OVDI Is Over — What's Next For Voluntary Disclosures?

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With the recent expiration of the IRS's second offshore voluntary disclosure initiative regarding unreported offshore accounts, the future path for practitioners is uncertain. The authors, both longtime tax practitioners in this area, examine the principal lessons learned during the last three years of aggressive enforcement and the two IRS settlement initiatives. They discuss strategic and tactical issues faced by practitioners advising noncompliant taxpayers who now wish to come forward, and they suggest a framework for a new, more permanent IRS voluntary disclosure policy that could succeed for years to come.

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The IRS's second voluntary disclosure initiative for American taxpayers with unreported foreign accounts ended on September 9. That marked the closure of an extraordinary 32-month period dating back to February 2009, during which more than 50 years of IRS voluntary disclosure practice underwent a sea change. The many practitioners working in this offshore compliance "industry" over the last three years have managed a wide array of intriguing clients, both domestic and foreign, and their emotions ranging from palpable fear to understandable anger and confusion. We have moved from a period of true partnership with the IRS in the summer of 2009 to a greater distrust of some IRS policies and penalty positions, and we now face substantial uncertainty about the IRS's plans for the future. However, the end of OVDI gives the IRS an opportunity to reap the maximum benefits of its and the Justice Department's significant enforcement victories over the last three years, reestablish a more productive relationship with professionals, and continue compliance gains if the voluntary disclosure program (VDP) is put on a stable, predictable footing.

For decades, most practitioners advised clients under long-standing IRS policies whereby those clients could receive protection from criminal prosecution but obtain no advance deals on civil penalties. More often than not, practitioners — including many former senior IRS and DOJ officials who later entered private practice — recommended "quiet" disclosures, in which clients filed amended tax returns and related forms going back six years and paid the tax and interest, and that was that.

Practitioners rarely made contact with the IRS Criminal Investigation division and initiated a "noisy" disclosure. Yet even then, civil penalties were almost never imposed. From our perspective, the system worked beautifully — knowing that draconian consequences were unlikely, taxpayers were encouraged back into compliance, and Treasury was provided with pools of assets to be taxed each year with little or no IRS resources being expended. Our clients felt like they had done the right thing, at a sometimes significant cost in taxes and interest, and in talking about voluntary disclosures with the IRS, practitioners never got the sense that the agency felt shortchanged.

Then, beginning in 2009, in a frenzied enforcement climate triggered largely by the UBS case, the IRS implemented two sequential VDPs, coupling a settlement initiative requiring payment of substantial civil money penalties with the taxpayer's "noisy" voluntary disclosure. The two initiatives and the related periodic guidance that was issued revolutionized practice in this area. Now that it's over, the criminal tax bar and other practitioners are wondering what's next.

Approximately a year ago, we wrote an extensive critique of the first VDP and its aftermath, offering praise and criticism when we believed it was due as well as suggestions for modifying the VDP.[1] The purpose of this report is to describe the lessons and implications of the last three years and prompt some thinking in the tax bar, and we hope in the tax enforcement community, about what comes next and how to maximize the effectiveness of this valuable compliance tool.

I. Background

For anyone who practices in this field, the events of the last few years are all too familiar. Beginning in late 2007, there were media reports of stolen client information from the Liechtenstein bank LGT and then, into 2008, more news of a cooperating banker from the Swiss financial giant UBS. The DOJ's Tax Division and IRS began to break down the generations-old barricade of Swiss bank secrecy, revealing significant tax noncompliance by thousands of U.S. citizens who were aided by several banks and professional advisers in Switzerland and other traditional bank secrecy havens. That juggernaut continues at a swift pace on multiple continents even now.

In 2008, as clients began to call us and our colleagues around the world, it was clear that there were many account holders at UBS and other foreign financial institutions who wanted to initiate voluntary disclosures before their names were given to the IRS. In February 2009, four days after a deferred prosecution agreement with UBS was announced, the IRS instituted what for simplicity's sake we will call Offshore Voluntary Disclosure Initiative (OVDI) #1. It offered a virtual guarantee against criminal prosecution and a civil closing agreement for taxpayers who came forward, filed six years of amended returns and foreign bank account report forms, and agreed to pay tax, interest, and civil penalties, including a miscellaneous penalty equal to 20 percent of the highest balance in the undeclared account.

OVDI #1 — for all of its fits, starts, and warts — was a smashing success for the IRS. Approximately 14,700 people participated in the program, sending more than $2 billion at latest count into the treasury (and billions more back into the system to be taxed in the future). It provided investigators with a wealth of data regarding dozens of banks around the world and their employees, outside investment advisers, and other third parties that aided Americans in hiding money abroad.

