Introduction to International Issues: Compliance Challenges Increase International Taxpayers' Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena

WHY ADDRESS TAX ISSUES FACING INTERNATIONAL TAXPAYERS?

In recent years, globalization has pushed an increasing number of taxpayers (including small- and medium-sized businesses and individuals) to seek economic opportunities abroad.[1] It also has increased competition among tax administration agencies for tax bases and sources of revenue. The revenue generated depends on governments' administrative capacities to collect taxes, and more importantly, on taxpayers' willingness and ability to comply. For this reason, 40 economies made it easier to pay taxes last year.[2] In contrast, a recent World Bank report ranks the United States 66th in time spent to comply and 62nd in the ease of paying taxes among 183 countries surveyed.[3]

International taxpayers who are subject to complex U.S. tax rules and reporting requirements can be grouped into four categories:

- U.S. individuals working, living, or doing business abroad;
- U.S. entities doing business abroad;
- Foreign individuals working or doing business in the U.S.; and
- Foreign entities doing business in the U.S.[4]

The complexity of international tax law, combined with the administrative burden placed on these taxpayers, creates an environment where taxpayers who are trying their best to comply simply cannot. For some, this means paying more U.S. tax than is legally required, while others may be subject to steep civil and criminal penalties. For some U.S taxpayers abroad, the tax requirements are so confusing and the compliance burden so great that they give up their U.S. citizenship.[5]

A recent IRS study of taxpayer needs and preferences showed that international taxpayers may have a greater current need for IRS services than the general taxpayer population.[6] Yet while the IRS has substantially stepped up and invested hundreds of millions of dollars

1 Memorandum for Secretary Geithner from J. Russell George, Treasury Inspector General for Tax Administration, *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011* 13 (Oct. 15, 2010).

2 The World Bank, The International Finance Corporation (IFC), and PricewaterhouseCoopers (PwC), *Paying Taxes 2011, The Global Picture* (2011).

3 *Id*. The report studied the impact of tax systems on businesses in terms of both tax cost and compliance burden.

4 *See, e.g.*, IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

5 National Taxpayer Advocate meeting with the U.S. Ambassador to Switzerland (Feb. 4, 2011). *See also* Brian Knowlton, *More American Expatriates Give Up Citizenship*, N.Y. Times, Apr. 25, 2010; Helena Bachmann, *Why More U.S. Expatriates Are Turning In Their Passports*, Time World, Apr. 20, 2010.

6 IRS, Wage & Investment Division (W&I) Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010).

in international enforcement programs, it has not adequately improved taxpayer services that would foster compliance.[7]

Compliance challenges facing international taxpayers include:

- The overwhelming complexity of international tax law;
- The complexity and administrative detail of often duplicative international reporting requirements;
- Steep penalties that may be disproportionate to tax liability;
- The IRS's focus on international tax enforcement without adequate coordination or a corresponding increase in service; and
- The lack of targeted taxpayer service for each of the four groups of international taxpayers, which leads to confusion, errors, and higher compliance costs for this population.

ANALYSIS

Background: International Tax Administration Affects Millions of Taxpayers.

Globalization makes international markets and investments more accessible to small businesses and individuals.[8] In fiscal year (FY) 2010 alone, approximately 6.4 million foreign individuals were issued nonimmigrant U.S. visas, and 1.2 million aliens obtained legal permanent resident status.[9] Over 100 million U.S. citizens have valid passports, including over 13 million Americans who received passports to travel abroad in FY 2010.[10] An estimated five million to seven million American citizens reside abroad.[11]

According to the Small Business Administration, from 2003 to 2010, U.S. small businesses' exporting activity increased about 80 percent to account for nearly $500 billion in annual sales and about 30 percent of America's export revenues.[12] In FY 2007, the most recent year for export data by firm size, 259,400 known small business exporters sold $311.7

7 The IRS requested and received approximately $249 million for international enforcement in FYs 2010 and 2011. *See* IRS, The Budget in Brief, FY 2010 and FY 2011. *See also* Pub. L. No. 111-117 (Dec. 16, 2009); Pub. L. No. 112-10 (Apr. 15, 2011). *See, e.g.*, Reuters, *Deutsche Bank U.S. Tax Fraud Deal Opens Floodgates* (Dec. 22, 2010) (reporting Deutsche Bank's $553.6 million and UBS's $780 million settlement with the IRS). *See also* National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

8 Michael Danilack, *Deputy Commissioner (International), IRS Large Business and International Division, The Impact of Globalization on Tax Administration*, panel presentation, 2010 IRS Research Conference (Oct. 2010).

9 U.S. Dept. of State, Immigrant and Nonimmigrant Visas Issued at Foreign Service Posts FYs 2006 – 2010, www.travel.state.gov (last visited July 28, 2011); U.S. Dept. of Homeland Security, Office of Immigration Statistics, Persons Obtaining Legal Permanent Resident Status: FYs 1820 to 2010, http://www.dhs.gov/files/statistics/immigration.shtm (last visited July 15, 2011).

10 U.S. Dept. of State, Passport Statistics, *at* www.travel.state.gov (last visited July 28, 2011).

11 *Cf.* IRS website, *Reaching Out to Americans Abroad* (Apr. 2009), and 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.

12 Karen Gordon Mills, Administrator of the U.S. Small Business Administration (SBA), Taking Your Small Business Customers International (Oct. 15, 2010), http://www.sba.gov/administrator/7390/6086 (last visited July 19, 2011).

billion in goods overseas, or 30.2 percent of the total.[13] U.S. business activity by foreign individuals and corporations rose dramatically in recent years, from approximately $180 billion in tax year (TY) 2000 to almost $545 billion in TY 2006.[14]

However, the IRS has no way to accurately identify international taxpayers and assess their filing compliance rate. It also lacks a reliable and accurate estimate of the international tax gap.[15]

International Provisions Are Among the Most Complicated in the Internal Revenue Code.

The United States generally taxes U.S. persons on their worldwide income and foreign persons on U.S.-source income that has a sufficient connection to the United States.[16] All U.S. persons, both individuals and businesses, generally must report and are taxed on all income, whether derived in the United States or abroad.[17] U.S. international tax rules are extremely complex, with highly technical requirements and limitations. U.S. individual taxpayers residing abroad have to navigate provisions such as the foreign earned income exclusion, foreign housing allowance, and foreign tax credit.[18] U.S. partnerships and corporations with foreign source income must delve into foreign tax credit (FTC) rules and limitations. U.S. owners of interests in foreign entities also must consider the possible application of the controlled foreign corporation (CFC) and passive foreign investment company (PFIC) rules.[19]

Foreign persons are subject to "net-basis" U.S. tax on income that is "effectively connected" with the conduct of a trade or business in the United States. This income is generally taxed in the same manner and at the same rates as the income of a U.S. person.[20] Foreign persons are also subject to a "gross-basis" U.S. tax at a 30-percent rate on certain categories of non-effectively-connected U.S. source income (*e.g.*, interest, dividends, rents, and royalties)

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13 SBA Office of Advocacy, The Small Business Economy: A Report to the President 37 (2010).

14 IRS, *Statistics of Income Studies of International Income and Taxes* 186, Figure R, *Income Paid to Foreign Persons for Selected Years, 1980-2006*. The inflation-adjusted distributions of U.S.-source income to foreign persons rose about 260 percent from TY 2000 to TY 2006. *Id*.

15 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-IE-R001, *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap* 2 (Jan. 27, 2009); National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

16 A U.S. person is any citizen or resident of the United States, a domestic partnership or corporation, or any estate or trust that is not considered foreign. Any person who does not fit the definition of a U.S. person is considered a foreign person. *See generally* Internal Revenue Code (IRC) § 7701.

17 *See generally* IRC §§ 1(a), 11(a), 61(a), and 862(a)(5); Treas. Reg. § 1.1-1(b). *See also* IRC §§ 861, 862, 864, 871, 881, and 882.

18 *See generally* IRC §§ 901, 903-904, 908-909, 911, and 912.

19 *See generally* IRC §§ 901-904; 951-964; 1291-1298. There are also multiple technically complicated rules and limitations, *e.g.*, interest allocation rules, accumulated earnings tax rules, personal holding company rules, and transfer pricing rules. *See also* IRC §§ 531-537; 541-547; 864; 482.

20 IRC §§ 871(b) and 882.

subject to certain exceptions and limitations.[21] The IRS generally collects the gross-basis tax imposed on foreign persons through withholding.[22]

In addition to complex statutory rules for the taxation of foreign income of U.S. persons and U.S. income of foreign persons, the United States has 60 bilateral income tax treaties with 68 countries.[23] Such treaties provide for reduced rates of tax or exemptions from tax for various items of income, but at the cost of increased complexity, especially for persons entitled to claim benefits under more than one bilateral treaty.

The Complexity and Administrative Detail of the International Reporting Requirements Are Overwhelming.

The IRS has 16 publications that address international issues for individuals, totaling 407 pages, with 110 references to other publications totaling 4,491 pages and 137 references to forms totaling 450 pages which have an additional 2,190 pages of instructions. At a minimum, individual international taxpayers spent 25 million hours reviewing and completing TY 2009 forms.[24] Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad*, illustrates the complexity of the filing requirements for individual U.S. taxpayers. The publication refers to at least eight other relevant IRS publications, totaling 563 pages. Further, the additional documents referred to by these eight publications include 4,727 pages of instructions, 667 pages of forms, and another 1,928 pages of form instructions for a total of 7,322 pages.

In addition to returns, these taxpayers may be required to file multiple additional forms, schedules, and information returns.[25] Foreign individuals with U.S. filing obligations cannot file electronically and also must comply with complex reporting requirements.[26] Publication 519, *U.S. Tax Guide for Aliens*, designed for individual foreign taxpayers with U.S. - source income, refers to at least 31 other relevant IRS publications totaling 1,329 pages, 31 forms totaling 87 pages, and 241 pages of form instructions. Thirteen of the 31 publications listed in Publication 519 make 151 references to other publications totaling 5,739 pages, and 244 references to forms totaling 735 pages and 3,204 pages of form instructions, including duplications.

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21 *See generally* IRC §§ 871 and 881. There is an exception to taxability of interest from certain bank deposits and portfolio obligations. *See* IRC §§ 871(h)-(i), 881(c)-(d). There are also limitations on interest deductions, known as "thin capitalization" rules, intended to prevent excessive interest deductions by foreign corporations. *See* IRC § 163(j).

22 *See generally* IRC §§ 1441-1446. Withholding rules are extremely technical and basically require the withholding agent (broadly defined as any person) to withhold or be liable for the withholding tax and any applicable penalties and interest.

23 IRS, *Tax Treaties*, http://www.irs.gov/businesses/international/article/0,,id=96739,00.html (last visited July 21, 2011).

24 IRS, Compliance Data Warehouse (CDW), IRTF_F1040, IRTF_F1040NR, and BRTF_F1042 tables, data extracted cycle 201143. *See also* IRM 21.8.1.1.3 (Oct. 1, 2009) that refers to IRS Publications 3, 54, 513, 514, 515, 516, 519, 570, 593, 597, 850 series (federal tax terminology glossaries in various languages); 901, 970, 972, 4588, and 4732. The National Taxpayer Advocate acknowledges that form complexity is not only due to the complexity of international tax law rules but also due to the complexity of the transactions.

25 *See, e.g.*, Forms 1116, 2555 or 2555-EZ; 3520, 3520-A; 5471; 5472; 926; 8865.

26 For example, in addition to an individual tax return (Form 1040NR or 1040NR-EZ), foreign individuals may have to file Forms 8288-A; 8805; 8833; 8840; and 8843.

U.S. and foreign entities engaged in cross-border activity are subject to even more complex reporting and withholding requirements.[27] The IRS has 43 publications pertaining to U.S. business taxpayers involved in economic activity abroad, totaling 1,212 pages. These publications refer to additional publications totaling 13,346 pages, 1,500 pages of forms, and another 5,018 pages of form instructions. For example, a U.S. person who engages in foreign activities indirectly through a foreign business entity must comply with burdensome and often duplicative self-reporting requirements.[28] The estimated burden to file a Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations,* is about 15 eight-hour work days.[29] Finally, foreign-owned U.S. entities and foreign entities with a U.S. trade or business must file a U.S. tax return and are subject to special rules for reporting transactions with related parties.[30]

Even Inadvertent Noncompliance May Result in Steep Civil and Criminal Penalties.

International taxpayers who do not comply with these complex requirements are subject to penalties that often are disproportionately high in comparison to the amount of tax involved. Most international penalties relate to information returns and are civil penalties that are not based on the amount of underpayment, including:

- A penalty for failing to file or for filing an incomplete Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*[31]
- A penalty for failing to file or for filing an incomplete Form 3520-A, *Information Return of Foreign Trust with a U.S. Owner.*[32]
- A penalty for failing to file Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations.*[33]

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27 For Business Master File and Non-Master File reporting and withholding requirements, see IRM 21.8.2 (Oct. 1, 2010) and IRM 21.8.3 (Oct. 1, 2010).

28 National Taxpayer Advocate 2009 Annual Report to Congress 140.

29 U.S. persons must report similar information with respect to interests in a controlled foreign partnership or a foreign disregarded entity on Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*, and Form 8858, *Information Return of U.S. Persons with Respect to Foreign Disregarded Entities*. The U.S. person capitalizing a foreign corporation with cash as well as other assets and liabilities is required to file Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*.

30 *See, e.g.*, IRS Form 1120-F, and Schedules H, I, P, M-1, M-2, M-3. A foreign partnership may be required to file IRS Forms 1042, 1065, 1065-B, and 8804.

31 The penalty is 35 percent of the gross reportable amount, except for returns reporting gifts, where the penalty is five percent of the gift per month, up to a maximum penalty of 25 percent of the gift. Only certain large gifts or bequests from certain foreign persons are required to be reported. *See generally* IRC §§ 6039F and 6048.

32 The penalty is equal to the greater of five percent of the gross value of trust assets determined to be owned by the United States person or $10,000. *See generally* IRC § 6048(b).

33 Certain United States persons who are officers, directors, or shareholders in certain foreign corporations are required to report information under IRC §§ 6035, 6038, and 6046. The penalty for failing to file each one of these information returns is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return. *See generally* IRC § 6038(b). IRC § 6038(c) further provides for a ten percent reduction of the foreign taxes available for credit under IRC §§ 901, 902, and 960 by a shareholder in a foreign corporation or a partner in a controlled foreign partnership who fails to furnish required information about such foreign entities. The amount of the IRC § 6038(c) penalty must be reduced by the amount of the dollar penalty imposed by IRC § 6038(b).

- A penalty for failing to file Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business,* or to keep certain records regarding reportable transactions.[34]
- A penalty for failing to file Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation.*[35]
- A penalty for failing to file Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships.*[36]
- A penalty for failing to file the Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (commonly known as FBAR).[37]
- A penalty for failing to file the new Form 8938, *Statement of Specified Foreign Financial Assets* (commonly known as FATCA).[38] An additional penalty regime for financial asset reporting will apply, and appears to overlap significantly with the disclosure requirements of the FBAR.[39]

In addition to information return penalties, "regular" failure to file, failure to pay, and fraud penalties may apply.[40] Finally, noncompliance may result in criminal charges, including criminal penalties for the failure to file an FBAR and willfully filing a false FBAR.[41]

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34 Taxpayers may be required to report transactions between a 25 percent foreign-owned domestic corporation or a foreign corporation engaged in a trade or business in the United States and a related party as required by IRC §§ 6038A and 6038C. The penalty for failing to file each one of these information returns, or to keep certain records regarding reportable transactions, is $10,000, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency.

35 The penalty for failing to file each one of these information returns is ten percent of the value of the property transferred, up to a maximum of $100,000 per return, with no limit if the failure to report the transfer was intentional. *See generally* IRC § 6038B.

36 United States persons with certain interests in foreign partnerships use this form to report interests in and transactions of the foreign partnerships, transfers of property to the foreign partnerships, and acquisitions, dispositions, and changes in foreign partnership interests under IRC §§ 6038, 6038B, and 6046A. Penalties include $10,000 for failure to file each return, with an additional $10,000 added for each month the failure continues beginning 90 days after the taxpayer is notified of the delinquency, up to a maximum of $50,000 per return, and ten percent of the value of any transferred property that is not reported, subject to a $100,000 limit.

37 Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50 percent of the total balance of the foreign account per violation. *See* 31 U.S.C. § 5321(a)(5). Non-willful violations that the IRS determines were not due to reasonable cause are subject to up to $10,000 per violation. *See generally* 31 U.S.C. § 5321(a)(5).

38 In 2010, Congress enacted the provisions commonly known as Foreign Account Tax Compliance Act (FATCA) as part of the Hiring Incentives to Restore Employment (HIRE) Act, Pub. L. No. 111-147 (Mar. 18, 2010). FATCA requires certain U.S. taxpayers holding foreign financial assets with an aggregate value exceeding $50,000 to report certain information about those assets on a new form (Form 8938, still in draft) that must be attached to the taxpayer's annual tax return. The statute required reporting for assets held in taxable years beginning after March 18, 2010. In June, 2011, however, reporting required under IRC § 6038D was suspended until Form 8938 is released *See* Notice 2011-55, 2011-29 IRB 53. Failure to report foreign financial assets on Form 8938 will result in a penalty of $10,000 (up to $50,000 for continued failure after IRS notification). FATCA also will require foreign financial institutions (FFIs) to report to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. *See generally* IRC §§ 1471-1474.

39 The penalty is $10,000 (and a penalty up to $50,000 for continued failure after IRS notification), but there is a reasonable cause exception. Further, underpayments of tax attributable to non-disclosed foreign financial assets will be subject to an additional substantial understatement penalty of 40 percent. *See generally* IRC §§ 6038D and 6662(b)(7).

40 *See generally* IRC §§ 6651, 6662, and 6663.

41 For example, failing to file an FBAR while violating certain other laws may result in a prison term of up to ten years and criminal penalties of up to $500,000. Tax evasion may result in a prison term of up to five years and a fine of up to $250,000. *See generally* 31 U.S.C. § 5322 and IRC §§ 7201 and 7206.

SUMMARY

The National Taxpayer Advocate is very concerned about the IRS's shift of emphasis away from improving taxpayer service and relieving procedural burdens facing low-profile international taxpayers. Given the overwhelming complexity of the international tax rules and reporting requirements and the potentially devastating penalties for even inadvertent noncompliance, adequate international taxpayer service becomes especially important. Increased international enforcement without substantial improvement in service may lead some voluntarily compliant taxpayers to give up and become noncompliant, slithering off into the cash economy and ultimately increasing the international tax gap.

The National Taxpayer Advocate's past two Annual Reports to Congress examined aspects of compliance challenges and inadequate taxpayer service for international taxpayers.[42] These reports provide a basis for the following administrative and legislative recommendations to help address the needs of diverse international taxpayers:

- Develop a way to identify U.S. taxpayers located or conducting business abroad and assess their filing compliance rate.
- Develop a comprehensive strategy and outreach materials, including a dedicated web page for small businesses, specifically targeting tax problems facing this taxpayer population based on a survey of needs and preferences of U.S. taxpayers abroad.
- Devote more tax attaché posts to taxpayer service, including reinstatement of in-person taxpayer service to U.S. taxpayers residing in Mexico.
- Open case resolution rooms at tax attaché posts and during tax events abroad.[43]
- Implement a pilot of the Pre-filing Agreement Program for small businesses with reduced fees and reduce filing fees for the Advanced Pricing Agreement (APA) program for small businesses with assets of $10 million or less.
- Provide international toll-free telephone access to the Accounts Management function in Philadelphia and the National Taxpayer Advocate (NTA) toll-free line for U.S. taxpayers in Canada and Mexico, followed by expansion to other countries with large U.S. taxpayer populations.
- Resolve the security issues with the Internet Customer Account Services (ICAS) system and reinstate the "My IRS Account" application, providing taxpayers outside the United States with online access to their accounts.
- Translate the complete IRS website content into Spanish, and translate more IRS forms and publications into other languages.

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42 National Taxpayer Advocate 2009 Annual Report to Congress 134-154 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*); National Taxpayer Advocate 2008 Annual Report to Congress 141-157 (Most Serious Problem: *Access to the IRS by Individual Taxpayers Located Outside the United States*).

43 The National Taxpayer Advocate recommends the creation of four Local Taxpayer Advocate positions co-located with current IRS posts in London, Paris, Frankfurt, and Beijing as a part of the revised international taxpayer service strategy, and to fund additional Local Taxpayer Advocate positions as additional attaché offices are opened. *See* Most Serious Problem: *Globalization Calls for Greater Internal IRS Coordination of International Taxpayer Service*, *infra*.

- Implement Estimated Waiting Time (EWT) functionality on IRS toll customer service lines and reduce the wait time for international taxpayers at the Accounts Management function.
- Amend IRC § 904(k)(2)(B) to increase the threshold amount for creditable foreign taxes on qualified passive income to $500 ($1,000 if filing a joint return) and index this amount for inflation in $50 increments.[44]

With respect to international taxpayers, the Most Serious Problems described below are detailed in the following discussions:[45]

- Globalization requires greater internal IRS coordination of international taxpayer service.
- Individual U.S. taxpayers working, living, or doing business abroad need expanded service targeting their specific needs and preferences.
- Small businesses involved in international economic activity require targeted IRS assistance.
- Foreign taxpayers face challenges in fulfilling U.S. tax obligations.
- U.S. taxpayers abroad face challenges with understanding how the IRS will apply penalties to taxpayers who are reasonably trying to comply or return into compliance.

[44] National Taxpayer Advocate 2009 Annual Report to Congress 400-402 (Legislative Recommendation: *Increase the Threshold for the Election to Claim the Foreign Tax Credit Without Filing Form 1116 for Individuals and Index It for Inflation*).

[45] *See also* Legislative Recommendation: *Allow Individual U.S. Taxpayers Residing Abroad the Option to Choose the Currency of Their Country of Residence as Their Functional Currency*, *infra*.

MSP #7

Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations

RESPONSIBLE OFFICIALS

Heather C. Maloy, Commissioner, Large Business and International Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Faris Fink, Commissioner, Small Business/Self-Employed Division
Beth Tucker, Deputy Commissioner, Operations Support
Frank Keith, Chief, Communications and Liaison

DEFINITION OF PROBLEM

Millions of foreign persons enter the United States for personal and business reasons each year.[1] Some of them may be subject to U.S. tax on U.S.-source income and have a U.S. filing obligation.[2] Many are not proficient in English and are unfamiliar with U.S. tax concepts, which make them less equipped to deal with the complexity of the U.S. tax code and reporting requirements.[3] For example, IRS Publication 519, *U.S. Tax Guide for Aliens*, applicable to individual foreign taxpayers with U.S.-source income, refers to at least 31 other relevant IRS publications totaling over 1,300 pages, 31 forms totaling 73 pages, and 251 pages of form instructions. Additionally, 16 of the 31 publications listed in Publication 519 include 160 references to other publications totaling more than 6,200 pages and 269 references to forms totaling over 650 pages and having more than 3,150 pages of form instructions, including duplications. However, the IRS does little to alleviate compliance burdens for this category of international taxpayers.[4] Some of the challenges these taxpayers face include:[5]

- Some nonresidents and their employers may not be aware of or fully appreciate the complex tax rules that apply to nonresident aliens with U.S.-source income;
- Even though some nonresidents earning wages from U.S. employers may have U.S. taxes withheld, they may not know that they must file tax returns or which returns to file;[6]

1 U.S. Dept. of State, *Immigrant and Nonimmigrant Visas Issued at Foreign Service Posts FYs 2006-2010, available at* www.travel.state.gov/pdf/FY10Annual-Report-TableI.pdf (last visited Nov. 1, 2011).

2 *See generally* Internal Revenue Code (IRC) §§ 871-885. There are also foreign individuals and entities that may remain overseas and have U.S.-source income and therefore U.S. filing obligations. However, often it is difficult to identify these taxpayers absent withholding.

3 *See Preface to International Issues, supra*; National Taxpayer Advocate 2010 Annual Report to Congress 3-14. *See also Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due, Hearing Before the S. Comm. on Finance*, 112th Cong. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

4 For categories of international taxpayers, see *Preface to International Issues, supra.*

5 *See* Government Accountability Office (GAO), GAO-10-429, *IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden* 13-14 (Apr. 2010). The GAO interviewed IRS officials responsible for conducting outreach efforts and representatives from groups that work with employers and nonresidents to assist them in fulfilling their tax obligations, such as paid tax return preparers, accounting and law firms, and university business officers.

