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A Wish List for the Possible Second Offshore Voluntary Disclosure Program

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U.S. taxpayers with still-unreported offshore financial accounts may have another opportunity for absolution this year, but it could come at a high price.

IRS Commissioner Douglas Shulman said in December that the IRS is considering a repeat of its special program allowing taxpayers with unreported offshore accounts to come forward voluntarily in exchange for decreased penalties and a significantly reduced risk of criminal prosecution.

He emphasized that if the offshore voluntary disclosure program (VDP) is renewed, taxpayers should expect to pay higher penalties than under the program that ended in 2009. (For prior coverage, see *Doc 2010-26296* or *2010 TNT 237-2*.)

IRS officials wouldn't comment further on the likelihood of a second VDP. But following Shulman's announcement, practitioners have been compiling their wish lists for the possible new program and reflecting on its predecessor.

Because any new program would need to be seen as fair to those taxpayers who came forward under the prior VDP, higher penalties would be desirable. A second VDP would also require significant additional IRS resources to process new disclosures. Tax practitioners say there may be hundreds of thousands of still-noncompliant taxpayers who could opt to enter the program.

Those designing a new program "must acknowledge the difficulty facing the IRS in creating and administering another VDP program and the extreme differences between the taxpayers who remain in some form of noncompliance," said Charles P. Rettig, a partner at Hochman, Salkin, Rettig, Toscher & Perez PC. The wide variety of taxpayers who are still outside the system includes those who may have thought they complied with a treaty that they later discovered does not apply to the foreign bank account reporting regime; those who were unaware of the previous VDP; those who filed returns outside the prior VDP; those untroubled by the risk of being discovered; and long-term nonresidents, he said.

The first offshore VDP, which ended October 15, 2009, received significant public attention and 14,700 disclosures. Over a year later, tax practitioners are giving it mostly positive reviews. Kevin E. Thorn, managing partner of the Thorn Law Group, said that although there have been some bumps in the road, the government has generally done a good job with the VDP. "I think they'll have it down pretty well in any subsequent program," he said.

Caroline D. Ciraolo, a partner at Rosenberg Martin Greenberg LLP, praised the IRS for raising public awareness of filing requirements. "What the IRS has accomplished, with the workload that they've had, is impressive," she said. Rettig agreed, saying, "The IRS is to be commended for their efforts with respect to the prior VDP and working with taxpayers and practitioners in an effort to resolve the numerous issues that surfaced during the processing of approximately 15,000 separate matters."

Goal One: Minimize the Pain

Practitioners' first priority in a new VDP is to keep the penalty increase as small as possible. The prior VDP offered taxpayers a reduced penalty rate of 20 percent instead of the FBAR and other potential penalties that might have applied. Program participants also had to pay the tax owed and an accuracy-related penalty. Thorn said that in light of Shulman's statement that any new VDP would have a higher penalty, a 25 percent penalty would be ideal.

Other practitioners agreed. "We understand that the penalty will be higher," Ciraolo said. However, she said there is no need to raise it much beyond the previous 20 percent. Ciraolo said a much higher penalty could deter taxpayers from entering the program, since in some cases penalties already far exceed the tax owed. Thorn emphasized that the key feature of the prior VDP for taxpayers was the set penalty for failure to file FBARs. The lack of certainty regarding FBAR penalties has kept other taxpayers from coming forward after that program ended, he said.

The penalty attached to the safe harbor provision could also increase, from 5 percent to perhaps 7 to 10 percent, Rettig said. The safe harbor applies when the taxpayer did not open the account, there has been no activity in the account while the taxpayer held it, and all applicable taxes have been paid on the funds in the account. The standard has proven difficult for taxpayers to meet, according to practitioners.

The IRS could also reconsider which of the possible penalties would apply to participants. "Instead of an accuracy-related penalty, we might anticipate a 75 percent civil fraud penalty for a single year," Rettig said.

Rettig also suggested that any future program allow de minimis exceptions for all penalties. He said the IRS should not waste limited resources on processing amended returns and determining penalties for interest in foreign accounts totaling less than $50,000 because doing so would hinder the search for taxpayers who have yet to come into compliance.

Penalty Relief

Practitioners said they would also like to see a mechanism for handling special cases that might merit reduced penalties. Many people who came forward under the prior program didn't know that they had an FBAR filing obligation, and some had been out of the United States so long that they were almost certainly off the IRS's radar, practitioners said. The original VDP provided no systematic way for those taxpayers to determine if they might qualify for reduced penalties.