Enforcement in the area continued, however, including through a 2009 settlement between the IRS and UBS, after which more than 4,450 account holders received notice that their names might be turned over and were given an opportunity to initiate a voluntary disclosure before that happened. Many did so, and additional taxpayers contacted practitioners for that purpose as well. In early 2011 the IRS implemented OVDI #2. OVDI #2 made a number of changes in the program, but in general, it (1) increased the number of years for which amended returns were required from six to eight, (2) expanded the nature of the assets subject to penalty, and (3) increased the penalty on the larger pool of foreign assets to 25 percent.[2]

A week after OVDI #2 ended on September 9, the IRS announced that the two programs had resulted in 30,000 Americans coming forward and paying some $2.7 billion in taxes, interest, and penalties (with not all penalties yet imposed). With thousands of boxes of filings shipped to an IRS service center in Austin, Texas, many latecomers still on extension for OVDI #2, and many participants considering opting out of the penalty regimes imposed in both programs, neither we nor the IRS are close to wrapping up both programs.

Yet, for anyone now seeking advice as to a voluntary disclosure, especially regarding offshore accounts, the fundamental question is whether we will revert to the practice environment that existed before OVDI #1 or whether the process has changed dramatically and permanently. Add to that the possibility that the IRS itself may, with little warning, provide new guidance on the VDP, and we are

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[1]Mark Matthews and Scott Michel, "IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment," *DTR*, Sept. 21, 2010.

[2]For many U.S. citizens living abroad who had not filed tax returns in prior years, this penalty constituted 25 percent of their net worth (bank accounts, homes, and businesses) for failure to file a form unknown to them, even if they owed no U.S. taxes. The IRS later created a safe harbor of a 5 percent penalty on financial assets for a class of this group, but the relatively narrow criteria did not draw in that many additional participants into OVDI #2.

clearly in a period of significant uncertainty. So it is time to step back and think about what has happened and where we are going.

II. Lessons Learned

Some fundamental truths have emerged from the events of the last three years, and those should inform practice and policy in a post-OVDI environment.

A. Iron Fist and Velvet Glove Strategy Works

As we noted above, practitioners have been consulted for decades by clients wishing to initiate voluntary disclosures arising from undeclared offshore accounts or countless other instances of tax noncompliance, but before 2008 those were all largely one-offs. When the enforcement apparatus of the DOJ Tax Division and IRS CI kicked in, taxpayers came into OVDI #1 in droves. With every media report of an indictment against bankers and investment advisers or rumors of investigations into other banks, there was a noticeable uptick in contacts from potential clients.

Through mostly skillful case selection and savvy media relations, the government's criminal tax enforcement apparatus created fear and uncertainty among those who had money hidden overseas. At the same time, OVDI #1 provided a path to forgiveness and a closing agreement — albeit a far more expensive one for taxpayers and the IRS than ever before — encouraging thousands to participate. Then, as UBS account holders began to receive notice that they were among the select group of 4,450, more people came in. And just last month, toward the end of OVDI #2, media reports revealed that the government was investigating up to 10 other foreign banks, prompting a last-minute rush into the second program before it expired.

The lesson is obvious: If the IRS wants people to come forward voluntarily, it needs to couple its VDP with well-publicized tax enforcement. A VDP without the enforcement component will prompt only the sorts of anecdotal disclosures we all saw before 2008. With the iron fist hammering away, however, thousands of people will come forward.

B. Practitioners Essential to a Successful VDP

Having spoken to many hundreds of taxpayers with unreported offshore accounts over the last two years, we can affirm that taxpayers in general, and those with significant noncompliance issues in particular, fear the IRS. They do not believe they will be treated fairly. And obviously, many do not want to suffer the most punitive consequences from their past behavior. When they approach a tax practitioner, most of them have no intention of contacting the IRS directly and confessing. This is not something they discuss with friends and family, because they are embarrassed about their dilemma. They go to see tax professionals for guidance. Their view of the disclosure process and their decision concerning whether and how to rectify their noncompliance is largely shaped by the tax professional they engage.

Accordingly, while lesson A above demonstrates that tax enforcement activities by the IRS can motivate noncompliant taxpayers, the IRS depends heavily on private tax professionals to channel those taxpayers into compliance. We are the gatekeepers. Our perception of, and experience with, the IRS in these cases informs the perspective we bring to bear with any given client who seeks our advice. If practitioners trust the IRS, believe the processes are just, and can point to specific experiences in which taxpayers have been treated fairly, we will recommend that taxpayers follow the compliance paths preferred by the IRS. Distrust of the IRS and a perception of unfairness will drive taxpayers to take other paths of corrective action, or not at all.

The experience of the last three years in the practitioner community demonstrates this point. Through much of OVDI #1, tax professionals were almost unreservedly directing clients into the noisy initiative process. Once the program was announced, we recognized the significant ramp up in enforcement, which could snare any potential client and render him instantly ineligible to make a voluntary disclosure. We saw the IRS's commitment to a series of civil penalties that, although they had never been previously imposed in any systematic way, could have catastrophic consequences for an individual client. And we accepted on its face IRS guidance that suggested, in FAQ 35, that our clients would have the opportunity to make the case that their conduct was not willful. That last factor alone prompted a significant percentage of our clients to take our advice to enter OVDI #1.