6 For example, in Canada, nonresidents are not generally required to file a tax return if the withholding (final) tax is withheld by the payor. Canada Revenue Agency, *at* http://www.cra-arc.gc.ca/tx/nnrsdnts/ndvdls/nnrs-eng.html#common (last visited July 25, 2011). *See also* Volume 2 study, *Analyzing Pay-as-You-Earn Systems as a Path for Simplification of the U.S. Tax System, infra.*

- Foreign individuals visiting the U.S. for short-term business trips may be unaware that they have a filing requirement, because comparable requirements may not exist in their own countries;
- Some tax return preparers are unfamiliar with nonresident alien tax rules;
- Foreign individuals cannot file Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, electronically; and
- Foreign individuals have difficulty obtaining Individual Taxpayer Identification Numbers (ITINs) because of the volume and complexity of the documentation needed and because they cannot apply for ITINs electronically, even through IRS-sanctioned acceptance agents.[7]

ANALYSIS OF PROBLEM

Background

Taxpayers with U.S. filing obligations may reside in 194 countries and more than 60 territories, colonies, and dependencies of these countries.[8] In fiscal year (FY) 2010 alone, more than 6.4 million foreign individuals received nonimmigrant U.S. visas.[9] From FY 2005 to FY 2010, the U.S. Department of State issued between 5.3 and 6.6 million nonimmigrant visas annually as described in Figure 1.7.1 below.[10]

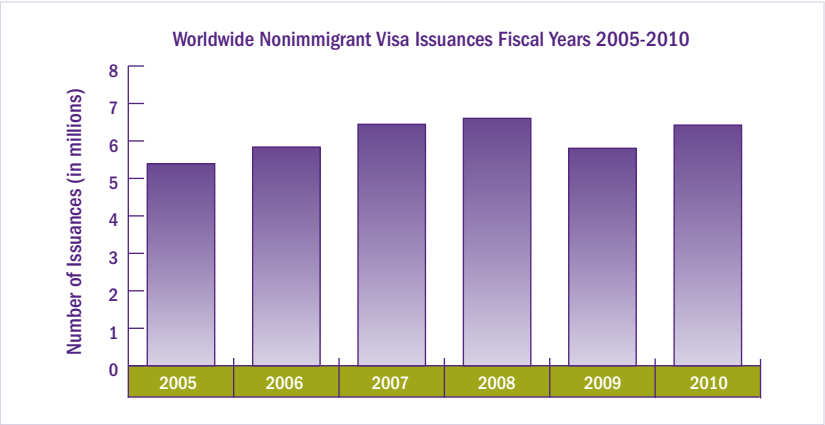
7 Because the IRS requires the ITIN application to be filed on paper with a tax return, these taxpayers cannot file their returns electronically. The National Taxpayer Advocate has voiced concerns about the IRS's ITIN policy for many years. *See* National Taxpayer Advocate 2010 Annual Report to Congress 319-334; Taxpayer Advocate Directive 2009-1 (Feb. 25, 2009); National Taxpayer Advocate 2009 Annual Report to Congress 520-522; National Taxpayer Advocate 2008 Annual Report to Congress 126-140; National Taxpayer Advocate 2004 Annual Report to Congress 143-162; National Taxpayer Advocate 2003 Annual Report to Congress 60-86.

8 *See* U.S. Department of State Fact Sheet, *Independent Countries of the World, available at* http://www.state.gov/s/inr/rls/4250.htm (last visited Oct. 14, 2011).

9 U.S. Dept. of State, *Immigrant and Nonimmigrant Visas Issued at Foreign Service Posts FYs 2006- 2010, available at* www.travel.state.gov (last visited July 28, 2011).

10 U.S. Dept. of State, *Worldwide Nonimmigrant Visas Issued at Foreign Service Posts FYs 2005- 2010,* Multi-Year Graphs, *available at* http://www.travel.state.gov/visa/statistics/graphs/graphs_4399.html (last visited July 28, 2011).

FIGURE 1.7.1, U.S. Department of State, Worldwide Nonimmigrant Visa Issuances, FY 2005–FY 2010



While the IRS has no reliable estimate of the number of nonresident alien taxpayers and foreign business entities that may have U.S. tax filing obligations,[11] it receives hundreds of thousands of returns from these taxpayers each year.[12] In tax year (TY) 2009, the IRS processed 702,607 returns from foreign individuals[13] and 33,043 returns of foreign corporations with U.S.-source income.[14]

The IRS Is Missing Opportunities to Educate Foreign Taxpayers.

The IRS has offices in only four countries, and even at these locations, the IRS tax attachés' main responsibilities focus on partner relationships, exchange of information agreements with foreign governments, and support of IRS investigations and examinations, with taxpayer service being an "important sideline."[15] The IRS attempts to reach out to this taxpayer population through Nationwide Tax Forums and other presentations, but it conducts most, if not all of these events, in the United States.[16] The target population by definition, however, resides outside the United States.

Because in-person taxpayer assistance is available at only four tax attaché posts abroad and is limited, the IRS cannot adequately educate foreign taxpayers and their foreign-based tax

11 Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-IE-R001, *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap* 2 (Jan. 27, 2009).

12 IRS Office of Research, Forecasting and Statistics, Document 6187 (Sept. 2010), Tables 1B.

13 *Id*.

14 IRS Document 6292 (Sept. 2010), at 6. In TY 2006, there were 14,897 foreign corporations with effectively connected U.S. income and 63,951 domestic corporations controlled by foreign persons. IRS, *International Tax Overview, Statistics of Income Bulletin* (Summer 2010), *available at* http://www.irs.gov/pub/irs-soi/10intertax.pdf.

15 The IRS posts are located in Frankfurt, London, Paris, and Beijing. *See* IRM 4.30.3.1 (Oct. 1, 2010); IRM 4.30.3.3 (Oct. 1, 2010). *See also* IRS Today Vol. 4 No.1 (Jan./Feb. 2008), *A Day in the Life of the Paris Tax Attaché,* http://wsep.ds.irsnet.gov/sites/co/candl/CLDocs/IC/irstoday/IRSToday_JanFeb_v10.pdf (last visited Dec. 23, 2011).

16 The IRS presented annually to groups such as the American Payroll Association, the National Association of College and University Business Officers, the American Bar Association, Tax Executives Institute, and local attorney and certified public accountant groups in the United States. GAO, GAO-10-429, *IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden* 12 (Apr. 2010).

advisors.[17] The IRS does not provide toll-free telephone assistance to taxpayers abroad.[18] It does not provide assistance in foreign languages (besides Spanish) even on a toll line; nor does it use web-based technologies to hold virtual face-to-face discussions with taxpayers.[19] IRS taxpayer service to nonresident alien taxpayers and foreign entities is limited to scarce English-language resources on the IRS.gov website. As a result, many of these taxpayers must hire a tax professional to fulfill their U.S. tax filing obligations. In contrast, the revenue agencies of several other countries provide full multilingual assistance and translate their entire websites and many tax assistance materials into various languages.[20]

Foreign Taxpayers Need Multilingual Taxpayer Service and Outreach Materials. Most IRS publications and website materials are not available in foreign languages, which means even web-based outreach to these taxpayers is problematic. The IRS should make relevant web resources, forms, and publications, including Publication 519, *U.S. Tax Guide for Aliens*, available in major foreign languages.

As a part of the federal government's effort to expand and integrate products and services for Limited English Proficient taxpayers, the IRS established the Multilingual Initiative program, later reorganized as the Language Services Branch (LSB).[21] In August 2010, LSB established the Asian Cadre, a group of bilingual employees to improve products and services in Chinese, Korean, Vietnamese, and Russian.[22] This innovative and cost-savvy approach has substantially improved products and publications in these languages.[23] The IRS can and should do more to translate forms, instructions, and publications into foreign languages, especially for nonresident taxpayers with U.S. filing obligations. The IRS also needs to place links to foreign language information prominently on the IRS.gov homepage, next to the Español link, to help foreign taxpayers with limited English proficiency.

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17 *See* Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences, infra.*

18 *See* National Taxpayer Advocate 2008 Annual Report to Congress 141-157.

19 Since at least 2008, TAS proposed development and implementation of a pilot of two-way videoconferencing environment to provide a face-to-face experience for customers who live in remote areas, who have mobility issues or who are otherwise unable to travel to an office where there is a TAS presence. For a more detailed discussion of the Virtual Service Delivery (VSD), see Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences, infra. See also* National Taxpayer Advocate 2010 Annual Report to Congress 267-277 (Most Serious Problem: *The IRS Has Been Reluctant to Implement Alternative Service Methods that Would Improve Accessibility for Taxpayers Who Seek Face-to-Face Assistance*); National Taxpayer Advocate 2008 Annual Report to Congress 95-113 (Most Serious Problem: *Taxpayer Service: Bringing Service to the Taxpayer*).

20 For example, the Canada Revenue Agency's website is viewable in English and French (http://www.cra-arc.gc.ca/menu-e.html), the Mexican Tax Administration website in Spanish and English (http://www.sat.gob.mx), the Netherlands Tax Agency in Dutch, English, and German (http://www.belastingdienst.nl/), and the Chinese State Administration of Taxation website in Chinese and English (http://www.chinatax.gov.cn/n480462/index.html). The Australian Taxation Office has its website translated *into 20 languages other than English*. See http://www.ato.gov.au/content/00171454.htm (last visited Oct. 14, 2011).

21 *See* Executive Order 13166, *Improving Services for Persons with Limited English Proficiency* (LEP), 65 FR 50121 (2000). *See also* Policy Statement P-22-3, IRM 22.31.1.1.2 (Apr. 1, 2006).

22 IRS, Language Services Program, http://mli.web.irs.gov/v3/home/index.asp (last visited July 31, 2011).

23 IRS publications translated into foreign languages by bilingual IRS employees contain the necessary foreign language tax terms and are adjusted to cultural and language differences of native speakers of those languages. In addition, the outsourced translation cost of one word ranges between 48 and 74 cents, while bilingual IRS employees conducted translations and reviews during their normal work hours without additional funding. Asian Cadre Training Conference, Washington, DC (July 19-22, 2011). *See also* email from IRS, Linguistic Policy, Tools and Services Section (Nov. 7, 2011).

The IRS needs focused outreach and separate publications in foreign languages for special groups of nonresident alien taxpayers, including:

- Foreign students and scholars;[24]
- Foreign professors and researchers;
- Visitors (business and pleasure);
- Foreign agricultural workers;
- Foreign athletes, artists, and entertainers;
- Foreign businessmen and investors, including real estate investors; and
- Foreign workers in U.S. territories, such as Guam, American Samoa, U.S. Virgin Islands, and the Commonwealth of Northern Marianna Islands.

The IRS should work with the departments of State and Homeland Security to distribute concise and plain-language publications for these groups at U.S. consulates and embassies that issue specific types of visas, and at U.S. ports of entry. It can also use U.S. embassy and consulate locations for virtual service delivery to provide assistance to these taxpayers.[25]

The IRS Should Develop Electronic Filing and Payment Options for Nonresident Alien Taxpayers.

Electronic filing is not available for the IRS Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, or 1040NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens with No Dependents*. Foreign taxpayers also cannot use the Electronic Federal Tax Payment System to pay federal taxes via the Internet or phone, unless they have a bank account at a U.S. banking institution.[26] In addition, current IRS ITIN policy precludes first-time ITIN applicants from filing electronic returns, and causes backlogs of hundreds of thousands of unworked and suspended applications, a practice the National Taxpayer Advocate has opposed for years and about which she has advocated for and proposed alternatives.[27]

The IRS should redesign its systems to allow free electronic filing of foreign taxpayers' returns and concurrent payment of tax liabilities through a foreign-issued credit card and a wire transfer from a foreign bank. Because the IRS requires first-time nonresident alien filers to provide a taxpayer identifying number (TIN) to file a tax return, it should develop a system for free electronic filing of the Form W-7, *Application for IRS Individual Taxpayer*

24 *See, e.g.*, Systemic Advocacy Management System (SAMS) Issue 21534 (July 26, 2011) (discussing the inability of foreign students at the University of Kansas at Lawrence to file returns electronically and multiple ITIN rejections under the scholarship exception).

25 VSD presentation materials, *Delivering Taxpayer Services Using Video Communications Technology*, IRS Senior Executive Team meeting (Sept. 6, 2011). For a detailed discussion of VSD, see Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences, infra.*

26 *See* Electronic Federal Tax Payment System, www.eftps.gov (last visited Oct. 15, 2011).

27 *See* National Taxpayer Advocate 2010 Annual Report to Congress 319-334; Taxpayer Advocate Directive 2009-1 (Feb. 25, 2009); National Taxpayer Advocate 2009 Annual Report to Congress 520-522; National Taxpayer Advocate 2008 Annual Report to Congress 126-140; National Taxpayer Advocate 2004 Annual Report to Congress 143-162; National Taxpayer Advocate 2003 Annual Report to Congress 60-86.

Identification Number, with functionality to allow electronic submission of required documentation proving that the nonresident alien has U.S.-source income.

CONCLUSION

Foreign taxpayers with U.S. tax obligations are less equipped than domestic taxpayers to deal with the complexity of U.S. tax law and reporting obligations because they have limited or no English proficiency and because U.S. tax law and filing requirements may be very different from those of their home countries. The IRS often does not address taxpayer needs by market segment and instead is organized around administration of particular provisions.[28] However, the IRS's mission as a tax administrator for all taxpayers requires it to meet these taxpayers' needs.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Make relevant web resources, forms, and publications, including Publication 519, *U.S. Tax Guide for Aliens,* available in major foreign languages.
2. Place links to information in foreign languages prominently on the IRS.gov homepage next to the Español link.
3. Develop focused outreach and separate publications in foreign languages for special groups of nonresident alien taxpayers and foreign entities.
4. Partner with the Departments of State and Homeland Security to distribute concise publications for these specific groups at U.S. consulates and embassies in conjunction with issuance of a specific type of visa and at U.S. ports of entry.
5. Partner with the Department of State for virtual service delivery at U.S. embassies and consulates abroad.
6. Allow electronic filing of 1040NR series tax returns and ITIN applications for nonresident alien taxpayers, at least to those not claiming a refund.

IRS COMMENTS

The IRS recognizes the issues faced by foreign taxpayers in fulfilling their U.S. tax obligations and we continue to look for opportunities to improve service delivered to this taxpayer base.

As previously discussed, last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address, and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in

[28] Many prior Annual Reports to Congress suggested or offered a basis for administrative and legislative recommendations to help address the needs of diverse taxpayer populations. For a detailed discussion, see *Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics, infra.*

large part by recognition of the complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating IRS efforts in this area across all IRS Business Operating Divisions to ensure that the IRS's international strategy is aligned, balanced, and coordinated.

Improving taxpayer services to foreign taxpayers in fulfilling their U.S. tax obligations is an important strategic goal for the office of the Deputy Commissioner, International and the IRS in general. As part of FY 2012 priorities, the International Executive team is committed to coordinate closely with Wage & Investment and the Director, e-Services to perform a thorough review of specific problems faced by foreign taxpayers, identify modern options available to improve service, and make recommendations for implementing effective improvements. We will consider the views included in the National Taxpayer Advocate's report in this effort.

Servicewide Initiatives

Media & Publications (M&P), part of the IRS's Wage & Investment's CARE organization, provides IRS-wide support for publishing and distribution services, including outreach and education products for all international taxpayers. M&P is participating in an agency-wide group that is working to improve services to international taxpayers. In brief, M&P:

- Authors and publishes tax products for U.S. and international taxpayers. These products are available to all taxpayers, regardless of where they live and work, through "Forms and Publications" on IRS.gov.
- Administers a small bulk forms distribution program for embassies and military bases.
- Provides mail order fulfillment services to national and international requesters.

In addition, M&P has identified some actions for FY 12 that will improve services for international taxpayers. These include:

- Expanding our products and services to meet the needs of Limited English Proficient (LEP) taxpayers.
- Focusing on delivering electronic publishing and providing electronic options for disseminating products in formats customer prefer.
- Creating user friendly URLs (product pages) that include the content that clearly and succinctly describes the product's summary of purpose and links to helpful html and pdf files.

Taxpayer Services

The IRS has several taxpayer service programs designed to foster compliance by foreign taxpayers. These include services abroad as well as services in the United States and are designed to provide taxpayer services to foreign taxpayers as well as any taxpayer with limited English proficiency.

In-person taxpayer services at four foreign posts led by Tax Attachés: Taxpayer assistance is provided in London, Paris, Frankfurt, and Beijing. In addition, outreach events are conducted by each Tax Attaché in his/her designated countries of jurisdiction to enhance taxpayer assistance and treaty partner relationships.

The Tax Attachés located in London, Paris, Frankfurt, and Beijing are responsible for a broad scope of liaison, service, and enforcement roles for countries within their area of responsibility. These duties range from providing taxpayer service involving U.S. citizens, non-resident aliens, and entities to maintaining treaty partner relationships, complying with exchange of information per income tax treaties, supporting Chief Counsel and the Department of Treasury, and conducting outreach events with the Department of State, practitioner communities, business organizations, and other federal, state, and local agencies.

Volunteer Income Tax Assistance: The IRS provides free tax assistance and return preparation in the United States at its Volunteer Income Tax Assistance (VITA) sites. All instructors have to certify on Link & Learn Taxes.[29] In addition, the IRS provides the VITA sites with software, training materials, and support via email throughout the tax season.

Link & Learn Taxes: The IRS's Link & Learn Taxes program offers a course entitled "Foreign Students and Scholars" that is directed at the over 500,000 international students and scholars who are at American colleges and universities to study, teach, and do research. Many of these individuals need assistance understanding their tax obligations. This course covers the completion of returns for international students and scholars, and is available online at IRS.gov.

This course is designed to teach tax preparers to:

- Distinguish between resident and nonresident aliens;
- Determine whether a nonresident alien is required to file;
- Determine the correct forms to file;
- Determine whether a tax treaty applies and determine which income is taxable and which is excludable; and

[29] Link & Learn Taxes, *linking volunteers to qualify e-learning solutions*, is the IRS web-based program providing nine courses: Basic, Intermediate, Advanced, Military, International, Puerto Rico, and Foreign Student, along with a refresher course for returning volunteers, and two optional specialty courses on Cancellation of Debt and Health Savings Accounts.

- Correctly complete Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition;* Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*; and 1040NR-EZ, *U.S. Tax Return for Certain Nonresident Aliens With No Dependents.*

Limited English Proficiency Initiative: The IRS, through its Volunteer Return Preparation Program (Volunteer Program), has established the LEP Initiative to assist Hispanic, Asian, and Russian speaking taxpayers file their taxes by increasing communication, education, and services to the LEP community. The LEP Initiative has the following four strategic goals:

1. Align the Volunteer Program's content delivery and resources with LEP Hispanic, Asian, and Russian taxpayers and partners needs;
2. Enhance relationships with existing community coalitions and establish new partnerships to support LEP programs;
3. Increase the effectiveness of communication with the LEP Hispanic, Asian, and Russian populations; and
4. Improve and expand education and awareness activities to influence behavior regarding voluntary tax compliance.

The Volunteer Program is working collaboratively with Multilingual Agency Services (MAS) to produce approximately 25 outreach forms in Spanish, Chinese, Korean, Russian and/or Vietnamese. Not all forms are available in all languages.

Over the Phone Interpreter Service and Pilot: In 2009, the IRS implemented the Over the Phone Interpreter (OPI) Service, which is available at Taxpayer Assistance Centers (TACs) throughout the United States. Currently, the IRS is piloting an OPI Service program for use at VITA/TCE sites nationwide. This program allows the IRS to serve LEP taxpayers by providing foreign language translation services to partners and volunteers at VITA/TCE sites. This pilot expands existing OPI services previously only available for use by IRS employees. The Volunteer Program is working collaboratively with MAS to deliver this program to participating VITA/TCE partners.

The service, offered at no cost to taxpayers or participating partners, allows our partners/volunteers to communicate with LEP taxpayers at their sites in over 170 foreign languages, thereby facilitating the return preparation process. For FY 2012, the IRS solicited interest in the pilot and received over 160 responses from partners. Although the pilot is limited to 50 participants due to funding, it will allow the IRS to evaluate the success of the pilot at the end of the filing season and make a determination whether to expand the offering of OPI services at VITA/TCE sites in the future.

Educating Foreign Taxpayers

The goal of the IRS is to ensure that all taxpayers with an obligation to pay U.S. taxes have the education and assistance that they need. While most Nationwide Tax Forums and webcasts are originally conducted in the United States, copies of previous Forum sessions and webcasts may be available on irs.gov to anyone with access to the Internet.

As the report of the National Taxpayer Advocate correctly noted, millions of foreign persons enter the United States every year. Some arrive as visitors, some arrive as students, and some come to work. Many of these foreign persons have no U.S. tax filing obligations. At the same time, many foreigners never travel to the United States at all, yet they may earn significant amounts of U.S. source income. It should be noted that a withholding agent can play an important role in the compliance process by educating the taxpayer at the time payments are made to the foreign taxpayer.

The Link & Learn program is available to anyone with access to the Internet. As noted earlier, in addition to the courses on the general federal income tax rules, this program has a course devoted entirely to the foreign student. It includes information that relates to any type of foreign taxpayer, however (for example, the resident/nonresident section).

Foreign Language

The IRS has taken several steps to increase the availability of taxpayer services to taxpayers with limited English proficiency. IRM 22.31.1, *The Multilingual Initiative*, was finalized in 2006.

As discussed earlier, OPI service is available at TACs throughout the United States. By calling the toll-free number, any nonresident alien in the United States has access to IRS assistance in their language of choice through the use of an over-the-phone interpreter. This service is available in over 170 languages and is available 24 hours a day, seven days a week.

In addition, the IRS has two special websites available to taxpayers with limited English proficiency. The first, www.irs.gov/espanol, includes access to many forms and publications in Spanish, including Publication 17, El Impuesto Federal sobre los Ingresos (Your Federal Income Tax). The second, www.irs.gov/languages, has information in Chinese, Korean, Vietnamese, and Russian. The IRS provides a DVD on basic tax responsibilities in five languages – Spanish, Chinese, Russian, Vietnamese, and Korean. This DVD is available at no charge to anyone.

In June 2010, the irs.gov website added a tab for "Other Languages" next to the Español link. The IRS has a page specifically designed for foreign students and scholars in the United States, with a substantial amount of information (in English) for the student.[30]

[30] *See* http://www.irs.gov/businesses/small/international/article/0,,id=96431,00.html.

Partner with the Departments of State and Homeland Security

The IRS agrees that maximizing the availability of taxpayer assistance enhances compliance with the U.S. tax laws. The IRS continues to explore how to expand the range of taxpayer services offered outside the United States.

The IRS will consider whether it is possible to work more directly with the Department of State or the Department of Homeland Security to distribute tax information to taxpayers obtaining specific visas. The IRS currently distributes its Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad*, to all of the U.S. consulates and U.S. embassies. Publication 4732 provides helpful information to all foreign taxpayers (which include resident and nonresident aliens), individuals and businesses, with U.S. tax reporting requirements, such as tax tips, common publications for international taxpayers, contact information for embassies and consulates with on-site IRS assistance, and helpful IRS Internet links and phone numbers. We will take into account the views of the National Taxpayer Advocate as we evaluate this possibility.

The IRS also recently published an informational fact sheet illustrating how present law works for dual citizens.[31] This information was distributed to various embassy staffs for dissemination.

The National Taxpayer Advocate also recommended that Virtual Service Delivery (VSD) be offered at embassies and consulates. The VSD is currently being piloted at several locations to test taxpayer acceptance of the technology. VSD will use high resolution monitors with a high definition camera, integrated as one unit. Based on the outcome of the pilot, the IRS will consider whether it can implement VSD services at the embassies and consulates.

Electronic Filing of Form 1040NR series and ITIN applications

As electronic filing implementation continues, Form 1040NR will be added to the list of forms that can be electronically filed. The National Taxpayer Advocate has discussed the issue of electronically applying for an ITIN in previous reports. The ITIN Unit has raised a number of issues that argue against permitting electronic filing of ITIN applications. At the present time, these conclusions have not changed.

