



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.

**I. 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.<sup>1</sup> 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.<sup>2</sup> It may also damage the IRS's credibility and reduce the effectiveness of any future initiatives. The following sections describe how this happened.

1. 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.<sup>3</sup> Where the IRS cannot prove that the failure was willful, the law authorizes a penalty of up to \$10,000.<sup>4</sup> 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.”<sup>5</sup>

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.<sup>6</sup> However, OVDP FAQ #35 stated that “[u]nder no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes.” 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

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<sup>1</sup> 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”).

<sup>2</sup> 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”).

<sup>3</sup> 31 U.S.C. § 5321(a)(5).

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

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

entirely in certain cases where the violation was due to reasonable cause. Thus, 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.<sup>7</sup> 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.

2. 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.<sup>8</sup>

We acknowledge that in the case of FBARs, there are “bad actors” whose sole or primary reason for establishing and maintaining

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<sup>7</sup> 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.

<sup>8</sup> 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).

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 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;<sup>9</sup>
- 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.

3. 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:

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<sup>9</sup> 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.<sup>10</sup>*

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.

4. 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.<sup>11</sup> 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.<sup>12</sup> 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
  - apply multiple FBAR penalties only in the most egregious cases.<sup>13</sup>

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

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

<sup>12</sup> 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).

<sup>13</sup> IRM 4.26.16.4.4(2) (July 1, 2008) (reasonable cause); IRM 4.26.16.4.5.3 (July 1, 2008) (“The burden of establishing willfulness is on the Service.”); IRM 4.26.16.4.7(3) (July 1,

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.<sup>14</sup> Thus, it has turned the IRS's burden of proof on its head.

5. 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."<sup>15</sup> 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*

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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.").

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

<sup>15</sup> 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).

*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.]*

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

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

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

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.”<sup>17</sup>

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<sup>16</sup> 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”).

<sup>17</sup> 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.

## **II. 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.



1. 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.<sup>18</sup> 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...*<sup>19</sup>

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*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.*<sup>20</sup>

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*[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.*<sup>21</sup>

2. 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

<sup>18</sup> 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).

<sup>19</sup> NYSBA Letter.

<sup>20</sup> 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).

<sup>21</sup> 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).

would otherwise be subject to FBAR penalties at the maximum statutory rate applicable willful violations.<sup>22</sup> 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.<sup>23</sup> It advised that the process was "appropriate for most taxpayers who have underreported their income with respect to offshore accounts,"<sup>24</sup> 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.<sup>25</sup>

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<sup>22</sup> 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.

<sup>23</sup> FAQ #10.

<sup>24</sup> FAQ #50.

<sup>25</sup> 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.<sup>26</sup> 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).<sup>27</sup> Like the OVDP, the LCCI did not involve an “examination.”<sup>28</sup> 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.

3. 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.<sup>29</sup> Rather, examiners could ask follow-up questions of participants who were obligated to cooperate.<sup>30</sup> It was reasonable for the IRS to do so in the OVDP as well.

As noted above, some OVDP examiners developed their own

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<sup>26</sup> 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.

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

<sup>28</sup> *Id.*

<sup>29</sup> 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.

<sup>30</sup> See, e.g., IRM 4.26.17.1 (May 5, 2008).

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.<sup>31</sup> The value of these accounts is the primary information the IRS needs to apply the mitigation guidelines.<sup>32</sup> 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.

### III. 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.<sup>33</sup> 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.

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

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<sup>31</sup> See *id.*

<sup>32</sup> See IRM Exhibit 4.26.16-2 (July 1, 2008).

<sup>33</sup> See OVDP FAQ #3, #10, #12, #14, #15, #34, #49, #50.

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,<sup>34</sup> the IRS received only 218,840 FBAR filings in 2008.<sup>35</sup> By comparison, the government closed only 2,386 FBAR examinations and initiated only 21 criminal investigations in 2010.<sup>36</sup> 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.<sup>37</sup> By generating such ill-will and mistrust, the IRS is squandering an opportunity to improve voluntary compliance.

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

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).
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

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

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

<sup>36</sup> IRS response to TAS information request (Sept. 14, 2011).

<sup>37</sup> IRS response to TAS information request (Sept. 14, 2011).

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

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).<sup>39</sup> 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.<sup>40</sup> 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.<sup>41</sup>

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

<sup>40</sup> 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).

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

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  
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