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Tax Evasion

IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year


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They would like to thank their partners and associates and the dozens of experienced and talented colleagues in the civil and criminal tax penalty bar who shared their experiences and concerns over the past year regarding the issues discussed herein.

Exactly one year ago, the tax world watched as the Internal Revenue Service conducted what may have been the most extraordinarily successful tax compliance feat in American history.

Earlier that year, senior prosecutors in the Tax Division of the Department of Justice, working with IRS, breached the generations-old wall of bank secrecy in Switzerland, sending a clear signal to Americans with undeclared foreign accounts that they are at serious risk of their previously sacrosanct bank account records being turned over to U.S. authorities.

The DOJ-IRS enforcement initiative in Switzerland was successful on multiple fronts.

The enforcement initiative was successful on multiple fronts:

- Federal prosecutors obtained indictments of and guilty pleas from account holders at UBS and charged Swiss lawyers, financial advisers, and other third parties with assisting U.S. taxpayers in tax evasion.

- The DOJ's Tax Division and the U.S. Attorney's Office for the Southern District of Florida reached an unprecedented deferred prosecution agreement with UBS that entailed the abrupt disclosure of more than 250 account holders' identities and account information, and reforms in the banking practices of one of the world's largest financial institutions.

- The DOJ and IRS persuaded the Swiss government to relax its long-standing barriers to treaty-based disclosures and to expand the types of cases in which the Swiss authorities would authorize the release of bank information.

- Capitalizing on the revenue needs and tax noncompliance in other countries, the U.S. government appears to have inspired (or is likely actively working with) other foreign governments to move against other worldwide financial institutions that are holding unreported assets.

- While not a matter of public record, we suspect that IRS's new Whistleblower Office has attracted tips and informants from around the world, including lists of names provided by private bankers or information technology personnel who saw an opportunity to claim a hefty reward.

• Buoyed by these recent successes and motivated by the near certainty that many more Americans have undeclared accounts in foreign financial institutions, the U.S. Congress passed, and President Obama signed this past March, the Foreign Account Tax Compliance Act (FATCA), which is likely to revolutionize the concept of "information exchange" where foreign bank accounts are at issue.

At the same time last year, IRS's Criminal Investigation Division, working with senior IRS management, developed a settlement initiative to encourage Americans with undeclared foreign accounts to come forward to make voluntary disclosures, and to agree in most instances to pay back taxes and interest for six years and a civil monetary penalty that, generally, would be capped at 20 percent of the highest balance of their foreign accounts over that period.

There were a few early bumps in the road in the program, which we will term the Offshore Voluntary Disclosure Initiative (OVDI). Just weeks after the OVDI was announced on March 23, 2009, however, CID had:

• created an efficient process that reduced the amount of agent (and practitioner) time needed to process each case;

• obtained for IRS useful, if not essential, data on the promoters and instrumentalities of offshore-based tax evasion and other noncompliance; and

• enabled tax practitioners nationwide to spell out for clients, and potential clients, the benefits of entering the program.

When the OVDI ended on Oct. 15, 2010, some 14,700 U.S. taxpayers had come forward to tell IRS about their secret foreign accounts. In doing so, they named their bankers and other advisers; agreed to pay tax, interest, and penalties; and also committed to bring, undoubtedly, billions of dollars in assets that could be taxed in the future back into the tax system. [1]

[1] To our knowledge, for the first half-century of the IRS criminal voluntary disclosure program, "noisy" disclosures—those that entailed an affirmative contact with CID to initiate the process, as required by the OVDI—never surpassed 100 per year nationally.

CID's initiative artfully aligned the interests of IRS, taxpayers, and practitioners in encouraging compliance in an efficient and effective manner, and by any measure, CID's achievement ranks in the upper tier of tax compliance successes ever implemented.

A year later, the mood in the tax community concerning the OVDI has soured somewhat as a result of how the OVDI cases are being handled in their civil phases, and the offshore enforcement program has lost momentum, just at the moment when IRS had maximum opportunity to exploit and expand its early success.

The mood in the tax community concerning the OVDI has soured somewhat as a result of how the OVDI cases are being handled in their civil phases, and the offshore enforcement program has lost momentum.

IRS should be processing yet thousands of new voluntary disclosures of accounts beyond Switzerland, motivated by the impressive criminal enforcement actions by the United States and other governments and the enactment of FATCA.

Instead, seasoned civil IRS revenue agents have been diverted from more productive tax compliance activities into minutiae and even trivial issues.

Private practitioners, who for all practical purposes had "sold" the OVDI to vast numbers of clients, are now warning new clients of the hazards of the ongoing civil audit process.

This situation can be rectified with quick action by IRS, and as tax practitioners and payers, we hope IRS changes course.

Some Seeing 'Bait and Switch'

We believe the momentum generated by CID first foundered during the new audit or review phase implemented for OVDI cases.

To be sure, some approaches IRS has adopted are commendable, expeditious, and sensible mechanisms for

the processing of these cases. This is particularly so as to sham entities created by taxpayers to hold foreign accounts and avoid withholding on U.S. investments, and as to passive foreign investment companies, or PFICs.

In other areas, beginning with delays in the assignment of cases to agents and meaningless administrative requests, and now, particularly, with regard to civil penalties, the service has taken steps that are discouraging practitioners and that represent to some a “bait and switch” with regard to the program.

Ethically obligated to advise clients of their various options to deal with a previously undeclared account, many practitioners find that when they explain what is happening to participants in the OVDI, particularly in the penalty context, recent potential clients are opting not to come forward, with many walking out of law and accounting offices to mull over their other options. Even field level IRS revenue agents and their managers —doing their best to process the thousands of ongoing audits in a professional manner—are expressing frustration to tax practitioners over what has happened to the program.

It is not too far off to say that in transitioning these cases to the civil side, IRS may be snatching defeat from the stunning set of results obtained last year, potentially burdening IRS for a generation to come with a sense of uncertainty, if not distrust, from the community of tax practitioners who operate as the initial gatekeepers to clients that are seeking a way out of a tough situation.

More important, if the situation is not remedied, the service may do lasting damage to an important component of its tax compliance function, the decades old voluntary disclosure policy (VDP).

In the program's current posture, IRS has neither the capacity to leverage that victory to thousands of additional taxpayers and the private sector has little enthusiasm to assist in that effort. This 180-degree reversal in less than a year strikes us as a regrettable turn of events.

The purpose of this article is to attempt to catalog in one place the perspective from the private sector on this ongoing program. We recognize the incredible demands on the time and attention of all IRS personnel, from senior officials to the line agents and their managers, as well as the utmost good faith it takes to operate an effective compliance program. But we hope this summary perspective from the taxpayer side will cause a reassessment of some of the current procedures, especially if IRS hopes to fully exploit its historic enforcement victory.