Electronic Payment of Taxes

While a foreign taxpayer cannot use the Electronic Federal Tax Payment System to pay federal taxes in exactly the same way as U.S. taxpayers can use the system, the IRS has several provisions that allow foreign taxpayers the option of paying their taxes electronically, even if the taxpayers do not have a bank account at a U.S. banking institution. They can use the Electronic Federal Tax Payment System by completing the same-day payment worksheet using the tax type code for the payment. Although the financial institution must have a relationship with a U.S.-based financial institution, it does not have to be an affiliate.

31 *See* http://www.irs.gov/newsroom/article/0,,id=250788,00.html.

In addition, if the taxpayer does not have a U.S. bank account or if the taxpayer's foreign financial institution does not have a relationship with a U.S. based financial institution, a cash management account can be used (without a fee) to make the payment through the EFTPS system, which utilizes RTN/ABA. In addition, they can use a credit card and pay online or by telephone. These options are discussed at www.irs.gov/e-pay, and in Publication 966, Electronic Choices to Pay All Your Federal Taxes (also available in Spanish).

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the issues faced by foreign taxpayers in fulfilling their U.S. tax obligations and agrees to consider her recommendations to improve service for these taxpayers. The National Taxpayer Advocate also commends the IRS for developing course materials about foreign students and scholars as a part of the Link & Learn Taxes program, although these courses are designed for VITA and TCE volunteers and not foreign taxpayers.[32] TAS supports the Limited English Proficiency program and the Multilingual Agency Services, which produced many outreach materials, forms, and publications in Spanish, Chinese, Korean, Russian, and Vietnamese.[33] We are also impressed with Over the Phone Interpreter service and pilot, and recommend that the IRS extend the service to all IRS phone assistors, including W&I Accounts Management function.[34]

The National Taxpayer Advocate is pleased with the IRS's willingness to explore opportunities to work more directly with the Departments of State and Homeland Security to distribute tax information to taxpayers obtaining visas. We applaud the virtual service pilot and urge delivery of this service at embassies and consulates.

The National Taxpayer Advocate is further encouraged that the IRS will add Form 1040NR to the list of forms that taxpayers can file electronically. However, and in the absence of a valid rationale, the IRS's continued refusal to consider electronic filing for any ITIN applications, including those with U.S.-source income, needlessly burdens applicants. These taxpayers must file paper applications and paper tax returns, and do not receive ITINs timely. Requiring paper ITIN applications to be attached to paper returns is also a labor intensive and inefficient use of IRS resources.

The National Taxpayer Advocate is concerned that the IRS does not address the recommendation to make relevant web resources and written materials available in major foreign

32 In addition, we disagree with the IRS that the VITA program has the capacity to address the needs of 500,000 foreign students and scholars, since VITA clients are overwhelmingly domestic low income taxpayers targeted for Earned Income Tax Credit outreach.

33 For example, bilingual TAS employees volunteered to review many MAS products in foreign languages. The IRS should expand LEP.

34 TAS participation in the OPI service program began March 31, 2008 with the initial start-up of a 12-month pilot of the service. The OPI service is available for all TAS employees.

languages to foreign taxpayers. Although the IRS provides some domestic interpreter services and some information on basic tax responsibilities in some foreign languages, these services not address the needs of *foreign* taxpayers to have comprehensive references in major languages. Most programs cited in the IRS comments are not available for alien taxpayers residing abroad.[35] Even though the IRS website contains a link to "Other Languages" next to the "Espanol" link, it does not put links in foreign languages or symbols, which means an LEP taxpayer cannot recognize where to seek information in his or her language.

The IRS should make more outreach materials available in foreign languages and translate Publication 519, *U.S. Tax Guide for Aliens*, into at least five major languages supported by Multilingual Agency Services. The National Taxpayer Advocate encourages the IRS to extend the OPI pilot to the International Accounts Management function. The IRS should also develop outreach and educational materials for distinct groups of foreign taxpayers described above (*e.g.*, professors and researchers); visitors (business and pleasure); foreign agricultural workers; foreign athletes, artists, and entertainers; foreign businesspeople and investors, etc., similar to materials created for foreign students as a part of the Link & Learn initiative.

The procedures and links described in the IRS comments confirm that foreign taxpayers cannot make electronic payments online or by phone from abroad using a foreign bank account. The web link to Electronic Funds Withdrawal (EFW) and Debit and Credit Card Payment (DCCP) Options for Individuals does not contain a Form 1040NR or 1040NR-EZ in the list of forms eligible for EFW or DCCP.[36] In addition, to complete an EFTPS or EFW payment, a foreign taxpayer must have an account with a financial institution that has the American Bankers Association Routing Transit Number, which foreign financial institutions are ineligible to obtain.[37] Taxpayers choosing to pay by credit card must pay a fee ranging from 1.90 to 3.93 percent of the payment amount. It is the IRS's responsibility as a tax administrator to provide free, seamless options for foreign taxpayers to fulfill their U.S. tax obligations.

35 For example, all VITA sites are located in the U.S. IRS, *Nationwide Free Tax Preparation Site List, available at* http://www.irs.gov/individuals/article/0,,id=219171,00.html (last visited Dec. 14, 2011).

36 IRS, *Electronic Funds Withdrawal and Credit or Debit Card Payment Options for Individuals,* http://www.irs.gov/efile/article/0,,id=119097,00.html (last visited Dec. 14, 2011).

37 IRS, *Pay Taxes by Electronic Funds Withdrawal,* http://www.irs.gov/efile/article/0,,id=101317,00.html (last visited Dec. 14, 2011). An ABA Routing Number will only be issued to a federal or state chartered financial institution that is eligible to maintain an account at a Federal Reserve Bank. *See* American Bankers Association, *ABA Routing Number*, http://www.aba.com/products/ps98_routing.htm (last visited on Dec. 14, 2011).

Recommendations

In conclusion, the National Taxpayer Advocate offers these recommendations:

1. Make relevant web resources, forms, and publications, including Publication 519, *U.S. Tax Guide for Aliens*, available in major foreign languages.
2. Develop focused outreach and separate publications in foreign languages for special groups of nonresident alien taxpayers and foreign entities.
3. Partner with the Departments of State and Homeland Security to distribute concise publications for these specific groups at U.S. consulates and embassies in conjunction with issuance of a specific type of visa and at U.S. ports of entry.
4. Partner with the Department of State for virtual service delivery at U.S. embassies and consulates abroad.
5. Extend Over the Phone Interpreter service to all IRS phone assistors, including W&I Accounts Management function.
6. Allow electronic filing of 1040NR series tax returns and ITIN applications for nonresident alien taxpayers.

MSP #8

Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences

RESPONSIBLE OFFICIALS

Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Faris Fink, Commissioner, Small Business/Self-Employed Division
Heather C. Maloy, Commissioner, Large Business and International Division
Beth Tucker, Deputy Commissioner, Operations Support
Frank Keith, Chief, Communications and Liaison

DEFINITION OF PROBLEM

The complexity of international tax law combined with the procedural burden placed on individual U.S. taxpayers working, living, and doing business abroad creates an environment where taxpayers who are trying their best to comply simply cannot.[1] For some taxpayers, this means paying more U.S. tax than is legally required or incurring steep civil and criminal penalties. For others, the tax requirements are so confusing and the compliance burden is so great that they give up their U.S. citizenship.[2] The number of renunciations increased tenfold between fiscal years (FYs) 2008 and 2010.[3]

IRS Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad,* illustrates the complexity of the filing requirements. The publication refers to at least eight other relevant IRS publications, totaling 563 pages. The documents referred to in Publication 4732 add 4,727 pages of instructions, 667 pages of forms, and another 1,928 pages of form instructions, for a total of 7,322 pages.

A recent IRS study of taxpayer needs and preferences showed that international taxpayers may have a "greater current need for IRS services than the general taxpayer population."[4] Compared to all tax returns, international individual returns have two times the math error rate, and are less likely to be filed electronically or prepared using a paid preparer.[5] While the IRS has substantially stepped up and invested hundreds of millions of dollars

1 *See* Introduction to International Issues: *Compliance Challenges Increase International Taxpayers' Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena*, *supra*.

2 National Taxpayer Advocate meeting with the U.S. Ambassador to Switzerland (Feb. 4, 2011). See also Brian Knowlton, *More American Expatriates Give Up Citizenship*, N.Y. Times, Apr. 25, 2010; Helena Bachmann, *Why More U.S. Expatriates Are Turning in Their Passports,* Time World, Apr. 20, 2010.

3 IRS, *Quarterly Publications of Individuals Who Have Chosen to Expatriate, as Required by Section 6039G,* FY 2005 – FY 2011, Federal Register, Vol. 70, No. 85, 217; Vol. 71, No. 25, 83, 166, 210, 228; Vol. 72, No. 22, 90, 151, 216; Vol. 73, No. 27, 90, 143, 212; Vol. 74, No. 23, 82, 138, 222; Vol. 75, No. 38, 99, 217; Vol. 76, No. 29, 90, 149.

4 IRS, Wage & Investment Division (W&I) Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010).

5 *Id*.

in international enforcement programs,[6] it has not adequately improved taxpayer service programs that would foster compliance among these taxpayers and target their specific needs and preferences.[7]

ANALYSIS OF PROBLEM

Background

The United States taxes the worldwide income of U.S. citizens, resident aliens, and domestic corporations.[8] An estimated five to seven million U.S. citizens reside abroad.[9] IRS data show that 858,760 taxpayers filed returns from a foreign address in calendar year (CY) 2009.[10]

Many U.S. taxpayers abroad are confused by the complex legal and reporting requirements and overwhelmed by the prospect of having to comply with them.[11] Some are even giving up their citizenship for that reason.[12] Overall, about 4,000 U.S. citizens renounced citizenship from fiscal year (FY) 2005 to FY 2010.[13] The number of renunciations increased more than tenfold from 146 in FY 2008 to 1,534 in FY 2010, with 1,024 renunciations during the first two quarters of FY 2011, as described on Figure 1.8.1 below.[14]

6 The IRS requested and received roughly a quarter of a billion dollars for international enforcement in FYs 2010 and 2011. *See* IRS, *The Budget in Brief*, FY 2010 and FY 2011. *See also* Pub. L. No. 111-117 (Dec. 16, 2009); Pub. L. No. 112-10 (Apr. 15, 2011). *See, e.g.*, Reuters, *Deutsche Bank U.S. Tax Fraud Deal Opens Floodgates* (Dec. 22, 2010) (reporting Deutche Bank's $553.6 million and UBS's $780 million settlement with the IRS).

7 *See* National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

8 *See generally* Internal Revenue Code (IRC) §§ 1(a), 11(a), 61(a), and 862(a)(5); Treas. Reg. § 1.1-1(b). *See also* IRC §§ 861, 862, 864, 871, 881, and 882.

9 IRS, 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 IRS, Office of Research, Forecasting and Data Analysis, Document 6149 (Mar. 11, 2010), Table 53. Some taxpayers living overseas may have filed using a domestic (U.S.) address, have been listed as a spouse or a dependent on a primary taxpayer return, or not have had a filing obligation because their incomes fell below the filing threshold. The IRS has no way to identify any overseas residents from the tax return filings of taxpayers showing a U.S. address.

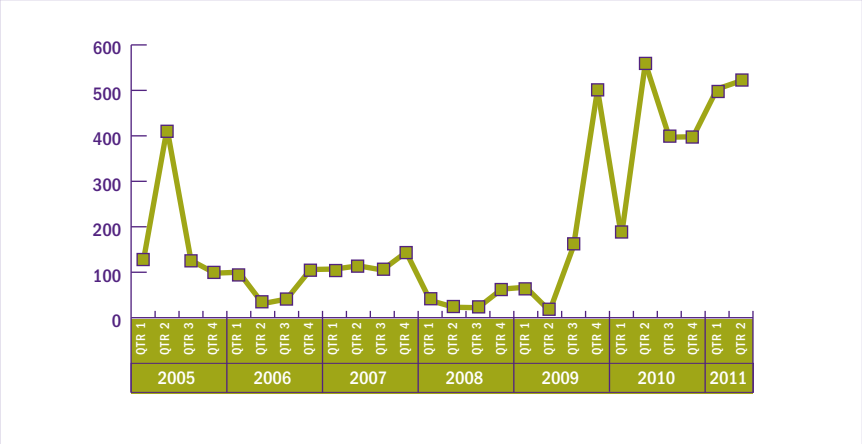
11 W&I, Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* 24 (Feb. 2010) (Study Report). *See also* W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad,* Project # 3-08-07-S-017T (Dec. 2008) (Focus Group Report).

12 National Taxpayer Advocate meeting with the U.S. Ambassador to Switzerland (Feb. 4, 2011). *See also* Brian Knowlton, *More American Expatriates Give Up Citizenship,* N.Y. Times, Apr. 25, 2010; Helena Bachmann, *Why More U.S. Expatriates Are Turning In Their Passports,* Time World, Apr. 20, 2010.

13 IRS, *Quarterly Publications of Individuals Who Have Chosen To Expatriate, as Required by Section 6039G,* FY 2005 – FY 2011 (through second quarter), Federal Register, Vol. 70, No. 85, 217; Vol. 71, No. 25, 83, 166, 210, 228; Vol. 72, No. 22, 90, 151, 216; Vol. 73, No. 27, 90, 143, 212; Vol. 74, No. 23, 82, 138, 222; Vol. 75, No. 38, 99, 217; Vol. 76, No. 29, 90, 149.

14 *Id.*

FIGURE 1.8.1, Renunciations of U.S. Citizenship by Quarter, FY 2005 to FY 2011 (thru 2nd Quarter)



U.S. Taxpayers Abroad Experience Serious Service Challenges and a Higher Compliance Cost than Their Domestic Counterparts.

A recent IRS study found that U.S. taxpayers abroad are underserved, need expanded self-service channels, and may experience higher post-filing problems than the general taxpayer population.[15] The study grouped the service challenges into the following categories:

- Burden — Difficulty finding information;
- Availability of response — Difficulty reaching or receiving a response from the IRS; and
- Clarity — Difficulty understanding information.[16]

Examples of specific responses by survey respondents include:

- "The website is very difficult to use. You almost need to be a tax specialist to find anything. I spent more than an hour looking for the information I needed and finally gave up in frustration."
- "No one has ever responded by email or letter."
- "The information and forms are very confusing."

Among the top taxpayer suggestions for additional products and services were:

- Information about specific tax issues (15 percent);
- The ability to prepare and file tax returns on the IRS website (seven percent);
- Simplified tax forms (five percent);
- Step-by-step/better/clearer instructions (four percent); and

15 Study Report at 4.

16 Study Report at 10-11. *See also* IRS, *W&I International Taxpayer Topline Report* 5, Pacific Consulting Group (Dec. 2009) (Survey Report).

- A toll-free phone line for international taxpayers (four percent).[17]

Study respondents and focus group participants also stated that finding a paid professional overseas to prepare U.S. tax returns is not only expensive, but difficult.[18]

IRS tax attachés estimate international tax preparation costs can exceed $1,000 per return, while civic organizations of American citizens abroad set the figure as high as $2,000 per return.[19] In contrast, the Treasury Inspector General for Tax Administration (TIGTA) estimates the average compliance costs for individuals in the United States range between $173 and $373.[20]

While the IRS has improved its IRS.gov website, the homepage does not prominently display the International Taxpayer link. IRS forms, instructions, and publications are lengthy and not designed to provide brief and concise information about specific international tax issues.[21] Further, survey and focus group participants say they need separate, specific information, publications and web pages for each of the nation's 60 tax treaties.[22]

Another challenge of dealing with the IRS for international taxpayers is the slow postal service in other countries, where one-way mail delivery can take up to three weeks.[23] These delays often compound IRS international mail delivery problems.[24]

Free Electronic Filing of International Returns and Forms for All U.S. Taxpayers Abroad Would Reduce Compliance Burdens.

The National Taxpayer Advocate is pleased that the IRS now accepts electronically filed returns with foreign addresses.[25] Because the IRS does not provide direct electronic filing from its website, these taxpayers have to use one of the IRS Free File Alliance partners that support international taxpayer tax preparation and filing.[26] However, only five of the

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17 Study Report at 26.

18 *Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010); W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad,* Project # 3-08-07-S-017T (Dec. 2008).

19 *Cf. Taxation of Americans Abroad,* position paper, Overseas Americans Week, Washington, DC (Apr. 11-15, 2011), *at* http://www.overseasamericansweek.com/documents/2011/Taxes%20Sheet.pdf (last visited July 30, 2011); and *Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010); W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad,* Project # 3-08-07-S-017T (Dec. 2008).

20 TIGTA, Ref. No. 2008-40-170, *Many Taxpayers Who Obtain Tax Refund Anticipation Loans May Benefit from Tax Preparation Services* (Aug. 29, 2008).

21 Most taxpayers needed information about a specific tax issue. Study Report at 24. For example, one practitioner stated Form 2555, *Foreign Earned Income Exclusion*, "is not a simple form." Practitioners also expressed a need for a more understandable Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*. Form 1116, *Foreign Tax Credit,* was also mentioned as a form that should be revised and simplified. Focus Group Report at 9-11.

22 *See, e.g.*, the only country-specific tax treaty publication – IRS Publication 597, *Information on the United States-Canada Income Tax Treaty* (Aug. 2009).

23 See also email from Executive Director, Association of American Citizens Abroad, to the National Taxpayer Advocate (May 13, 2011) (providing examples of compliance challenges facing U.S. taxpayers abroad).

24 Mail to international locations is often undeliverable or significantly delayed. About 65 percent of all international mail is classified as "undeliverable as addressed." National Taxpayer Advocate 2010 Annual Report to Congress 221.

25 *See* IRS, *U.S. Citizens and Resident Aliens Abroad, at* http://www.irs.gov/businesses/small/international/article/0,,id=97324,00.html (last visited Oct. 4, 2011).

26 *See* IRS, *About the Free File Alliance*, at http://www.irs.gov/efile/article/0,,id=200980,00.html (last visited July 31, 2011).

17 Free File providers accept electronic returns from U.S. citizens and resident aliens with foreign addresses. The program is also limited to taxpayers with an Adjusted Gross Income (AGI) of $57,000 or less in tax year (TY) 2011; those with an AGI exceeding $57,000 have to purchase commercial software.[27]

IRS data for CY 2009 show that taxpayers with foreign addresses filed 858,760 Form 1040 series returns, but only 284,810 of them were filed electronically.[28] It is a longstanding position of the National Taxpayer Advocate that taxpayers should be able to file their returns electronically without a transaction fee.[29] A free template and direct filing portal would eliminate fees and increase the number of taxpayers filing their returns electronically, benefiting both taxpayers and the government. At the very least, the IRS should require all Free File Alliance partners to allow tax preparation and filing of all international forms for individuals with foreign addresses.

Simplification of Returns and Forms for Individual U.S. Taxpayers Abroad Can Substantially Decrease Burden and Avoid Waste of IRS Resources.

The IRS has broad authority to prescribe the time and manner in which taxpayers file returns and the format of various required forms.[30] The annual income of many individual U.S. taxpayers abroad may be below the foreign earned income exclusion and foreign housing exclusion or deduction combined.[31] Taxpayers in many countries may have a higher effective income tax rate than in the U.S., and therefore the foreign tax credit (FTC) will result in zero or *de minimis* tax liability in the U.S.[32] For TY 2009, 5.5 million taxpayers (or 89 percent of the 6.2 million individuals claiming an FTC) had an FTC of $300 or less.[33]

Figure 1.8.2 below shows that for TY 2009, 88 percent of all taxpayers claiming the foreign earned income exclusion (FEIE) did not have U.S. tax liability after applying the exclusion. After the application of the FTC, only about nine percent of these taxpayers had a U.S. tax liability.

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27 IRS, Freefile, *at* http://www.freefile.irs.gov/how-efile-works.html (last visited Nov. 22, 2011).

28 IRS Document 6109, Calendar Year Return Projections by State CYs 2010-2017, 2010 Update (Nov. 2010).

29 *See Tax Return Preparation Options for Taxpayers, Hearing Before the S. Comm. on Finance,* 109th Cong. (Apr. 4, 2006) (statement of Nina E. Olson, National Taxpayer Advocate). *See also* National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: *Free Electronic Filing for All Taxpayers*).

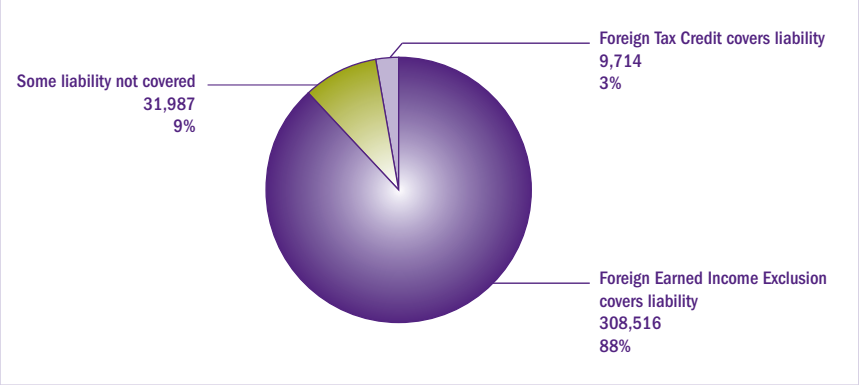
30 *See, e.g.*, IRC §§ 6001, 6011.

31 IRC § 911(b)(2)(D), (c) and (d). In tax year (TY) 2010, the indexed-for-inflation foreign earned income exclusion was $91,500.

32 *See generally* IRC §§ 901 and 903.

33 IRS, Compliance Data Warehouse (CDW), IRTF_F1040 Table, Data Drawn Cycle 201140. Similar IRS analysis showed that nearly 2.7 million or 86 percent of individual taxpayers claiming a FTC had a credit of $300 or less for TY 1999. IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

FIGURE 1.8.2, U.S. Taxpayers Abroad Who Did Not Have U.S. Tax Liability After Application of FEIE and FTC in TY 2009[34]



In both situations, the IRS can and should significantly simplify tax return and information reporting forms and expand self-serve options, including TeleFile,[35] fax,[36] and a free web application from IRS.gov ("Netfile").[37] This approach would substantially decrease burden on U.S. taxpayers abroad and free up IRS resources for examinations of other returns with substantial tax liabilities.[38]

The IRS Has Not Acted on Recommendations to Provide In-Person and Toll-Free Telephone Service in Countries Where the Most U.S. Taxpayers Live.

While the IRS educates and assists domestic taxpayers through more than 400 Taxpayer Assistance Centers (TACs) around the country and serves practitioners at its Nationwide Tax Forums (in the U.S.), taxpayers abroad lack toll-free telephone service and in-person assistance in most countries.[39] As described earlier, the IRS invests millions of dollars in international enforcement, neglecting service needs of these taxpayers.[40] The IRS has not

34 IRS, Compliance Data Warehouse (CDW), IRTF_F1040 Table, Data Drawn Cycle 201140. Similar IRS analysis showed that nearly 2.7 million or 86 percent of individual taxpayers claiming a FTC had a credit of $300 or less for TY 1999. IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

35 National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 121-155 (*TeleFile – Taxpayers' Characteristics and Filing Behaviors: A Study to Enhance Taxpayer Assistance Blueprint Knowledge*).

36 Focus group and survey participants suggested the IRS accept faxed signatures as opposed to only accepting original signatures for tax returns to help lower the costs and time associated with international mail.

37 Financial Crimes Enforcement Network (FinCEN) recently has created a free and easy-to-use online Report of Foreign Bank and Financial Accounts (FBAR) filing system, FinCEN press-release (July 18, 2011). *See* BSA E-Filing System, *File an FBAR,* at http://bsaefiling.fincen.treas.gov/Enroll_Individual.html (last visited July 30, 2011).

38 *See* email from Executive Director, Association of American Citizens Abroad, to the National Taxpayer Advocate (May 13, 2011) (providing examples of compliance challenges facing U.S. taxpayers abroad). *See also* SAMS Issue No. 22425 (Oct. 16, 2011).

39 IRS, Contact My Local Office, *at* http://www.irs.gov/localcontacts/index.html (last visited Oct. 26, 2011). National Taxpayer Advocate 2009 Annual Report to Congress 134-154; National Taxpayer Advocate 2008 Annual Report to Congress 141-157. The IRS does maintain four overseas tax attaché posts, mostly devoted to examinations and the exchange of information with foreign governments; only a limited number of attaché employees are assigned to taxpayer service. In recent years, the IRS decreased the number of tax attaché posts in foreign cities from 15 to four, while increasing the number of locations and employees devoted to criminal investigations from eight to 18.

