were hesitant to opt out. The IRS would be the first to argue that taxpayers should not rely on FAQs and memos posted to a website. Given the perception that the IRS had

⁶⁰ Memorandum from Deputy Commissioner for Services and Enforcement for 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).

⁶¹ IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (first posted May 6, 2009).

⁶² Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

⁶³ Memorandum from Deputy Commissioner for Services and Enforcement for Commissioner, LB&I Division and Commissioner, SB/SE Division, *Authorization to Apply Penalty Framework to Voluntary Disclosure Requests with Offshore Issues* (Mar. 1, 2011).

⁶⁴ IRS, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, <http://www.irs.gov/businesses/international/article/0,,id=235699,00.html> (first posted Feb. 8, 2011).

⁶⁵ Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011).

recently reneged on FAQ #35, it had already lost its credibility. Thus, the opt-out memo provided little reassurance to skeptical taxpayers, particularly those who lived overseas or had come to the U.S. to escape repressive foreign governments.

Requiring taxpayers who would be subject to lesser penalties under existing statutes to opt out of the 2009 OVDP wastes resources and unnecessarily burdens taxpayers.

By requiring taxpayers who believed they are eligible for lesser penalties under existing statutes to opt out of the 2009 OVDP, the IRS wasted resources and unnecessarily burdened taxpayers. If the taxpayer opted out and the IRS later examined the case, the examiner would have to re-develop the analysis that the prior examiner was required to complete when he or she compared **"the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer,"** as required by 2009 OVDP FAQ #35.⁶⁶ Moreover, the taxpayer, after having incurred the expense of applying and then being forced to opt out, might not be as cooperative in any future examination, potentially leading to litigation and additional government expense. This is a waste of IRS and taxpayer resources.

On the other hand, if the IRS does not examine the case, it will either have allowed a willful violator to avoid penalties even after nearly completing an examination, or will have given terrible service to a non-willful violator by encouraging him or her to apply and then opt out, without providing any closure.⁶⁷ Moreover, the IRS will have severely inconvenienced the taxpayer, burdening him or her with unnecessary expenses and paperwork and threats of prosecution and disproportionate penalties for no good reason. Thus, the IRS's reinterpretation of FAQ #35 – and requiring taxpayers to opt out to obtain lesser penalties that apply under existing statutes – only seems to make sense if coercing taxpayers to agree to pay more than they actually owe is a goal, which it is not.

Because taxpayers relied on the plain language of FAQ #35, the IRS should have accepted the penalty that would apply under "existing statutes."

The public's reasonable interpretation of FAQ #35 is consistent with longstanding IRS policy, the terms of the predecessor to the 2009 OVDP, and concepts of fairness and due process.

As noted above, the IRS issued the March 1 memo to clarify what the IRS perceived as an "ambiguity" that led examiners to believe they had to accept less than the 20 percent

⁶⁶ Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011) (noting that if a taxpayer opts out, a committee will determine whether to "reassign" the case for an examination and, if so, to whom). The taxpayer would not be given an opportunity to address the committee. *Id.*

⁶⁷ As noted above, IRS guidance indicates that it will examine anyone who withdraws from the 2009 OVDP or 2011 OVDI. See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011).

penalty if a lesser penalty would apply under "existing statutes."⁶⁸ The National Taxpayer Advocate does not agree that FAQ #35 is ambiguous. Rather, the IRS examiners' interpretation of FAQ #35 is the most natural reading of its clear and unambiguous language. Many practitioners share this view.⁶⁹ Moreover, according to longstanding IRS policy:

An exaction by the United States Government, which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the United States Constitution. Accordingly, a Service representative in his/her conclusions of fact or application of the law, shall hew to the law and the recognized standards of legal construction. It shall be his/her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers.⁷⁰

Actually demanding more than a taxpayer owes would legitimize those who (unjustifiably) claim the IRS regularly violates the Constitution. Thus, it is inherently reasonable for the public, the National Taxpayer Advocate, and the IRS's revenue agents to interpret the terms of the 2009 OVDP as not demanding more than would otherwise be due under existing statutes. The IRS simply does not seek to use threats and unequal bargaining power to extract more than a taxpayer owes, particularly after the taxpayer has come forward to make a voluntary disclosure. Moreover, it is reasonable for taxpayers to expect the IRS to apply "existing statutes" which reflect only statutory "maximum" penalty amounts, using the mitigation guidelines and other taxpayer-favorable guidance provided in the current IRM, as described above. This interpretation of FAQ #35 is also consistent with the settlement that the IRS previously offered to FBAR violators pursuant to LCCI, a predecessor of the 2009 OVDP.⁷¹

⁶⁸ We note that President Barack Obama recently signed the *Plain Writing Act of 2010* (H.R. 946), Pub. L. 111-274, Oct. 13, 2010, 124 Stat. 2861 (5 U.S.C. 301 note), to "improve the effectiveness and accountability of Federal agencies to the public by promoting clear Government communication that the public can understand and use." *Id.* It defines "plain writing" as writing that is "clear, concise, well-organized, and follows other best practices appropriate to the subject or field and intended audience." *Id.*

⁶⁹ See, e.g., NYSBA Letter ("[M]any taxpayers and practitioners interpreted this third modification [FAQ #35] to mean that the Service would consider whether a taxpayer should be subject to non-willful FBAR penalties as opposed to a 20% miscellaneous penalty..."); CCH Federal Taxes Weekly, *Practitioners' Corner: Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13., 153, 155 (Mar. 31, 2011) (quoting Baker Hostetler tax partner, James Mastracchio, as saying: "We were able to make FAQ 35 submissions requesting a review of the willfulness issue all along until February 8 of this year ... [the IRS] seems to be changing the rules of the game halfway through.... the troubling thing is that closing the program to willfulness consideration under FAQ 35 now, based on a resource issue, when some persons have been granted relief, treats similarly situated taxpayers differently."); Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010) (stating "the FAQ 35 process now appears to be a classic 'bait and switch.' Practitioners advised clients that FAQ 35 would offer a chance at penalty mitigation, but now our experience is that the language in that guidance is essentially an empty promise."); Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011) (same).

⁷⁰ Policy Statement 4-7; IRM 1.2.13.1.5 (Feb. 23, 1960). While FBAR is not technically a tax, that does not give the IRS a license to extract more than properly due.

⁷¹ See, e.g., CCA 200603026 (Sept. 1, 2005).

A court could require IRS to apply FAQ #35 consistently.

Because taxpayers have relied on a reasonable interpretation of FAQ #35, a court might require the IRS to follow it based on the so-called "Accardi" doctrine or similar legal theories based on the "duty of consistency" or "equality of treatment."⁷² Courts often acknowledge that taxpayers generally may not rely on the IRM or similar types of guidance.⁷³ In some cases, however, particularly where taxpayers have reasonably relied on IRS procedures, courts have required the IRS to follow them to avoid inconsistent results.⁷⁴ For example, after the IRS issued press releases announcing changes to procedures in the IRM that would require its special agents to give partial Miranda warnings that were not constitutionally required, some courts relied on the Accardi doctrine to suppress evidence obtained by agents who failed to comply with the new procedures.⁷⁵ The Accardi doctrine was later limited to situations where taxpayers had detrimentally relied on the government's procedures.⁷⁶ If taxpayers relied on the procedures, however, a court could require the IRS to abide by them.

An unpublished reversal by IRS leaders makes IRS employees look like they are arbitrarily applying FAQ #35, potentially favoring some taxpayers over others.

The appearance that the IRS is not treating taxpayers consistently (*e.g.*, accepting less than 20 percent before it issued the March 1 memo, but not after) combined with its failure to explain why it was doing so created appearance problems for IRS employees.⁷⁷ These

⁷² The Accardi doctrine was originally based on an agency's failure to follow its regulations. See, *e.g.*, *Shaughnessy v. United States ex rel Accardi*, 349 U.S. 280, 281 (1955); *Vitarelli v. Seaton*, 359 U.S. 535 (1959). As noted below, however, it has been extended to other guidance and procedures.

⁷³ See, *e.g.*, *Avers v. Comm'r*, T.C. Memo. 1988-176 ("the I.R.M. requirements are merely directory rather than mandatory, and noncompliance does not render respondent's actions invalid.").

⁷⁴ For further discussion of the Accardi doctrine and related legal theories, see, *e.g.*, Thomas W. Merrill, *The Accardi Principle*, 74 *Geo. Wash. L. Rev.* 569 (2005-2006); Joshua I. Schwartz, *The Irresistible Force Meets the Immovable Object: Estoppel Remedies for an Agency's Violation of Its Own Regulations or Other Misconduct*, 44 *Admin. L. Rev.* 653 (1992); Christopher M. Pietruszkiewicz, *Does the Internal Revenue Service have a Duty to Treat Similarly Situated Taxpayers Similarly?* 74 *U. Cin. L. Rev.* 531, 532-534 (2005). Even in the absence of written procedures, the IRS may have a duty of "equality of treatment" and "consistency," but these theories may require the taxpayer to prove competitive disadvantage or invidious discrimination. See, *e.g.*, *Int'l Bus. Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966) (IRS abused discretion in prospectively (not retroactively) revoking beneficial private ruling given to taxpayer's competitor while denying the taxpayer a similar ruling in the interim). Compare *Avers v. Comm'r*, T.C. Memo 1988-176 (tax shelter investor not entitled to settlement on terms offered to other shelter investors because the offers were in error and the taxpayer failed to prove discriminatory purpose) with *Sirbo Holdings, Inc. v. Comm'r*, 476 F.2d 981 (2d Cir. 1973) (reasoning the IRS could not settle with one taxpayer while refusing to settle on the same terms with another similarly situated taxpayer without explanation).

⁷⁵ See, *e.g.*, *United States v. Heffner*, 420 F.2d 809 (4th Cir. 1969) ("An agency of the government must scrupulously observe rules, regulations, or procedures which it has established. When it fails to do so, its action cannot stand and courts will strike it down.... It is of no significance that the procedures or instructions which the IRS has established are more generous than the Constitution requires.... Nor does it matter that these IRS instructions to Special Agents were not promulgated in something formally labeled a 'Regulation' or adopted with strict regard to the Administrative Procedure Act; the Accardi doctrine has a broader sweep.... The arbitrary character of such a departure is in no way ameliorated by the fact that the ignored procedure was enunciated as an instruction in a 'News Release.')" (internal citations omitted); *United States v. Leahy*, 434 F.2d 7 (1st Cir. 1970) (explaining its suppression of evidence obtained without following IRM procedures: "we have the two factors intersecting: (1) a general guideline, deliberately devised, aiming at accomplishing uniform conduct of officials which affects the post-offense conduct of citizens involved in a criminal investigation; and (2) an equally deliberate public announcement, made in response to inquiries, on which many taxpayers and their advisors could reasonably and expectably rely. Under these circumstances we hold that the agency had a duty to conform to its procedure, that citizens have a right to rely on conformance, and that the courts must enforce both the right and duty").

⁷⁶ *United States v. Caceres*, 440 U.S. 741, 752-53 (1979).

⁷⁷ According to the IRS, the number of OVDP agreements for less than the 20 percent offshore penalty "is not tracked and therefore cannot be determined." IRS response to TAS information request (Sept. 14, 2011).

employees may have been perceived as arbitrarily providing preferential treatment to some taxpayers and not others, in violation of the rules of ethics.⁷⁸

The IRS may have violated the Freedom of Information Act.

The Freedom of Information Act requires the IRS to make available to the public all "administrative staff manuals and instructions to staff that affect a member of the public," unless an exemption applies.⁷⁹ Thus, the IRS's failure to make its March 1 memo timely available to the public appears to have violated the FOIA.⁸⁰ Moreover, if an item is not properly published and the taxpayer is not otherwise given "timely" notice of it, it may not be "relied on, used, or cited" by the IRS against a taxpayer.⁸¹ Accordingly, the IRS's reliance on the March 1 memo may also have violated the FOIA.

CONCLUSION

The 2009 OVDP appears to have been a great deal for those engaged in criminal tax evasion. They were not affected by the IRS's "clarification" that it would not consider non-willfulness, reasonable cause, or the mitigation guidelines in applying the offshore penalty because their violations were willful and unlikely to qualify for mitigation. However, the IRS is perceived as having "renege[d]" the terms of the 2009 OVDP that would benefit taxpayers whose violations were not willful. Many felt that the IRS placed them in the unacceptable position of having to agree to pay amounts they did not owe or face the prospect the IRS would assert excessive civil and criminal penalties. This perceived reversal burdened taxpayers, wasted resources, violated longstanding IRS policy, opened the IRS to potential legal challenges, and was not properly disclosed as required by FOIA. It also damaged the IRS's credibility. As a result, it is likely to have more difficulty gaining participation in any future settlement initiatives.

⁷⁸ The ethical rules applicable to all executive branch employees state: "Employees shall act impartially and not give preferential treatment to any private organization or individual.... Employees shall endeavor to avoid any actions creating the appearance that they are violating the law or the ethical standards set forth in this part." 5 C.F.R. §§ 2635.101(b)(8) and (14). By not timely releasing the March 1 memo or otherwise explaining why it would accept penalties of less than 20 percent for some taxpayers but not others, the IRS fosters the appearance that its employees are violating the ethical rules by giving preferential treatment to some taxpayers but not others.

⁷⁹ See 5 U.S.C. § 552(a)(2)(C). No exemptions appear to apply in this case.

⁸⁰ See generally, Memorandum from Counsel to SPDR, *Request for Review of Opinion – Instructions to Staff under 5 U.S.C. 552(a)(2)(C)* (July 27, 2011) (suggesting the IRS comply with the requirement to post items "promptly" by doing in the "quarter in which they are issued"). The IRS posted the March 1 memo in response to a Taxpayer Advocate Directive issued by the National Taxpayer Advocate on August 16, 2011. See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The March 1 memo is now available at http://www.irs.gov/pub/irs-drop/ovdi_memo_use_of_discretion_3-1-11.pdf.

⁸¹ According to the law, a "staff manual or instruction that affects a member of the public may be **relied on, used, or cited** as precedent by an agency against a party other than an agency **only** if— (i) it has been indexed and either **made available or published** as provided by this paragraph; or (ii) the party has **actual and timely notice** of the terms thereof." 5 U.S.C. § 552(a)(2)(flush) (emphasis added).