OVDI—Context and Early Implementation

For decades, IRS has recognized that it is vital to tax compliance policy to have a mechanism where taxpayers who have sinned, but who have not yet been caught, can come back into compliance without fear of criminal prosecution. Among the many reasons for such a policy is the indisputable fact that IRS does not have the resources to catch every noncompliant taxpayer, and that it is far more efficient to encourage people to come forward on their own than to try to detect and pursue everyone who has cheated on their taxes.

Indeed, an effective VDP is particularly apt for the current international enforcement environment, especially given the rapt attention paid by the popular financial media. IRS can capitalize on and reap broad benefits from recent enforcement victories without having to conduct the time- and resource-intensive international investigations that would otherwise be required to bring most taxpayers into compliance.

Thus, in various iterations, IRS has had a VDP in place since the middle of the last century. In a nutshell, the policy has provided that IRS will not recommend criminal prosecution for any person who:

- comes forward before IRS is aware of his or her noncompliance;
- makes a truthful and complete disclosure;
- pays, or makes good faith arrangements to pay, all liabilities; and
- cooperates with any ensuing audit.

Until the OVDI, we and our colleagues routinely advised our clients of this policy, and of their options to come forward. With such a policy, IRS provides a vehicle to bring wrongdoers efficiently back into the tax system. Most states, and many other countries, have similar programs. It is “black letter” tax compliance policy that having such a mechanism in place is an important component of fostering voluntary compliance.

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In the foreign account area (where detection and enforcement is particularly challenging), IRS has had some false starts in its multidecade effort to crack offshore secrecy. In the 1980s and 1990s, the service appeared to make enforcement in this area a priority. IRS obtained information from key private bankers about the Cayman Islands and other offshore havens, issued summonses to credit card processors, and implemented two programs, the Offshore Voluntary Compliance Initiative and the so-called Last Chance Compliance Initiative, to encourage Americans to come forward and disclose their foreign accounts.

These programs were only marginally successful in bringing in U.S. taxpayers, largely because they were not accompanied by vigorous enforcement. The whole concept of voluntary disclosure is the classic "velvet glove/iron fist" strategy—without the iron fist, the velvet glove is not terribly welcoming.

What happened last year was different, largely because the Justice Department and CID moved with great effect, and a lot of publicity, to exploit enforcement opportunities and open up Swiss bank vaults to the inspection of U.S. tax authorities for the first time. This extraordinary set of events enabled IRS to implement the OVDI on March 23, 2009, and to encourage Americans to come forward.

The program had a rocky beginning. CID offices around the country adopted different procedures. Some offices at first insisted on interviewing every taxpayer coming forward. CID offices were inconsistent in offering to "pre-clear" a taxpayer, meaning that before the taxpayer provided information, CID would check to see if his or her disclosure would be considered timely. CID personnel developed a list of 35 questions, many of them irrelevant to VDP criteria, that all participants were initially required to answer. As interested clients began to flood CID offices, particularly in major urban centers, there was a risk that the OVDI would bog down and, like its predecessor initiatives, fail.

But once CID effectively assessed the taxpayers coming forward and gauged the resource drain of its procedures, it turned on a dime and implemented a nationwide, uniform process that was largely consistent with the historical VDP, that was easy for practitioners to explain to the clients, and that made far more efficient use of CID resources.

In brief, CID offices were authorized to conduct pre-clearances to assure nervous taxpayers that their disclosures would not be bounced because a name had already been turned over, and then to accept voluntary disclosures on a short form "intake letter," signed under penalties of perjury, that provided the information for CID to determine whether the case met the contours of the VDP and to build a substantial data set to help target future criminal enforcement efforts.

The system worked well. Most of the taxpayers who came forward would likely never have been caught by IRS, even though many of them unquestionably committed serious and intentional criminal tax offenses by deliberately using offshore financial accounts to hide unreported income—some for decades. Moreover, even if they had been nabbed in an audit or investigation, many of these taxpayers would never have been prosecuted. Many were elderly, others had inherited accounts they had barely touched with funds never earned in or transferred to the United States, and some came from families with extraordinary personal circumstances—the Holocaust or the Iranian Revolution, for example—that would have presented obstacles to even the most effective federal prosecutor in persuading a jury that criminal conduct had occurred.

But Americans from all over the world came forward in droves. In doing so, they named their bankers, lawyers, and financial advisers, which provided IRS with reams of leads for future investigations, treaty requests, and other enforcement initiatives. Clients felt relieved to have solved their problems, many having lingered for generations before doing so—often afraid that coming forward would imperil other family members. For tax practitioners the practice was gratifying: We were helping our clients solve a problem that had kept them up at night, or, they feared, that would burden their children after their deaths.

If there was ever a convergence of interests among IRS, the tax practitioner community, and, candidly, thousands of noncompliant taxpayers, this was it.

The OVDI Moves to the Civil Phase

Once a taxpayer cleared through the Criminal Investigation Division, under the OVDI the case would then be referred for civil examination. This is where the OVDI, in our view, has broken down to some extent. To understand this, one must appreciate how voluntary disclosures have been treated in a civil context previously.

Until the OVDI, 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.

And for those who came forward with "noisy" disclosures, in which an audit was more likely, the Examination Division recognized that treating such taxpayers with a degree of fairness and proportionality was important to the overall VDP. After all, what lawyers and accountants would strongly recommend coming forward to clients when, in a prior case, a client had been hit with disproportionate or even maximum penalties?

To be sure, Congress gave IRS the leeway to extract extraordinary penalties for failing to report foreign accounts, and we understand the importance for IRS to respond to that grant of authority and use it. Beginning in 2004, willful failure to file the Report of Foreign Bank and Financial Accounts (FBAR) became subject to a penalty of as much as 50 percent of the account balance, per year. So a multiyear willful failure to file could result in a confiscation of an entire account and then some. Additional penalties exist, of course, for fraudulently underreporting one's income (75 percent of the tax), and for willful failure to file other special forms and schedules associated with maintaining interests in foreign trusts, corporations, or partnerships, or with the receipt of foreign-source gifts or bequests. But in the past, presumably recognizing the importance of a bona fide VDP, IRS has been more active in imposing these penalties in routine audits or investigations than in voluntary disclosure cases (although in our experience, even the assertion of such penalties in audits have been quite rare).

Notwithstanding the general paucity of penalty assessments in the past, in implementing the OVDI, IRS offered what appeared to be a deal that could not be ignored. Given the possibility of multiyear FBAR penalties, taxpayers would face a capped penalty of no more than 20 percent of their account value at its highest balance in the last six years. IRS also offered a narrow safe harbor for a 5 percent penalty, essentially for cases of inherited or gifted accounts, with tax paid (or non-U.S. source) funds, and where the recipient had not used the money.