40 *See* Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service, infra.*

implemented the agreed-upon recommendations from the National Taxpayer Advocate's 2008 and 2009 Annual Reports to Congress to establish a toll-free line for U.S. taxpayers in Canada[41] and Mexico, and to open case resolution rooms at tax attaché posts and during tax events abroad.[42] The IRS also has not agreed to reopen the post in Mexico City, Mexico, in a country where about one million U.S. taxpayers reside.[43] Instead, it asked the National Taxpayer Advocate to cancel the recommendation to "devote more to taxpayer service, including reinstatement of in-person taxpayer service to U.S. taxpayers residing in Mexico" based on insufficient funding.[44]

In response to National Taxpayer Advocate recommendations in the 2009 Annual Report to Congress, the Large Business and International division (LB&I) conducted an attaché post expansion analysis to determine the locations in which increased IRS presence would have the largest impact on international tax compliance.[45] The quantitative analysis evaluated countries based on the following criteria:

- Large populations of U.S. citizens;
- Large or quickly growing number of U.S. companies;
- Strong trade partnership with the U.S.;
- Sizable gross domestic product;
- Sizable existing tax workload that supports a need for a foreign post; and
- Organization for Economic Co-operation and Development (OECD) member or a member of Leeds Castle Group.[46]

After analyzing these criteria for 111 countries, LB&I selected nine as candidates for post expansion:

- Seven treaty countries based on the highest increase of double taxation cases over the past five years (India, Japan, Poland, Israel, Philippines, South Africa, Australia); and
- Two no-tax treaty countries based on corporate growth rate and potential for tax treaties (Brazil and Chile).

41 SAMS Issue 17493 (May 14, 2010). For example, Canadian taxpayers can call Canada Revenue Agency toll-free from anywhere in the continental U.S.

42 National Taxpayer Advocate 2009 Annual Report to Congress 134-154; National Taxpayer Advocate 2008 Annual Report to Congress 141-157. *See* Department of Treasury, Joint Audit Management Enterprise System (JAMES) TAS--09-ARC-001MSP, 7-3-1; IRM 1.55.6.2 (Jan. 1, 2011).

43 It is estimated that about 1,036,300 U.S. taxpayers reside in Mexico and 687,700 in Canada. National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

44 LB&I Request for Cancellation of Agreed to Action(s), TAS-09-ARC-001MSP, 7-3-1 (Apr. 15, 2011).

45 National Taxpayer Advocate Annual Report to Congress recommendations are tracked on the JAMES system. JAMES, IRS Response to TAS recommendation, TAS--09-ARC-001MSP, 7-3-1.

46 IRS Tax Attaché Posts Expansion Proposal, Executive Summary, *Increase the Number of Foreign Posts of Duty* (undated). Email from LB&I official to TAS (Oct. 11, 2011). In 2006, the tax authorities of ten countries formed the so-called "Leeds Castle Group," which meets regularly to discuss issues of global and national tax administration, including mutual compliance challenges, tax shelters, and the challenges of increased globalization. The participating countries are Australia, Canada, China, France, Germany, India, Japan, South Korea, the U.K., and the U.S.

The study further suggested conducting additional analysis based on executive input and finalizing post-expansion recommendations. However, the study abruptly ended due to "budgetary and other considerations." The National Taxpayer Advocate believes that the IRS should not underestimate the value of in-person service to voluntary compliance and should request funding for tax attaché post expansion, at least for countries where most U.S. taxpayers live.[47] The IRS should also allocate resources to TAS for creation of four Local Taxpayer Advocate (LTA) positions co-located with current IRS posts in London, Paris, Frankfurt, and Beijing as a part of the revised international taxpayer service strategy, and to fund additional LTA positions as additional attaché offices are opened.[48]

Use of Innovative and Cost-Effective Methods of Providing In-Person Service to U.S. Taxpayers Abroad Could Significantly Improve Compliance.

The IRS should be proactive and innovative in finding cost-effective ways to serve U.S. taxpayers abroad, beginning by expanding electronic services to these taxpayers, including secure email, electronic access to IRS accounts, virtual face-to-face meetings, and encrypted email correspondence about account-specific international return inquiries.[49] For example, the Social Security Administration, which has no offices outside the U.S., has partnered with the Department of State to provide a full range of services, including accepting applications for benefits through specially trained embassy and consulate employees in 33 countries with a relatively large number of Social Security customers.[50] Among such cost-efficient initiatives might be:

- Partnering with the Department of State to train embassy and consulate staff to provide a full range of taxpayer services, including assistance with preparation of tax returns, similar to what the Social Security Administration does for beneficiaries overseas;
- Extending toll-free telephone service to taxpayers in Canada and Mexico where about 700,000 and over one million U.S. citizens live, respectively;[51]
- Conducting seminars and Tax Forums for international taxpayers through webcasts;

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47 National Taxpayer Advocate 2009 Annual Report to Congress 154.

48 *See* Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service, infra.* Local Taxpayer Advocates will be solely devoted to educating taxpayers abroad and resolving their compliance problems with the IRS. The actual cases would be worked by stateside TAS employees but the Local Taxpayer Advocate would be responsible for outreach, education, case intake and identification of systemic problems for relevant populations. The IRS can free up funding either by re-allocating funds from enforcement to taxpayer service or by moving some of the existing tax attaché positions to TAS.

49 For example, Entrust, Inc., provides secure email and authentication solutions to many government agencies. *See generally* www.Entrust.com. The IRS uses Entrust encryption for internal communications. The IRS does currently provide international taxpayers with the Electronic Tax Law Assistance (ETLA) tool via IRS.gov, which allows taxpayers to submit tax law questions by email to the IRS. IRS, *Help with Tax Questions - International Taxpayers,* http://www.irs.gov/help/page/0,,id=133197,00.html (last visited July 30, 2011). However, this tool cannot be used for account-specific inquiries. Focus group participants also complained about "not getting clear answers to their questions or not getting answers at all." Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad* 7, Project # 3-08-07-S-017T (Dec. 2008).

50 *See* U.S. Social Security Administration, Office of International Operations, *Service Around the World,* at http://www.ssa.gov/foreign/index.html (last visited July 28, 2011).

51 *See* National Taxpayer Advocate 2009 Annual Report to Congress 143-154. Because Canada is allocated the same "country code + 1" as the United States, additional cost of extending existing 1-800 service for the continental U.S. to Canada would be minimal.

- Piloting secure email communications and access to the MyIRS account application for international taxpayers, including providing answers to account-specific questions; and
- Implementing Virtual Service Delivery (VSD) for international taxpayers.[52]

In FY 2010, TAS proposed VSD operation to conduct virtual face-to-face meetings and conferences with taxpayers.[53] This proposal led to a TAS pilot to conduct videoconferencing from locations where TAS lacks geographic presence, including IRS and third-party locations, such as Low Income Taxpayer Clinics.[54] TAS also proposed to extend the VSD pilot to international taxpayers who would contact TAS from their home computers or secure third-party locations (*e.g.*, U.S. embassies and consulates or organizations of U.S. citizens abroad), and suggested a secure email pilot for international taxpayers. The IRS should not delay the implementation of these projects that would substantially improve service for the underserved taxpayers abroad.

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Simplify tax return and information reporting forms for individual U.S. taxpayers abroad.
2. Expand self-serve options, including TeleFile, fax, and Free File, and develop a free website application from IRS.gov (NetFile).
3. Extend telephone access to the existing Accounts Management function and the National Taxpayer Advocate (NTA) toll-free lines for the continental U.S. to taxpayers in Canada and Mexico.
4. Pilot secure email communications, virtual service delivery, and access to the MyIRS account application for international taxpayers, including answers to account-specific questions and access to TAS.
5. Establish a tax attaché office in Mexico.
6. Partner with the Department of State to train embassy and consulate staff to provide a full range of taxpayer services, including assistance with preparation of tax returns, similar to what the Social Security Administration does for beneficiaries overseas.

52 VSD uses video communications technology to (1) provide a service delivery alternative outside of IRS facilities; (2) enhance utilization of IRS resources; (3) smooth staffing and workload imbalances; and (4) increase access to face-to-face service where currently unavailable. Virtual Service Delivery - Delivering Taxpayer Services Using Video Communications Technology, IRS Commissioner Briefing (Sept. 26, 2011).

53 VSD presentation materials, Delivering Taxpayer Services Using Video Communications Technology, IRS Senior Executive Team meeting (Sept. 6, 2011).

54 Prior to its inclusion in the IRS Virtual Service Delivery Pilot, TAS had proposed the development and implementation of a two-way videoconferencing environment to provide a face-to-face experience for customers who live in remote areas, have mobility issues or are otherwise unable to travel to an office where there is a TAS presence, or live in a high-density population area where TAS does not currently have an office.

IRS COMMENTS

The IRS recognizes the issues faced by individual United States taxpayers working, living, or doing business abroad and we continue to look for opportunities to improve service delivered to this taxpayer base.

Last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address, and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in large part by recognition of the great high complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating IRS efforts in this area across all IRS Business Operating Divisions to ensure that IRS' international strategy aligned, balanced, and coordinated.

Improving taxpayer services to U.S. taxpayers who work, live, and conduct business abroad is an important strategic goal for the office of the Deputy Commissioner, International and the IRS in general. As part of FY 2012 priorities, the International Executive team is committed to coordinate closely with Wage and Investment and the Director, e-Services to perform a thorough review of specific problems faced by overseas taxpayers, identify modern options available to improve service, and make recommendations for implementing effective improvements. We will consider the views included in the National Taxpayer Advocate's report in this effort.

Current Overseas Taxpayer Service Programs

The IRS has several overseas taxpayer service programs designed to foster compliance and provide information to U.S. taxpayers living or doing business abroad:

In-person taxpayer services at four foreign posts led by Tax Attachés: Taxpayer assistance is provided in London, Paris, Frankfurt, and Beijing. In addition, outreach events are conducted by each Tax Attaché in his or her designated countries of jurisdiction to enhance taxpayer assistance and treaty partner relationships.

The Tax Attachés located in London, Paris, Frankfurt, and Beijing are responsible for a broad scope of liaison, service, and enforcement roles for countries within their area of responsibility. These duties range from providing taxpayer service involving U.S. citizens, non-resident aliens, and entities to maintaining treaty partner relationships, complying with exchange of information per income tax treaties, supporting Chief Counsel and Department of Treasury, and conducting outreach events with Department of State, practitioner communities, business organizations, and other federal, state, and local agencies.

Free return preparation for U.S. military living overseas: To assist all military personnel living overseas, the IRS provides free tax assistance and return preparation at its Volunteer Income Tax Assistance (VITA) sites. For FY 2011, the IRS had 66 VITA sites located overseas at U.S. military bases where volunteers prepared approximately 45,000 returns.

To ensure that the military personnel who work at overseas VITA sites are properly trained each year, IRS instructors travel overseas to teach at these sites. For FY 2011, ten IRS instructors held classes at 21 military bases in Europe, Asia, and Guam. One or two representatives from each of the overseas VITA locations attended an IRS-led class and then returned to his or her home location to train the rest of the preparers at their VITA site. All instructors have to certify on Link & Learn Taxes through the International level.[55] In addition, IRS provides these sites with software, training materials and support via e-mail throughout the tax season.

Technology Applications available to taxpayers: The IRS has implemented several technology enhancements that can assist taxpayers to obtain information more easily and we will continue to make additional improvements in this area. A new phone application, IRS2Go, can be downloaded to a smartphone for free. Taxpayers can use this app to do a number of things, including checking the status of their tax refund and subscribing to tax tips. In addition, the IRS posts videos on YouTube (www.youtube.com/irsvideos) to help taxpayers understand their tax obligations and has a news feed on Twitter (@IRSnews). Taxpayers also can access video clips of tax topics, archived versions of live panel discussions and Webinars, and audio archives of tax practitioner phone forums on the IRS Video portal (www.IRSvideos.gov). If taxpayers need to determine if there is a filing requirement for Form 6251, *Alternative Minimum Tax for Individuals,* an electronic "AMT Assistant" is available on IRS.gov. An electronic "Withholding Calculator" is also available on IRS.gov to help taxpayers determine if they need to file a new Form W-4, Employee's Withholding Tax Certificate, or if they need to complete a new Form W-4 to change their withholding allowances. In addition, the IRS has developed user-friendly URLs on IRS.gov (e.g., www.irs.gov/form.1040) where taxpayers can find current and prior forms/instructions and publications and related useful information.

Piloting secure email communications: The IRS understands the growing need to electronically communicate with both domestic and international taxpayers via email and must do this while providing for the security of taxpayer data and maintaining the public's trust and confidence in that ability. To explore the use of the secure email functionality for exchange of information with our partners such as other federal agencies, state and local jurisdictions, government contractors, and banks, the IRS has established a limited pilot program for the exchange of taxpayer audit information with large scale organizations through the LB&I Division. This is a complex process that requires a significant amount of

[55] Link & Learn Taxes, *linking volunteers to quality e-learning solutions*, is the IRS web-based program providing nine courses: Basic, Intermediate, Advanced Military, International, Puerto Rico and Foreign Student, along with a refresher course for returning volunteers and two optional specialty courses on Cancellation of Debt and Health Savings Accounts.

effort and coordination between the IRS and the business taxpayer participants including resolving information technology compatibility issues. While the IRS is hopeful regarding the success of this pilot, it is important to recognize that there are considerable barriers to expanding this implementation to individual taxpayers, including authentication issues, computer security issues, and budgetary restraints on resources.

Implementing Virtual Service Delivery (VSD): VSD is being used by the IRS at multiple locations. As the service is expanded in more locations, we will consider whether it is possible to implement VSD abroad in United States Embassy and Consulate facilities.

Significant Improvement

IRS FBAR and Title 31 Helpline: In July 2011 the IRS opened a new telephone help line for questions about foreign bank account reports. The IRS FBAR and Title 31 Helpline connects practitioners and filers, both in the U.S. and abroad, with a team of specially trained technicians, examiners and specialists to answer technical questions about Title 31, the Bank Secrecy Act. They answer questions related to reports required by the Bank Secrecy Act, such as the FBAR.

The Helpline is open Monday through Friday, 8:00 a.m. to 4:30 p.m., Eastern Time, and has a voice message feature for any calls received after hours. The Helpline has a toll-free number for calls from within the U.S. and a non-toll-free number for calls from outside of the U.S. Taxpayers and practitioners can also find answers on FBAR frequently asked questions page on IRS.gov or by sending an inquiry to FBARquestions@irs.gov.

In addition, in January 2011, the IRS established a Servicewide FBAR Communication Strategy Team to provide increased awareness and information to taxpayers. This servicewide collaboration helped to ensure taxpayers and practitioners received consistent, accurate and accessible information pertaining to FBAR filing requirements, the penalty structure, and the tangential Voluntary Disclosure Program.

The team employed traditional means of disseminating information by posting articles and updating Frequently Asked Questions on IRS.gov. Additionally, the team sought out new methods of reaching a wider audience, specifically filers residing abroad. Those methods included a June 1, 2011 FBAR Webinar, *Reporting Foreign Financial Accounts on the FBAR,* Twitter alerts, and a May 6, 2011 educational video, *When & How to Report Foreign Financial Accounts*. The Twitter alerts not only invited participation in the FBAR Webinar, but were also used to remind FBAR filers of the June 30 filing deadline.

Mexico City Post

With respect to the recommendation to re-open the Mexico City post, we do not believe that the magnitude of the overseas service challenge can be adequately addressed by incurring the substantial costs of placing single individuals in overseas offices to answer the telephone or handle walk-in assistance requests.

The factors considered for opening a foreign post are many. In addition to taxpayer assistance, a primary factor is managing the treaty relationship as the Competent Authority is charged with properly administering the Income Tax Treaties and Tax Information Exchange Agreements that the United States has entered with foreign jurisdictions. We are able to effectively manage our treaty relationship responsibilities with Mexico (Exchange of Information and the Mutual Agreement Procedure) from the United States.

Furthermore, as with most foreign posts, the location of Mexico City will not afford every taxpayer an opportunity to avail themselves of taxpayer service as not all taxpayers resident in Mexico are able to travel to Mexico City. Especially given limited budgets, our efforts will be focused on delivery channels that leverage automated tools.

Partnering with Department of State

The IRS agrees that maximizing the availability of taxpayer assistance enhances compliance with the U.S. tax laws. The IRS continues to explore how to expand the range of taxpayer services offered outside the United States.

The Federal Benefits Units (FBU) is a partnership between the Social Security Administration (SSA) and the Veteran's Administration (VA). Those employees have access to the VA and SSA databases to resolve issues, initiate benefits, etc.

The IRS will consider whether it is possible to work more directly with the Department of State to provide taxpayer services through consul employees. While we will explore this recommendation, we do have concerns with existing workload as well as complications of having non-IRS personnel provide these services. We will take into account the views of the National Taxpayer Advocate as we evaluate this possibility.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes that individual United States taxpayers working, living, or doing business abroad face special burdens in complying with their U.S. tax obligations, and that providing service to this taxpayer base is an important strategic goal.

However, the IRS comments confirm the lack of a coordinated service strategy for U.S. taxpayers working, living, and conducting business abroad. The IRS does not present a clear picture of how it plans to improve services for these taxpayers. The efforts cited, such as the web-based AMT Assistant and electronic withholding calculator, are generic. They do not offer specific programs addressing these taxpayers' needs and preferences as indicated

in at least three recent research, focus group, and survey reports.[56] It is also unclear how U.S. taxpayers working overseas for foreign employers could benefit from the withholding calculator. The National Taxpayer Advocate is also unaware of any servicewide effort by the Deputy Commissioner, International to coordinate service for U.S. taxpayers abroad. Most importantly, while the IRS states that it will consider the views of the National Taxpayer Advocate, and cites several "servicewide" initiatives to address international taxpayer service, including an FBAR Communication Team, none of these initiatives have included representatives of the Taxpayer Advocate Service.

The FBAR and Title 31 Helpline is a commendable effort that the IRS should extend to other international issues, with special IRS email addresses available for different international tax law topics. The National Taxpayer Advocate also applauds the free voluntary return preparation for military personnel abroad. The IRS should find partners among organizations of U.S. citizens and expand VITA to civilian U.S. taxpayers overseas. This effort would not require additional resources because about 66 VITA sites are co-located with U.S. military installations abroad and can provide free services to civilians.

The National Taxpayer Advocate also commends the IRS for establishing a pilot program to exchange information by secure email with other federal agencies, state and local jurisdictions, government contractors, and banks. However, the IRS does not commit to use this technology to improve basic services for U.S. taxpayers abroad.

While we are appreciative of the IRS's agreement to consider working with the Department of State to deliver VSD and other taxpayer services through embassy and consular facilities, the National Taxpayer Advocate encourages the IRS to set definitive timeframes for establishing VSD and extending secure email to all international taxpayer communications. The IRS should work with TAS and extend the TAS VSD pilot to taxpayers abroad who now have no means of receiving for face-to-face assistance from an advocate. Finally, the IRS should support the pilot proposed by TAS to use secure email to international taxpayers.

The IRS comments did not consider our recommendations to simplify income tax reporting for U.S. taxpayers abroad who have no U.S. tax liability or have only a minimal liability. The IRS should also test self-serve electronic options for these taxpayers, including Telefile, free filing by Internet (Netfile), and online access to IRS accounts.

The National Taxpayer Advocate reiterates her recommendation to extend in-person and toll-free telephone service to U.S. taxpayers residing in Mexico. The IRS's reluctance to reopen its Mexico City post is disappointing, considering that Mexico is the country with the largest number of U.S. taxpayers abroad, yet is without a single venue for them to receive help face-to-face. The IRS cites as a reason for its position that the Competent Authority

[56] W&I, Research & Analysis, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors, Research Study Report* (Feb. 2010); W&I, Research & Analysis, Focus Group Testing Report: *Customer Service Needs of U.S. Taxpayers Living Abroad,* Project # 3-08-07-S-017T (Dec. 2008); W&I International Taxpayer Topline Report 5, Pacific Consulting Group (Dec. 2009) (Survey Report).

can manage treaty relationships from its office in Florida, but as the IRS admits, tax attaché responsibilities are not limited to Competent Authority assistance.

In the course of preparing this report, the National Taxpayer Advocate requested a full copy of the study entitled "IRS Tax Attaché Expansion Proposal," which was conducted in response to the National Taxpayer Advocate's recommendation in the 2009 Annual Report to Congress.[57] The only document provided — the IRS Tax Attaché Posts Expansion Proposal, Executive Summary, *Increase the Number of Foreign Posts of Duty* (undated) — makes a strong case for post expansion and then abruptly ends with a handwritten, anonymous statement that due to budgetary considerations the expansion is not warranted.[58] The National Taxpayer Advocate believes that American taxpayers have a right to know the unaltered results of this study, so their representatives in Congress can make an informed decision about whether to fund the expansion. At the very least, the IRS should provide funding to co-locate Local Taxpayer Advocates with its posts abroad.[59]

Recommendations

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

1. Simplify tax return and information reporting forms for individual U.S. taxpayers abroad.
2. Expand self-serve options, including TeleFile, fax, and Free File, and develop a free website application from IRS.gov (NetFile).
3. Extend telephone access to the existing Accounts Management function and the National Taxpayer Advocate (NTA) toll-free lines for the continental U.S. to taxpayers in Canada and Mexico.
4. Pilot secure email communications, virtual service delivery, and access to the MyIRS account application for international taxpayers, including answers to account-specific questions and access to TAS.
5. Establish a tax attaché office in Mexico.
6. Partner with the Department of State to train embassy and consulate staff to provide a full range of taxpayer services, including assistance with preparation of tax returns, similar to what the Social Security Administration does for beneficiaries overseas.

57 IRS response to TAS research request (Nov. 22, 2011). *See also* National Taxpayer Advocate 2009 Annual Report to Congress 134-154; National Taxpayer Advocate 2008 Annual Report to Congress 141-157; IRS response to TAS recommendations, Department of Treasury, JAMES TAS--09-ARC-001MSP, 7-3-1.

58 Email from LB&I official to TAS (Oct. 11, 2011).

59 *See* Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service*, *infra*.

MSP #9 Small Businesses Involved In International Economic Activity Need Targeted IRS Assistance

RESPONSIBLE OFFICIALS

Faris Fink, Commissioner, Small Business/Self-Employed Division
Heather C. Maloy, Commissioner, Large Business and International Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Beth Tucker, Deputy Commissioner, Operations Support
Frank Keith, Chief, Communications and Liaison

DEFINITION OF PROBLEM

As a result of globalization, an increasing number of taxpayers, including small businesses, engage in international transactions.[1] While complex international tax law and reporting requirements fully apply to small businesses involved in cross-border activity, the IRS has no comprehensive outreach strategy to help these businesses meet their tax obligations.[2] Because these taxpayers may have trouble understanding international tax rules and may not be able to afford professional representation, they need targeted taxpayer service.[3] In addition, the President's National Export Initiative requires all federal agencies to facilitate exports by U.S. companies, especially small businesses and first-time exporters, and to help these businesses overcome administrative hurdles.[4] However, the IRS does little to accommodate these taxpayers in terms of industry and country-specific education and outreach, special filing and tax law assistance, and affordable or low-cost pre-filing and post-filing programs available to large and midsize businesses.

ANALYSIS OF PROBLEM

Background

An estimated 253,000 small businesses made up 91.7 percent of all known exporters in calendar year 2009.[5] During the same period, approximately 163,000 small businesses comprised about 90.8 percent of all U.S. importers. According to the Small Business Administration (SBA), from 2003 to 2010, U.S. small businesses' exporting activity

1 Memorandum for Secretary Geithner from J. Russell George, Treasury Inspector General for Tax Administration, *Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011* 13 (Oct. 15, 2010).

2 Small businesses involved in cross-border activity include U.S. taxpayers with assets of $10 million or less and located abroad or engaged in international business transactions. For the list of international returns, see generally IRM 21.8.1 (Aug. 12, 2011) and IRM 21.8.2 (Sept. 9, 2011).

3 A 2004 Small Business Administration study reported that the inability of small businesses to fully comprehend the complex international tax rules, or to obtain costly legal representation to reduce their U.S. tax liabilities, may have contributed to small firms with less than $10 million in revenues not realizing the full benefits of the foreign tax credit. Innovation Information Consultants, Inc. (study for U.S. Small Business Administration), *The Impact of Tax Expenditure Policies on Incorporated Small Businesses* 4 (Apr. 2004).