By the time we reached OVDI #2, we had all suffered through the series of policy changes and reversals during 2009 and 2010. We had endured unanticipated and unadvertised aggressive audits of our clients' amended returns, spent hours explaining to clients why they had to sign new powers of attorney and Form 872 statute extensions, and helplessly watched while a cadre of IRS technical advisers interpreted discounted penalties and safe harbors so narrowly that they became meaningless, in some cases producing absurdly unfair and disproportionate results. The Service's reversal on FAQ 35 and its refusal to consider individual cases of non-willfulness were nearly the last straws. We and our colleagues came to doubt the fairness of the IRS process and communicated that (intentionally or not) to new clients.

As an ethical matter, tax practitioners are required to discuss with any potential client the nature and consequences of their past violations.[3] But we are not legally or ethically required to recommend a particular strategy. A far larger percentage of our clients elected not to enter OVDI #2 than entered OVDI #1. Many just walked away. That was not what the IRS wanted, but it happened because we had no choice but to answer our clients' questions about our experiences in OVDI #1.

As we said in our previous article, there were instances in OVDI #1 when the IRS took commendable steps — institutionalizing the ''pre-clearance'' process, enabling taxpayers to disregard patently sham trusts or corporate structures, and allowing for the modified reporting regime on passive foreign investment companies. Those positive steps were in part attributable to excellent communication between the practitioner community and the IRS. One thing that has been made clear over the last three years is that when practitioners communicate sensible ideas to the IRS, it listens. That alone is to be applauded.

But OVDI #1 was a mixed blessing. And now we have no idea how the thousands of submission boxes sitting in Austin as part of OVDI #2 will be processed. Some of us fear a repeat of many of the OVDI #1 problems. Our experiences with both OVDI programs will for years shape our advice to clients who approach us for help in coming back into compliance, whether their situation involves foreign accounts or more garden-variety tax noncompliance.

We all share with the IRS the common goal of bringing noncompliant taxpayers back into the system. IRS officials often discuss the importance of the partnership between the Service and the practitioner community. Significant damage was done to that partnership in the two OVDI programs. A major lesson has been that IRS credibility and our experience in these cases will influence the advice the gatekeepers give to our clients. A well-executed VDP that appeals to the practitioner community will in turn satisfy our clients and produce positive results.

C. Leveraging IRS Resources Is Essential

With a long and complex tax code, a huge and diverse global economy, and limited enforcement resources, the IRS needs to develop a sound, predictable, and efficient self-correction mechanism. It is indisputably far more efficient for noncompliant taxpayers to rectify their own misdeeds than it is for the IRS to try to catch them all, much less to then audit, investigate, prosecute, and collect taxes from them.

Before the OVDI programs, the IRS's VDP deal was that if those persons came forward, whether noisily or quietly, they could avoid criminal prosecution. Intentional or not, the IRS's track record in nearly all those cases was that severe civil penalties were not imposed. The system dispensed rough justice: Many taxpayers escaped significant penalties for their prior noncompliance, but the IRS brought them and their assets back into the system to be taxed year after year. The IRS expended little resources on the program. CI processed the occasional noisy disclosure, and from all appearances, the service centers happily accepted amended tax and information returns, deposited the checks into the treasury, and moved on. Few, if any, of those cases required more than a dozen hours of IRS personnel time; there was usually little concern that amended filings prepared under the watch of attorneys and accountants would be anything other than accurate and complete. While that resulted in some individual taxpayers getting away with decades of prior tax evasion, from a broad policy perspective, the Service got far more out of the system than it was required to put in.

In OVDI #1, the IRS spent far more of its own resources to bring taxpayers back into the system and process their filings. There were months of individualized, intensive audits of the amended filings. That lasted until the IRS apparently recognized that the resources devoted to the process outweighed any incremental benefit. Still, agents spent countless hours poring over amended returns, plugging numbers into audit reports (often making errors, however unintentional), scrutinizing foreign bank statements and foreign exchange rates to ensure a precise penalty calculation, and then pushing the entire process through the funnel of a closing agreement. To this day, we do not understand why the IRS did anything but spot-check selected returns. Other than raising the PFIC issue, the agent reviews found very few ''new'' taxes that were not already on the first amended returns, yet the cost to the IRS was enormous, not to mention the opportunity costs of failing to use those resources on more lucrative audits. We do not know how OVDI #2 will be handled, but with some 12,000 submissions sitting in Austin, it does not take a genius in math to count the personnel hours that will quickly mount even with minimal certification and closing agreement procedures.