In conclusion, the National Taxpayer Advocate preliminarily recommends that the IRS:⁸²

1. Revoke the March 1 memo.
2. Direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple FBAR penalties only in the most egregious cases).⁸³
3. Replace all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI.⁸⁴ This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use the taxpayer-favorable provisions of the IRM (described above) to make this determination.
4. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.⁸⁵

⁸² On August 16, 2011, the National Taxpayer Advocate directed the IRS to take similar actions by issuing a Taxpayer Advocate Directive (TAD). See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at www.irs.gov/advocate. The IRS appealed the TAD to the Deputy Commissioner for Services and Enforcement. Memorandum for Deputy Commissioner for Services and Enforcement from Commissioner, LB&I and Commissioner, SB/SE, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Aug. 30, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>. The National Taxpayer Advocate reiterated these directives in a follow-up memo to the Deputy Commissioner. See Memorandum for Deputy Commissioner for Services and Enforcement from National Taxpayer Advocate, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Sept. 22, 2011), available at www.irs.gov/advocate. The IRS did not timely respond to the National Taxpayer Advocate's memo. For a recommendation that would address the IRS's failure to respond to TADs, see Legislative Recommendation: *Codify the Authority of the Office of the Taxpayer Advocate in Precedential Cases, Rule-making, and Systemic Administration*, *infra*.

⁸³ OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

⁸⁴ This recommendation is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, *NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative*, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance). Moreover, settlement initiatives are often published in the Internal Revenue Bulletin. See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

⁸⁵ The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced five percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

IRS COMMENTS

The IRS strongly disagrees with the inaccurate "bait and switch" characterizations made in the National Taxpayer Advocate's report. The 2009 Offshore Voluntary Disclosure Program (OVDP) was a highly successful program that provided a way for taxpayers with previously undisclosed accounts and unreported income to come into compliance with the U.S. tax laws. As discussed below, the 2009 OVDP was a voluntary program that taxpayers could choose to enter into. If at any time during the certification process, a taxpayer disagreed with the results provided for under the program (*e.g.*, if a taxpayer believed that a facts and circumstances determination would show that penalty mitigation is appropriate), the taxpayer could opt out of the program and its penalty structure. This option is still available today.

Global tax enforcement is a top priority at the IRS, and we have made significant progress on multiple fronts, including ground-breaking international tax agreements and increased cooperation with other governments. In addition, the IRS and Justice Department have increased efforts involving criminal investigation of international tax evasion.

The combination of efforts helped support the 2009 OVDP and the 2011 Offshore Voluntary Disclosure Initiative (OVDI). The programs gave U.S. taxpayers with undisclosed assets or income offshore an opportunity to get compliant with the U.S. tax system, pay their fair share and avoid potential criminal charges.

The 2009 program led to approximately 15,000 voluntary disclosures as well as another 3,000 applicants who came in after the deadline, but were allowed to participate in the 2011 initiative. Beyond that, the 2011 program (with an increased offshore penalty) has generated an additional 12,000 voluntary disclosures.

The goal of the programs was to get individuals back into the U.S. tax system and to turn the tide against offshore tax evasion. The cases came from every corner of the world, with bank accounts covering 140 countries. In addition to billions in revenue, the two disclosure programs provided the IRS with a wealth of information on various banks and advisors assisting people with offshore tax evasion, and the IRS will use this information to continue its international enforcement efforts.

The National Taxpayer Advocate expresses concerns regarding the provisions of FAQ #35 under the 2009 OVDP. The "bait and switch" characterization is incorrect. As noted in the report, an IRS memorandum was issued March 1, 2011, clarifying the intent of FAQ #35 and how it applied. This memorandum was subsequently published on IRS.gov. The OVDP was never intended to allow mitigation of penalties in the certification program. By its nature, OVDP is a settlement program that allows taxpayers a streamlined way to get back into the US tax system without a full examination. OVDP is a certification process, not an examination process. The program was premised on providing taxpayers certainty

regarding the penalty structure (including clarity in the period covered) without a full examination.

It is important to recognize that relief is available to address the issues raised in the report. Throughout the entire program, taxpayers have had the opportunity to opt out of the settlement structure and request an examination if the taxpayer disagrees with the result provided for under the program. An examination is the appropriate forum for detailed facts and circumstances determinations. Moreover, the opt-out procedures and additional guidance issued on June 1, 2011, clarify that, depending on the facts and circumstances, it may be preferable for a particular taxpayer to opt out of the 2009 OVDP or 2011 OVDI and provide guidance for taxpayers regarding the decision whether to opt out.

The IRS disagrees with many assertions made in the report. The IRS did not change the terms of the program mid-stream. The program was never intended to require facts and circumstances determinations to be made within the settlement program. It was, however, always intended that a facts and circumstances determination would be available in an examination following opting out of the settlement program. Taxpayers who opted out of the program remain in the Criminal Investigation program and do not face criminal prosecution to the extent issues were disclosed. In addition, guidance is explicit that in some cases, taxpayers will have the same agent for an examination following opt out. Taxpayers should not feel compelled to stay in OVDP because of fear of opting out.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate generally supports the IRS's efforts to combat offshore tax evasion. However, such efforts should not create confusion or fear in the hearts of those who made honest mistakes. Moreover, even efforts aimed at intentional tax evasion should conform to generally accepted concepts of due process, transparency, and procedural fairness. The way in which the IRS implemented the OVDP and OVDI did not meet those high standards, and likely reduced respect for the US tax system and negatively impacted future compliance, as further described below.

As this report was being prepared, the National Taxpayer Advocate issued a Taxpayer Advocate Directive (TAD) recommending that the IRS take steps similar to the preliminary recommendations described above.⁸⁶ SB/SE and LB&I appealed the TAD to the Deputy Commissioner for Services and Enforcement, who modified it.⁸⁷ The IRS's formal response (above) is very similar to the Deputy Commissioner's memo, in that it is conclusory and provides little in the way of explanation or rationale. The Deputy Commissioner agreed to release the March 1 memo to the public, but disagreed with the National Taxpayer Advocate's other recommendations. The National Taxpayer Advocate commends the IRS for releasing the memo, as required by law.

Following the Deputy Commissioner's memo, the National Taxpayer Advocate elevated the remaining recommendations to the Commissioner of Internal Revenue for a formal response. For TAS's response to the IRS's comments (above) and the Deputy Commissioner's memo, see the National Taxpayer Advocate's memo to the Commissioner of Internal Revenue (the "Memo to the Commissioner"), which is reprinted immediately following the recommendations section below.⁸⁸

It seems impressive that the OVDP and OVDI brought in about 30,000 taxpayers, as estimated by the IRS comments (above). However, an estimated five to seven million U.S. citizens reside abroad,⁸⁹ many of whom have FBAR filing requirements. Many citizens residing in the U.S. also have FBAR filing requirements. Yet, the IRS received only 218,840

⁸⁶ See Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*) (Aug. 16, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

⁸⁷ Memorandum for Deputy Commissioner for Services and Enforcement from Commissioner, LB&I and Commissioner, SB/SE, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Aug. 30, 2011), available at www.irs.gov/advocate; Memorandum for Deputy Commissioner for Services and Enforcement from National Taxpayer Advocate, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Sept. 22, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

⁸⁸ Memorandum for Commissioner of Internal Revenue from National Taxpayer Advocate, *Recommendations Regarding Taxpayer Advocate Directive 2011-1* (Sept. 26, 2011), available at <http://www.irs.gov/advocate/article/0,,id=251887,00.html>.

⁸⁹ IRS website, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

FBAR filings in 2008.⁹⁰ There is little doubt that a large number of people still have not filed FBARs and many such violations are inadvertent.

As discussed in the Memo to the Commissioner, even if the IRS chooses to ignore the damage caused by its reversal on FAQ #35, it must clarify its seemingly inconsistent statements about what people should do if they learn they have inadvertently failed to file an FBAR. In an effort to encourage taxpayers to enter into the OVDP and OVDI, the IRS emphasized the severe FBAR penalties that could apply outside of these programs, suggesting that the more reasonable provisions of the still-current IRM might be obsolete, and that those making "quiet" corrections might be subject to more severe penalties than they had been in the past. TAS, American Citizens Abroad (an organization representing Americans overseas), and the U.S. Ambassador to Canada have been receiving complaints from people who inadvertently failed to file an FBAR and are confused and worried about how the IRS is administering FBAR penalties both inside and outside of the voluntary disclosure programs.⁹¹

Many are under the impression the IRS will always seek to apply the maximum FBAR penalty applicable to willful violations, regardless of the situation. The U.S. ambassador to Canada reportedly sought to reassure them, stating:

[The United States] government isn't out to get honest "grandmas" who don't owe anything to the Internal Revenue Service....My message on this is to sit tight. We are not unreasonable. We are not unsympathetic. We are not irresponsible. The IRS is exploring ways to accommodate the roughly one million dual Canadian-American citizens living here.⁹²

For nearly two months the IRS responded with deafening silence. As the press continued to repeat the IRS's tough talk about how seemingly minor FBAR violations could trigger draconian penalties and dual citizens tearfully described to reporters how the IRS was actually seeking such outrageous penalties, the IRS declined to comment.⁹³ Finally, in early December, as this document was in-route to the printer, the IRS posted some guidance on its website, which suggested that it might still apply the reasonable provisions that appear

⁹⁰ National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

⁹¹ See, e.g., Barrie McKenna, *Ottawa Seeks Leniency for Canadians in U.S. Tax Hunt*, *The Globe and Mail* (Oct. 18, 2011) ("The U.S. ambassador, along with many federal MPs, have been flooded with calls and e-mails from Canadians worried they'll face punishing penalties..."). For a sample of submissions to TAS's Systemic Advocacy Management System (SAMS) by Canadian residents, see the Memo to the Commissioner, *infra*. See also American Citizens Abroad (ACA), *The FBAR Scam*, www.aca.ch/fbarscam.pdf (last visited Nov. 16, 2011).

⁹² For more detail about problems facing Canadians and possible solutions, see Richard Lipton, *Fear and Loathing North of the Border*, 133 *Tax Notes* 1405 (Dec. 12, 2011).

⁹³ See, e.g., Amy Feldman, *REFILE-Undisclosed Foreign Accounts? The IRS Is Coming*, *Reuters* (Nov. 9, 2011), <http://www.reuters.com/article/2011/11/09/offshoreaccounts-irs-idUSN1E7A80V920111109>; Amy Feldman, *Taxpayers with Overseas Accounts Seethe at Penalties*, *Reuters* (Dec. 8, 2011), <http://www.reuters.com/article/2011/12/08/us-usa-taxes-foreign-idUSTRE7B723920111208> ("One woman called from Australia on a Sunday night and started crying on the phone; another said she'd gotten psoriasis from the stress. A few were considering expatriating as soon as they could get their taxes in order....The IRS had no comment for this story...").

in IRM 2.26.16, and that it might issue additional guidance.⁹⁴ The U.S. ambassador to Canada announced that the guidance would waive penalties against inadvertent late-filers and also allow those who took part in the OVDI and OVDP to get money back, as recommended by the National Taxpayer Advocate.⁹⁵ While the IRS-released fact sheet is helpful, it has not been vetted like changes to the IRM or items published in the Internal Revenue Bulletin, and the IRS would be the first to point out that taxpayers generally cannot rely on fact sheets and press releases. As of this writing, we do not know what other steps the IRS will take to address the problem.

Recommendations

The National Taxpayer Advocate recommends the IRS take the following actions:

1. Revoke the March 1 memo and disclose such revocation as required by the Freedom of Information Act.
2. Immediately direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple FBAR penalties only in the most egregious cases).⁹⁶ Post any such guidance in the electronic reading room on IRS.gov, as required by FOIA.
3. Issue a notice or similar public pronouncement that:
 - a. Describes, reaffirms, and expands the taxpayer-favorable procedures provided by IRM 4.26.16;
 - b. Tells people what to do if they discover they have inadvertently failed to file FBARs, reassuring them that they are most likely to receive a warning letter in accordance with the IRM if they follow the instructions provided by the notice;⁹⁷

⁹⁴ See, *e.g.*, IRS, *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, FS-2011-13 (Dec. 7, 2011); Kristen A. Parillo, IRS to Minimize Penalties on Dual U.S.-Canadian Citizens Unaware of U.S. Tax Filing Obligations, 2011 TNT 233-9 (Dec. 5, 2011); Marie Sapirie, *Reasonable Cause May Save Expats From Failure-To-File Penalties*, 2011 TNT 237-3 (Dec. 9, 2011).

⁹⁵ See *Id.*

⁹⁶ OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

⁹⁷ This guidance should address the problems facing Canadians who learn they have failed to file FBARs. For further discussion, see Richard Lipton, *Fear and Loathing North of the Border*, 133 Tax Notes 1405 (Dec. 12, 2011).

- c. Reaffirms that people accepted into the OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by OVDP FAQ #35 (cross-referencing the guidance issued pursuant to recommendation #2); and
 - d. Commits to replacing all OVD-related frequently asked questions (FAQs), fact sheets, press releases, and memos on IRS.gov with guidance published in the Internal Revenue Bulletin that describes the OVDP, OVDI, and how the IRS will handle voluntary disclosures outside of those programs. This guidance should incorporate comments from all internal and external stakeholders.⁹⁸
 4. Allow taxpayers who agreed, under the OVDP, to pay more than they believe they would be liable for under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.⁹⁹
 5. Reinstate the International Planning and Operations Council (IPOC) or a similar servicewide forum for addressing international taxpayer issues and vetting international tax compliance initiatives, FAQs, and any similar materials that may appear on the IRS website.

⁹⁸ The guidance should address questions currently being posed by practitioners. See, e.g., Scott D. Michel and Mark E. Matthews, *OVDI Is Over – What's Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 18, 2011); Richard Lipton, *Fear and Loathing North of the Border*, 133 Tax Notes 1405 (Dec. 12, 2011).

⁹⁹ The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced five percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.



YOUR VOICE AT THE IRS



THE OFFICE OF THE TAXPAYER ADVOCATE OPERATES INDEPENDENTLY OF ANY OTHER IRS OFFICE AND REPORTS DIRECTLY TO CONGRESS THROUGH THE NATIONAL TAXPAYER ADVOCATE.

Response Due:
January 26, 2012

October 26, 2011

MEMORANDUM FOR DOUGLAS SHULMAN, COMMISSIONER OF
INTERNAL REVENUE SERVICE

FROM: Nina E. Olson
National Taxpayer Advocate

SUBJECT: Recommendations Regarding Taxpayer Advocate Directive 2011-1

Pursuant to Internal Revenue Code section 7803(c)(3), I am submitting recommendations regarding Taxpayer Advocate Directive (TAD) 2011-1. Section 7803(c)(3) provides as follows:

The Commissioner shall establish procedures requiring a formal response to all recommendations submitted to the Commissioner by the National Taxpayer Advocate within 3 months after submission to the Commissioner.

Accordingly, a formal response to the recommendations set forth below is due within **three months**.