Building flexibility into the system would help lawyers reduce the concerns of prospective VDP participants, who want to know that the IRS will at least hear them out, said Mark E. Matthews, a partner at Morgan Lewis & Bockius LLP. "There needs to be flexibility, because it is a herculean effort to get relief on these [special] cases," he said, noting that the IRS already has a team of technical advisers to the VDP that could evaluate requests for penalty relief.

Others agree that a forum for evaluating possibly mitigating circumstances should be included in a second program. Kathryn Keneally, a partner at Fulbright & Jaworski LLP, said it is important that revenue agents have discretion to reduce penalties when the taxpayer did not act willfully.

"There are many examples where mitigation is appropriate, ranging from people who live and work outside the United States to those who maintain foreign accounts because they lost family in the Holocaust or other horrific events," she said. There are several reasons why taxpayers don't report accounts, such as accountants' mistakes and return preparation software that checks the question box regarding foreign accounts "no" by default, she said, adding, "More people will come into compliance if they have a chance to be heard on these issues."

One way the IRS could clarify the criteria for reasonable cause relief for taxpayers and their lawyers is through the use of hypothetical examples. Ciraolo said the IRS could provide examples of what constitutes reasonable cause -- either based on hypothetical cases or on actual examples from the prior VDP -- in frequently asked questions. The prior VDP had a set of FAQs that will have to be updated and reissued for any future program.

"Hypothetical examples of reasonable cause will be much appreciated by the practitioner community," Ciraolo said, adding, "It took a lot of work to get to the point where someone from the IRS would have a conversation about adding, "It took a lot of work to get to the point where someone from the IRS would have a conversation about reasonable cause" in the prior VDP. Ciraolo said it would be helpful if the IRS would address in FAQs what role the Internal Revenue Manual penalty mitigation guidelines will play in the new VDP.

Procedural Issues

More written guidance, perhaps in reissued FAQs, could provide certainty to taxpayers and their lawyers. Ciraolo said the pre-clearance procedure needs written clarification. "How does a practitioner request pre-clearance? What information needs to be provided? What guarantees come with an 'all-clear' response? Can the Service come back and say, 'We made a mistake'?" she asked. She added the program's opt-out procedure to the list for inclusion in future guidance.

Also, in some cases under the current VDP, revenue agents provided spreadsheets calculating alternative penalties under FAQ 35. Ciraolo would like FAQ 35 to be a part of the new VDP and the FAQ 35 spreadsheets to be included with every closing agreement.

Ciraolo also said that although the advance payment provisions of the VDP have been helpful, there should be better coordination within the IRS to avoid random notices about payments and inadvertent refunds of payments before closing agreements are executed.

When? And How Long?

Timing is another major consideration for practitioners. "We are all very hopeful that it will come out soon," Ciraolo said, adding that taxpayers who made post-October 2009 disclosures need to know how they will be treated. An announcement well before June would help bring taxpayers into the system early enough to file a timely FBAR for 2010. Also, to promote compliance, the deadline for entering the new VDP should not fall on a tax return filing deadline, she said.

The previous VDP was scheduled to last six months but was extended once, to October 15, 2009, from the original September 23 deadline. Thorn said that a yearlong open amnesty period would be welcome and would help bring taxpayers in. Matthews said the IRS should consider implementing the program without a set expiration date. Setting a firm deadline requires any subsequent program to have higher penalties, and higher penalties reduce the incentive to come in, he said.

Rettig agreed that a new VDP should have no deadline. "A new VDP should be in the form of the mitigation guidelines in the IRM and reflect ongoing IRS policy with respect to previously undisclosed interests in foreign accounts. Efforts to increase foreign account compliance should not be allowed to destroy the overall voluntary disclosure practice of the IRS and the Department of Justice," he said.

Keneally added: "As diligently as the Service has worked to get the word out, there will always be people who get the message later in the process. The program can always be terminated with sufficient advance notice. It is clear that enforcement activities in this area will be ongoing, so the opportunity to come into compliance voluntarily should be ongoing too."

Other Lessons From the Past

However it may be designed, any subsequent program will benefit from administrators' experience. Although the administration of the VDP has not been entirely smooth, practitioners have seen signs of flexibility at the IRS that should help in processing a second wave of disclosures.