The essence of OVDI was to leverage a civil penalties deal into the VDP. That could have been

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[3]*See* Circular 230, section 10.21; American Institute of Certified Public Accountants Statement on Standards for Tax Services No. 6. Note that CPAs are required to consider withdrawing from a client relationship if the client does not rectify past inaccuracies; lawyers are not under any strict ethical obligation.

done without requiring revenue agents to process each return by performing a detailed audit report and flyspecked calculations, and then issuing complex audit reports and closing agreements. That scrutiny is unnecessary in a rough-justice VDP when the taxpayer, under the guidance of a tax practitioner, has voluntarily acknowledged the noncompliance. The odds of a taxpayer deliberately committing new acts of evasion during a voluntary disclosure are remote. Spot-checks alone would be more than enough to keep the applicants honest.

We have no access to internal IRS records that would identify how much time and government money were spent processing the OVDI filings and issues. We strongly believe that a far more streamlined system could have been designed and could have captured 95 percent or more of what came in during the programs. One lesson from the OVDI experience is that the Service should consider a more sensible approach that measures the costs and benefits of any given disclosure system. While spending $100 million to get 100 percent compliance in a program is admirable, if spending $20 million gets you 95 percent of the way there, that is something worth considering.

D. One Size Does Not Fit All

Tax noncompliance is found in a wide variety of conduct with dramatically varying levels of knowledge or willfulness. We can leave aside for the moment the issues unrelated to offshore accounts. In the relatively narrow categories of behavior associated with unreported bank accounts, private practitioners encountered a broad range of culpability. There were a few of the stereotypical offshore tax cheats — native-born U.S. citizens who, on their own accord, decided to evade taxes and developed plans to use offshore entities and accounts to shield from taxation funds earned in the United States. That is the media image of offshore tax evaders and an image promoted by IRS public statements. For that group, the penalty levels in the OVDI programs were, in our judgment, appropriate, perhaps even generous when combined with a criminal amnesty.

It may surprise most observers, but we saw few cases like that. It is anyone's guess why. It may be that this aggressive and risk-prone group was prepared to let it ride. Or perhaps there simply are not as many of them as anticipated.

One large group of taxpayers in OVDI #1 comprised persons whose foreign accounts were established by their parents or other family members, with the assets passing by gift or inheritance. Those taxpayers often had knowingly failed to disclose their accounts to their return preparers, and thus they did not report the accounts on FBARs or report the income on their returns. Many of them had family stories involving the Holocaust or political or economic oppression outside the United States. The persons who had opened the accounts originally were often foreign-born and had since died. The funds were rarely earned in the United States, and our clients often relied entirely on non-U.S. financial advisers. Many clients were afraid to come forward or to discuss the issue with friends and family, and they believed that if they approached a professional they would send family members to jail or even risk their own exposure by an unethical lawyer seeking a whistleblower reward. To us (not to mention to our clients), that group was categorically different than the core tax evader who skimmed funds from a business and deposited them in an overseas account.

Yet OVDI #1 made no real distinction between that group and the volitional tax evader. While IRS guidance would have reduced the penalty to 5 percent for some inherited or similar accounts, officials interpreted that guidance so narrowly that we joked about the mythical unicorn. We suspect that out of the thousands of participants in OVDI #1, very few received that 5 percent safe harbor penalty, even though a large component of the program involved inherited or gifted accounts.

Starting mostly with OVDI #2, another group of taxpayers began streaming in. They had lived abroad for many years. Some had been born to foreign parents and left this country as infants; many were dual citizens at birth. All had routine "foreign" bank accounts in their country of residence and were fully compliant with the tax laws of that country. Few had grown up in countries that taxed worldwide income. Others had been assured by foreign accountants that they did not owe U.S. taxes (which was often true because of the foreign tax credits available to them). A few did not even know they were U.S. citizens. Yet, in part because of frightening publicity in their home country, for the first time, the taxpayers in that group — which comprised probably only a small percentage of noncompliant Americans living abroad — were anxious and concerned.

In the guidance for OVDI #2, the IRS, to its credit, attempted to create a penalty safe harbor of 5 percent as long as these sorts of individuals involved had little or no U.S.-source income.[4] But even that penalty structure discouraged most persons in this group from entering OVDI. Most of them owed little or no U.S. taxes, and having to

[4]What constitutes U.S.-source income can, of course, be a highly technical question. In light of the experiences in OVDI #1, there was little trust among the practitioner community that this question would be interpreted in the taxpayer's favor.

forfeit 5 percent of their unreported financial accounts just for peace of mind seemed excessive, especially given the need to expend thousands of dollars in legal and accounting fees to submit eight years of tax returns and FBARs. We can attest that many people in that group are likely, at best, to start filing next year, and that some will simply remain noncompliant and expect, with good reason, that the IRS will never find them.[5]

This phenomenon is being experienced most dramatically in Canada, with its hundreds of thousands of U.S. citizens. Those individuals, many of whom left the United States during childhood before they had entered any tax system, were stunned and angered by recent publicity regarding OVDI #2 in Canada. Despite the recently added 5 percent safe harbor for some members of that group, they cannot comprehend why the IRS is clinging to a penalty structure that could take a portion of their net assets when most of them owed no or de minimis U.S. taxes. Several highly critical articles and editorials have been published in Canada,[6] and criticism of the United States is gaining political traction north of the border. The increasingly negative attitudes toward the United States, and especially the IRS, hurt cooperation in a critical relationship.