We should acknowledge that we thought at the time that these provisions would be too punitive in some cases (and the 5 percent safe harbor far too narrow), and we still believe that IRS would have brought in twice as many persons with a more lenient framework, or at least a program that explicitly allowed a consideration of reduced penalties in a wider variety of cases.

Having said that, we fully appreciate that from IRS's perspective, some form of punitive sanction was essential, if for no reason other than to reinforce a sense of fairness to the general public that these taxpayers were getting more than a slap on the wrist. (This is especially the case because the media image of these taxpayers emphasizes the most extreme examples of willful evasion.) In this regard, IRS likely viewed the penalty framework as a reasonable compromise designed not to offend the senses of the general public while still making a tempting invitation to those persons with undisclosed accounts. IRS surely views the fact that thousands still came forward as proof that judgment was correct, and it is hard to quarrel with that judgment.

As to how participants in the OVDI viewed the terms of the program, that often depended as much on their overall net worth and their psychological makeup as anything else. For persons whose undeclared foreign accounts represented a small portion of their overall wealth, the program's benefits were obvious—the 20 percent penalty did not exact much of a cost at all. For others, whose offshore assets comprised most of their net worth, the financial sanction is much more painful, especially given the overall decline in portfolio values since 2007 and the imposition of the 20 percent penalty on the highest balance in the past six years.

Many who came forward had emotional issues in addressing situations set up by their parents or grandparents; others found it a welcome development—just the push they needed.

In all events, for many, the combination of "peace" on the criminal front and a cap on the financial sanction was a deal too good to pass up, and far more beneficial than a strategy of hiding and hoping that IRS would never discover their accounts.

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Clarification on Civil Penalties

As with any federal tax issue, of course, there were clarifications and fine print to handle. So IRS issued a series of "Frequently Asked Questions" (concededly at the request of the practitioner community) to address various nuances of the program. There are considerable issues raised by these FAQs, but with regard to the civil examination function and the civil penalty framework, practitioners focused on at least three.

First, quite appropriately, IRS said that if anyone had failed to file an FBAR for a foreign account as to which there had been no taxable income, or as to which income had been reported, no penalty would be assessed (FAQ 9). This seemed utterly fair, especially given the various types of "signature authority" relationships given to family members, business associates, and others, which should not warrant the imposition of monetary sanctions, and given the relative ignorance regarding the FBAR in the taxpaying public until 2008.

Second, for those clients who felt like they had a reasonable explanation for failing to report their foreign account, FAQ 35 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.

Practitioners read this as saying, in essence, if a client has legitimate reasons why a penalty should not be imposed, those reasons will be evaluated and penalties would be fairly applied.

Third, the FAQs dealt with the failure to report entity accounts. This was somewhat surprising to practitioners, because the rules on FBAR reporting for entities have been confusing for years, and none of us could recall a penalty examination, much less a penalty imposed, in such cases. However, the FAQs provided that where there was any income tax noncompliance arising in an unreported foreign entity or as to an undisclosed foreign asset, the value of that entity or asset would be included in the penalty calculation (FAQ 20). Practitioners took comfort, however, in the guidance in FAQ 35 assuring that under no circumstances would a taxpayer have to pay more under the program than the Internal Revenue Code would authorize.

Tax practitioners interpreted this combined guidance as creating a mechanism for the processing of reasonable cause arguments, especially in cases of little or no unreported income, or in cases of nonwillful tax noncompliance, such as the omission of income from a controlled foreign corporation known to the taxpayer's return preparer. Most of us told our clients that while it would be a waste of time to ask for lenience in a case of willful noncompliance, we believed IRS would listen to practitioners whose clients had unusual circumstances or even reasonable cause arguments, and, as they had been for decades in the processing of voluntary disclosures, have some appreciation that not all taxpayers with undeclared accounts were crooks.

So with FAQs in hand, and our prior experience as a guidepost, we waited for the cases to process through CID and be assigned to revenue agents. And when this started to happen (somewhat belatedly), the OVDI quickly changed from a smooth, efficient mechanism that was attractive to thousands of taxpayers to an audit process that has bogged down in delay, technicalities, unexplainable bureaucratic demands, and ultimately, the appearance that IRS is not prepared to consider mitigating circumstances of any kind to avoid imposition of the 20 percent asset-based penalty.

And this story has just begun. With the hundreds of clients in our firms' combined practices who have participated in the OVDI, we have signed exactly five closing agreements. On current timelines, IRS will be spending thousands of agent hours on the original 15,000 cases from 2009 well into 2011, if not beyond.

Implementation of the Civil Function

An initial group of cases passing to the civil side were assigned, apparently randomly, to well-meaning agents for a full and complete audit. To us, this appeared to be a waste of resources. Most of the taxpayers who entered the OVDI did so under the advice of competent tax professionals who knew that filing inaccurate returns in the middle of a voluntary disclosure was, in short, the surest way for their clients to go to jail.

We and our colleagues were quite confident that the amended returns being filed would be accurate, and we could not understand why senior IRS personnel seemed to think otherwise. As we frequently pointed out, why would these taxpayers take the step of raising their hands to come forward, only to begin new criminal acts of deception?

But IRS officials were apparently concerned that these clients were still at risk of trying to cheat, so the initial tranche of OVDI participants assigned to agents received regular exam audit treatment—requests not just for foreign bank statements, but for all domestic accounts as well; inquiries into line items on the original returns that had nothing to do with a foreign account; demands for interviews with the taxpayers, etc.

Undoubtedly countless hours have been spent by agents reviewing essentially meaningless issues, all apparently in the name of measuring compliance among a group of amended returns filed by taxpayers who knew their disclosure had to be truthful and complete or they risked criminal prosecution.

Some of these full-bore first-round audits involved small accounts. In a few of our cases, the foreign accounts were worth less then $50,000—the tax at stake less then $10,000, and in a few cases, less than $1,000. (Many of these examinations, begun late last year, are still ongoing.)

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After three months or so, a second tranche of cases were assigned to placeholder agents working out of the Philadelphia Service Center, the IRS center responsible for most international tax reporting issues. Taxpayers received information document requests (IDRs) asking for a variety of documents, and compiling the material took some time. Practitioners who called the agents on the IDRs to seek extensions—which are routinely granted in most audits—were ignored, and we were at an utter loss as to what to do. No human being, apparently, was authorized to interface with us.

