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No Factual Determinations Made in Offshore Disclosure Initiative, IRS Official Says

by Jeremiah Coder

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The IRS's new offshore voluntary disclosure initiative (OVDI) does not permit agents reviewing the disclosures to make factual determinations about factors like willfulness or reasonable cause, said a senior IRS official on May 7 in remarks designed to clear up misconceptions about the program's procedural rules.

John McDougal, special trial attorney and division counsel in the IRS Small Business and Self-Employed Division (SB/SE), said that "this is the way the commissioner intended the program to work" in 2009, but miscommunication within the agency caused some agents to make determinations in easy, clear cases. "We thought it was blessed, but it wasn't," he said at the Civil and Criminal Penalties committee of the American Bar Association Section of Taxation meeting in Washington.

The 2011 program states that "the only comparison that is to be done within the program is the offshore penalty versus the maximum possible statutory penalty," McDougal said. If the maximum penalties are less than the offshore penalty, that is what the IRS will apply. Taxpayers wanting a determination about willfulness or reasonable cause must opt out of the program and ask for an examination, he said, in which case "all years, all penalties are on the table."

The OVDI announced in February is different from the long-standing criminal voluntary disclosure practice because the civil initiative "only tells you how the Service is going to treat you on the civil side in determining what you owe and have to pay," McDougal said. The goal of the 2011 program, which ends August 31, is to provide "predictability and certainty" about how taxpayers will be treated when a voluntary disclosure is made, he said.

McDougal said the new lower penalty tiers laid out in the 2011 OVDI are available to taxpayers who made disclosures before the announcement of the new program, meaning the IRS will open closed cases to consider lower penalties when taxpayers believe they fall into the appropriate framework.

Under the OVDI frequently asked questions, it is explicit that the penalty taxpayers pay under the program is "a proxy for everything the Service is giving up," McDougal said. "It is not an FBAR penalty," he said, correcting the prevalent misunderstanding that it was a substitute penalty. The FAQ also makes clear that noncompliant accounts include "those that have untaxed money that should have been taxed in the account, not just accounts that are currently producing income that's not being taxed," he said.

Mark E. Matthews, a partner at Morgan Lewis & Bockius LLP, said the tax bar has been adjusting to the new voluntary disclosure programs. One challenge has been that

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the IRS seems to view all participants in the civil initiatives as coming in with significant criminal exposure. The 2011 initiative lacks a fail-safe mechanism to discuss a taxpayer's willfulness, leading to difficult practitioner discussions with clients, he said. "The perception is that some agents are leaning very hard to keep you in the program, to keep you from opting out."

Larry A. Campagna of Chamberlain, Hrdlicka, White, Williams & Martin said it is a big problem that the program seems to "make a presumption of willfulness." Under the FBAR regime, the government has the burden of proof in showing willfulness in order to collect the penalty, he said. For taxpayers considering making a quiet disclosure, there is significant risk of all possible penalties and all open years.

McDougal acknowledged that taxpayers opting out of the initiative would face normal exams in which agents consider all potential penalties and years. Agents are now expected to determine whether "older years are open under an exception to the statute of limitations that will allow them to go back," he said, but generally the IRS will only be able to go back six years absent indications of fraud. Agents will reach appropriate resolution based on all the facts, and taxpayers have traditional appeals rights to contest any conclusions made in the exam, he said. No set of rules exists on how Appeals should handle the cases, he said, but offshore cases don't lend themselves to the coordinated issue approach. Taxpayers who enter the program but then opt out will have the same agent conduct the exam, he said.

Campagna asked if the IRS might offer an expedited review of the willfulness factor in light of the short program window. McDougal said there was no presumption of willfulness in a disclosure case, but noted that the initiative "is an offer to resolve cases. If you want to take the offer, take the offer. If you think you got a slam dunk willfulness argument, then you shouldn't take the offer, you should go for an examination." But there is no specific fast-track procedure, he said.

Audience members raised the problem of dual residents who innocently didn't realize they had a U.S. filing requirement but may be subject to losing 25 percent of their net worth under the 2011 initiative. Matthews said he is cautiously optimistic the IRS will release guidance soon, perhaps on that issue. McDougal acknowledged that taxpayers who believe they have no tax liability and no risk of criminal prosecution may end up deciding to wait a little longer before entering the program.

Scott Michel of Caplin & Drysdale said the number of Americans living abroad who want to come into compliance is the biggest issue facing practitioners, "but the one size fits all of the program makes the decision difficult." McDougal said that even if an FBAR is filed, a taxpayer is technically noncompliant if any tax is not paid, including incorrectly reported interest. It is reasonable for CI to require taxpayers to sign an extension of the statute of limitations, he said.

Speaking from the audience, Samuel Berman, special counsel, IRS Small Business/Self-Employed Division, said foreign individuals deemed "in and doing business" in the U.S. are no longer subject to an FBAR filing requirement. That language, spelled out in the 2008 version, was dropped in the recent FBAR revised form and instructions and is no longer part of the "definition of who has to file," he said.

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Matthews said that under the 2011 initiative, nonfinancial assets are now "potentially in the penalty box" if in any way connected to tax noncompliance. McDougal said the connection to nonfinancial assets subject to the penalty are funds used to acquire the asset that were improperly taxed.

"The commissioner expects that the complete disclosures will have been made of any returns in the works" by the August 31 deadline, McDougal said. That requires gathering more information upfront, including from questionnaires that help the IRS broaden its efforts to uncover noncompliance. All disclosure cases are being triaged in the Austin service center, with hopes that easy cases can be closed to free up agent resources to spend on the more difficult cases, he said.

Matthews said that with the approaching deadline and large amounts of information that must be submitted, any incomplete disclosure package should be infused with "showing as much good faith as possible." McDougal said the IRS will "help the taxpayer formulate a request to the taxpayer's bank and help use appropriate language that should in our opinion get the appropriate result, but it doesn't mean we will intervene between the taxpayer and the bank."

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