BACKGROUND

Procedural history

On August 16, 2011, TAD 2011-1 (attached) directed the IRS to take various actions to implement 2009 Offshore Voluntary Disclosure Program (OVD) FAQ #35 and to release an internal memo to the public. On August 30, 2011, Faris Fink, Commissioner, Small Business/Self-Employed (SB/SE) Division and Heather C. Maloy, Commissioner, Large Business & International (LB&I) Division appealed the TAD (attached). They agreed to release the memo, but declined to take the actions relating to the implementation of OVD FAQ #35. On September 22, 2011, I issued a rebuttal memo (attached) to the Deputy Commissioner for Services and Enforcement addressing the points raised in the IRS's appeal and restating our remaining recommendations.

On October 14, 2011, the Deputy Commissioner for Services and Enforcement rescinded the items described in TAD 2011-1 that SBSE and LB&I had not agreed to implement (attached). His memo set forth a conclusion, but did not specifically address the points raised by the TAD or the rebuttal memo. I am submitting recommendations (below) to you for a formal response that includes an analysis of the points raised by this memo, the rebuttal memo, and the TAD.¹

Overview of the Problem

Existing FBAR statutes provide for a wide range of FBAR penalties — severe penalties for “bad actors,” but no significant penalties for “benign actors.”

Under existing statutes, a “bad actor” who fails to file a Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts* (FBAR) may face severe civil and criminal penalties, while a “benign actor” may face no penalty at all.² For example, if the IRS proves a violation was willful, a person may be liable for civil FBAR penalties of up to 300 percent of the account balance for willful failures continuing over a six-year period (50 percent per year). By contrast, the maximum civil penalty is \$10,000 for each non-willful failure and no penalty may be imposed if the reasonable cause exception applies.

Moreover, because the FBAR statute specifies only a “maximum” penalty amount that the IRS “may” impose, it does not contemplate that the IRS would apply the maximum penalty in every case. Accordingly, Internal Revenue Manual (IRM) section 4.26.16 implements the statute by instructing employees to:

- Issue warning letters in lieu of penalties;
- Consider reasonable cause;
- Assert the penalty for willful violations only if the IRS has proven willfulness;
- Impose less than the maximum penalty for failure to report small accounts under “mitigation guidelines;” and
- Apply multiple FBAR penalties only in the most egregious cases.³

As a result, under existing statutes and procedures the IRS would never have asserted multiple FBAR penalties at the maximum rate against a benign actor. Rather, benign actors who came forward to correct a mistake could reasonably expect a penalty that was appropriately calibrated to the severity of the violation, with a warning letter being the most likely outcome in many situations.

¹ Our recommendations (below) have evolved since we issued the TAD, as new information has come to light. The detailed analysis contained in the TAD and the rebuttal memo continue to support the recommendations contained in this memo.

² 31 U.S.C. § 5321(a)(5).

³ IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause); IRM 4.26.16.4.5.3 (July 1, 2008) (“The burden of establishing willfulness is on the Service.”); IRM 4.26.16.4.7(3) (July 1, 2008) (warning letter in lieu of penalties); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines); IRM 4.26.16.4.7 (July 1, 2008) (“the assertion of multiple [FBAR] penalties ... should be considered only in the most egregious cases.”).

OVDP FAQ #35 attracted benign actors by promising to apply "existing statutes."

Under the OVDP, a person is generally subject to a 20 percent "offshore" penalty in lieu of various penalties, including FBAR.⁴ However, OVDP FAQ #35 stated that "[u]nder no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes." Other FAQs threatened that bad things would happen to those who did not apply to the OVDP.⁵ The combination of these warnings and the promise of FAQ #35 prompted many benign actors whose violations were not willful, and who would never have been subject to any significant penalty under existing statutes, to apply to the OVDP.

On March 1, 2011, the IRS retroactively changed the terms of the OVDP by retracting its promise to apply existing statutes.

Although the public and IRS revenue agents interpreted FAQ #35 as written, we understand that the IRS actually intended for its agents to compare the 20 percent penalty to the maximum penalty applicable to willful violations, without regard to the willfulness or reasonable cause provisions embedded in existing statutes. On March 1, 2011, more than a year after the 2009 OVDP ended, the IRS issued a memo (the "March 1 memo") instructing OVDP examiners not to consider whether taxpayers would pay less under existing statutes, except in limited circumstances. The March 1 memo is widely viewed as contradicting FAQ #35.

The IRS's approach treats similarly situated taxpayers differently and turns the burden of proof on its head.

The IRS's reversal treats those whose OVDP applications were processed before March 1, 2011 differently than those whose applications were processed later. Moreover, even when the IRS made FAQ #35 comparisons after March 1, 2011, it applied existing statutes inconsistently. The IRS did not consistently request information needed to determine if the violation was willful or subject to the reasonable cause exception — some examiners did and some did not. Yet, it used the maximum willful FBAR penalty for comparison purposes unless the *taxpayer proved* the violation was not willful.⁶ Thus, some examiners turned the IRS's burden of proof on its head.

⁴ Our discussion focuses on the FBAR penalty because it is often the largest and most disproportionate penalty involved.

⁵ See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

⁶ IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty."). This critical aspect of the program was not included in the FAQs nor was it available to taxpayers or IRS employees in any written form. Moreover, it is contrary to the IRS's interpretation of the first sentence of FAQ #35 which states: "Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing." However, we believe the "discretion" language in the first sentence of FAQ #35 could be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, IRM 1.2.17.1.6 (Aug. 28, 2007).

Benign actors remain confused about how to proceed.

Now that both the OVDP and the subsequent 2011 Offshore Voluntary Disclosure Initiative (OVDI) are closed to new applicants, benign actors who have failed to file FBARs are confused about what they should do. TAS and the U.S. Ambassador to Canada have apparently been receiving similar complaints from Canadians who are confused and concerned about FBAR penalties.⁷ Many appear to be under the impression that the IRS will always seek to apply the maximum FBAR penalty applicable willful violations, regardless of the situation, even outside of the OVDP and OVDI.

DISCUSSION

If the IRS does nothing to address OVDP FAQ #35, benign actors will pay more than they should.

If the IRS does not consider willfulness or reasonable cause, or requires taxpayers to bear the burden of proving nonwillfulness, the benign actors will face a penalty inside the OVDP that is disproportionately harsh — and many are too frightened of the IRS and possible criminal or bankrupting civil penalties to opt out.

This initiative is different from most previous initiatives involving tax shelters because it attracted both bad actors and benign actors who made honest mistakes. If the IRS had clearly communicated that everyone would be presumed to be a bad actor (or willful violator) as the TAD appeal asserts, it would not have attracted benign actors.

The IRS affirmatively attracted benign actors to the OVDP in two ways. First, it announced a method within the OVDP that would treat these differently situated taxpayers differently and fairly — by applying “existing statutes” to benign actors. Second, it threatened that bad things would happen to them outside of the program.⁸ The fact that so many benign actors came in for what would be a terrible deal for them if they had understood the IRS's intent (and were afraid to opt out) shows that the IRS did not clearly communicate what it meant to say.

⁷ See, e.g., Barrie McKenna, *Ottawa seeks leniency for Canadians in U.S. tax hunt*, The Globe and Mail (Oct. 18, 2011) (“The U.S. ambassador, along with many federal MPs, have been flooded with calls and e-mails from Canadians worried they'll face punishing penalties...”). For a sample of submissions to TAS's Systemic Advocacy Management System (SAMS) by Canadian residents, see attachment 1.

⁸ See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

If the IRS does nothing to address FAQ #35, both IRS credibility and voluntary compliance is likely to suffer.

The IRS's miscommunication has consequences. If the government does not appear to treat benign actors fairly when they try to correct honest mistakes, then fewer people (even well-advised people) will try to correct their mistakes, and voluntary compliance will suffer.

Even if it were inclined to do so, the IRS does not have the resources to rely entirely on enforcement. The IRS needs taxpayers to cooperate and comply voluntarily. While an estimated five to seven million U.S. citizens reside abroad,⁹ the IRS received only 218,840 FBAR filings in 2008.¹⁰ By comparison, the government closed only 2,386 FBAR examinations and initiated only 21 criminal investigations in 2010.¹¹ While the OVDP attracted 15,364 applications (perhaps less than one percent of those who did not file FBARs),¹² a more effective initiative would have prompted even more taxpayers to come into compliance without leaving those who did come forward feeling terrified, tricked, or cheated. By generating such ill will and mistrust, the IRS is squandering an opportunity to improve voluntary compliance.

Accordingly, we believe the IRS should create a fair process to evaluate willfulness, reasonable cause, etc. within the OVDP, with the proper burden of proof (on the IRS) as the public understood it to be doing at the outset.¹³ Under that approach, the IRS will still have succeeded in bringing the accounts into the open, and collecting all back tax and interest, and most penalties. The alternative, which is akin to a "guilty until proven innocent" approach, is not a good one for an agency of the United States government to follow.

⁹ IRS web site, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

¹⁰ National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

¹¹ IRS response to TAS information request (Sept. 14, 2011).

¹² *Id.*

¹³ A former federal prosecutor involved in the UBS case apparently agrees. See Jeffrey A. Neiman, *Opting Out: The Solution for the Non-Willful OVDI Taxpayer*, 2011 TNT 176-6 (Sept. 7, 2011) ("While the IRS does not have unlimited resources, an expedited review process could have been established to compare the facts and circumstances of an individual taxpayer's overseas account to a set of predetermined objective factors that would have allowed the IRS to assess a reasonable and fair FBAR-related penalty and avoided higher penalties for non-willful taxpayers.").

The IRS might have avoided the FAQ #35 miscommunication problem by vetting or clearing the OVDP with internal and external stakeholders.

If the IRS had more thoroughly vetted the OVDP FAQs and the March 1 memo with internal or external stakeholders, it might have avoided the miscommunication problems described above and in the TAD.¹⁴ The IRS recently replaced the International Planning and Operations Council (IPOC), the only service-wide forum for addressing international taxpayer issues, with separate "bilateral" meetings between LB&I and each of the other divisions. If the IPOC had been consulted about the OVDP FAQs, it might have alerted the IRS to the fact that benign actors and IRS revenue agents were going to be confused. If TAS had been consulted about the OVDP FAQs, we might have pointed out the apparent inconsistencies between the IRS's intent and the plain language of the FAQs. Similarly, if the IRS had published the OVDP guidance in the Internal Revenue Bulletin, as it has done with respect to prior settlement initiatives, both internal and external stakeholders would have had the opportunity to identify ambiguities and potential problems.¹⁵

If the IRS does not issue additional clarifying guidance about how it will administer the FBAR penalties, the millions of benign actors who have not filed FBARs will remain confused.

The IRS has been talking tough about how it may impose severe penalties against anyone who did not apply to the OVDP and OVDI. For example, recent IRS statements include:

Those taxpayers making 'quiet' disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years. OVDP FAQ #10.

Taxpayers who do not submit a voluntary disclosure run the risk of detection by the IRS and the imposition of substantial penalties, including the fraud penalty and foreign information return penalties, and an increased risk of criminal prosecution. OVDP FAQ #3.

Failing to file an FBAR subjects a person to a prison term of up to ten years and criminal penalties of up to \$500,000. OVDP FAQ #14.

¹⁴ For further discussion of transparency, see National Taxpayer Advocate 2011 Annual Report to Congress (Most Serious Problem: *The IRS's Failure to Consistently Vet and Disclose its Procedures Harms Taxpayers, Deprives it of Valuable Comments, and Violates the Law*).

¹⁵ Settlement initiatives are often published in the Internal Revenue Bulletin after being vetted internally and with the Treasury Department. See, e.g., Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

[For those who opt out of the OVDP] All relevant years and issues will be subject to a complete examination. At the conclusion of the examination, all applicable penalties (including information return and FBAR penalties) will be imposed. Those penalties could be substantially greater than the 20 percent penalty. OVDP FAQ #34.

[Q] Is the IRS really going to prosecute someone who filed an amended return and correctly reported all their income? ... [A] When criminal behavior is evident and the disclosure does not meet the requirements of a voluntary disclosure under IRM 9.5.11.9, the IRS may recommend criminal prosecution to the Department of Justice. OVDP FAQ #49.

As noted above, this tough talk has created confusion and consternation, particularly among U.S. citizens living abroad. *Yet, the IRS has remained silent about the seemingly reasonable way in which the IRM suggests that it will apply FBAR penalties.* The IRS could help to allay these concerns by issuing a notice or similar public pronouncement that describes what benign actors should do, and emphasizes that they will often not be subject to any penalties under existing statutes.¹⁶ The IRS could further allay these concerns by initiating a public guidance project, which incorporates comments from all internal and external stakeholders, and describes how it will administer FBAR penalties and its voluntary disclosure practice in the future.¹⁷

RECOMMENDATIONS

In summary, I recommend the IRS take the following actions:

1. Revoke the March 1 memo and disclose such revocation as required by the Freedom of Information Act (FOIA).
2. Immediately direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple

¹⁶ If necessary, the IRS could create an expedited review procedure for processing voluntary disclosures from taxpayers whose violations were unlikely to have been willful.

¹⁷ This recommendation is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance).

FBAR penalties only in the most egregious cases).¹⁸ Post any such guidance in the electronic reading room on IRS.gov, as required by FOIA.

3. Issue a notice or similar public pronouncement that:
 - a. Describes and reaffirms the taxpayer-favorable procedures provided by IRM 4.26.16;
 - b. Tells people what to do if they discover they have inadvertently failed to file FBARs, reassuring them that they are most likely to receive a warning letter in accordance the IRM if they follow the instructions provided by the notice;
 - c. Reaffirms that people accepted into the OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by OVDP FAQ #35 (cross referencing the guidance issued pursuant to recommendation #2); and
 - d. Commits to replacing all OVD-related frequently asked questions (FAQs) and memos on IRS.gov with guidance published in the Internal Revenue Bulletin that describes the OVDP, OVDI, and how the IRS will handle voluntary disclosures outside of those programs in the future. This guidance should incorporate comments from all internal and external stakeholders.¹⁹
4. Allow taxpayers who agreed to pay more under the OVDP than the amount for which they believe they would be liable under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.²⁰
5. Reinstate the International Planning and Operations Council (IPOC) or a similar service-wide forum for addressing international taxpayer issues and vetting international tax compliance initiatives.

Attachments

1. Canadian Offshore Voluntary Disclosure Issues, A Sample of Submissions to the IRS's Systemic Advocacy Management System (SAMS) (Oct. 11, 2011).

¹⁸ OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

¹⁹ The guidance should address questions currently being posed by practitioners. See, e.g., Scott D. Michel and Mark E. Matthews, *OVDI is Over – What's Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 18, 2011).

²⁰ The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced 5 percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

2. Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act) (Aug. 16, 2011).
3. Memorandum for Deputy Commissioner for Services and Enforcement, from Commissioner, Small Business/Self-Employed (SB/SE) Division and Commissioner, Large Business & International (LB&I) Division, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Aug. 30, 2011).