Finally, the logjam broke in the spring of this year, and these and other cases were assigned to a group of revenue agents. Senior IRS personnel conducted training sessions and crafted a new, more abbreviated form of IDRs, and the practitioner community believed that, finally, the audit function seemed to be moving along so these cases would be resolved efficiently and rapidly.

We acknowledge that there were significant delays caused by the process of seeking foreign records and the return preparation process itself, as accountants preparing our clients' amended tax returns had to fit that work around existing current year deadlines. These delays are continuing—many foreign banks remain slow in providing statements or other assistance, and over the next few weeks, accountants will face the Oct. 15 deadline for extended 2009 income tax filings.

On the other hand, as to many cases submitted to CID during the OVDI period, we have yet to hear from a revenue agent. We suspect that IRS will begin to put increasing pressure on practitioners to complete the required OVDI submissions. We hope they understand that much of the delay in closing out these cases has originated with action, or inaction, by the service, and that we and our colleagues are doing the best we can to move the cases forward.

Practitioners had to prepare forms anew for sometimes large families of clients literally scattered over the globe. Our clients believed that we had made a mistake and they were being forced to pay more professional fees as a result.

The first series of obstacles were almost frivolous from the private sector perspective. Suddenly IRS demanded new powers of attorney (Forms 2848) in accordance with a prescribed form. [2] After weeks of communication based on 2848s that had been acceptable to CID, some revenue agents would not speak to us until a new POA was on file based on a form prescribed nationwide. Practitioners had to prepare forms anew for sometimes large families of clients literally scattered over the globe. Our clients believed that we had made a mistake and they were being forced to pay more professional fees as a result.

[2] The new form was neither legally necessary nor required by IRS policy. It was designed to add to the POA the Title 31 FBAR penalty (which was not, in any event, technically being imposed—the form closing agreements treat the 20 percent asset-based penalty as a "miscellaneous penalty" imposed under Title 26). If there was an issue at all (and we do not believe there was), it could have been resolved with a one-page memorandum of understanding with Treasury's Financial Crimes Enforcement Network.

Then, our clients were asked to extend the civil statute of limitations by signing a Form 872 for just one of the years in the OVDI program, 2006. Remember that these are taxpayers who essentially admitted to engaging in fraudulent conduct to CID in their intake letters, and who had also committed to IRS to file amended tax returns dating back to 2003 (and could be thrown out of the OVDI and prosecuted if they failed to file those returns).

We still do not understand the logic of this request (and neither did most of the agents with whom we dealt). [3] But again, clients were forced to absorb a few hundred dollars more in legal and accounting fees, because every taxpayer in the program has had to sign these waivers. Even in cases where, technically, a three-year statute would have run, agents are still being directed to obtain these waivers. The request for 872s led to another round of panicked calls from clients about what this all meant. [4]

[3] The only plausible theory we can construct is the fear that a few taxpayers might "opt out" of

the program, but the continued availability of multiple open years, criminal sanction "sticks," and multiple 50 percent FBAR penalties makes that concern de minimus compared to the burdens imposed on IRS and practitioners.

[4] Of course, unlike the POAs, the 872s must be filed with multiple original signatures, creating logistical burdens on taxpayers scattered around the world. Problems in this area continue—an agent recently advised us that she had been directed to reject an 872 because notwithstanding the proper original signatures, it was not on the green paper original form.

And then, having secured this waiver for 2006, predictably, IRS agents, citing pressure from above, have been demanding prompt production of amended returns and FBARs even, in some instances, contacting our clients directly when a phone call to a practitioner is not returned within a matter of hours.

Agents continue, even as this article goes to press, to waste precious audit resources scrambling for new POAs and 872s. In fact, we just received a first request for an 872 for Tax Year 2007 "because that statute will expire in April 2011" according to the agent, meaning practitioners face yet thousands more unproductive exercises.

Some Progress

A new series of problems with a more technical tone began to emerge, and here, IRS has made considerable progress, which will save weeks of audit time. The problems manifested themselves in two areas:

- sham entities used by taxpayers, often at the suggestion or initiation of their foreign banks, to add a layer of concealment to their account; and

- investments in passive foreign investment companies, known as PFICs.

In recent weeks, IRS has adopted solutions to these issues that will help in moving these thousands of OVDI cases to closure.

Sham Entities

As anyone who has followed the UBS case knows, once the qualified intermediary (QI) regime came into effect in 2000, it was common practice for Swiss and other foreign bankers to recommend to their U.S. private banking clients a change in account structure. Previously, accounts held in the individual names of U.S. citizens or residents could be maintained without any fear of the U.S. withholding tax. But the QI regime changed that—banks that had signed QI agreements with IRS would have to obtain Forms W-9 from account holders or prohibit their American clients from making investments in U.S. stocks, bonds, or other assets.

Some U.S. account holders simply decided to forgo investing in U.S. assets, but others who wished to obtain a portfolio that included American stocks or bonds were in a quandary—if they continued to invest in U.S. assets, the bank would require a Form W-9, identifying the account holder and providing a taxpayer identification number. For American account holders who were not reporting their accounts on their tax filings, that presented a problem.

Numerous foreign banks approached these account holders with the option of creating a new entity to become the purported beneficial owner of the account. The bankers usually recommended creation of a foreign corporation, often through the British Virgin Islands, Panama, or Hong Kong, or through a foreign trust, often a Liechtenstein stiftung, or foundation.

Upon the filing of a Form W8-BEN showing this newly formed entity as the account owner, U.S. account holders could forgo a Form W-9 and then invest in U.S. assets without fear of a QI imposed withholding regime. Many American account holders at financial institutions worldwide adopted this new account structure.

In the context now of filing amended returns, practitioners were faced with the question of whether a taxpayer had to report these sham foreign entities as bona fide foreign corporations, requiring, for example, Forms 5471, or foreign trusts, necessitating the filing for Forms 3520 or 3520A.

Practitioners approached IRS early on in the civil phase of the OVDI, and IRS responded. Quickly, recognizing that this was in the context of a settlement initiative, it drafted an alternative closing agreement form that, in essence, allowed the taxpayers to disregard these entities for filing purposes on the single condition that at the time the closing agreement is signed, the entity is disbanded and/or terminated.

This was a sensible reaction by IRS. It would have been almost silly for taxpayers to bear the administrative burden and the professional fees of filing forms for these foreign corporations or trusts when their sole purpose was to act as a shell to conceal the individual account holder's beneficial ownership. Practitioners applauded this decision at the time, and it continues to ease the burden on both the taxpayers and the agents auditing these cases, likely resulting in a more expeditious disposition of these cases than otherwise would have occurred.