There were other patterns of conduct that did not fit OVDI: corporate noncompliance, unfiled FBARs from minor children, more complicated and yet legitimate trust structures, and the like. No doubt the IRS initially designed the program believing more hardcore tax cheats would come forward than did. But it was clear by the end of OVDI #1 than most of those who came forward did not fit that category. Some agents have conceded that although they would have imposed no penalties in a particular case, they were told to take a hard line. The oddity, of course, is that OVDI penalties may well be higher than they would have been in an audit initiated by the IRS. This turns the VDP on its head. The modest efforts to create a discounted penalty regime for inherited accounts or for persons with a life based outside the United States were insufficient to persuade people to enter the program. The IRS's turnabout on FAQ 35 exacerbated that problem. When it stopped considering willfulness except in an opt-out scenario, the IRS made it plain that it essentially considered nearly every one of these noncompliant taxpayers to fit the same mold.

Although the IRS responded to practitioner concerns in this area by announcing opt-out procedures in June, we do not see that as a material improvement. Under the procedures, the taxpayer must formally and irrevocably forgo the penalty cap offered by the applicable OVDI and trust his case to a senior committee of IRS personnel that will decide whether to refer the matter for a full audit or to send it to the original agent to process a reduced penalty.

The opt-out procedure is inherently uncertain and will likely discourage most taxpayers from using it. Those who do, even in benign circumstances, face additional professional fees to process their case to conclusion. Practitioners, stung by the overly strict application of the criteria for discounted penalties in other instances, have doubts about what will happen. What criteria will the special committee use? Can a revenue agent operate unchecked to assert maximum penalties simply because there is a multiyear pattern of noncompliance? What will happen at IRS Appeals? (Astonishingly, there is no apparent requirement that the revenue agent consider that even convicted offshore defendants were only required to pay a single 50 percent FBAR penalty; and a 50/50 ''hazards'' settlement on a willful FBAR penalty might represent 150 percent of the value of the account, not a terribly attractive option.) We have already seen a ''luck of the draw'' aspect to the process — some agents and their managers are more sympathetic than others to the gradations of willfulness.

The IRS simply has been unable to develop a cost-effective approach to a penalty mitigation structure that can consistently recognize and efficiently address the varied reasons for noncompliance. We recognize that some penalties may be appropriate in most of these cases, but a system that treats nearly everyone with an undeclared foreign

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[5]One unintended consequence of the OVDI programs and the publicity surrounding them as to this group is a significant increase in the number of U.S. citizens residing outside the United States and who hold citizenship elsewhere who want to expatriate. Expatriation requires a certification under penalties of perjury that the taxpayer has complied with all U.S. tax obligations for the preceding five years, so some remedial action is usually required. But while the rules on expatriation are technical, and for many people there is a significant exit tax, we are finding that many clients wish to discuss this option. Sadly (and ironically), for the United States this represents an outflow of talent, culture, and capital. Some of our wealthiest citizens are expatriating themselves or their children before inheritance to avoid the U.S. tax system.

[6]Suzanne Steel, ''Read Jim Flaherty's Letter on Americans in Canada,'' *Financial Post*, Sept. 16, 2011, *available at* http://business.financialpost.com/2011/09/16/read-jim-flahertys-letter-on-americans-in-canada/; Editorial, ''Be Thankful They Don't Take It All,'' *The Globe and Mail*, Sept. 29, 2011; Chris Morris, ''U.S. Tax Net Even Affects Premier,'' *Telegraph-Journal*, Oct. 1, 2011, *available at* http://telegraphjournal.canadaeast.com/news/article/1444557; John Ferri, ''IRS Pursues Americans Up North,'' *GlobalPost*, Oct. 4, 2011, *available at* http://www.globalpost.com/dispatch/news/regions/americas/canada/111003/american-canadians-wanted-by-irs-taxes%20; ''IRS Sweep — U.S. Citizens Victimized,'' *The Windsor Star*, Aug. 26, 2011, *available at* http://www.windsorstar.com/news/sweep/5310072/story.html.

account in roughly the same manner is more likely to breed distrust among tax practitioners and their future clients and will undermine the principles of the VDP.

III. What Now for the Noncompliant Taxpayer?

What should a tax professional tell a new client after September 9? Some may come forward only because their bank is publicly disclosed as the target of a DOJ investigation or appears to be providing names of U.S. account holders. Others will have just learned that they have inherited an account or that they have a filing obligation. Still others are receiving notice that their accounts will be disclosed under the Foreign Account Tax Compliance Act, which ushers in a new era of automatic disclosure in 2013.