Memorandum for Deputy Commissioner for Services and Enforcement, from National Taxpayer Advocate, *Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)* (Sept. 22, 2011).

Memorandum for National Taxpayer Advocate, from Deputy Commissioner for Services and Enforcement, *Taxpayer Advocate Directive 2011-1* (Oct. 14, 2011).

cc: Steven T. Miller, Deputy Commissioner for Services and Enforcement
 William J. Wilkins, Chief Counsel
 Heather C. Maloy, Commissioner, Large Business and International Division
 Faris R. Fink, Commissioner, Small Business/Self-Employed Division
 Nikole Flax, Assistant Deputy Commissioner, Services and Enforcement
 Jennifer Best, Special Assistant to the Commissioner
 Ken Drexler, Senior Advisor to the National Taxpayer Advocate
 Eric LoPresti, Senior Attorney Advisor to the National Taxpayer Advocate
 Rosty Shiller, Attorney-Advisor to the National Taxpayer Advocate
 Judy Wall, Special Counsel to the National Taxpayer Advocate

Canadian Offshore Voluntary Disclosure Issues

A Sample of Submissions to the IRS's Systemic Advocacy Management System (SAMS)

22133 - Voluntary Offshore Disclosure Harms Citizens

USA citizens living in Canada are not hiding money. Many of us are married to Canadian Citizens and have accounts established for daily living. Interest earned is available through the annual Canadian income tax. Are we interpreting the media reports incorrectly? I was only aware of filing a tax return when there was income in the USA and everybody I have talked to have said the same thing. The penalties are astronomical and we don't know who our voice is. Thanks [name redacted]

22134 - Offshore Voluntary Disclosure Initiative (OVDI)

Just came to know that even though I'm on visa in US, I've to report my foreign accounts. And 2011 OVDI is the only way to get into compliance now. I've foreign accounts where I've sent my W2 taxed savings. I was not aware that even though I am on VISA, I have to report this. Now paying 25% penalty on my already taxed income is like taking away my 2-3 years of my savings completely. This money I've been saving to buy an apartment for my family but now all those dreams are shattered. If I do amend my returns outside the program there is risk of audit with may be max penalties. There is no clear solution. My case is not like I'd foreign business or other sources of income which I tried to hide. It is a plain case of an immigrant who is sending his savings back home. There is interest income of around 25K over the past few years and the total tax I have to owe would be around 2K after taking the foreign tax credit. Now, paying around 35K just because I failed to report this due to my lack of clear understanding of this fact is heart breaking. There is tremendous mental pressure and don't know what to do. If you can please request the government to relax the law if its W2 savings only or give us a fair chance to represent our case without threatening of max penalty, it would be helpful. Not only more folks will come in but it will serve the compliance issue in much proficient manner. As of now for us the only options are either pay our hard earned savings or just return to our home country. Please help.

22173 - Filing Requirements for Americans Living Abroad

My wife is a U.S. Citizen. She has been living with me in Canada since 1999. I recently discovered that she should be filing a U.S. tax return each year. Where can we get help with this? I have searched your website and the U.S. Consulate website for help. I am looking for someone to advise me as to exactly what forms would be applicable for our case so that we may comply. I may also need help in completion of the forms. This issue affects tens of thousands of dual Citizens who were unaware and are in need of your assistance in order to comply with US tax laws. Thank you.

22195 - No Help or Advocacy Available for Canadians

There does not seem to be ANY U.S. tax help available for Canadians. I have searched the IRS website thoroughly. On the website there are all kinds of numbers and e-mail addresses and websites where you can go for help or to find a tax advocate or contact a local tax office. These are available for all 50 states, for Puerto Rico and USVI - tax help is even available for people who live in Beijing. But not for Canada, which is like a blank hole on the map.

22203 - Unfairly Taxing Expats in Canada

September 6, 2011

This letter was printed in the Vancouver Sun today. I agree completely and have nearly the identical story to the author. Please read and intervene on the IRS assault on Canadian citizens.

My three concerns are:

1. As an individual who has not lived, worked, or been associated with the United States for many years, as someone who has paid Canadian taxes for an extended period of time, and as a person who in opting for Canadian citizenship in 1986 saw it as a renunciation of US citizenship, why should I be penalized a minimum of 5% of my Canadian assets by the IRS?
2. What is particularly disturbing is the position of the children of U.S. citizens who reside in Canada. According to the US House of Representatives website which ... provides for automatic U.S. citizenship to children born outside the U.S. where one or both parents are considered US citizens. This means that our children are considered US citizens and subject to the provisions of the IRS, i.e., they too must file US taxes and disclosures, and suffer the consequences of the IRS pursuit of undisclosed non-US financial accounts. These children, however, are Canadian; they were born in Canada; they have never lived or worked in the United States; in many cases they have never set foot south of the border; and they have no affiliation with the U.S. government. They should not be subject to U.S. taxes and disclosures, and the substantial IRS penalties for non-disclosure.
3. There is also my exposure to the U.S. Estate Tax. My accountant has confirmed that yes, upon my death, since the US considers me a citizen my children will be subject to the U.S. Estate Tax as well as any taxes levied by the Canadian government. This means that my children will be subject to both Canadian and U.S. estate taxes, probate, et al. This amounts to a double taxation which is unfair. I suggest to you that the U.S. Estate Tax be waived for those assets which are clearly Canadian.

22393 - OVDI Dual Taxation

I am a Canadian citizen and have been for 30 years. I was born in the US and moved back to Canada with my parents when I was 3 months old. I applied and received my Canadian citizenship when I was 22 years old. Today (Sept 22, 2011), from the CBC radio news, I found out that I am suppose to be filing taxes with the US. I am in shock and very upset! I have never lived and worked in the US. I have never owned property in the U.S. I do not consider myself a U.S. taxpayer. I consider myself a Canadian taxpayer and have never once received any benefit from the U.S. There was an amnesty to voluntarily disclose but this ended Sept 9th, 2011. Now what?? If I am considered a U.S. citizen, as an advocacy for U.S. taxpayers, I would like to know what your organization is doing about this. The penalty, I am assuming, that I would have to pay will steal from me all of my savings for my children's education.

22433 - Lack of Information on Taxes for Dual Citizenships

I was born in Canada; my mother is from the United States. When I was a born, my mother applied for me to get dual citizenship, and I received a certificate of birth abroad. I am now 30 years old, and just now discovering that it is required for me to have been filing tax returns in the U.S., even though I wasn't born and have never lived in the United States. As a Canadian there was no clear way for me to be aware of this. There has been no attempt by the IRS to contact me to notify me that I haven't filed and am past due. I am now stuck trying to figure out how, and how many years I need to file for. This is becoming a big deal to friends and family I know that live here in Canada. Being born and raised in Canada there is no way for me to have known about these requirements. I see this as a major problem as there may be penalties for me not having done so.

22497 - FBAR Penalties Harm Canadian Dual Citizens

Dear SAMS,

I was born in the US, but immigrated to Canada 43 years ago, married a Canadian and became a Canadian citizen five years later. Since then I have resided, worked and paid taxes in Canada, and never had any U.S. source income or U.S. assets of any kind. I never renewed my U.S. passport and entered the U.S. only for short family visits or vacations. I consider myself a Canadian.

With no U.S. income or assets, I had no reason to assume you needed to file U.S. tax returns, and had never heard of FBAR reports. In 2010, my mother's U.S. accountant, after completing her estate taxes, assured me I had no further personal filing obligations.

At retirement age, I suddenly find out that the IRS claims I owe them \$70,000 for not annually filing a 1-page form reporting my "offshore" Canadian bank and investment accounts!! They threaten to take EVERYTHING if I resist their claims, but offer an "amnesty" if you come forward and file the FBARs. It holds out the prospect of reducing the penalty to zero, but in practice the IRS apparently always claims 5-25% of the money, including that of my Canadian husband since we converted to joint accounts in November, 2010 after I was re-diagnosed with lymphoma.



YOUR VOICE AT THE IRS



THE OFFICE OF THE TAXPAYER ADVOCATE OPERATES INDEPENDENTLY OF ANY OTHER IRS
OFFICE AND REPORTS DIRECTLY TO CONGRESS THROUGH THE NATIONAL TAXPAYER ADVOCATE.

August 16, 2011

MEMORANDUM FOR HEATHER C. MALOY, COMMISSIONER,
LARGE BUSINESS & INTERNATIONAL DIVISION
FARIS FINK, COMMISSIONER,
SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Nina E. Olson
National Taxpayer Advocate

SUBJECT: *Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure
Program FAQ #35 and comply with the Freedom of Information Act).*

TAXPAYER ADVOCATE DIRECTIVE

I am issuing this Taxpayer Advocate Directive (TAD) to direct that within **15 business days** the Commissioner, Large Business and International Division (LB&I) and the Commissioner, Small Business/Self-Employed (SB/SE) Division take the actions described in the numbered sections below. Within **10 business days** please also provide me with a written response to this TAD discussing the action(s) you plan to take and whether you plan to appeal.¹

1. Disclose the March 1, 2011 memo for Offshore Voluntary Disclosure Initiative (OVDI) Examiners that addresses the use of discretion in 2009 Offshore Voluntary Disclosure Program (OVDP) cases (the "March 1 memo") on IRS.gov, as required by the Freedom of Information Act (FOIA) (whether or not it is revoked).²
2. Revoke the March 1 memo and disclose such revocation as required by FOIA.
3. Immediately direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the taxpayer proves it was not. Direct them to use standard examination procedures to determine whether

¹ See IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).

² Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

a taxpayer would be liable for a lesser amount under existing statutes (*e.g.*, because the taxpayer was eligible for (a) the reasonable cause exception, (b) a non-willful penalty because the IRS lacked evidence to establish its burden to prove willfulness, or (c) application of the mitigation guidelines set forth in the IRM) without shifting the burden of proof onto the taxpayer.³ Post any such guidance on IRS.gov. Commit to replace the March 1 memo and all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI.⁴ This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use standard examination procedures to make this determination, as provided in item #3 (above); and

4. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes the option to elect to have the IRS verify this claim (using standard examination procedures, as described above), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.⁵

I. AUTHORITY

Delegation Order No. 13-3 grants the National Taxpayer Advocate the authority to issue a TAD to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) "when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment or provide an essential service to taxpayers."⁶ For the reasons described below, the IRS's failure to implement 2009 OVDP FAQ #35 violates taxpayer rights, imposes undue burden, results in inequitable treatment of taxpayers, and has likely undermined respect for the IRS and the tax system.

³ OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

⁴ This directive is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance). Moreover, settlement initiatives are often published in the Internal Revenue Bulletin. See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

⁵ The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced 5 percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

⁶ Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). See also IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).

Prior to issuing this TAD, the Taxpayer Advocate Service (TAS) raised concerns about 2009 OVDP FAQ #35 with the IRS on multiple occasions. On March 18, 2011, my staff met with the Deputy Commissioner's staff to express my concerns. I also personally discussed the problem with the Commissioner of Internal Revenue. On April 26, 2011, I issued a Taxpayer Assistance Order (TAO) to the LB&I Commissioner, which described my concerns in writing. On April 27, 2011, in a memo that requested both IRS executives and subject matter experts for my staff to work with, I informed each operating division, the Commissioner, and the Deputy Commissioner that we had heard complaints about the OVDP, and would likely discuss the problem in the National Taxpayer Advocate Annual Report to Congress.⁷ My staff have contacted SB/SE and LB&I at various levels seeking to address these concerns in cases involving taxpayers who sought assistance from TAS. On June 30, 2011, I raised my concerns again in the National Taxpayer Advocate's Fiscal Year 2012 Objectives Report to Congress.⁸ To date, the IRS has not adequately addressed these concerns. Therefore, the procedural requirements for issuing this TAD are satisfied.⁹

II. DISCUSSION

Background

U.S. persons are generally required to report foreign financial accounts on Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts (FBAR)* and to report income from such accounts on U.S. tax returns. Leaving aside criminal penalties, the maximum civil penalty for a series of missed FBAR filings can be financially devastating — an amount equal to the greater of \$100,000 or 50 percent of the account balance for each violation each year, potentially accruing to the greater of \$600,000 or 300 percent of each account balance over a six year period — an amount that the Internal Revenue Manual (IRM) acknowledges “can greatly exceed an amount that would be appropriate in view of the violation.”¹⁰

With significant FBAR penalties as leverage, the IRS “strongly encouraged” people who failed to file these and similar returns and report income from foreign accounts to participate in the 2009 Offshore Voluntary Disclosure Program (OVDP),

⁷ Memorandum from National Taxpayer Advocate, *The National Taxpayer Advocate's 2011 Annual Report to Congress-Contact and Subject Matter Expert Request for Potential Most Serious Problems* (Apr. 27, 2011).

⁸ National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 23-24 (*IRS's Inconsistency and Failure to Follow Its Published Guidance Damaged Its Credibility with Practitioners Involved in the Voluntary Disclosure Program*).

⁹ IRM 13.2.1.6.1 (July 16, 2009).

¹⁰ IRM 4.26.16.4(5) (July 1, 2008); 31 U.S.C. § 5321(a)(5)(C) (willful FBAR penalty); 31 U.S.C. § 5321(b)(1) (indicating a six-year period of limitations applies to FBAR violations).

rather than quietly filing amended returns and paying any taxes due.¹¹ It warned that taxpayers making "quiet" corrections could be "criminally prosecuted," while OVDP participants would generally be subject to a 20 percent "offshore" penalty in lieu of various other penalties, including the FBAR penalty.¹² While the OVDP appeared to be a great deal for those involved in criminal tax evasion, it was a terrible deal for many whose violations were not willful or who would be eligible for reasonable cause exceptions.

Example. Compare person A, a U.S. citizen and resident, who evades tax on income that he hid in an offshore account in Country A, with person B, a U.S. resident and citizen of Country B, who paid tax to Country B on income which he put into a retirement account in Country B before arriving in the U.S.¹³ A's failure to report income and file FBARs in the U.S. was willful and B's failure was not. The maximum civil penalty for willful FBAR violations is the greater of \$100,000 or 50 percent of the account value per year, but the maximum for non-willful violations is \$10,000 and no penalty applies to those who qualify for the reasonable cause exception.¹⁴ Moreover, given the way in which the IRS has historically administered the statute outside of the OVDP, B might have received a warning letter for failing to file FBARs.¹⁵ Thus, the 20 percent offshore penalty is a great deal for A but not for B. B would have paid less outside the OVDP.