PFICs

A second and knottier technical issue then emerged—the PFIC issue. Many account holders at foreign banks were placed, often without their knowledge, into foreign mutual funds that are not suitable for Americans. (Presumably, many of the banks, knowing that their clients likely did not intend to report these accounts to IRS, did not care.)

These funds, unlike U.S. mutual funds, do not "distribute" capital gains or income each year; rather, they simply plow such amounts back into the fund, increasing the net asset value of a given share. The Internal Revenue Code treats many of these funds as PFICs. The code imposes a punitive tax regime on such investments upon certain distribution events, entailing in many circumstances the calculation of additional value going back to the date of the initial purchase of the funds (which in some cases could be decades), the addition of throwback interest charges to the imputed income, and taxation at ordinary, not capital gains rates. [5]

[5] I.R.C. Section 1291.

Practitioners who had labored in the vineyards of international tax knew about PFICs, but few other people did. Acting on directions from the technical advisers, agents (who had also never heard of the concept) suddenly bombarded practitioners with inquiries about whether there were any PFICs contained in a given foreign account. Agents have also asserted that the burden fell upon our clients to identify the PFICs and then to report them pursuant to Section 1291 of the code.

Meanwhile, practitioners were facing the prospect of going back to various foreign banks—which had been quite recalcitrant in providing necessary data in the first place—to ask for information that would enable us to ascertain if a given investment was, in fact, a PFIC, and if so, whether we could reconstruct the data from years ago.

A group of practitioners approached IRS and argued that in the context of a settlement initiative, the service could adopt a shortcut to the highly technical PFIC regime. Just recently, IRS accepted, with appropriate modifications, a proposal made by the tax bar to adopt a modified PFIC mark-to-market reporting regime for purposes of the OVDI. This article is not the place to set forth the technical details of this new regime—any practitioner handling a significant number of OVDI cases is aware of the new regime and can provide an explanation.

The PFIC issue is by no means resolved for good—agents will continue to press practitioners to identify PFIC investments, many taxpayers and practitioners have no idea whether a given investment is or is not a PFIC, and other questions remain unanswered.

The point here is that again, IRS is to be given great credit for reacting to a set of circumstances that, without intervention, could have slowed down the processing of the civil audits considerably.

The PFIC issue is by no means resolved for good—agents will continue to press practitioners to identify PFIC investments, many taxpayers and practitioners have no idea whether a given investment is or is not a PFIC, and other questions (such as whether this alternative regime will apply to more recent disclosures) remain unanswered. Meanwhile, the foreign banks where accounts were held are not cooperating with practitioner requests to identify PFICs, and the new regime still requires practitioners to obtain historical data that may be unavailable. Having said this, however, the new approach on PFICs is a constructive step, and should help move these cases along.

The Penalty Framework

The more serious problems in the civil processing of the OVDI cases in recent weeks have emerged with regard to various issues concerning civil penalties. It is here that IRS is taking steps that, in our view, may damage the voluntary disclosure policy for some time.

The civil penalty issues manifest themselves in four respects:

- implementation of FAQ 9, which says no penalties will be imposed where there is no unreported income;
- implementation of the 5 percent safe harbor;
- imposition of penalties on foreign entities and assets; and
- demonstrations by taxpayers of reasonable cause for failure to report.

FAQ 9

FAQ 9 provides, in essence, that where a taxpayer has failed to report a foreign account, penalties will not be assessed if there is no unreported income associated with the account. To be sure, the FAQ does not contain an explicit de minimis or materiality component. But practitioners believed that under a common sense view, FAQ 9 treatment might be granted in cases where the unreported income was negligible.

For example, many of our clients had bullion on deposit at foreign banks. Holding aside the proposition that the FBAR instructions have never, until recently, explicitly said that bullion on deposit was reportable, tax professionals believed that bullion accounts would not likely be subject to penalties. After all, gold does not pay interest.

However, most banks charge fees for maintaining a bullion account, and so many banks insist that an account holder keep a small amount of cash on deposit to fund the maintenance fees. These accounts, of course, bear interest, nearly always at rates that bear no relationship to the high fees charged by the foreign financial institutions.

Because this interest—sometimes no more than a few dollars—was not reported by OVDI participants, our colleagues around the country report that agents are insisting that the gross bullion value be included in the calculation of the 20 percent penalty. Thus, someone with, say, $300 of unreported interest income could face a penalty of hundreds of thousands of dollars for failing to list gold bullion on an FBAR, when, frankly, it was not clear that they had to list it in the first place.

More broadly, practitioners have been told that if any account drew more than a few hundred dollars in interest, it will not be eligible for FAQ 9 treatment.

The 5 Percent Safe Harbor

The initial memorandum describing the settlement initiative, issued March 23, 2009, provided as follows:

> If, (a) the taxpayer did not open or cause any account to be opened or entities formed, (b) there has been no activity in any account or entity (no deposits, withdrawals, etc.) during the period the account/entity was controlled by the taxpayer, and (c) all applicable U.S. taxes have been paid on the funds in the account/entity (where only account/entity earnings have escaped US taxation) then the penalty … is reduced to five percent.

More than a few OVDI participants believed they met these criteria. Their parents or grandparents had established the accounts with money earned outside the United States, or with tax paid funds from U.S. sources. They had inherited or been gifted the accounts and they had never touched the money.

When these clients approached tax practitioners about participating in the program, the 5 percent safe harbor was foremost in their minds. We now are finding that clients with de minimis usage, such as testing an ATM abroad to withdraw $500, are disqualified from the 5 percent safe harbor.

We appreciate that IRS needs to be consistent in its treatment of taxpayers and that part of the OVDI's purpose was to create a regime where cases could be processed quickly, but in our view the 5 percent penalty could be applied to situations where the account holder has been largely passive about the foreign account, and agents could be given broad guidelines so they could ascertain rapidly whether the safe harbor should apply.

There were some UBS customers, however, who truly never touched their money. When they sought our advice last year they would have been eligible. However, in 2008 and 2009 UBS, under incredible pressure from the Justice Department, started to require all of its U.S. clients to move their accounts elsewhere. Daily, we and our colleagues fielded calls from anguished clients who, for years, had been advised by their previously "trusted" UBS bankers, and who now were being told that they had 30 days to close their accounts or UBS would simply do it for them.

As to many of these accounts, UBS had already implemented a "freeze," prohibiting the clients from touching the funds. When told they had to exit the bank, many participants in the OVDI repatriated the funds to the United States, and others, who wished for various legitimate reasons to maintain foreign accounts, found other banks willing to take their money; invariably, these persons signed a W-9, "declaring" their new accounts. These persons had not, until UBS made them, touched their accounts.

