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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 (OVDP) 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 OVDP 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On October 14, 2011, the Deputy Commissioner for Services and Enforcement rescinded the items described in TAD 2011-1 that SBSE and LB&I had not agreed to implement (attached).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.<sup>1</sup>

## 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.<sup>2</sup> 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.<sup>3</sup>

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

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<sup>1</sup> 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.

<sup>2</sup> 31 U.S.C. § 5321(a)(5).

<sup>3</sup> 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.”).

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.

*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.<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> Thus, some examiners turned the IRS’s burden of proof on its head.

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

<sup>5</sup> See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

<sup>6</sup> 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,

*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.<sup>7</sup> 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.<sup>8</sup> The fact that so many benign actors came in for what would be a

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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).

<sup>7</sup> 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.

<sup>8</sup> See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

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.

**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,<sup>9</sup> the IRS received only 218,840 FBAR filings in 2008.<sup>10</sup> By comparison, the government closed only 2,386 FBAR examinations and initiated only 21 criminal investigations in 2010.<sup>11</sup> While the OVDP attracted 15,364 applications (perhaps less than one percent of those who did not file FBARs),<sup>12</sup> 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.<sup>13</sup> 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.

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<sup>9</sup> 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.

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

<sup>11</sup> IRS response to TAS information request (Sept. 14, 2011).

<sup>12</sup> *Id.*

<sup>13</sup> 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.<sup>14</sup> 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.<sup>15</sup>

**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.

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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.

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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.

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[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

<sup>14</sup> 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*).

<sup>15</sup> 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).

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.

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[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.<sup>16</sup> 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.<sup>17</sup>

## 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 FBAR penalties only in the most egregious

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

<sup>17</sup> 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).

cases).<sup>18</sup> 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.<sup>19</sup>
  
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.<sup>20</sup>
  
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).

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<sup>18</sup> 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.”

<sup>19</sup> 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).

<sup>20</sup> 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).
  4. 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).
  5. 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  
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