The IRS announced, however, in OVDP FAQ #35 that:

Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes.¹⁶

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- ¹¹ See IRS, *Voluntary Disclosure: Questions and Answers*, <http://www.irs.gov/newsroom/article/0,,id=210027,00.html> (Feb. 9, 2011) (first posted May 6, 2009) (hereinafter OVDP "FAQ"). According to the IRS, "[t]axpayers are strongly encouraged to come forward under the Voluntary Disclosure Practice.... Those taxpayers making "quiet" disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years.... The IRS will be closely reviewing these returns to determine whether enforcement action is appropriate." OVDP FAQ #10. The IRS affirmatively advised "...the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts..." OVDP FAQ #50.
- ¹² OVDP FAQ #12. This discussion focuses on the civil FBAR penalty because it is often the largest penalty for which the offshore penalty is a substitute. See 31 USC § 5321.
- ¹³ Another common "non-willful" situation involves a U.S. resident who maintains an account in another country as a convenient way to send funds to relatives. Alternatively, a U.S. citizen may be living and paying taxes in a foreign jurisdiction, yet oblivious to U.S. filing and reporting obligations.
- ¹⁴ See 31 U.S.C. § 5321(a).
- ¹⁵ IRM 4.26.16.4.7(3) (July 1, 2008).
- ¹⁶ OVDP FAQ #35 (Emphasis added.). The FAQ discussion of "discretion" could reasonably be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, IRM 1.2.17.1.6 (Aug. 28, 2007).

As noted above, "existing statutes" applicable to FBAR violations provide for a reasonable cause exception, apply a lower maximum penalty to non-willful violations, and place the burden of proving willfulness upon the IRS.¹⁷ The IRS's implementation of existing statutes also requires that it apply significantly less than the statutory maximum penalty amounts to certain taxpayers with relatively low account balances under "mitigation" guidelines.¹⁸ Thus, taxpayers who would not have been subject to significant penalties because their violations were not willful, because they had relatively low account balances, or because they qualified for the "reasonable cause" exception believed the statement "[u]nder no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes" applied to them.

It seemed reasonable for taxpayers to believe the IRS would adhere to the publicly-announced terms of the program and make this comparison as part of the 2009 OVDP because it did so under the Last Chance Compliance Initiative (LCCI), the predecessor of the OVDP.¹⁹ Under the LCCI, examiners were expressly directed to apply FBAR mitigation guidelines to avoid inappropriately high FBAR penalties.²⁰

What procedures are causing a problem?

On March 1, 2011, more than a year after the 2009 OVDP ended, after learning that examiners were spending the time to compare the 20 percent penalty to what would be due under existing statutes, the IRS "clarified" its seemingly unambiguous statement in FAQ #35.²¹ The March 1 memo directed examiners to stop accepting less than the 20 percent offshore penalty under the 2009 OVDP regardless of whether a taxpayer would pay less under existing statutes, except in narrow circumstances. Even in those few cases where the IRS was supposedly still applying FAQ #35, it generally did not consider reasonable cause and

¹⁷ See 31 U.S.C. § 5321(a)(5). See also *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994); *U.S. v. Williams*, 2010-2 USTC ¶ 50,623 (E.D. VA. 2010); CCA 200603026 (Sept. 1, 2005) (noting "there is no willfulness if the account holder has no knowledge of the duty to file the FBAR," that "the criteria for assertion of the civil FBAR penalty are the same as the burden of proof that the Service has when asserting the civil fraud penalty under IRC section 6663... [that the IRS will have to show] 'clear and convincing evidence,' [of willfulness]," and that "the presumption of correctness with respect to tax assessments would not apply to an FBAR penalty assessment for a willful violation"); IRM 4.26.16.4.5.3(1)-(3) (July 1, 2008) ("(1) The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty. (2) A finding of willfulness under the BSA must be supported by evidence of willfulness. (3) The burden of establishing willfulness is on the Service.").

¹⁸ See generally IRM 4.26.16 (July 1, 2008).

¹⁹ See e.g., CCA 200603026 (Sept. 1, 2005) (noting that [the LCCI letter] "says, 'Also, civil penalties for violations involving [FBARs] will be imposed for only one year and we may resolve the FBAR penalty for less than the statutory amount based on the facts and circumstances of your case.' The instructions to agents contained in the Guidelines for Mitigation of the FBAR Civil Penalty for LCCI Cases provide: 'The examiner may determine that the facts and circumstances of a particular case may warrant that a penalty under these guidelines is not appropriate or that a lesser amount than the guidelines would otherwise provide is appropriate.' If agents follow these guidelines we need not be imposing the FBAR penalty arbitrarily in cases in which it clearly does not apply.").

²⁰ See, e.g., IRM Exhibit 4.26.16-4 (July 1, 2008) (LCCI penalty mitigation guidelines).

²¹ Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDP Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

assumed the violation was subject to the maximum penalty for willful violations unless the taxpayer could prove that the violation was not willful.²² Thus, in the absence of evidence, taxpayers who would be subject to the lower penalty for non-willful violations (or given a warning letter or overlooked) outside of the program would be subject to the 20 percent penalty inside the program. Moreover, the IRS did not provide any guidance to taxpayers regarding what evidence they could use to establish non-willfulness or reasonable cause.

What is the problem?

The IRS materially changed the terms of the 2009 OVDP after taxpayers applied to it in reliance on the original terms, treating similarly situated taxpayers differently.

Some taxpayers applied to the OVDP with the reasonable expectation, based on FAQ #35, that they could do no worse inside the program than they would fare in an audit. For those whose applications the IRS processed before March 1, this belief was mostly true.²³ For those whose applications the IRS processed after March 1, it was not. In other words, among similarly situated taxpayers who timely entered the 2009 OVDP, those whose cases were processed before March 1 could get a better deal than those whose cases were, through no fault of their own, processed after March 1. Such inconsistent treatment is simply unfair and arbitrary.

Those unlucky taxpayers who believed they should pay less under existing statutes and whose applications the IRS had not processed by March 1 had two options. They could either agree to pay more than they thought they owed or "opt out" of the 2009 OVDP and face the possibility of excessive civil penalties and criminal prosecution. Both options were problematic.

Opting out would leave a taxpayer worse off than if he or she had not entered the OVDP. The taxpayer's return was much more likely to be audited than if he or she had made a "quiet" correction.²⁴ Even taxpayers who made quiet corrections and were audited would be better off because they would not have wasted the

²² IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty").

²³ We understand that at least in some cases, the IRS did not shift the burden of proof until after March 1.

²⁴ IRS guidance indicates that it "will" examine anyone who withdraws from the 2009 OVDP or 2011 OVDI, though the scope of the examination and identity of the examiner will depend upon what an IRS committee decides. See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011).

resources necessary to apply to the OVDP and any audit would likely cover fewer years.²⁵ Encouraging taxpayers to opt out would also waste all of the resources already expended on the 2009 OVDP application by the IRS, as it plans to examine them anyway. In any future examination, the IRS is likely to request and review the items that were before the examiner processing the 2009 OVDP submission.²⁶

The other option available to these unlucky taxpayers whose applications were not processed by March 1, *i.e.*, to remain in the program and pay more than they believed they owed under "existing statutes" — was even worse. Even inadvertently applying pressure to taxpayers who would otherwise pay less under existing statutes to pay more than they owe violates IRS policy along with most conceptions of fairness and due process. According to IRS policy:

An exaction by the United States Government, which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the United States Constitution. Accordingly, a Service representative in his/her conclusions of fact or application of the law, shall hew to the law and the recognized standards of legal construction. It shall be his/her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers.²⁷

The IRS's reversal could be subject to legal challenge.

If a court determines that a taxpayer has reasonably relied on FAQ #35 to his or her detriment, it might require the IRS to follow FAQ #35. It could base this decision on the so-called "Accardi" doctrine or similar legal theories based on the "duty of consistency" or "equality of treatment."²⁸ Courts often acknowledge that taxpayers generally may not rely on the IRM or similar types of guidance.²⁹ Particularly where taxpayers have reasonably relied on IRS procedures, however, courts have required the IRS to follow its procedures

²⁵ Audits of those making quiet corrections would be likely to cover fewer years because, unlike those who applied to the OVDP, those making quiet corrections are less likely to have been asked to agree to extend the statutory period of limitations with respect to old years.

²⁶ This contradicted the portion of 2009 OVDP FAQ #35, which stated "[T]hese examiners [the OVDP examiners] will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer."

²⁷ Policy Statement 4-7, IRM 1.2.13.1.5 (Feb. 23, 1960). Moreover, the IRS mission is to "provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with *integrity and fairness to all*." IRM 1.1.1.1 (Mar. 1, 2006) (emphasis added).

²⁸ The Accardi doctrine was originally based on an agency's failure to follow its regulations. See, e.g., *Shaughnessy v. United States ex rel Accardi*, 349 U.S. 280, 281 (1955); *Vitarelli v. Seaton*, 359 U.S. 535 (1959). As noted below, however, it has been extended to other guidance and procedures.

²⁹ See, e.g., *Avers v. Comm'r*, T.C. Memo. 1988-176.

to avoid inconsistent results.³⁰ For example, after the IRS issued press releases announcing changes to procedures in the IRM that would require its special agents to give partial Miranda warnings that were not constitutionally required, some courts relied on the Accardi doctrine to suppress evidence obtained by agents who failed to comply with the new procedures.³¹ The Accardi doctrine was later limited to situations where taxpayers had detrimentally relied on the government's procedures.³² As noted above, however, it appears that some taxpayers may, in fact, have detrimentally relied on FAQ #35, for example, by incurring significant fees to participate in the OVDP and agreeing to extend the period of limitations.

The IRS did not publish the March 1 memo as required by law.

The Freedom of Information Act (FOIA) requires the IRS to make available to the public all "administrative staff manuals and instructions to staff that affect a member of the public," unless an exemption applies.³³ Thus, the IRS's failure to make its March 1 memo available to the public appears to have violated the FOIA. Moreover, if an item is not properly published and the taxpayer is not otherwise given "timely" notice of it, it may not be "relied on, used, or cited" by the IRS against a taxpayer.³⁴ While giving taxpayers notice of the March 1 memo might address this problem, it may be difficult to argue that such notice is timely. Accordingly, the IRS's use of and reliance on the March 1 memo may constitute a second FOIA violation.

³⁰ For further discussion of the Accardi doctrine and related legal theories, see, e.g., Thomas W. Merrill, *The Accardi Principle*, 74 *Geo. Wash. L. Rev.* 569 (2005-2006); Joshua I. Schwartz, *The Irresistible Force Meets the Immovable Object: Estoppel Remedies for an Agency's Violation of Its Own Regulations or Other Misconduct*, 44 *Admin. L. Rev.* 653 (1992); Christopher M. Pietruszkiewicz, *Does the Internal Revenue Service have a Duty to Treat Similarly Situated Taxpayers Similarly?* 74 *U. Cin. L. Rev.* 531, 532-534 (2005). Even in the absence of written procedures, the IRS may have a duty of "equality of treatment" and "consistency," but these theories may require the taxpayer to prove competitive disadvantage or invidious discrimination. See, e.g., *Int'l Bus. Machines Corp. v. U.S.*, 343 F.2d 914 (Ct. Cl. 1965), cert. denied, 382 U.S. 1028 (1966) (IRS abused discretion in prospectively (not retroactively) revoking beneficial private ruling given to taxpayer's competitor while denying the taxpayer a similar ruling in the interim). Compare *Avers v. Comm'r*, TC Memo 1988-176 (tax shelter investor not entitled to settlement on terms offered to other shelter investors because the offers were in error and the taxpayer failed to prove discriminatory purpose); with *Sirbo Holdings, Inc. v. Comm'r*, 476 F.2d 981 (2nd Cir. 1973) (reasoning the IRS could not settle with one taxpayer while refusing to settle on the same terms with another similarly situated taxpayer without explanation).

³¹ See, e.g., *United States v. Heffner*, 420 F.2d 809 (4th Cir. 1969) ("An agency of the government must scrupulously observe rules, regulations, or procedures which it has established. When it fails to do so, its action cannot stand and courts will strike it down.... It is of no significance that the procedures or instructions which the IRS has established are more generous than the Constitution requires.... Nor does it matter that these IRS instructions to Special Agents were not promulgated in something formally labeled a 'Regulation' or adopted with strict regard to the Administrative Procedure Act; the Accardi doctrine has a broader sweep.... The arbitrary character of such a departure is in no way ameliorated by the fact that the ignored procedure was enunciated as an instruction in a 'News Release.'") (internal citations omitted); *United States v. Leahey*, 434 F.2d 7 (1st Cir. 1970) (explaining its suppression of evidence obtained without following IRM procedures: "we have the two factors intersecting: (1) a general guideline, deliberately devised, aiming at accomplishing uniform conduct of officials which affects the post-offense conduct of citizens involved in a criminal investigation; and (2) an equally deliberate public announcement, made in response to inquiries, on which many taxpayers and their advisors could reasonably and expectably rely. Under these circumstances we hold that the agency had a duty to conform to its procedure, that citizens have a right to rely on conformance, and that the courts must enforce both the right and duty.");

³² *United States v. Caceres*, 440 U.S. 741, 752-53 (1979).

³³ See 5 U.S.C. § 552(a)(2)(C). No exemptions appear to apply in this case.

³⁴ 5 U.S.C. § 552(a)(2) (flush). To invalidate the agency's action, however, a taxpayer would need to establish that he or she was adversely affected by a lack of publication or would have been able to pursue an alternative course of conduct. See *Zaharakis v. Heckler*, 7744 F.2d 711, 714 (9th Cir. 1984).

The IRS reversal has damaged its credibility with practitioners and may reduce voluntary compliance along with participation in any future initiatives.

People voluntarily comply with tax laws for a variety of reasons other than economic deterrence.³⁵ According to one study, research "clearly shows that financial incentive, as well as the risk of detection and punishment, is less important than the influence of norms and moral values."³⁶ For example, a taxpayer who values integrity, honesty, and the benefits of government may feel guilty if he or she violates the rules. The strength of these motives may depend on whether the taxpayer perceives that the government or the IRS is acting with respect for basic elements of procedural justice such as impartiality, honesty, fairness, politeness, and respect for taxpayer rights.³⁷ The IRS generally acknowledges that such perceptions drive compliance.³⁸ Thus, the perception that the IRS is acting unfairly by treating similarly situated taxpayers differently and changing the terms of the OVDP after taxpayers have acted in reliance on them is likely to reduce respect for the IRS as well as voluntary compliance.

Perhaps even more importantly, many respected tax practitioners who undoubtedly play a significant role in facilitating tax compliance (or noncompliance) by their clients³⁹ have lost faith in the fairness and integrity of the IRS because of its reversal.⁴⁰ As a result, the IRS is likely to have more difficulty gaining participation in any future settlement initiatives.⁴¹

³⁵ See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) (summarizing existing literature); IRS Oversight Board, 2009 Taxpayer Attitudes Survey (Feb. 2010) (finding 92 percent of survey respondents indicated that personal integrity influences their tax compliance behavior whereas only 63 percent cited the fear of an audit.).