A major stumbling block for the VDP was how to deal with the passive foreign investment company regime, which applied to many of the foreign mutual fund investments that participants held in their overseas accounts. The IRS solved the problem with an extrastatutory regime that allowed participants to follow a mark-to-market method for all their PFIC investments, thereby simplifying the statutory calculations that required documentation that was often unavailable. (For prior coverage, see *Doc 2010-20058* or *2010 TNT 177-3*.)

The IRS also generally allowed taxpayers in the VDP to disregard sham entities that had been used to avoid the qualified intermediary withholding regime for filing purposes, requiring only that the entity be terminated by the date of the closing agreement.

Practitioners uniformly support continuing both of those solutions.

Ciraolo also suggested that the IRS designate a select number of IRS employees trained in PFIC calculations to respond to PFIC-related questions from taxpayers, practitioners, and revenue agents. The group could issue FAQs to promote consistency and to avoid having to continually answer the same questions, and it could even make available an evolving list of investments that the IRS has considered to be PFICs in other cases.

Another procedural problem that has affected the VDP is the insistence of some agents on having signed Forms 872 to extend the statute of limitations, Matthews said.

Any new VDP should limit the imposition of the miscellaneous/offshore penalty on financial accounts subject to disclosure on the FBAR, said Ciraolo. The values of other assets, such as real estate or foreign entities, are beyond the scope of the civil FBAR penalty and should not be included in miscellaneous/offshore penalty calculation, she said. Instead, any potential penalties for failure to file other disclosure forms such as forms 3520, 3520A, or 5471 should be replaced by the miscellaneous/offshore penalty, which is imposed in lieu of all other applicable penalties, she said. Ciraolo noted that penalties imposed for failure to file such forms are likely subject to reasonable cause arguments, since many taxpayers are unfamiliar with those filing requirements.

In announcing the new program, the IRS should issue as many of the documents as possible in multiple languages, said Ciraolo. Near the end of the last program, the IRS issued announcements in Chinese, French, Korean, Russian, Spanish, and Vietnamese, but for many taxpayers with offshore accounts, they came too late. Ciraolo said the IRS has an opportunity this time to reach a much broader audience, including many taxpayers for whom English is a second language.

Bringing Taxpayers In

Regardless of what the new deal offers, taxpayers may still refuse to come forward.

"Unfortunately, there are also a fair number of people who feel that they can take their chances. Some people think that the risk involves only particular banks or countries. If there is well-publicized enforcement involving other banks and other parts of the world, more people will come forward," Keneally said.

Also, some taxpayers who believed they had low culpability considered the original 20 percent penalty high, and that may have kept some of them from coming forward under the original program. Some who are now in the VDP have expressed frustration at the apparent intransigence of IRS officials who refuse penalty relief in situations with mitigating circumstances. And although a pre-clearance letter from the IRS Criminal Investigation division is generally sufficient to stave off criminal charges, the DOJ reviews every disclosure case on the merits for criminal prosecution. (For prior coverage, see *Doc 2010-25849* or *2010 TNT 233-5*.)

As a result, taxpayers who are fairly sure they aren't criminally liable are increasingly considering making a riskier quiet disclosure by filing returns and paying back taxes instead of coming forward through the formal voluntary disclosure process, according to practitioners. That is not ideal for either the taxpayer, who faces the possibility of higher penalties if audited before the statute of limitations closes, or the IRS, said Matthews.

The price of non-disclosure could be high. The civil penalties for failure to file an FBAR include the greater of $100,000 or 50 percent of the value of the account at the time of the violation. Criminal penalties include a fine of up to $250,000 or five years in jail, or both. Additional penalties may also apply. Some practitioners expect that the IRS will seek to apply all available penalties against taxpayers who fail to use the voluntary disclosure process. (For prior coverage, see *Doc 2010-23978* or *2010 TNT 216-1*.)

Administrative Challenges Ahead

For many taxpayers with unreported foreign accounts, a prompt announcement of a second offshore VDP would mean a major benefit. However, the IRS has many issues to consider in designing a new program, including how best to use its resources. Another penalty concession, even one slightly higher than that offered under the prior VDP, would likely entice many more taxpayers to come in -- a boon to the tax system, but also a possible administrative challenge.

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