4 National Export Initiative, Exec. Order No. 13534, 75 Fed. Reg. 12433 (Mar. 11, 2010).

5 U.S. Census Bureau, Profile of U.S. Importing and Exporting Companies, 2008-2009 (Apr. 12, 2011), *at* http://www.census.gov/foreign-trade/Press-Release/edb/2009/2009Highlights.pdf (last visited Nov. 4, 2011). The study defines a company as small if having between zero and 99 employees.

increased about 80 percent to account for nearly $500 billion in annual sales and about 30 percent of America's export revenues.[6] Between 2004 and 2008, U.S. corporate income tax returns filed with Form 1118, *Foreign Tax Credit - Corporations*, increased by 12.8 percent. In the same period, returns filed with Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, increased by 18.2 percent.[7]

The National Taxpayer Advocate discussed the compliance challenges facing small businesses involved in international economic activity in the 2009 Annual Report to Congress and made several recommendations to alleviate burden for these taxpayers.[8] However, the IRS has been slow to address those concerns.

U.S. Small Businesses and Entrepreneurs Involved in International Economic Activity Need Comprehensive Industry and Country-Specific Outreach and Education Materials.

The IRS does not have a comprehensive outreach strategy specifically targeting small businesses with international operations or even a dedicated web page for these taxpayers. By the IRS's own admission, there are a "myriad of pages" dealing with specific industries and international activities.[9] As discussed in the 2009 Annual Report to Congress, the IRS has 43 publications totaling 1,212 pages that relate to U.S. small businesses involved in economic activity abroad. These publications in turn refer to other publications comprising 13,346 pages, 1,500 pages of forms, and another 5,018 pages of form instructions. This vastly complicates the search for the information that small business taxpayers need to meet their tax obligations.

The IRS does not offer a separate publication or targeted assistance to small businesses involved in international activity as it does, for example, to the construction business, gas retailers, or the auto industry.[10] Nor does the IRS provide international reporting information or links to relevant forms and instructions for start-up international businesses on its website.[11] The first three links on the IRS.gov landing page for international businesses are devoted to the Foreign Account Tax Compliance Act (FATCA), the international tax gap, and foreign athletes and entertainers.[12] International small businesses are left to navigate the complex rules or regulations on their own or hire a tax professional, or face severe penalties

6 Karen Gordon Mills, Administrator of the U.S. Small Business Administration (SBA), *Taking Your Small Business Customers International* (Oct. 15, 2010), *at* http://www.sba.gov/administrator/7390/6086 (last visited July 19, 2011). *See also* SBA Office of Advocacy, *The Small Business Economy: A Report to the President* 37 (2010).

7 LB&I FY 2011 Business Plan 6.

8 National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

9 *Id*. at 149 (IRS Comments to Most Serious Problem: U.S. *Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

10 *See, e.g.*, IRS Pub. 3780, *Tax Information for Small Construction Business* (Nov. 2003). *See also* IRS, Construction Tax Center, *at* http://www.irs.gov/businesses/small/industries/article/0,,id=185182,00.html; IRS, Automotive Tax Center, *at* http://www.irs.gov/businesses/small/industries/article/0,,id=183642,00.html; IRS, Gas Retailers Tax Center, *at* http://www.irs.gov/businesses/small/industries/article/0,,id=185190,00.html (last visited Oct. 11, 2011).

11 *See* Small Business and Self-Employed Tax Center - Your Small Business Advantage, *at* http://www.irs.gov/businesses/small/index.html (last visited July 31, 2011).

12 IRS, Tax Information for International Businesses, *at* http://www.irs.gov/businesses/international/index.html (last visited July 31, 2011).

for noncompliance.[13] In contrast, the SBA has a dedicated office and numerous materials to assist U.S. small businesses with international operations.[14]

A good starting point would be a survey of needs and preferences of international small businesses and a new research project identifying the customer base.[15] Based on the study results, the IRS should fine-tune outreach and education materials for different groups of small businesses with international operations by type of business (trade, manufacturing, services, etc.) and by country of operation for the largest trading partners such as Canada, Mexico, China, Japan, and the United Kingdom.[16]

U.S. Small Businesses and Entrepreneurs Involved in International Economic Activity Need Special Assistance and Simplified Information Reporting.

U.S. small businesses and entrepreneurs involved in international transactions are subject to burdensome information reporting requirements and may face significant penalties for even inadvertent noncompliance.[17] An example of the burden facing U.S. taxpayers who conduct business through a foreign corporation that they significantly own or control is Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations.*[18] Form 5471 is four pages long, not including Schedules J, M, and O. The instructions are 16 pages long. *According to the IRS's own estimates, a small business taxpayer might easily need three work weeks to complete and file this form.*[19] Many international small businesses cannot afford professional assistance to comply with procedural and reporting requirements, and it should not be necessary. These taxpayers, which are most vulnerable to missing a filing deadline or a required form and potentially incurring penalties, need simplified information reporting and free filing assistance.

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13 *See* Preface to *International Issues: Compliance Challenges Increase International Taxpayers' Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives In The International Arena, supra.*

14 SBA, Office of International Trade, *at* http://www.sba.gov/about-offices-content/1/2889/about-us/2903 (last visited July 26, 2011). SBA also has a separate page devoted to importing and exporting, *at* http://www.sba.gov/category/navigation-structure/starting-managing-business/managing-business/exporting-importing (last visited Oct. 11, 2011).

15 *See, e.g.*, IRS, W&I Research Study Report, *Understanding the International Taxpayer Experience: Service Awareness, Use, Preferences, and Filing Behaviors* (Feb. 2010); IRS, Small Business/Self-Employed Division (SB/SE) Research – Philadelphia, Project # 05.02.001.03, International Taxpayer Research Project 7 (Aug. 2003).

16 SBA Office of Advocacy, *The Small Business Economy: A Report to the President* 42 (2010). There are 60 tax treaties with 68 countries, but the IRS has only one country-specific publication, which addresses the U.S. – Canada tax treaty. *See* IRS Pub. 597, *Information on the United States - Canada Income Tax Treaty* (Sept. 2011).

17 *See, e.g.*, Controlled Foreign Corporation (CFC), Controlled Foreign Partnership (CFP), and Passive Foreign Investment Company (PFIC) information reporting (Forms 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*; 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*; 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*; 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*; 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*).

18 *See generally* IRC §§ 951-965 (addressing the taxation of shareholders of Controlled Foreign Corporations (CFCs)).

19 *See* instructions to IRS Form 5471 (2008). The estimated burden for those filing this form is 82 hours, 45 minutes for recordkeeping, 16 hours, 14 minutes for learning about the law or the form, and 24 hours, 17 minutes for preparing and sending the form to the IRS. The total burden adds up to 123 hours and 16 minutes, or about 15.4 eight-hour work days.

In March 2010, the President created the National Export Initiative to help U.S. companies — especially small businesses — overcome "the hurdles to entering new export markets, by assisting with financing, and in general by pursuing a government-wide approach to export advocacy abroad."[20] The Initiative was designed to increase "exports of goods, services, and agricultural products," and to "create good high-paying jobs." The National Taxpayer Advocate believes the IRS should actively participate in this Initiative and make it a part of a servicewide international taxpayer service strategy.[21] It should facilitate small business involvement in international transactions and export activities by providing a specialized technical assistance program and by simplifying information reporting, especially for first-time exporters and start-up businesses.[22] This special assistance may include a dedicated phone line, a small business export tax center on the IRS website — a one-stop service approach offering virtual meetings with IRS employees, interactive tax law assistance and simplified online return filing — as well as walk-in sites and workshops for small businesses involved in export activity.

U.S. Small Businesses and Entrepreneurs Involved in International Economic Activity Need Affordable or Low-Cost Access to Pre-filing and Advance Pricing Agreement Programs Similar to Those Available to Large Businesses.

While the IRS continuously improves and realigns programs for large international businesses, most of them are either unavailable or too costly for small businesses.[23] For example, the Pre-filing Agreement Program (PFA), Compliance Assurance Process (CAP), and Quality Examination Process (QEP) are available only to large businesses, while the Fast Track Settlement (FTS) is offered to small business taxpayers at a limited number of U.S. locations.[24] Only the advance pricing agreement (APA) program is available to small businesses involved in international transactions.[25] The IRS acknowledges that "the complexity or novelty of transfer pricing issues do not necessarily depend on the dollar volume of transactions, but small business taxpayers have lesser transfer pricing experience and resources."[26] However, it charges a $22,500 user fee for the APA program that makes it cost-prohibitive for many.[27] The IRS also charges a user fee for an international letter ruling up to $14,000.[28] In contrast, the Canada Revenue Agency established a reduced fixed fee of

20 National Export Initiative, Exec. Order No. 13534, 75 Fed. Reg. 12433 (Mar. 11, 2010).

21 *See* Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service, infra*.

22 The IRS has broad authority to prescribe the time and manner in which taxpayers file returns and the format of various required forms. *See, e.g.*, IRC §§ 6001, 6011.

23 IRS, *IRS Takes Next Steps in International Realignment; Bolsters Transfer Pricing Compliance Programs and International Coordination*, IR-2011-81 (July 27, 2011).

24 Rev. Proc. 2009-14, 2009-1 C.B. 324; Rev. Proc. 2003-40, 2003-1 C.B. 1044; Announcement 2005-87, 2005-2 C.B. 1144; IRS Pub. 4837 (Oct. 2010). FTS is available to small business taxpayers Chicago, IL; Houston, TX; St. Paul, MN; Philadelphia, PA; central New Jersey; and San Diego, Laguna Niguel, and Riverside, CA. Announcement 2011-5, 2011-4 I.R.B. 430.

25 *See* Rev. Proc. 2006-9, 2006-1 C.B. 278; Rev. Proc. 2008-31, 2008-1 C.B. 1133.

26 2010 APA Statutory Report, IRS Announcement 2011-22, 2011-1 C.B. 672.

27 The regular APA user fee is $50,000. *See* Rev. Proc. 2006-9, 2006-1 C.B. 278, § 4.12.

28 The IRS also charges a $50,000 for a pre-filing agreement. *See* Treas. Reg. § 301.9100-1; Rev. Proc. 2011-1, Appendix A, 2011-1 I.R.B. 1. *See also* National Taxpayer Advocate 2007 Annual Report to Congress 66 (Most Serious Problem: *User Fees: Taxpayer Service for Sale*).

$5,000 (Canadian) for small businesses participating in its APA program, and the Mexican Internal Revenue Service began issuing free letter rulings on international tax issues.[29]

In the 2009 Annual Report to Congress, the National Taxpayer Advocate recommended that the IRS extend the pre-filing agreement program to small business taxpayers involved in international transactions and reduce filing fees for the APA program for businesses with assets of $10 million or less. The IRS explained its disagreement with the recommendation to open the pre-filing agreement program to small business taxpayers by saying "[i]t is not appropriate to use a pre-filing agreement (PFA) to clarify for the taxpayer an issue that has numerous legal complexities."[30] It also commented that the PFA user fee will be cost-prohibitive for most small businesses. While it did not object to lowering the user fees for the "smallest taxpayers" willing to participate in the APA program, it did not change the APA user fee schedule. IRS data show the number of small business taxpayer APAs that it completed decreased from the maximum of 19 in tax year (TY) 2006 to only seven in TY 2010, while the average combined time for the IRS to complete a small business taxpayer APA steadily increased from an average of 8.1 months in TY 2000 to over 34.5 months in TY 2010.[31]

The National Taxpayer Advocate believes U.S. small businesses and individual entrepreneurs deserve the same level of confidence large and midsized businesses have in the finality of a tax position on a return. As a first step, the IRS should deliver on its promise to reduce APA user fees for the "smallest" taxpayers. As part of its servicewide international taxpayer service strategy, the IRS should consider reducing or eliminating letter ruling fees on international issues for small business taxpayers, and implementing pilots to test the scope of raised issues, the possibility of cost reduction, and the desirability of making programs available to large businesses accessible to small business taxpayers. TAS offers its assistance in this effort.

CONCLUSION

The National Taxpayer Advocate is concerned about the IRS's continued neglect of U.S. small businesses and entrepreneurs involved in international transactions. The IRS should substantially improve service for small business taxpayers by providing special assistance to new international small businesses, country-specific education and outreach materials, simplified information reporting for small businesses and overseas American entrepreneurs, and free or nominal-cost pre-filing and post-filing programs for small businesses

29 *See* Shiraj Keshvani, *Canada's APA Program*, presentation at the ABA Section of Taxation 2009 Joint Fall CLE Meeting, Chicago, IL (Sept. 25, 2009); Fourth Annual U.S. - Latin American Tax Planning Strategies Conference, Government Roundtable Report 8-9, Miami, FL (June 17, 2011). To receive a letter ruling from the Mexican Internal Revenue Service, which is binding of the government but not on the taxpayer, the taxpayer simply has to send an email with a substantive question including all relevant facts to the taxing authority. Tax letter rulings may apply either to future or past transactions or tax positions, but are limited to real and concrete situations. Taxpayers may disagree with the government's interpretation and withdraw from the program.

30 National Taxpayer Advocate 2009 Annual Report to Congress 149.

31 Annual APA Statutory Reports, *at* http://www.irs.gov/businesses/corporations/article/0,,id=96191,00.html (last visited Oct. 19, 2009). Given the number of processed small business APAs from TY 2000 to TY 2010, the APA program was largely underutilized by the small business community, perhaps, due to excessive user fees.

involved in international activity. Once again, TAS offers its assistance to the IRS in finding creative, innovative, and cost-efficient ways to improve service to these taxpayers.[32]

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Survey the needs and preferences of U.S. small businesses involved in international transactions and conduct a new study in collaboration with TAS Research to properly identify this taxpayer population and its needs.
2. Develop publications, education, and outreach materials for small businesses involved in international transactions, including start-up businesses (regardless of form, *i.e.*, corporation, partnership, limited liability company, or sole proprietorship), and country-specific materials for major trading partners, similar to the publication addressing the U.S.–Canada tax treaty.
3. Develop a special assistance program for these taxpayers, including a dedicated toll-free telephone line, a small business exporting center on the IRS website, and walk-in sites and workshops for small businesses involved in international activity.
4. Simplify information reporting for U.S. small businesses and entrepreneurs involved in international transactions.
5. Reduce filing fees for the APA program and letter rulings on international issues for small businesses with assets of $10 million or less.
6. Test pilots of the PFA program and other programs available for large businesses, for small businesses but with reduced fees.

IRS COMMENTS

The IRS recognizes the issues faced by small businesses engaged in international economic activities and we continue to look for opportunities to improve service delivered to this taxpayer base.

As previously discussed, last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in large part by recognition of the complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating the IRS's efforts in this area across all IRS Business Operating Divisions to ensure that the IRS' international strategy is aligned, balanced, and coordinated.

32 National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

The IRS will consider developing a comprehensive outreach strategy to help small businesses meet their international tax obligations, and we will consider the views included in the National Taxpayer Advocate's report in this effort.

The IRS continues to look for ways to assist small business taxpayers engaged in domestic and international activities and we have taken a number of steps in this area. For example, the IRS has recently expanded the Fast Track Settlement (FTS) program to some small businesses. In Announcement 2011-5, 2011-4 I.R.B. 430,[33] the IRS announced the opportunity for small business/self-employed taxpayers to use FTS to expedite case resolution in Chicago, IL; Houston, TX; St. Paul, MN; Philadelphia, PA; central New Jersey; and San Diego, Laguna Niguel, and Riverside, CA. Additional locations may be identified and added to this program by mutual agreement between SB/SE and the Office of Appeals.

The IRS will continue to explore whether additional special programs, as well as tailored education and outreach, are needed for small businesses. The report of the National Taxpayer Advocate has suggested a survey be conducted as a starting point to determine the needs and preferences of international small businesses in addition to conducting a new research project to identify the customer base. We will consider this option as we move forward.

We will continue to assess whether improvements can be made; however, it should be recognized that the IRS currently provides assistance to international taxpayers in a variety of ways. IRS Media & Publications (M&P), part of the IRS's Wage & Investment division's CARE organization, provides IRS-wide support for publishing and distribution services, including outreach and education products for all international taxpayers. M&P is participating in an agency-wide group that is working to improve services to international taxpayers. In brief, M&P:

- Authors and publishes tax products for U.S. and international taxpayers. These products are available to all taxpayers, regardless of where they live and work, through "Forms and Publications" on IRS.gov.
- Administers a small bulk forms distribution program for embassies and military bases.
- Provides mail order fulfillment services to national and international requesters.

The Tax Forms and Publications (TFP) office develops technical tax law forms, instructions, and publications in support of needs identified by the business units. TFP also contains the Multilingual and Agency Services office, which maintains and enhances web-tools for international taxpayers. M&P will continue to collaborate with the appropriate business unit to produce published documents (*e.g.*, forms, publications, and notices) that facilitate tax administration and reduce taxpayer burden.

[33] IRS, *Extension of Fast Track Settlement for SB/SE Taxpayers Pilot Program* (Jan. 24, 2011), *available at* http://www.irs.gov/irb/2011-04_IRB/ar10.html.

The IRS will also continue to assess whether simplified information reporting for small businesses is feasible and appropriate. It is important to note, however, that the reduced burden of simplifying the information reporting forms must be balanced with the compliance risks of additional enforcement challenges. For example, a Form 5471 contains a balance sheet and income statement for the foreign corporation enabling the IRS to evaluate whether potential non-compliance exists. Such information may also be of significant use to a taxpayer preparing a U.S. tax return or preparing U.S. financial statements. A Form 5471 properly completed and attached to the original return informs the IRS of the scope and impact of a foreign corporation's operations, and serves as a very relevant source of information as the IRS decides whether to examine or accept returns as filed.

With respect to the proposal to allow a reduced APA filing fee, we will continue to take the recommendation into account. Any plan to increase the number of small business taxpayer APAs must take into account the potential impact on the Program as a whole, including the potential need for additional resources and the potential effect on case processing times. Any significant increase in caseloads, without a commensurate increase in resources could lead to further backlogs and/or undesirable structural changes. As part of the APA Program's announced merger with the U.S. Competent Authority, the IRS is addressing a number of strategic issues, including small business APAs.

With respect to the recommendation to test pilot the pre-filing agreement program and other programs available for large businesses for small businesses, but with reduced fees, we question whether the magnitude of the problems faced by small businesses engaged in international activities can be adequately addressed by programs designed to clarify for the taxpayer an issue that has numerous legal complexities. A PFA is generally entered into to resolve, in advance of filing, the determination of facts affecting a tax position on a return, the application of well-established legal principles to known facts, or the methodology used by the taxpayer to determine an appropriate amount of income, deduction, allowance or credit.

A PFA program for small businesses would require significant additional IRS resources. Due to the current fiscal and staffing constraints, at this time, the IRS is not in a position to conduct a pilot program that offers reduced PFA user fees for small businesses. Inquiries received from small businesses regarding the PFA program indicate issues that would be considered for acceptance are complex issues and would take as much, if not more, resources to address than the typical issues submitted by large businesses.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the burdens faced by small businesses engaged in international economic activities and that it agrees to consider her preliminary recommendations. She also commends the IRS for expanding the Fast Track Settlement program to some small businesses and encourages the IRS to make FTS available at more offices around the country.

However, the IRS comments confirm the lack of a coordinated taxpayer service strategy for small business taxpayers involved in international economic activity. The efforts cited by the IRS, such as Media & Publications or Tax Forms and Publications activities "for U.S. and international taxpayers," do not offer separate, specific programs addressing these businesses' needs and preferences. The National Taxpayer Advocate is not aware of any servicewide effort by the Deputy Commissioner, International to coordinate taxpayer service to small businesses involved in international activity. This lack of commitment to improving service for small businesses, which make up more than 90 percent of all known U.S. exporters and importers, may undermine the concerted government effort to increase "exports of goods, services, and agricultural products" by small businesses and to "create good high-paying jobs."[34] The National Taxpayer Advocate believes the IRS cannot delay the development of dedicated services for these taxpayers, including a small business exporting center on IRS.gov, and must fine-tune assistance to meet the needs and preferences of small businesses with international operations.

The National Taxpayer Advocate also believes simplified information reporting should not harm the IRS's ability to evaluate potential noncompliance. The IRS should employ a data-driven approach to simplification based on the number of noncompliant small businesses that were audited because of evaluation of a specific information reporting form (*e.g.*, Form 5471) and the amount of unpaid liabilities collected based on the form. The IRS should use its broad authority to require information reporting wisely, without impairing small businesses' ability to comply. These taxpayers should not be forced out of international economic activities by prohibitive costs of compliance, including professional representation.

We agree with the IRS's observation that a reduced APA filing fee might lead to increased filings. An increase in filings would indicate that more small business taxpayers need this service with a more reasonable fee structure. It is almost certain that the resulting increase in filings will require more resources to avoid additional backlogs, given that it currently takes an unacceptably long average of almost three years to process APAs with the existing resources.

While the IRS acknowledges that small businesses are facing complex international tax issues that "would take as much, if not more, resources to address than the typical

[34] National Export Initiative, Exec. Order No. 13534, 75 Fed. Reg. 12433 (Mar. 11, 2010).

issues submitted by large businesses," it continues to effectively deny these taxpayers the pre-filing assistance that large businesses receive. While we agree that these initiatives may require more resources, we believe that there is sufficient data and analysis available today that would enable the IRS to make a compelling and convincing case for additional funding in this area, so that U.S. small businesses can be competitive in a global economy without fear of running afoul of the tax laws.

Recommendations

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

1. Survey the needs and preferences of U.S. small businesses involved in international transactions and conduct a new study in collaboration with TAS Research to properly identify this taxpayer population and its needs.
2. Develop publications, education, and outreach materials for small businesses involved in international transactions, including start-up businesses (regardless of form, *i.e.*, corporation, partnership, limited liability company, or sole proprietorship), and country-specific materials for major trading partners, similar to the publication addressing the U.S.–Canada tax treaty.
3. Develop a special assistance program for these taxpayers, including a dedicated toll-free telephone line, a small business exporting center on the IRS website, and walk-in sites and workshops for small businesses involved in international activity.
4. Simplify information reporting for U.S. small businesses and entrepreneurs involved in international transactions.
5. Reduce filing fees for the APA program and letter rulings on international issues for small businesses with assets of $10 million or less.
6. Test pilot versions of the PFA program and other programs available for large businesses for small businesses, but with reduced fees.

MSP #10 Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service

RESPONSIBLE OFFICIALS

Faris Fink, Commissioner, Small Business/Self-Employed Division
Heather C. Maloy, Commissioner, Large Business and International Division
Joseph H. Grant, Acting Commissioner, Tax Exempt and Government Entities Division
Richard E. Byrd Jr., Commissioner, Wage and Investment Division
Chris Wagner, Chief, Appeals
Beth Tucker, Deputy Commissioner, Operations Support
Frank Keith, Chief, Communications and Liaison

DEFINITION OF PROBLEM

In recent years, the IRS has devoted substantial resources to improving international tax administration and responding to the challenges of globalization. However, the IRS's international tax administration strategy has focused on stepped-up enforcement without adequate coordination or a corresponding increase in service to international taxpayers. The IRS recently replaced the International Planning and Operations Council (IPOC), the only servicewide forum for addressing international taxpayer issues, with separate "bilateral" meetings between the Large Business and International (LB&I) division and each of the other divisions. The lack of efficient IRS-wide coordination of international taxpayer service may undermine international enforcement initiatives and discourage future compliance by taxpayers dealing with the complexity and procedural burden of the international tax rules.