³⁶ See, e.g., Swedish Tax Agency, *Right from the Start: Research and Strategies* 6 (2005).

³⁷ See, e.g., Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Legis. 111, 113 (Winter 2009) (summarizing norms theories).

³⁸ According to the IRS policy statement, "[p]enalties are used to enhance voluntary compliance.... the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance." Policy Statement 20-1 (June 29, 2004). As the "penalty handbook" explains, "[p]enalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system." IRM 20.1.1.2(10) (Dec. 11, 2009). It acknowledges that disproportionately large or seemingly unfair penalties may discourage voluntary compliance. IRM 4.26.16.4 (July 1, 2008) (noting that the penalties for failure to file the required Report of Foreign Bank and Financial Accounts (FBAR) "should be asserted only to promote compliance with the FBAR.... examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARS, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future.... Discretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation."); IRM 20.1.1.1.3 (Dec. 11, 2009) ("[a] wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance.").

³⁹ For a discussion of the role of preparers and their potential impact on tax compliance, see National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 44 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

⁴⁰ See, e.g., CCH Federal Taxes Weekly, *Practitioners' Corner: Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13., 153, 155 (Mar. 31, 2011) (quoting Baker Hostetler tax partner, James Mastracchio, as saying: "We were able to make FAQ 35 submissions requesting a review of the willfulness issue all along until February 8 of this year ... [the IRS] seems to be changing the rules of the game halfway through.... It is clear that the IRS has been faced with a shortfall in administrative resources to review FAQ 35 submissions ... the troubling thing is that closing the program to willfulness consideration under FAQ 35 now, based on a resource issue, when some persons have been granted relief, treats similarly situated taxpayers differently."); Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010) (stating "from the viewpoint of the practitioner community perhaps more important, the FAQ 35 process now appears to be a classic 'bait and switch.' Practitioners advised clients that FAQ 35 would offer a chance at penalty mitigation, but now our experience is that the language in that guidance is essentially an empty promise."); Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011).

⁴¹ According to the IRS, all of the 3,000 applications to the 2011 OVDI came in after the 2009 OVDP deadline and before the IRS's announcement of the 2011 OVDI on March 1, 2011. IRS response to TAS information request (July 13, 2011). Thus, it appears that the 2011 OVDI may not have received any significant number submissions after the IRS's reversal became known.

The IRS's reversal could also make taxpayers and practitioners generally less willing to trust and cooperate with the IRS in other situations.

III. CONCLUSION

The 2009 OVDP was a great deal for people involved in criminal tax evasion. They were not affected by the IRS's "clarification" that it would not consider non-willfulness, reasonable cause, or the mitigation guidelines in applying the offshore penalty because their violations were willful. However, the IRS is perceived as having reneged on the terms of the 2009 OVDP that would benefit taxpayers whose violations were not willful. Many felt the IRS treated them unfairly as compared to similarly situated taxpayers. It placed them in the unacceptable position of having to agree to pay amounts they do not owe under "existing statutes" or face the prospect that the IRS would assert excessive civil and criminal penalties.

The IRS's perceived reversal burdened taxpayers, wasted resources, violated longstanding IRS policy, opened the IRS to potential legal challenges, and was not properly disclosed as required by FOIA. It also damaged the IRS's credibility with taxpayers as well as the practitioner community. As a result, the IRS is likely to have more difficulty gaining participation in any future settlement initiatives. This erosion in trust for the IRS among taxpayers and practitioners is also likely to have a negative impact on IRS's mission and voluntary tax compliance more generally.

Attachment

National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 23-24 (*IRS's Inconsistency and Failure to Follow Its Published Guidance Damaged Its Credibility with Practitioners involved in the Voluntary Disclosure Program*).

cc:

Steven T. Miller, Deputy Commissioner, Services and Enforcement
Douglas Shulman, Commissioner of Internal Revenue

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

AUG 30 2011

MEMORANDUM FOR STEVEN T. MILLER, DEPUTY COMMISSIONER
FOR SERVICES AND ENFORCEMENT

FROM: Heather C. Maloy
Commissioner, Large Business and International Division
Faris R. Fink
Commissioner, Small Business/Self-Employed Division

SUBJECT: Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary
Disclosure Program FAQ #35 and comply with the Freedom of Information Act)

In accordance with IRM 13.2.1.6.2 (TAD Appeal [Process]), we appeal the above- referenced
Taxpayer Advocate Directive (TAD), dated August 16, 2011. The TAD directed us to take
certain actions within 15 business days. The actions were described as follows in the TAD:

1. Disclose the March 1, 2011, memo for Offshore Voluntary Disclosure Initiative (OVDI) Examiners that addresses the use of discretion in 2009 Offshore Voluntary Disclosure Program (OVDP) cases (the "March 1 memo") on [RS.gov, as required by the Freedom of Information Act (FOIA) (whether or not it is revoked).
2. Revoke the March 1 memo and disclose such revocation as required by FOIA.
3. Immediately direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the taxpayer proves it was not. Direct them to use standard examination procedures to determine whether a taxpayer would be liable for a lesser amount under existing statutes (e.g., because the taxpayer was eligible for (a) the reasonable cause exception, (b) a non-willful penalty because the IRS lacked evidence to establish its burden to prove willfulness, or (c) application of the mitigation guidelines set forth in the [RM) without shifting the burden of proof onto the taxpayer. Post any such guidance on IRS.gov.
4. Commit to replace the March 1 memo and all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI. This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to

use standard examination procedures to make this determination, as provided in item #3 (above); and

5. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes the option to elect to have the IRS verify this claim (using standard examination procedures, as described above), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.

Regarding Action 1, we agree to disclose the March 1, 2011, memo on irs.gov.

We disagree with and appeal Actions 2, 3, 4, and 5. These actions are interrelated and substantively originate from a single issue - the application of FAQ 35.

The 2009 Offshore Voluntary Disclosure Program (OVDP) was designed to provide a way for taxpayers with previously undisclosed assets and unreported income to resolve their tax problems. The OVDP offered a uniform penalty structure that required taxpayers to pay either an accuracy-related or delinquency penalty and, in lieu of all other penalties that may apply, an offshore penalty equal to 20 percent of the amount in foreign bank accounts/entities in the year with the highest aggregate account asset value. Some of the penalties covered by the offshore penalty include: (1) a penalty for failing to file the Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts, commonly known as an "FBAR"); (2) a penalty for failing to file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts; (3) a penalty for failing to file Form 3520-A, Information Return of Foreign Trust With a U.S. Owner; and (4) a penalty for failing to file Form 5471, Information Return of U.S. Person with Respect to Certain Foreign Corporations.

This provides taxpayers who made voluntary disclosures certainty regarding the resolution of their tax liabilities. If this resolution was not acceptable to a taxpayer, the taxpayer, in accordance with FAQ 35, could request that the case be referred for an examination of all relevant years and issues. The procedures that we have followed and the communications our examiners provided to taxpayers and their representatives clearly afforded the application of all examination procedures and appeal rights.

FAQ 35's answer states as follows:

"Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes. If the taxpayer disagrees with the IRS's

determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues. At the conclusion of this examination, all applicable penalties, including information return penalties and FBAR penalties, will be imposed. If, after the standard examination is concluded the case is closed unagreed, the taxpayer will have recourse to Appeals.”

The National Taxpayer Advocate asserts “total penalties that would otherwise apply” should refer to the total penalties that would be imposed after a standard examination. We disagree. The comparison should only involve issues that can be resolved using the information available during the certification of the voluntary disclosure. So, for example, if the period of limitations had run on the FBAR penalty for some of the years or the bulk of the offshore assets were not subject to the FBAR penalty, an agent could make a comparison that determined that the taxpayer’s liability under OVDP was higher than that under existing statutes and could give the taxpayer the benefit of the lower liability.

The mitigation standards are part of the Examination IRM. The National Taxpayer Advocate states that taxpayers believed that IRS would apply these mitigation standards in part because they were applied under the Last Chance Compliance Initiative (LCCI). This is not logical since the language of the 2009 OVDP FAQs was demonstrably different than the guidelines of the LCCI. Had the IRS intended to apply the mitigation standards in the course of the verification, we would have used the LCCI language and we would have required that taxpayers submit the necessary documentation with their application. We did neither of these things.

That an examination during the OVDP verification process is not contemplated as part of the OVDP is signaled by the OVDP procedures and numerous FAQs, including FAQ 35 itself when it says that “If the taxpayer disagrees with the IRS’s determination, as set forth in the closing agreement, the taxpayer may request that the case be referred for a standard examination of all relevant years and issues.” FAQ 28 provides that “if any part of the penalty framework is unacceptable to the taxpayer, the case will be examined and all applicable penalties may be imposed.” Similarly, FAQ 34 provides that “if any part of the penalty structure is unacceptable to a taxpayer, that case will follow the standard audit process. All relevant years and issues will be subject to a complete examination. At the conclusion of the examination, all applicable penalties (including information return and FBAR penalties) will be imposed.”

The OVDP process also signals that examinations will not be a part of the program in that taxpayers are not requested to submit information regarding their level of knowledge-information that would be needed during an examination that would have to consider such

things as whether a taxpayer had reasonable cause for failing to file an FBAR or whether a taxpayer was entitled to the FBAR mitigation provisions.

It therefore stands to reason that a taxpayer who filed a voluntary disclosure but believed he should owe less than the 20 percent offshore penalty should have expected that the route to that outcome would only come through a full examination, not solely through application of FAQ 35.

The Advocate claims that "opting out would leave a taxpayer worse off than if he or she had not entered the OVDP". We do not believe this assertion is based in fact and it is contrary to guidance issued by the Deputy Commissioner Services and Enforcement.

This guidance (Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 Offshore Voluntary Disclosure Program (2009 OVDP) and the 2011 Offshore Voluntary Disclosure Initiative (2011 OVDI) states "The procedures have been designed to balance the interests at stake, to ensure fairness and consistency for all taxpayers in the 2009 OVDP and 2011 OVDI and to allow for flexibility where necessary". Further, the guidance states "It should be recognized that in a given case, the opt out option may reflect a preferred approach. That is, there may be instances in which the results under the applicable voluntary disclosure program appear too severe given the facts of the case."

The Advocate claims that taxpayers would be subjected to the possibility of "excessive civil penalties and criminal prosecution". We disagree. First, taxpayers who opt out do not lose the criminal protections afforded through the disclosure. Instead, only "to the extent that issues are found upon a full scope examination that were not disclosed, those issues may be the subject of review by the Criminal Investigation Division. " Moreover, a full scope examination requires determinations that are based upon the facts and circumstances of the case. Examiners cannot arbitrarily assert penalties nor pursue criminal fraud without a meritorious argument. Examination outcomes also follow normal procedural remedies for disagreement in the form of Appeal rights.

In conclusion, for the reasons set forth above, we respectfully appeal Actions 2, 3, 4, and 5. We request that the Deputy Commissioner rescind this TAD in accordance with the authority vested in him by Delegation Order 13-3.



YOUR VOICE AT THE IRS



THE OFFICE OF THE TAXPAYER ADVOCATE OPERATES INDEPENDENTLY OF ANY OTHER IRS
OFFICE AND REPORTS DIRECTLY TO CONGRESS THROUGH THE NATIONAL TAXPAYER ADVOCATE.

Response Due:
October 6, 2011

September 22, 2011

MEMORANDUM FOR STEVEN T. MILLER, DEPUTY COMMISSIONER,
SERVICES AND ENFORCEMENT

FROM: Nina E. Olson
National Taxpayer Advocate

SUBJECT: Appeal of Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore
Voluntary Disclosure Program FAQ #35 and comply with the Freedom of
Information Act)

On August 16, 2011, I issued Taxpayer Advocate Directive (TAD) 2011-1 (attached), which directed the IRS to take various actions to implement 2009 Offshore Voluntary Disclosure Program (OVDP) FAQ #35 and to release a March 1, 2011 memo, as required by the Freedom of Information Act (FOIA). On September 1, 2011, I received a copy of the TAD appeal signed by Faris Fink, Commissioner, Small Business/Self-Employed (SB/SE) Division and Heather C. Maloy, Commissioner, Large Business & International (LB&I) Division. SB/SE and LB&I agreed to release the memo, but did not agree to take the other four actions relating to the implementation of OVDP FAQ #35.

Part I of the discussion below summarizes our primary OVDP concerns. Part II addresses aspects of the TAD appeal not addressed in Part I. Part III concludes the discussion and restates the directives that remain unresolved.

The IRS harmed taxpayers seeking to correct honest mistakes.

One basic problem with the OVDP is that it assumes all participants are tax evaders hiding money overseas, when in fact, the IRS has steered many people into the program who made honest mistakes. Because of the uncertainty concerning the penalties that will apply

if they opt out, IRS procedures are pressuring many of them to pay more than they owe. The IRS Commissioner has stated that the purpose of the OVDP is to bring people back into the U.S. tax system.¹ Pressuring those who made honest mistakes to pay more than they owe is more likely to prompt taxpayers to avoid all contact with the IRS and the U.S. tax system in the future, rather than to come back into it.² It may also damage the IRS's credibility and reduce the effectiveness of any future initiatives. The following sections describe how this happened.

The IRS retroactively changed the terms of the OVDP. Where a person is required to file Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts (FBAR)*, and willfully fails to do so, the law authorizes a penalty up to the greater of \$100,000 or 50 percent of the balance of the undisclosed account each year.³ Where the IRS cannot prove that the failure was willful, the law authorizes a penalty of up to \$10,000.⁴ Finally, where a taxpayer can show that he or she had reasonable cause for failing to file an FBAR and the balance in the account is reported, the statute provides that “no penalty shall be imposed.”⁵

Under the OVDP, a person is generally subject to a 20 percent “off-shore” penalty in lieu of various penalties that otherwise would apply, including the penalty for failure to file an FBAR.⁶ However, OVDP FAQ #35 stated that “[u]nder no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes.” This was an important statement that practitioners and taxpayers relied on.

Given the statutory provisions described above, it seemed clear to most practitioners and many IRS agents that the phrase “existing statutes” included those statutes that reduced the maximum FBAR penalty to \$10,000 for nonwillful violations and waived the penalty entirely in certain cases where the violation was due to reasonable cause. Thus,

¹ IR-2011-94, *IRS Shows Continued Progress on International Tax Evasion* (Sept. 15, 2011) (quoting the Commissioner as saying “[M]y goal all along was to get people back into the U.S. tax system”).

