Alerts and Updates

New 2012 Offshore Voluntary Disclosure Program; Taxpayer Advocate Criticizes IRS "Bait & Switch"; Current Offshore Enforcement Initiatives

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2012 Offshore Voluntary Disclosure Program Announced by IRS: Details and Issues

On January 9, 2012, the Internal Revenue Service (IRS) announced that it had reopened the Offshore Voluntary Disclosure Program (OVDP) following the closure of the 2011 and 2009 programs and the collection of more than $4.4 billion USD from those programs. The third offshore program comes as the IRS continues working on a wide range of international tax issues and follows ongoing efforts with the U.S. Justice Department to pursue criminal prosecution of international tax evasion.

The new program will be open for an indefinite period of time, and its terms could change over time.

The program is similar to the previous programs, but with a few key differences. The previous programs had a deadline for applying; the new program has no application deadline.

The overall penalty structure for the new program is similar to the 2011 Offshore Voluntary Disclosure Initiative (OVDI).

The new program's penalty framework requires individuals to pay a penalty of 27.5 percent (up from 25 percent in the 2011 OVDI and from 20 percent in the 2009 OVDP) of the highest aggregate balance in foreign bank accounts/entities or value of foreign assets during the eight full tax years prior to the disclosure. The 5-percent or 12.5-percent penalties remain the same in the new program as in the 2011 OVDI. (The 5-percent penalty applied in very limited situations such as where the taxpayer inherited an offshore account and made very small withdrawals from the account. The 12.5-percent penalty applies to accounts whose highest value did not exceed $75,000.)

The new program requires that taxpayers file all original and amended tax returns and information returns, such as the Report of Foreign Bank and Financial Accounts (FBAR). Payment for back-taxes and interest for up to eight years as well as payment of the accuracy-related and/or delinquency penalties are required. Under certain circumstances, installment payouts of the liability or an offer in compromise may be available.

As under the prior programs, taxpayers who feel that the penalty structure is disproportionate or unwarranted under their circumstances may opt out and subject themselves to an audit.

More details will be available within the next month on IRS.gov. In addition, the IRS will be updating key Frequently Asked Questions and providing additional specifics on the new offshore program.

Ways Taxpayers Can Determine If Voluntary Disclosure Is Right for Them

The factors for determining whether a taxpayer should make a voluntary disclosure are numerous and complex. A taxpayer considering making a voluntary disclosure may want to discuss the matter with experienced legal counsel. That discussion would be protected from disclosure by attorney-client privilege, which is particularly vital in instances where the taxpayer ultimately decides not to make the disclosure. However, a consultation regarding the voluntary disclosure program with a taxpayer's accountant is not a privileged communication. If the decision were made not to enter the new program, and the IRS discovers the foreign financial account, the taxpayer's accountant could become a witness for the IRS against the taxpayer. This would not be the case if an attorney, rather than an accountant, had been consulted.

A taxpayer contemplating a voluntary disclosure also may want to consider the differences in the financial consequences of participating in the new program, opting out of the new program or making a traditional voluntary disclosure. (It is unknown at this time, but it appears that the IRS may initially process all voluntary disclosures regarding offshore issues through the 2012 OVDP.) In many instances, the 2012 OVDP would involve more years, higher taxes and significantly larger penalties than a traditional voluntary disclosure. Taxpayers participating (willingly or not) in the 2012 OVDP may face an IRS unwilling to negotiate, notwithstanding facts supporting the reduction or elimination of penalties. Taxpayers who believe their situation warrants reduced penalties may be advised by the 2012 OVDP agents that they can opt out of the program and take their chances in a full-blown examination. Before that decision is made, however, a taxpayer should perform a careful analysis of the facts surrounding the case. That analysis should be directed at determining:

- exactly what years are open under the statute of limitations (possibly less than the eight years under the 2012 OVDP),
- the magnitude of additional tax and interest due,
- what tax penalties are applicable (fraud, accuracy-related or none) and

- what additional information-return penalties may apply in cases involving foreign accounts, trusts, gifts, corporations and other business entities.

Key to this analysis are issues regarding negligence, fraud, willfulness, mitigation, burden of proof (on the taxpayer or on the IRS) and quantum of proof (clear and convincing, or mere preponderance of the evidence).

Once all this analysis is completed, the decision whether to make a voluntary disclosure can be made and, if disclosure is made, whether it might be under the inflexible 2012 OVDP or through potentially less-rigid traditional means.