ANALYSIS OF PROBLEM

Background

IRS Commissioner Douglas Shulman announced an agency-wide international initiative in 2008.[1] As part of that initiative, the IRS committed to improving tax administration to deal more effectively with the increasing globalization of individual and business taxpayers through servicewide cooperation in addressing emerging international issues, and collaboration on international matters throughout the IRS. In 2008, the IRS created the Servicewide Approach to International Tax Administration, which had taxpayer service as its number one strategic goal. It also contained initiatives to improve service options for international taxpayers, enhance outreach to these taxpayers, provide tools for earlier certainty on complex issues, and strive for burden reduction in the international tax law arena. In October 2009, the IRS realigned the Large and Mid-Size Business (LMSB) division to

[1] *See Tax Issues Related to Ponzi Schemes and an Update on Offshore Tax Evasion Legislation, Hearing Before the S. Comm. on Finance,* 111th Cong. (Mar. 17, 2009) (statement of Douglas Shulman, Commissioner, Internal Revenue Service).

create a more centralized organization dedicated to improving international tax compliance for individual and business taxpayers. As part of the organizational shift, the name of the IRS's large corporate unit — LMSB — was changed to the Large Business and International division.[2] The IRS's focus in this area also moved significantly away from taxpayer service and toward enforcement.[3] The new LB&I division was enhanced by adding about 875 compliance employees to an existing staff of nearly 600.[4]

The IRS Has Taken a One-Sided Approach to the Challenges of International Tax Administration, Focusing Mainly on Enforcement.

While acknowledging the complexity of international tax law and the growth "in number and variety" of taxpayers with international activities, the IRS strategic plan is silent about planned improvements to international taxpayer service and focuses mainly on enhancing international enforcement.[5] The IRS Strategic Plan for 2009-2013 emphasizes the IRS's commitment to developing "deep expertise on specific international enforcement topics" and supporting employees "with the systems and processes needed to analyze data related to international enforcement efforts." The plan generally identifies "priorities for increased enforcement resources," using the following strategies:

- Expanding employee knowledge and awareness of international tax issues;
- Developing deep expertise and capabilities in key international issue areas;
- Enhancing coordination with treaty partners and international organizations; and
- Aggressively targeting areas of significant risk.[6]

Although the IRS has consolidated and realigned the compliance functions devoted to international taxpayers in the LB&I operating division (OD), it has not dedicated adequate resources to or adequately coordinated the international taxpayer service activities that are scattered throughout all ODs and functions.[7] Nor did the IRS request any substantial

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2 *IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration,* IRS News Release, IR-2010-88 (Aug. 4, 2010).

3 While in 2008, the IRS's number one strategic goal was to improve taxpayer service, since 2009 the IRS focuses on international law enforcement initiatives. *Cf.* IRS LMSB, *Servicewide Approach to International Tax Administration, Strategic Goal 1: Improve Taxpayer Service, at* http://lmsb.irs.gov/international/dir_compliance/global/sis1.asp (last visited Oct. 29, 2008), and IRS LMSB, *Servicewide Approach to International Tax Administration, Strategic Initiatives and FY2009 Priorities, IRS Goal: Enforce the Law to Ensure Everyone Meets Their Obligation to Pay Taxes, at* http://lmsb.irs.gov/international/dir_compliance/global/sis1.asp (last visited Oct. 7, 2011).

4 *IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration,* IRS News Release, IR-2010-88 (Aug. 4, 2010). Most of the additional examiners, economists, and technical staff were current employees who specialized in international issues within other parts of the LMSB operation.

5 *IRS Strategic Plan 2009-2013, Objective 3: Meet the challenges of international tax administration.*

6 *Id.*

7 International Realignment, LMSB Division Talking Points (Aug. 2010). In October 2009, LMSB launched a new initiative called "Large Business and International Expansion," which ultimately centralized all of the IRS's offshore and international compliance units in the LB&I division.

increases in funding for international taxpayer service in its budget requests for fiscal year (FY) 2010 to FY2012.[8]

As a result, the IRS's approach to international tax administration is one-sided. It is focused on stepped-up enforcement with no corresponding increase in services tailored to changing taxpayer demographics and the specific needs and preferences of different groups of international taxpayers.[9] These general categories include U.S. individuals working, living, or conducting business abroad; U.S. entities doing business abroad; foreign individuals working or doing business in the U.S.; and foreign entities doing business in the U.S.[10]

Increased Service Tailored to Different Categories of International Taxpayers Is Important for the Success of IRS Strategic Enforcement Initiatives in the International Arena.

The Commissioner has recognized that international transactions are extremely complex and require consolidation of all IRS compliance resources.[11] However, the complexity of transactions, combined with the complexity of international tax law and procedural requirements, also affects the ability of international taxpayers to comply and creates a great need for IRS services.

In the United States, tax administration is largely based on voluntary compliance (*i.e.*, on taxpayers' willingness and ability to comply).[12] Voluntary compliance also depends on the fairness of tax administration, where service options are easily available and affordable for those making a good faith effort to comply. Burdensome reporting and record-keeping

8 In FY 2011, the IRS requested an enforcement account increase of $293.4 million, an increase of about $121 million allocated to international compliance and only about $1.7 million to international taxpayer services. IRS, *The Budget in Brief*, FY 2011. Similarly, in FY 2010, the IRS requested an increase of $332.2 million "for investments in strong compliance programs, including a robust portfolio of international enforcement initiatives." Of the $332.2 million increase, about $128 million was requested for international compliance, of which $3.1 million was for international service. IRS, *The Budget in Brief*, FY 2010. It appears that the IRS requests for enforcement spending for FYs 2010 and 2011 were funded in full (for FY 2011 – on FY 2010 levels). *See* Pub. L. No. 111-117 (Dec. 16, 2009); Pub. L. No. 112-10 (Apr. 15, 2011). For example, the approved FY 2010 budget included an additional 742 full time equivalents (FTEs) and $104.11 million to support international enforcement, and only 42 FTE and $3.12 million to support international taxpayer service. The approved FY 2011 budget did not fund the requested additional 30 FTE and $1.78 million for international taxpayer service. IRS response to TAS research request (Nov. 22, 2011). For FY 2012, the IRS has requested $72.6 million for international service and enforcement, of which about $35 million is requested for Foreign Account Tax Compliance Act (FATCA) implementation, about $15.8 million for increased international coverage, $8.5 million for Criminal Investigation international expansion, $8.8 million for international data analysis, and $4.5 million for other direct costs (includes Appeals and Chief Counsel). Although the request is for "International Service and Enforcement," it appears that no additional funding is requested for international taxpayer service. IRS FY 2012 Budget Request, Congressional Budget Submission 10 (Feb. 14, 2011), *at* http://www.treasury.gov/about/budget-performance/Documents/CJ_FY2012_IRS_508.pdf.

9 *See* Introduction to Diversity Issues: *The IRS Should Do More to Accommodate Changing Taxpayer Demographics, infra*.

10 *See* Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations, supra.*

11 IRS, Remarks of Douglas Shulman Before the Tax Executives Institute (Oct. 21, 2008), *at* http://www.irs.gov/newsroom/article/0,,id=187958,00.html.

12 For example, of the $2.3 trillion in tax revenue received by the IRS in FY 2010, direct enforcement revenue accounted for only $57.6 billion, or about three percent. The remaining 97 percent resulted from voluntary compliance, though this includes some voluntary compliance that indirectly results from enforcement. IRS, *Fiscal Year 2010 Enforcement and Service Results* (Nov. 20, 2010), *at* http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf; Government Accountability Office (GAO), GAO-11-142, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements* 20 (Nov. 2010). *See also Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due, Hearing Before the S. Comm. on Finance,* 112th Cong. (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

requirements, overly strict enforcement actions, poorly designed voluntary disclosure initiatives, and lack of transparency combined with inadequate taxpayer service may increase the burden on taxpayers who try to comply, and discourage future compliance.[13]

The four general categories of international taxpayers described above all need specific services and face varying compliance challenges, which are often unique to each group. Therefore, to achieve the result that increased enforcement is intended to achieve — bringing more international taxpayers into compliance and reducing the international tax gap — the IRS has to design services to meet these diverse needs and preferences.[14]

Greater Internal Coordination of International Taxpayer Service Is Necessary for Achieving the Strategic Goals of International Tax Administration.

The National Taxpayer Advocate is concerned that the IRS has shifted away from improvement and coordination of international taxpayer service. On February 25, 2011, the IRS dissolved the International Planning and Operations Council, the only servicewide forum for addressing international taxpayer issues, and replaced it with separate, "bilateral" meetings between LB&I and each of the other divisions.[15] The National Taxpayer Advocate voiced concerns that the dissolution of the council would have a negative effect on servicewide collaboration and customer service initiatives for international taxpayers, which cannot be addressed and resolved on a bilateral as opposed to a multilateral basis.[16] To date, the IRS has not offered bilateral meetings to TAS, the only IRS organization solely devoted to taxpayer rights and assistance.

The IRS is a member of the Forum on Tax Administration (FTA) and its Taxpayer Services Subgroup, which is devoted to sharing innovative approaches to taxpayer service among member countries.[17] However, the IRS lacks a forum to share the information it receives through FTA about best practices in tax administration and taxpayer service with other ODs and functions, including TAS.[18] TAS is not represented in the IRS delegation to the FTA Taxpayer Services Subgroup.

13 *Id. See also* Lewis I. Baurer, World Bank Group, *Tax Administrations and Small and Medium Enterprises (SMEs) in Developing Countries* 1 (July 2005); *Introduction to International Issues, supra;* Most Serious Problem: *IRS Offshore Voluntary Disclosure Program "Bait and Switch" May Undermine Trust for the IRS and Future Compliance Programs, infra.*

14 *See* Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations, supra.*

15 Email from Deputy Commissioner (International), LB&I, to all BOD executives (Feb. 25, 2011).

16 Email from the National Taxpayer Advocate to the Deputy Commissioner (International), LB&I (Feb. 25, 2011). To date, LB&I has not had a "bilateral" meeting with TAS.

17 FTA was created by the Organization for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs (CFA) in July 2002. FTA includes "the heads of revenue bodies and their teams" from 43 OECD and non-OECD countries. Currently, IRS Commissioner Douglas Shulman is the FTA chair.

18 Many countries are now focused on reducing the administrative burden on taxpayers by simplifying and reducing compliance obligations and helping taxpayers interact with the revenue body in a more efficient, less costly way. FTA, Taxpayer Services Sub-group, Information Note, *Programs to Reduce the Administrative Burden of Tax Regulations* 7 (follow-up report) (Mar. 2010).

Challenges facing international taxpayers call for greater internal coordination and strategic, servicewide direction of international taxpayer service.[19] Especially during the current economic downturn, the IRS should expand assistance to international taxpayers and re-establish the IPOC as a servicewide forum.[20] The National Taxpayer Advocate suggests that the IRS create an international taxpayer service subgroup within IPOC, addressing specific needs and compliance challenges of international taxpayers and coordinating international taxpayer service initiatives for all IRS functions. The IRS should also include TAS in developing its servicewide approach to international tax administration and its interactions with tax administration agencies from other countries.

International Taxpayers Need Local Taxpayer Advocates Abroad as They Consistently Seek Assistance from the Taxpayer Advocate Service.

The IRS's international taxpayer service strategy does not include in-person return preparation or filing assistance for international taxpayers even though the IRS provides such services to domestic taxpayers through a network of Taxpayer Assistance Centers (TACs). In addition, the IRS Nationwide Tax Forums offer case resolution services to tax professionals and their clients in several American cities each year, but the IRS does not provide similar services abroad. Many international taxpayers may be unaware of the Tax Forums or unable to participate because of their locations or the cost of travel. The IRS maintains tax attaché posts in only four countries,[21] and even at these locations, the IRS attaches' main responsibilities include partner relationships, exchange of information agreements with foreign governments, and support of IRS investigations and examinations, with taxpayer service being an "important sideline."[22] Since 2008, the IRS has suspended overseas assistance tours at U.S. embassies because these tours were not cost-effective and "minimal in relation to the number of taxpayers living abroad."[23] International taxpayers lack a low-cost or free communication channel to reach the IRS for assistance.[24]

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19 Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations, supra.*

20 According to an International Monetary Fund expert, "[t]he first element in a tax compliance strategy for an economic crisis is to expand assistance to taxpayers." *See* John Brondolo, International Monetary Fund (IMF) Staff Position Note, *Collecting Taxes During an Economic Crisis: Challenges and Policy Options* 9 (July 14, 2009).

21 The IRS posts are located in Frankfurt, Germany; London, United Kingdom; Paris, France; and Beijing, China. *See* IRM 4.30.3 (Oct. 1, 2010), *Overseas Posts*. At the same time, taxpayers with U.S. filing obligations may reside in 194 countries, and more than 60 territories, colonies, and dependencies of these countries. *See* U.S. Department of State Fact Sheet, *Independent Countries of the World, at* http://www.state.gov/s/inr/rls/4250.htm (last visited Oct. 11, 2011).

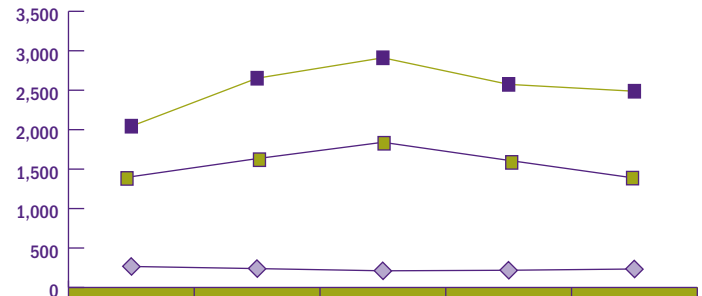
22 IRM 4.40.3.2 (Oct. 1, 2010). *See also* IRS Today Vol. 4 No.1 (Jan./Feb. 2008), *A Day in the Life of the Paris Tax Attaché,* http://wsep.ds.irsnet.gov/sites/co/candl/CLDocs/IC/irstoday/IRSToday_JanFeb_v10.pdf (last visited Dec. 19, 2011).

23 W&I is responsible for planning and implementing all overseas tours, including Volunteer Income Tax Assistance (VITA), Volunteer Embassy/Consulate Tax Assistance (VECTA) and taxpayer assistance. IRM 4.30.3.2 (Oct. 1, 2010). During the last overseas assistance tour from Feb. 28 to Mar. 31, 2008, IRS employees provided face-to-face assistance to 2,603 individuals at 21 U.S. embassies, spending approximately four days at each location. In 2007, W&I assisted 2,090 individuals at 25 locations. W&I responses to TAS research request (Oct. 14 and 19, 2009).

24 The IRS does not provide international toll-free or voice-over-the-Internet (VOIP) service for international Taxpayers, even for those calling from Canada or Mexico. See National Taxpayer Advocate 2008 Annual Report to Congress 141-157; National Taxpayer Advocate 2009 Annual Report to Congress 134-154.

Many international taxpayers who cannot obtain help from the IRS for various reasons seek the assistance of the Taxpayer Advocate Service.[25] TAS case receipts for taxpayers with military, U.S. territory, and foreign addresses or international issues ranged between 3,714 and 4,962 cases, showing consistent use of TAS between fiscal year (FY) 2007 and FY 2011 as described on Figure 1.10.1 below.[26]

FIGURE 1.10.1, International TAS Cases in FYs 2007–2011



	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
U.S. Territory	2,044	2,652	2,911	2,574	2,487
Foreign Address	1,404	1,633	1,840	1,611	1,387
U.S. Military Abroad	266	239	211	218	234

A review of cases with foreign addresses reveals that about 16 percent of the inquiries came from three countries.[27] Twenty-two percent of all inquiries involved three primary issues:

- Identity theft;
- Original return processing; and
- Reconsideration of assessment (Substitute for Return, 6020B, Audit).[28]

25 For a detailed discussion of compliance challenges of international taxpayers, see Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need IRS Assistance the Most; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations, supra.*

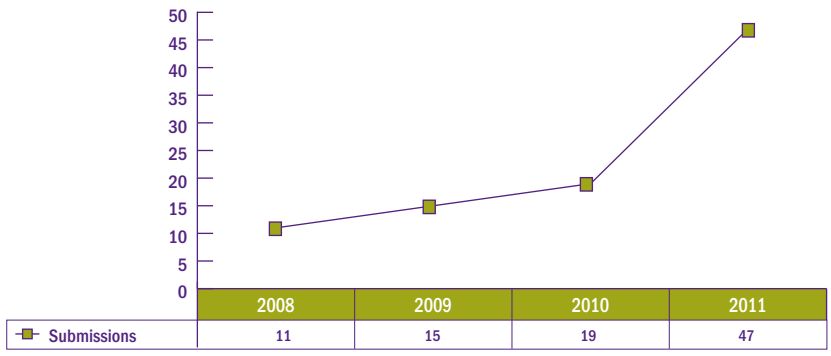
26 Taxpayer Advocate Management Information System (TAMIS) database, FYs 2007–FY 2011.

27 Canada submitted 7.1 percent of total inquiries, followed by the United Kingdom with 4.7 percent and Israel with 4.1 percent. These numbers do not include taxpayers with military or U.S. territory addresses. Taxpayer Advocate Management Information System (TAMIS) database, FYs 2007-2011.

28 If the taxpayer failed to file a timely return, the IRS may have made a return, referred to as a substitute for return (SFR), as authorized by IRC § 6020(b), based on information reported to the IRS. The SFR may reflect income reported by third parties, but allow only the standard deduction, one exemption, and a filing status of single or married filing separately. *See* IRM 4.12.1.25.3 (Oct. 5, 2010); IRM 4.12.1.24.12 (Oct. 5, 2010).

TAS also operates the Systemic Advocacy Management System (SAMS), a database of systemic tax issues and information submitted by IRS employees and the public.[29] The number of SAMS submissions involving international issues increased more than threefold from CY 2008 to CY 2011, with a spike of 47 submissions during first three quarters of CY 2011 (thru Oct. 20, 2011), as shown on Figure 1.10.2 below.

FIGURE 1.10.2, International SAMS Issue Submissions in CYs 2008–2011 (through Oct. 20, 2011)



The inability of international taxpayers to access IRS services from abroad contributes to growing confusion and frustration about U.S. tax administration. TAS is the only IRS function exclusively devoted to resolving taxpayer issues with the IRS. While TAS has at least one office in all 50 states, the District of Columbia, and Puerto Rico, the international taxpayers' right to TAS assistance is constrained by the lack of Local Taxpayer Advocate (LTA) office overseas.[30] Therefore, the IRS's international taxpayer service strategy should include creation of at least four LTA positions co-located with IRS offices abroad.[31] While international cases would still be worked in TAS offices in the United States, the overseas LTAs would devote their time to educating taxpayers abroad, resolving their compliance issues, and identifying systemic issues facing international taxpayers.[32] The IRS can free up funding for LTA positions abroad by reallocating funds from enforcement to taxpayer service.

29 TAS, Systemic Advocacy Management System, *at* http://www.irs.gov/advocate/article/0,,id=117703,00.html (last visited Oct. 26, 2011). Systemic issues are eligible for SAMS submission if they impact segments of the taxpayer population, locally, regionally or nationally; relate to IRS systems, policies, and procedures; require study, analysis, administrative changes or legislative remedies; or involve protecting taxpayer rights, reducing or preventing taxpayer burden, ensuring equitable treatment of taxpayers or providing essential services to taxpayers.

30 *See generally* IRC §§ 7803; 7811. *See also* IRS Pub. 1, *Your Rights as a Taxpayer.* The law requires at least one LTA in each state. International taxpayers cannot access TAS toll-free from abroad.

31 TAS suggests having one LTA and one support employee (secretary) per office.

32 *See* IRM 4.30.3.3 (Sept. 12, 2006) for tax attaché post jurisdictions.

CONCLUSION

The National Taxpayer Advocate is concerned about the IRS's one-sided approach to international tax administration, which is focused on stepped-up enforcement without adequate coordination and a corresponding increase in service, and most importantly, the lack of targeted taxpayer service for each group of international taxpayers. The failure to coordinate international taxpayer service strategy among all of the IRS's operating divisions and functions may undermine the effectiveness of international enforcement initiatives.

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. Reinstate the International Planning and Operations Council as a servicewide forum devoted to international taxpayer service and enforcement.
2. Create an international taxpayer service subgroup within IPOC to address specific needs and compliance challenges of international taxpayers and coordinate international taxpayer service initiatives for all IRS functions.
3. Include the National Taxpayer Advocate or her designee in the IRS's team for the Forum on Tax Administration Taxpayer Services Subgroup.
4. Provide funding for TAS to establish Local Taxpayer Advocate positions in each of the four existing tax attaché offices abroad and include such positions in future expansion of attaché offices.

IRS COMMENTS

The IRS recognizes the need to increase internal IRS coordination of international taxpayer service. We have made a number of improvements in this area and continue to look for opportunities to improve service delivered to this taxpayer base.

As previously discussed, last year, the IRS reorganized the office of the Deputy Commissioner, International (LB&I) to align international technical professionals within a single office to better identify, address and resolve significant compliance issues faced by both individuals and businesses operating across borders. This realignment was driven in large part by recognition of the great high complexity of the tax law applicable to taxpayers engaged in international activities and investments and the commensurate challenges to the IRS in communicating and enforcing those legal complexities. The Deputy Commissioner, International is responsible for coordinating IRS efforts in this area across all IRS Business Operating Divisions to ensure that the IRS's international strategy aligned, balanced, and coordinated.

Also as previously discussed, improving taxpayer services to U.S. taxpayers who work, live, and conduct business abroad is an important strategic goal for the office of the Deputy Commissioner, International and the IRS in general. As part of FY 2012 priorities, the International Executive team is committed to coordinate closely with Wage & Investment and the Director, e-Services to perform a thorough review of specific problems faced

by overseas taxpayers, identify modern options available to improve service, and make recommendations for implementing effective improvements. We will consider the views included in the National Taxpayer Advocate's report in this effort.

Current IRS Efforts

The IRS has taken a number of steps throughout the operating divisions to better coordinate delivery of service to international taxpayers.

W&I Research & Analysis (WIRA) has been capturing and defining the service needs of international taxpayers through a portfolio of research designed to identify the demographic profile as well as the tax preparation and filing habits of international taxpayers, service channel preferences, potential barriers to service, and opportunities for service improvement. This multi-tiered approach to international research included demographic and tax filing profiles of international taxpayers, focus groups with tax practitioners who service international clients, interviews with the four international IRS Tax Attachés, interviews with U.S.-based multinational companies employing U.S. citizens working abroad, and the 2009 IRS Survey of International Taxpayers. The primary research resulted in the 2010 *Understanding the International Taxpayer Experience Research Study Report* and presents the first comprehensive analysis of the service needs of this growing, yet underserved, taxpayer segment.

As a result of WIRA's international research, two recommendations have been implemented. The first recommendation resulted in a Free File link being placed on the IRS.gov International Taxpayer page as well as a tag line identifying those software companies that support foreign addresses on the IRS.gov Free File page. The second recommendation resulted in a partnership with the international affinity group American Citizens Abroad (ACA) in an effort to reach additional taxpayers beyond the IRS's scope. ACA featured the report as well as the researchers on their website and throughout their organization. Additionally, ACA reached out to their international network to publicize the survey through an article in their newsletter. This partnership broadens the awareness of international tax obligations as well as creates a means of reaching a wider base of international taxpayers.

Currently a case is being presented for the rollout of an international interactive tax law application (ITA) as a result of a third recommendation from the report. The International Taxpayer Experience Report was shared with LB&I, who shared it with current Tax Attachés overseas as well as other employees. Additionally, the research was presented at the biannual Service-wide 2010 Research Manager's Conference and the 2011 IRS Software Developers Conference, as well as to the IRS Free File Alliance.

Building on the success of the first phase of international taxpayer research, WIRA kicked off a second phase of research to further develop and refine the IRS's understanding of international taxpayer service needs, preferences, and behaviors. The focal point of this

second phase of research is the 2011 IRS Survey of Individuals Living Abroad, with its specific interest in international taxpayers' experiences, expectations, and preferred alternatives to an IRS international telephone line.

In an effort to reach a wider population of international taxpayers, WIRA used groundbreaking research methodology and resources, including the IRS non-filer database, U.S. Department of State Passport data, Certificate of Loss of Nationality data, and expatriate affinity groups to administer the 2011 survey to international filers and non-filers, nonresident aliens, overseas military personnel, and expatriates. With 1,753 unique responses from individuals living in 81 countries, WIRA has obtained feedback from previously never-before-reached populations on their unique compliance issues, service needs, and taxpayer burden. WIRA received an additional 157 survey responses from a survey link placed on the expatriate affinity group ACA website. A comprehensive report of the survey findings as well as updated demographic and tax filing profiles of international taxpayers is slated to be completed and released in spring 2012.

Furthermore, the IRS has formed an agency-wide group that is working to improve services to international taxpayers. One of the initial tasks was to summarize the support work currently done. In brief, IRS's Media & Publications function:

- Authors and publishes tax products for U.S. and international taxpayers. These products are available to all taxpayers, regardless of where they live and work, through "Forms and Publications" on IRS.gov.
- Administers a small bulk forms distribution program for embassies and military bases.
- Provides mail order fulfillment services to national and international requesters.