² See Suzanne Steel, *Read Jim Flaherty's Letter on Americans in Canada*, Financial Post (Sept. 16, 2011), <http://business.financialpost.com/2011/09/16/read-jim-flahertys-letter-on-americans-in-canada/> (according to the Canadian Finance Minister “many U.S.-Canadian dual citizens are unaware of their obligations to file with the IRS.... most have paid taxes in Canada and have no tax liability in the United States, but still face the threat of prohibitive fines [under FBAR]... These are people who have made innocent errors of omission that deserve to be looked upon with leniency.... We support efforts to crack down on legitimate tax evasion. These measures, however, do not achieve that goal”).

³ 31 U.S.C. § 5321(a)(5).

⁴ *Id.*

⁵ *Id.*

⁶ Our discussion focuses on the FBAR penalty because it is often the largest and most disproportionate penalty involved.

FAQ #35 prompted many people whose violations were not willful to apply to the OVDP.

On March 1, 2011, however, more than a year after the 2009 OVDP ended, the IRS issued a memo (the "March 1 memo") suggesting it would no longer consider whether taxpayers would pay less under existing statutes, except in limited circumstances.⁷ The March 1 memo is widely viewed as contradicting the IRS's statement in FAQ #35. The impression that the IRS has pulled a "bait and switch" in an important voluntary compliance initiative tarnishes the agency's image for transparency and fair dealing, undermines the public's willingness to trust the agency, may undermine its legal position if some of these cases proceed to litigation, and is likely to blunt the effectiveness of any voluntary compliance initiative that the IRS may offer in the future.

Without FAQ #35 the OVDP penalty structure assumes all participants are tax evaders hiding money overseas, when in fact, the IRS steered many people into the program who made honest mistakes. Without FAQ #35, OVDP attempts to apply a single set of rules to two very different populations — those whose violations were willful and those whose violations were not. This is a challenge that does not arise as frequently in other settlement initiatives. For example, a taxpayer is less likely to have "inadvertently" understated income with respect to a highly-structured tax shelter transaction that required advice from a sophisticated tax advisor than to have inadvertently failed to file an FBAR with respect to a seemingly innocuous foreign account. Thus, it makes more sense to have a single set of rules to address tax shelters than to address the failure to file an FBAR.⁸

We acknowledge that in the case of FBARs, there are "bad actors" whose sole or primary reason for establishing and maintaining unreported overseas accounts was to evade tax. Since these actors may be subject to civil penalties of up to 50 percent of the maximum account balance (or \$100,000, if greater) for each year of noncompliance plus

⁷ The IRS did not initially release the memo to the public, as required by FOIA, but has now done so in response to the TAD. We commend the IRS for releasing the memo.

⁸ Even in the case of tax shelters, however, it is easy to make the mistake of lumping everyone into the same bucket and then having to back-track. For example, when policymakers designed the one-size-fits-all strict liability penalty for failure to report a listed transaction under IRC § 6707A, they probably did not contemplate how disproportionate it could be for some. The penalty was originally \$100,000 for individuals and \$200,000 for entities, regardless of the amount of the decrease in tax shown on the return. In the National Taxpayer Advocate's 2008 Annual Report to Congress, we highlighted the unfair and extreme results this penalty could produce and recommended changes. Congress subsequently revised the penalty to be 75 percent of the decrease in tax resulting from the transaction in most cases. See Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, Title II, § 2041(a), 124 Stat. 2506, 2560 (2010).

the possibility of criminal penalties, the IRS's offer to apply a penalty of 20 percent of the maximum account balance for a single year seems lenient and provided a substantial incentive for them to disclose and pay.

By contrast, there are relatively "benign actors" whose primary reason for establishing and maintaining overseas accounts was unrelated to tax. Examples practitioners have provided include:

- residents of Canada or other foreign jurisdictions who were born in the U.S. while their parents were temporarily working or vacationing here and have dual citizenship, but who have never lived here and never filed tax returns here;
- people who inherited an overseas account or opened one to send money to friends or relatives abroad;⁹
- refugees from Iran when the Shah fell, or from other countries, who have felt compelled to conceal their assets out of concern that the countries from which they fled might pursue them; and
- Holocaust survivors and their children who are frightened that the Holocaust could happen again and feel safer spreading their assets around in case they are seized in one place or another.

In these circumstances and others, the IRS may be unable to prove willful noncompliance or may, indeed, be convinced that the non-compliance was not willful or that the taxpayer had reasonable cause. These taxpayers ordinarily would not be subject to an FBAR penalty, or if they were, it would generally not exceed \$10,000, particularly if the taxpayer voluntarily corrected the problem before being contacted by the IRS.

The IRS reversal treats some similarly-situated taxpayers who made honest mistakes differently than others. Among similarly situated taxpayers who inadvertently failed to file an FBAR and timely entered the OVDP, those whose cases the IRS processed before March 1, 2011, could get a better deal (paying less than the 20 percent offshore penalty) than those whose cases it processed later. As commentators have noted:

⁹ We recognize that a special five-percent rate may apply to some of these taxpayers, but that exception is too narrow to apply in some sympathetic cases. OVDI FAQ #52.

It would violate the principle of horizontal equity to apply a tougher standard to taxpayers in the 2009 [O]VDP simply because they have not yet closed their cases, compared to similarly situated taxpayers that have already settled their cases and obtained relief pursuant to FAQ 35. To permit such arbitrary and unfair outcomes for similarly situated taxpayers participating in the same program would severely undermine the foundational principles of our system of taxation and deter taxpayers from making voluntary disclosures in the future.¹⁰

In our view, it violates fundamental notions of due process and fair dealing to give taxpayers whose cases the IRS happened to process earlier a better deal than those whose cases it happened to process later. This, too, will undermine public trust.

Even when making the FAQ #35 comparison, the IRS applies existing statutes inconsistently. Under existing statutes, the IRS bears the burden of proving that a person willfully violated a known legal duty before it may impose the penalty applicable to willful FBAR violations.¹¹ This is appropriate because "willfulness" is a common element that the government must prove in criminal cases, where the government always bears the burden of proof. In addition, because the existing statute specifies only a "maximum" FBAR penalty amount that the IRS "may" impose, the statute does not contemplate that the IRS would apply the maximum penalty for willful violations in every case. Some commentators have even suggested that doing so would be unconstitutional.¹² Accordingly, IRM 4.26.16 implements existing statutes by instructing employees to:

- issue warning letters in lieu of penalties,
- consider reasonable cause,
- assert the penalty for willful violations only if the IRS has proven willfulness,
- impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and

¹⁰ Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011).

¹¹ *Ratzlaf v. United States*, 510 U.S. 135 (1994); IRM 4.26.16.4.5.3 (July 1, 2008).

¹² See 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 and Proc. (Dec. 2009 - Jan. 2010).

- apply multiple FBAR penalties only in the most egregious cases.¹³

Although the IRS did not have a nationwide checklist of information that it would request to determine what the FBAR penalty would be under existing statutes (e.g., whether the violation was willful) and whether these taxpayer-favorable IRM provisions applied, some revenue agents created their own checklists and routinely requested such information before the IRS issued the March 1 memo. Following the March 1 memo, however, the IRS has selectively applied these IRM provisions in cases where the IRS has made the FAQ #35 comparison. In some cases, it used the maximum willful FBAR penalty for comparison purposes unless the taxpayer had proved the violation was not willful.¹⁴ Thus, it has turned the IRS's burden of proof on its head.

Based on our conversations with practitioners, we believe it is a wholly unrealistic to expect that taxpayers will risk massive civil and criminal penalties by opting out of the OVDP, even in the most sympathetic cases. On June 1, 2011, the Deputy Commissioner issued a memo (the "opt-out memo") that stated a "taxpayer should not be treated in a negative fashion merely because he or she chooses to opt out."¹⁵ However, this direction was not incorporated into the OVDP FAQs because the memo was issued long after the OVDP ended. FAQ #34 states that for those who opt out:

*All relevant years and issues will be subject to a **complete examination**. At the conclusion of the examination, **all applicable penalties (including information return and FBAR penalties) will be imposed**. Those penalties could be substantially greater than the 20 percent penalty. [Emphasis added.]*

¹³ IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause); IRM 4.26.16.4.5.3 (July 1, 2008) ("The burden of establishing willfulness is on the Service."); IRM 4.26.16.4.7(3) (July 1, 2008) (warning letter in lieu of penalties); IRM Exhibit 4.26.16-2 (July 1, 2008) (mitigation guidelines); IRM 4.26.16.4.7 (July 1, 2008) ("the assertion of multiple [FBAR] penalties ... should be considered only in the most egregious cases.").

¹⁴ IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty."). This critical aspect of the program was not included in the FAQs nor was it available to taxpayers or IRS employees in any written form. Moreover, it is contrary to the IRS's interpretation of the first sentence of FAQ #35 which states: "Voluntary disclosure examiners do not have discretion to settle cases for amounts less than what is properly due and owing." However, we believe the "discretion" language in the first sentence of FAQ #35 could be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." See, e.g., Policy Statement 8-47, IRM 1.2.17.1.6 (Aug. 28, 2007).

¹⁵ See Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDP (June 1, 2011).

Most people would view a "complete examination" of all issues and years, and application of "all applicable penalties" as being treated in a "negative fashion." Moreover, the opt-out memo did not clearly state whether the taxpayer-favorable provisions of IRM 4.26.16 (described above) would apply or if the IRS would seek to impose the statutory maximums. Given this ambiguity and the IRS's seemingly arbitrary approach in applying "existing statutes" inside the OVDP, taxpayers and practitioners believe they will not be treated fairly if they opt out.

The IRS's decision to administer the OVDP using technical advisors and telephone assistants rather than by issuing written guidance that taxpayers and practitioners could rely upon has also created the impression that the IRS might arbitrarily assert civil and possibly even criminal FBAR penalties. Moreover, the opt-out memo warned that, "to the extent that issues are found upon a full scope examination that were not disclosed, those issues may be the subject of review by the Criminal Investigation Division." Furthermore, according to the New York State Bar Association (NYSBA),

many revenue agents in the field have indicated that taxpayers who opt out of the voluntary disclosure programs will have a very difficult time convincing the Service not to impose maximum civil penalties. As a result, many taxpayers feel compelled to stay in the voluntary disclosure programs and accept inappropriately large penalties because they fear that if they opt out, they automatically will be assessed with huge information return penalties....¹⁶

The IRS has been accepting these "inappropriately large" penalties in violation of FAQ #35 and its own policy to "determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers."¹⁷

¹⁶ Letter from NYSBA Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (hereinafter, "NYSBA Letter").

¹⁷ Policy Statement 4-7, IRM 1.2.13.1.5 (Feb. 23, 1960).

The problem with the IRS's position that it will generally not consider willfulness or reasonable cause in the OVDP is that it proceeds from an assumption that all noncompliant actors should be treated as "bad actors" under the OVDP and that anyone who is a "benign actor" should opt out and go through the examination process. That assumption and the IRS's approach is misguided because practitioners have told us they would not advise taxpayers who have already come forward to take their chances with Exam.

Practitioners are not certain what standards the IRS will use to compute an appropriate penalty — as the IRS's shifting position within the OVDP has amply demonstrated, it may not adhere to its most recent nonbinding pronouncement — and the taxpayers would be assuming an enormous risk that the IRS could ultimately assert penalties of 50 percent of the maximum account balance for each year (which could bankrupt them) as well as criminal penalties. Particularly for those who reside abroad and naturally keep the majority of their assets in accounts where they live, this may represent nearly 50 percent of their net worth for each violation — 300 percent or more of their net worth over six years.

Even if the risk the IRS will take that position is remote, what practitioner would advise his client to assume that risk and what taxpayer would do so? Practitioners tell us that virtually no one would do so without further certainty about what rules will apply and what the result is likely to be if they opt out. Thus, while the IRS's assertion that anyone may request that his or her case go to Exam sounds logical, it is not currently viewed as a viable option. If the IRS refuses to consider nonwillfulness and reasonable cause within the OVDP, the practical result will be that the bad actors and the benign actors will both pay the same 20 percent penalty. That is not a fair or reasonable result.

In addition, according to the opt-out memo, the examination process will start over with a new examiner for taxpayers who opt out. Thus, if any are brave enough to opt out, the IRS's reinterpretation of FAQ #35 means they (and the IRS) will have wasted all of the resources in submitting and processing OVDP submissions.

Why the initial IRS response does not address the problem.

We appreciate the IRS's attempt to justify its approach in the TAD appeal. To the extent not already explained above, the following points describe why we respectfully disagree with the specific analysis contained in the TAD appeal.

The TAD appeal does not address the disparate treatment of similarly situated taxpayers (described above). Instead of addressing this central issue, the appeal focuses on how it was not reasonable for taxpayers, practitioners, IRS revenue agents, and the National Taxpayer Advocate to expect the IRS to determine what a taxpayer would "otherwise be liable for under existing statutes" in cases where the violation was not willful. Yet, the only reason the March 1 memo was necessary was because the IRS's own revenue agents interpreted FAQ #35 in accordance with its plain language.¹⁸ Recently-published comments from key stakeholders emphasize the importance of this issue:

Many taxpayers and practitioners interpreted this third modification [FAQ #35] to mean that the Service would consider whether a taxpayer should be subject to non-willful FBAR penalties as opposed to a 20% miscellaneous penalty...¹⁹

We were able to make FAQ 35 submissions requesting a review of the willfulness issue all along until February 8 of this year ... [the IRS] seems to be changing the rules of the game halfway through.... the troubling thing is that closing the program to willfulness consideration under FAQ 35 now, based on a resource issue, when some persons have been granted relief, treats similarly situated taxpayers differently.²⁰

[t]he FAQ 35 process now appears to be a classic 'bait and switch.' Practitioners advised clients that FAQ 35 would offer a chance at penalty mitigation, but now our experience is that the language in that guidance is essentially an empty promise.²¹

¹⁸ According to IRS data, about 7,070 agreements had been signed as of May 20, 2011. IRS response to TAS information request (Sept. 14, 2011).

¹⁹ NYSBA Letter.

²⁰ CCH Federal Taxes Weekly, *Practitioners' Corner: Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13, 153, 155 (Mar. 31, 2011).

²¹ Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010).

Labeling the OVDP a "certification" had no bearing on whether the IRS would consider the willfulness of the violation in determining what a taxpayer would "otherwise be liable for under existing statutes." The TAD appeal suggests (on page 3) that the IRS's characterization of the 2009 OVDP as a "certification" rather than an "examination" provided a clear signal to the public that when doing the FAQ #35 comparison the IRS would assume that participants would otherwise be subject to FBAR penalties at the maximum statutory rate applicable willful violations.²² It would have been illogical for the public to reach such a startling conclusion.