More Enforcement Initiatives

On January 9, 2012, Sen. Carl Levin, D-Mich., Chairman of the Senate Armed Services Committee and Permanent Subcommittee on Investigations of the Homeland Security and Governmental Affairs Committee, made the following statement regarding the IRS announcement that it is reopening its offshore voluntary disclosure program:

The fact that 33,000 taxpayers have turned themselves in and paid $4.4 billion in back taxes, with more to follow, shows how enormous the offshore tax evasion problem is. Taxpayers are turning themselves in, because federal prosecutors have finally begun to go after the individual tax haven banks, bankers, and other financial professionals helping them cheat on their taxes. The Justice Department needs to keep up the pressure to stop offshore tax evasion costing us an estimated in $100 billion each year in unpaid taxes. And Congress must finally enact stronger laws to combat offshore tax abuses, including passing my Stop Tax Haven Abuse Act, S. 1346.

Levin's announcement comes on the heels of the U.S. Department of Justice's indictment of three Swiss bankers, Michael Berlinka, Urs Frei and Roger Keller for conspiring with U.S. taxpayers and others to hide more than $1.2 billion in assets from the IRS. The indictment alleges that these assets were hidden in undeclared accounts of U.S. taxpayers at the Swiss bank where the defendants worked as client advisers.

According to the indictment filed in Manhattan federal court: The defendants worked as client advisers at the Zurich branch of their bank, which provides private banking, asset management and other services to clients around the world.

During their time at the bank, the defendants allegedly conspired with various U.S. taxpayers and others to hide from the IRS both the existence of certain Swiss bank accounts, as well as the income they generated. In particular, the defendants opened and serviced dozens of undeclared accounts for U.S.

taxpayers in 2008 and 2009, in an effort to capture business lost by UBS AG and another large international Swiss bank in the wake of widespread news reports that the IRS was investigating UBS for helping U.S. taxpayers evade taxes and hide assets in Swiss bank accounts. After the reports, both banks stopped servicing undeclared accounts for U.S. taxpayers.

To capitalize on the business lost by the banks and to otherwise increase the assets under their bank's management and fees earned from those assets, the defendants and other client advisers allegedly told various U.S. taxpayer-clients that their undeclared accounts would not be disclosed to the U.S. authorities because the bank had a long tradition of bank secrecy. The defendants and other client advisers at the bank also told their U.S. taxpayer-clients that the bank was less vulnerable to United States law enforcement pressure because the bank did not have offices outside Switzerland. Members of the bank's senior management participated in some of these sales pitches to U.S. taxpayer-clients. Additionally, to further the conspiracy, the defendants and/or other client advisers allegedly took steps that included the following:

- They opened and serviced undeclared accounts for U.S. taxpayer-clients in the names of sham corporations and foundations formed under the laws of Liechtenstein, Panama, Hong Kong and other jurisdictions for the purpose of concealing the identities of the U.S. taxpayer-clients from the IRS;

- They received and retained at their bank documents that falsely declared that the sham entities were the beneficial owners of certain accounts when, in fact, the accounts were owned by U.S. taxpayers;

- They permitted certain U.S. taxpayer-clients to open and maintain undeclared accounts at their bank using code names and numbers to minimize references to the actual names of the U.S. taxpayers on Swiss bank documents;

- They ensured that account statements and other mail for U.S. taxpayer-clients were not mailed to them in the United States; and

- They sometimes communicated with U.S. taxpayer-clients using their personal email accounts to reduce the risk of detection by law enforcement.

By 2010, the collective maximum value of the assets in undeclared accounts beneficially owned by defendants' U.S. taxpayer-clients of and other client advisers at this Swiss bank was more than $1.2 billion, with many accounts holding in excess of $10,000 in any one year.

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

The Taxpayer Advocate's annual report to Congress disclosed that on August 16, 2011, the Taxpayer Advocate issued Directive 2011-1, ordering the IRS to take certain action relative to the 2009 Offshore Voluntary Disclosure Program ("2009 OVDP"). The IRS is not bound by the directive, but the IRS Commissioner is required to respond to the directive by the end of January 2012.

The actions contained in the directive, if approved by the IRS Commissioner, will require that the IRS, among other things:

- 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), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.
    - In verifying the taxpayer’s claim, 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.
- Direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by the 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the taxpayer proves it was not.
- Direct examiners to use standard examination procedures to determine whether a taxpayer would be liable for a lesser penalty under existing statutes (*e.g.*, because the taxpayer was eligible for (1) the reasonable cause exception, (2)a nonwillful penalty because the IRS lacked evidence to establish its burden to prove willfulness or (3) application of the mitigation guidelines set forth in the IRM) without shifting the burden of proof onto the taxpayer.

Background

As stated by the Taxpayer Advocate, one basic issue with the 2009 OVDP is that it assumed all participants are tax evaders hiding money overseas when, in fact, the IRS has steered many people into the program who made honest mistakes. Taxpayers with bona fide arguments for not having filed FBARs had their stories ignored and were faced with the alternatives of paying penalties that did not apply to them or opting out of the 2009 OVDP and face examinations that the IRS threatened could result in even-higher penalties then the 2009 OVDP provided and even criminal prosecution. Consequently, many taxpayers felt compelled to accept the 2009 OVDP penalty structure even though the penalties did not apply to their circumstances. According to the Taxpayer Advocate, 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.