There are several open questions:

- What civil penalties will be imposed? One would think that the IRS will seek to exact an amount somewhere north of 25 percent for offshore cases, and probably less than the 50 percent paid by most of those who pleaded guilty to criminal tax offenses.
- What about accuracy-related and similar penalties, or penalties for information returns such as Form 3520 or Form 5471? Will the "tax-based" penalty remain at 20 percent for prior years? How will implementation of FATCA's new penalty, which raises this to 40 percent of any tax attributable to unreported foreign assets, affect the overall VDP regime?
- How many years will be involved? OVDI #2 expanded the time period from six to eight years, even though in most cases that exceeded the open civil statutes of limitations. We suspect that was not just so OVDI #2 would exact more pain, but because many of the persons OVDI #2 targeted were UBS clients who waited to initiate a voluntary disclosure until they received notice that their identity was likely to be revealed to the IRS. But if a new disclosure is limited to any period open under the applicable limitations period, does that mean that people who waited until now will get a better deal as to the number of years involved, than those who came forward in OVDI #2? In light of the applicable statutes of limitations, how long can the IRS cling to 2003 as a start date?
- Is the program structure still the same? Admirably, CI used a pre-clearance process in the OVDI programs, and one would think that would remain available. Will "optional intake letters" continue to be required? And how does the process differ for non-foreign-account cases?
- Will the IRS continue, as a matter of policy, to refrain from imposing penalties on taxpayers who failed to file information returns or FBARs but who have no unreported income? Are FAQs 17 and 18 relief procedures still available?
- Can a taxpayer still make the type of voluntary disclosure contemplated by Internal Revenue Manual section 9.5.11.9(6) — that is, the submission of amended returns with a cover letter (by an attorney) offering to pay penalties? Will that submission be deemed the same and treated the same as a pre-clearance request?
- Will the alternative PFIC analysis still be available for offshore cases? Will the IRS continue to permit taxpayers to "sham" offshore trust or corporate structures established solely for the purpose of holding financial assets in foreign accounts?
- Are the reduced penalties for longtime nonresident U.S. citizens still available, and if the 5 percent penalty is unavailable, has the new floor jumped to at least 25 percent?
- Will any taxpayer — even one with no prior knowledge of the FBAR filing requirement — be pulled into a VDP process with high proposed FBAR penalties simply upon the filing of a first FBAR form?

There are surely other areas of uncertainty. Given these questions, it is difficult to offer advice to clients that remotely resembles what we have been telling them for the last three years. Having said that, we generally see the climate as follows:

First, in a case with serious potential for criminal prosecution, a noisy disclosure is probably essential. The IRS obviously still prefers a noisy disclosure through CI, and in light of express guidance over the past three years, when any case has facts that would likely give rise to a criminal referral, this may be the only sensible approach. Indeed, for clients of any bank that has been in the news, one would think that given the publicity over ongoing settlement negotiations with Swiss banks, time is of the essence to submit a pre-clearance request.

Second, there are the cases on the other extreme, in which the client has no realistic criminal exposure — for example, the longtime nonresident citizen who has failed to file returns or FBARs but owes little tax. If they initiate contact with CI, presumably their cases will be referred to exam. Those taxpayers are therefore entering a burdensome IRS process with high transaction costs and uncertainty regarding penalties. Indeed, the IRS may reflexively seek higher penalties if it believes the taxpayer should and could have participated in either OVDI. It would not want to "reward" any taxpayer for delaying disclosure.

For this group the most sensible option may be to initiate some quiet remediation or to comply from now on. Regarding the former, in a case in which the IRS will probably be unable to sustain proof of willfulness, the quiet filings for past years may or may not attract attention, but in any event the Service will be limited in the degree to which it can sustain a significant sanction. The best argument we can think of for a retrospective cleanup in these cases is that if the returns are detected or subsequent returns are audited, the taxpayer can argue that she exercised good faith in coming forward and trying to make things right. A taxpayer might also choose to file delinquent returns and not file FBARs for prior years. That half measure would at least bring the taxpayer back into the tax system but reduce the risk that an FBAR might be pulled for review — some cleanup, but less good faith. Another reason for a taxpayer to file delinquent or amended returns would be to expedite the expatriation process, which requires the taxpayer to certify to five previous years of tax compliance.

For some clients in this category, however, the increased risk of detection is a high price to pay for what they see as largely foot faults. For this group the ''compliance from now on'' option will be far more attractive, especially if little U.S. tax is owed or the client lives outside the United States. This is a perfectly viable option for many noncompliant taxpayers, and obviously, at least upfront, far less expensive. The only difference for much of this group between compliance going forward and quiet retrospective filings is that someone who simply starts filing and then get audited cannot argue that she acted in good faith to address prior-year noncompliance.