In addition, the IRS has identified actions for FY 2012 to improve services for international taxpayers. These include:

- Expanding products and services to meet the needs of limited-English proficient taxpayers.
- Focusing on delivering electronic publishing and providing electronic options for disseminating products in formats customer prefer.
- Creating user friendly URLs (product pages) that include content that clearly and succinctly describes the product's purpose and links to helpful html and pdf files.

Current Taxpayer Service Programs for International Taxpayers

The following are current taxpayer services offered by the IRS to international taxpayers:

In-person taxpayer services at four foreign posts led by Tax Attachés: Taxpayer assistance is provided in London, Paris, Frankfurt, and Beijing. In addition, outreach events are conducted by each Tax Attaché in his or her designated countries of jurisdiction to enhance taxpayer assistance and treaty partner relationships.

The duties of the Tax Attaché include the provision of taxpayer service involving U.S. citizens, non-resident aliens, and entities and the presentation of outreach events with the Department of State, practitioner communities, business organizations, and other federal, state, and local agencies.

Telephone service: In July 2011, the IRS opened a new telephone helpline for questions about foreign bank account reports. The IRS FBAR and Title 31 Helpline connects practitioners and filers, both in the U.S. and abroad, with a team of specially-trained technicians, examiners, and specialists to answer technical questions about Title 31, the Bank Secrecy Act. They answer questions related to reports required by the Bank Secrecy Act, such as the FBAR.

The team employed traditional means of disseminating information by posting articles and updating Frequently Asked Questions on IRS.gov. Additionally, the team sought out new methods of reaching a wider audience, specifically filers residing abroad. Those methods included a June 1, 2011, FBAR Webinar, *Reporting Foreign Financial Accounts on the FBAR*, Twitter alerts, and an educational video, *When & How to Report Foreign Financial Accounts*, which was posted to IRS.gov. The Twitter alerts not only invited participation in the FBAR Webinar, but were also used to remind FBAR filers of the June 30 filing deadline.

It must be noted, however, that WIRA research reveals that "nearly 70 percent of survey respondents reported a preference for improving online services (*i.e.*, improve website interactivity specific to international tax issues) over improving the telephone service (*i.e.*, improve access by providing an international toll-free line)."

Volunteer Income Tax Preparation Assistance: The IRS provides free tax assistance and return preparation at its Volunteer Income Tax Assistance or Tax Counseling for the Elderly sites. In addition, the IRS provides the VITA/TCE sites with software, training materials, and support via e-mail throughout the tax season. All volunteers in the VITA or TCE program have to certify on the IRS' Link & Learn Taxes program. Link & Learn Taxes, *linking volunteers to qualify e-learning solutions,* is the IRS web-based program providing nine courses: Basic, Intermediate, Advanced, Military, International, Puerto Rico, and Foreign Student, along with a refresher course for returning volunteers, and two optional specialty courses on Cancellation of Debt and Health Savings Accounts. These courses, including the International and the Foreign Student courses, are available on IRS.gov.

Free return preparation for U.S military living overseas: To assist all military personnel living overseas, the IRS provides free tax assistance and return preparation at its VITA sites. For FY 2011, IRS had 66 VITA sites located overseas at U.S. military bases where volunteers prepared approximately 45,000 returns.

Limited English Proficiency (LEP) Initiative: The IRS, through its Volunteer Return Preparation Program (Volunteer Program), has established the LEP Initiative to assist

Hispanic, Asian and Russian speaking taxpayers file their taxes by increasing communication, education and services to the LEP community.

Over the Phone Interpreter (OPI) Service and Pilot: In 2009, the IRS implemented the Over the Phone Interpreter (OPI) Service, which is available at Taxpayer Assistance Centers throughout the United States. Currently, the IRS is piloting an OPI Service program for use at VITA/TCE sites nationwide. This program allows the IRS to serve LEP taxpayers by providing foreign language translation services to partners and volunteers at VITA/TCE sites. This pilot expands existing OPI services previously only available for use by IRS employees. The service, offered at no cost to taxpayers or participating partners, allows our partners/volunteers to communicate with LEP taxpayers at their sites in over 170 foreign languages, thereby facilitating the return preparation process

Foreign Language Websites: The IRS has two special websites available to taxpayers with limited English proficiency. The first, www.irs.gov/espanol, includes access to many forms and publications in Spanish, including Publication 17, *El Impuesto Federal sobre los Ingresos (Your Federal Income Tax)*. The second, www.irs.gov/languages, has information in Chinese, Korean, Vietnamese, and Russian. The IRS provides a DVD on basic tax responsibilities in five languages — Spanish, Chinese, Russian, Vietnamese, and Korean. This DVD is available at no charge to anyone.

Publications: The IRS has created several publications to assist international taxpayers. Publication 4732, *Federal Tax Information for U.S. Taxpayers Living Abroad* is provided to all U.S. consulates and U.S. embassies. Publication 519, *U.S. Tax Guide for Aliens*, Publication 901, *Tax Treaties*, and Publication 597, *Information on the United States — Canada Income Tax Treaty*, are available on IRS.gov and also may be available at U.S. consulates and U.S. embassies.

The IRS continues to make improvements in this area. We will take into account the recommendations of the National Taxpayer Advocate as we move forward.

With respect to the recommendation to reinstate the International Planning and Operations Council as a servicewide forum devoted to international taxpayer service and enforcement, we do not believe that the challenges of coordinating international taxpayer service can be sufficiently addressed through this means given the focus and frequency of Council meetings. We have taken steps to expand our strategic approach to international compliance across Business Operating Divisions (BOD). The new international strategy, training programs, and knowledge management networks will accommodate our cross-BOD efforts. Although the IRS dissolved the International Planning and Operations Council, we have replaced it with "bilateral meetings" between LB&I and the other divisions.

We have made a number of improvements in coordination within the IRS. One recent achievement in summer 2011 occurred as a result of collaboration with Tax Exempt and Government Entities (TE/GE) to facilitate a servicewide strategic approach to global tax

administration. The outcome is a Memorandum of Understanding describing a comprehensive, collaborative relationship between the two divisions. A representative of the Deputy Commissioner, International will participate in TE/GE's International Steering Committee, which plans and coordinates TE/GE's efforts to address international issues arising from cross-border activities of the TE/GE taxpayer base. At the working level, TE/GE experts will participate in LB&I's new International Practice Networks and will take advantage of LB&I's new international training programs. Together, the two divisions will further develop training and strategies designed to address the international issues confronted by TE/GE stakeholders. LB&I and TE/GE believe the collaborative, strategic approach captured by the new MOU will position the IRS well to address the challenges our global economy presents for tax administration.

The IRS will continue efforts to expand our strategic approach to international compliance by conducting "bilateral meetings" with all BODs as well as with TAS to address specific needs and compliance challenges of international taxpayers, and coordinate international taxpayer service initiatives for all IRS functions.

With respect to the recommendation relating to the Forum on Tax Administration, the role of the Taxpayer Services Subgroup is to enable the sharing of information about emerging and ongoing service delivery challenges among tax administrations. The work conducted by the Subgroup is shared with member countries and is distributed as appropriate within the IRS. The IRS has one delegate who serves as a member (and currently the Chair) of the Taxpayer Services group. That delegate is available to work with National Taxpayer Advocate to share this work and to obtain the National Taxpayer Advocate's input and ideas about service delivery in tax administration.

With respect to the recommendation to establish Local Taxpayer Advocate positions in each of the four existing tax attaché offices abroad and include such positions in future expansion of attaché offices, we will consider options in this area, but do not believe that educating taxpayers abroad, resolving their compliance issues, and identifying systemic issues facing international taxpayers can be adequately addressed by placing single individuals in overseas offices. Establishing an LTA in each of the four existing tax attaché offices abroad will not afford every taxpayer an opportunity to avail himself or herself of Taxpayer Advocate services as not all taxpayers residing abroad are able to travel to the posts.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased that the IRS recognizes the need to increase internal coordination of international taxpayer service and acknowledges improving taxpayer service to international taxpayers as an important strategic goal. We commend W&I Research & Analysis on its efforts to determine the taxpayer service needs and preferences of U.S. taxpayers abroad. Nonetheless, we note that WIRA needs to be able to accurately identify distinct subsegments of the international U.S. taxpayer population. If it bases its efforts on broad categorizations of the population, its research results will be of limited value in ascertaining specific service needs.

The IRS comments confirm the lack of a coordinated service strategy for international taxpayers. The IRS does not present a clear picture of how it plans to improve servicewide coordination of services for these taxpayers. As discussed in the TAS comments on specific most serious problems dealing with international issues, current IRS efforts and service programs are sporadic and not coordinated.[33] The National Taxpayer Advocate is concerned that in the absence of a servicewide forum for international taxpayer service, the IRS will be unable to properly evaluate needs and preferences of this taxpayer segment and take cost-effective steps to address them. The reasons cited by the IRS for the dissolution of the International Planning and Operations Council appear to be superficial, because it is within the IRS's power to adjust "the focus" and increase "the frequency" of council's meetings. Bilateral meetings, offered as a substitute for an open exchange of opinions at a servicewide forum, cannot achieve the goal of coordinating all taxpayer service and compliance activities. Moreover, bilateral meetings do not allow for a free and full discussion of the problems facing international taxpayers, by which all interested and impacted IRS functions can hear each other's perspective. The National Taxpayer Advocate is also unaware of any servicewide effort by the Deputy Commissioner, International to coordinate service for U.S. taxpayers abroad. Moreover, to date, the IRS has not offered bilateral meetings to TAS or invited the National Taxpayer Advocate to participate in the International Executive team meetings. While we appreciate the commitment of the IRS to "consider the views included in the National Taxpayer Advocate's report," periodic meetings would assist the IRS in doing so and ensure that related problems can also be identified and resolved.

With respect to the Forum on Tax Administration, the National Taxpayer Advocate appreciates the availability of the IRS delegate and is looking forward to establishing periodic meetings for sharing and obtaining suggestions and ideas about best practices in service delivery around the world.

[33] *See* TAS comments to Most Serious Problems: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Need Expanded Service Targeting Their Specific Needs and Preferences; Small Businesses Involved in International Economic Activity Need Targeted IRS Assistance; Foreign Taxpayers Face Challenges in Fulfilling U.S. Tax Obligations, supra; U.S. Taxpayers Abroad Face Challenges With Understanding How the IRS Will Apply Penalties to Taxpayers Who Are Reasonably Trying to Comply or Return Into Compliance, infra.*

Finally, the National Taxpayer Advocate disagrees with the IRS's assessment that "educating taxpayers abroad, resolving their compliance issues, and identifying systemic issues facing international taxpayers can[not] be adequately addressed by placing single individuals in overseas offices." Today, international taxpayers lack access to face-to-face assistance from taxpayer advocates. Although we agree that "establish[ing] LTA positions in each of the four existing tax attaché offices abroad will not afford every taxpayer an opportunity to avail him or herself of Taxpayer Advocate services," the National Taxpayer Advocate believes it would give international taxpayers the opportunity to access advocacy services as needed. Not every taxpayer uses TAS services in the United States, but every taxpayer has the right and the opportunity to obtain face-to-face TAS assistance in every state. Establishing LTA positions at IRS offices abroad will enable underserved taxpayers to request an advocate's intervention in person and facilitate appropriate service to taxpayers in a specific country or area. LTAs at foreign posts also could travel to meet with taxpayers at other locations within their jurisdiction.

Recommendations

The National Taxpayer Advocate recommends that the IRS:

1. Reinstate the International Planning and Operations Council as a servicewide forum devoted to international taxpayer service and enforcement.
2. Create an international taxpayer service subgroup within IPOC to address specific needs and compliance challenges of international taxpayers and coordinate international taxpayer service initiatives for all IRS functions.
3. Provide funding for TAS to establish Local Taxpayer Advocate positions in each of the four existing tax attaché offices abroad and include such positions in future expansion of attaché offices.

MSP #11

U.S. Taxpayers Abroad Face Challenges in Understanding How the IRS Will Apply Penalties to Taxpayers Who Are Reasonably Trying to Comply or Return into Compliance

RESPONSIBLE OFFICIALS

Faris Fink, Commissioner, Small Business/Self-Employed Division
Heather C. Maloy, Commissioner, Large Business and International Division
Frank Keith, Chief, Communications and Liaison
William J. Wilkins, Chief Counsel

DEFINITION OF PROBLEM

U.S. taxpayers abroad who do not comply with complex information reporting requirements are subject to financially devastating penalties that often are not commensurate with the tax liability at issue. These penalties may range from $10,000 per violation to the greater of $600,000 or 300 percent of the foreign account balance for willful failures continuing over a six-year period.[1] The National Taxpayer Advocate is concerned about an apparent shift in the IRS's approach to the application of these civil penalties. Although the IRS's longstanding policy is to use penalties "to encourage voluntary compliance,"[2] there are indications the IRS may have used penalties as leverage against taxpayers who have entered into voluntary disclosure programs, often penalizing those who are trying to become compliant.[3]

Organizations representing U.S. taxpayers abroad and individual submitters have complained about Foreign Bank Account Report (FBAR) "penalty abuse" and application of excessive penalties to relatively "benign actors."[4] The Taxpayer Advocate Service (TAS) and the U.S. Ambassador to Canada have received similar complaints from Canadians who are confused and concerned about FBAR penalties.[5] In a letter to the New York Times, the

1 Most international penalties are related to information returns and are civil penalties that are not based on the amount of underpayment, *e.g.*, for failure to file information returns under 31 U.S.C. § 5321(a)(5) and IRC §§ 6038, 6038A, 6038B, 6038C, 6039F, 6046, 6046A, 6048. *See also* IRC §§ 6038D, 6662(b)(7). See also 31 U.S.C. § 5321(b)(1).

2 *See, e.g.*, H.R. Conf. Rep. No. 101-386 at 661 (1989) ("the IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance."); the IRS's 1998 Penalty Policy Statement acknowledged "the Service uses penalties to encourage voluntary compliance by ...helping taxpayers understand that compliant conduct is appropriate and that non-compliant conduct is not." *See* Policy Statement P-1-18 (Aug. 20, 1998), *superseded by* Policy Statement 20-1 (June 29, 2004). For an in-depth analysis of the civil tax penalty regime, see National Taxpayer Advocate 2008 Annual Report to Congress vol. 2, at 1 (*A Framework for Reforming the Penalty Regime*).

3 *See* Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Program "Bait and Switch" May Undermine Trust in the IRS and Future Compliance Programs, infra.*

4 *See, e.g.*, American Citizens Abroad, The FBAR Scam (article submitted to Tax Notes International, Sept. 2011), *at* http://www.aca.ch/joomla/index.php?option=com_content&task=view&id=488&Itemid=132 (last visited Oct. 27, 2011). FBAR is the penalty for failure to file the required Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR). *See* 31 U.S.C. § 5321(a)(5); 31 C.F.R. § 1010.350.

5 *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..."); TAS Systemic Advocacy Management System (SAMS) Submissions No. 22023, 22133, 22134, 22173, 22195, 22203, 22393, 22433, 22497; for Calendar Year (CY) 2011, there were 48 international SAMS submissions (Dec. 20, 2011).

Washington Post, and the Wall Street Journal, the Canadian Finance Minister expressed concerns about the far-reaching implications of the Foreign Account Tax Compliance Act (FATCA) and the "nerve-wracking" effect of FBAR reporting rules on hundreds of thousands of "honest and law-abiding" dual U.S. – Canadian citizens, including many seniors.[6] Many appear to be under the impression that the IRS will always seek to apply the maximum penalties, regardless of the situation, even to benign actors. Absent clear procedures and transparent guidance about how these taxpayers can return into compliance without being subject to maximum penalties, the IRS is squandering an opportunity to substantially improve voluntary compliance by millions of low-profile U.S. taxpayers abroad.[7]

ANALYSIS OF PROBLEM

Background

The law requires international taxpayers to file a number of information returns and imposes severe civil penalties for failing to file, many of which are not based on the amount of the underpayment of tax.[8] Among the most publicized are the penalties for failure to disclose foreign financial accounts (FBAR) and foreign financial assets (FATCA).

A taxpayer may be subject to a civil FBAR penalty of up to $10,000 per violation for failing to report foreign financial accounts on Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts*, even if the failure was not "willful."[9] If the government establishes the failure was willful, the maximum penalty is the greater of $100,000 or 50 percent of the

6 *See, e.g.*, Financial Post (Canada), *Read Jim Flaherty's letter on Americans in Canada* (Sept. 16, 2011); MSN Money, *Canada Tells IRS to Back Off* (Sept. 20, 2011). The letter was reprinted in a number of Canadian and U.S. newspapers.

7 While an estimated five million to seven million U.S. citizens reside abroad, the IRS received only 218,840 FBAR filings in 2008. 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. *See also* National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*).

8 For a list of international information return penalties see *Introduction to International Issues: Compliance Challenges Increase International Taxpayers' Need for IRS Services and May Undermine the Effectiveness of IRS Enforcement Initiatives in the International Arena, supra*. These penalties include but are not limited to penalties under IRC §§ 6038, 6038A, 6038B, 6038C, 6039F, 6046, 6046A, 6048. See also IRC §§ 6038D, 6662(b)(7); 31 U.S.C. § 5321(a)(5).

9 *See* 31 U.S.C. § 5321(a)(5)(B); 31 C.F.R. § 1010.350. 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 $100,000. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 821(a), 118 Stat. 1586 (Oct. 22, 2004) established a penalty for non-willful violations and increased the penalty for willful violations.

balance of the undisclosed account annually.[10] The taxpayer may also face criminal penalties of up to $500,000 and ten years in prison.[11]

For taxable years beginning after March 18, 2010, an additional penalty regime for financial asset reporting applies, and appears to overlap significantly with the disclosure requirements of the FBAR. The Foreign Account Tax Compliance Act, enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, imposes a penalty of $10,000 (and of up to $50,000 for continued failure after IRS notification) on U.S. taxpayers holding financial assets outside the United States who failed to report those assets to the IRS on the new Form 8938, *Statement of Specified Foreign Financial Assets*.[12] Further, underpayments of tax attributable to non-disclosed foreign financial assets are subject to an additional substantial understatement penalty of 40 percent.[13] The IRS has suspended information reporting requirements until it releases the final version of Form 8938.[14]

Strict Application of Overlapping Penalties May Reduce Rather Than Improve Voluntary Compliance.

U.S. taxpayers abroad are concerned about overlapping and stacking penalties that cover the same conduct and are disproportionate to the tax liability at issue. For example, a dual U.S.-Canadian citizen living in Canada would not generally have a U.S. tax liability after application of the foreign earned income exclusion (FEIE) and foreign tax credit (FTC). However, he or she still may be liable for the FBAR penalty for failing to report a financial interest in or signature authority over a foreign financial account exceeding $10,000, and for the FATCA penalty for failure to report foreign assets in excess of $50,000. Therefore, a taxpayer who fails to report $50,000 of savings in a Canadian bank account could be liable for both penalties of $20,000 for a non-willful violation and up to $160,000 for a willful failure annually. Strict application of both penalties can penalize taxpayers who are reasonably trying to return into compliance, which may reduce rather than improve voluntary compliance.

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10 31 U.S.C. § 5321(a)(5)(C). The penalty can reach 300 percent of the account balance if the willful failures continue over a six-year period. A six-year statute of limitations applies to the civil FBAR penalty. See 31 U.S.C. § 5321(b)(1).

11 31 U.S.C. §§ 5321(a)(5)(C) and 5322; 31 C.F.R. § 1010.840(b). To establish willfulness for either civil or criminal penalties, the IRS generally has to establish that the taxpayer had knowledge of the FBAR filing requirement. *See generally* CCA 200603026 (Sept. 1, 2005) (suggesting "there is no willfulness if the account holder has no knowledge of the duty to file the FBAR"). It is unclear to what extent answers to questions on Form 1040, Schedule B, regarding the taxpayer's signature authority over foreign accounts establish willfulness. *Compare U.S. v. Sturman*, 951 F.2d 1466 (6th Cir, 1991) (suggesting that the failure to answer the questions on Form 1040, Schedule B, regarding signature authority over foreign accounts may create an inference that the failure to file an FBAR was willful), *with U.S. v. Williams*, 2010-2 USTC ¶ 50,623 (E.D. Va. 2010) (concluding that an individual who indicated on Form 1040, Schedule B, that he did not have signature authority over foreign accounts did not willfully fail to file the FBAR because he reasonably believed the IRS already knew about the accounts).

12 The Foreign Account Tax Compliance Act, enacted in 2010 as part of the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (Mar. 18, 2010), added new IRC § 6038D, *Information With Respect to Foreign Financial Assets*. FATCA also applies to foreign financial institutions (FFIs) that are required to report to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. *Id*. (codified as IRC §§ 1471-1474).

13 *See generally* IRC §§ 6038D and 6662(b)(7).

14 Notice 2011-55, 2011-29 I.R.B. 53.

We acknowledge that many international information reporting penalties, and FBAR and FATCA in particular, were designed to fight offshore tax evasion by "bad actors" whose sole or primary reason for establishing and maintaining unreported overseas accounts was to hide income and avoid paying U.S. taxes they legally owe.[15] By contrast, there are relatively "benign actors" whose primary reasons for establishing and maintaining overseas accounts are unrelated to tax, and those who would have at most a *de minimis* tax liability after application of the foreign earned income exclusion, foreign housing exemption or deduction, and foreign tax credit.[16] Examples of these "benign actors" given by tax practitioners include:

- Residents of Canada or other foreign countries who were born in the U.S. while their parents were vacationing or temporarily working here and have dual citizenship, but have never lived or filed tax returns in the U.S.;
- People who inherited an overseas account or opened one to send money to friends or relatives abroad;[17]
- Refugees from Iran when the Shah fell, or immigrants from other totalitarian countries who felt compelled to conceal their assets in offshore accounts out of concern that the governments they fled might pursue them; and
- Holocaust survivors and their children who are frightened that persecution based on national origin could happen again and feel safer spreading their assets around in case they are seized in one place or another.

According to the IRS policy statement, "[p]enalties are used to enhance voluntary compliance.... [T]he Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance."[18] As the "penalty handbook" explains, "[p]enalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system."[19] It acknowledges that disproportionately large or seemingly unfair penalties or "[a] wrong [penalty] decision, even though eventually corrected, ha[ve] a negative impact on voluntary compliance."[20]

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15 *See* Joint Committee on Taxation, JCS-2-11, *General Explanation of Tax Legislation Enacted in the 111th Cong.* 193-219; 223-232 (Mar. 2011); Joint Committee on Taxation, JCS-5-05, *General Explanation of Tax Legislation Enacted in the 108th Cong.* 377-378 (May 2005). *See also* Statement of Senator Levin on HIRE Act, H.R. 2847, 111th Cong. 2d Sess., 156 Cong. Rec. S1745-01 (Mar. 18, 2010); Joint Committee on Taxation, JCX-42-09, *Technical Explanation of the "Foreign Account Tax Compliance Act of 2009"* (Oct. 27, 2009).

16 For TY 2009, 88 percent of all taxpayers claiming the foreign earned income exclusion did not have U.S. tax liability after applying the exclusion. After the application of the foreign tax credit, only about nine percent of these taxpayers had a U.S. tax liability. See Most Serious Problem: *Individual U.S. Taxpayers Working, Living, or Doing Business Abroad Require Expanded Service Targeting Their Specific Needs and Preferences, supra.*

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

18 Policy Statement 20-1 (June 29, 2004).

19 IRM 20.1.1.2(10) (Dec. 11, 2009).

20 IRM 20.1.1.1.3 (4)(C) (Dec. 11, 2009). *See also* 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.... In exercising their discretion, 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.").

The Potential for Strict Application of FBAR and Other Penalties Causes Unnecessary Stress and Fear Among Benign Actors Who Made Honest Mistakes.

Now that both the Offshore Voluntary Disclosure Program (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.[21] As noted earlier, some of these taxpayers have complained to TAS and the U.S. Ambassador to Canada.[22] Many seem to believe the IRS will always seek the maximum FBAR penalty for willful violations, regardless of the situation, even outside of the OVDP and OVDI.