IRS Retroactively Changed the Terms of the OVDP

Where a person is required to file an FBAR, and willfully fails to do so, the law authorizes a penalty of up to the greater of $100,000 or 50 percent of the balance of the undisclosed account each year. Where the IRS cannot prove that the failure was willful, the law authorizes a penalty of up to $10,000. 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 (by filing or correcting a previously filed FBAR), the statute provides that "no penalty shall be imposed."

Under the 2009 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. However, 2009 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 a significant statement on which taxpayers relied. Given the statutory provisions described above, it seemed apparent 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, 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. The March 1 memo seemingly contradicts the IRS's statement in FAQ #35.

One Penalty Structure for All Taxpayers Is Improper

Without FAQ #35, the 2009 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, the 2009 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.

Many taxpayers who entered the 2009 OVDP were relatively "benign actors" whose primary reason for establishing and maintaining overseas accounts was unrelated to taxes. For instance:

- residents of Canada or other foreign jurisdictions who were born in the United States while their parents were temporarily working or vacationing here and have dual citizenship, but who have never lived in the United States and never filed tax returns here;

- people who inherited an overseas account or opened one to send money to friends or relatives abroad;

- 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.

Is Application of the March 1 Memo Fundamentally Unfair?

The IRS's March 1 "revocation" of FAQ #35 results in some similarly situated taxpayers who made honest mistakes being treated 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, even where the delay in processing the application was due to the IRS's tardiness in handling the file.

The March 1 memorandum and the "revocation" of FAQ #35, seems to violate fundamental notions of due process and fair dealing by giving taxpayers whose cases the IRS happened to process earlier a better deal than those whose cases it happened to process later. As the Taxpayer Advocate suggests, this is likely to undermine public trust.

In addition, even when making the FAQ #35 comparison, the IRS has applied 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. This is appropriate because "willfulness" is a common element that the government has to 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. 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 glaring cases.

Following the March 1 memo, the IRS 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. Thus, it has turned the IRS's burden of proof on its head.

The Opt-Out "Option"

The 2009 OVDP offered taxpayers dissatisfied with the penalty structure the opportunity to "opt out" of the program. Faced with growing concern about the "fairness" of its retroactive revocation of FAQ #35, and concern about the opt-out alternative, on June 1, 2011, the IRS issued a memorandum (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" of the 2009 OVDP. However, taxpayers opting out could hardly feel that they would not be treated differently, given the provisions of FAQ #34, which stated 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* (available to those who did not opt out).

Under these circumstances, it is unlikely that a taxpayer would believe that opting out was a viable option when faced with the consequence of the assertion of massive penalties. The opt-out "option" not only suggested increased civil penalties and assessment of additional taxes, but also included an even-larger consequence for those who dared to seek to be treated fairly. The opt-out memo cautioned 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."

Issues with the IRS's 2009 OVDP Penalty Structure

An issue with the IRS's 2009 OVDP penalty structure is that it will generally not consider willfulness or reasonable cause. The penalty structure proceeds from an assumption that all noncompliant actors should be treated as "bad actors" under the 2009 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 may be viewed by some as misguided. What taxpayer who has already come forward would take their chances with exam, given the IRS's pronouncements regarding how that examination will be conducted. In the examination, what standards will the IRS will use to compute an appropriate penalty—as the IRS's shifting position within the 2009 OVDP has demonstrated, it may not adhere to its most recent nonbinding pronouncement—and the taxpayers would be assuming a significant 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.

Thus, while the IRS's assertion that anyone may request that his or her case go to exam sounds logical, it does not appear to be a viable option. If the IRS refuses to consider nonwillfulness and reasonable cause within the 2009 OVDP, the practical result will be that the bad actors and the benign actors will both pay the same 20-percent penalty. That does not seem a fair or reasonable result.

Conclusion

Because of the foregoing concern, the Taxpayer Advocate issue the directive referenced above. The IRS operating divisions responsible for administering the 2009 OVDP have rejected the directive's most essential provisions regarding consideration of lack of willfulness and reasonable cause and the amendment of previously executed closing agreements imposing unwarranted penalties. The IRS Commissioner is required to respond to the directive by the end of January 2012.

For Further Information

If you would like more information about voluntary disclosure for offshore accounts, please contact Thomas W. Ostrander, the author of this *Alert*; Hope P. Krebs or Stanley A. Barg in Philadelphia; Jon Grouf in New York; Anthony D. Martin in Boston; any member of the International Practice Group; Michael A. Gillen of the Tax Accounting Group; or the attorney in the firm with whom you are regularly in contact.