So that leaves the harder cases in the middle. Those are cases in which five years ago we might have judged the criminal prosecution potential to be quite low, such as inherited or gifted accounts with relatively passive activity by the taxpayer. However, the IRS and the DOJ Tax Division have made clear through their pursuit of dozens of criminal cases that they do not necessarily view these cases through the same prism as we might have in the past. A number of individuals prosecuted for having undeclared UBS accounts inherited them; a few did not really use them all that much; and for a few, very little, if any, tax was at issue.

For those cases, the practitioner has no choice but to explain to the client the risks and benefits of each possible approach and work through the choices with the client. In a case involving an account of any material size, we doubt whether a truly quiet disclosure can be made. The IRS is likely better able to scrutinize amended income tax returns in service center processing or, perhaps more important, delinquent (or even first-year-filed) FBARs sent to Detroit with the required explanatory statement describing the reasons for the late or amended filing. Indeed, one would think it sound tax enforcement policy to design a system to capture those filings for further review, and that may be occurring. We see the opportunity for a true quiet disclosure greatly diminished in any situation involving the disclosure of any substantial foreign account. In those cases, the primary difference between the noisy and quiet disclosures from the past — the likelihood of audit or civil penalties — is not as stark as it once was.

Otherwise, the issue is whether the IRS would react with anger or hostility to a quiet disclosure if the returns or FBARs get pulled for audit. During both OVDI programs, the IRS expressed disdain for quiet disclosures, threatening to detect and even prosecute persons who attempted quiet disclosures during both initiatives.[7] We have heard of anecdotal instances of IRS agents stating as much, and we are aware of a few cases in which quiet disclosures have been detected and opened for examination. In the criminal information filed in a recent case that resulted in a guilty plea, the IRS made plain that quiet disclosures were not considered true voluntary disclosures, although in that very unusual case the quiet disclosure failed to report all accounts.[8]

While we understand the IRS's motives to drive people into the OVDI programs, we urge it to carefully consider whether to maintain that stance post-OVDI. Many federal prosecutors over the years have acknowledged that it would be almost impossible to get a jury to convict a taxpayer who came forward with a timely, truthful, and complete quiet disclosure. Further, aggressive enforcement action against taxpayers who file amended tax returns, arising solely from the IRS's wish that they contact CI first, might overwhelm CI and possibly bring the valid and routine practice of amending tax returns to a halt. No matter how innocent the reason for the error requiring amendment, what practitioner would risk putting a client in criminal jeopardy by recommending an amended return, hoping to explain later to a skeptical revenue or special agent the noncriminal reasons for the original inaccuracies? Treasury regulations recognize that taxpayers can in some instances file qualified amended returns in nonfraudulent situations and avoid

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[7] OVDI #1 FAQ 10; OVDI #2 FAQ 16.

[8] *United States v. Schiavo* (D. Mass. 2011), *Doc 2011-10984, 2011 TNT 99-21.*

accuracy-related penalties.[9] An aggressive institutional IRS position against quiet disclosures appears to undercut that lawfully recognized path toward rectifying prior noncompliance.

Absent clear guidance, in the post-OVDI environment, practitioners will often have to speculate with their client on how the IRS will react. We cannot tell a client what will happen because of the uncertainties about the IRS treatments they will encounter in a noisy as opposed to a detected quiet disclosure. This is bad for all parties in the tax system. Taxpayers may face excessive penalties and higher transaction costs as the price of attempting to become compliant. Practitioners will face awkward moments when a client asks for a recommended course of action and the choice frankly involves not just the facts of the case but also the client's tolerance for risk. We would much prefer to recommend a predictable and fair path to compliance rather than discuss risk. The Service will have no systematic data about the impact of its enforcement efforts, and it will be unwittingly sanctioning "hide the pea" and audit lottery games. This will have other pernicious effects on the tax system. It is time for the IRS to reevaluate the VDP and issue clear guidance.

IV. The Need for a Long-Term Plan

While the OVDI programs are probably the largest tax compliance success story in U.S. history, we believe they have just made a dent in the amount of tax noncompliance in this area. We are convinced that there is plenty of offshore tax noncompliance still to be discovered and corrected. More people will want to come forward because of ongoing enforcement against banks throughout the world and because FATCA's implementation is two years away. Many U.S. citizens or resident account holders are now receiving letters from their foreign financial institutions threatening to close their accounts or recommending that they consult a tax practitioner for advice on making a voluntary disclosure.

The IRS cannot catch everyone with an undeclared foreign account, and it is far more efficient to drive those persons voluntarily back into the system rather than try to find them. And requiring everyone with an undeclared account to contact CI initially will waste division resources on cases that would have held no reasonable potential for criminal prosecution. The IRS must also live with the statutory regime whereby to collect an FBAR-related civil penalty of any kind, it must enlist the assistance of the DOJ (which itself has limited resources), file an individual lawsuit against the account holder, and meet a high burden of proof.