First, as an incentive to participate most settlement initiatives offer taxpayers a lower penalty than would otherwise apply. It makes sense for the IRS to give up penalties that might otherwise apply so that it can bring more taxpayers back into the U.S. tax system and improve future compliance. As noted above, that was the Commissioner's stated goal for the OVDP. Thus, it would have been illogical for people to assume that the IRS was offering a "deal" for taxpayers to pay more than they would have owed outside of the program. Moreover, in public statements, the IRS "strongly encouraged" nearly all taxpayers to participate.²³ It advised that the process was "appropriate for most taxpayers who have underreported their income with respect to offshore accounts,"²⁴ regardless of whether the IRS could prove the violation was willful. Thus, those whose violations the IRS could not prove were willful reasonably expected to receive some incentive to come forward. While FAQ #35 did not provide a clear incentive, it provided assurance they would not be worse off if they participated. The incentive for these taxpayers was a more rapid and certain resolution of the matter, but they would not have assumed such finality would come at the cost of paying more than they owed.²⁵

²² As noted above, under existing statutes the IRS would not have imposed such penalties except in the most "egregious" cases where it could meet its burden to prove that the violations were willful.

²³ FAQ #10.

²⁴ FAQ #50.

²⁵ Under the IRS's interpretation of FAQ #35, many of those who made inadvertent errors are worse off under the initiative. For example, a taxpayer who has expended the time and resources to apply, responded to IRS information requests, agreed to extend the period of limitations on assessment of FBAR penalties, waited for the IRS to process the OVDP application, is now expected to opt out and be subject to "a complete examination" of all issues and years. He or she will then be subject to "all applicable penalties." A taxpayer in this situation is worse off than if he or she had simply started complying with the FBAR requirements in 2009. Such a taxpayer avoided the time and expense of participating in the OVDP. The FBAR statute of limitations, which continues to run whether or not a return is filed, will have expired on all but the most recent six years. The IRS is unlikely to detect any violations, and if it does, the taxpayer is unlikely to be subject to any significant FBAR penalty because the IRS cannot prove that the violation was willful. Moreover, if the IRS follows its IRM, it is likely to issue a warning letter in lieu of a penalty or to assert an FBAR penalty only with respect to a single violation. In 2010, the government closed only 2,386 FBAR examinations, assessed less than \$41 million in FBAR penalties, referred a negligible number (too few to list) to DOJ for collection, initiated only 21 criminal investigations, and convicted only 7 people for willful FBAR violations. IRS response to TAS information request (Sept. 14, 2011). By contrast, it issued 131 warning letters in lieu of penalties. *Id.*

Second, the IRS can determine whether a willful or non-willful penalty applies under "existing statutes" (in accordance with the IRM provisions described above) using a certification process. Indeed, some examiners identified and requested the information they needed to make this determination from OVDP participants who were obligated to cooperate.²⁶ Moreover, some applied the taxpayer-favorable provisions of the IRM, which implements existing statutes (as described above).

Finally, the IRS did not ignore willfulness considerations, reverse the burden of proof, or ignore the taxpayer-favorable sections of the IRM when administering the predecessor of the OVDP (called the Last Chance Compliance Initiative or LCCI).²⁷ Like the OVDP, the LCCI did not involve an "examination."²⁸ Thus, the mere characterization of the process as a "certification" rather than an "examination" did not put the public on notice that the IRS would ignore the taxpayer-favorable provisions of the IRM or that it would assume all violations were willful.

The TAD appeal does not effectively distinguish the LCCI where it followed the IRM (e.g., by applying mitigation guidelines and considering willfulness) from the OVDP where it did not. The TAD appeal suggests (on page 3) that taxpayers should have known that the IRS would not consider willfulness, reasonable cause, and the mitigation guidelines because it did not require that taxpayers submit information addressing these issues when applying to the OVDP. However, the IRS did not request such information from those applying to the LCCI.²⁹ Rather, examiners could ask follow-up questions of participants who were obligated to cooperate.³⁰ It was reasonable for the IRS to do so in the OVDP as well.

²⁶ Similarly, OVDI FAQ #27 expressly provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination." Moreover, merely providing taxpayers the option to opt out if they disagree with the FAQ #35 comparison did not signal that the IRS would not actually do the comparison inside the OVDP, as the TAD appeal seems to suggest.

²⁷ See, e.g., Letter 3649 (Rev. 5-2006); Notice 1341 (Rev. 2-2007).

²⁸ *Id.*

²⁹ The IRS had a checklist of items that it requested as part of the LCCI. See, e.g., Letter 3649 (Rev. 5-2006); Notice 1341 (Rev. 2-2007). This checklist was somewhat different than the items taxpayers were to submit with OVDP applications. OVDI FAQ #21, #22; IRS, *Offshore Voluntary Disclosures – Optional Format* (Rev. 7-28-2009), available at <http://www.irs.gov/pub/foia/ig/ci/ltr-voluntary-disclosure-option-format-20090729.doc> (last visited Sept. 13, 2011). However, neither the LCCI nor the OVDP required taxpayers to submit items specifically addressing willfulness or non-willfulness.

³⁰ See, e.g., IRM 4.26.17.1 (May 5, 2008).

As noted above, some OVDP examiners developed their own checklists requesting follow-up information bearing on willfulness and reasonable cause. Thus, the content of the initial application package was not sufficient to lead taxpayers to doubt the unambiguous terms of OVDP FAQ #35. It did not lead the experienced practitioners quoted above or the IRS examiners who developed their own checklists to reach such a conclusion.

Moreover, under the OVDP the IRS urged taxpayers to include a schedule of the value of any unreported foreign accounts.³¹ The value of these accounts is the primary information the IRS needs to apply the mitigation guidelines.³² Thus, the items the IRS requested that taxpayers submit when applying to the LCCI and OVDP were not so significantly different as to alert the public that the IRS would follow the IRM in applying existing statutes under the LCCI but not the OVDP, particularly in light of OVDP FAQ #35.

Conclusion

We commend the IRS for releasing the March 1 memo, as required by FOIA and the TAD. However, if the IRS does not consider willfulness or reasonable cause, or requires taxpayers to bear the burden of proving nonwillfulness, the benign actors will face a penalty inside the OVDP that is disproportionately harsh — and many are too frightened of the IRS and possible criminal or bankrupting civil penalties to opt out.

As noted above, this initiative is different from most previous initiatives involving tax shelters because it attracted both bad actors and benign actors who made honest mistakes. If the IRS had clearly communicated that everyone would be presumed to be a bad actor (or willful violator) as the TAD appeal asserts, it would not have attracted benign actors.

The IRS affirmatively attracted benign actors to the OVDP in two ways. First, it announced a method within the OVDP that would treat these differently situated taxpayers differently and fairly — by applying “existing statutes” to benign actors. Second, it threatened that bad things would happen to them outside of the program.³³ The fact that so many benign actors came in for what would be a terrible deal for them if they had understood the IRS's intent (and

³¹ See *id.*

³² See IRM Exhibit 4.26.16-2 (July 1, 2008).

³³ See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

were afraid to opt out) shows that the IRS did not clearly communicate what it meant to say.

Such miscommunication has consequences. If the government does not appear to treat benign actors fairly when they try to correct honest mistakes, then fewer people (even well-advised people) will try to correct their mistakes and voluntary compliance will suffer. Even if it were inclined to do so, the IRS does not have the resources to rely entirely on enforcement. It needs taxpayers to cooperate and comply voluntarily. While an estimated five million to seven million U.S. citizens reside abroad,³⁴ the IRS received only 218,840 FBAR filings in 2008.³⁵ By comparison, the government closed only 2,386 FBAR examinations and initiated only 21 criminal investigations in 2010.³⁶ While the OVDP attracted 15,364 applications, a more effective initiative would have prompted even more taxpayers to come into compliance without leaving those who did come forward feeling terrified, tricked, or cheated.³⁷ By generating such ill-will and mistrust, the IRS is squandering an opportunity to improve voluntary compliance.

Accordingly, we believe the IRS should create a fair process to evaluate willfulness, reasonable cause, etc. within the OVDP, with the proper burden of proof (on the IRS) as the public understood it to be doing at the outset.³⁸ Under that approach, the IRS will still have succeeded in bringing the accounts into the open, and collecting all back tax and interest and most penalties. The alternative, which is akin to a "guilty until proven innocent" approach, is not a good one for an agency of the United States government to follow.

More specifically, I continue to direct the IRS to take the following actions within **ten (10) business days**:

1. Revoke the March 1 memo and disclose such revocation as required by the Freedom of Information Act (FOIA).

³⁴ IRS web site, *Reaching Out to Americans Abroad* (Apr. 2009), <http://www.irs.gov/businesses/article/0,,id=205889,00.html>; W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010) (citing U.S. Department of State data). This number does not include U.S. troops stationed abroad.

³⁵ National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

³⁶ IRS response to TAS information request (Sept. 14, 2011).

³⁷ IRS response to TAS information request (Sept. 14, 2011).

³⁸ A former federal prosecutor involved in the UBS case apparently agrees. See Jeffrey A. Neiman, *Opting Out: The Solution for the Non-Willful OVDI Taxpayer*, 2011 TNT 176-6 (Sept. 7, 2011) ("While the IRS does not have unlimited resources, an expedited review process could have been established to compare the facts and circumstances of an individual taxpayer's overseas account to a set of predetermined objective factors that would have allowed the IRS to assess a reasonable and fair FBAR-related penalty and avoided higher penalties for non-willful taxpayers.").

2. Immediately direct all examiners to follow FAQ #35 by not requiring a taxpayer to pay a penalty greater than what he or she would otherwise be liable for under "existing statutes." This direction should clarify that examiners should apply "existing statutes" in the same manner that the IRS applies them outside of the OVDP (*e.g.*, IRM 4.26.16 implements existing statutes by instructing employees to: issue warning letters in lieu of penalties, consider reasonable cause, assert the penalty for willful violations only if the IRS has proven willfulness, impose less than the maximum penalty for failure to report small accounts under "mitigation guidelines," and apply multiple FBAR penalties only in the most egregious cases).³⁹ Post any such guidance in the electronic reading room on IRS.gov as required by FOIA.
3. Commit to replace all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI.⁴⁰ This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use the taxpayer-favorable provisions of the IRM (described above) to make this determination.
4. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes (as implemented by the IRS outside of the OVDP, and described above) the option to elect to have the IRS certify this claim, and offer to amend the closing agreement(s) to reduce the offshore penalty.⁴¹

³⁹ OVDI FAQ #27 already provides that "the examiner has the right to ask any relevant questions, request any relevant documents, and even make third-party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination."

⁴⁰ This directive is consistent with recent comments from external stakeholders. See, *e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, reprinted as, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance). Moreover, settlement initiatives are often published in the Internal Revenue Bulletin. See, *e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 ("Son-of-Boss" settlement initiative).

⁴¹ The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced 5 percent or 12.5 percent offshore penalty rates under the 2011 OVDI. See OVDI FAQ #52; OVDI FAQ #53.

Attachment

Taxpayer Advocate Directive 2011-1 (Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act)

cc:

Douglas Shulman, Commissioner of Internal Revenue

William J. Wilkins, Chief Counsel

Heather C. Maloy, Commissioner, Large Business and International Division

Faris Fink, Commissioner, Small Business/Self-Employed Division

Nikole Flax, Assistant Deputy Commissioner, Services and Enforcement

Jennifer Best, Special Assistant to the Commissioner

Ken Drexler, Senior Advisor to the National Taxpayer Advocate

Eric LoPresti, Senior Attorney Advisor to the National Taxpayer Advocate

Rosty Shiller, Attorney-Advisor to the National Taxpayer Advocate

Judy Wall, Special Counsel to the National Taxpayer Advocate



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

October 14, 2011

MEMORANDUM FOR NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE

FROM: ~~Steven T. Miller~~
Deputy Commissioner for Services and Enforcement

SUBJECT: Taxpayer Advocate Directive 2011-1

Pursuant to Delegation Order No. 13-3, which grants the Deputy Commissioner the authority to modify or rescind any form of Taxpayer Advocate Directive, this memorandum sets forth the agreements to and rescissions of Taxpayer Advocate Directive (TAD) 2011-1.¹

Background

On August 16, 2011, the National Taxpayer Advocate issued TAD 2011-1 to the Commissioner, Large Business & International Division, and the Commissioner, Small Business/Self-Employed Division to:

1. Disclose the March 1, 2011, memo for Offshore Voluntary Disclosure Initiative (OVDI) Examiners that addresses the use of discretion in 2009 Offshore Voluntary Disclosure Program (OVDP) cases (the "March 1 memo") on IRS.gov, as required by the Freedom of Information Act (FOIA) (whether or not it is revoked).
2. Revoke the March 1, 2011, memo and disclose such revocation as required by FOIA.
3. Immediately direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the taxpayer proves it was not. Direct them to use standard examination procedures to determine whether a taxpayer would be liable for a lesser amount under existing statutes (e.g., because the taxpayer was eligible for (a) the reasonable cause exception, (b) a non-willful penalty because the IRS lacked evidence to establish its burden to prove willfulness, or (c) application of the mitigation guidelines set forth in the IRM) without shifting the burden of proof onto the taxpayer. Post any such guidance on IRS.gov.

¹ See Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev.1), *Authority to Issue Taxpayer Directives* (Jan. 17, 2001). See also IRM 13.2.1.6.1 *Tax Appeal Process*.

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4. Commit to replace the March 1, 2011, memo and all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI. This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use standard examination procedures to make this determination, as provided in item #3 (above); and
5. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes the option to elect to have the IRS verify this claim (using standard examination procedures, as described above), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.

Appeal

On August 30, 2011, TAD 2011-1 was appealed to me by to the Commissioner, Large Business & International Division, and the Commissioner, Small Business/Self-Employed Division.

Agreement to and Rescission of TAD 2011-1

I have had the opportunity to review and consider thoroughly the August 30, 2011, appeal and your rebuttal memorandum of September 22, 2011. Pursuant to Delegation Order No. 13-3, Taxpayer Advocate Directive (TAD) 2011-1 is agreed in part and rescinded in part. Action 1 of the TAD has been completed and is sustained. For the reasons stated in the August 30, 2011, appeal, actions 2-5 under the TAD are rescinded.

I believe that the relief you seek is generally provided in the existing opt out procedures. Throughout the entire program, taxpayers have had the opportunity to opt out of the settlement structure and request an examination if there is disagreement relating to the result provided for under the program. An examination is the appropriate forum for detailed facts and circumstances determinations. Moreover, the opt out procedures and additional guidance issued on June 1, 2011, clarify that, depending on the facts and circumstances, it may be preferable for a particular taxpayer to opt out of the 2009 OVDP or 2011 OVDI. The materials also provide guidance for taxpayers regarding the decision whether to opt out. Also clear in that guidance is that when appropriate, taxpayers will have the same agent for an examination following opt out.

cc: Heather C. Maloy
Faris R. Fink