Now, IRS is taking the view that the forced closure of these accounts and the movement of the funds, irrespective of the reason, constitutes "use" of the money and disqualifies these account holders from the otherwise applicable 5 percent safe harbor (even though the taxpayer had initiated the disclosure prior to the movement). For some clients who came forward expressly believing, with good reason, that the 5 percent penalty would apply, this means millions of dollars in additional penalty payments.

The OVDI's initial memo appears explicitly to recognize that some taxpayers who inherited or were gifted

funds were frozen into inaction. Now, however, a hypertechnical reading of this memorandum drives IRS to impose on this group of OVDI participants the same penalties imposed on those who actively utilized and enjoyed the fruits of the funds in their accounts.

Foreign Entities

In implementing the OVDI, IRS recognized, quite properly, that many unreported accounts were held in foreign corporations or trusts that were not simple nominees subject to shamming but bona fide operating entities. The I.R.C. sets forth various reporting requirements for such entities: Americans with "controlled foreign corporations" must file a Form 5471 with their tax returns; those with foreign trusts, or who receive foreign gifts or bequests, may have to file a Form 3520 or 3520A, and so forth.

It is fair to say that many accountants are unaware of these filing requirements, and indeed many tax lawyers who have never dealt in international tax issues do not know about them either.

The failure to file these forms carries various penalties, some based on the size of trust distributions, the amount of funds in a trust, or similar criteria. However, these penalties generally have an exception for reasonable cause, and throughout the years, IRS has routinely granted reasonable cause waivers to taxpayers who discover that they have failed to comply with one of these technical reporting requirements.

In implementing OVDI, IRS decided to include a provision in the initiative that dealt with these entities. In essence, the FAQs provide that where a foreign entity's account had not been reported on an FBAR and there was "income tax non-compliance" with regard to any foreign entity or asset, then the value of that entity or asset will be included in the calculation of the 20 percent penalty. This rule is now being applied literally and under a strict liability concept.

It apparently makes no difference if the failure to report the entity account on an FBAR was the taxpayer's fault or, in this highly complex area of the code, due to professional negligence or mistake. It matters not whether the amount of income tax noncompliance is negligible or de minimis. In the most extreme case, a nickel's worth of unreporting will result in the inclusion of the entity's value in the 20 percent penalty calculation. Such a plainly disproportionate result is not fair.

The 20 percent penalty applies to all assets (or at least the taxpayer's share) held by foreign entities (e.g., trusts and corporations) for which the taxpayer was required to file information returns, as well as all foreign assets (e.g., financial accounts, tangible assets such as real estate or art, and intangible assets such as patents or stock or other interests in a U.S. business) held or controlled by the taxpayer. [6]

[6] FAQ 20.

Thus, this penalty regime applies even to assets as to which the I.R.C. does not require reporting by U.S. taxpayers.

We are not aware, for example, of any requirement that foreign art be reported on a tax return. In these cases, the promise in the FAQs 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" is empty.

Indeed, some of the penalties that would otherwise apply to technical non-filings are nominal—the failure to file, or to file a complete Form 5471 regarding a controlled foreign corporation is penalized at $10,000. Yet the service—with the "Sword of Damocles" 50 percent per year FBAR penalty at the ready—is leveraging technical and minor compliance failures to include many times that amount as part of the overall penalty settlement.

Line agents are willing to listen and are often sympathetic. But when the issue is referred up the chain, the answer to any plea for reason, proportion, and fairness in these situations is simply "no."

FAQ 35

As indicated above, a key factor for many practitioners urging their clients to enter the OVDI was FAQ 35. It appeared to operate as a sort of fail-safe procedure for unusual cases. While as we have noted, many OVDI participants have engaged previously in conduct that would easily fit the contours of willful and intentional tax fraud, others came to practitioners with noncompliant reporting but with strong cases for nonwillful behavior.

Rather than risk a criminal investigation, and relying on what we expected would be a legitimate process crafted under the language of FAQ 35, practitioners urged disclosure as the safer course.

When practitioners began to raise FAQ 35 this spring, agents at first indicated that anyone seeking FAQ 35 relief was effectively opting out of the OVDI and that they would simply impose multiple FBAR penalties under long-standing "mitigation guidelines" contained in the Internal Revenue Manual. [7] Note that these guidelines offer little comfort to the large majority of OVDI participants—an account exceeding $1 million will likely be hit with multiyear 50 percent penalties.

[7] See Internal Revenue Manual, ¶ 4.26.16 et seq.

Recently, the service has at least begun to accept a letter raising special circumstances, but to our knowledge, there are few cases under serious consideration for FAQ 35 relief.

We are well aware that the prevailing attitude in the IRS enforcement community now is that these account holders knew they had unreported income, knew should have checked the box on their Schedule B "yes," and had they done so, they would have been directed to the FBAR. Under this view everyone is guilty of willful noncompliance. [8]

[8] This view, however, may be called into question by the recent decision by Judge Liam O'Grady in *United States v. Williams*, No. 1:09-cv-437 (E.D.Va. 2010) (finding that the government had failed to meet the burden to prove willfulness for an FBAR penalty in a case where the taxpayer pleaded guilty to failing to report income from an undisclosed foreign account on his tax return).

Given the history of enforcement in this area—where penalties were rarely, if ever, imposed—the failure to consider bona fide applications for penalty relief on a group of self-disclosing taxpayers strikes us as unreasonable.

However, many of these cases present more nuanced facts, and given the history of enforcement in this area—where penalties were rarely, if ever, imposed—the failure to consider bona fide applications for penalty relief on a group of self-disclosing taxpayers strikes us as unreasonable.

Moreover, and 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.

One final point needs to be made about FAQ 35 and our sense that within the OVDI, and post-OVDI, there will be little penalty relief. There is a broad category of taxpayers comprised of Americans living overseas who have not been fully compliant with their tax filing requirements. Most of these people reside in countries that collect an income tax, and with the foreign tax credit, they would owe little, if any, U.S. tax. Some of them are almost "accidental" Americans—born in the United States but citizens and lifelong residents of a foreign country.

The recent enforcement push targeting Americans with undeclared foreign accounts has swept this group into the mix as well, and they are seeking advice on how to come back into technical compliance with their filing obligations. Some of these people entered the OVDI, while others are just now considering their options.

These people often have a good faith basis for their prior omissions—often misunderstandings about their obligations or incorrect advice from foreign professionals. But such people, to the extent they are in the OVDI, are getting no traction with their reasonable cause arguments, and are facing the same aggressive penalty strategy employed on the more garden variety foreign account cases. Indeed, in some of these cases, individuals own homes through foreign companies or trusts—because that is the way it is done where they live—and are facing the inclusion of 20 percent of the value of their personal residences in the penalty calculations.