We also think an honest evaluation of the taxpayers in both OVDI programs will clearly demonstrate that the one-size-fits-all penalty regime is inappropriate. And yet the cost of attempting to sort out these cases through traditional exam methods is simply too high for both the IRS and taxpayers. To complicate matters further, the IRS must balance the desire to promote future voluntary disclosures with the clear message that those who come in after September 9 are not reaping benefits from their delay compared with those who came forward in the OVDI programs.

We recommend that the IRS at least acknowledge that not all cases present criminal or even civil penalty issues, and that for many fact patterns, having the taxpayer simply make corrected and/or delinquent filings is the more efficient option. We suggest returning to a rough-justice concept that minimizes IRS resources applied to this class of tax noncompliance by offering the following:

1. Clear guidance that a taxpayer has the option of entering through CI or filing delinquent or amended returns and FBARs and other information returns, consistent with the instructions for those filings, such as the FBAR explanatory statement. Obviously, there are risks to the taxpayer and practitioner in choosing a quiet approach: If an investigation has begun, the taxpayer's filings will not be eligible under the VDP, and even if it has not, the taxpayer may still have to wait years for assurance that the matter has been cleaned up without further action. But the Service does not have to insist that everyone come in through CI.

2. A centralized VDP processing team in a particular service center, with personnel trained in evaluating the issues ordinarily seen in these cases, including reasonable cause arguments and, for offshore account cases, technical matters such as PFICs and foreign exchange issues. This group would process the disclosures that came in through CI with a minimal certification procedure and an occasional spot-checking audit so practitioners and their clients know that is a risk.

3. A mechanism to screen quiet disclosures and spot-check some of them through audit. The possibility of audit in those circumstances should ensure across-the-board truthfulness and completeness in the filings and a serious evaluation of whether a client might benefit from an initial approach to CI.

[9] *See* reg. section 1.6664-1 and -2.

4. A penalty regime with 20 percent accuracy-related penalties and, in offshore cases, a capped penalty of 30 percent of the undeclared financial assets in lieu of FBAR and all information return penalties with a clear list of willfulness-related criteria and an expedited procedure for review and appeal of willfulness issues and mitigating facts. The criteria should be more nuanced than simply ''Did the taxpayer check the box on Schedule B 'no' or fail to report income?'' But there should be no prejudice, in terms of penalties, whether a taxpayer elects to go through CI or make a quiet filing; the facts of the underlying conduct should drive the penalty determination. FATCA's penalty of 40 percent of the tax attributable to income from foreign assets not reported on new Form 8938 is in place now and prospectively, so it will eventually replace the 20 percent accuracy-related penalty.

5. A six-year lookback. We recognize that returning to a six-year lookback will appear to give people coming in now a better deal than under OVDI #2, but we believe that perception should be reduced by (i) the increase in the offshore penalty to 30 percent; (ii) the realization that OVDI #2 was in part specially designed to capture the truly dilatory taxpayers in the group of 4,450 receiving UBS notices; and (iii) the gradual year-by-year increase in the tax-based penalty to the 40 percent rate imposed by FATCA. Six years has always been the standard VDP period, and we recommend returning to that framework.

6. Waiver of penalties in cases when there is no unreported income, with the addition that even if there is underreporting or nonfiling, the asset-based penalty will be waived when there is little or no tax due.

7. No end date for this ongoing VDP. Practitioners and taxpayers will still be motivated to come forward before detection.

8. A separate path for Americans living abroad whereby they can reenter the system without the imposition of penalties except when there is evidence of fraud or willfulness. Surely a ''check the box,'' Q&A-type system can be designed for those cases, with enough spot-checking to deter cheating.

We acknowledge that the entire offshore account issue may eventually disappear if FATCA in its current form remains the law of the land (or, more accurately, the law of the world). By ushering in an era of automatic disclosure combined with reporting of foreign accounts on Form 1040s, FATCA will likely give the IRS the opportunity, through simple matching, to detect unreported foreign assets. But FATCA is not foolproof, and we suspect an effective matching system is a decade away. Meanwhile, aggressive enforcement in this area continues, and we believe that many more holders of undeclared accounts are still out there. With fast and sensible action, the IRS has a tremendous opportunity now to maintain the compliance gains of the last three years.

In the list above, we have hardly addressed all the issues that would arise in a new VDP. But with this general approach, we believe that the IRS and the practitioner community can return to some of the good aspects of life before OVDI, while still recognizing that the landscape has permanently changed. Everyone gains from a more simplified and straightforward self-correction program. That program does not stop the IRS from continuing its important enforcement efforts against international noncompliance; indeed, it would benefit greatly from heightened enforcement. A sensible combination of the iron first and the velvet glove, with clear rules and reasonably certain and predictable dispositions, can promote tax compliance in this area for generations to come.