The IRS has been using threatening language 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.[23]
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> ***
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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.[24]
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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.[25]
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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 examination, all applicable penalties (including information return and FBAR penalties) will be imposed. Those penalties could be substantially greater than the 20 percent penalty.[26]
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21 *See, e.g.*, Letter from American Citizens Abroad to the Commissioner, IRS, National Taxpayer Advocate, and Secretary of the Treasury, *American Citizens Abroad (ACA) Response to FBAR Penalties Imposed on Americans Residing Overseas* (Nov. 1, 2011). For a discussion of recent problems with the IRS's offshore voluntary compliance program, see Most Serious Problem: *The IRS's Offshore Voluntary Disclosure Program "Bait And Switch" May Undermine Trust in the IRS and Future Compliance Programs, infra.*

22 *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…").

23 OVDP FAQ #10.

24 OVDP FAQ #3.

25 OVDP FAQ #14.

26 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.[27]

This "tough talk" has created confusion and consternation, particularly among U.S. citizens abroad, and has resulted in a flood of media coverage and multiple entries on TAS's Systemic Advocacy Management System.[28] Some comments are reproduced below:

> I am fairly typical of dual citizens living outside the U.S. since 1980. I've been trying now for over a year to become compliant, not having realized like almost everyone here that I needed to file FBARs for past years. I have to pay someone at least a couple thousand francs to do it for me, even though I have not owed any U.S. taxes for years and have always filed and paid Swiss taxes. This is simply sick, and for a family that struggles financially. I see no reason at all to remain an American. There is a moral dilemma here.[29]

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> I am an average American-born citizen who married a Dane and moved to Denmark. I was unaware that I was supposed to file a form telling the IRS of a bank account I opened here in Denmark to deposit my meager income from my Danish employer. Not only am I to report my bank account but also all other accounts, including pension and retirement accounts. I was hunted down by the IRS and harassed for living overseas but not claiming a foreign bank account. It's become overwhelming and intrusive. I am now considering giving up my U.S. citizenship as I can honestly say that this abuse of the IRS and government power is not what America is supposed to be about. These regulations have now lost all sense of logic and reason and have been used to harass average citizens living and working abroad trying to make a simple living. It's becoming abusive.[30]

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27 OVDP FAQ #49.

28 Westlaw search of U.S. and foreign media reveals more than a hundred publications regarding the confusion of U.S. taxpayers abroad and concerns about unfair application of penalties (Search conducted on Oct. 28, 2011). *See, e.g.*, MSN Money, *Canada Tells IRS to Back Off* (Sept. 20, 2011) ("Tax crackdown could ensnare tens of thousands of innocent US citizens, and our neighbor to the north is having none of it."); Financial Post (Canada), *Americans in Canada: Tax Confusion Reigns* (Sept. 19, 2011) (The article also has dozens of comments on Facebook (last visited Oct. 29, 2011). The number of SAMS submissions involving international issues increased more than threefold from calendar year (CY) 2008 to CY 2011, with a spike of 48 submissions in CY 2011 (through Oct. 25, 2011). *See* Most Serious Problem: *Globalization Requires Greater Internal IRS Coordination of International Taxpayer Service, supra.*

29 American Citizens Abroad, *The FBAR Scam* 5 (article submitted to Tax Notes International, Sept. 2011), *at* http://www.aca.ch/joomla/index.php?option=com_content&task=view&id=488&Itemid=132 (last visited Oct. 27, 2011) (a testimonial from an American in Switzerland).

30 *Id.*

> I was born in Canada; my mother is from the United States. When I was 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 U.S. 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.[31]
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> I was born in the U.S., 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 US source income or US assets of any kind. I never renewed my US passport and entered the US only for short family visits or vacations. I consider myself a Canadian. With no US income or assets, I had no reason to assume you needed to file US tax returns, and had never heard of FBAR reports. In 2010, my mother's US 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.[32]

The IRS's silence about what comes next and how benign actors may become compliant without paying disproportionate penalties has caused frustration in Canada, one of the closest allies of the United States, where hundreds of thousands of dual citizens live.[33]

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31 SAMS Submission No. 22433, *Lack of Information on Taxes for Dual Citizens* (data drawn on Oct. 11, 2011).

32 SAMS Submission No. 22497, *FBAR Penalties Harm Canadian Dual Citizens* (data drawn on Oct. 11, 2011). Many U.S. citizens abroad disagree with the IRS's interpretation of the term "offshore," especially applied to their accounts and assets in high tax jurisdictions, such as Canada. While Black's Law Dictionary does not provide a definition of "offshore," free online resources and common sense explains it as "[l]ocated or based in a foreign country and not subject to tax laws." *See, e.g.*, The Free Dictionary, at http://www.thefreedictionary.com/offshore (last visited Oct. 29, 2011). The IRS's website defines the term "offshore" as following: "[W]hen referring to a country, [offshore] means a jurisdiction that offers financial secrecy laws in an effort to attract investment from outside its borders. When referring to a financial institution, "offshore" refers to a financial institution that primarily offers its services to persons domiciled outside the jurisdiction of the country in which the financial institution is organized. IRS, *Abusive Offshore Tax Avoidance Schemes - Glossary of Offshore Terms*, http://www.irs.gov/businesses/small/article/0,,id=106572,00.html (last visited Oct. 29, 2011).

33 *See* National Taxpayer Advocate, 2009 Annual Report to Congress 144 (Most Serious Problem: *U.S. Taxpayers Located or Conducting Business Abroad Face Compliance Challenges*. *See also* The Globe and Mail (Canada), *U.S. Tax Crackdown Hits Canadian Residents* (June 23, 2011) ("A tax crackdown by the United States has sent more than one million Americans and green-card holders living in Canada scrambling to figure out how to comply.").

Canada's Finance Minister sent a letter to several major U.S. newspapers stating that the IRS is spreading "unnecessary stress and fear" among law-abiding Canadians in its aggressive pursuit of offshore tax cheats. The letter, *inter alia*, states:

> The Americans are trying to target places in the world that house a lot of tax evaders, and that's not Canada... This is not a tax haven... Most of these Canadian citizens, many with only distant links to the United States, have a very limited knowledge of their reporting obligations to the United States... These are honest and law-abiding people, including senior citizens now caught up in a nerve-wracking situation. Because they work and pay taxes in Canada, they generally do not owe any taxes in the United States. ... They are not high rollers with offshore bank accounts. These are people who have made innocent errors of omission that deserve to be looked upon with leniency."[34]

Increasing the danger that taxpayers who have reasonably and in good faith tried to comply will nonetheless be penalized may achieve an opposite result: that the IRS or the tax rules will be perceived as unfair, and voluntary compliance will suffer.[35]

Benign Actors Need Clear Guidance on How to Avoid FBAR, FATCA, and Other Penalties if They Are Reasonably Trying to Comply or Return Into Compliance.

Most if not all penalty provisions applicable to international taxpayers, including FATCA and FBAR, contain a reasonable cause exception and give the IRS a broad authority to issue regulations and guidance.[36] For example, the FBAR statute specifies only a "maximum" penalty that the IRS "may" impose; it does not *require* the IRS to apply the maximum penalty, or indeed any penalty, in every case.[37] It also provides for a reasonable cause exception without specifying what constitutes "reasonable cause." The Internal Revenue Manual (IRM) 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.[38]

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34 *See* Financial Post (Canada), *Read Jim Flaherty's letter on Americans in Canada* (Sept. 16, 2011).

35 One dual U.S. – Canadian citizen noted in regard to potential IRS actions after the expiration of the OVDI: "Can they come after me for more?...Nobody knows what they'll do." *See* The Globe and Mail (Canada), *Help! I'm on the IRS Hit List* (Sept. 20, 2011). *See also* Letter from American Citizens Abroad to the Commissioner, IRS, the National Taxpayer Advocate, and the Secretary of the Treasury, *American Citizens Abroad (ACA) Response to FBAR Penalties Imposed on Americans Residing Overseas* (Nov. 1, 2011).

36 *See, e.g.*, IRC §§ 6038D(g); 6038A(d)(3); 6038B(c)(2); 6039F(c)(2); 31 U.S.C. § 5321(a)(5)(B)(ii); (reasonable cause exception); IRC §§ 6038A(a); 6038B(a)(2); 6038D(h); 6039F(e) (authority to issue regulations).

37 *See generally* 31 U.S.C. §§ 5314(a) and 5321(a)(5).

38 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.").

Yet the IRS has remained silent about the seemingly reasonable way in which the IRM suggests that it will apply FBAR penalties. To date, the IRS has not issued guidance about what constitutes "reasonable cause" for failure to file an FBAR. Although the IRS authorizes agents to issue a warning letter in lieu of an FBAR penalty, it provides them with little specific guidance, and no examples, about when such a letter is appropriate.[39] Thus, taxpayers who have reasonably tried to comply and have little or no tax liability may still be subject to the penalty. Most importantly, these "benign-actor" taxpayers have no clear sense that they will be treated differently from "bad-actor" taxpayers.

The IRS could 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 and other penalties and its voluntary disclosure practice in the future.[40] The IRS's current work on implementation of FATCA legislation makes this a good time to provide guidance to taxpayers and IRS employees by issuing a notice or similar public pronouncement that describes what benign actors should do, and emphasize that they will often not be subject to any penalties under existing statutes.[41] The IRS can improve compliance by increasing the fairness of the tax system instead of over-penalizing those who are trying to become compliant.

CONCLUSION

In conclusion, the National Taxpayer Advocate offers these preliminary recommendations:

1. The IRS should issue a notice or similar public pronouncement that:
    a. Describes and reaffirms the taxpayer-favorable procedures regarding the application of the FBAR penalty provided by IRM 4.26.16;
    b. Tells taxpayers what to do if they discover they have inadvertently failed to file FBARs; and

39 IRM 4.26.16.4 (July 1, 2008) (noting that the penalties for failure to file the required FBAR "should be asserted only to promote compliance with the FBAR ... In exercising their discretion, 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.").

40 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); Scott D. Michel and Mark E. Matthews, *OVDI Is Over – What's Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 7, 2011) (same); Letter from American Citizens Abroad to the Commissioner, IRS, the National Taxpayer Advocate, and the Secretary of the Treasury, *American Citizens Abroad (ACA) Response to FBAR Penalties Imposed on Americans Residing Overseas* (Nov. 1, 2011).

41 *See, e.g.*, Scott D. Michel and Mark E. Matthews, *OVDI Is Over — What's Next for Voluntary Disclosures?*, 2011 TNT 201-3 (Oct. 7, 2011) (recommending, *inter alia*, not applying penalties to Americans living abroad absent fraud or willfulness, and a waiver of penalties in cases when there is no unreported income, or there is little or no tax due). The IRS is working on implementing FATCA and developing new reporting requirements to be incorporated in Treasury regulations expected to be issued in proposed form by the end of 2011. See IRS Notices 2011-55, 2011-29 I.R.B. 53; 2011-53, 2011-32 I.R.B. 124; 2011-34, 2011-19 I.R.B. 765; 2010-60, 2010-37 I.R.B. 329.

c. Reassures them that they are most likely to receive a warning letter if they follow the instructions in the notice.[42]

2. As part of the FATCA implementation project, develop specific guidance to clarify how taxpayers who have reasonably tried to comply with international information reporting requirements can avoid multiple penalties for the same conduct.

IRS COMMENTS

The IRS seeks to fairly administer its penalty regimes. It is not the case, as stated in the National Taxpayer Advocate's report, that there has been a shift in the IRS's approach to the application of civil penalties. The IRS does recognize that there has been confusion and inaccurate assertions regarding the IRS' application of penalties. The IRS recently published an informational fact sheet illustrating how present law penalties operate.[43]

As stated in the recently-issued IRS fact sheet and in news release IR-2008-79 (June 17, 2008), the IRS will not assert FBAR penalties if IRS determines the violations were due to reasonable cause and the delinquent FBARs are filed. The IRS is sensitive to the unusual nature of the FBAR penalty when compared to Title 26 penalties and additions to tax. While Title 26 penalties and additions to tax are generally defined at a set rate (*e.g.*, five percent, 0.5 percent per month, 20 percent of the underpayment, etc.), Congress has defined the FBAR penalty in terms of maximum or "up to" amounts. This can create the impression that examiners assert the FBAR penalty only at the maximum rate. This is not the case. Guidelines exist to ensure that excessive penalties are not asserted. The IRM advises examiners to propose penalties only up to amounts necessary to insure future compliance. Additional guidance is provided on mitigation of the penalty — even down to zero — if circumstances warrant it.[44] Further restraint is provided by requiring that the Office of Chief Counsel provide input upon all FBAR penalties proposed. Additionally, the IRS Appeals Division provides a pre-assessment appeals conference when the taxpayer files a timely protest to the penalty proposal. In short, measures are in place to prevent taxpayers from being subjected to financially devastating penalties.

While the penalties for failing to file foreign information returns (*e.g.*, Forms 8938, 5471, 3520, 3520-A, etc.) do not contain mitigating guidelines to allow examiners to depart downward from the penalty rate, all penalties for failing to file foreign information returns can be abated in full if the failure to file was due to reasonable cause and not willful neglect.[45]

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42 On October 26, 2011, the National Taxpayer Advocate issued a memorandum to the Commissioner of Internal Revenue underlining some of these recommendations, which are also discussed in the Most Serious Problem: The *IRS's Offshore Voluntary Disclosure Program "Bait and Switch" May Undermine Trust in the IRS and Future Compliance Programs*, *infra*. See Memorandum for Douglas Shulman, Commissioner of Internal Revenue, from Nina E. Olson, National Taxpayer Advocate, Recommendations Regarding Taxpayer Advocate Directive 2011-1 (Oct. 26, 2011), *infra, at* 229.

43 *See Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.,* http://www.irs.gov/newsroom/article/0,,id=250788,00.html.

44 IRM 4.26.16.

45 IRM 20.1.9.1.1 states that reasonable cause applies to most, but not all, of the penalties. Reasonable cause will be considered by the examiner per IRM 20.1.1, *Introduction and Penalty Relief*, prior to assessing the penalty.

IRS guidance to examiners on penalties is included throughout the IRM. All penalties are subject to reasonable cause or good faith exceptions, either as a matter of policy[46] or under the consolidated reasonable cause exception in IRC § 6664. In fact, IRM Exhibit 21.8.2-1 contains a Failure to File decision tree to assist examiners with reasonable cause determinations in the context of Form 5471. This resource can be used to determine reasonable cause exceptions for other penalties.

The IRM remains the primary source of guidance on penalties. IRM 4.26.16.4 includes general guidelines, non-willful penalty considerations, willful penalty considerations (definition, willful blindness, reasonable cause, evidence, *et al.*) and mitigation. IRM 20.1.1.3 provides a detailed discussion of reasonable cause under the title *Criteria for Relief from Penalties*.

The penalties set by Congress in Title 31 are maximum amounts before mitigation. Although the maximum non-willful and willful FBAR penalties are $10,000 and 50 percent of the account balance as of the date of violation, respectively, examiners are free to determine whether the facts and circumstances of a particular case justify a penalty and if no penalty is appropriate, they should issue the FBAR warning letter.[47]

The IRS disagrees with the assertion in the report that we used penalties as leverage against taxpayers who have entered into voluntary disclosure programs. As discussed in our prior response, 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.

With regard to the recommendations in the report, the IRS notes the following.

The IRS agrees that heightened public awareness regarding the FBAR penalty is critical to increasing FBAR reporting compliance. As discussed, the IRS recently published an informational fact sheet illustrating how present law penalties operate, including a reminder that FBAR penalties do not apply if the IRS determines that there is reasonable cause.[48]

We have also been taking other steps in this regard. The IRS's servicewide FBAR Communication Strategy Team, established in January 2011, leads a coordinated campaign to share consistent, accurate and easily-accessed FBAR information that helps filers comply with their filing obligations and, thereby, avoid the FBAR penalty.

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46 IRM 20.1.9.2 states the examiners must consider any reason a taxpayer provides in conjunction with the guidelines, principles, and evaluating factors relating to reasonable cause based on the facts and circumstances.

47 IRM 4.26.16 Exhibit-2.

48 *See Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, http://www.irs.gov/newsroom/article/0,,id=250788,00.html.

IRS efforts during the past year included an October 2011 update to news release IR-2008-79, a June 2011 FBAR webinar, and the issuance of electronic reminders of the FBAR filing deadline of June 30. IR-2008-79 offers taxpayer-favorable guidance regarding FBARs that were inadvertently not filed and other helpful information about FBAR penalty application. The June 2011 webinar focused on FBAR reporting requirements following issuance of the Financial Crimes and Enforcement Network's final rule on FBAR responsibilities. The broadcast was available both domestically and abroad, and hosted over 2,300 participants. The IRS also used its Twitter account to issue FBAR filing deadline reminders and to provide IRS.gov web addresses identifying who was required to file.

The IRS will continue to share information with the public using IRS.gov and other communication vehicles designed to reach FBAR filers, both domestic and abroad.

With respect to the second recommendation to clarify how multiple penalties can be avoided for the same conduct, it is important to recognize that FBAR is required under Title 31 for other law enforcement purposes in addition to tax administration. As a consequence, different policy considerations apply to FBAR and other information reporting (e.g., Form 8938). These are reflected in the law defining differing categories of persons required to file Form 8938 and the FBAR, differing filing thresholds for Form 8938 and FBAR reporting, and differing assets (and accompanying information) required to be reported on each form. Although certain information may be reported on both Form 8938 and the FBAR, the information required by the forms is not identical in all cases. These differing policy considerations were recognized during the passage of the HIRE Act and the enactment of § 6038D, and the intention to retain FBAR reporting notwithstanding the enactment of § 6038D was specifically noted in the Technical Explanation Of The Revenue Provisions Contained In Senate Amendment 3310, The "Hiring Incentives To Restore Employment Act," Under Consideration by the Senate (Staff of the Joint Comm. on Taxation, JCX-4-10 (February 23, 2010)) (Technical Explanation) accompanying the HIRE Act. The Technical Explanation states that "[n]othing in this provision [section 511 of the HIRE Act enacting section 6038D] is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision." (Technical Explanation at p. 60).

The IRS is aware of overlap between FBAR and FATCA reporting in certain respects and, consequently, is cognizant of the potential for overlapping penalties for noncompliance under both regimes. To the extent that filers face overlapping reporting obligations under both FBAR and § 6038D, we note the presence under both reporting regimes of a reasonable cause exception to penalty application. As a result, noncompliant filers may well qualify for the reasonable cause exception to penalties under Title 31 for FBAR noncompliance and qualify for the reasonable cause exception to penalties under Title 26 for § 6038D noncompliance. The IRS will be sensitive to claims of reasonable cause in response to application of the § 6038D penalty.

Taxpayer Advocate Service Comments

The National Taxpayer Advocate is pleased with the IRS's affirmation that all penalty considerations, including reasonable cause and mitigation guidelines for the FBAR penalty, continue to apply to the facts and circumstances of a particular case. Even though it took the IRS almost two months to publicize an FBAR fact sheet online, in response to a recommendation in her Taxpayer Advocate Directive and Memorandum to the Commissioner of Internal Revenue as well as multiple unfavorable press reports, it is a step in the right direction.[49]

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 benign actors 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.

For example, an estimated five to seven million U.S. citizens reside abroad, many of whom have FBAR filing requirements,[50] yet the IRS received only 218,840 FBARs in 2008.[51] These numbers leave little doubt that a large number of people still have not filed FBARs and many such violations are likely inadvertent.

As discussed in the Memorandum to the Commissioner, the National Taxpayer Advocate has recommended that the IRS 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 taxpayers making "quiet" corrections might be subject to stiffer penalties than in the past. TAS, organizations 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.[52]

49 *See* IRS, *Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.*, FS-2011-13 (Dec. 2011), at http://www.irs.gov/newsroom/article/0,,id=250788,00.html. See also Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and Comply with the Freedom of Information Act*) (Aug. 16, 2011); Memorandum for Douglas Shulman, Commissioner of Internal Revenue, from Nina E. Olson, National Taxpayer Advocate, Recommendations Regarding Taxpayer Advocate Directive 2011-1 (Oct. 26, 2011), *infra*.

50 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.

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

52 *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).

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.[53] Finally, in early December, as this document was en route to the printer, the IRS posted guidance on its website which suggested that it might still apply the reasonable provisions that appear in IRM 4.26.16 and the Penalty handbook, and issue additional guidance.[54]

While the IRS-released fact sheet is helpful, it has not been vetted in a manner similar to changes to the IRM or items published in the Internal Revenue Bulletin — and the IRS itself would be the first to point out that taxpayers generally cannot rely on fact sheets and press releases.[55] U.S. taxpayers abroad need formal guidance upon which they can rely.

Further, we note that this guidance was developed without any consultation with the National Taxpayer Advocate. Throughout this and other responses to the Most Serious Problems impacting international taxpayers, the IRS has referred to various "servicewide" teams or taskforces — yet the Taxpayer Advocate Service is not represented on these teams.[56] Congress placed the Office of the Taxpayer Advocate inside the IRS so that the IRS could benefit from the independent perspective of the statutory "voice of the taxpayer" before it implemented guidance. For over two years, in the arena of international tax administration, the IRS has failed to reach out to or heed that voice. The fearful climate we have today among "benign actor" international taxpayers demonstrates what can happen when it dismisses or ignores the National Taxpayer Advocate's concerns.

The IRS recognizes that FBAR and FATCA reporting obligations overlap in certain respects and, consequently, may result in overlapping penalties for the same conduct. The National Taxpayer Advocate appreciates the IRS's willingness to consider reasonable cause under both reporting regimes. While the IRS is diligently working on implementing FATCA guidance, it can address overlapping penalties and its position in regard to reasonable cause consideration under both regimes.

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53 *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...").

54 *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).

55 For example, the FBAR IRM does not contain an explanation of what constitutes reasonable cause for the purposes of Title 31. Instead, the IRS relies on IRM issued for Title 26 penalties for reasonable cause consideration under the FBAR statute. *See, e.g.*, IRM 4.26.16; IRM 20.1.1.3.

56 For example, in its response above, the IRS stated, "The IRS's servicewide FBAR Communication Strategy Team, established in January 2011, leads a coordinated campaign to share consistent, accurate and easily-accessed FBAR information that helps filers comply with their filing obligations and, thereby, avoid the FBAR penalty." Despite calling the team "servicewide", the Taxpayer Advocate Service is not represented on this team.

Recommendations

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

1. Issue guidance in form of IRM changes or public guidance published in the Internal Revenue Bulletin 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 guidance.[57]
2. As part of the FATCA implementation project, develop specific guidance to clarify how taxpayers who have reasonably tried to comply with international information reporting requirements can avoid multiple penalties for the same conduct.
3. Include representatives of the Taxpayer Advocate Service on "servicewide" teams that are addressing and developing guidance about international information reporting requirements, penalties, and related compliance initiatives.
4. Regularly consult with and provide briefings to the National Taxpayer Advocate on all matters pertaining to international information reporting requirements, penalties, and related compliance initiatives.

[57] 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).

MSP #12 The IRS's Offshore Voluntary Disclosure Program "Bait and Switch" May Undermine Trust for the IRS and Future Compliance Programs

RESPONSIBLE OFFICIALS

Steven T. Miller, Deputy Commissioner, Services and Enforcement
Heather C. Maloy, Commissioner, Large Business and International Division
Faris Fink, Commissioner, Small Business/Self-Employed Division
Victor S.O. Song, Chief, Criminal Investigation
Chris Wagner, Chief, Appeals

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

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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 OVDP, "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 longstanding 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

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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

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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

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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

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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 OVDP, 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 OVDP "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 OVDP 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 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."

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:

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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 OVDP[60]
2. May 6, 2009 – posted OVDP Q&A 1-30[61]
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 #35[62]
8. March 1, 2011 – issued a memo announcing the general terms of the 2011 OVDI[63]
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 OVDI[65]
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 makes 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]

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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

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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*, 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 (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. 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.").

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 "reneged on" 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.

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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]

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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

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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.

TAXPAYER ADVOCATE SERVICE
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 (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.[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 statues, 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 <u>only</u> 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.

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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.

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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.

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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).

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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, probation, 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.

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.

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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

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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 OVDI 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.

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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 F2d 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 clients[39] 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]

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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. Itshould also direct OVDP examiners to

use standard examination procedures tomake 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.

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 "offshore" 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 backtrack. 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 noncompliance 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 OVDI (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 assistors 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]

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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]

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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.

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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. OVDP 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).

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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]

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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