We believe IRS is casting too wide a net in imposing the asset-based penalty on an "expat" group who probably owes little if any U.S. tax.

We believe IRS is casting too wide a net in imposing the asset-based penalty on this "expat" group, who, as noted, probably owes little if any U.S. tax. [9] So far, however, the service does not appear prepared to listen to special pleas from this group.

[9] The sweep of the 20 percent penalty knows no apparent bounds. We have cases where voluntary disclosures involving foreign accounts were initiated well before March 2009—IRS wants 20 percent in these cases when arguably people who came forward that early should be given a much better deal. And while this may be anecdotal, we are aware of one case involving a voluntary disclosure of an undisclosed domestic bank account, and the IRS agent has asked for 20 percent of the highest balance held in that account as well.

Moving Forward

As noted, the OVDI is by no means nearing completion. We suspect that nearly one year after the CID program closed, no more than 5 percent to 10 percent of the cases are remotely near the signing of a closing agreement.

We cannot imagine the thousands of IRS agent and manager hours that are being wasted on the review of amended returns that were prepared in the context of the OVDI, when these same highly trained agents and managers could be examining the tax returns of people who have not come forward in good faith or could be conducting other audits of businesses. We suspect that IRS statistics on revenue generated from non-OVDI audits will decline this year, as hundreds of seasoned revenue agents have been devoted to, among other things, soliciting new powers of attorney and statute extensions from every participant in the OVDI and trying to figure out whether a given foreign mutual fund is or is not a PFIC.

And as we move into the second season of tax preparation, with the Oct. 15 deadline upon us, we envision that the accountants involved in these cases will have to set them aside to meet current filing deadlines, inevitably frustrating the agents and managers who themselves are being pressured to close out these cases.

Without responsible intervention, the situation could get contentious by year's end.

We appreciate that the OVDI is not the only pressing matter on the plate of senior IRS management. Congress continues to tinker with the tax law on a regular basis, enacting broad new laws, such as FATCA, and leaving IRS little time to create the underlying technical rules. The recent health care reform legislation has dumped a massive set of time-sensitive compliance and enforcement issues in IRS's lap (without providing sufficient resources). The service is also undertaking to create an entirely new regulatory regime for income tax preparers. While the practitioner community has tried to interface with senior IRS personnel on many of the issues arising in the OVDI matter, and some have privately expressed sympathy, we have a sense that what was the "flavor of the year" in 2009 is now on the back burner.

We certainly recognize that some readers will dismiss the comments in this article as typical complaints of taxpayer representatives who always believe in their clients. We are well aware that our clients have benefited more than anything from a decision not to initiate criminal prosecution in these cases. Further, we know that given the six-year window of amended returns (PFICs aside), many clients have engaged in tax noncompliance for generations. And we admit to being frustrated by the huge unanticipated costs and burdens imposed on clients who are already paying the largest foreign account-related penalties ever imposed. [10]

[10] In fact, in many cases with smaller accounts, the professional fees are effectively doubling or more the "penalty" of this program.

But we are actually motivated by three other broad policy factors that we sense are lost in the morass of these cases.

Waste of Resources

The first derives from our sense of the enormous waste of resources being thrown at these audits. Hundreds of agents are spending tens of thousands of hours in detailed reviews, entering tax return data, and preparing comprehensive adjustment worksheets for cases where the returns and tax payments plus penalties were already coming in due to actions by CID, not these examinations.

There appears to be no strategic assessment. The same effort and procedures are under way on a $100,000 offshore account as on a $100 million dollar account. The OVDI was to be an efficient settlement program, not a system to ensure precise technical accuracy in every aspect of these amended filings.

We are not suggesting that IRS should simply trust these taxpayers with no checks at all. In our view, however, Exam should have set up tolerances and indicators the way they do in most other audit programs. We submit that for account sizes below certain thresholds—say $5 million—they should have simply determined whether the checks attached to the amended returns exceeded some predictable figure—say 35 percent or more of the account size—and simply cashed the checks. Larger accounts or accounts involving certain foreign advisers/promoters or other red flags could have been selected for a harder look. [11]

[11] We note briefly that several states, rather than simply waiting to cash the inevitable stream of checks, decided to impose their own bureaucratic overlay complete with mandatory forms and multiple extension requests.

It would have been far more efficient for the service to recognize that approximate amounts arrived at in genuinely limited review time are better than precise, and not very different, amounts arrived at in exhaustive reviews. These filings, in the words of one of our colleagues, should be "looked at and checkmarked, the

checks for tax and penalties deposited, and let's move on."

Handling the Next Wave of Disclosures

Second, independent of the resource issue above, at least so far, IRS seems to have failed to reap huge enforcement, compliance, and revenue producing gains within their grasp based on the effective exploitation of the initial investigative breaks and international negotiations with the Swiss government. Such a win should generate enormous compliance gains—and clearly billions of dollars and thousands of noncompliant taxpayers have been returned to the system.

But given the continuing rapid international developments—exploitation of data thefts, other foreign governments beginning to join the effort and conducting aggressive investigations, the enactment of FATCA—surely tens of thousand of additional taxpayers are interested in coming into compliance. Even though the assets held in undeclared foreign accounts is, for IRS, "found money" (with no political pushback against aggressive enforcement), we are hearing anecdotal reports that while the DOJ continues to pursue foreign banks around the world, IRS intends to dedicate fewer resources to manage the audit and VDP fallout.

Bluntly put, we wonder if IRS Exam would, candidly, welcome news of additional waves of thousands of VDP cases in the aftermath of future enforcement activity against new financial institutions in new regions of the world. (These actions appear to be in the offing.) We cannot foresee how under the current processes, IRS can process a second wave, much less a third. What should it tell IRS about its current procedures if it cannot handle the aftermath of some of the most meaningful tax enforcement work in American history?

Moreover, our sense is that only modest numbers are now coming forward to make voluntary disclosures. IRS has not provided any sense of the penalty for this new group—these clients have to be advised that penalties could technically be multiples of their account—and they are now told by practitioners who are living through the OVDI cases that the review process will be exhaustive, expensive, and punitive, irrespective of specific and potentially mitigating circumstances.

For practitioners, we are a far cry from the advice last summer when we could say all signs pointed to a "noisy" voluntary disclosure. Now, within ethical boundaries and practical tactical realities, we often wind up painting a much more nuanced and negative view of the voluntary disclosure program.

We have already found that, increasingly, except for UBS customers, potential clients who hear their options are deciding not to initiate traditional voluntary disclosures. This is causing clients to opt in some cases for quietly amending their returns or complying only on a forward going basis. For the former group, we suspect that IRS is still unable to do much more than simply process the amended filings, meaning it cannot track and account for additional foreign account income coming into the system. For the latter group, IRS is, of course, losing substantial revenue. (In both instances, IRS loses transparency, the penalties, and proof of the compliance effect of their actions.)

Some potential clients thank us for an initial meeting and then decide to "hide and hope"; to them the service is missing a huge opportunity to bring them back into the system. Older clients simply think they will die before detection and that their children can pick up the pieces safely afterwards.

IRS could be riding a wave of increasing disclosures as the international dominos fall. But instead, increasingly, noncompliant taxpayers (with their likely billions in assets) are shying away from coming forward.

IRS could be riding a wave of increasing disclosures as the international dominos fall. But instead, increasingly, noncompliant taxpayers (with their likely billions in assets) are shying away from coming forward.

Compliance Policy Undermined

Finally, we believe that our national tax compliance policy is being undermined considerably by these events.

We may be taxpayer representatives, or even "defense lawyers," but whether IRS likes it or not, we and our many respected and able colleagues across the country who work in our area of the tax bar are the "intake personnel" for the voluntary disclosure policy. For generations, private practitioners have been told by government officials that we are "partners" in motivating tax compliance.

We, however, are now frustrated by what is going on with the OVDI, and we fear that the mounting problems in the OVDI will cause tax practitioners around the country to shy away from noisy disclosures. The VDP has always been under the province of CID; notwithstanding CID's incredible success of last year, the approach taken by the civil side of IRS has considerably diminished practitioner enthusiasm for the VDP generally and will likely jeopardize that important component of tax policy for a generation.

A Rescue Possible?

When the program was announced, we thought that IRS arrived at the still historic "20 percent of the account

penalty" to dispense "rough justice" in an efficient manner to widely disparate taxpayers. The current bureaucratic approach to every form and adjustment is completely at odds with the historical VDP and is a significant element in the IRS's loss of important momentum at exactly the wrong time for offshore compliance.

We believe that prompt action by senior IRS officials can substantially rescue this program and even return it to the robust compliance and tax revenue generator it has demonstrated it can be. The following steps would be an important start:

- Move to a much more strategic and streamlined program of reviewing the amended returns. Use account size or other undisclosed "red flag" indicators to select only a few cases for more detailed reviews. Stop wasting time with new POAs, statute extensions, and the like. In most cases, there should only be minimal data entry and simply a prompt cashing of the checks. To some extent, since we began to put this article together, we have seen more rapid movement in attempting to close cases, so we hope that this step may be partially under way.

- Create a fair but efficient system to address unusual cases. Some account holders truly did not know they were supposed to report their accounts; in other cases, professional advisers made mistakes. Still other cases present issues of penalty proportionality—is it really fair to impose a seven-figure penalty based on a few thousand dollars of unreported income? A one-time withdrawal or a mandatory account closure should not disqualify an OVDI participant from the 5 percent penalty. There should be an internal but bona fide procedure for agents to resolve those types of issues, with input from taxpayer counsel, and a single layer for an expedited appeal. Most practitioners ought to have the good sense to know what cases would warrant special treatment and what cases will not; those cases that suggest a real abuse of the process can be dismissed quickly.

- While it is not quite the subject of an article about problems in the ongoing OVDI, we firmly believe that in conjunction with streamlining the OVDI audit process and exhibiting a bit more lenience, IRS should undertake two steps to encourage, perhaps dramatically, an increase in voluntary disclosures, which strikes us as almost a necessity if IRS wishes to continue to benefit from increased international transparency and information exchange.

First, we suggest that IRS revisit the penalty mitigation guidelines located in the Internal Revenue Manual regarding the FBAR penalty, and consider implementing a new penalty framework for cases involving undeclared foreign accounts and assets. We think the service should be careful not to ratchet up the penalties too much because eventually they will be so steep as to confiscate the entire account in most cases, thus reducing incentives to come forward. But a more certain penalty regime, perhaps amending the IRM guidelines, [12] should still generate new takers.

[12] As noted earlier, right now, the IRM provides that any account exceeding $1 million will likely be hit with penalties of 50 percent per year. Given that probably more than 80 percent to 90 percent of the cases out there entail accounts of this size, such a "mitigation" guideline is not terribly enticing.

This framework might contain revised dollar thresholds, criteria for determinations of nonwillfulness or reasonable cause, and a streamlined process for reaching a penalty resolution as expeditiously as possible with a right of appeal. Or there could be presumptive penalties so that there will be limited room for special circumstances or a true FAQ 35 process. If practitioners have an ability to quantify the cost to a client of coming forward, and provide a reasonable sense of the likelihood that penalties might be waived or reduced, we expect that disclosures will increase.

Second, IRS should consider a more systematic approach to voluntary disclosures in general. When CID adopted the nationwide "preclearance" system, combined with the short form intake letter, practitioners and clients were able to move voluntary disclosure cases forward quickly. We suggest that this procedure be institutionalized within the service, whether through a service center-based approach or some other organizational method, so there is a consistent, efficient method to process voluntary disclosure through the CID side, and then out to a dedicated corps of agents to bring these cases to closure.

There could be standard procedures and forms (perhaps online, as was adopted by the state of New York), and a streamlined preclearance process with simple on-campus reviews for the majority of the cases. Selected cases could be moved to the field for more detailed reviews. This would save untold resources and allow IRS to harvest much more efficiently future compliance victories in this arena.

Future International Compliance

The world is moving toward a much more transparent financial system. Countries that previously guarded their

bank secrecy rules tightly are now signing mutual assistance agreements and exchanging information more rapidly. FATCA is likely to cause most banks all over the world to open the curtains on all types of accounts held by Americans worldwide.

IRS and DOJ will continue, we expect, to be aggressive in pursuing enforcement measures in particular cases. IRS cannot possibly process greater numbers of cases. Instead, we urge the service to consider approaches that incentivize taxpayers to come forward, and practitioners to encourage them to do so.

These types of steps can revitalize the VDP, opening the gates again to many thousands of additional taxpayers, moving beyond Switzerland and Europe to equally promising jurisdictions elsewhere in the world. Rather than watching this phenomenally successful program wither away in the details of hyper-detailed audits and disproportionate and unfair penalties, creating legions of unhappy volunteer taxpayers and their frustrated representatives, the service should seize on last year's victory and leverage it for enhanced tax compliance. That is what compliance victories are for. But right now, we doubt whether IRS can even process any more “victory.”

There is a better way to see this remarkable program through to its conclusion, and we urge policymakers in the tax enforcement community, in both the legislative and executive branches, to review the situation quickly, reverse the trend lines now in place, and consider implementing a more efficient system so IRS can continue to bring many more taxpayers back into the system.

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